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 end-of-year media news conference, Zurich, 13 December 2002.

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The National Bank has decided to leave the target range for the three-month Libor rate unchanged at 0.25%–1.25%. For the time being, the three-month Libor is to be kept in the middle of the target range. Owing to the low level of inflation, we have been able to ease monetary policy substantially since March 2001, having since then lowered the target range for the three-month Libor by a total of 2.75 percentage points. We took decisive steps in response to declining economic growth and the upward trend of the Swiss franc. Interest rates were last lowered on 26 July of this year. The imponderables with respect to the development of the global economy remain considerable, and a sustained economic upswing in Switzerland is not likely until some time in the second half of 2003. We are therefore maintaining our expansionary monetary policy and shall keep the attractiveness of Swiss franc investments low. This does not jeopardise price stability. Assuming that the three-month Libor rate will remain stable at 0.75%, average annual inflation is expected to lie between 0.7% and 1.6% in the next three years. For 2003, we are anticipating economic growth of just over 1%, while zero growth is to be expected in the current year.

Economic activity

In Switzerland, economic activity has stabilised somewhat in the last two quarters despite the delay in the global economic upswing. After having been on a decline during four quarters, GDP slightly exceeded the previous period's level in the second and third quarters 2002. Positive stimuli emanated from the development of exports and from consumption.

Nevertheless, the economic situation in Switzerland remains tight. The deterioration on the labour market and the fall in stock market prices are depressing consumer sentiment and available income. Incoming orders and the order backlog in the export sector remain at an unsatisfactory level, a sign that the recovery in exports is still uncertain. Capacity utilisation in manufacturing and in construction continues to fall short of the desired level, while corporate investment activity is currently at a very low ebb.

The present growth slump in Switzerland can only be overcome if both exports and equipment investment increase consistently. We expect exports to grow markedly in line with the international economic upswing in the second half of 2003. Equipment investment should follow with a slight time lag. Until the middle of next year, however, the Swiss economy is likely to grow only very moderately. Until then, unemployment could therefore continue to rise. Private consumption, which has long been the mainstay of economic activity, will pick up only slowly next year. Real economic activity should increase by just over 1% in 2003, while for this year we expect zero growth.

Inflation forecast

I shall now turn to the course of inflation and our new inflation forecast. Our inflation forecast of June 2002 (the green dash-dotted curve in the graph) shows that at that time we assumed, based on a stable three-month Libor rate of 1.25%, that inflation would gradually rise to 1.9% in the first quarter 2005.

Year-on-year inflation, as measured by the national consumer price index, dropped to 0.3% in the third quarter 2002 from 0.7% in the second quarter. In October and November it rose to approximately 1%. These fluctuations are due mainly to changes in the exact points in time when data on clearance sales prices are collected. This is also the main reason why our forecast of June 2002 over-estimated the development of inflation in the third quarter 2002.

Our new inflation forecast (red dashed curve) is based on the assumption that growth in the US will pick up again from the second quarter 2003 onward. The US economy is likely to achieve its growth potential stepwise until the beginning of 2004. In the EU, the upswing will take a little longer. We are not expecting a significant acceleration of growth before the end of 2003. We assume 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 0.75% during the next three years, inflation should average 0.7% in 2003, move up to 0.9% in 2004 and reach 1.6% in 2005. Forecast inflation will remain below 1% until the end of 2004 except in the fourth quarter of 2002. In the course of 2005, however, a marked acceleration will set in, with forecast inflation reaching the 2% mark in the fourth quarter of 2005.

The new forecast is consistently below that of June 2002. It reflects the delay in the economic upswing. In the new forecast, inflation will rise more markedly at the end of the forecasting horizon due to an even more expansionary monetary policy since June.

Expansionary monetary policy to be continued

At our last media conference, I pointed out that the National Bank must be prepared to react quickly to changes in the economic situation. When the delay in economic recovery became discernible in summer, we acted immediately by again lowering interest rates. Since then, nothing of basic significance has changed in our assessment of the situation. We shall adhere to our expansionary monetary policy in the foreseeable future. We will thus contribute to the economic rebound and continue to keep Swiss franc investments unattractive. The low interest rate level and the relatively strong growth of monetary aggregates currently do not represent a threat to price stability. Once a sustained economic recovery becomes discernible, we shall have to review our monetary policy and adjust it to the new circumstances. There is still no sign, however, that the time for this is approaching. On the contrary, the risks still point downward. Should the recovery in the US and in Europe be delayed or should the Swiss franc appreciate markedly, the expected upswing in Switzerland would be threatened. In such a case, the National Bank is ready to react by appropriate means. Under present conditions, however, our monetary policy is sufficiently expansionary.

Currently, the risk of deflation is being widely discussed. As can be seen from our forecast, this risk is likely to be negligible in Switzerland in the medium term. Certainly, in the short term it is always possible for special effects, e.g. a marked reduction in the oil price, to lead to negative inflation rates in individual quarters. Nevertheless, we consider a continuously falling price level in conjunction with a strong decline in the demand for goods and in production improbable in the present circumstances. Our expansionary monetary policy and the flexibility of the Swiss economy would prevent such a development.

