Jean-Pierre Roth: Recent financial and economic developments in Switzerland

Introductory remarks by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Geneva, 17 June 2004.

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The economy has developed in line with the expectations expressed in our monetary policy assessments of December and March. The economic recovery has increasingly gained hold in Switzerland and abroad and has become broader-based. Against this backdrop, we have reached the conclusion that the time has come for a slight tightening of monetary policy. The target range for the three-month Libor is being raised by 25 basis points with immediate effect and the Libor is being kept around 0.5%. This move reverses half of the latest interest rate cut of 6 March 2003; then the three-month Libor was reduced from 0.75% to a historic low of 0.25% due to fears of deflation and the appreciation of the Swiss franc at that time. The interest rate range extends from 0.0% to 1.0%. Even after this adjustment our monetary policy will remain expansionary and continue to support the economic upswing.

Let me offer some comments on our decision and the outlook for prices as summarised in the new inflation forecast. The graph provides you with the current and the last inflation forecasts. The dash-dotted green curve is the March forecast, which presupposes that the three-month Libor rate would remain unchanged at 0.25% in the next three years. As the graph shows, inflation in the first quarter developed as predicted by us (blue curve). The dashed red curve represents the new forecast. This is based on a steady three-month Libor of 0.5%. The forecast begins in the second quarter of the current year and ends in the first quarter of 2007.

In order to analyse the inflation prospects, it is useful to differentiate three phases. I shall begin with the short-term inflation prospects. In particular, I shall discuss the role of oil prices. Then I will present our outlook for the economy, which affects the medium-term inflation forecast. Finally, I shall talk about the long-term inflation prospects. For this, an analysis of monetary developments is helpful.

The development of oil prices

In the short term, i.e. for a period of approximately one year, monetary policy can hardly steer price developments. Price levels are largely determined by monetary policy decisions made in the past. Inflation may, however, be temporarily influenced by events that are not attributable to monetary policy. We are currently experiencing such an event in the form of higher oil prices.

Price increases for oil products have contributed significantly to the rise in annual inflation measured by the national consumer price index (CPI) from 0.5% in April to 0.9% in May. The increase in the oil price is also the main reason why our inflation forecast exceeds the March forecast until the first quarter of 2005 despite the higher interest rate level.

Such a rise in prices cannot and may not be corrected with monetary policy measures as long as no wage-price spiral is set in motion. First, we do not know whether this price rise is a permanent or merely a temporary phenomenon. Second, the change in oil prices impacts directly on the price level, whereas monetary policy changes act only indirectly and after a considerable time lag. Third, higher oil prices constitute a cost shock that cannot be countered by means of monetary policy. Experience shows that a monetary policy which attempts to counteract the effects of a one-off increase in oil prices on the price level can cause considerable damage to the national economy. Furthermore, it must be noted that the present price increase is modest in a historical comparison. For example, during the second oil price shock at the end of the 1970s, oil cost approximately twice as much as today calculated at current prices. Our interest rate decision of today is thus not aimed at combating the effects of the oil price rise on inflation.

The increase in oil prices nevertheless casts a shadow over the prospects for the economy, which are optimistic overall. We are not of the opinion, however, that the upswing is threatened by this. Model calculations have shown that higher oil prices would slow growth in Switzerland only moderately. It must also be mentioned that, given the exchange rate developments, the increase in the oil price was less marked in Switzerland than in the US and in the euro area. Despite higher oil prices, inflation in our country has remained within the range that we equate with price stability.

Economic prospects

For a period of one to two years, the development of inflation depends decisively on the economic outlook. Our economy has already been on a growth track for a year now. Real gross domestic product in the third and fourth quarters of 2003 grew at an annualised rate of more than 2% compared with the previous quarter. In the first quarter of 2004 the trend continued at a slightly weaker rate of 1.6%.

Due to improved economic activity abroad and the favourable exchange rate, exports exceeded their year-earlier level by 7.4%. Equipment investment, which had expanded by as much as 7.5% in the final quarter of 2003, declined slightly due to special effects. The upswing has also made itself felt in certain domestic sectors. This is evident in private consumption, which increased by 2.3%. The uptrend, which had begun towards the end of last year, thus continued. Surveys confirm that consumer sentiment has improved. Construction investment also topped the year-earlier level by a hefty 2.8%. The expansion in mortgage loans by 5.5% confirms the revival in the construction and real estate sectors.

The upswing is also evident from a stabilisation on the labour market. For the first time in five quarters employment slightly exceeded the corresponding year-back level. The job vacancies indices reveal that demand for labour is gradually rising again. The favourable overall picture is confirmed by the economic barometer of the Institute for Business Cycle Research at the Swiss Federal Institute of Technology.

How do we assess economic development in the near future? For this year, we are forecasting economic growth of close to 2.0%. Growth is therefore likely to be underpinned by both higher exports and stronger domestic demand and to lead to a gradual decline in unemployment as from the second half of 2004. Towards the end of 2005, the economy should again be working close to capacity, and this will influence price formation. Our inflation forecast of March already showed that, given an unchanged interest rate of 0.25%, inflation would exhibit a rising trend as from the second half of 2005. The reason was to be found in improved capacity utilisation and unemployment declining in step with the more favourable economic conditions. This assessment has not changed in any way. The new forecast, adjusted for the 25 basis points rise in the three-month Libor, now suggests that, as from the second quarter of 2005, inflation will fall short of the figure predicted by the last forecast. It makes it clear that the normalisation of the monetary policy course now initiated improves inflation prospects.

