Jean-Pierre Roth: Review of the Swiss economy

Introductory remarks by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Geneva, 14 June 2002

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The National Bank has decided to leave the target range for the three-month Libor rate unchanged at 0.75% - 1.75%. For the time being, the three-month Libor is to be kept in the middle of the target range. Since the last assessment of 21 March 2002, the National Bank has again adjusted its monetary policy. On 2 May 2002, we lowered the target range for the three-month Libor by 0.5 percentage points to the current level. Some time earlier, on 27 March 2002, we had already lowered repo rates by approximately 10 basis points, which led to a corresponding change in the three-month Libor. In both cases, we acted in response to the appreciation of the Swiss franc, which had led to an undesirable tightening of monetary conditions. Since March 2001, the National Bank has eased its monetary policy substantially, lowering the target range for the three-month Libor by a total of 2.25 percentage points. After the cyclical downturn in the second half of last year, there are now signs that the world economy is starting to pick up, which will also benefit economic activity in Switzerland. However, uncertainties regarding the upswing in Switzerland persist. For the time being, the National Bank will thus maintain its expansive monetary policy stance. This does not jeopardise price stability. Assuming that the three-month Libor rate will remain stable at 1.25%, average annual inflation is expected to hover between 0.9% and 1.6% in the next three years. For 2002, the National Bank still anticipates a growth rate of around 1%.

The difficult situation of the world economy has had a marked influence on the development of business activity in Switzerland in the past few months. Following a decline in the third quarter 2001, the economy stabilised in the fourth quarter, and in the first quarter 2002 gross domestic product again rose somewhat. Notably exports and capital spending were on the decline during this period, while private and government consumption as well as the construction industry exerted a stabilising influence. On the whole, the development in the past six months fulfilled our expectations.

We assume that the Swiss economy will grow extremely moderately and below its potential until mid-2002. Growth is likely to pick up perceptibly again only during the second half of 2002. Consumption will remain robust and strengthen economic activity. The actual upswing, however, should be triggered by higher exports and these, in turn, will depend on improved economic conditions worldwide. With a slight time lag, capital spending is also expected to grow markedly again. As already stated, we still believe that real economic activity should increase by around 1% in 2002. In 2003, growth should continue to approach its potential, thereby clearly exceeding this year's level. Unemployment is unlikely to rise much more, and the production gap should gradually disappear in the course of the coming year.

I shall now describe the development of inflation over the past few months and explain our new inflation forecast in more detail. The dotted green curve in the graph shows our inflation forecast of December 2001. At that time, we assumed that the three-month Libor rate would remain stable at 1.75% and accordingly expected a slight general rise in inflation to approximately 1.5% by the end of 2004. The fluctuations in inflation predicted for 2002 reflect basis effects. Last December's forecast was based on the assumption that the US economy and the European economy would stagnate until mid-2002 and would then gradually return to their potential growth path.

Our forecast of December 2001 slightly overestimated the development of inflation for the first quarter 2002 and at the same time slightly underestimated inflation for the second quarter 2002. The deviation from the forecasting path is due mainly to the development of oil prices and the changed time of collecting data on clearance sales prices for clothing and shoes. Year-on-year inflation, as measured by the national consumer price index, rose to 0.6% in the first quarter 2002 from 0.4% in the fourth quarter 2001. In April, inflation increased to 1.1%, while declining again in May to 0.6%. The distinct rise in April was largely due to yet again higher oil prices and higher prices for clothing and shoes. At 1.6%, the price pressure on domestic goods still clearly exceeds that on foreign goods.

The dashed red curve in the graph shows our latest inflation forecast, while the table contains the corresponding average annual inflation. Our new forecast rests on the assumption that after the surprisingly strong first quarter, growth in the US will be considerably weaker in the second quarter of this year. Subsequently, however, the US economy should gradually return to its potential growth path.

In Europe, the economy will stagnate until the middle of this year and should then again accelerate markedly. We expect that the dollar/euro rate will remain at about the current level and that the oil price will be around $25 per barrel.

On the assumption that the three-month Libor rate will remain stable at 1.25% during the next three years, inflation should average 0.9% in 2002, move up to 1.3% in 2003 and reach 1.6% in 2004. The forecast inflation will accelerate over time. Throughout the forecasting period, however, it will remain within the range of price stability. Until mid-2003, the forecast inflation will be considerably influenced by basis effects, which explains the various fluctuations. After that it will be largely determined by monetary policy effects.

Until the beginning of 2004, the new forecast is very similar to the forecast of December 2001. In the new forecast, however, inflation then rises rapidly and at the end of the forecasting period it is only barely within the range of price stability. This difference is primarily due to the even more expansionary monetary policy compared with last December. With the global economy improving and Swiss business activity picking up, an enduringly expansionary monetary policy will in time lead to higher inflation rates.

We consider the current level of the three-month Libor rate as appropriate for the time being to enable the economy to return to sustainable, inflation-free growth. Monetary policy decision-making is difficult under present circumstances. Given the strength of the Swiss franc we have very considerably relaxed monetary policy and cut interest rates much more than the European central bank. We are aware that our expansionary policy entails certain risks. Yet we believe that in view of the sluggish development of the Swiss economy and the strength of the Swiss franc we are conducting a reasonable policy. To adopt a more restrictive monetary policy would be premature at the present time and might jeopardise the still fragile economic recovery, notably in the export sector. We are also of the opinion that we still have sufficient leeway to counter any increased price pressures in good time and that price stability is currently not threatened.

