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

Introductory remarks by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank and Chairman of the Board of Directors of the Bank for International Settlements, at the half yearly media news conference, Geneva, 19 June 2008.

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The Swiss National Bank (SNB) is leaving the target range for the Swiss franc three-month Libor unchanged at 2.25-3.25%. It intends to hold the rate in the middle of the target range for the time being.

Despite a slowdown in economic activity, the global economy remains robust and the price of oil has continued to climb. This has led to a general increase in inflation. The situation on the financial markets is still uncertain, but less turbulent than it was a few months ago. Although the Swiss economy has also grown at a slower pace, the SNB has not changed its forecast of real GDP growth of between 1.5% and 2% for 2008. However, it has increased its inflation forecast and is now expecting an average rate of 2.7% in 2008. Nevertheless, assuming that the Libor remains unchanged at 2.75%, inflation should edge back down to 1.7% in 2009 and 1.3% in 2010, as a result of the expected economic downturn.

Considerable risks are attached to this inflation forecast. Stronger price increases are likely, should energy prices rise again or the Swiss franc depreciate on the foreign exchange market. A more significant slowdown in the global economy might ease inflationary pressure.

Given these conditions, the SNB is maintaining its cautious stance and leaving its monetary policy strategy unchanged. In view of the medium-term inflation outlook, it can afford to do so. After all, there is enough reason to suggest that the current inflationary trend is of a transitory nature. The SNB will keep a close watch on the price of oil, movements in the Swiss franc, the economy, and developments in the financial markets, so as to assess their impact on the inflation outlook and react swiftly, in order to maintain price stability in the medium term.

Global economic outlook

With exports accounting for 52% of GDP, the Swiss economy has a strong global presence. This is an opportunity, but it also means that the international environment has a considerable impact on economic developments in Switzerland. The US economy – until recently the principal driver of global economic growth – has made scant headway over the last three quarters. However, the period of near-stagnation which the US economy is currently experiencing is not likely to be too prolonged. The resolutely expansionist nature of US monetary and fiscal policy, combined with a weak US dollar that favours exports, should help to reenergise the US economy. A recovery is expected towards the end of the year, albeit a tentative one, given that the deterioration in the employment outlook, the erosion of purchasing power and the fall in property prices look set to weigh on consumer sentiment and income.

Europe represents the second pole in the global economy. Although the continent enjoyed strong growth during the first quarter of 2008, the remainder of the year should see a slowdown. A number of factors will contribute to this loss of momentum. First, the strong euro and the sharp downturn in the US economy are dampening exports. The sub-prime crisis has led to a tightening of credit conditions, while consumer confidence has deteriorated. This will have a knock-on effect on consumer spending. However, the slowdown in Europe will be much less pronounced than in the US, although the subsequent pick-up in economic activity will also probably be gradual.

The Asian economies, which constitute the third major hub, continue to exhibit strong growth as a whole, since they remain virtually unaffected by the slowdown in the US economy. Nevertheless, they have been hit by rising commodity and food prices, which are seriously reducing incomes.

Regional variations aside, it would therefore be reasonable to conclude that the global economy, as a whole, is not witnessing a significant slowdown at present – as opposed to one of the rather more alarming scenarios that were only recently being mooted. The impact of the crisis in the financial sector on the rest of the economy has been felt less acutely and a lot more slowly than could have been expected. It is precisely the continued robust global growth which is the main reason for the sharp rise in food and oil prices – although market speculation may have accentuated this trend. In most countries, the rise in the price of oil has translated into an increase in consumer prices. After remaining at a moderate level for a long time, inflation is again a cause for concern. This increase in the indices risks destabilising inflation expectations, which have remained very stable over the last number of years.

Swiss economic outlook

Last year saw the Swiss economy still operating at a dynamic pace, but there was a distinct fall-off during the first few months of 2008. In the first quarter, real GDP grew at an annualised rate of only 1.3%. This compares to growth rates in the region of 3% or even 4% which we saw in 2007. The slowdown is attributable to three major factors. First, the economy was turning over at an exceptionally high rate last year. A slowdown was therefore inevitable as much as it was desirable. It reduces the likelihood of the economy overheating and reflects the normalisation of monetary policy which we have undertaken in recent years. Second, the slowdown in exports played an added role, by curbing manufacturing activity. Finally, problems on the financial markets resulted in a significant drop in stock market transactions. This had a negative impact on added value in the banking sector.

