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 end-of-year media news conference, Zurich, 13 December 2007.

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Economic outlook

The last few months have seen a number of remarkable events in the global economy. The US dollar has plunged, dropping below the level attained in 1995 against the Swiss franc. Oil prices have continued to soar, threatening to breach the hundred dollar mark. Sub-prime credit markets continue to disrupt financial markets. How have these factors affected the international economy? The US economy is affected simultaneously by the unfavourable developments in real estate markets, which are impacting on credit markets, and by increasing oil prices. At the same time, the fall in the dollar is bolstering external demand, so that most observers are not forecasting more than a temporary decline in US economic growth next year. As for the European economy – which is less open than the national economies of which it is composed – it is only slightly affected at present by the upturn in the euro, mirroring the downturn in the US dollar. The outlook for European growth in 2008 remains favourable, despite a light downward correction. All in all, the international economic situation remains generally positive, although it is true to say that this assessment is even more uncertain than three months ago.

Despite its substantial international integration, the Swiss economy, at this point, is scarcely affected by the turmoil in the international financial markets. Growth remained strong in the third quarter. Real gross domestic product rose at an annual rate of 3.3%. Employment continued improving across the board, in line with our expectations. In both the industrial and service sectors, the process of new job creation carried on. In construction, employment stabilised at a high level. Unemployment continued falling.

As a result of the favourable developments in the labour market, consumer sentiment remains buoyant. Consequently, household expenditure is still increasing at a robust pace. Furthermore, strong demand for labour is now leading to a faster increase in real wages. Given this situation, private consumption should continue to support growth in 2008. Due to impetus from Europe, Asia and the oil-producing countries, goods exports are advancing further. Looking at production, expectations remain optimistic both for the manufacturing sector and for non-financial services – businesses expect the growth phase to persist. Investment activity remains lively.

The banking sector is faced with the uncertainties that have arisen out of the developments in the US real estate market together with the structured products that relate to this market. It is possible that the contribution of the Swiss financial sector to GDP growth will fall as early as the fourth quarter of this year, due to a drop in the volume of activity on financial markets. Other factors could also have an impact during the course of 2008, for instance, via a decline in the total wage bill paid by the sector.

Against this backdrop, Swiss GDP growth is likely to settle at around 2% in 2008. This easing-off should allow for a reduction in the level of capacity utilisation. In a moment I will outline the risks attached to our baseline scenario.

Developments in monetary and financial conditions

Since the onset of the sub-prime credit crisis in August, yields on long-term Swiss Confederation bonds have remained almost unchanged. For 10-year maturities, the rate has fluctuated around 3%. For shorter maturity bonds, however, the search for quality investments has resulted in a drop in rates. Yields on two-year maturities, for instance, have fallen from 3.0% to 2.0%. However, this decline has been partly offset or even fully neutralised by an increase in risk premiums, in particular in the case of issuers with poor ratings. Since September, the depreciation in the US dollar has accelerated. The Swiss franc has also strengthened a little against the euro, although the movements were more volatile in nature.

Monetary and financial conditions can also be analysed in terms of volumes. Special attention should be given to commercial lending, since a shortage of credit in the current circumstances would be equivalent to a tightening in monetary conditions. However, no effect of this kind can be identified in Switzerland, not even in the most recent statistics. On the contrary, trends that have been observed over a period of several years continue to hold. The gradual slowdown in the growth of mortgage loans, whose rate of increase is now below 4%, is persisting. The growth in other lending is still picking up pace, confirming the momentum of the business cycle. These loans are now growing at a rate of 16%, which is faster than in the boom period of 1999 and 2000. At this rate, the level attained during that previous boom will soon be reached again.

The behaviour of the monetary aggregates might appear to contradict movements in lending. However, we should not forget that money is a long-term indicator, while the other credits are an indicator that moves in line with the business cycle. In response to past increases in interest rates, a transfer from sight deposits and savings deposits to higher-yield term deposits is underway. Consequently, the M1 and M2 monetary aggregates, which do not include term deposits, are declining. M3, which incorporates all types of deposits, is registering very moderate growth compatible with more stable inflation in the medium and long term.

Risks associated with the inflation outlook

As usual, our assessment of the inflation outlook is embedded in the baseline scenario that we consider the most probable future development. However, the uncertainties associated with the scenario are greater than usual. This is due to a convergence of various trends with differing effects on the economy.

First of all, there are a number of events that could slow down the economy, thereby moderating inflation. A deterioration in the international growth outlook associated with a widening of the impact of the crisis in the US real estate market should be placed in this first category. If the resulting slowdown in the growth of the Swiss economy remains moderate, this would reinforce price stability. However, a substantial slowdown would necessitate a change of direction for us.

Next, there are some developments that could simultaneously slow the economy and threaten price stability. An example of this, if it were to prove persistent, is the rise in oil prices. In this respect, monetary policy finds itself in a dilemma and care needs to be taken in order to prevent prices from spiralling out of control.

