Jean-Pierre Roth: Recent financial and economic developments in Switzerland

Introductory remarks by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Berne, 13 June 2003.

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The National Bank has decided to leave the target range for the three-month Libor rate unchanged at 0.0%-0.75%. For the time being, the three-month Libor is to be kept at the lower end of the target range at 0.25%. In the past two years we took decisive steps in response to declining economic growth and to the upward trend of the Swiss franc. Owing to the low inflationary pressure we have narrowed the target corridor for the three-month Libor by a total of 3.25 percentage points since March 2001. Interest rates were last lowered on 6 March of this year. The recovery of the global economy is likely to be delayed still further so that in Switzerland, too, any perceptible economic upswing can only be expected to materialise during the course of 2004. 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 0.25%, average annual inflation is expected to amount to 0.6% this year, 0.4% next year, and 1.2% in 2005. For 2003 we anticipate real economic activity to stagnate overall.

Let me continue by saying a few words about the financial markets. After that, I will focus on the Swiss economy and our new inflation forecast. The last part of my remarks will concentrate on the latest adjustment to the ECB's monetary policy concept and the National Bank's profit distribution.

Financial markets

After the war in Iraq the financial markets reassessed the economic situation. The risks emanating from the international political situation lost significance, and the markets returned their focus on the fundamentals. The different markets have been giving off mixed signals.

On the one hand, yields on long-term bonds in the major currencies fell to their lowest level in years. This is a reflection of the fact that bond markets expect low inflation and subdued economic movement for an extended period. Equity markets, on the other hand, recovered somewhat in the second quarter. Risk premiums on corporate bonds went down as well. This is a sign that some market participants are quite confident that corporations will make a stronger showing.

Exchange rates underwent a revaluation too. The marked decline of the US dollar against the euro can partly be interpreted as a normalisation after the previous exaggerations, and partly be attributed to the widening disequilibrium in the balance of payments and in the US budget. Moreover, given the extremely low US dollar interest rates, currency risks could be hedged at favourable conditions by concluding forward contracts - an attractive option in times of decreased risk capability. With the resulting forward sales the dollar came under further pressure. As regards the Swiss franc, we have noted that the euro/franc exchange rate has for the first time reached its pre-9/11 level.

The price losses on equities of the past few years - the SPI today is approximately 40% below its peak - have had a significant effect in Switzerland. They put pressure on both corporations and individuals, with foreseeable higher old-age provisions and nascent insecurity in this area being one of the concerns. The Swiss financial sector, which makes an above-average contribution to gross national product, has been particularly hard hit by the stock market correction. The cut-backs which are now necessary in the financial sector will put a strain on the Swiss economy for an extended period to come.

Economic activity

Economic activity in Switzerland weakened in the first quarter of 2003. According to preliminary estimates of seco, real gross domestic product contracted compared with the previous period and was again slightly below the previous year's level. The renewed deterioration in the economic situation did not come unexpectedly. It was primarily the result of the recurring downturn of the global economy, which is partly a reflection of the uncertainties in connection with the Iraq war. Swiss exports were down again in the first quarter, and the foreign trade contribution became distinctly negative. Consumer spending had a slightly stabilising effect while investments continued to decline overall.

Even though geopolitical uncertainties have meanwhile largely given way, the economic situation in Switzerland remains difficult. The marked deterioration in the labour market makes for more uncertainty and depresses consumer sentiment. Even though there are first signs suggesting a stabilisation of demand for capital goods, corporate investment activity is still at a low ebb. Despite the weaker franc against the euro, incoming orders and the order backlog stayed at an unsatisfactory level up until April. Capacity utilisation in the industry remains inadequate. Swiss gross domestic product is therefore not likely to grow in the second quarter of 2003 either.

Any recovery of the Swiss economy is dependent on a sustained increase in growth in exports, which should then lead to a turnaround in the currently still weak capital spending. We expect that this upswing will set in gradually in the second half of 2003 and then continue at a more vigorous pace next year. Private consumption should also pick up a little more. GDP growth is therefore likely to increase somewhat in the second half of the year but will nevertheless remain moderate. In the current year we anticipate real economic activity to stagnate overall. For next year we expect a perceptible economic upswing. We are likely to see a continued rise in unemployment to the end of the year and do not expect the labour market to improve before the middle of 2004.

Inflation forecast

I shall now turn to the course of inflation and our new inflation forecast. Annual inflation, as measured by the national consumer price index, stood at 1.0% both in the fourth quarter of 2002 and the first quarter of 2003. In April, inflation dropped to 0.7% and amounted to 0.4% in May. This decline is primarily attributable to a basis effect. While inflation of domestic goods has remained fairly stable as of late, inflation of imported goods was relatively volatile. This is a result of oil prices having fluctuated sharply in the recent past. With regard to domestic goods, it is striking that rents have not risen for a while now while prices for other services - particularly public services - have augmented at an above-average rate. The core rate of inflation calculated by the National Bank has stood at slightly below 1% for a while.

