Philipp Hildebrand: Economic situation and monetary conditions in Switzerland

Introductory remarks by Mr Philipp Hildebrand, Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Geneva, 17 June 2010.

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The Swiss National Bank (SNB) is maintaining its expansionary monetary policy. Consequently, it is leaving the target range for the three-month Libor unchanged at 0.00–0.75% and intends to hold the Libor in the lower part of the target range, at around 0.25%.

The recovery of the global economy continues and the Swiss economy is benefiting from it. Although the weakening of the euro with respect to the Swiss franc is dampening export activity, this activity is being supported by growth in foreign demand. The domestic sector is still performing favourably. For 2010, the SNB is now expecting real GDP growth of about 2.0%. In view of these pleasing developments, the deflationary risk in Switzerland has largely disappeared.

At the same time, uncertainty has increased since the last monetary policy assessment. The latest tensions on the financial markets, particularly with regard to the public finances of some individual countries, have increased the downside risks. Should these downside risks materialise and, via an appreciation of the Swiss franc, lead to a renewed threat of deflation, the SNB would take all the measures necessary to ensure price stability.

The SNB's conditional inflation forecast for 2010 and 2011 has increased slightly since March. It remains unchanged for 2012. Assuming an unchanged three-month Libor of 0.25%, average inflation for 2010 is expected to amount to 0.9%, for 2011 to 1.0% and for 2012 to 2.2%. This forecast shows that short-term price stability is guaranteed. It also shows that the current expansionary monetary policy cannot be maintained over the entire forecast horizon without compromising medium and long-term price stability. The forecast is still associated with very considerable uncertainties.

Global economic outlook

I would now like to take a closer look at the economic situation and at monetary conditions.

The upturn in the global economy continues, supported by economic policies which remain very accommodating. The emerging economies, in particular, are recording high GDP growth rates. The US has seen a further recovery of domestic demand and the labour market. In Europe, restrained expenditure on the part of households and companies means that economic activity remains subdued. However, positive movements in new orders and the indices for European manufacturing suggest stronger economic growth.

Global growth forecasts for 2010 and 2011 have been revised upwards. The smallest revision was that for the European economy. On the one hand, more restrictive fiscal policies are likely to hold back growth in Europe. On the other hand, however, growth is supported by the depreciation of the euro and low capital market interest rates in the major EU economies.

However, further developments are associated with considerable uncertainties. The biggest risk for the global economy is the continued increase in tension on financial markets, particularly due to the public finances of some individual countries. This could affect the real economy via a loss of confidence on the part of households and companies as well as through an additional burden on banks. At the same time, there are upside risks for the global economy. Domestic demand in the emerging economies and the US could, once again, prove surprisingly robust. In Europe, export activity could increase more strongly than expected.

Swiss economic outlook

In Switzerland, the economic recovery has continued. In the first quarter of 2010, real GDP rose by 1.6% on an annualised basis, and was 2.2% above the year-back quarter. Economic activity was mainly driven by household demand and exports of goods and services.

The firming of the economic recovery led to a renewed rise in the demand for labour, and short-time work fell significantly. Since the beginning of the year, seasonally adjusted unemployment has also fallen slightly. Leading indicators for labour demand are pointing upwards. The SNB anticipates a gradual improvement in the labour market. Despite the uncertainties in connection with public finances in many countries, global economic activity is still having a supportive effect. Consequently, capacity in the export sector is likely to be increasingly better utilised. Consumption and construction investment will be supported by the improved labour market outlook and the expansionary monetary policy.

The SNB expects real GDP to increase by approximately 2% for 2010 as a whole.

Monetary and financial conditions

The expansionary monetary policy is reflected in monetary conditions. Since last November, the three-month Libor had been held at the desired level of 0.25%. However, from mid-May it began sinking rapidly and is currently well below that level. The fall in the rate is a sign that the banking system is currently holding a very large amount of liquidity. My colleague, Jean-Pierre Danthine, will talk about this in greater detail.

