News conference

Berne, 18 June 2009

Introductory remarks by Jean-Pierre Roth

Since the beginning of the financial crisis in August 2007, our monetary policy has passed through three distinct stages.

In the first stage, as the interbank market gradually dried up, we sought to protect the Swiss economy from a deterioration in conditions on the credit market. From the start of the crisis, we countered the forces pushing the level of the three-month Libor up by undertaking appropriate reductions in the repo rate. Between September 2007 and September 2008, we were able to stabilise the Libor at 2.75%. Thus we protected our economy from a rise in interest rates resulting from the increase in risk premia on the money market. Since we were confident that the economic downturn would have a moderating effect on prices, we refrained from adopting a more restrictive monetary policy, despite the fact that soaring oil prices caused inflation to rise and risked destabilising inflation expectations.

The second stage began in autumn 2008 with the emergence of the first indications of a swift downturn in the economy and the sharp deterioration in the financial crisis after the collapse of Lehman Brothers investment bank. We rapidly relaxed our monetary policy by bringing down our Libor target by 225 basis points to a level of about 0.5% within three months. At the same time, we had been charged with stabilising the financial sector, committing ourselves to take over a large portfolio of illiquid UBS assets. In addition, we concluded euro versus Swiss franc swap arrangements with the European Central Bank and the central banks of Poland and Hungary, to ease refinancing of banks that had granted mortgage loans in Swiss francs in these two countries. These swaps made it possible to counteract the rise in the Libor generated by an additional demand for Swiss francs outside our normal field of operation.

The third stage began in March 2009. By then, price stability was threatened, not by the temporary inflationary escalation of 2008, but quite the opposite – the risk of a fall in prices over the coming three years. Since, by that time, our room for manoeuvre in the area of interest rates was limited, we decided to turn to unconventional instruments in order to bring about a further relaxation in monetary conditions.

How has the economic and financial situation developed since our assessment in March?

Global economic outlook

Global economic activity declined more sharply than expected in the first quarter of 2009, especially in Europe and Japan. However, recent financial and macroeconomic indicators have shown a few encouraging signs. Stock exchange indices have started to edge up. Oil prices, which had been falling since July 2008, have been rising again since March. Risk premia in the money and capital markets have declined. In addition, the indices of business activity and household confidence has clearly turned upward again, even if they remain at historically low levels. The combined effect of all these developments leads us to modify our risk assessment but does not substantially affect our scenario for the global economy. We still believe that positive growth could set in within the US in the second half of the year and in Europe at the beginning of next year. We continue to expect a modest global recovery, so that the considerable under-utilisation of production capacities will not be eliminated in the next few quarters. Consequently, unemployment is likely to increase further in the developed countries as a whole.

Swiss economic outlook

As expected, the Swiss economic situation continued to deteriorate in the first months of the year. In the first quarter, GDP contracted by 3.2% in annualised terms. However, this figure obscures a much sharper drop in final demand. As in the preceding quarter, part of production was, in effect, absorbed by an increase in stocks. External demand again plummeted and the level of capacity utilisation fell substantially in the manufacturing sector. Final domestic demand by private entities stagnated, and is most likely to weaken in the months ahead, since companies will reduce their equipment investment and household expenditure will be checked by growing uncertainty in the labour market. The number of individuals affected by short-time working was rising fast at the beginning of the year, and unemployment is increasing at a regular pace. This trend is likely to persist in the next few months since the leading indicators of labour demand are falling sharply.

Nevertheless, it is to be hoped that the signs of improvement observed abroad will be gradually transmitted to the Swiss economy. From the second quarter, the decline in exports is likely to slow down. However, growth figures will probably remain negative over the next few quarters due to the weakening in domestic demand as well as the reduction of inventory levels. For 2009 as a whole, the Swiss National Bank (SNB) continues to forecast a reduction in GDP of between 2.5% and 3%. These figures are still relatively moderate by comparison with other countries since Switzerland benefits from the broad diversification and relative flexibility of its economy. Even so, I wish to stress that the risks attached to our forecast are clearly skewed to the downside.

Changes in monetary and financial conditions

How have monetary and financial conditions developed since our last assessment in March? Let us begin by looking at movements in interest rates on the money and capital markets as well as currency movements on the foreign exchange markets.

On the money market, three-month Libor moved down, but not as far as we would have liked. Its decline was checked by the level of risk premia, and it currently stands at around

40 basis points. As announced in March, the objective is still “to gradually bring the Libor down to the lower end of the new target range, i.e. to approximately 0.25%.” Progress will be slow, since monetary policy can only influence risk premia indirectly, for instance, by promoting a climate of greater confidence in the banking sector.

