SCHWEIZERISCHE NATIONALBANK
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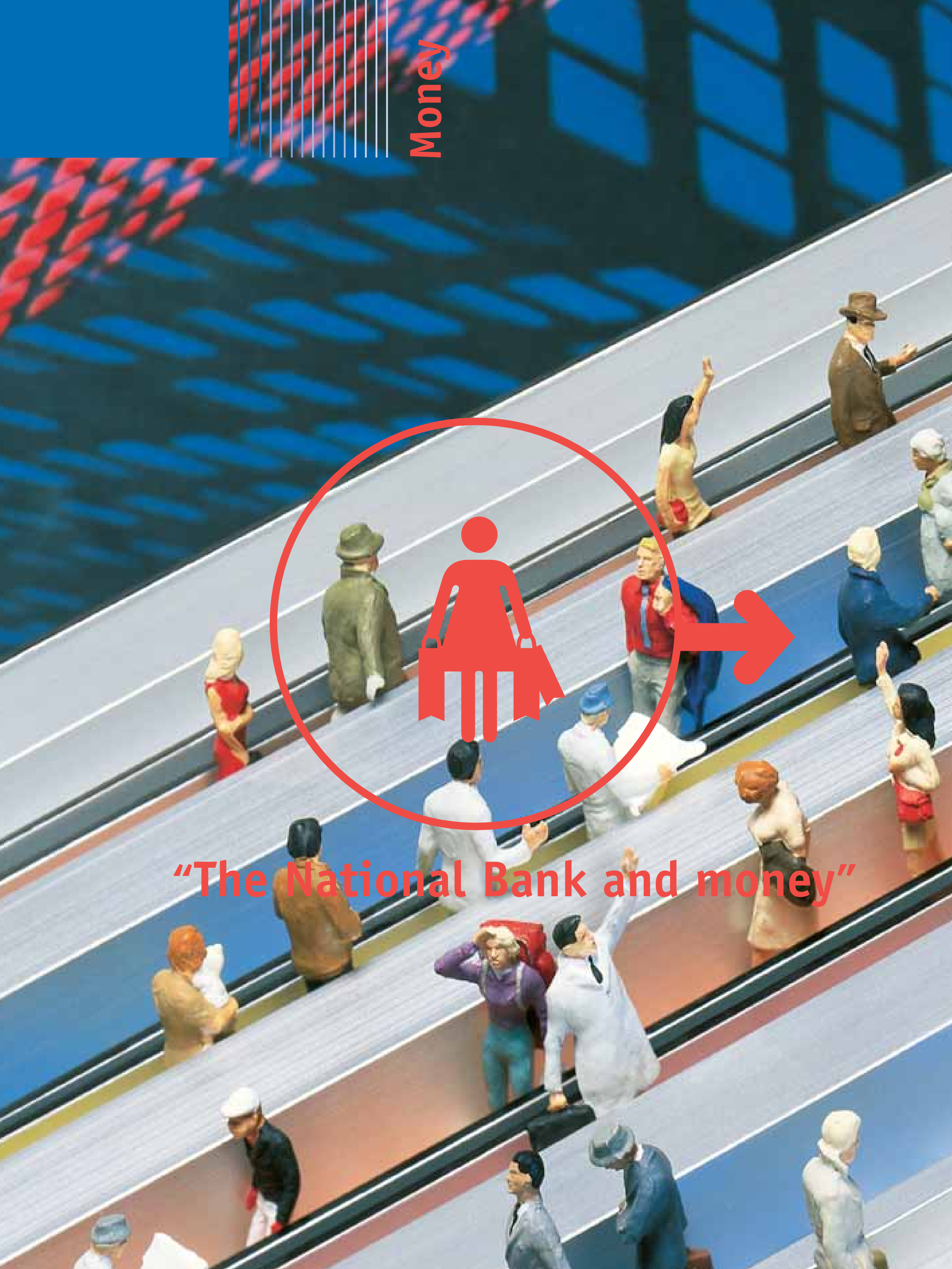
SWISS NATIONAL BANK

The Swiss National Bank and that vital commodity: money

Swiss National Bank - a name that conjures up images of banknotes or closely guarded gold bars stored in underground vaults. Mysterious as it may seem, the day-to-day work of the National Bank encompasses a much wider range of tasks. The National Bank’s primary function is to pursue a reliable monetary policy for the benefit of the Swiss economy and the Swiss people.

The activities of the National Bank concern us all. This brochure is intended to give you a better understanding of key aspects of money, the commercial banks, monetary policy and the National Bank. We hope you enjoy reading it.

Contents at a glance



"The National Bank and money"

This chapter sets out what money is, why we need money and where our money comes from. [Money > Barter > Properties of money > The origin of banknotes > Central banks > Gold > Gold reserves > Electronic money]

Money

What exactly is money?

An odd question at first glance. Of course, we all know what money is. But as so often in life, it is all a bit more complicated. Let us put it to the test and ask: how much money do you have right now? Do not just count the cash in your pockets or your purse. Money also includes credit balances on postal, wage and other accounts that you can use to make payments. The money on these accounts is called deposit money because payment is effected simply by transferring a deposit from one account to another.

Money is everything that is accepted by everyone as a means of payment: cash and deposit money

Although money is not perishable, its value or purchasing power can fall – sometimes very rapidly. One of the National Bank's most important functions is to keep the value of money as stable as possible.

Money makes life simpler

In the dim and distant past people did not need money. Things for everyday use they made themselves. If people made more than they needed, they swapped the surplus for other goods. In small, close-knit communities that worked quite well, and there was no need for money. But bartering has one disadvantage: You have to find someone whose needs match up with yours. A farmer offering milk who needs a coat has to find a tailor who wants milk. That's not always easy! That is why, instead of bartering amongst themselves, people began using a special medium of exchange for their transactions. This had to be a commodity that everyone wanted and could also be stored. And so money came into being as a generally accepted medium of exchange. In the course of history, many commodities have served as generally accepted mediums of exchange – or money: shells, salt, tea, blankets, cigarettes, precious stones, silver, gold.

There is another advantage with money. Because everything is exchanged for the same commodity – money – it is easier to compare prices and to make calculations.

✱ *In other words, money has three functions. It is the generally accepted medium of exchange and payment. It serves as a store of value, and it is also a measure of value.*

Money

What properties does money have to have?

In order for a commodity to be generally accepted as a means of payment, and so that it can be used as money, people must have confidence in it. People must be able to count on this commodity being valuable. It must be scarce, since only things that are scarce are also valuable.

However, money must not be too scarce either, since that would hamper the progress of business. One important function of the National Bank is to supply the economy with the correctly measured amount of money.

* *The three conditions for any form of money: general acceptance, confidence in its value, scarcity.*

From gold and silver coins to paper money

It is easy to understand why gold and silver were used as a means of payment for so long in so many ages and cultures: precious metals are rare, and therefore valuable and much sought-after. They are not perishable and are difficult to forge. In the form of coins, they are easily transportable and transferable. For all these reasons it was easy for precious metals to become accepted as a universal means of payment.

But coins have one major disadvantage: they are heavy, and when large sums are involved whole bags full have to change hands. For this reason it proved much more convenient to deposit gold and silver with a bank, ask the bank for a receipt and simply use these pieces of paper as a means of payment. And that was how “bank notes”, the forerunners of our present-day paper money, came into being.

