Philipp Hildebrand: Global and Swiss economic outlook

Introductory remarks by Mr Philipp Hildebrand, Chairman of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 16 December 2010.

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

The global economic recovery is continuing. While the growth dynamic in emerging economies is vigorous, the recovery in the industrialised economies remains modest overall. Growth in Switzerland was robust in the third quarter of 2010, but the weakening of exports, in particular, points to a significant reduction in growth in the quarters ahead. The SNB expects GDP to grow by some 1.5% in 2011, following growth of about 2.5% in the current year.

Monetary policy operates in an environment of heightened uncertainty. Concerns about stability in the euro area have led to renewed financial market tensions. Against this backdrop, the Swiss franc has again appreciated. Should these tensions be exacerbated and put a strain on economic developments in the euro area, this would also have a detrimental effect on the Swiss economy. If a deflation threat emerges, the SNB would take the measures necessary to ensure price stability.

The SNB's conditional inflation forecast for 2012 and 2013 is slightly below the September forecast. This correction is the result, in particular, of the less favourable economic outlook for Europe compared with the last assessment. For 2011 it is marginally higher, due mainly to a higher price for oil. Assuming an unchanged three-month Libor of 0.25%, average inflation for 2010 is expected to amount to 0.7%, for 2011 to 0.4% and for 2012 to 1.0%. The conditional inflation forecast shows that there is no threat to price stability in the short term. However, the rising path in 2012 and 2013 shows that the current expansionary monetary policy cannot be maintained over the entire forecast horizon without compromising long-term price stability. The inflation forecast is still associated with a very high level of uncertainty.

Global economic outlook

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

Overall, the recovery in the global economy continued, encouraged by expansionary economic policies and vigorous economic activity in the emerging economies. In the euro area, however, growth slowed markedly in the third quarter. The favourable developments in Germany's economy differ from those in the peripheral countries of the euro area, with their weak growth. The recent financial market turmoil is likely to hamper activity in the euro area. Although domestic demand is gradually firming up in the US, the momentum is insufficient for a sustainable reduction in unemployment, which remains high. In addition, construction investment is suffering from the situation on the real estate market. Consequently, GDP growth in the US will remain modest. The vigorous economic momentum in the emerging economies is likely to provide positive stimulus for global growth in the future.

The SNB has made slight downward revisions to its growth forecasts for the global economy, mainly for Europe in 2011 and 2012. Uncertainty with regard to global economic developments remains very considerable and the risks are still to the downside.

Swiss economic outlook

Growth of the Swiss economy remained robust in the third quarter. Consequently, utilisation of production factors increased. Technical capacity utilisation has returned to a normal level in manufacturing, while in the construction industry it is in fact considerably higher than the long-term average. Employment also increased moderately and unemployment declined further. However, the indications of a significant slowdown in growth increased. Goods exports stagnated from June to October, mainly due to weaker demand from Europe. Exports of services declined most recently.

Inflation, as measured by the national consumer price index, fell to 0.2% in November. The decrease over recent months is mainly attributable to the fall in the prices of imported consumer goods. Accordingly, the core inflation indices calculated by the SNB were somewhat higher, and have remained steady since the last monetary policy assessment.

For the coming months, the SNB expects economic growth to continue. However, it is likely to be significantly lower in the quarters ahead – a development attributable to both the generally subdued economic activity in the industrialised countries and the appreciation of the Swiss franc. Consequently, the SNB expects GDP to grow by some 1.5% in 2011, following growth of about 2.5% in the current year.

Monetary and financial conditions

Monetary and financial conditions in Switzerland are shaped by the expansionary monetary policy. Since mid-September, the three-month Libor has remained fairly constant within the lower part of the target range. Yields on high-quality Swiss bonds remain at a low level, despite the latest increase. This also applies to long-term real interest rates, which are ultimately decisive in investment and consumption decisions. Historically low interest rates for corporate loans and mortgages also create conditions which stimulate domestic final demand.

Concerns about stability in the euro area have led to renewed financial market tensions. Against this background, the Swiss franc has again appreciated. As shown in the survey carried out by the delegates of the SNB regional contact network and published next week in the *Quarterly Bulletin,* business activities of numerous companies are hampered by this development. An aggravation of the crisis in the euro area would inevitably have further negative consequences for the Swiss economy.

As my colleague, Jean-Pierre Danthine, will outline in more detail later, liquidity-absorbing operations have continued since the monetary policy assessment of September 2010. As a result, bank sight deposits with the SNB have fallen further. Nevertheless, the monetary base is still significantly higher than its level prior to the financial crisis. The broader monetary aggregates have continued to expand strongly since the last assessment, and pose a potential threat to long-term price stability.

In view of the expansionary monetary conditions, lending business remained brisk. According to the SNB survey on bank lending, banks maintained their lending standards for companies and households in the third quarter of 2010. Several banks reported that household demand for mortgages increased again. This is reflected in the continued high growth rate of mortgage volume. Moreover, real estate prices continue to rise. The situation on the mortgage and real estate markets still requires the full attention of the SNB.