However, the slowdown in production did not spread to all sectors of activity. Growth remained strong in the retail and wholesale business, the hotel and catering trade and the transportation and communication industries. This shows that domestic demand remains – on the whole – robust. With the first few months of 2008 seeing a steady flow of new jobs, the favourable climate on the job market continues to be conducive to private consumption in particular.

Further growth in demand and production is likely over the next few quarters, albeit at a more modest pace. High prices for oil products and uncertainty related to the US real estate crisis will undoubtedly continue to hamper economic activity. However, growth in household consumption and equipment investment looks set to continue. The SNB continues to forecast GDP growth of between 1.5% and 2% for 2008. However, this average annual growth rate is boosted by the strong growth achieved in the second half of 2007. It therefore conceals what has been a noticeable slowdown in economic activity, with quarterly rates below potential throughout the rest of the year.

Changes in the monetary and financial framework

How have monetary conditions evolved since our last assessment in March? They have become somewhat more relaxed. This is mainly attributable to two factors.

First, the Swiss franc has depreciated by 3% against our 26 most important trading partners, thereby partially offsetting the appreciation that occurred at the beginning of the year. This softening is having a direct impact on inflation, by increasing the prices of imports. To give an example, the impact of oil prices on inflation has been amplified, with the price of a barrel of Brent crude rising 18% by mid-May in terms of Swiss francs, but only 13% in terms of US dollars. In the longer term, the weakening in the Swiss franc is indirectly contributing to the increase in prices by stimulating demand.

Second, real short-term interest rates have dropped. There has been a rise in expected inflation for the near future and this means – for given nominal interest rates – lower real expected yields for short maturities.

An analysis of monetary conditions in terms of volumes leads to similar conclusions. Let us begin with money, which is the best indicator to use if a broad-brush and long-term outlook for the economy and inflation is required. The M1 and M2 monetary aggregates, which were declining until not long ago, have been practically stable for some months. As for M3, it is continuing to exhibit moderate growth.

The sub-prime crisis has confirmed the importance of mortgage loans as an indicator of the degree of relaxation of monetary policy. The reason for this is simple. Because construction projects are long-term in nature, real estate investment reacts particularly sensitively to interest rates. Consequently, mortgage loans were growing at a rate of 5–6% in 2003 and 2004, when our monetary policy was firmly expansionary. These growth rates then declined gradually as we tightened our monetary policy in 2006 and 2007. Last April, they settled at around 3.3%. The growth rate of other loans – a particularly heterogeneous category – remains high, confirming that the underlying trend in the economy remains dynamic.

In December, we emphasised the need to give particular attention to conditions in the credit market in the light of the sub-prime crisis. In order to do this, the SNB conducted a survey of 20 banks in March, in which they provided us with information on their intentions and expectations. This survey completed the analysis of credit volumes. It reveals, first, that banks have not significantly tightened lending conditions with respect to either households or companies over the course of the last few months. Second, the banks state that, in broad terms, demand for credit has remained unchanged. Third, they do not expect any significant change in either supply or demand in the months ahead. Thus this survey confirms the conclusions of the analysis of credit volumes which, as we have seen, are continuing to rise. Unlike similar surveys conducted in the US and the euro area, it shows that, for the time being, the sub-prime crisis has not led to a deterioration in credit conditions in Switzerland.

Inflation and inflation risks

Inflation developed in line with expectations during the first quarter of this year. Our March forecast was 2.4%, whereas actual inflation was 2.5%. Nonetheless – as you can see from the charts – we are forecasting higher and more persistent inflation for the rest of the year. However, it should drop back below the 2% level from the beginning of next year, although there are significant risks attached to this relatively favourable forecast. A more pronounced price surge would clearly be a concern should there be a further increase in the prices of energy and food. In addition, it is possible that movements in the Swiss franc will not contribute to easing upward pressure on import prices. Having said that, we should also not underestimate the potential for movements in the prices of raw materials to reverse, and inflation pressures to abate in the event of a pronounced global economic slowdown, especially as we do not yet know the consequences of the financial market turbulence. Today's monetary policy decision reflects our assessment of these different risks.