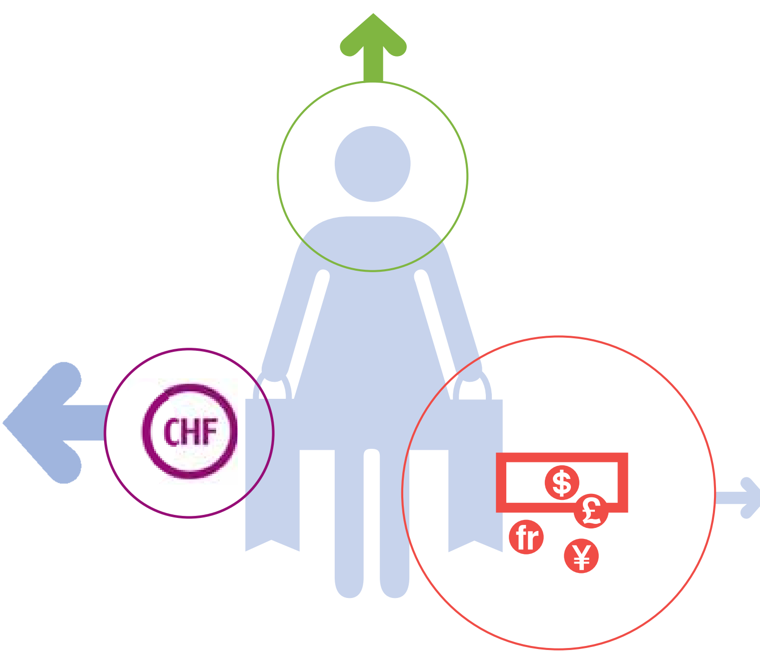
* *As trade and industry have progressed, money has become more and more abstract: coins, paper money, deposit money.*

How central banks came into being

As recently as 1870, there were 28 banks in Switzerland that had the right to issue banknotes. Such a large number could not help but cause confusion, thereby precluding general acceptance of, and confidence in, banknotes. The federal government therefore set about regulating the issue of banknotes.

It gradually became clear that the best solution would be a single, central institution to issue banknotes. Such an institution would be best placed to create confidence and keep the value of the currency stable. As the idea of establishing a central bank found more and more supporters, the principle was laid down in the Constitution in 1891. There were still a few hurdles to overcome, though, before the Swiss National Bank commenced operations in 1907. It has the sole right to issue banknotes. The minting of coins, however, is still the responsibility of the Confederation.

✱ *Today, only the National Bank has the right to produce and issue banknotes.*



Can banknotes be redeemed in gold at the National Bank?

In the early days this was actually possible: although the banknotes that were in circulation alongside gold coins were practical, they were ultimately only a proxy for the precious metal. The National Bank was under an obligation to redeem banknotes in gold upon request and to back its banknotes by gold. But since then the role of gold has changed considerably. Banknotes have been declared legal tender, the obligation to redeem banknotes in gold and the gold backing requirement have been abolished and coins that no longer contain any precious metal have been put into circulation.

Sometimes central banks are unable to keep the value of their own money stable. In the most extreme cases, the residents of a country completely lose confidence in the national currency and resort to substitute money – often foreign currencies such as the US dollar.

How will the value of our money be preserved without it being backed by gold?

In the days when paper money had to be backed by gold, gold was its anchor. Since the gold output rose only slowly, there was hardly any danger that there would suddenly be too much gold and thus too much paper money in circulation. Today central banks undertake to increase the amount of money in circulation in carefully measured quantities. In this way they can ensure that the value of money is maintained. This undertaking on the part of central banks plays the anchor role now.

Although a cashless society would be technically feasible nowadays, cash still plays an important part in our everyday life. In fact, the use of cash in Switzerland is continuing to increase, albeit not as strongly as formerly.

Goodbye to cash?

Gold and silver coins still had a material value. This is no longer the case with present-day notes and coins. Their value is set by the issuer; they are therefore merely a medium for conveying information about this value. Such information is independent of its medium. It can also be conveyed electronically. At present a number of forms of electronic money are being developed in direct competition with central bank cash. Will such money supersede cash? Whether and how quickly new forms of money catch on will depend on how much confidence those who subscribe to the systems that are being offered have in them and the number of people who use them.

Money

What criteria are applied when designing new banknotes?

When designing new banknotes priority is given to security and to ensuring that the note has an up-to-date appearance and that individual denominations can be easily distinguished from one another. Since the 1950s, the National Bank has issued a new series of banknotes roughly every twenty years. Frequently it has played a pioneering role in the development of security and design features.

Where are the banknotes printed?

The legendary “banknote press” that one comes across so often is not located at the National Bank itself. Unlike other central banks, the Swiss National Bank does not have its own note printing facility. Up until the 1970s, Swiss banknotes were printed in England. Since then they have been printed by the Zurich company Orell Füssli Sicherheitsdruck AG under contract to the National Bank.

Who is responsible for the issuing of coins?

While the National Bank has the sole right to issue banknotes, the right of coinage is vested in the Confederation. Swissmint (formerly “Eidgenössische Münzstätte”, the Federal Mint) is part of the Federal Department of Finance and mints Swiss coins, which the National Bank puts into circulation.

Does having little money necessarily mean you are poor?

In common speech not having much money means that you are poor and having lots of money means you are rich. But economists use the term “money” more narrowly to refer to means of payment only, i.e. coins, banknotes and deposit money. However, wealth can also include securities, physical assets and property. It is quite possible for a wealthy person to have only a little money, although he is certainly not poor.

Who decides how much goods and services cost?

In the kind of free market economy that we have in Switzerland the prices of goods and services are determined by supply and demand. If demand is high, prices usually rise. It then becomes more advantageous for suppliers to bring more goods or services onto the market. If the supply is increased while demand remains the same, prices may fall again. Price changes help to ensure that supply and demand remain in balance.

What happens when a country deletes several noughts on its banknotes?

