Jean-Pierre Roth: The Swiss National Bank's new inflation forecast

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, 16 December 2004.

* * *

Economic growth in Switzerland has lost some of its momentum. For this year, however, we still anticipate economic growth to be close to 2%. In the coming year, we expect the economy to expand by 1.5% to 2%. On the assumption that the three-month Libor rate will remain unchanged at 0.75%, we expect an annual inflation rate of 1.1% in 2005 and 1.3% in 2006. Less dynamic growth, the weaker US dollar and the decline in excess liquidity have dampened the anticipated inflationary pressure somewhat. The target range for the three-month Libor rate will therefore be left unchanged at 0.25-1.25% and the rate will again be kept in the middle of the range. The National Bank's monetary policy continues to have an expansionary effect. Should unexpected developments push up the Swiss franc sharply, we will take appropriate action.

Allow me to explain our decision. It is based on the outlook for price developments in the coming three years as summarised in our new inflation forecast. The graph depicts the current and the previous inflation forecasts. The dash-dotted green curve reflects the September forecast. Like the current forecast, it was based on the assumption of the three-month Libor rate remaining unchanged at 0.75% in the following three years. We can see from the graph (blue line) that inflation in the third quarter of this year was insignificantly higher than we had forecast in September. The dashed red curve represents the new forecast. It begins in the fourth quarter of 2004 and ends in the third quarter of 2007.

The new forecast differs from the previous ones in three points. Firstly, the projected inflation is higher until the third quarter of 2005. Secondly, the inflationary uptrend sets in half a year later. And thirdly, inflationary pressure has decreased in the long term, which is evidenced by the lower-lying curve. There are significant economic facts behind these three deviations, which I would like to comment on.

1. Slightly higher inflation in 2005

The increase in the anticipated inflation until the third quarter of 2005 is predominantly attributable to the rise in oil prices. At the September assessment, the price of Brent in London stood at USD 41. By the end of October, the price had surged to over USD 50 before dropping back to around USD 40. Higher prices of oil products were the main cause for the rise in inflation in the last few months. Annual inflation between May and September hovered around 1%. A fresh spurt in oil product prices in October and November triggered a rise in annual inflation to 1.3% and 1.5% respectively. According to the new inflation forecast, the annual rate of inflation will increase to 1.5% on average in the first quarter of 2005. We presume that oil prices will tend to go down. Consequently, inflationary pressure will subside somewhat, particularly towards the end of 2005. With an unchanged monetary policy, we are likely to see an inflation rate of 0.9% in the first quarter of 2006.

2. Continued recovery

In order to assess inflation in the medium term, economic prospects are paramount. During a phase of economic recovery, as we are currently experiencing, how rapidly the capacity utilisation rate increases is important from a monetary policy perspective.

Even though GDP growth in the fourth quarter of 2004 is likely to be lower than we projected in the September assessment, we expect the Swiss economy to expand by close to 2% this year. The upswing will continue next year. We anticipate a growth rate of 1.5% to 2% for the whole of 2005. The fact that the economy braved the oil price hike and the stronger franc is testimony to a robust recovery.

There is less uncertainty now as to the inflation prospects for next year. Utilisation of economic resources, which is slowly increasing, will not lead to any additional pressure on prices in 2005. As can be gleaned from the new inflation forecast, improved capacity utilisation is likely to have an impact on price development only in the course of 2006.

The current inflation forecast for the medium term, ie for the coming two years, is characterised by a similar course to the one charted in September. In the new forecast, the point at which inflation will begin to climb again has been postponed by half a year. If monetary policy remains unchanged, annual inflation will be 1.1% in 2005 and 1.3% in 2006.

3. Lower inflation in the longer term

After having discussed the medium-term inflation prospects, allow me now to move on to the long-term prospects.

The assessment of inflation prospects in the longer term depends on a number of factors, such as the development of monetary and credit aggregates and different asset prices. Long-term forecasts are fraught with a high degree of uncertainty. In spite of this, a central bank must make a sound assessment of the effects of its monetary policy in the longer term. The need for a forward-looking stance is due to the fact that monetary policy has its strongest effect on prices only after a lag of two to three years.

M1 was 5.4% below the year-earlier level in November; M2 was down by approximately 3%. M3 increased by 1.4%. Although there is still ample provision of liquidity, it has dwindled as a result of the latest developments. Compared with the September assessment, we have therefore made a downward correction of our inflation projection for the years 2006 and 2007.

According to our September forecast - based on an unchanged three-month Libor rate of 0.75% - inflation would have climbed to 2.9% in the second quarter of 2007. With an unchanged monetary policy, the current forecast predicts an increase of only 2.3%. At the end of the new forecasting horizon in the third quarter of 2007, inflation would stand at 2.6%. The lower long-term inflation forecast suggests that there is currently more room for manoeuvre in maintaining an expansionary monetary policy course.