Monetary policy decision

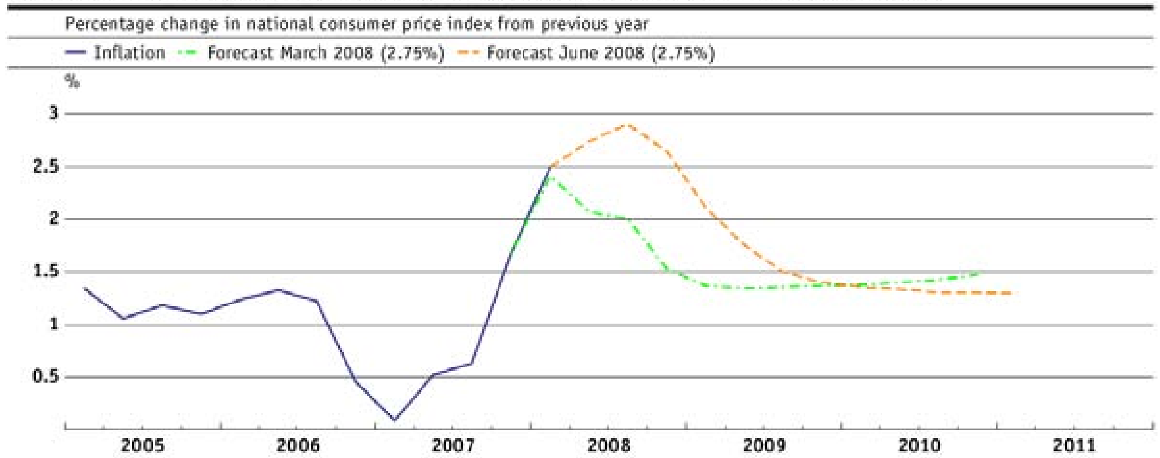
Inflation has exceeded the 2% mark since December 2007. However, in our view this situation is temporary and the expected slowdown in the economy should have a moderating effect. We are expecting that inflation will already move back below the 2% level in 2009. Moreover, given the prevailing uncertainty as regards both the global economy – which could suffer a greater-than-expected slowdown – and the fallout from the international financial turmoil – which has hit Switzerland fairly hard compared to other industrial countries – we consider that a prudent attitude remains appropriate and that a change of monetary policy is not called for in the current circumstances. Nevertheless, we must remain very vigilant. A renewed rise in energy prices, a stronger economy than expected, a weakening of the Swiss franc or an increase in inflation expectations would pose a threat to medium-term price stability. We will therefore continue to keep a close watch on these factors, so as to be able to react quickly in order to maintain price stability in the medium term.

Inflation forecast chart

How has our inflation forecast been revised? The dashed red curve on the chart represents the new forecast. It covers the period from the second quarter of 2008 to the first quarter of 2011, and maps the future development of inflation on the assumption that the three-month Libor remains unchanged at 2.75% over the forecasting period. For purposes of comparison, the dash-dotted green curve shows the inflation forecast of the March monetary assessment, based on a three-month Libor of 2.75%.

The new forecast shows inflation rising in the short term, and exceeding 2% by the first quarter of next year. The increase is primarily due to the rise in oil prices combined with continued robust economic activity. However, the forecast shows that the expected slowdown in the economy, the fall in capacity utilisation rates and a baseline effect as regards energy prices will all contribute to a decline in inflation, which should thus, in the medium term, arrive at a level that is fully compatible with price stability.

Inflation forecast of March 2008 with Libor at 2.75% and of June 2008 with Libor at 2.75%



Observed inflation June 2008

	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4
Inflation	1.35	1.06	1.18	1.10	1.23	1.33	1.22	0.46	0.09	0.52	0.63	1.68	2.50			

Inflation forecast of March 2008 with Libor at 2.75% and of June 2008 with Libor at 2.75%

	2008				2009				2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast March 2008, Libor at 2.75%	2.41	2.07	2.01	1.53	1.37	1.35	1.36	1.37	1.38	1.40	1.43	1.47				
Forecast June 2008, Libor at 2.75%		2.75	2.91	2.65	2.12	1.76	1.50	1.40	1.36	1.34	1.31	1.31	1.30			