The capital market was affected by forces working in opposite directions. On the one hand, long-term rates of interest, which were affected by global developments, rose slightly. This increase reflects renewed optimism about an upturn in the economy, inflationary fears and increased capital requirements on the part of the public sector. On the other hand, risk premia have fallen somewhat. Nonetheless, they remain elevated, and – moreover – the reductions that have occurred have been varied, depending on the quality of borrowers, the maturity of the bond in question and the industry.

The months from November 2007 to March 2009 saw a significant appreciation in the Swiss franc, by 10% in trade-weighted terms and by 11% against the euro. Although interest rates had been reduced between October and December last year, the strengthening of the Swiss franc had the unwelcome effect of tightening monetary conditions. In view of this development, we decided at our March assessment to prevent further appreciation of the Swiss franc against the euro by purchasing foreign currencies on the foreign exchange market. We achieved our objective. Since then the appreciation of the Swiss franc against the euro has ceased and its volatility with respect to the European currency has diminished considerably.

Let us now proceed to an examination of monetary conditions in terms of volume – in other words, in terms of credit and monetary aggregates. Overall, credit is still growing at an annual rate of more than 3%. However, this general figure is composed of a number of different movements in opposite directions. Mortgage lending has been increasing more and more rapidly since November. The growth rate rose from 3.6% in December to 4.2% in April, an advance related to the fall in the Libor. Other credits for all currencies, by contrast, began falling in April (–0.8%), as might be expected in this phase of the economic cycle. Other credits granted in Swiss francs, however, continued growing at a rate of 1.2%, despite the fact that they were already at a relatively high level. Loans granted to private companies grew at a rate of 10.2% in the first quarter of 2009 as compared to the first quarter of 2008. Thus, we do not perceive the slightest indication of any credit crunch in Switzerland. Clearly, with the decline in the quality of certain borrowers during a recession, it is inevitable that a cyclical tightening of loan conditions will occur, but this cannot be termed a credit crunch.

This statistical information is confirmed by the quarterly survey on lending conditions which the SNB has been conducting with the 20 most important Swiss banks since the beginning of 2008. The survey shows that a third of the banks questioned tightened their lending conditions slightly. This proportion is a little higher for loans granted to large companies than those granted to small and medium-sized companies.

To summarise, the situation on the bank lending market remains relatively relaxed and clearly better than that in the US or in the euro area. Nonetheless, deterioration cannot be ruled out for the future.

We now move on to monetary developments. For more than eighteen months now, the demand for liquidity on the interbank market has increased substantially and – as I mentioned before – the loss of trust among banks has brought the market to a standstill. The SNB has been forced to take the place of the lending banks and provide the market with generous amounts of liquidity through a major expansion of its repo lending. Moreover, additional liquidity has been created by purchasing foreign currency on exchange rate markets and bonds issued by private sector borrowers, and by making Swiss franc funding available through swap arrangements with the European Central Bank and with the central banks of Poland and Hungary. Consequently, in May, the monetary base was up by 132% within the space of one year and now amounts to CHF 105 billion. The medium and long-term inflationary threat of this large amount of liquidity is limited because we will be able to absorb it rapidly, by slowing our lending or by issuing SNB Bills, as soon as confidence returns to the markets.

However, liquidity accumulated by the banks could give rise to excessive creation of money through a massive expansion of bank credit. In May, growth in the narrow monetary aggregates, which are very sensitive to changes in the rate of interest, exceeded 40% for M1 and 30% for M2. In essence, this strong rate of growth reflects a preference on the part of the general public for the most liquid monetary assets over time deposits, due to financial uncertainty and the fall in interest rates. The M3 aggregate, which is not affected by these substitution effects, continued growing at a more moderate rate of 4.2% in May, which shows that, at present, created central bank money is confined at the interbank level and has not been transmitted to the rest of the economy. Monetary policy needs to ensure that the level of the monetary aggregates does not become excessive over a longer period. The indicators we are monitoring show that this is not currently the case.

Inflation and inflation risks

Inflation developed in line with our expectations. In the first quarter it was zero, while we were anticipating 0.1%. Overall, our forecasts are unchanged for the current year, with inflation remaining negative for the rest of 2009. This, in essence, is attributable to the prices of imported goods, which are down by comparison to their high levels in 2008. However, inflation for domestic goods and services, despite weakening during the year, will remain above 1%.

The outlook for the following years has been very slightly adjusted upwards. We shall return to this point in a few moments.