Finally, there are developments that could stimulate economic activity – which is already at a high level – as well as exacerbating inflationary risks. In this category we should mention a possible continued weakening in the Swiss franc. To date, the depreciation of the currency has mainly stimulated the economy without pushing up prices. Negative effects on inflation have been limited due to productivity gains, the opening up of the labour market and the appearance of new international competitors.

The concurrence of these contradictory risk factors makes a global evaluation difficult and encourages the adoption of a prudent and watchful attitude.

Monetary policy decision

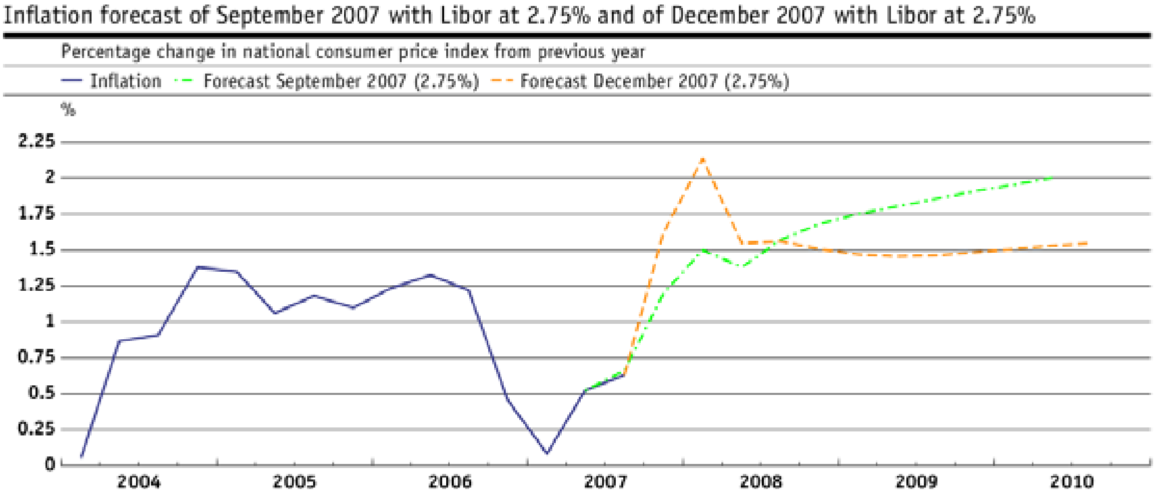
We have decided to leave the current Libor target range unchanged and to continue aiming for the middle of the range. This decision is based on the following considerations. Our analyses show that, following the slowdown in the global economy, the outlook for inflation has improved, if we disregard the temporary rise that will occur over the next few months as a result of the rise in oil prices. Moreover, the turmoil affecting the international financial markets and the uncertainty with respect to the extent of possible fall-out on the rest of the economy all call for prudence. The risk of a rise in inflation has not been dispelled; of that there can be no doubt, given the rise in oil prices, the weakness of the Swiss franc against the euro, and the high level of capacity utilisation. Nevertheless, we do not consider this to be a matter of urgency and view an adjustment in our policy as unnecessary under the current circumstances. It is evident that we will continue to keep a very close watch on developments in the situation.

Inflation forecast graph

I will now turn to the final part of my remarks. What is our inflation forecast? The dashed red curve on the graph represents the new forecast. It relates to the period between the fourth quarter of 2007 and the third quarter of 2010, and maps the future development of inflation on the assumption that the 2.75% level remains constant over the forecasting period. For purposes of comparison, the dash-dotted green curve shows the inflation forecast of the September monetary assessment, which was also based on a three-month Libor of 2.75%.

The new forecast indicates that inflation will rise in the first half of 2008. It is likely that it will breach even the 2% level. However, this increase will be temporary and will be chiefly due to the rise in oil prices. After that time, inflation will settle at around 1.5%, with a slight upward trend at the end of the period. The slowdown in the international economy explains the downward revision in the inflation outlook for 2009 and 2010.

Naturally, any forecast is uncertain, and at present both upside and downside risks are greater than usual. Consequently, we will continue to keep a close watch on developments in the financial markets, the international economy, oil prices and the Swiss franc exchange rate, in order to assess their impact on the inflation outlook and to be in a position to react swiftly should the need arise.



Observed inflation December 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	1.22	0.46	0.09	0.52	0.63	

Inflation forecast of September 2007 with Libor at 2.75% and of December 2007 with Libor at 2.75%

	2007				2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast September 2007, Libor at 2.75%			0.66	1.20	1.50	1.38	1.57	1.69	1.75	1.80	1.85	1.91	1.96	2.00		
Forecast December 2007, Libor at 2.75%				1.62	2.14	1.54	1.56	1.51	1.47	1.46	1.46	1.48	1.51	1.53	1.55	