The monetary development

Our inflation forecast is much less certain over a longer horizon. For this period of time, it is particularly helpful to consider monetary factors. For the monetary analysis, I shall deal with the development of the money stock M3. When interest rates were last cut on 6 March 2003, short-term interest rates in Switzerland fell to a very low level. Since the opportunity costs for holding money were consequently reduced to practically zero, the demand for liquidity increased markedly. Immediately following the interest rate reduction, annualised monthly growth rates of more than 15% were observed for M3. Once the demand for liquidity by companies and households has reached the desired higher level, liquidity should only increase in line with nominal gross domestic product and should not pose a threat to price stability. In actual fact, the growth rates of M3 have fallen recently, but nevertheless the economy has more liquidity at its disposal than is compatible with price stability in the medium term.

According to our last forecast published in March, given an unchanged monetary policy and a three-month Libor of 0.25%, inflation could have climbed to 3% in the fourth quarter of 2006. The current forecast shows that - on the assumption that the three-month Libor will remain stable at 0.5% in the next three years - inflation will only rise to 2.7% by the end of 2006. At the end of the new forecasting horizon in the first quarter of 2007, inflation would slightly exceed 3%. By taking a small step towards the normalisation of the short-term interest rate level, we are thus gradually and cautiously siphoning off excess liquidity in order not to jeopardise price stability in the long term either.

Financial markets

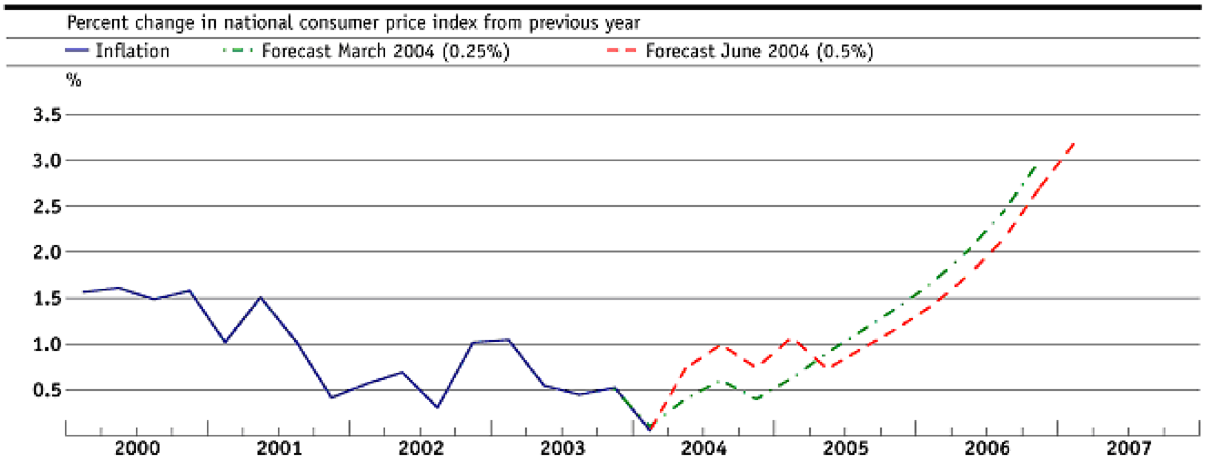
Is the economic analysis on which our inflation forecast rests in conformity with that of the financial markets? In the recent past, a flattening of the interest rate curve was observed in Switzerland. Interest rates for maturities of up to ten years in particular moved up. This shows that the financial markets have anticipated a somewhat less expansionary monetary policy. Since economic activity began to pick up momentum more rapidly in Switzerland than in the neighbouring countries, it became evident that interest rates would rise sooner, which enhanced the attractiveness of the Swiss franc somewhat. Nevertheless, the competitiveness of Swiss companies remains intact. At the very long end of the interest rate curve interest rates have hardly moved, an indication of consistently low inflation expectations. The markets assume that the National Bank's monetary policy is in conformity with its goal of ensuring price stability in the long term.

Monetary policy still expansionary

In March 2001, we initiated a series of interest rate reductions in response to the sluggish business climate and the enduring strength of the Swiss franc. In a particularly difficult international environment with deflationary trends we allowed the three-month Libor to finally fall to a historic low of 0.25% in March 2003. For five quarters it persisted at this level. Today's adjustment of our monetary policy should not be seen as a changeover to a restrictive policy. Our interest rate increase is merely to be regarded as an appropriate step towards more neutral monetary conditions following a lengthy period of extraordinary circumstances. It is an indication that we view economic prospects more optimistically and that we trust the economic upswing in Switzerland to be robust. Our monetary stance remains expansionary.

Every forecast and every decision is fraught with uncertainty and risks. Should the economic recovery be delayed due to unexpected events or should the Swiss franc appreciate markedly, we shall react appropriately. As in the past, the Swiss National Bank shall keep all its options open.

Inflation forecast of March 2004 with Libor at 0.25% and of June 2004 with Libor at 0.5%



Observed inflation June 2004

	2001				2002				2003				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Inflation	1.02	1.50	1.03	0.41	0.56	0.69	0.31	1.01	1.05	0.54	0.45	0.52	0.06			

**Inflation forecast on March 2004 with Libor at 0.25%
and of June 2004 with Libor at 0.5%**

	2004				2005				2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast March 2004, Libor at 0.25%	0.10	0.40	0.60	0.40	0.63	0.90	1.15	1.40	1.68	2.03	2.45	3.00				
Forecast June 2004, Libor at 0.5%	0.06	0.73	0.99	0.74	1.07	0.73	0.95	1.18	1.43	1.75	2.15	2.70	3.20			

Inflation forecast of June 2004 (98 kb)