Jean-Pierre Roth: Review of the Swiss economy

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the Bank's Annual General Meeting, Berne, 29 April 2005.

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Dear shareholders
Dear guests

2004: the economic upswing continues

The economic upswing that began in summer 2003 continued last year. Economic growth moved into the positive zone and came close to its potential level once again. While growth was slightly negative in 2003, it reached 1.7% for 2004 as a whole.

The recovery in Switzerland is due in large part to the rebound in global economic growth, which reached its highest level since 1976. Swiss companies have benefited from this situation: last year, exports rose by 6.7% – a significant increase compared with the 2003 figure. This figure reflects our exporters' continuing wish to adapt to changes in demand, as well as the untiring efforts to streamline Swiss industry and maintain Switzerland's appeal as a location for business.

The Swiss economy's strong presence on the international markets has been a reality for a long time. As our direct investments abroad have grown, however, it has taken on a new dimension in recent years. Not everyone is aware that while Switzerland is a champion in savings, it also boasts a performance in the area of foreign investments that is unrivalled. In 2003, we invested some CHF 20 billion abroad – a sum equivalent to almost 20% of national savings. Roughly half of these investments were concentrated in the European continent. Over the years, and given Switzerland's trade surplus, our companies have thus developed an extremely dense international network of production facilities. In addition to the 4 million jobs within the domestic economy, Swiss companies employ a further 1.8 or so million people abroad. Of these, 1 million work in European countries.

These figures show that Switzerland has by no means resigned itself to low growth, but has seized the opportunities created by the opening-up of borders and markets. These days, a lot of people worry about competition from low-wage countries and the resulting relocations. However, they overlook the fact that our country is a major beneficiary from the more pronounced international division of labour brought about by globalisation. The relocation of certain production stages is inevitable. It allows our companies to stay competitive in the face of high Swiss labour costs. In some respects, the jobs created abroad secure those at home with more added value.

"One out of every two francs is earned abroad" is the phrase that comes to mind when the performance of our exporters is being discussed. This also means, however, that one out of every two francs is still earned in Switzerland. Put another way, the domestic economy plays a crucial role in our country's economic development both on a demand and production level. In 2004, domestic turnover grew more slowly than sales abroad. The growth figure of 1.8%, however, was still higher than in the previous year.

Household consumption played a central role in this respect: this began to recover towards the end of 2003 in the wake of the general economic upturn and the rise in earnings. A good showing by the construction sector also contributed to higher demand for household equipment. In contrast to their counterparts in Germany, Swiss consumers remained relatively optimistic in 2004, and this helped to sustain the level of business activity.

Where public-sector demand is concerned, the financial constraints imposed by the Confederation and cantons put a brake on the growth in spending in 2004. For the first time in several years, public-sector demand rose less quickly than the other components of domestic demand.

In this initial phase in the economic cycle, the return of confidence would normally have triggered growth in investments aimed at adapting the means of production to future needs. But such an upsurge has so far been largely absent, both in Switzerland and in other European countries. Although the profitability of companies has improved, they have given priority to raising the utilisation of existing capacity rather than expansion or modernisation, as the latter are considered to entail substantially more risks. As a result, growth in capital spending was modest in 2004.

This cautious approach by companies also affected the development of the labour market: contrary to expectations, unemployment fell only slightly in the past year. This can be ascribed, on the one hand, to weak growth and large productivity gains and, on the other, to a lack of confidence in the soundness of the recovery.

Monetary situation starts to normalise

Thus, 2004 saw the economic situation starting to return to normal. Our aim was therefore to modify our policies so as to gradually bring the monetary framework into line with the new environment. A normalisation of the monetary situation should go hand in hand with an economic normalisation in order to ensure that price stability is maintained in the medium term.

We waited until June – when the signs of a recovery became manifest – for an initial quarter-point rise in the target range for the three-month Libor. This decision did not really come as a surprise. In fact, the markets were expecting corrective action to be taken during the year. We proceeded to adjust rates again in September, but decided to leave them unchanged in December 2004 and March 2005 when it became increasingly clear that the economy was slowing down. Our three-month rate is 0.75%. Meanwhile, long rates fell during 2004, but have risen slightly since.

The current interest rate reflects the fact that we are still pursuing an expansionary monetary policy: in view of the prospects for growth and inflation, our rates are relatively low. However, this phase of normalisation of monetary policy is not yet over. It will be continued according to the requirements for maintaining price stability in the medium term.

Where prices are concerned, 2004 was another year of stability despite the spectacular price rise of oil products. Inflation rose to 0.8% over the year as a whole, and peaked at 1.5% in November. The low inflation rate gave Swiss companies a further competitive advantage on the international marketplace.