Interest rates on the capital market have also fallen. In June, yields on 10-year Swiss Confederation bonds fell to a record level. The low capital market interest rates reflect a higher demand for Swiss government bonds. In addition, long-term inflation expectations continue to be firmly anchored.

Private companies are also benefiting from low interest rates on capital markets. Credit risk premia have fallen further and rates of interest on bank loans are also at a very low level.

Since the last monetary policy assessment, the Swiss franc has appreciated against the euro. It has simultaneously depreciated against the US dollar. As a result, the trade-weighted external value of the Swiss franc has only slightly increased.

The expansionary monetary policy is also reflected in the monetary aggregates. Thus, the monetary base rose to a record CHF 128.6 billion in May, and growth of the monetary aggregates is continuing at a high level. For example, M2 was growing at 10.2% in May and M3 at 7.1%. Credit growth also increased further. After slowing to 2.7% in September 2009, the rate of growth increased to 4.1% in April. This acceleration is attributable to loans not secured by mortgages, which have been growing since April. Mortgage loans grew at a rate of over 5% in April.

There are still no signs of any credit crunch in the survey on bank lending conditions conducted regularly by the SNB. The survey even provides initial indications of a possible trend reversal. During the financial crisis, a number of banks had reported a slight tightening in their loan conditions. However, in the first quarter of 2010, a few banks (for the first time) reported an easing.

We continue to observe a considerable increase in loan volumes for residential mortgages. This increase, along with movements in real estate prices, represents a risk that demands the full attention of the SNB. My colleague, Thomas Jordan, will discuss this topic in greater depth.

Development of the SNB's balance sheet as a consequence of monetary policy

In my following remarks, let me focus on the extraordinary development of the SNB's balance sheet. As is the case at other central banks, the balance sheet has undergone a considerable expansion and change in its composition since the beginning of the financial crisis. By May 2010, it had nearly tripled in size to over CHF 300 billion.

This extraordinary development in the balance sheet is a direct consequence of monetary policy. The SNB had lowered interest rates sharply during the financial crisis, but by the spring of 2009, the traditional interest rate instrument was practically exhausted. Consequently – with an incipient threat of deflation – the SNB adopted unconventional measures to loosen the monetary conditions further. By carrying out long-term repo transactions and foreign exchange swaps, acquiring Swiss franc bonds issued by private sector borrowers and purchasing foreign currency, the banking system was supplied with large amounts of liquidity. In the past few months, foreign exchange purchases, in particular, have been an effective instrument for averting deflationary risks. While the liquidity created by purchasing foreign exchange and Swiss franc bonds is of a permanent nature, liquidity resulting from repos and currency swaps is temporary. It flows back automatically when transactions are not renewed. This has occurred to a large extent in the meantime.

The considerable expansion in the SNB's balance sheet is therefore primarily attributable to the increase in foreign exchange reserves. These have more than quadrupled to just over CHF 230 billion as a result of the interventions since the beginning of the financial crisis. From today, the SNB will also be publishing information on current foreign exchange reserves on its website (www.snb.ch) at the beginning of each month.

The high level of foreign exchange reserves will inevitably increase currency risk and mean that debtors are concentrated in a few major countries. These risks ultimately represent the burden the SNB has assumed in order to protect the Swiss economy from the threat of deflation, in line with its mandate. Balance sheet risks have risen overall. The SNB is now reaping the benefits of having continuously increased its allocation to provisions in previous years. This gave it the room for manoeuvre it needed for measures in times of crisis. The higher allocation to provisions decided on recently has further strengthened the SNB's capital base. The SNB has sufficient equity capital to withstand even large losses.

In the long term, a large part of the liquidity that has been created is excess liquidity. As my colleague, Jean-Pierre Danthine, will explain, the SNB has the necessary instruments at its disposal to withdraw this liquidity.