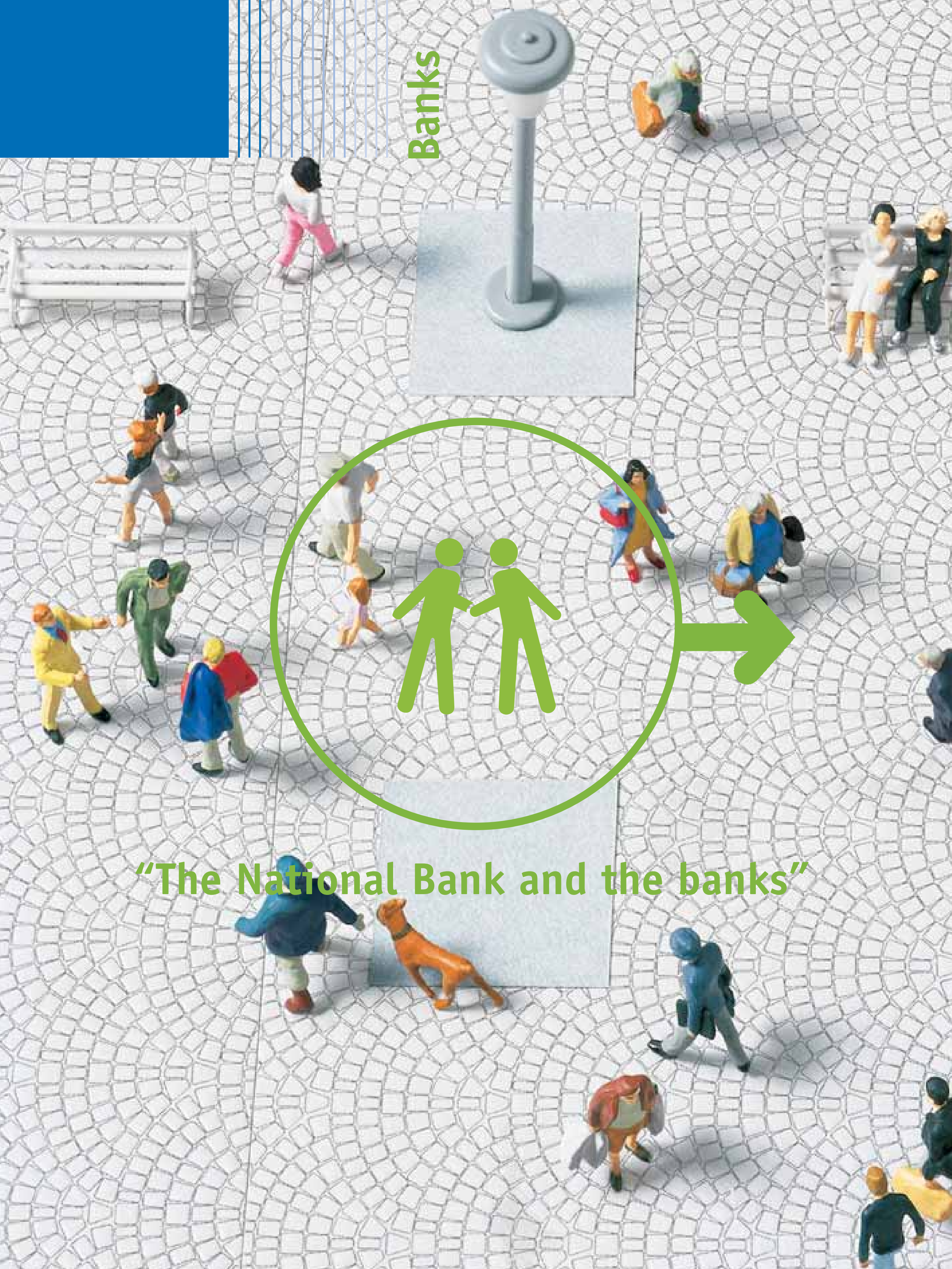
Very high face values on banknotes are usually the result of a prolonged period of inflation. Such notes become inconvenient for daily use. Payments have to be made in denominations of hundreds of thousands or millions. Some countries faced with such a situation delete several noughts on their notes in order to make them simpler to use again as a means of payment. The problem of inflation itself is a harder nut to crack.

Must everyone use the banknotes issued by the National Bank?

The Swiss franc is the statutorily prescribed means of payment in Switzerland. This means that banknotes issued by the National Bank must be accepted in Switzerland whenever they are offered in payment, except if it is suspected that they might be forged. Of course, it is also permitted to pay with credit cards or in a currency other than the Swiss franc, provided that the seller agrees.

Which banknote is used the most?

The 100-franc note. There are over 70 million notes of this denomination in circulation. The circulation of the 200-franc note, which was only introduced in 1997, runs to a good 30 million.



“The National Bank and the banks”

This section explains how the banks create money and how the National Bank performs its function as banker to the banks. [Commercial banks > Interest > Money creation > Connection with the National Bank > Banking Law]

Banks

The functions of the banks

Money and banks – these two terms are closely related. Most people have an account with a bank and many will have taken out a bank loan, to buy a car, for example, or as a mortgage for a house. Accepting savings deposits and granting loans are typical activities for banks. Banks are the intermediaries between savers who would like to invest their money and borrowers who would like to raise money.

But people have contact with their banks not only as savers or borrowers. People pay their bills by instructing their bank to transfer money to another account. Other services provided by the banks include exchanging foreign currencies or advising on securities transactions.

The primary function of the banks is to accept savings deposits and grant loans. Together with the Post Office, banks operate the cashless payments system and provide financial and investment services.

Savings come primarily from private households. Demand for loans, on the other hand, comes mainly from businesses, which use the funds to finance their investment.

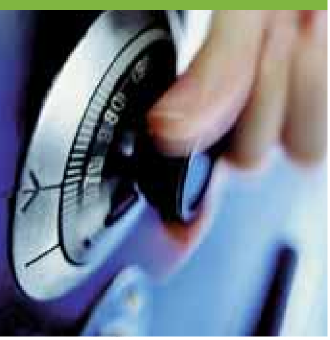
The banks and interest

Banks offer investment opportunities and in turn use this money to grant loans. They pay savers interest and charge borrowers interest on their loans. Interest is the price that a borrower pays for being able to realise his plans now, even though he does not have enough money saved up for this. Interest compensates the saver for giving up the use of his money for a certain time. The bank pays the saver less interest than it charges the borrower. The difference between these interest rates covers the bank's costs and earns it profits.

What determines the level of lending and savings rates? Interest rates are a function of supply and demand, just like other prices. The lower the rate of interest, the greater the readiness to borrow money and to spend it on investments, such as buying new machinery. However, when interest rates are low, there is less incentive to save, and people will prefer to spend their money instead. Banks have to pitch their interest rates at the right level to ensure that the inflow of money from savers and the demand for loans are more or less in equilibrium. The banks play a key role when it comes to setting lending and savings rates.

Interest is the price for money that is lent, i.e. loans. The level of interest, known as the interest rate, is determined by supply and demand.

Banks



How banks create money

Banks collect money from savers and lend it to borrowers. Through this intermediary role the banks create new money. Banks are therefore “money creators”. A simple example will show how this works. Let us assume that a saver pays 20,000 francs in notes into his account with the bank. The amount of money in the economy does not change as a result of this deposit. Although the notes are no longer in circulation but in the bank’s strongroom, the saver’s account has been credited with 20,000 francs.

Letting the money lie idle in the strongroom will not earn the bank anything. So why not lend someone the money in return for being paid interest? A businessman needs money for computer equipment. Out of the 20,000 francs that the saver has paid in, the bank lends the businessman 16,000 francs and credits his account with this amount. Has the money supply changed as a result of this transaction? The saver still has 20,000 francs on his account. The businessman, as a borrower, now has 16,000 francs. The money supply has therefore increased by 16,000 francs. If the businessman now uses the 16,000 francs to buy computers and the computer dealer pays the cash sum that he has received into his bank account, the latter will in turn lend someone else part of that sum. This once again leads to an increase in the money supply; and so money creation goes on.

Can the banks create as much money as they like? The saver's bank has not lent out the whole 20,000 francs but has kept 4,000 francs as a reserve. For it must expect that the saver will want to withdraw a certain amount from his account. Having to hold such sums as reserves does set a certain limit on the banks' ability to create money. Nevertheless, the banks are real "money multipliers".

✱ *The banks create new money by granting loans. Their capacity to create money is limited since they have to set aside a certain proportion of their deposits as reserves rather than using them all to grant loans.*

Banks

The National Bank and the banks

The banks' reserves limit their capacity to create money and grant loans. At the same time, these reserves are the link between the banks and the National Bank. For in order to top up their reserves, the banks have to turn to the National Bank and borrow from it. For this purpose they have accounts – known as sight deposit accounts – with the National Bank.

