Jean-Pierre Roth: 2003 – a year of renewal

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the Bank's Annual General Meeting, Bern, 30 April 2004.

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2003: a year of renewal

As I told you a year ago, 2002 was a year of disappointments. But today I am glad to report that in 2003 the outlook brightened steadily.

2003 got off to an inauspicious start, however. The prospect of war in Iraq gave rise to uncertainty and apprehension, gravely undermining confidence among both households and companies. Then investors' confidence was shaken by a number of financial scandals, triggering a sharp fall in the stock markets in the third quarter. Even the rapid military outcome to the conflict in Iraq did not resolve the situation. In addition to this, the threat of a SARS epidemic exacerbated the problems already being experienced by greatly weakened sectors such as transport and tourism.

Only in the summer did a measure of calm start to return as the international business cycle gradually picked up. Not only did economic growth in the United States steadily gain momentum, but the Japanese economy experienced an almost unhoped-for rebound while the emerging economies of Asia - led by China - cast off their SARS fears and resumed their dynamic growth. This contributed in no small part to the upswing in the world economy. Closer to home, the European economies slowly emerged from their lethargic state. Switzerland's neighbours saw an upswing in industrial output and exports, although domestic demand in these countries remained - and still remains - sluggish.

In Switzerland, too, the long-awaited but oft-delayed upswing finally began to make itself felt. The first signs of the upturn became apparent in the summer. These were initially in isolated areas but then became increasingly widespread. The confidence indicators began rising, and order books swelled. The turnaround was facilitated by a marked weakening of the Swiss franc, which was itself triggered by a renewed easing of our monetary policy in March. This downward correction in the franc, which continued for the rest of the year, came as a welcome respite for Switzerland's export industry, which had been buffeted by the weak global economy and the fall-off in international trade.

The Swiss franc's slide against the European currency was gradual, extending over almost a year. Our currency's exchange rate dropped from CHF 1.46 against the euro in March 2003 to CHF 1.55 today, thus depreciating by about 6%. The franc's fall is even greater in real terms owing to the higher inflation rate which prevailed - and still prevails - in the euro zone. Also in real terms, the Swiss franc is worth less in euros than when the single currency was launched five years ago. This development shows that, as the new European currency has gained in stature, the markets have taken a different view of the safe-haven role traditionally played by the franc. It is probably also to the euro's existence that we owe the Swiss franc's reduced volatility and its rather controlled weakening, whereas the dollar experienced difficulties. This is a reaction to which we were not accustomed; moreover, it is good news for our economy. While it may be justified by the United States' huge external deficit, the slide of the greenback has nevertheless exerted an asymmetrical impact: it has hit European exporters hard, but has not affected Asian currencies that have been kept artificially low by massive intervention. The Swiss franc's fall against the single currency has sheltered us somewhat from these upheavals.

Guarded optimism for 2004

Our economic forecasts for the current year are marked by cautious optimism. The recovery that began in the third quarter of 2003 is set to continue. The production gap, which measures the difference between actual production and its potential level, is expected first to stabilise and then to gradually narrow. However, this will take time.

As usual, the first signs of an economic recovery appeared in the industries geared to exports. Next, capital goods investment began to pick up, driven by the high rate of depreciation in new technologies; there is therefore significant pent-up demand. To a large extent, these investments feed on imports, so that the immediate impact on our economy is limited. Moreover, as investment is also gaining steam among our neighbours, our own capital goods industry, with its strong export bias, has improved.

While consumer spending has held up well in the past two years, it is expected to gain momentum as the economic environment brightens. Consumption will thus continue to support growth, though it will probably cede pride of place to more cyclical components such as capital expenditure and exports. It will benefit, in particular, from the gradual improvement that will be seen on the labour market. At this stage of the economic cycle, of course, we must first expect gains in productivity, which means that unemployment will only decline slowly. Nevertheless, here too, the medium-term outlook is now good.