This year the National Bank began publishing its inflation forecast once every quarter. Our inflation forecast of March 2003 (the dash-dotted green curve in the graph) shows that at that time we assumed, based on a stable three-month Libor rate of 0.25%, that inflation would gradually rise to 2.5% in the fourth quarter 2005. This inflation forecast was based on the assumption that the US economy would see a decisive recovery already from the second quarter of 2003, followed by an upswing in Europe toward the end of 2003. This proved to be too optimistic a scenario.

In our latest inflation forecast (red dashed curve) we anticipate a renewed delay in the global recovery of just over half a year. Growth in the US, however, is likely to pick up as early as 2003. The US economy is not expected to reach its growth potential before the end of 2004, however. Economic activity in Europe will only see modest growth for the time being. We anticipate that a significant acceleration of growth will not set in before the middle of 2004, with potential growth being reached in the course of 2005. 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 0.25% during the next three years, average inflation should amount to 0.6% in 2003, drop to 0.4% in 2004 and climb to 1.2% in 2005. It is thus forecast to remain under 1% until mid-2005. In the course of 2005, however, an acceleration will get under way, with forecast inflation reaching the 2.5% mark in the second quarter of 2006.

The new forecast is consistently below that of March 2003. The low inflation at the beginning of 2004 is attributable to a basis effect as a result of the development of oil prices. The lower inflation forecast for the period thereafter is due to the delayed economic upswing. According to the new forecast, inflation in 2006 is no longer in the range that the National Bank equates with price stability. It should be noted that these forecasts assume that monetary policy will remain expansive over the next three years. We can preempt such a rise in inflation by tightening monetary policy at a later time.

Relaxed monetary policy

Our interest rate cut of 50 basis points last March was the last possible downward interest rate adjustment. Our intention was to resolutely counter the appreciation of the Swiss franc vis-à-vis the euro in the current difficult economic environment. So far, it has been a successful step: the Swiss franc has depreciated markedly against the euro. Monetary conditions have again become considerably more relaxed. For the time being, we intend to continue to implement an expansionary monetary policy and to support the economic recovery in Switzerland. Swiss franc investments are to remain unattractive in the foreseeable future.

Economic recovery is still uncertain. There is even recurring talk of a deflation risk in Switzerland. We consider this to be a minimal risk. In a few months, inflation may well be negative. An actual deflation spiral leading to a strong decline in the demand for goods and in output is, however, highly unlikely as long as the Swiss franc does not appreciate inordinately. We shall therefore continue to take decisive steps to combat a tightening of the monetary conditions brought about by any significant rise of the Swiss franc against the euro.

You will certainly have taken note of the high growth rates of the money supply aggregates in the last few quarters. The money supply aggregates are currently growing at rates last seen at the end of the eighties. The question arises to what extent this expansion in the money supply has an inflationary effect. First, let it be said that we are deliberately conducting an expansionary policy. That partly explains the above-average money supply growth. It also must be noted, however, that the painful experiences investors have made on the stock markets and the uncertain economic situation have significantly heightened the preference for liquidity. A look at credit statistics confirms that the money supply did not grow as a result of credit creation and therefore does not serve to finance any existing demand for goods. Moreover, our economy currently has free capacities so that increased demand will not immediately push up prices. We are therefore convinced that we have sufficient time at our disposal to keep inflation within the bounds of price stability by tightening monetary policy at a later point in time.

I should like to emphasise once more that in the present situation 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. Such efforts include a further liberalisation of the domestic economy, an increase in competitiveness in the structurally weak sectors, and sound public finances.

Adjustment of the monetary policy concept of the ECB

A few weeks ago, the European Central Bank (ECB) finalised a monetary policy assessment and slightly adjusted its monetary policy concept. In future, the ECB will no longer lay down the reference value for the money supply M3 every year but will keep it unchanged for longer periods of time. In communicating its monetary policy decisions, the ECB will, other than in the past, first comment the general price and economic development and only afterwards the development of the money supply. Furthermore, the ECB has confirmed its definition of price stability. It considers price stability to have been achieved when the inflation rate is below 2%. At the same time, the ECB has announced that it will now be aiming at an inflation rate of nearly 2% in the medium term.