In the interbank payments system, Swiss Interbank Clearing (SIC), the National Bank supervises the bulk of cashless payments.

Why do the banks need reserves? First of all, they must make allowances for their depositors withdrawing cash – at cash-point machines, for example. But then they are also required under the National Bank Act to hold sufficient reserves with the Swiss National Bank in the form of coins, banknotes and sight deposit accounts. These are known as "minimum reserves". And finally, the banks use the funds on their sight deposit accounts with the National Bank to effect their customers' cashless payments and their own interbank transfers. Payments go through the jointly-owned payments system, Swiss Interbank Clearing (SIC), and through the postal accounts. Bank-to-bank payments are effected only if the bank has enough money on its sight deposit account.

By providing the banks with reserves or liquidity, the National Bank has a decisive influence on the banks' money creation and the volume of payment instruments circulating in the economy. Because the National Bank grants the banks loans and provides them with reserves, it is also known as the "banker to the banks".

The legal requirement to hold reserves binds the banks to the Swiss National Bank. These reserves provide the fuel needed to ensure that the banking system works and money can be created.

In order for a bank to be entered in the Commercial Register and to be able to carry on its business, it must have received authorisation from the Swiss Financial Market Supervisory Authority (FINMA). This authority is apointed by the Federal Council and is responsible for the financial market participants. Its main purpose is to see that the interests of customers who have entrusted their money to a bank in good faith are not harmed in any way.

The banks and the law

Banks are essential for money creation. They manage savings and grant loans. These vital functions, which are based on trust, require special legal provisions. The Banking Law stipulates that banks must have adequate capital resources and adequate liquidity. Liquidity comprises both the minimum reserves and other liquid assets, including securities that are easy to sell.

Because in the course of their business banks gain insights into the commercial and financial circumstances of their customers, banking secrecy protects the customers' privacy.

* *For the protection of creditors and to safeguard the security of the banking system, the Banking Law lays down provisions governing capital resources, liquidity, authorisation conditions, supervision and banking secrecy.*

Banks

Where and by whom was the first bank set up?

Money changing and lending were part of many ancient cultures. The Middle Ages saw an expansion of trade in Europe and with it the need for professional banking services. Some of the first banks were the banking houses in the trading cities of Italy in the 14th century.

Who is allowed to set up a bank in Switzerland nowadays?

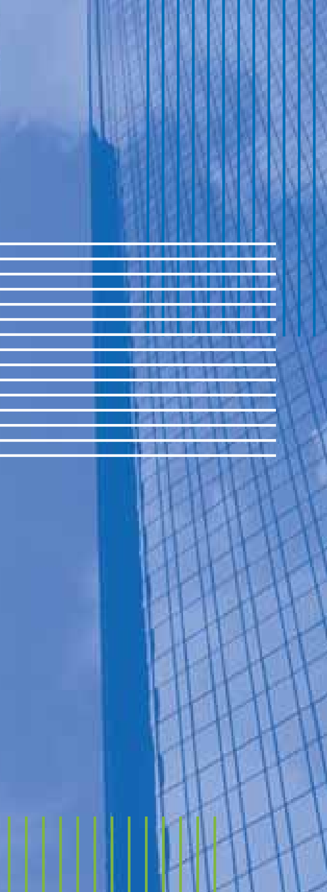
Anyone who meets the statutory conditions and obtains authorisation from the Swiss Financial Market Supervisory Authority may open a bank in Switzerland. The conditions for authorisation, which are laid down in the Banking Law, are strict, as savers and investors need to be protected. For example, a bank must show that it has a sound organisational structure and the required minimum capital. Also, those entrusted with its administration and management must "enjoy a good reputation and thereby assure the proper conduct of business operations."

What is the difference in meaning between "note-issuing bank" and "central bank"?

Both terms refer to the same thing, namely a bank that is responsible for supplying the country with money. The former term highlights the bank's monopoly in the issue of banknotes, while the latter conveys the idea of a central institution that issues money, manages a country's money supply and plays a central role in the payments system.

Could the economy still operate if there were no banks?

Theoretically, an economy without banks is possible. A house could be financed with the help of relations and a company could also borrow from other companies. However, banks have some crucial advantages over private borrowing arrangements. They have specialised knowledge and manage large amounts of savings, so they can respond to the needs of a large number of borrowers. For this reason a modern economy without banks is now virtually inconceivable.



What would happen if everyone suddenly decided to withdraw their money from the banking system?

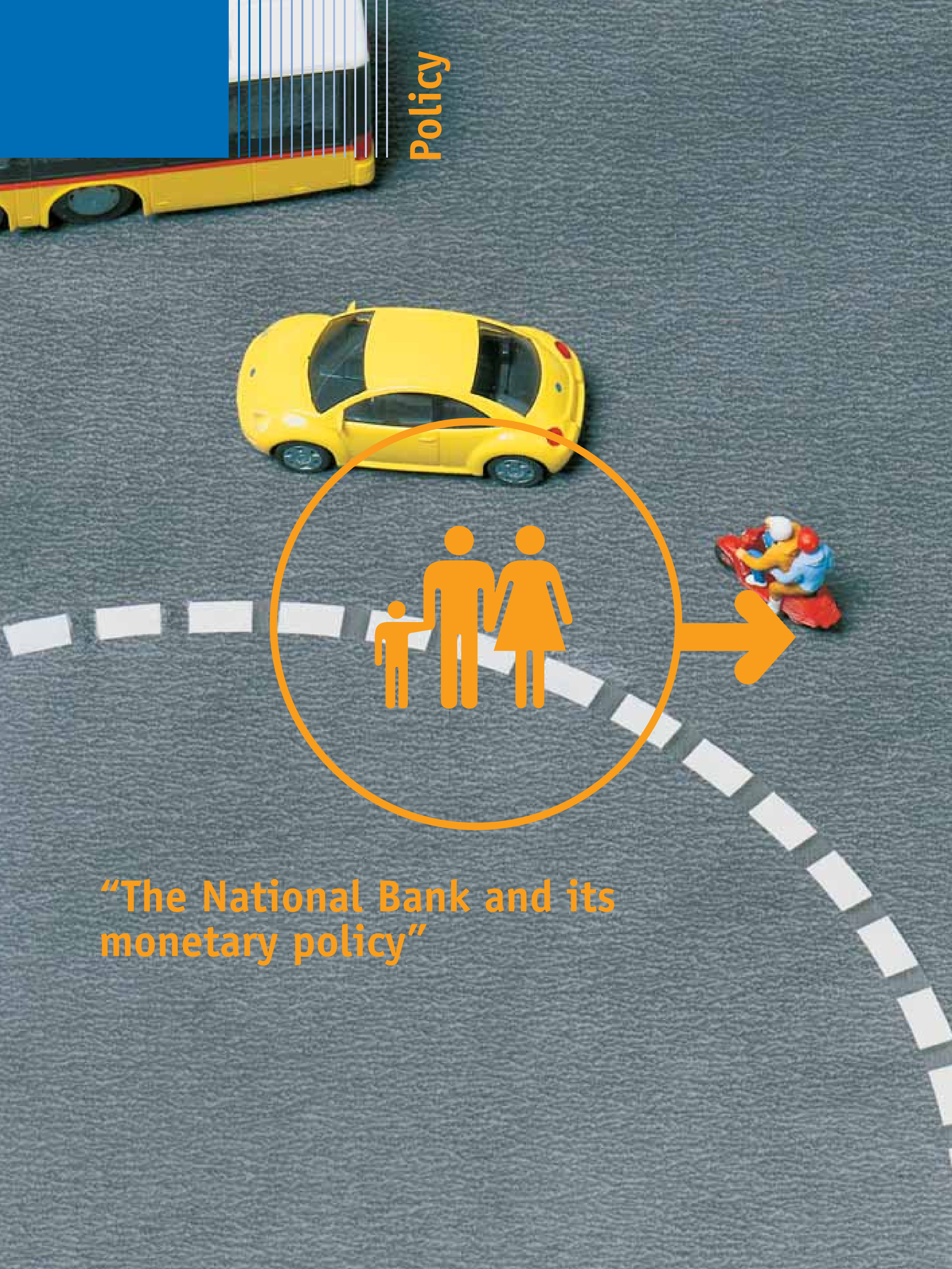
➜ The banks would face major difficulties.
Although they hold a certain amount of liquid assets as a reserve (e.g. cash), it would not be enough to cover a massive surge in the demand for banknotes. Consequently, if there were a run on the banks, the National Bank and the banks would have to take emergency measures.
However, in a sound economy with an efficient banking system such a situation is very unlikely to arise.

