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Monetary policy assessment of 15 March 2007

National Bank raises the target range for the three-month Libor by 0.25 percentage points to 1.75–2.75%

The Swiss National Bank (SNB) is raising the target range for the three-month Libor with immediate effect by 0.25 percentage points to 1.75–2.75%. The SNB intends to hold the rate in the middle of the target range for the time being.

Switzerland's economy is in excellent shape. As expected, it continues to perform positively. This is having a favourable effect on the labour market. For 2007, the National Bank still expects real GDP growth to remain at approximately 2%. By raising the target range, the National Bank is ensuring that the inflation outlook will remain favourable.

The drop in oil prices in the second half of last year will hold back inflation until the middle of 2007. Assuming that the three-month Libor will remain unchanged at 2.25%, the National Bank expects an average annual inflation rate of 0.5% in 2007, 1.4% in 2008 and 1.6% in 2009. On the assumption that monetary policy will remain unchanged, projected inflation will thus continue to show a slight upward trend over time. Consequently, in order to ensure price stability in the long term, the SNB will probably have to continue its policy of interest rate normalisation. However, any assessment of the inflation outlook is subject to greater uncertainty. While, on the one hand, structural changes in the economy are having more of a dampening effect on prices, the high level of capacity utilisation and exchange rate movements, on the other, are exacerbating the risk of higher production costs being increasingly passed on to prices. Should the inflation outlook change, the National Bank will take appropriate measures.

International environment

The analysis of the international situation has changed little since the last monetary policy assessment. The US economy is set to expand close to its potential growth rate in 2007. The European economy will continue to perform favourably. The decline in oil prices will curb this year's rate of inflation measured with respect to the year-back quarter.

Press release

Economic outlook

Economic activity in Switzerland continues to be brisk. According to a provisional assessment by SECO, real gross domestic product (GDP) in the fourth quarter of 2006 grew at an annualised rate of 1.8% compared with the previous period. Based on its analysis of a number of indicators, the National Bank does not exclude that fourth-quarter growth may be somewhat higher. The broad-based, healthy economic situation had a positive impact on the labour market. Year-on-year growth in employment was the highest in five years. The upward trend in the labour market has given consumer sentiment yet another lift.

Most demand components can again be expected to shore up economic growth in the next few quarters. The upbeat consumer sentiment and the income trend will push up household spending. Considering the high level of capacity utilisation and the bright economic outlook, equipment investment is also set to rise. Exports will be another factor boosting economic growth. The healthy economy will stimulate the labour market again this year and result in a further drop in the unemployment rate.

The National Bank expects economic developments to be broad-based and balanced also in 2007, yet possibly somewhat less dynamic. The SNB still projects real GDP to expand by approximately 2%. Consequently, the economy progresses somewhat faster than its long-term average. However, special factors, including strong competition from new providers in the transition countries and emerging markets of Asia as well as the fact that the Swiss labour market has been opened up to foreign nationals, are continuing to ease the pressure on prices.

Monetary developments

The policy of gradual adjustments to the interest rate pursued to date is increasingly affecting financial market conditions. In the course of 2006, short-term interest rates adjusted to the longer-term rates. The interest rate curve flattened, which led to a rise in real interest rates for short and medium-term maturities. The changes in the interest rate structure sparked a switch from savings deposits to higher-interest time deposits. The annual growth rates of M1 and M2, which include sight and savings deposits, were negative in the fourth quarter of 2006. By contrast, M3, which comprises time deposits, showed a moderate increase.

The growth rate of mortgage lending continues to recede gradually, while that of other loans, however, is witnessing continued strong growth, which is mainly attributable to unsecured loans. During phases of strong economic performance, this category exhibits particularly sharp growth rates. However, these loans are still below the level they had reached at the beginning of the boom years of 1999/2000.

After having lost ground against the euro over an extended period, the Swiss franc has recovered slightly as of late. The exchange rate is important to the National Bank insofar as it influences the inflation outlook, either directly via the prices of imported goods or indirectly via economic activity. So far, the exchange rate has had no notable effect on inflation. Experience has shown that the development of exchange rates impacts on consumer prices with a time lag. There is a great deal of uncertainty, however, regarding the extent and the duration of this effect.

The National Bank has pointed out on several occasions that we ought not be deceived by the relative stability of the Swiss franc/euro exchange rate. There have been several instances in the past when the Swiss franc firmed during a bearish spell in the financial markets. The same applied to the latest developments in the financial markets. Exchange rates have shown increased volatility again in recent times. Financial market participants and entrepreneurs should be aware of the exchange rate risks they incur.