The National Bank defines price stability in the same way as the ECB. The question thus arises whether we, too, should as a principle aim at the upper level in the range of price stability. We see no reason to make any changes in our concept. Switzerland is a small open economy and the proportion of imported goods in the national consumer price index amounts to 25%. As a result of exchange rate fluctuations, the inflation rates are significantly more volatile than in the euro area. There is therefore no sense in aiming at an excessively narrow range of inflation. Such temporary fluctuations in inflation do not pose a problem for the Swiss economy and should not be countered by means of special monetary policy actions. Furthermore, the euro area also has the problem that there is a large spread in inflation between the peripheral countries and the countries at the centre. In striving for an inflation rate of less than, but close to, 2% in the medium term in the entire euro area, the ECB is trying to prevent inflation in the central countries from being pushed down towards zero, or even below zero, for any length of time. In Switzerland, this problem does not exist as only inflation measured in Switzerland is relevant for our monetary policy.

Additional agreement between the Federal Department of Finance and the SNB on the distribution of profits on the free assets

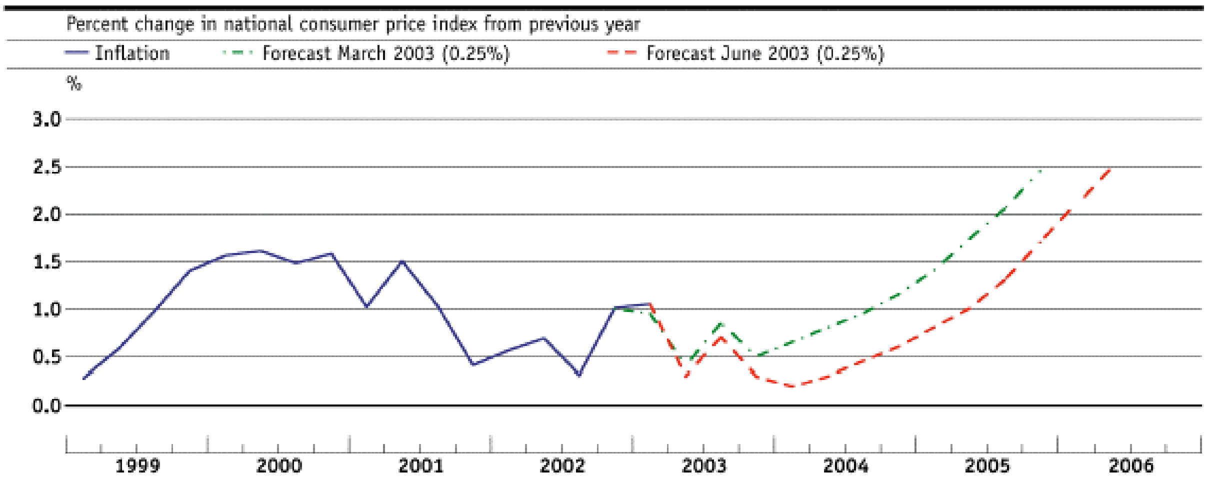
At yesterday's meeting the Bank Council of the National Bank agreed to an additional agreement between the Federal Department of Finance and the Swiss National Bank on the distribution of profits on the free assets (income on reinvested proceeds from gold sales). The profit distribution of the National Bank will thus increase by Sfr 300 million to a total of Sfr 2.8 billion (for the financial year 2003) in spring 2004. In 2005 and 2006, it will be gradually raised up to Sfr 3 billion. The National Bank's profit distribution has so far not taken account of this income on reinvested gold proceeds.

On discussing this transaction, the bank authorities of the National Bank expressed their concern that it was now even more obvious that the National Bank's profit transfer was reaching a level that cannot be maintained in the long term. The Governing Board shares the bank authorities' concern that a later return to the "normal level", which will only amount to approximately Sfr 1 billion, is likely to create considerable political difficulties.

From today's vantage point, it cannot be ruled out, moreover, that as a result of the additional distribution on the income-yielding free assets the National Bank's provisions will be reduced more rapidly than had been assumed when the main agreement on the National Bank's profit distribution was concluded in April 2002. At 2.9% a year, the income forecast on which this agreement was based is rather optimistic given the low yield level on the financial markets for some time to come. It may therefore well be that a downward adjustment will become necessary as early as 2007, when, in terms of the agreement, the level of distribution will be reconsidered. In any case, the National Bank does not consider an annual profit distribution of Sfr 3 billion from 2007 onward as by any means a certainty.

We think it is important to draw attention to these risks well in time. We also explained them to the Head of the Federal Department of Finance and asked him to advise the responsible persons of the cantons of our misgivings.

Inflation forecast of March 2003 with Libor at 0.25% and of June 2003 with Libor at 0.25%



Inflation Forecast June 2003 with Libor at 0,25%	2003	2004	2005
Annual average inflation in %	0.6	0.4	1.2