Is there the opposite of money creation, i.e. destruction of money?

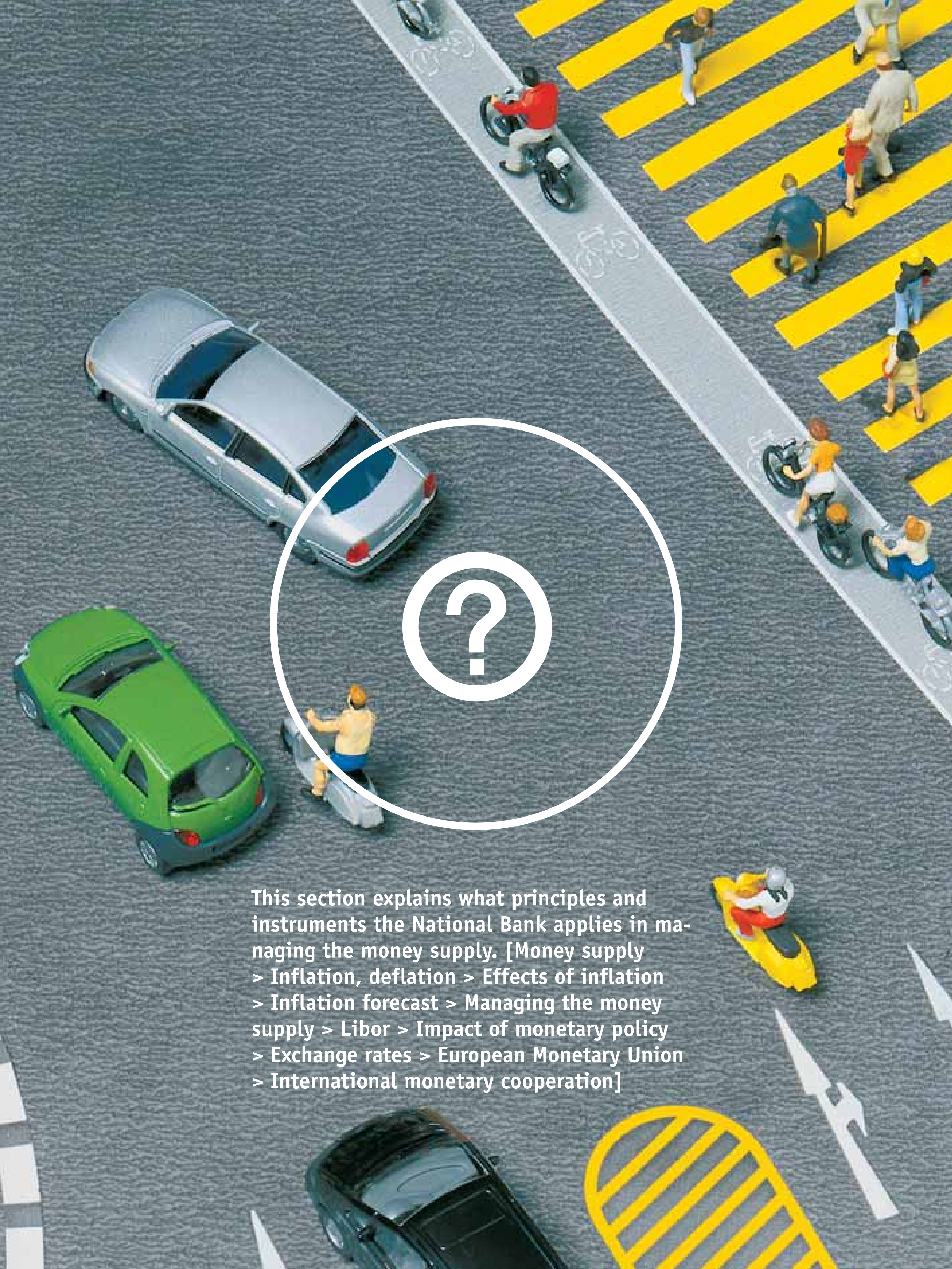
➜ The process whereby money is destroyed can be explained in the same way as money creation. Suppose a saver decides to withdraw his money from his savings book and keep it in cash. But the bank has lent most of it out in the form of a loan and kept back only a small reserve. It therefore needs to call in the loan. Fortunately the loan happens to expire just at that time and the borrower repays it in the form of banknotes. The bank pays the saver his credit balance and deletes the loan from its books. The money supply has thus been reduced by the amount of the loan. In other words, money has been destroyed.

Why are there different interest rates?

➜ Interest is the price paid for the use of borrowed money. The rate of interest can differ, depending for example on the type of borrower. Savers lend their money at a lower rate to a borrower with a high credit rating like the State than to someone who engages in high-risk business. And usually the rate paid on a long-term loan will be higher than that on a short-term loan, because lending for a longer period entails more risk. But the overall interest rate level can also move in a particular direction, e.g. when inflation is rising. Lenders then expect a higher rate of interest in order to protect themselves against the fall in the value of money. Borrowers will pay this price because their debt burden is lighter owing to inflation.



“The National Bank and its monetary policy”



This section explains what principles and instruments the National Bank applies in managing the money supply. [Money supply > Inflation, deflation > Effects of inflation > Inflation forecast > Managing the money supply > Libor > Impact of monetary policy > Exchange rates > European Monetary Union > International monetary cooperation]

Policy

The National Bank's mandate

The National Bank's mandate, as laid down in the Federal Constitution and in the National Bank Act, is to pursue a monetary policy that serves the interests of the country as a whole. The National Bank must supply the economy with sufficient money for it to be able to utilise its growth potential and exploit it to the full. On the other hand, the National Bank must regulate the money supply in such a way that money retains as much of its value as possible. The measures with which the National Bank influences the money supply are known collectively as monetary policy.

The National Bank manages the economy's money supply. This is referred to as monetary policy. The National Bank pursues a policy aimed at allowing the economy to grow while keeping prices as stable as possible.