Monetary policy decision

At our monetary policy assessment in March, we identified a number of elements that led us to foresee negative inflation for 2009 and a risk of deflation for 2010 and 2011. In view of this threat, we relaxed monetary conditions by taking supplementary measures. We reduced the three-month Libor target range by 25 basis points to 0–0.75%, aiming for a rate of 0.25%. In order to achieve this, we granted longer-term repo credits and concluded foreign exchange swaps. To prevent the Swiss franc from further appreciating against the euro, we purchased foreign currency on the foreign exchange market; we also purchased bonds issued by private sector issuers to foster a decline in capital market risk premia. All in all, these operations achieved their objective. The situation is gradually normalising, although it remains very vulnerable. The risks are still clearly skewed to the downside and are major. Given these conditions, and in view of the inflation forecast, we consider that the time for a correction has not yet come, but that an additional relaxation of monetary conditions is not necessary either. We have thererfore today decided to continue our expansionary monetary policy, maintaining all of the measures we implemented on 12 March.

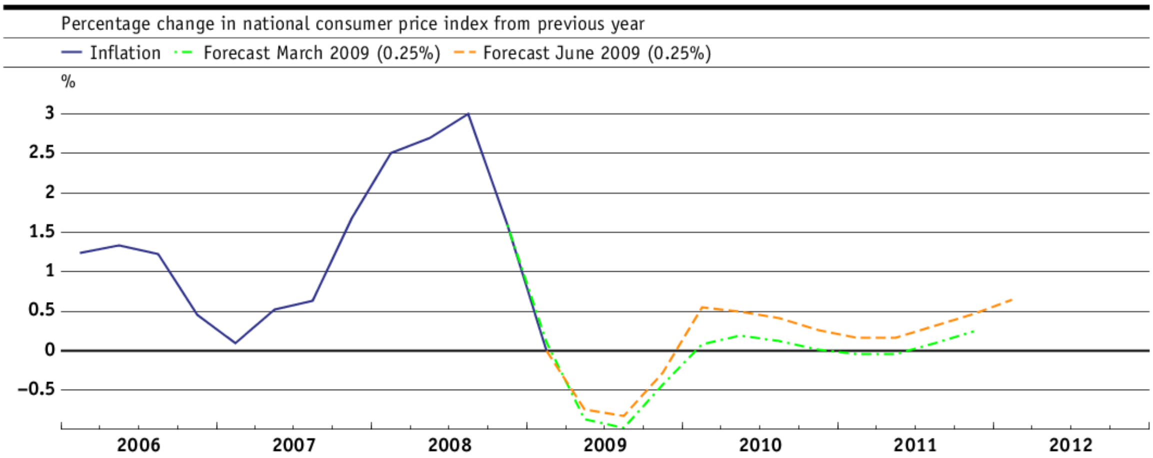
Inflation forecast chart

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 2009 to the first quarter of 2012, and maps the future development of inflation on the assumption that the three-month Libor remains unchanged at 0.25% over the forecasting period. For purposes of comparison, the dash-dotted green curve shows the inflation forecast of the March monetary assessment, which was also based on a three-month Libor of 0.25%.

The new forecast still shows negative inflation for 2009, but with a very slight adjustment upwards. This is explained by the recent upturn in prices of fossil fuels and of commodities in general. However, as an average for the year, inflation will remain negative, at an unchanged rate of –0.5%. In 2010, inflation is likely to return to slightly positive rates and could be a little above the figure forecast in March. This is due to the fact that although domestic inflation is falling it will still amount to around 1% at the end of the year while imported deflation recedes more rapidly. Finally, for 2011, the new forecast shows that inflation will accelerate a little at the end of the forecast horizon if the Libor remains at a level as low as that being aimed for at present. Thus, we see that the Libor cannot remain at 0.25% indefinitely. However, as our forecast also shows, it would not be advisable to increase the Libor now since the very weak inflation rates expected in 2010 (0.4%) and 2011 (0.3%) indicate that the deflation risk has not completely disappeared.

We continue to use an inflation forecast to guide our decisions. In this way, we will ensure that the unconventional measures currently in force do not compromise medium and long-term price stability.

Inflation forecast of March 2009 with Libor at 0.25% and of June 2009 with Libor at 0.25%



Observed inflation June 2009

	2006				2007				2008				2009				2006	2007	2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Inflation	1.23	1.33	1.22	0.46	0.09	0.52	0.63	1.68	2.50	2.70	3.00	1.60	0.00				1.1	0.7	2.5

Inflation forecast of March 2009 with Libor at 0.25% and of June 2009 with Libor at 0.25%

	2009				2010				2011				2012				2009	2010	2011
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Forecast March 2009, Libor at 0.25%	0.10	-0.86	-0.98	-0.43	0.09	0.19	0.13	0.01	-0.05	-0.04	0.10	0.25					-0.5	0.1	0.1
Forecast June 2009, Libor at 0.25%		-0.74	-0.83	-0.28	0.55	0.50	0.40	0.26	0.16	0.17	0.31	0.46	0.65				-0.5	0.4	0.3