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Monetary policy assessment of 13 September 2007

SNB aiming to calm the money market

The Swiss National Bank is aiming to calm the Swiss franc money market. The SNB is targeting a three-month Libor of around 2.75%, after this rate has climbed as high as 2.9%. The target range will be adjusted to 2.25–3.25%. Despite the recent turbulence on the financial markets, economic developments in Switzerland continue to meet expectations, even though the downside risks are somewhat stronger. For 2007, the National Bank still expects real GDP to grow at a rate of close to 2.5%. Next year, this momentum is likely to slow somewhat. Due to the international credit crisis, assessment of the economic situation and inflation prospects has become less certain.

To date, the turmoil on the financial markets has scarcely affected the inflation outlook. However, inflation prospects have deteriorated slightly due to the good state of the economy, the continued high price of oil and the low level of the Swiss franc. Assuming that the three-month Libor remains unchanged at 2.75%, the SNB expects an average annual inflation rate of 0.6% in 2007, 1.5% in 2008, and 1.8% in 2009. Thus, the forecast level of inflation will continue to rise, although only slowly. Bearing in mind the uncertainties in the financial markets, the National Bank is monitoring further developments in the international economy, the oil price and the exchange rate closely, in order to assess their impact on the prospects for inflation.

At present, the uncertainties associated with the assessment of the economic and inflation outlook are greater than usual. Structural changes in the economy are still having a favourable impact on inflation. A cooling in the global economy triggered by the mortgage and loan crisis would also hold down prices. A downturn in oil prices and a strengthening in the Swiss franc would have similar effects. By contrast, the high degree of resource utilisation and the rise in import prices are having an inflationary effect. Overall, the risks of an unexpected rise in inflation are just as great as the risks that inflation will be lower. With time, the degree of uncertainty is likely to decrease. The SNB is targeting a three-month Libor of approximately 2.75% for the time being, and is reviewing the situation continually.

Press release

International environment

The latest developments in the international financial markets – mortgage crisis in the US, correction on stock markets, liquidity shortage on the money markets – have made it difficult to assess the international environment. However, the economic situation does not appear to have changed significantly. The US economy is growing at a slightly slower pace than expected, and the downside risks have increased. After decreasing between mid-July and mid-August, the oil price has risen again.

Economic outlook

On the whole, the Swiss economy has grown in line with the SNB's expectations despite the turbulence on the financial markets. In the second quarter, real GDP rose at an annualised rate of 3.0%, as compared with the previous quarter. Employment has continued to record broad-based growth and has increased particularly strongly in the services sector, reflecting robust domestic demand. However, a further upswing has also been recorded in construction and in manufacturing.

The economic indicators have continued to paint a rosy picture. Consumer confidence has remained high and consumer spending has increased further. Exports have surged, boosted in particular by demand from Europe, with equipment goods and semi-manufactures being especially favoured. Capacity utilisation has remained at a high level overall.

This growth can be expected to persist, thanks to the healthy state of the Swiss economy. The favourable outlook for the labour market should continue to impact positively on income and consumption, and corporate investments are set to advance further. Export demand is likely to be maintained. For the current year, the SNB therefore still expects real GDP to grow by close to 2.5%. However, if the uncertainty in the financial markets persists, it is conceivable that the momentum from abroad and the growth contribution from the domestic financial sector could be reduced. This would have a dampening effect on the economy as well as on prices. Careful monitoring of these developments will continue.

Changes in the general monetary environment

Since the intensification of the US mortgage crisis, yields on Confederation bonds have fallen significantly. However, this is not the case for corporate bonds or the interbank market, due to the fact that credit risk premiums have risen. The three-month Libor for Swiss francs, for instance, has risen to as high as 2.9%. Overall, higher credit risk premiums bring about a tightening in monetary conditions.

Foreign exchange markets are very volatile. In the last three months, the exchange rate of the Swiss franc against the euro has fluctuated between 1.62 and 1.66. In trade-weighted terms, the nominal exchange rate has risen 1.4% since the last quarterly assessment on 14 June. The volatility of the exchange rate can increase rapidly, as witnessed once again in the recent period. Participants in the Swiss franc credit market and entrepreneurs should always be aware of the exchange rate risks they incur.

Once again, growth in mortgage lending has slowed and currently stands at 3.8%. In the past, mortgage lending increased faster than growth in the economy as a whole. Expressed as a ratio to GDP, it has now stabilised at 135%, which is 18% more than in 2000. Growth in lending has increasingly switched to other loans, and these have recorded more powerful expansion, at 11%, than at the beginning of the upswing of the years 1999–2000.

M1 and M2, which include sight and savings deposits, have contracted further. At times of rising interest rates, a transfer of sight and savings deposits into higher interest-bearing time deposits can be observed. The M3 monetary aggregate, which includes term deposits, is growing at a moderate pace, indicating that, even in the longer term, low rates of inflation may be expected.