In order to measure the average movement in prices, a "basket" of goods is used. In Switzerland the national consumer price index measures each month the changes in the price of such a basket of selected goods and services, as are consumed by the average household.

Inflation and deflation

The prices of goods and services are constantly changing. Movements in the prices of individual goods are caused by the interplay of supply and demand. When the overall level of prices rises – and not just the prices of individual goods – this is called inflation. If, on the other hand, most prices are falling, this is referred to as deflation.

The National Bank wants to prevent both inflation and deflation: its objective is price stability. It considers price stability to be an increase in the consumer price index of less than 2% per annum.

An increase in the general level of prices is called inflation and means that the value of money is falling. If the level of prices is falling, this is referred to as deflation: money is gaining in value. Both are undesirable and potentially harmful.

Policy

The situation in Germany after the First World War is one of the most striking examples of inflation: the price of a newspaper rose from 50 pfennigs in January 1921 to 70,000 marks by the end of 1922. Hundreds of thousands of people lost their entire savings as a result of this inflation.

A fall in the level of prices – deflation – also has harmful consequences. This is because a slide in prices, and therefore also incomes, will cause a deterioration in economic performance: purchases will be deferred, products and services will become increasingly harder to sell and borrowers will no longer be able to meet their obligations.

Why is inflation a bad thing?

Why does the National Bank want to try to ensure that the level of prices remains as stable as possible? What is so bad about inflation? Not all incomes increase at the same rate as prices. Many people suffer a loss of purchasing power, for example, because their pensions are not fully adjusted in line with inflation. The losers also include lenders that grant loans at 5% only to discover when the loan comes to be repaid a year later that the level of prices has in the meantime risen by 10%. In general, in an inflation situation borrowers are on the winning side, while savers are the losers.

Prices and price expectations influence the decisions of businesses and households. In an inflation situation price signals get mixed up. The faster and higher inflation climbs, the less money can fulfil its functions as a unit of account, store of value and even as a means of payment. As a result the performance of the economy as a whole suffers.

The National Bank sets itself price stability as an objective because inflation and deflation hamper the functions of money and lead to an arbitrary redistribution of income and wealth that distorts markets and adversely affects growth.

How can the National Bank prevent inflation and deflation?

The National Bank must continually assess whether its monetary policy is appropriate. However, monetary policy measures do not have an immediate effect but take two to three years to work through. The National Bank therefore needs indications of how prices might move in future. Of major importance in this respect is, for example, information on expected future business performance in the various sectors of the economy and on trends in the labour market and in wages, exchange rates and the money supply. On the basis of such information the National Bank can see whether the economy is developing within healthy boundaries or whether overheating and inflation are perhaps looming on the horizon.

The knowledge that the National Bank acquires from this information is consolidated in an inflation forecast for the next three years. If the forecast shows that prices might rise by more than 2% per annum and that the economy is overheating, then the National Bank will tighten the monetary reins. If there is a risk of an economic downturn and declining prices, then the Bank will provide the economy with additional liquidity.

How does the National Bank manage the money supply?

What does the National Bank do when it wants to adjust the money supply? To inject fresh money into the economy, it grants the financial market participants (banks) loans and credits them with the equivalent amounts on their sight deposits. The banks thus have more reserves or liquid resources that they can in turn use to grant loans to their customers and so set the money creation mechanism into motion.

As collateral for its loans, the National Bank receives securities. With repos (repurchase agreements), the tool most frequently used to provide the banks with liquidity, the National Bank buys securities from a bank and at the same time agrees with the bank that it will repurchase these securities at a later date. The bank is given a loan for a certain period of time and in return the National Bank acquires the securities from the bank. For the money it lends in this way the National Bank charges interest at what is known as the repo rate.

Another sort of transaction used to influence the money supply is the foreign exchange (or “forex”) swap, in which currencies are swapped instead of securities.

✱ The National Bank mainly uses repos for managing the money supply.

The National Bank determines how much new money the banks are to receive through the interest it charges for central bank credit: it cuts the repo rate when it wants to provide the banks with plenty of liquidity and raises the rate when it wants to tighten the money supply.

How the National Bank makes its monetary policy intentions known

The National Bank informs the public of its monetary policy thinking and intentions; it wants the public to understand what the National Bank is doing and to be able to trust its monetary policy. For this reason the National Bank regularly announces how high it wants to keep the Libor rate (London Interbank Offered Rate) for 3-month Swiss franc deposits. Libor is the interest rate which the major banks charge each other for deposits in various currencies. It is set on a daily basis in London.

The National Bank controls the Libor rate through its daily repos. In order to retain some leeway, the National Bank sets a target range for Libor of one percentage point within which Libor can fluctuate.

The National Bank bases its monetary policy on three pillars: the price stability target (annual inflation of no more than 2%), the inflation forecast for the next three years and the target range for the 3-month rate for Swiss franc deposits (Libor).

Policy

The impact of monetary policy

Let us assume that, in preparing its inflation forecast, the National Bank realises that the economy is growing too rapidly and that inflation will accelerate sharply. What is to be done?

In order to combat the threat of inflation, the National Bank tightens the monetary reins. First of all, it announces that it is raising the Libor rate target range. Then it increases the rate at which it grants loans to the banks, the repo rate. National Bank money therefore becomes more expensive for the banks. In due course the banks adjust their lending rates. Businesses and households borrow less and give up part of their planned expenditure.

Because interest rates are higher, investments in Swiss francs also become more attractive. Demand for Swiss franc investments increases and the price of the franc – the exchange rate – rises. Swiss goods become more expensive in comparison with foreign goods, which slows down exports.

Thus when the National Bank increases interest rates, this depresses demand for goods and services. Companies slow down their output. Since they can no longer sell their products as easily as before, they refrain from putting up their prices any further. The National Bank's objective has been achieved: the risk of inflation has been averted.

The National Bank's monetary policy impacts upon the economy in many different ways: it influences interest rates and the exchange rate, and thus also consumption, investment, exports and ultimately inflation.

The National Bank should not let inflation occur in the first place. Once it has set in, it is very difficult to get rid of again without drastic effects on the economy and on the labour market.

Monetary policy is a balancing act: if the National Bank cuts interest rates by too much, there will be a risk of inflation; but if interest rates are too high, there will be a threat of recession or even deflation.

Monetary policy and exchange rates

Sometimes exchange rates cause serious disruptions. For instance, the Swiss franc exchange rate has risen sharply on a number of occasions in the past, thereby making exports much more expensive. The Swiss export industry was threatened with a loss of competitiveness – and a resultant loss of jobs. At times the franc also weakened, thereby making imports more expensive and exports cheaper. Although stronger demand for Swiss goods stimulated output, it also gave rise to unwanted price increases.

The exchange rate fluctuates because of changes in supply and demand. A stronger and a weaker franc both have desirable and at the same time undesirable effects on the economy.

What action can the National Bank take against undesirable exchange rate fluctuations? Let us assume that the franc is rising against the euro to an extent that is unacceptable for the Swiss economy. The National Bank can cut interest rates, making investments in Swiss francs less attractive. In extreme cases it can even buy euros in order to boost demand for the euro and thus its exchange rate. But such measures have an effect on the money supply. If the National Bank cuts interest rates, the banks borrow more from it. If it buys euros, the banks obtain extra Swiss francs. Either course of action will increase the money supply and entail inflationary risks. Conversely, if the franc is weak, the National Bank can raise interest rates and even buy Swiss francs from the banks for euros. But that reduces the amount of francs in the money supply and slows down the economy.