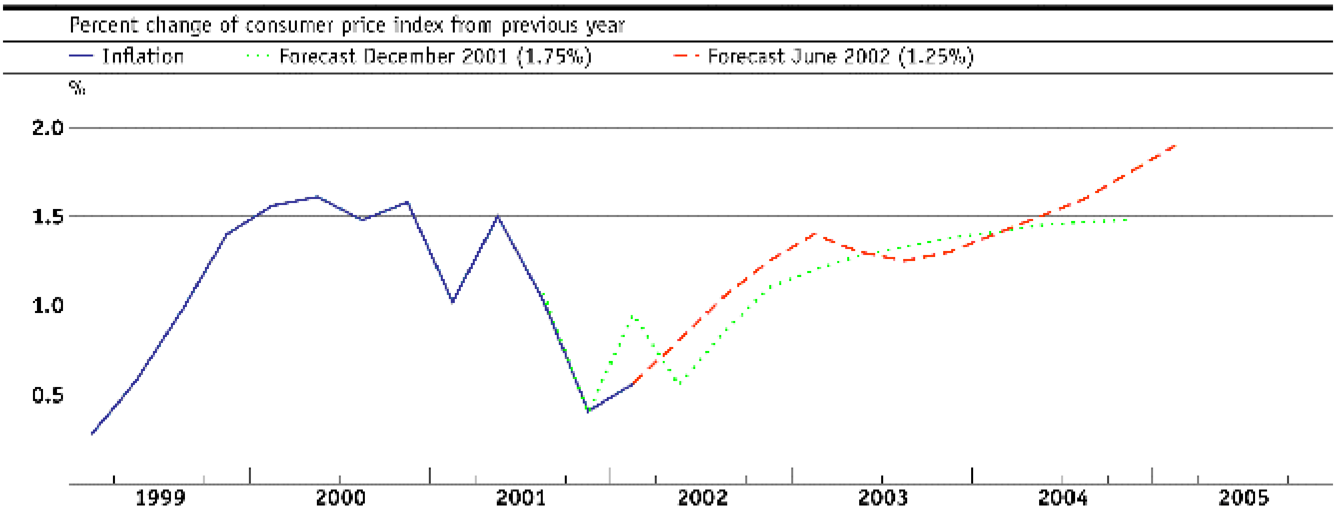
The National Bank must be ready and willing to react to changes in the world economy. At the moment, we see mainly two risks which might compel us to reassess the situation and to adjust our monetary policy course. For one thing, the economic recovery in Europe might be delayed somewhat. For another, the Swiss franc could again come under upward pressure. In both cases, the National Bank would react with adequate means.

To conclude my remarks, I would like to reiterate what role the exchange rate plays in our monetary-policy decision-making process. We live in a system with flexible exchange rates. Such a system is very advantageous for Switzerland, but once in a while exchange rate fluctuations have to be reckoned with. We are currently going through a period characterised by a strong Swiss franc. In the past, there have always been phases during which the Swiss franc tended to be very strong. Experience has also shown, though, that there have always been corrective phases as well.

It is the National Bank's responsibility to maintain price stability in the medium term, thus creating a favourable environment for the development of all sectors of the economy. For monetary policy, the exchange rate is an extremely important measure, as it influences the price level directly via import prices as well as indirectly via capacity utilisation in the export sector, and thus via economic growth. Particularly the last nine months exemplify the strong influence of the exchange rate on Switzerland's monetary policy. We always neutralised the tightening of monetary conditions, which was brought about by the appreciation of the Swiss franc, and rendered Swiss franc investments less attractive.

We are aware of the fact that these measures do not provide relief to all sectors of the economy at the same time or to the same extent. The present situation is difficult for the export industry and for parts of the tourism sector. We should not forget, however, that enterprises in the rest of Europe also have to contend with unfavourable conditions. High inflation or calls for massive pay rises, as seen in some countries, may cause production costs to surge. Switzerland as an industrial location remains attractive. Its advantages include low inflation, high social stability, performance-oriented and well-trained employees, trade unions with an awareness of economic correlations, a first-rate public infrastructure and administrative system and, last but not least, a low interest rate level and favourable financing possibilities in a first-class financial centre. The export industry's situation should improve rapidly once the global economy, and in particular the European economy, start to rebound. Experience has shown that the export industry always does everything in its power to further increase its productivity and to remain competitive internationally in the current exchange rate environment. Its efforts must be supported by a strengthening of domestic competition in Switzerland. The export industry will remain a key engine of growth in Switzerland and an essential basis of our prosperity.

Inflation Forecast December 2001 with Libor at 1.75% and June 2002 with Libor at 1.25%



The main ticks on the horizontal axis indicate the beginning of the first quarter of the respective year.
The value for each quarter is recorded in the middle of the quarter.

Inflation Forecast June 2002 with Libor at 1,25%	2001	2002	2003	2004
Annual average inflation in %	1.0	0.9	1.3	1.6