Jean-Pierre Roth: Review of the Swiss economy in 2005 and outlook for 2006

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the General Meeting of Shareholders of the Swiss National Bank, Berne, 28 April 2006.

* * *

Mr President of the Bank Council
Dear shareholders
Dear guests

Faltering economic activity in 2005

As we now know from the revised figures for the Swiss national accounts, 2005 was better than anticipated. An economic slow-down became apparent from autumn 2004, but the lost ground was more than regained in 2005 thanks to the strength of our exports.

The temporary lull in the economy had resulted mainly from uncertainties following the rise in energy prices. These concerns were further augmented by the fact that part of US refinery production was out of service in autumn. From January to August, the price of crude oil surged by 50% to reach a peak level of some USD 65, before a partial correction set in. As a result, business and consumer confidence was shaken. Demand for capital goods softened while at the same time the growth in consumer demand was slow. Not until the second half of 2005 did unmistakeable buoyancy in economic activity become apparent.

The indecisiveness in the economy did not affect all parts of the global economy equally. The United States remained the driving force in the industrialised world, with growth rates maintained close to potential and above the OECD average. The emerging Asian economies again provided a particularly vigorous growth hub, and the rise in manufacturing production in China stimulated international trade. Consequently, all of Asia – and especially Japan – benefited from the strength of the Chinese economy. The European economy, meanwhile, lacked vigour in the first part of the year. This was due, in particular, to chronic weakness in domestic demand. In early 2005, Germany, France and Italy even experienced a situation of near-stagnation. Although the economic climate recovered subsequently, this improvement was often hesitant.

To a large extent, the Swiss economy escaped the European lethargy due to its relatively diversified export markets. Our foreign trade sagged in the first quarter of 2005 but returned to a strongly expansionary course thereafter. Consumption was relatively firm even if the rate of growth remained extremely modest. Investments failed to show the strength exhibited in 2004 because of the hesitations about the soundness of the recovery. Even construction had a difficult start to the year because of the adverse weather conditions – despite the strong support provided by low interest rates. Although this industry subsequently rallied, it was unable to recover the strength it had enjoyed in 2004.

For the year as a whole, the Swiss economy grew 1.9%, which was slightly below the figure reached in 2004.

In the uncertain economic environment that prevailed in 2005, the Swiss National Bank did not continue with the normalisation of interest rates which it had embarked on in spring 2004. Not until the end of the year, when the indications of economic recovery had been clearly confirmed, did we decide to resume the gradual normalisation of interest rates. In December 2005 and March 2006, we increased the target range for the threemonth Libor by 25 basis points on each occasion. This rate now stands at 1.25%, which is comparable to the current rate of increase in prices. In other words, it remains extremely attractive, given the healthy state of the economy.

2005: Another year of price stability

Despite the increase in oil product prices, 2005 was again a year of price stability. Indeed, it was the twelfth in succession, since the annual rise in consumer prices in Switzerland has remained below 2% since 1994. Consequently, the SNB has fulfilled its mandate.

The low knock-on effects of the rise in energy prices surprised many observers. In this respect, the current situation is very different from that experienced at the time of the oil shocks in the 1970s. This is because the Swiss economy is more exposed to competition than in the past and there are major under-utilised productive resources around the world. Nevertheless, this favourable constellation should not cause us to relax our vigilance with respect to inflationary phenomena.

Favourable outlook for 2006

The prospects for the Swiss economy in 2006 are good, although the most recent rise in oil prices constitutes a new source of uncertainty. The world economy continues to grow and the US economy remains robust despite the interest rate hikes by the Fed and the slight softening in the property market that ensued. The Asian economies are deriving increasing benefits from China's vitality. An economic upturn is also visible in Europe, especially in Germany, even though it is still moderate. In addition, the fact that world growth is generating more demand for investment goods is creating a particularly favourable situation for our exports.

We may expect a positive spin-off from this good foreign trade performance for all areas of the Swiss economy – in production as in employment. To date, the rise in sales abroad has been handled through substantial gains in productivity, but we may hope that this will now be followed by a resumption of investment in equipment, along with increased recruitment. Consequently, the overall economic climate in Switzerland is likely to continue improving over the next few months, thereby supporting consumption. We project growth of slightly over 2% for the year as a whole.

This return to growth does not constitute a threat to price stability. Our forecasts indicat that average inflation for this year is likely to be about 1%, and the outlook remains just as favourable for 2007. Compared with other countries, Switzerland will continue to enjoy a privileged position in this respect.

What may we expect from monetary policy? The inflation forecast we published in March clearly indicates that the current interest rate level is incompatible with long-term price stability. Consequently, we will continue to implement the strategy of monetary normalisation pursued since June 2004. We will be doing so in the conviction that a preventive approach is much less painful for our economy than belated corrective measures.