In the event of undesirable exchange rate fluctuations the National Bank can adjust interest rates and intervene on the foreign exchange market.

The National Bank and European Monetary Union

Exchange rate fluctuations are no longer possible if different currencies are replaced by one currency, i.e. if a monetary union is created. This is how a common currency – the euro – came into being in Europe. The European Central Bank (ECB) is responsible for monetary policy in the euro area. The countries that have adopted the euro no longer pursue independent monetary policies.

Switzerland is surrounded by euro area countries, with which it has close links although it is not a member of the euro area. Since Switzerland has not adopted the euro, the National Bank can conduct an independent monetary policy. This has helped to keep the level of interest rates in Switzerland lower than in other countries. The advantages of this autonomous monetary policy may possibly be offset by the risk of strong exchange rate fluctuations in the Swiss franc against the euro.

✱ *The National Bank's autonomous monetary policy enables it to make due allowance for the particular circumstances of Switzerland.*

International monetary cooperation

International trade in goods and services is increasing, and the interdependence of national economies is growing. As a result, international cooperation on monetary matters is becoming increasingly important.

Switzerland is a member of the International Monetary Fund (IMF), in which it is represented by the Chairman of the Governing Board of the National Bank and the Finance Minister. The IMF monitors the economic policy of its member states on a regular basis, as well as examining the performance of the world economy. In extreme cases it assists its members by making credit facilities available to them. The National Bank is also a member of the Bank for International Settlements (BIS), which promotes international monetary cooperation. Another important institution is the Organisation for Economic Cooperation and Development (OECD). And finally, the National Bank also maintains active contacts with other central banks.

Policy

Do share prices on the stock market depend on the SNB's monetary policy?

→ Share prices depend on investors' expectations concerning future trends in the economy. Monetary policy influences these expectations. For example, tight money and high interest rates will sooner or later have an effect on economic activity, and as a result the stock market generally loses momentum. Conversely, if monetary policy is eased, economic prospects revive and this is normally good news for the stock market.

Do other countries pursue a similar monetary policy?

→ Today most countries aim at price stability and try to create conditions that allow their economies to achieve balanced growth. The idea, once held, that the economy could be encouraged to keep on growing through the pursuit of a very liberal money supply policy without this leading to inflation has now been abandoned. However, although a marked convergence of monetary policy objectives has taken place, differences in practice persist.

Does the SNB coordinate its monetary policy with foreign central banks?

→ The National Bank lays down its monetary policy with reference to conditions in Switzerland. On the other hand, the Swiss economy is very much dependent on developments abroad. The National Bank therefore needs to know what foreign central banks are thinking and doing. Such knowledge is imparted through the regular exchange of information between the National Bank and foreign central banks.

Why is the dollar such an important currency?

→ The dollar is the currency of the world's most important economy, the United States. Compared with other currencies, the value of the Swiss franc in relation to the dollar has remained relatively stable over a long period. The dollar is used in many other countries as a second currency and also plays an important role in international payments and settlements.

Why doesn't the National Bank try to keep inflation at zero?

Higher prices are not only caused by inflation. Products and services can become dearer because of quality improvements. But it is not always possible to assess this factor accurately when measuring inflation. This is why an inflation index often records inflation at a somewhat higher level than is actually the case. The National Bank takes account of this fact when it equates "price stability" with an annual inflation rate of less than 2%. If it targeted an inflation rate of 0%, the money supply would usually be too tight.

Does the economy influence the National Bank?

Economic conditions are always changing in ways that hit some sectors harder than others. Thus exporters suffer from a marked appreciation of the franc, whereas the construction industry, for example, remains virtually unaffected. In such a situation the export industry will want monetary policy to be eased. When judging whether or not to change its monetary stance, the National Bank must consider not only the interests of a single sector, but also the situation of the economy as a whole.

Couldn't the National Bank simply prevent unemployment?

Unemployment can have various causes. For example, it can be the result of cyclical weakness. In this case the central bank will ease monetary policy. This will stimulate demand in the economy at large and help to bring unemployment down again. But when unemployment persists at a high level, the reasons often lie elsewhere, e.g. in an over-regulated labour market. There is nothing that monetary policy can do in this situation. Instead, changes to the law are needed to encourage job creation.

"The National Bank as a company"

This section sets out the legal and organisational basis of the Swiss National Bank. [Functions of the SNB > Legal basis > Independence > Services on behalf of the Confederation > Organisation > Profits]

SNB

Is the National Bank a company at all?

Yes, the Swiss National Bank is a company. It has a business purpose, i.e. to supply the economy with money and to conduct a monetary policy that serves the interests of the country as a whole. In order to comply with this business purpose, the National Bank employs staff. It keeps accounts, with a balance sheet and an income statement, it has a business organisation, supervisory authorities and even proprietors (i.e. shareholders) who share in the profits.

A special feature of the National Bank is its legally established monopoly position with respect to banknotes. This means it is the sole company in Switzerland permitted to issue banknotes. Another special feature is the fact that its mandate is laid down in both the Federal Constitution and the National Bank Act.

✱ *The National Bank is a company with a number of special features. It has the sole right to issue banknotes. It fulfils a special public function: the National Bank pursues a monetary policy in the interests of the country as a whole.*

The National Bank as a joint-stock company

The National Bank has the legal personality of a joint-stock company. Its shares are traded on the stock exchange. The majority of the shares are held by the cantons and the cantonal banks. The remaining shares are in the hands of companies and private individuals.

Since the National Bank fulfils a public function, its administration is subject to supervision by the federal government. The Bank Council is responsible for supervising the management of the Bank. The majority of its members – representing various parts of the country and sectors of the economy – are appointed by the Federal Council. Upon the proposal of the Bank Council, the Federal Council appoints the three members of the Governing Board, the National Bank's senior management body.

But there are major differences. The shareholders of a normal joint-stock company can decide at the Annual General Meeting how the net profit is to be distributed. The distribution of the National Bank's net profit, on the other hand, is governed by the Federal Constitution and the National Bank Law. Only a certain percentage of the net profit is paid out as a dividend: the bulk goes to the cantons and the Confederation.

Because the National Bank fulfils a public function, its organisation, its supervision, the location of its head offices and much more besides are governed by the National Bank Law. It is a joint-stock company incorporated under special public law. The majority of its shares are held by the cantons and the cantonal banks.

How independent is the National Bank?

In performing its functions the National Bank must adhere to the provisions of the Constitution and the National Bank Law. The Federal Council appoints the National Bank's Governing Board and, together with the shareholders, approves the annual report and accounts. So where in all this is the independence of the National Bank that is laid down in the Constitution?

Crucial to the National Bank's independence is that it does not have to follow any instructions from government with regard to monetary policy decisions. The Governing Board alone is responsible for monetary policy. This independence in monetary policy is intended to counter the risk that short-term political interests might endanger the long-term interests of the country.

The National Bank is administered with the active involvement of, and supervision by, the Confederation. Yet it enjoys a high degree of independence; the Governing Board of the National Bank determines monetary policy on its own authority.