4. Exchange rate

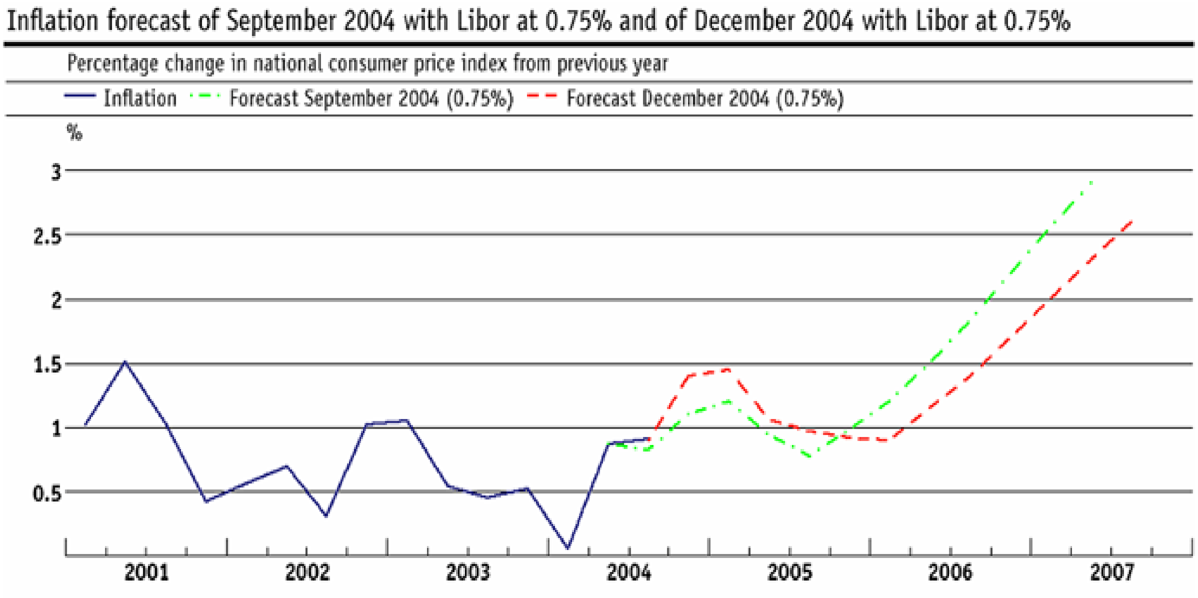
The dollar has plummeted since October. It has lost 7.9% vis-à-vis the Swiss franc. Notwithstanding the sharp fluctuations of the dollar, the franc has remained virtually unchanged against the euro. The depreciation of the dollar has a direct impact on the Swiss economy in that it undermines the price competitiveness of the export industries. Moreover, a weak dollar also exerts an indirect influence by clouding growth prospects in Europe, our largest sales market.

The appreciation of the franc has tightened monetary conditions. At the same time, the weaker dollar has a dampening effect on import prices and, consequently, on inflation prospects.

5. Continuation of expansionary monetary policy

I will now come to my concluding remarks. The inflation forecast shows that the process of normalisation of monetary policy has not yet ended. In light of my comments it should nevertheless not be difficult to understand our decision to leave the three-month Libor rate at 0.75%. Since inflationary pressure is expected to ease in the long term, there is no need to take a further step toward a normalisation of interest rates at this point in time. In addition, the stronger franc has already resulted in more restrictive monetary conditions. With our decision to keep the three-month Libor rate on hold, we are adhering to our current monetary policy course: we are making use of our monetary policy leeway to support growth without jeopardising long-term price stability.

Every forecast and every decision is fraught with uncertainty. Should unexpected events delay economic recovery or push up the Swiss franc sharply, we shall take appropriate action. For such cases, the Swiss National Bank keeps all its options open.



Observed inflation December 2004

	2001				2002				2003				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Inflation	1.02	1.50	1.03	0.41	0.56	0.69	0.31	1.01	1.05	0.54	0.45	0.52	0.06	0.87	0.91	

Inflation forecast on September 2004 with Libor at 0.75% and of December 2004 with Libor at 0.75%

	2004				2005				2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast September 2004, Libor at 0.75%			0.83	1.10	1.20	0.93	0.78	0.98	1.21	1.50	1.84	2.20	2.55	2.90		
Forecast December 2004, Libor at 0.75%				1.40	1.45	1.06	0.97	0.92	0.90	1.15	1.40	1.70	2.00	2.30	2.60	