While the resumption of growth is heartening, we should not rest on our laurels since the expected figures are still lower than those needed to cope with the increasing financial requirements of our aging population. Much still needs to be done to raise potential growth in our economy. The proposals on liberalisation of the domestic market that have been put to the Federal Parliament by the Federal Council are a step in the right direction. Additional reforms should be planned, with the objective of stimulating internal competition and reducing the level of market regulation. It is certainly worrying to see our country's frequent low ranking in terms of the indicators that measure market liberalisation. The vitality of countries that have created more room for private initiative should serve as an inspiration to us. Given the healthy state of our economy, the timing is excellent for pursuing a programme of economic reform. We would be making a grave mistake if we declared ourselves content with the results we have already achieved. By ensuring price stability, the SNB, for its part, creates an environment that favours both general economic expansion and structural adjustment.

Stable financial markets

2005 was a year of great uncertainties, with the surge in oil prices, disruptions to refining capacity in the United States, and geopolitical tensions. What is more, the world economy is still characterised by profound imbalances, such as the deficit in US external accounts and the lack of flexibility in the Chinese monetary system. Turning now to monetary policy, there were often considerable disparities in 2005, for instance, the progressive hikes in the rate of interest in the United States at a time when monetary policy in Europe was characterised by a waiting-game approach.

Despite these potentially destabilising factors, financial markets remained relatively calm. In currency markets, the dollar picked up in the wake of tighter US monetary policy, while the yen moved only slightly against the Swiss franc. The exchange rate of the euro against the Swiss franc fluctuated within a narrow range, thereby reflecting the strong convergence of fundamentals in Switzerland and the euro area. Over the past few months, the Swiss franc has even trended downward – a decline that is hard to explain given the low rate of Swiss inflation as compared to the rest of Europe. If this trend were to accelerate and give rise to an excessive relaxation in monetary conditions with respect to economic developments, a normalisation of interest rates would become even more essential.

Generally speaking, the capacity of financial markets to absorb shocks and to cope with imbalances is one result of globalisation and the progress in financial intermediation. In addition to stimulating goods markets, globalisation has also enlarged and deepened financial markets, and is doing so to a growing extent. Freedom of movement of capital is now the rule between industrialised countries and is also becoming more widespread in emerging countries. This makes it easier for the deficits of one group of countries to be financed by the surpluses of the others.

In itself, the greater efficiency of financial markets is an additional factor contributing to growth, and is therefore a good thing. However, it is still possible that the continued indebtedness of some countries (due to the substantial disparity in national savings efforts) could dangerously weaken financial markets in the event of a crisis of confidence.

The stability of global financial markets last year was a positive factor for our country, with its manifold connections to the global economy and a currency that has often suffered from external monetary turbulence. However, this high level of market stability should not be regarded as permanent. There are still major underlying risks and there is no justification for diminishing our vigilance as regards possible market instability. Meanwhile, companies need to remain cautious about exchange rate risks, despite the fact that the volatility of the Swiss franc has been low over the past few years. For its part, the SNB is aware of the vulnerability of financial markets and takes particular care to ensure that its monetary policy is properly understood by economic agents. We command a high level of credibility because of the attention we pay to communicating our decisions and the monetary stability results achieved in our country. This makes our interest rate policies very effective.

The SNB in the centre of political debate

Nowadays, credibility is even more important because of the fact that financial markets are extensive and closely linked. In the past, central banks were able to demonstrate their regulatory power by intervening in markets to influence rates and prices, particularly exchange rates. These days, they face global markets where the relative paucity of their means requires them to use tact rather than force to achieve their objectives. To this end, they depend upon their credibility. This smoothes out price volatility and makes it possible for monetary decisions to impact fully on market expectations.

In other words, credibility is a precious monetary policy asset. We need to devote all our efforts to maintaining it. The SNB cannot merely rely on the good results it has achieved in the past. It must be able to convince markets of its determination to deploy all the means at its disposal to maintain monetary stability in the country, now and in the future.

Nowadays it is generally recognised that a central bank is only credible if it can deploy its resources without having to obtain prior authorisation from the government, and without the risk of being penalised by the state authorities. This is why it is essential that a central bank be independent. In Switzerland, the independence of the National Bank is guaranteed under article 99 of the Federal Constitution and article 6 of the National Bank Act. This legal framework is sufficient.

However, credibility is not merely a matter of legal independence. It also depends on the political environment within which a central bank operates, since markets are concerned about more than just the formal autonomy of the monetary authorities. They also pay attention to the degree of political acceptance of central bank decisions. If monetary affairs are subject to permanent political debate, this can become a hindrance to credibility.