The dollar and the oil price as disruptive elements

The foreign exchange and commodity markets experienced the most turbulence in 2004. The US dollar, which had been falling since 2001, accelerated towards the end of the year, when it hit a record low against the euro. Switzerland was affected in much the same way as the other European countries: the Swiss franc appreciated by about 7% against the US currency during the last three months of the year. This development has since improved somewhat.

Despite the dollar's sharp drop over the last few months, its current exchange rate is still higher in real terms than it was in the mid-1990s. The current situation is particularly difficult, however, as a whole series of Asian currencies, including the Chinese renminbi, are pegged to the dollar. The greenback's fall has thus reinforced the competitiveness of numerous emerging markets versus the European economies. For us here in Switzerland it has been positive to note that the nose-diving dollar has not unleashed any speculation on the Swiss franc. The Swiss franc-euro exchange rate has remained remarkably stable at around CHF 1.55 per euro. Since the single European currency was introduced on 1 January 1999, the Swiss franc's nominal appreciation has been more than offset by the inflation differential between Switzerland and the euro area. The competitive position of our exporters has thus improved against their European counterparts.

The dynamism of the Asian economies has boosted demand for commodities, notably oil. The soaring price of this "black gold" continues to pose a serious threat to the recovery of the industrialised economies.

Guardedly optimistic outlook for 2005

As it is benefiting from price stability, low interest rates and a strong competitive position, the Swiss economy is well placed to profit from the world economic upturn. However, the outlook for the global economy in 2005 is not quite as good as it was in the past year: growth is put at around 4%, down from 5% in 2004. Growth will continue to be driven by Asia and America. Europe – and especially

Germany, our biggest market – will continue to chug along with a growth rate of between 1.5% and 2%.

In this slightly less dynamic environment, the Swiss economy is unlikely to exceed its 2004 growth figure. Business activity has fallen off slightly since the autumn but should slowly gain momentum again in the next few months. Overall, we are expecting GDP to grow by about 1.5%. The labour market should see a gradual decline in the number of jobseekers in the second half of the year as companies gradually use up the resources currently available.

A much-debated question is the extent to which monetary policy contributes to long-term growth. It would appear that the growth of an economy depends first and foremost on the development of its resources and then on their productivity. Monetary policy cannot change this situation; it can only be vigilant in maintaining a stable framework that is conducive to the efficient development of productive activities.

The National Bank succeeded in doing this in 2004. Moreover, our forecasts suggest that price stability should continue in 2005 and 2006, with inflation averaging around 1%.

Completion of the gold sales

On 31 March, we completed our sales of the 1,300 tonnes of gold no longer required for monetary policy purposes. These sales had begun on 1 May 2000. The fears expressed in some quarters that our gold sales would destabilise the market have proven to be unfounded. By selling the gold in small instalments and according to a fully transparent schedule, we succeeded in assuaging the market's fears. Moreover, our sales strategy and risk hedging also proved effective in financial terms: the 1,300 tonnes of gold were sold at an average price of CHF 16,241 per kilo. This was CHF 700 more than the average market price during the same sales period. An additional profit of more than CHF 900 million was therefore realised.

At the end of the sales programme, the National Bank still held 1,290 tonnes of gold, corresponding to one third of the value of its currency reserves.

Even though it has been demonetised, the yellow metal still plays an important role in our reserves. It is an asset category that traditionally affords good protection in times of crises in the international monetary system. It also allows us to hold part of our reserves on our own country, which is not possible with financial assets. Moreover, as expressly requested by Parliament, Article 99 of the Federal Constitution requires the National Bank to hold part of its currency reserves in gold. The Governing Board considers that the holdings of 1,290 tonnes are appropriate to the current international environment. It does not intend to proceed with further sales of gold.

Distribution of profit

This General Meeting of Shareholders will find a special place in the National Bank's annals, as you are going to decide on how the proceeds of the gold sales are to be distributed. This will close a chapter first opened in 1997, when a group of experts came to the conclusion that the SNB's currency reserves were larger than required for the execution of its mandate and that it could thus consider selling half its gold holdings, once the Swiss franc's gold parity was discontinued.

As you know, the Governing Board adopted the expert group's conclusions and indicated to the Federal Council that, based on the profit figure following revaluation, an amount corresponding to half the gold holdings could be earmarked for purposes other than monetary policy.