The National Bank as banker to the Confederation

The Confederation's domestic and foreign payments are effected through its accounts with the National Bank. The National Bank also manages the Confederation's securities holdings, assists in the investment of state funds and offers its services for Confederation bond issues. It is banker to the Confederation.

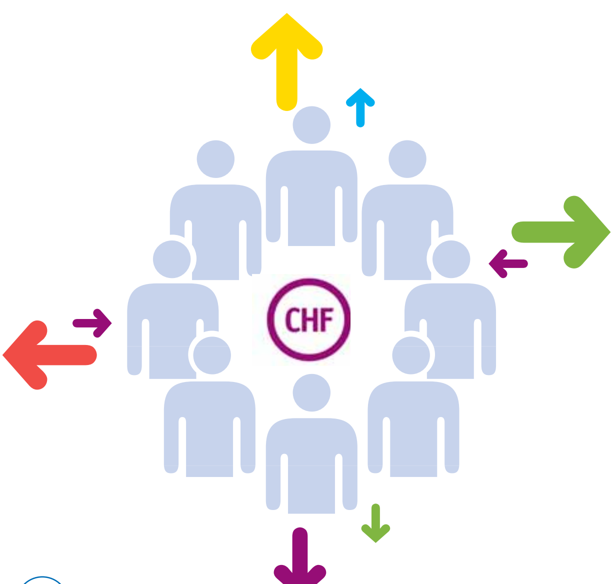
SNB

How the National Bank is organised

The Governing Board is responsible for the management of the National Bank. Its three members are each in charge of one of the National Bank's three Departments. Department I is based in Zurich; it carries out the preparatory work for monetary policy decisions. Department II, which is based in Berne, is responsible for issuing banknotes as well as overseeing the payment system, and it monitors developments in the financial system. Department III, which is also based in Zurich, implements monetary policy, for example by concluding repos and carrying out foreign exchange transactions.

The three Departments are divided between the National Bank's two Head Offices in Zurich and Berne. In addition, it has representatives in various parts of Switzerland. It monitors and reports on developments in the local economy. With around 600 employees, the Swiss National Bank is one of the smallest central banks in Europe.

✱ *The National Bank is divided into three Departments. It has representative offices in various parts of Switzerland and employs around 600 people.*



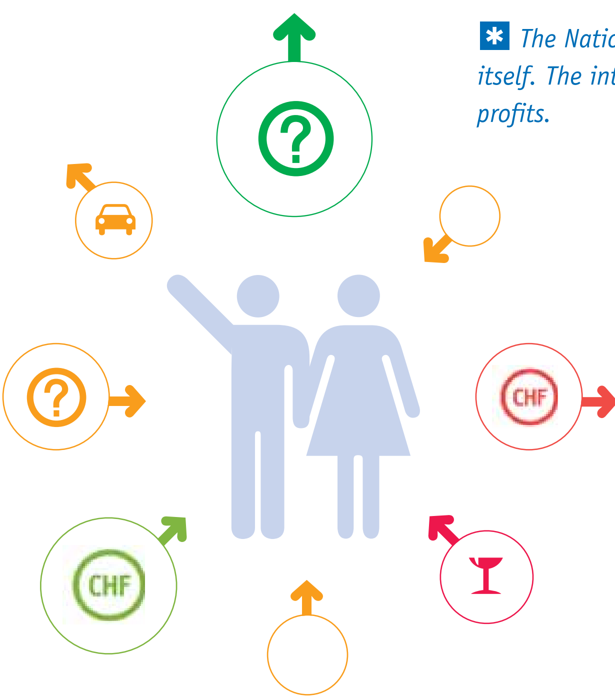
How does the National Bank make a profit?

The average cost of producing a banknote is around 30 centimes. The National Bank has around 100 million new banknotes printed each year to replace old notes. The cost of printing is around 30 million Swiss francs a year.

The National Bank is the only institution that can supply the banks, and thus the economy, with money: it buys assets (securities, foreign currencies) from the banks and pays them with money it creates itself. The assets generate interest income which enables the National Bank to make profits. Although there is also expenditure, such as staff expenditure or the cost of printing banknotes, to set against the income, this expenditure is quite modest compared with the interest income earned on the assets. However, it is not the primary objective of the National Bank to earn as big a profit as possible. Its main purpose is to pursue a monetary policy that furthers the interests of the economy and the people.

The most important items on the liabilities side of the National Bank's balance sheet are notes in circulation and liabilities to the banks and the Confederation. The assets side is dominated by repo claims, foreign currency holdings and the gold stocks.

The National Bank acquires assets with money it creates itself. The interest income on these assets enables it to make profits.



Why does the National Bank have a Head Office in Zurich and another in Berne?

The fact that the National Bank has two Head Offices (in Zurich and in Berne) has to do with its history. It was founded at a time when communications and transport were less developed than now, and so it was decided to set up one Head Office in Zurich, the financial centre of Switzerland, and another in Berne, the country's administrative capital.

Doesn't the independence of the National Bank conflict with Switzerland's democratic principles?

Central banks are often given considerable independence in monetary policy decision-making. This is important if unpopular measures need to be taken, e.g. in order to combat inflation. However, central banks do not go unsupervised. The National Bank is required to report to the public on its activities. The Governing Board is also accountable to Parliament.

Who owns the National Bank?

The Swiss National Bank is owned by its shareholders. A majority of its shares are held by the cantons and the cantonal banks. Many private individuals are also National Bank shareholders. The Confederation, however, owns no National Bank shares. The number of voting rights that a private individual may exercise is limited. So the National Bank cannot simply be taken over by a private investor.

Does the National Bank make a profit every year?

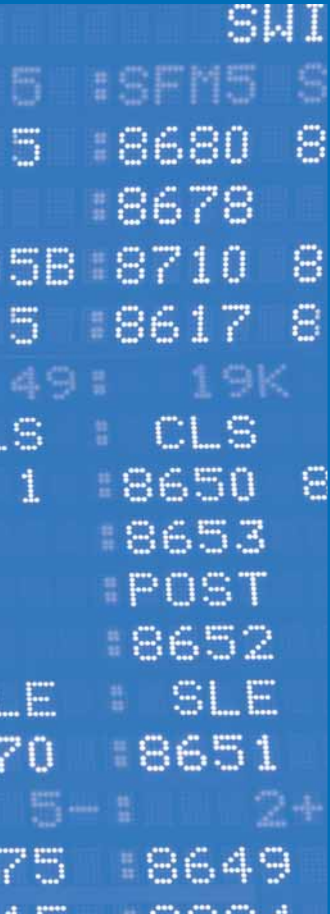
We are used to the National Bank posting impressive profits. But this need not always be the case. For example, if foreign currencies depreciate against the Swiss franc, the National Bank may incur considerable losses on its foreign currency investments. Thus it might in some circumstances have to report a loss rather than a profit.

Is it possible to visit the National Bank?

The National Bank has bank counters with regular opening hours. Among other services, information on banknotes is available there and badly worn notes can be exchanged for new ones. The National Bank does not, however, organise guided tours or visits for the public.

How can I find out more about the National Bank?

Information on the National Bank and its activities is available on the Internet at http://www.snb.ch. You can also order other publications on this website.



Published by the
Swiss National Bank

2nd edition 2006

Concept and design:
Interbrand Zintzmeyer & Lux, Zurich

Advisor: Peter Eisenhut

Copies can be ordered at: http://www.snb.ch
Available in English, German,
French and Italian