Impact of foreign exchange market interventions on the SNB balance sheet

Since the beginning of the financial crisis, the SNB balance sheet has lengthened considerably and its composition has changed, in particular due to the SNB's foreign exchange market interventions. Since the beginning of 2010, the balance sheet total has increased from CHF 207 billion to some CHF 280 billion. Moreover, the significant appreciation in the Swiss franc has resulted in considerable exchange rate losses on the SNB's foreign currency investments. My colleague, Thomas Jordan, will take a closer look at the risks for the SNB associated with the lengthening of the balance sheet.

After the beginning of the financial crisis, the SNB lowered money market interest rates to virtually zero. Despite these decisive reductions in interest rates, the Swiss economy faced the threat of deflation from March 2009 onwards. This required the SNB, as part of its mandate, to undertake a further monetary policy easing. In view of the limited size of the domestic capital market compared to other countries, foreign currency purchases seemed the most appropriate course of action for Switzerland. This allowed for the absorption of extreme exchange rate developments, which could have triggered a deflationary dynamic. In absorbing the upward pressure on the Swiss franc, the SNB may have taken on a higher balance sheet risk, however, in doing so, it countered the risk of a deflationary trend.

Although the Swiss franc has appreciated sharply since the beginning of the year, the deflation threat has declined as the economic recovery has strengthened. The appreciation of the Swiss franc has impaired the competitive position of Swiss exporters. However, the negative impact on export demand has been reduced by robust economic growth in the economies importing Switzerland's goods and services.

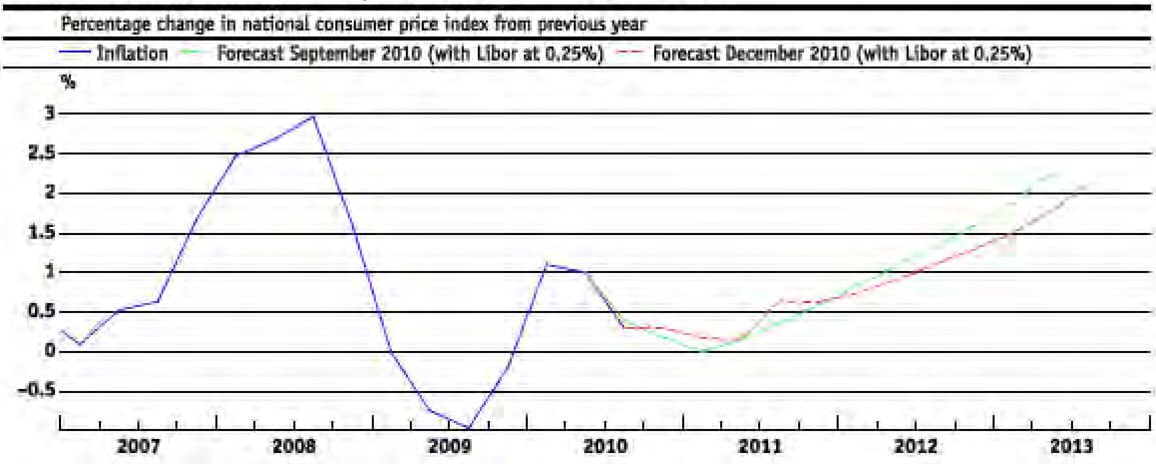
Chart of conditional inflation forecast

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 shows the future path of inflation, assuming that the three-month Libor remains constant at 0.25% over the entire forecast horizon, and it covers the period from the fourth quarter of 2010 to the third quarter of 2013. For purposes of comparison, the (dash-dotted) green curve shows the inflation forecast published in September, which was also based on the assumption of a three-month Libor of 0.25%.

The new conditional forecast shows that inflation remains low for 2011 and 2012. The forecast for the next few quarters is revised because new data has been taken into account. The new forecast for 2011 is slightly above that published in September because the oil price has increased. The increase in inflation in the third quarter of 2011 is attributable to a base effect, because inflation in the third quarter of 2010 was comparatively low. Compared to the forecast published in September, inflation in 2012 and 2013 rises less steeply, particularly due to the fact that the economic outlook for Europe is less favourable than in the previous quarter. Towards the end of the forecast horizon, inflation rises briskly and exceeds the upper bound of 2%, assuming that the three-month Libor remains at the current level. This shows that the current expansionary monetary policy cannot be pursued for the entire forecast horizon without compromising long-term price stability. Due to the risks mentioned previously, this forecast is associated with a very high level of uncertainty.

Conditional inflation forecast of September 2010 and of December 2010



Observed inflation December 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	1.00	0.30		0.7	2.4	-0.5

Conditional inflation forecast of September 2010 with Libor at 0.25% and of December 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 September 2010, Libor at 0.25%			0.40	0.18	0.00	0.15	0.36	0.59	0.84	1.08	1.33	1.60	1.89	2.25			0.7	0.3	1.2
Forecast December 2010, Libor at 0.25%				0.30	0.17	0.15	0.64	0.63	0.74	0.91	1.11	1.30	1.50	1.78	2.14		0.7	0.4	1.0