The possible uses for the sales proceeds have been the subject of much political debate. None of the proposed solutions have succeeded in attracting a consensus among the population or in the Federal Parliament. On 16 December, the parliamentary debate was concluded without an agreement being reached. Thus, a sum of CHF 21.1 billion, corresponding to the proceeds of the gold sales, has been included in the usual profit distribution procedure.

Some people fear that, following this transfer, the National Bank will no longer have sufficient currency reserves. I have a word of reassurance for them. This issue has been examined in depth and has been discussed by our Bank Council. Our currency reserves total CHF 60 billion – an amount which may be considered appropriate by comparison with other industrialised countries.

But nor are these reserves excessive. Furthermore, it is important that the currency reserves evolve over time, in tandem with the size of our economy. This is why, in accordance with Article 99 of the Constitution and Article 30 of the National Bank Act, the SNB has adopted a provisioning policy that provides for gradual growth in its currency reserves. This year, CHF 885 million have been reserved for this purpose, and similar sums will have to be set aside in the future.

The closing of our accounts for 2004 thus brings with it an extraordinary allocation of profit to the Confederation and the cantons. It is important to emphasise that – paradoxically – the distribution of the CHF 21.1 billion accruing from the gold sales does not actually make them any richer. Up to now, the public sector received the income earned on this capital: a sum of CHF 400 million will also be allocated to them from this source this year. As of the beginning of next year, this income will no longer be distributed. As a result, the Confederation and the cantons will gain in terms of capital, but will lose in terms of transfers of interest income. If they use the proceeds of the gold sales to repay their debts, the reduction in financing charges will correspond approximately to the reduction in the profits paid to them by the SNB. In net terms, there will be few – if any – additional funds available for new expenditures. It is therefore important that decision-makers at all levels maintain a rational approach.

The COSA initiative

The distribution of the gold sale proceeds will not put an end to the political debate about the distribution of the National Bank's profits. Next year, the Swiss electorate will probably be asked to vote on the "COSA initiative", which proposes allocating the first billion Swiss francs of our current profit to the cantons, with the balance going to the state Old Age and Survivors' Insurance scheme (AHV/AVS).

The National Bank has consistently taken the line of not intervening in domestic political debates unless the fulfilment of its constitutional mandate is in jeopardy. Two years ago, I mentioned to you that the COSA initiative threatened to undermine our autonomy. Linking the National Bank's profits to the financing of a key element in our country's social security system would create a mechanism that would force the SNB to manage its reserves for the purpose of generating the highest possible returns rather than for performing its monetary mandate. This would weaken our international credibility and hence also the credibility of our policies. No other central bank of an industrialised country is faced with a similar situation. All of these banks deliver their profits to the state, and the SNB is no exception.

Our main argument against the COSA initiative, however, is that it rests on an illusion – namely, that a central bank is able to transfer profits of over CHF 1 billion every year. Once this illusion has been dispelled, it will become clear that the initiative makes no sense, as nothing would remain for the state pension scheme.

And, as we have often stated in the past, the current disposable profit of CHF 2.5 billion Swiss cannot be sustained. As the President of the Bank Council pointed out just now, our annual disposable profit averages about CHF 1 billion. As this year's negative result shows, it is subject to sharp fluctuations.

The fact that we are now distributing more than this amount is because we are gradually releasing the provision for future profit distributions. This provision amounted to CHF 13.4 billion in 2001, but had dropped to CHF 6.9 billion by the close of our 2004 accounts. This development does not come as a complete surprise. A progressive fall in the provision had been predicted, though the speed of the decline – a result of the current low interest rates – had not been expected. Our profit distribution may already have to be reduced in 2007, when the agreement we concluded in 2002 with the Federal Department of Finance on the distribution of profits is revised. Our profit distributions will gradually decrease towards the CHF 1 billion level.

Ladies and gentlemen, dear shareholders,
dear guests,

2004 was a relatively favourable year for the Swiss economy. A few clouds have recently appeared on the horizon. The recovery has unfortunately weakened, so a fall in unemployment is not imminent. We will continue to pursue a monetary policy aimed at maintaining the level of economic activity, though we will keep a careful watch on the general level of prices.

With prices remaining stable, interest rates low and a good level of competitiveness, our economy is well equipped to resume a brisker growth trajectory in line with the global economy.

As in the past, however, the international environment remains fraught with uncertainty at both the economic and monetary level. The independent course steered by the National Bank has made it possible to create a monetary framework conducive to the development of our economy. This success hinges not only on the correct interest rate decisions, but also on the credibility conferred upon us by our autonomy of action and by sufficient resources for intervening in the markets. It is in the nation's interest to preserve this achievement.

Thank you for your attention, and for your interest in the Swiss National Bank and its activities.