

Thomas Jordan: The Swiss economy and global economic outlook

Introductory remarks by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Media News Conference of the Swiss National Bank, Berne, 14 June 2012.

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The Swiss National Bank (SNB) will maintain the minimum exchange rate of CHF 1.20 per euro and will enforce it with the utmost determination. It remains prepared to buy foreign currency in unlimited quantities for this purpose. Even at the current rate, the Swiss franc is still high. Another appreciation would have a serious impact on both prices and the economy in Switzerland. The SNB will not tolerate this. If necessary, it stands ready to take further measures at any time.

The target range for the three-month Libor remains at 0.00–0.25%. Essentially, the SNB's conditional inflation forecast is unchanged from its March forecast. It is based on a three-month Libor of 0.0% and continues to assume that the Swiss franc will weaken over the forecast horizon. For 2012, the forecast shows an inflation rate of –0.5%. For 2013, the SNB is expecting inflation of 0.3% and for 2014, of 0.6%. Consequently, in the foreseeable future, there is no risk of inflation in Switzerland.

The SNB expects that the global economy will only recover slowly. While the emerging economies make a major contribution to global growth, momentum in the advanced economies will remain subdued. In Europe, in particular, economic activity will be extremely weak on account of the financial and debt crisis. Switzerland will experience a significant economic slowdown over the rest of the year. Only because of the unexpectedly strong winter half-year does the SNB now expect growth of around 1.5% for 2012.

The risks for the Swiss economic situation remain exceptionally high. The uncertainty about future developments in the euro area has again risen. If global activity proves disappointing or the turmoil on the financial markets increases, downside risks will again emerge for the economy and price stability in Switzerland. The imbalances in the Swiss residential mortgage and real estate markets increased further last quarter. Consequently, the SNB welcomes the Federal Council decision to make available a countercyclical capital buffer which can counter adverse developments on the domestic credit market.

Global economic outlook

Let us examine the economic outlook and the inflation prospects in a little more detail. In the first quarter of 2012, the global economy continued to grow at a moderate pace although this varied considerably from one region to another. The emerging economies were still making a major contribution to global growth. By contrast, overall momentum in the advanced economies was subdued, although here, too, differences from one country to another were considerable. Japan experienced strong growth in the first quarter due to a catch-up effect. In the US, momentum was moderate. In the euro area, a number of countries are in deep recession, while in Germany, GDP continued to expand strongly. Overall, the economy in the euro area stagnated.

As in the last monetary policy assessment, we assume that the global economy will continue to recover slowly. This will be driven by globally expansionary monetary policy and strong domestic demand in the emerging economies. In the euro area and the US, developments are likely to be more subdued. Here we assume that the European financial and sovereign debt crisis will gradually ease. However, risks in this respect remain high. In particular, the difficult situation in Greece and Spain has already led to a significant deterioration in the

confidence of households and companies in the euro area. As a result, the economic situation remains vulnerable.

These high risks are also affecting the financial markets. Following a temporary recovery at the beginning of the year, the situation on the financial markets at present is again tense. A substantial correction has taken place on the share markets. By contrast, investments perceived to be safe, such as US, German or UK government bonds, recorded all-time low yields and correspondingly high price gains. Real yields on these investments are in negative territory for most maturities, measured in terms of inflation expectations. In addition, interest rates on money markets are at record-low levels worldwide.

Swiss economic outlook

In Switzerland, real GDP rose faster than expected in the first quarter. The stabilising effect of the minimum exchange rate against the euro played a major role in this development, with goods exports declining only slightly in the first quarter, in an international environment that remained weak, while exports of services rose. An improvement in consumer confidence encouraged a substantial increase in private consumer spending. However, GDP growth was also supported by temporary effects. Value added in the banking industry benefited from the optimistic mood on the financial markets during the first months of the year. In manufacturing and the hospitality industry, however, activity declined, underscoring the particularly negative impact of the strong Swiss franc on these industries.

For the second quarter, we expect a significant slowdown in GDP growth. Since the global economy is expected to recover slowly, and the value of the Swiss franc is still high, the demand for exports is likely to remain subdued, even in the subsequent period. The high level of uncertainty and the pressure on profit margins are impacting negatively on corporate investment. Only because of the unexpectedly strong winter half-year does the SNB now expect growth of around 1.5% for 2012.

Swiss inflation outlook

The inflation outlook for Switzerland has remained largely unchanged from the monetary policy assessment in March. Since the fourth quarter of 2011, the annual inflation rate has been in negative territory. This is mainly attributable to a base effect, because last quarter the price level remained almost unchanged from the previous quarter. Thus the minimum exchange rate has put a halt to the deflationary situation that had arisen as a result of the strong appreciation of the Swiss franc last summer. Surveys on inflation expectations confirm that deflation is not expected at present. As the surveys also show, there continues to be no danger of inflation. This corresponds to our conditional inflation forecast which reaches 0.8% at the end of the three-year forecast horizon. Overall, the path of inflation is again more subdued than in the March forecast, due to the fact that the Swiss franc is weakening less rapidly than was forecast at that time.