Recognising that monetary matters should be conducted in a relatively calm setting does not mean that the policies adopted by the central bank should escape all democratic controls. Nowadays this form of control is tighter than ever before. Indeed, most monetary regimes now require that the central bank report to the legislative authorities on the execution of its mandate. This is also the case in Switzerland, since article 7 of the National Bank Act requires that we present a report on the fulfilment of our tasks to the Federal Assembly each year.

Despite these measures, National Bank affairs are often the focus of animated political debate. Paradoxically, these debates do not relate to monetary policy in the narrow sense of the word, but rather to other aspects of a more operational nature – such as the level of the monetary reserves or the distribution of the profits.

Allow me to give you an example. Following recent deliberations by the National Council's Control Committee, information was published to the effect that an additional part of the SNB's gold stocks might be liquidated to fund another extraordinary distribution of profits amounting to some CHF 10 billion. This created the totally mistaken impression that the National Bank was oversupplied with monetary reserves.

Now that half our gold stocks have been sold and the proceeds distributed to the Confederation and the cantons, the SNB holds an appropriate level of monetary reserves in the form of gold and foreign exchange for the conduct of monetary policy. Bearing in mind the economic importance of our country, however, our level of currency reserves does not place us in a leading position amongst the group of the best endowed countries. Far from it, in fact. In 1950, our reserves amounted to 30% of GDP. This percentage has now fallen to 12.5%, situating us in a respectable middle position on the international scale – along with the Scandinavian countries. If we bear in mind that, unlike these nations, Switzerland is also an important international banking centre, we cannot reasonably conclude that our current monetary reserves are excessive.

What is more, the law is perfectly clear on who has the final word in this matter. It is the Bank Council – not parliamentary committees – that is authorised to assess the SNB's reserves policy, including any augmentation or depletion of the bank's monetary reserves. The reserves policy adopted by the Bank Council bears the hallmark of common sense, aiming for a gradual rise in the level of monetary reserves so that the relationship of reserves to GDP does not deteriorate over time. This approach is consistent with the fact that, at present, we only have a moderate level of reserves.

Those who believe that the SNB has surplus monetary reserves overlook the fact that Switzerland's central bank constitutes a form of insurance with respect to the monetary stability of the country. Like all kinds of insurance, the National Bank – faced as it is with expanding markets and increasing risks – must be able to rely on its reserves growing in tandem with the economy. If they did not do so, its ability to operate on the markets would be weakened. In this respect, it is the country's long-term interests that must not be lost sight of.

The debate on the Cosa initiative (under which SNB profits would be used for the AHV/AVS, the Swiss old age and survivors' insurance scheme) is another example of a political move that could lead to a weakening in our monetary credibility. This initiative would hinder us in fulfilling our mandate, and last year I had the opportunity of explaining to you in detail why this is so. Allow me to briefly reiterate these reasons.

First of all, by creating a direct relationship between our profits and the funding of an important element in our system of social security, the initiative would establish a dangerous link, since it would certainly place the SNB under constant pressure to distribute more profits in the future. Higher profit distribution would only be possible if we took bigger investment risks or if we reduced our monetary reserves. Markets would start to ask themselves whether the SNB's goal was to ensure the monetary stability of the country or to generate profits. As I pointed out before, there is a risk that constant debate on this topic could sap market perception of our independence. This would damage our credibility and hamper our monetary policy. At the end of the day, implementation of this initiative would undermine confidence in the Swiss franc.

Second, the initiative assumes that our profit distribution can be held permanently at a level above CHF 1 billion a year. This is an illusion. The only possible outcome is bitter disappointment on the part of our fellow Swiss. All our calculations show that, as confirmed in the remarks made by the President of the Bank Council on the results for 2005, the SNB's medium-term profit distribution potential amounts to only CHF 1 billion a year. If we deduct the gains due to the spectacular increase in the price of gold and to exchange rate gains from the CHF 12 billion profit recorded for 2005, the distributable profit falls to CHF 2 billion. This would mean that last year's results were good, but no more than that.

To hope that the SNB could distribute considerably more than CHF 1 billion in profits over a sustained period is tantamount either to forcing it to take more risks in managing its reserves, or to cutting back the level of funds set aside as currency reserves. In other words, its position on the markets would be weakened. Given our current level of reserves, this would be unwise.

Dear shareholders
Dear guests

The Swiss National Bank must retain the confidence of the population and the markets if it is to conduct its policies effectively. The Cosa initiative is playing with fire. It constitutes a permanent invitation to press never-ending financial demands. It places the SNB at the centre of a permanent political debate which threatens both its credibility and the effectiveness of its policies. That is why good sense dictates that it be rejected.

The SNB needs the support of everyone in this tricky phase and, in particular, the support of its shareholders. I would like to thank you for your attendance today, and for your continual interest in our activities.