Inflation forecast chart

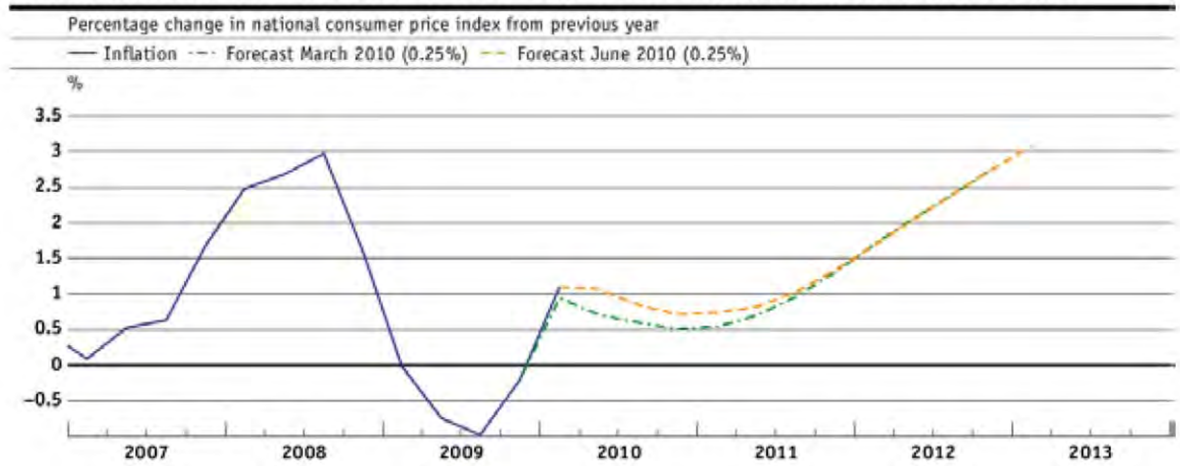
I would now like to comment on the new, conditional inflation forecast in more detail.

The (dashed) red curve on the chart represents the new, conditional inflation forecast. It covers the period from the second quarter of 2010 to the first quarter of 2013 and shows the future inflation development on the assumption of the three-month Libor remaining constant at 0.25% over the entire forecasting horizon. For purposes of comparison, the (dash-dotted) green curve shows the inflation outlook published in March, which was also based on the assumption of a three-month Libor of 0.25%.

The new forecast shows unchanged inflation prospects. However, new data have led to a slight upward revision in the inflation forecast in the short term, so that inflation arrives at nearly 1% in the second quarter of 2010. Since the oil price in the first half of 2009 was lower than in 2010, this level is due to a base effect attributable to oil prices. Thereafter, inflation is projected to remain below 1% until the second quarter of 2011. On the one hand, the base effect attributable to oil prices weakens. On the other hand, production remains below its potential. The forecast shows that – should the Libor remain at the level targeted today – inflation accelerates from the third quarter of 2011 onwards. At 2.2%, the inflation forecast for

2012 is the same as in the March forecast. The forecast shows that the current expansionary monetary policy cannot be maintained over the entire forecast horizon without compromising medium and long-term price stability. The forecast is still associated with very considerable uncertainties.

Conditional inflation forecast of March 2010 with Libor at 0.25% and of June 2010 with Libor at 0.25%



Observed inflation June 2010

	2007				2008				2009				2010				2007	2008	2009
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Inflation	0.09	0.52	0.63	1.68	2.47	2.68	2.97	1.58	-0.02	-0.75	-0.97	-0.20	1.10				0.7	1.3	1.9

Conditional inflation forecast of March 2010 with Libor at 0.25% and of June 2010 with Libor at 0.25%

	2010				2011				2012				2013				2010	2011	2012
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Forecast March 2010, Libor at 0.25%	0.95	0.71	0.60	0.52	0.55	0.70	0.96	1.30	1.70	2.07	2.39	2.75					0.7	0.9	2.2
Forecast June 2010, Libor at 0.25%		1.06	0.85	0.71	0.74	0.81	1.02	1.33	1.69	2.04	2.40	2.76	3.07				0.9	1.0	2.2