Monetary and financial conditions

Let us now turn to monetary and financial conditions. These are virtually unchanged from the first quarter of 2012. After the March monetary policy assessment, the euro remained more or less stable against the major currencies. Since the beginning of May, it has weakened by around 5% against the US dollar. As a result, the Swiss franc has depreciated slightly in export-weighted terms, even if the exchange rate has remained unchanged with regard to the euro.

Interest rates in the Swiss franc money market continue to fluctuate around zero. In the past quarter, the Libor persisted at a very low level, at around 10 basis points. For the foreseeable

future, interest rate expectations remain exceptionally low, and levels of interest rates on futures – derived from Libor futures contracts – are in fact, in some cases, substantially below zero.

Yields on bonds with high credit ratings are also very low in Switzerland. At the beginning of June, ten-year Confederation bonds attained a new all-time low, at around 0.5%. Thirty-year bonds were trading in the market at yields of under 1%. For short to medium-term maturities, yields were in negative territory, in some cases very negative.

The low interest rates continue to be reflected in robust growth in lending and rising real estate prices. As a result, the imbalances on the Swiss residential mortgage and real estate markets have increased further. Following my presentation, my colleague Jean-Pierre Danthine will take a closer look at the risks for financial stability in connection with the mortgage and real estate markets.

SNB monetary policy

Let us now return to the SNB's monetary policy. The debt problems in some euro area countries have deteriorated seriously over the recent period. Accordingly, the euro has lost value against most countries since May. This has led to increased upward pressure on the EUR/CHF exchange rate. Even in this difficult environment, we have consistently enforced the minimum exchange rate of CHF 1.20 per euro.

To defend the minimum exchange rate, we purchased foreign currency. This has led to a further expansion in Swiss franc liquidity and the SNB balance sheet. Even when the minimum exchange rate was first introduced, we drew attention to the fact that its enforcement could have significant consequences for our balance sheet. Another appreciation of the Swiss franc would constitute a very substantial threat to the Swiss economy and the risk of deflationary developments coming about. This is why it is necessary to accept an expansion of the balance sheet arising out of the enforcement of the minimum exchange rate. The SNB is in a position to bear the ensuing risks.

Even at a level of CHF 1.20 per euro, the Swiss franc is still high, presenting large parts of our economy with a difficult situation. Consequently, we will continue to enforce the minimum exchange rate with the utmost determination and will buy foreign currency in unlimited quantities for this purpose. If necessary, we stand ready to take further measures at any time.

Management of foreign currency investments

I will conclude today with a few comments about the management of our foreign currency investments. In the recent period, this topic has returned to the spotlight of public discussion. In particular, the possibility of establishing a sovereign wealth fund with the SNB's foreign currency holdings has given rise to discussion. In this respect, it is important, first of all, to point out that the SNB does not hold its foreign currency in the form of banknotes or bank deposits. The funds are invested in different investment categories and currencies. For a considerable period, the SNB has held not just the traditional instruments – government bonds of countries with high credit ratings – but also bonds issued by private sector borrowers and shares. Holdings of shares currently make up some 10% of foreign currency investments.

In order to diversify its investments further, in 2010, the SNB included additional currencies such as the Australian and Singapore dollars as well as the Swedish krona and Danish krone in its investment universe. Since the first quarter of 2012, the SNB has also been investing in the Korean won. Additional investment opportunities in the advanced and emerging economies are continually being evaluated, both for bonds and for shares, although this is subject to an adequate level of liquidity in the markets in question.

The idea of a sovereign wealth fund may appear attractive at first glance. However, in the current situation, it does little to assist Switzerland or Swiss monetary policy. The sovereign wealth funds in Norway and the oil states cannot serve as models for the management of the SNB's currency reserves. All of them invest state income surplus derived from commodity exports. A Swiss sovereign wealth fund funded from SNB foreign exchange, by contrast, would be financed through money creation.

From our point of view, the three following points, in particular, speak against a sovereign wealth fund. First, the creation of such a fund would not help to enforce the minimum exchange rate. The only decisive factor is the SNB's willingness to buy foreign currency in unlimited quantities against Swiss francs. Second, all investments abroad are subject to an exchange rate risk, whether they be government bonds, shares, real estate, commodities or investments in infrastructure, and irrespective of whether they appear on the SNB balance sheet or on that of a separate sovereign wealth fund. Consequently, outsourcing the foreign currency investments would not reduce Switzerland's exchange rate risk. Third, outsourcing the foreign exchange to a sovereign wealth fund would call into question the independence of monetary policy and the SNB, as well as the freedom of action for monetary policy. The size and composition of the SNB's balance sheet are a reflection of monetary policy. The SNB must also be in a position to dispose of the assets it has purchased and determine the composition of its balance sheet as required. Only in this way can it conduct an independent and target-oriented monetary policy.