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Monetary policy assessment of 13 March 2008

Swiss National Bank leaves the target range for the three-month Libor unchanged at 2.25–3.25%

The Swiss National Bank (SNB) is leaving the target range for the 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.

The international environment will probably result in a slowdown in economic activity in Switzerland. The National Bank forecasts GDP growth between 1.5% and 2% for 2008. Due to the sharp increase in energy prices, the inflation forecast for the current year has been adjusted upwards. The SNB is now forecasting an average rate of inflation of 2% for 2008. A further rise in the oil price could result in yet a further deterioration in this forecast. However, on the assumption of an unchanged Libor of 2.75%, the SNB expects inflation to ease toward the end of the year. Average annual inflation is likely to amount to 1.4% in 2009 and 2010. This forecast is fraught with a great deal of uncertainty, in particular with regard to the global economy, which shows downside risks.

Under the current circumstances, the monetary policy takes into account short and medium-term considerations. On the one hand, the Swiss economy continues to be buoyant and inflationary pressures have increased. On the other hand, the expected slowdown in worldwide growth and its impact on the Swiss economy is likely to contribute to alleviating demand pressure in the medium term. In this situation, the SNB is maintaining its cautious stance and leaving its monetary policy unchanged. Given the favourable inflation outlook in the medium term, the National Bank can afford to do so. However, it will continue to keep a close watch on developments in the financial markets, the international economy, oil prices and the Swiss franc exchange rate, in order to assess their impact on the inflation outlook.

Press release

International environment

The international environment has deteriorated since the last monetary policy assessment in December, and the impact of the crisis in the US real estate market is worsening. In line with most forecasting institutions, the SNB is now expecting a sharper downturn in the US economy and – to a lesser extent – in Europe. Moreover, given the fact that the price of oil has been surprisingly immune to the global economic slowdown, it expects higher inflation in industrialised countries.

Economic outlook for Switzerland

Despite its strong international integration, the Swiss economy, at this point, is little affected by slower growth in its main export markets. In the fourth quarter of 2007, economic activity has even outpaced all expectations. Driven by strong domestic demand, real GDP grew at an annualised rate of 4.2%. Consequently, for 2007 as a whole, GDP growth came to 3.1%. The Swiss economy thus clearly exceeded its long-term average growth figure for the fourth year in a row. During the last few months, the inflation rate has risen considerably as a result of the increase in energy prices. In addition, because of strong demand, higher production costs could be passed on to prices more easily. While inflation was close to zero a little less than a year ago, it reached 2.4% in January and February.

The labour market has continued to profit from the strength of economic activity. Employment improved substantially in the fourth quarter, and the unemployment rate dropped to 2.5% in seasonally-adjusted terms in February. Since the indicators for the demand for labour are still at a high level, the rise in employment is likely to continue in the first part of 2008.

In line with the December forecast, Switzerland's economy will grow at a more moderate pace in 2008. Given the deterioration in the international environment, this slowdown will be somewhat more pronounced than anticipated previously. The SNB now forecasts GDP growth between 1.5% and 2% for 2008.

Monetary and financial conditions

On the whole, monetary conditions are tighter than they were in December. Yields on Swiss Confederation bonds have remained close to their December level. By contrast, yields on private sector bonds have in some cases risen sharply on account of higher risk premiums.

The Swiss franc has strengthened since the beginning of the year. Taking into account the inflation differential between Switzerland and its trading partners, the real effective exchange rate of the Swiss franc has returned to the level of 2006.

Monetary and financial conditions can also be analysed in terms of volumes. M3 continues to register moderate growth which is consistent with a moderate level of inflation in the medium and long term. The gradual slowdown in the growth of mortgage loans, which set in with the normalisation of interest rates, was maintained. Even though growth rates of other types of loans have stabilised, they remain at a high level, reflecting a healthy economy.

Risks associated with the assessment of the inflation outlook

Upside risks predominate in connection with the inflation forecast for the current year. For the following years, upside and downside risks are more symmetrical.

Even though the recent rise in inflation did not come as a surprise, it was underestimated. The new forecast indicates that inflation will hover around 2% until the third quarter of 2008.