The scenario for a recovery that I have presented is, needless to say, full of imponderables. The risks are everywhere. They may take the shape of an uptrend or a downtrend. We can thus not rule out the possibility that the international economy will show more robust growth than anticipated. A swift build-up of inventories, for example, would appreciably accelerate the cycle. But the downside risks could also be triggered at any time by new political disorders. Given the significant internal and external imbalances throughout the world, such unrest could fuel greater volatility on the currency and equity markets. The strength of the recovery is also uncertain. In the United States, the economic recovery, which has been driven largely by tax breaks, is not yet firmly in place; households, labouring under a heavy debt burden, may be frightened by the slow pace of job growth. Should confidence be lost, a renewed fall in the dollar or a correction in the prices of financial assets would deliver another blow to the global economy. The situation in some emerging economies is likewise precarious. Lastly, we must bear in mind the difficulties currently being encountered by some of our neighbours, difficulties that could weaken or even delay the start of the upswing on our continent.

Monetary policy

In the unstable environment we are still experiencing, our monetary policy must remain expansionary. We know that our interest rates, currently at an historically very low level, will have to be increased if we wish to maintain price stability once the economic situation has been confirmed. The inflation outlook we published last March shows this clearly. However, we believe that it is not yet the moment to return to normalisation:

- Admittedly, the Swiss economy is now on a path of modest growth, but it has considerable idle resources and competition on the international markets is fierce. In the present circumstances, therefore, there is little risk of overheating.
- Growth in money supply is strong, but the preference for liquidity is unusually high against the current background of uncertainty and lending is showing only moderate expansion. Moreover, monetary aggregates have been somewhat inflated by the repatriation of funds which have until now been placed on the Swiss franc euro market.
- Lastly, even if some regions of the country are experiencing a scarcity of housing, there is no evidence of a real estate bubble developing such as we saw at the end of the 1980s.

The inflation outlook thus remains positive. We are projecting an inflation rate of about 0.5% this year and 1% next year. It is unlikely that, in the months ahead, we will again see inflation rates below zero, as we did last March. Negative inflation would require a steep fall in the price of oil. The debate over deflation, which was so topical barely a year ago, is by and large no longer one of our concerns and has disappeared from the discussions among central bankers. Our interest rate cut in March 2003 was intended to protect us against such a development. The goal has been achieved.

The need for reforms

Events in recent years have shown once again that there is no way we can make ourselves impervious to disturbances emanating from the world’s markets. Such disturbances will inevitably impact on the development of our economy. This does not mean, however, that we are completely at their mercy: for a small country such as Switzerland, the best defence against external shocks is an efficient and flexible economy, capable of standing up to competition and adapting swiftly to changes in the international environment.

However, we must also ensure that the problems caused by our internal structures, which are sometimes not ideally suited to current challenges, do not gain the upper hand. Our economy must be able to benefit from favourable domestic conditions that will allow it to develop and flourish. We have all witnessed its disappointing performance throughout the 1990s. This situation can only be corrected by the resolute implementation of structural reforms aimed at improving its long-term potential for growth.

The issue is all the more pressing as we are witnessing the gradual ageing of the Swiss population. The problems caused by this trend have been identified by and large, and the measures needed have been repeatedly analysed. The goal is simple: everything must be done to increase our economy's trend rate of growth in order to ensure better financing of its future needs. The solutions are complex because there is no magic potion. On the contrary, there are any number of different steps we can take to enhance our productivity: they range from promoting competition to repealing unnecessary regulations. Moreover, they have to be backed up by stringent control of public spending and deficits in order to ensure the efficient use of our resources and - above all - to avoid passing on a negative financial legacy to future generations. The Federal Council has adopted a legislative programme that gives priority to economic growth and a restructuring of the federal finances. We hope that Parliament will debate this programme in a spirit of intergenerational solidarity, keeping in mind the long-term interests of our country. Measures to promote growth would certainly be instrumental in ensuring the smooth future functioning of our economy, but they would also allow us to develop a climate of confidence necessary for today's investment and consumption decisions. Their impact on the economy would thus not be negligible. As for monetary policy, its role in this area can only be to provide price stability, an essential factor for confidence and macroeconomic efficiency.

Dawn of a new era

Ladies and gentlemen, as the President of the Bank Council indicated earlier on, the National Bank is at an historic turning point today. As of tomorrow, our institution will be governed by new legislation. The new National Bank Act will enter into force in less than 24 hours. Our operational framework, our range of instruments, our organisation and our duty of notification will all be affected.

Likewise, our mandate will be - perhaps not modified - but at least made more explicit. Article 5 of the new Act stipulates that "The National Bank shall pursue a monetary policy serving the interests of the country as a whole. It shall ensure price stability. In so doing, it shall take due account of the development of the economy".