Reasons for the monetary policy decision

The inflation prospects have changed since the monetary policy assessment in December 2006. In the current year, the inflation rate will be lower than was expected at that time. Once the dampening effect on inflation emanating from the decline in oil prices in the second half of 2006 has waned, we will witness an increase in annual inflation starting in the middle of 2007. This rise will be more significant than expected at the last assessment. The reason for this is the softening of the Swiss franc, which has partially neutralised the impact of the last increase in the interest rate. This development in the Swiss franc will push up future inflation by stimulating the economy and increasing import prices. By lifting the target range, the National Bank is ensuring that inflation will remain within the range defined as price stability also in the longer term.

Inflation forecast based on a three-month Libor of 2.25%

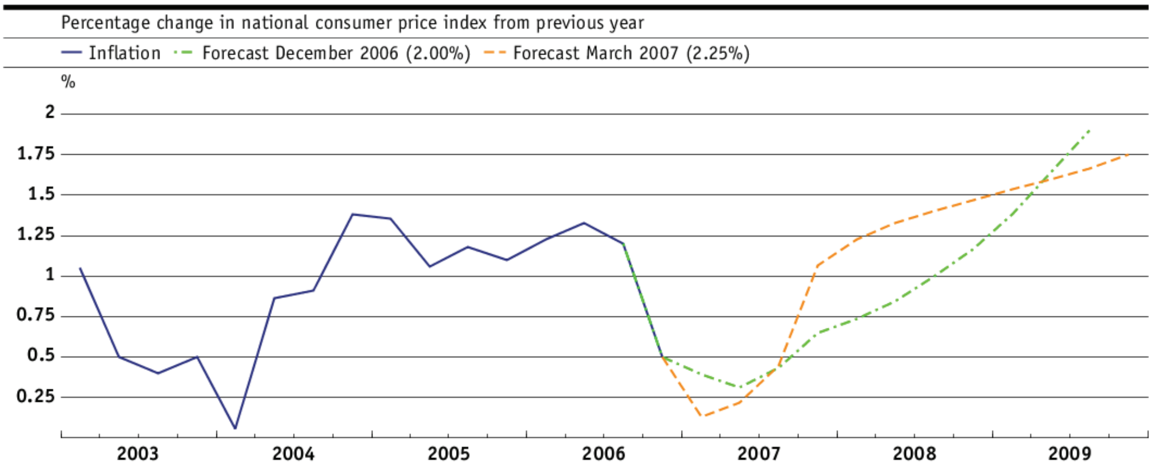
The inflation forecast of the National Bank maps the future development of prices on the assumption that the three-month Libor will remain constant over the forecasting period. The inflation projection published after the interest rate increase in December 2006 was based on an unchanged three-month Libor of 2.00% (green curve). The new inflation forecast calculated with a constant interest rate of 2.25% is shown in red. Until approximately the end of 2007, the curve is a little lower than in December. After that, it is significantly higher for the period of one year. During the course of 2009, the new forecast drops below the previous one again. This reflects the dampening effect of today's interest rate decision. While inflation dynamics have become weaker, they are still trending upwards over time. This shows that, even with a three-month Libor of 2.25%, monetary policy still has a slightly expansionary effect.

However, the inflation forecast is subject to some uncertainty. Economic developments might be more vigorous than expected. The recent softening of the Swiss franc against the euro may in time lead to stronger price pressure on imported European goods. A further weakening of the Swiss franc would increase this risk even more.

Course of normalisation to be pursued further for the time being

With today's decision to increase the three-month Libor by 25 basis points, the SNB has maintained its monetary policy course of gradual normalisation. In order to ensure long-term price stability, it will probably have to continue with this policy. However, any assessment of the inflation outlook is subject to greater uncertainty. While, on the one hand, structural changes in the economy are having more of a dampening effect on prices, the high level of utilisation of resources and exchange rate movements, on the other, are exacerbating the risk of higher production costs being increasingly passed on to prices. Should the inflation outlook change, the National Bank will take appropriate measures.

Inflation forecast of December 2006 with Libor at 2.00% and of March 2007 with Libor at 2.25%



Observed inflation March 2007

	2003				2004				2005				2006			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Inflation	1.05	0.50	0.40	0.50	0.06	0.87	0.91	1.38	1.35	1.06	1.18	1.10	1.23	1.33	1.20	0.50

Inflation forecast of December 2006 with Libor at 2.00% and of March 2007 with Libor at 2.25%

	2006				2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast December 2006, Libor at 2.00%				0.50	0.40	0.31	0.44	0.65	0.74	0.85	1.00	1.17	1.38	1.64	1.90	
Forecast March 2007, Libor at 2.25%					0.13	0.22	0.44	1.06	1.22	1.33	1.41	1.47	1.54	1.60	1.66	1.75

Press release