Under the current circumstances, there is the risk that inflationary patterns become entrenched because once the expectation of rising prices has taken hold, it is difficult to correct it. Moreover, the current situation runs the risk of spinning out of control because oil prices – hitherto little affected by the slowdown in global economic growth – could continue to climb.

However, the risk of the economy growing at a slower pace than anticipated is not to be underestimated. In this case, the medium-term inflation forecast would have to be corrected downward.

Monetary policy decision

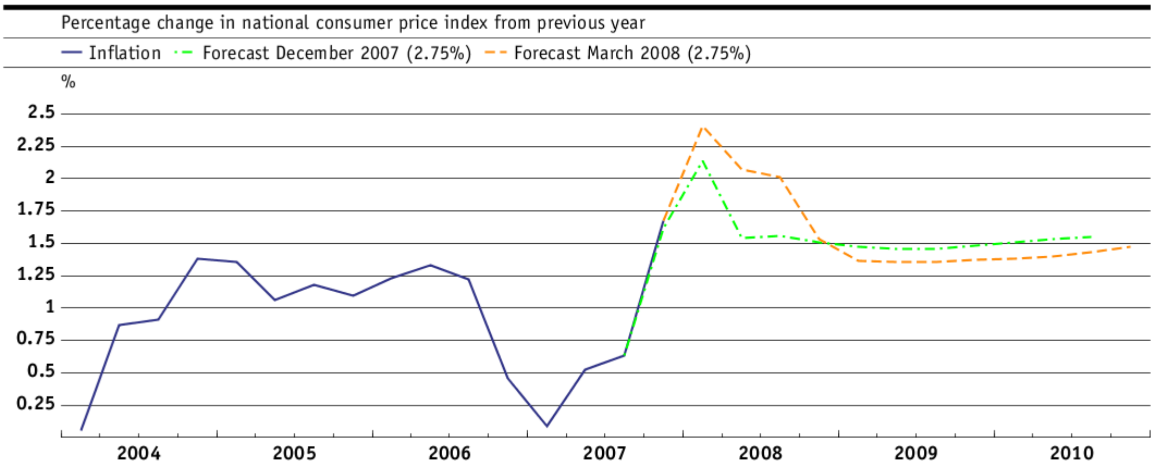
Inflationary pressures have increased since December 2007. However, given the deterioration in the economic outlook, the SNB is not changing its monetary policy. It is of the opinion that an adjustment in the interest rate is not called for under the current circumstances. The turmoil in the international financial markets, and the uncertainty with respect to the extent of possible spin-offs on the rest of the economy, is also a reason to exercise caution.

Inflation forecast based on a three-month Libor of 2.75%

The SNB inflation forecast maps the future development of prices on the assumption that the three-month Libor remains unchanged over the forecasting period. Like the inflation forecast published in December, the new inflation forecast shown in red is calculated with a three-month Libor of 2.75%. Until the fourth quarter of 2008, the curve representing the March forecast is higher than that for December. After that, the new curve is lower, with inflation stabilising at a level of 1.4%. Higher-than-expected inflation at the beginning of the year and the higher forecast for the whole of 2008 are due to brisk demand on the goods, services and labour markets, the high level of capacity utilisation which facilitates the passing on of costs, the price of oil, raw materials and other goods and – finally – the delayed effects of the weak exchange rate in 2007. The improvement in the inflation outlook for 2009 and 2010 is attributable to the fact that the economy will be slowing more rapidly than anticipated in December.

By leaving the three-month Libor at 2.75%, the SNB is maintaining the long-term inflation outlook essentially unchanged. Each forecast is fraught with uncertainties, and both the downside and upside risks are currently higher than usual. The National Bank will therefore keep a close watch on the developments in the financial markets, the global economy, the price of oil and the Swiss franc so as to assess their impact on the inflation.

Inflation forecast of December 2007 with Libor at 2.75% and of March 2008 with Libor at 2.75%



Observed inflation in March 2008

	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	0.63	1.68

Inflation forecast of December 2007 with Libor at 2.75% and of March 2008 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 December 2007, Libor at 2.75%				1.62	2.14	1.54	1.56	1.51	1.47	1.46	1.46	1.48	1.51	1.53	1.55	
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

Press release