The objective of price stability is not new. In fact, the National Bank has always been guided by this goal in its activities. The desire to guarantee the purchasing power of our currency underpinned the link established in the past between the franc and gold, and it was this same concern that led Switzerland, in 1973, to abandon the fixed exchange rates of the post-war period, which were undermined by widespread lack of discipline. The objective of price stability is now inscribed in law, which reinforces its legitimacy. Our monetary system is thus now as clearly defined as it used to be under the gold standard.

We define price stability as an annual rate of inflation of less than 2%. We were able to maintain such stability in the course of the past year, and I am pleased to note that this objective has been reached in each of the past ten years - an unparalleled achievement internationally. It is a modest, but highly important, contribution to the prosperity of our country. Our history has shown that inflation - or deflation - can have damaging effects that often cause suffering to the most vulnerable members of our society.

One of Switzerland's traditional values is this concern for price stability. It is a significant achievement that the National Bank will endeavour to preserve in the years to come.

The new Act also stipulates that we must take due account of the development of the economy in setting any course of action. There can be no doubt that monetary policy has short-term repercussions on economic activity. A tighter monetary policy designed to combat a flare-up of inflation tends to cause business activity to slow down. Such a slowdown may be necessary, for instance to reduce the likelihood of overheating, but it has painful side effects on various sectors of the economy. In pursuing price stability, we must be careful not to lose sight of the costs, and must use tact and discretion. The obligation to take account of the economy is now inscribed in law, but in reality this is nothing new: we have always made the state of economic activity in Switzerland one of our prime concerns. Our massive interest rate cuts in recent years while the economy was in the doldrums is ample proof of this stance.

Having to take account of the economy also means that we cannot be dogmatic in our pursuit of price stability, which must be seen as a medium-term goal. As a small, open economy, we are constantly exposed to external shocks. As our inflation rate tends to be more volatile than that of large countries or economic zones, temporary movements beyond the bounds of price stability cannot be ruled out. Trying to keep too tight a lid on prices would have adverse effects on the economy and would be counterproductive. It is just as obvious, though, that monetary policy has its limits. While it can contribute to the development of the economy by providing a stable, transparent and efficient monetary framework, we must not expect that it will be able to increase its long-term potential, or that it will succeed in energizing the economic machinery and forcing it to perform beyond its technical capacity.

The new legislation now requires us to give an account of the management of our mandate to Parliament and the Federal Council. This obligation towards Parliament is new. It is the logical counterweight of our independence, an independence which has been guaranteed by the federal Constitution since 2000. We are free to choose - within the limits of the law - the means necessary to carry out our mandate; on the other hand, though, the country is entitled to expect us to be able to justify our actions.

Lastly, the new Act grants us greater freedom in the choice of instruments to manage our monetary reserves. As you know, the National Bank has considerable monetary reserves. These reserves, which are a national asset, are essential for pursuing an independent monetary policy by reinforcing confidence in our currency. They are thus instrumental in ensuring its stability. It is crucial, however, that these reserves be managed effectively and with due regard to liquidity and security requirements.

Over the next few weeks, we will define to what extent we wish to take advantage of the investment possibilities offered by the new Act. We will present our plans on this matter at our press conference on June 17.

Conclusion

The Swiss economy has enjoyed a high degree of monetary stability for some years now, and this advantageous situation should last for a number of years to come. While the international environment in which we operate has improved, it remains unstable. We cannot rule out fresh setbacks. However, we can count on the significant adaptability of our companies and look to the future with confidence.

Nevertheless, our high standard of living in international terms should not lull us into complacency. In recent decades, we have seen our position among the leaders of the most highly developed countries eroded. Corrective measures are necessary. Let’s be clear: the main threat to our prosperity does not come from abroad, where the “made in Switzerland” label is still a success when it is associated with quality. The threat comes from within Switzerland. Take, for instance, our excessive predilection for regulations - often an invisible barrier to the free play of competitive forces - and our hesitation to fully accept an international environment that is more competitive and innovative than it was 20 years ago. The guiding principle for our structural reforms should be: more competition and fewer regulations. We have to have the courage to take this path in order to durably enhance our economic growth. This is essential to the balanced development of our economy and to the confidence that each of us feels in the future.

It is with this wish that I conclude my remarks. Thank you for your attention and for the interest you show in the National Bank and its activities.