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

Introductory remarks by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank and Chairman of the Board of Directors of the Bank for International Settlements, at the half-yearly media news conference, Berne, 14 June 2007.

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The Swiss National Bank is raising the target range for the three-month Libor with immediate effect by 0.25 percentage points to 2.00–3.00%. With this move, the National Bank is ensuring that inflation prospects remain favourable. The SNB intends to hold the rate in the middle of the target range for the time being.

Switzerland's economy is in excellent shape. Indeed, the economy is developing even better than expected back in March. For 2007, the National Bank now expects real GDP to grow at a rate of close to 2.5%. The healthy economy in the neighbouring countries and exchange rate developments have been contributing factors. Together with a renewed rise in oil prices, this has led to a slight deterioration in inflation prospects – even after today's increase in the interest rate. Assuming that the three-month Libor remains unchanged at 2.50%, the National Bank expects an average annual inflation rate of 0.8% in 2007, 1.5% in 2008, and 1.7% in 2009. Consequently, forecast inflation continues to rise.

However, at present there is considerable uncertainty with regard to the assessment of the inflation outlook. On the one hand, structural changes in the economy still have a dampening effect on prices. On the other hand, given the high level of capacity utilisation and movements in the exchange rate, there is a danger that higher production costs will increasingly be passed on to prices. Should economic momentum remain unchanged or should movements in the Swiss franc result in a further relaxation of monetary conditions, further increases in the interest rate are likely in the months ahead.

Economic outlook

The international environment has a strong impact on economic developments in Switzerland. According to the IMF forecasts, the global economy is poised to grow at a sustained rate of approximately 5% in 2007. While the economic activity in the United States has been satisfactory, it is a little less dynamic than expected. By contrast, the economic situation in Europe is clearly healthier than we had expected. This encouraging development has had a favourable impact on our economy.

Economic activity in Switzerland continued to be dynamic in the first months of the year. In the first quarter, gross domestic product (GDP) was up by 3.2% saar, exceeding the long-term average growth rate by a significant amount.

The strong economic performance assisted the recovery of the labour market. Employment was up in industry as well as in the construction and service areas. As a result, unemployment figures dropped further and the unemployment rate fell below the level of 3%. Demand indicators were still trending upwards, which should result in a renewed drop in unemployment in the months ahead. Moreover, labour demand continued to be met by a significant influx of labour from abroad. The opening of the labour market within the context of the bilateral agreements with the EU creates additional growth potential.

The competitive position of our economy is high, and the recent depreciation of the Swiss franc on the foreign exchange market gave it an additional boost. While exports continued to increase at a rapid pace, their growth rate may slow down somewhat compared with 2006.

The healthy state of the economy and the improvement in the labour market have a favourable impact on consumer sentiment. Since the beginning of the year, household spending has been increasing at very steady pace. A continuance of this trend is possible, since the current near full employment is likely to lead to an increase in real wages.

During the next quarters, companies will continue to step up equipment investment since the rate of technical capacity utilisation – in particular in the manufacturing sector – is high. Construction investment should stabilise at a high level.

These developments in demand components led us to revise our GDP growth forecast upwards for 2007. For the current year, we now expect growth close to 2.5%.

Development in monetary and financial conditions

In the Swiss capital market, we have been observing a steady increase in long-term interest rates over the past three months. The yield on 10-year Swiss Confederation bonds reached 3% in May. Real interest rates for long maturities have therefore registered an increase. This is a new development because up until now, long-term interest rates had not clearly reacted to the progressive increase in the Libor. This will reinforce our efforts to tighten monetary conditions, since economic activity reacts more noticeably to long-term interest rates than to short-term ones.

By contrast, in foreign exchange markets, movements in the Swiss franc have resulted in a relaxation of monetary conditions. As of the beginning of 2006, the Swiss franc started losing ground steadily vis-à-vis the euro. However, it firmed slightly against the dollar during the same period. Since our March assessment, the actual depreciation of the Swiss franc, i.e. weighted in terms of exports , amounts to 1.7%. The corresponding relaxation in monetary conditions is weakening the effects of our policy of lifting interest rates and is increasing inflationary pressure through two channels. One the one hand, it is bringing about an increase in import prices, which could have an effect on consumer prices. Even though the impact of this channel may have diminished during the past few years due to increased competition, there is no guarantee that – against the current backdrop of near full employment – it will not again be reactivated. On the other hand, it is strengthening the competitive position of our economy, thereby giving exports and economic activity a boost. As a consequence, the weak franc could heighten inflationary pressure in an economy already running at full steam.

On the credit market, growth in mortgage lending is slowly receding, with the current rate of increase below 5%. The “other loans” category continues to expand rapidly, while matching observations of the past in comparable phases of the economic cycle. This category is now growing at a rate of about 8–10%, as at the beginning of the 2000s, when their level in fact considerably exceeded the levels we are currently experiencing.

M1 and M2 shrank, which is nothing out of the ordinary during a phase of rising interest rates. When this happens, savings and sight deposits are shifted into time deposits. M1 and M2 are affected by this substitution. M3, which is not affected, is growing at a rate of 2% to 3%, which is appropriate for an expanding economy.

Inflationary risks

In the current environment, price stability is subject to three types of risk:

The first risk is connected with the development in the price of oil. The barrel price for Brent crude rose by 40%, from USD 51.0 in January to USD 71.7 in May. This will lead to higher inflation during the course of the year. Unlike oil price hikes between 2004 and 2006, the most recent rally took place when capacity utilisation was higher. If the current surge in oil prices were to continue, it could affect prices more easily than previously.