In the present situation, however, other efforts are needed besides an expansionary monetary policy in order to maintain or to enhance the attractiveness of Switzerland as an industrial and business centre. The efforts aimed at a further liberalisation of the domestic economy may not be abandoned. Sectors suffering from structural problems must improve their competitiveness by means of consistent adjustments.

Our experience with the monetary policy concept

Let me briefly describe the experience gained with our monetary policy concept. We introduced this concept exactly three years ago. You are acquainted with the main elements: definition of price stability, inflation forecast as main indicator and target range for the three-month Libor rate as operational target.

Overall, our experience with our monetary policy concept has been good. Recently, this experience was discussed at an internal conference. Since the new concept was adopted, we have widened the basis of our monetary policy decisions and further developed our analysis of indicators and models. The more extensive use of relevant information enabled us to react more swiftly and with more foresight than formerly to changes in the economic situation.

Our monetary policy concept met with a positive public reception in Switzerland. The same applies to the financial markets and international organisations such as the IMF and the OECD. The concept has vastly improved transparency. By publishing studies on internal decision-making processes and the forecasting models used, we have made further relevant information accessible. The public is thus in a better position to understand the reasoning behind monetary policy decisions.

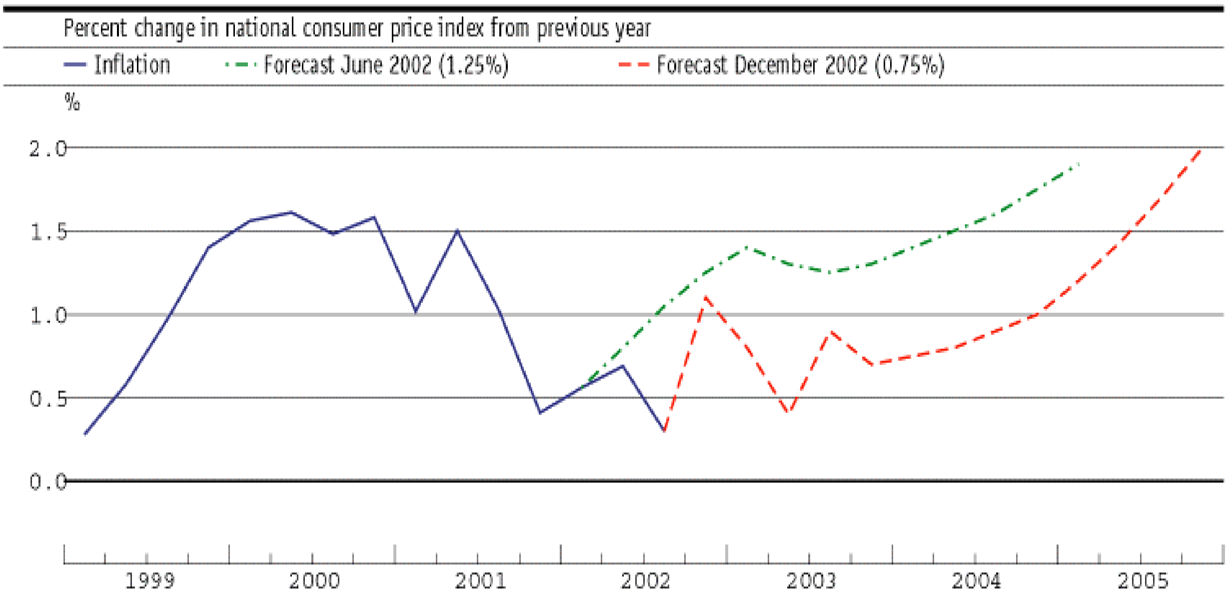
So far, we have published our inflation forecasts regularly in June and December. We should like to take this a step further and will in future publish an updated inflation forecast after every quarterly assessment of the situation. This will further help to improve transparency. From 2003 onwards, we will also inform the public of our monetary policy by publishing new inflation forecasts in March and September. As in the past, we shall present our June and December inflation forecasts at our media conferences. In March and September, the inflation forecast will be published within the context of the press release on the quarterly assessment of the situation.

Gold sales

On 22 September this year, the Swiss people and the cantons rejected both the gold initiative and the counter-proposal. The National Bank, however, continues to implement its programme for the sale of half of its gold reserves. For the time being, the surplus gold reserves will still figure in our balance sheet. To date, approximately 660 tonnes of a total of 1,300 tonnes of gold have been sold. We see no reason to change our strategy: these assets are surplus reserves which are no longer needed for monetary policy and which may be put to another use. In order to use the reserves for other purposes, the gold is sold and the proceeds are invested in securities.

We invest the proceeds from the gold sales in Swiss and foreign securities. The portfolio from the surplus reserves is thus less exposed to exchange rate fluctuations than the foreign exchange reserves. The earnings deriving from invested gold proceeds flow into the SNB's income statement and thus become available for profit distribution in favour of the Confederation and the cantons. As from 2003, annual profit distribution will amount to Sfr 2.5 billion. The profit distribution agreement concluded with the Confederation last April need not be revised. It already provides for an automatic revision of the situation in the event that the National Bank's earnings should permanently exceed the expected level.

Inflation forecast of June 2002 with Libor at 1.25% and of December 2002 with Libor at 0.75%



Inflation Forecast December 2002 with Libor at 0.75%	2002	2003	2004	2005
Annual average inflation in %	0.7	0.7	0.9	1.6