Inflation risks

Various risks can cause inflation to move in either direction. The oil price, which is high and volatile despite occasional slackening, poses a risk to price stability. Aggregate demand is still strong, when set in relation to production capacity. Moreover, the degree of capacity utilisation and the pressure on prices is often underestimated when the economic situation is good. In addition, the Swiss franc remains at a low level, despite the recent upturn. This is reflected – not least – in the accelerating increase in import prices. These higher prices for imports could impact upon consumer prices.

However, there are also factors that could limit the risk of inflation. These include a possible reduction in the rate of growth. The question as to whether the US mortgage crisis and the crisis on the credit markets will affect the economic cycle and inflation, or the extent of such effects, is still uncertain. The opening up of the Swiss labour market, though, as well as the greater pressure on margins caused by international competition, are both factors that continue to hold down prices.

Monetary policy decision

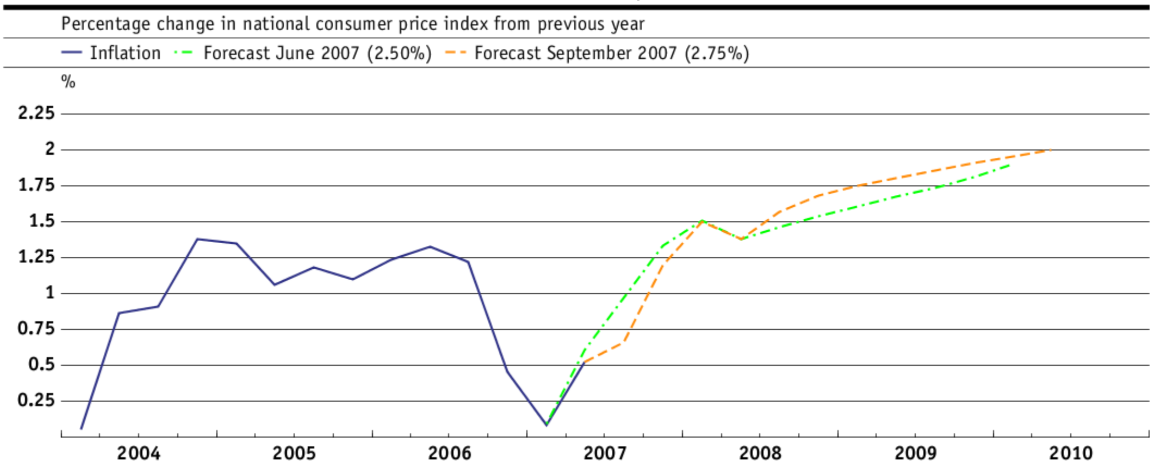
On the assumption that the three-month Libor remains unchanged, the inflation outlook has deteriorated somewhat since the June assessment, and the level of uncertainty associated with the forecast is greater. The rise in the three-month Libor from 2.5% to 2.9% since then, due to the increase in the risk premium, has led to a tightening in the general monetary environment. The new inflation forecast shows that, with a three-month Libor of 2.75%, the inflation outlook is almost unchanged from that in June. The SNB is therefore looking to calm the money market and is targeting a three-month Libor of approximately 2.75%. The target range will be adjusted by 25 basis points to 2.25–3.25%.

Inflation forecast graph

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 June was based on an unchanged three-month Libor of 2.50% (green curve). The new inflation forecast calculated with a constant interest rate of 2.75% is shown in red. Due to the increase in the interest rate, its path is approximately the same as the June curve. Inflation is projected to increase until the first quarter of 2008, and then decline slightly in the second quarter of 2008. In essence, the reason why the forecast follows this path is because of past movements in oil prices (baseline effects). Based on an unchanged three-month Libor of 2.75%, inflation will rise to a level of 2% from mid-2008.

Any forecast or decision is associated with uncertainty and risks. This is particularly the case in the current period of high volatility on the financial markets. The SNB continues to monitor developments closely.

Inflation forecast of June 2007 with Libor at 2.50% and of September 2007 with Libor at 2.75%



Observed inflation September 2007

	2004				2005				2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Inflation	0.06	0.87	0.91	1.38	1.35	1.06	1.18	1.10	1.23	1.33	1.22	0.46	0.09	0.52		

Inflation forecast of June 2007 with Libor at 2.50% and of September 2007 with Libor at 2.75%

	2007				2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast June 2007, Libor at 2.50%		0.61	0.97	1.33	1.51	1.38	1.47	1.54	1.61	1.68	1.74	1.81	1.90			
Forecast September 2007, Libor at 2.75%			0.66	1.20	1.50	1.38	1.57	1.69	1.75	1.80	1.85	1.91	1.96	2.00		

Press release