The second risk is due to the fact that demand is growing at too rapid a pace in relation to the development in production capacity. We estimate the GDP growth rate that can be sustained without pushing up inflation – potential GDP growth – at between 1.5% and 2%. This is lower than the growth rate we have observed since 2006. Measuring the output gap is tricky, however, because certain favourable factors, such as the influx of skilled labour, the deregulation of certain domestic markets and increased global competition might have pushed up potential GDP growth. Having said this, however, we should not overlook those factors which have the opposite effect. For instance, equipment investment has receded, which has a dampening effect on potential growth. Moreover, even if capacity utilisation as a whole is not excessive, bottlenecks might occur in certain sectors of the economy. And, above all, experience has shown that the output gap is often underestimated during phases of growth. Consequently, the risk of underestimating the output gap may now be greater than that of overestimating it.

The third risk is associated with the future development of the Swiss franc. As its exchange rate is determined by the market, it is subject to fluctuations. Movements in the export-weighted Swiss franc index alter the degree of restrictiveness of our monetary policy. Normally, during periods of rising

interest rates, this index tends to increase, thereby amplifying the effects of monetary policy by mitigating price increases in imported products and slowing the expansion in economic activity. This reaction pattern was not observed during the past two years, which could put pressure on interest rates.

Monetary policy decision

Before commenting our decision today, I would like to point out the changes that are shaping our current environment. In December 2005, when the present cycle of interest rate hikes began, we were concerned with the normalisation of the interest rate level – at the time the Libor was at 0.75% – while allowing the economy to reduce its level of unused resources. Our concern now is to ensure that monetary conditions are such that the healthy state of the economy does not jeopardise price stability in the medium term.

We are still observing that the competitive pressure in the market is high, the labour market very flexible and that movement in the monetary aggregates is moderate. However, my analysis of the current situation has demonstrated that the inflation outlook has deteriorated in different respects since our last assessment: higher oil prices will have an impact on the consumer price index; economic performance, which is better than expected, will result in an improved utilisation rate and increase pressure on prices and, finally, a renewed weakening of the Swiss franc has neutralised the intended tightening in monetary conditions. Today's decision to raise the target range for the three-month Libor by 25 basis points takes into account this deterioration in the outlook for price stability.

Inflation forecast graph

I will now turn to the last part of my remarks. What is our inflation forecast? The dashed red curve represents the new forecast which covers the period from the second quarter of 2007 to the first quarter 2010. It shows the inflation outlook after today's increase in the Libor under the assumption that the level of 2.50% will be kept constant during the forecasting period. For purposes of comparison, the dash-dotted green curve shows the inflation forecast of the March monetary assessment which was based on a Libor of 2.25%.

The combined effect of higher oil prices, economic developments that were better than expected and a weaker franc leads to a deterioration in the inflation forecast for the coming months. Today's interest rate rise will stabilise the rate of inflation at a slightly higher level from mid-2008 onwards than that established last March. Inflation will subsequently continue to rise and approach the 2% mark towards the end of the forecasting period.

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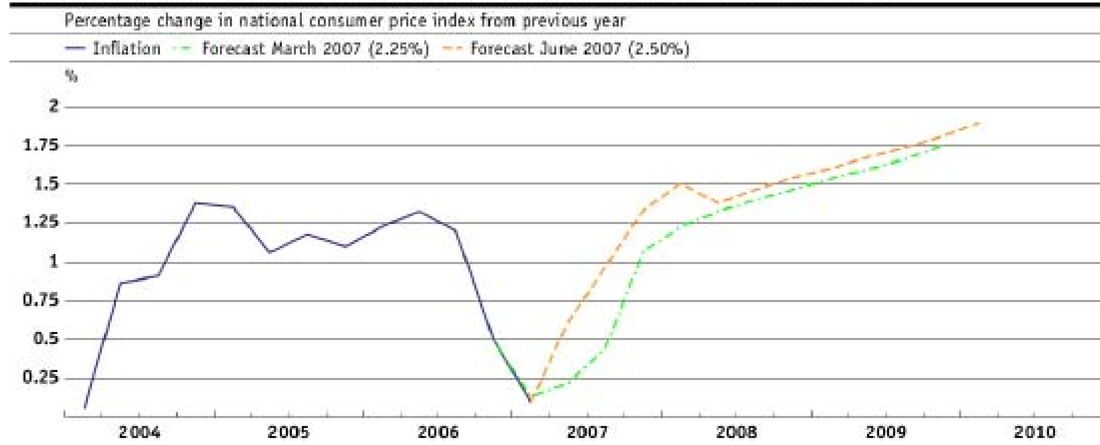
In lifting the three-month Libor by 25 basis points today, deterioration in the inflation prospects over the past months will be offset. Any forecast and any decision are obviously fraught with uncertainty and risk. Should economic momentum remain unchanged or should movements in the Swiss franc result in a further relaxation in monetary conditions, further increases in the interest rate are likely in the months ahead.

Inflation forecast of March 2007 with Libor at 2.25% and of June 2007 with Libor at 2.50%



Observed inflation June 2007

	2004				2005				2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Inflation	0.06	0.87	0.91	1.38	1.35	1.06	1.18	1.10	1.23	1.33	1.20	0.50	0.10			

Inflation forecast of March 2007 with Libor at 2.25% and of June 2007 with Libor at 2.50%

	2007				2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast March 2007, Libor at 2.25%	0.13	0.22	0.44	1.06	1.22	1.33	1.41	1.47	1.54	1.60	1.66	1.75				
Forecast June 2007, Libor at 2.50%		0.61	0.97	1.33	1.51	1.38	1.47	1.54	1.61	1.68	1.74	1.81	1.90			