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Monetary policy assessment of 18 September 2008

Swiss National Bank leaves 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 Swiss franc three-month Libor unchanged at 2.25–3.25%, and intends to hold the rate in the middle of the target range for the time being. It is continuing its generous and flexible provision of liquidity to the Swiss franc money market.

The slowdown in economic activity, which first made its appearance in the US, is now spreading to Europe and, to a lesser extent, to the emerging economies. Despite a substantial correction, oil prices remain high. They continue to curb the international economy and exert inflationary pressure. The situation on the financial markets is a matter for concern.

Developments in the Swiss economy are in line with the SNB's expectations. During the first half of the current year, the growth rate dropped back, after having reached 3.3% in 2007. The economy has remained relatively robust despite the deterioration in the world economy, but the slowdown is likely to continue over the months to come. The SNB is maintaining its June forecast of real GDP growth between 1.5% and 2% for 2008.

Its inflation forecast has changed only slightly from that published in June; at most, inflation is predicted to decrease a little less quickly next year than might have been expected three months ago. Assuming that the Libor remains unchanged at 2.75%, inflation should reach 2.7% in 2008 and then ease back to 1.9% in 2009 and 1.3% in 2010, as a result of the economic downturn and the stabilisation of oil prices. Due to the substantial risks associated with the future path of the international economy, financial markets and energy prices, this forecast involves considerable uncertainties.

The prospect of inflation decreasing in the medium term makes it possible for the SNB to maintain its monetary policy course without any modification. However, caution is necessary in view of the current risks. Therefore, the SNB will keep a close watch on developments in the global economy, the financial markets and oil prices, so as to be in a position to react swiftly, if the need arises.

Press release

Global economic outlook

The international economy has a strong impact on the Swiss economic outlook. Consequently, the inflation forecasts are based on assumptions with regard to the future path of the global economy. The SNB has revised its June assumptions in two areas. First, it is now assuming a weaker economy for the remainder of 2008, both in the US and in Europe, with the recovery expected for 2009 and 2010 to be delayed. Second, the SNB now predicts a less marked drop in inflation in the US and Europe next year than it had expected three months ago.

Swiss economic outlook

Turning to Switzerland, economic developments in recent months have been in line with SNB expectations. In the second quarter of the year, real GDP growth was slightly below its medium-term potential. The slowdown in financial activity continues to weigh upon growth. Manufacturing and construction, however, are recording a more substantial decrease, although in most cases the initial point of departure was a very high level of activity. Therefore, even though capacity utilisation rates have fallen slightly and staff shortages have become less acute, it is still true to say that capacity utilisation remains at levels above the historical norm.

For the second half of 2008 and the beginning of 2009, the SNB forecasts a continuation of the economic downturn. Consequently, the positive output gap should gradually close. The SNB is leaving its forecast of real GDP growth of between 1.5% and 2% for 2008 unchanged. Following the upward revision in the level of GDP for 2007, it is more likely that the final growth figure for 2008 will be located in the upper part of this range.

Monetary and financial conditions

Monetary conditions are almost unchanged as compared to the situation at the June assessment. Despite the turbulence in the financial markets, the Swiss franc has remained relatively stable. The yield on Confederation bonds – largely determined by interest rate movements in international financial markets – have fallen for all maturities, reflecting the deterioration in the global economic outlook and the heavy demand for the highest-quality securities. Risk premia on interbank markets remain high because of the financial crisis. The SNB's choice of the three-month Libor as the objective it aims to stabilise, rather than the rate for secured interbank loans, means, however, that it continues to shield the Swiss economy to a very considerable extent from the fluctuations in these premia.

At present, the financial crisis has not had any impact on the granting of domestic loans. The rate of growth of mortgage loans attained 3.6% in July. However, as is generally the case towards the end of a business cycle, the rate of growth of other loans – particularly that of unsecured loans – appears to be slowing. Turning now to lending standards, a survey of 20 banks representing 85% of the domestic credit market, which was conducted by the SNB in July, confirmed that the sub-prime crisis has not led to a deterioration in credit conditions in Switzerland. These results differ from those obtained in similar surveys in the US and the euro area.

Since the beginning of 2006, growth rates of the monetary aggregates have been moderate or even negative, which also means that low inflation rates can be expected in the medium and long term.

Inflation and inflation risks

Since December, inflation has been above the 2% mark. The fact that the economy was operating at very high capacity levels last year facilitated the pass-through of oil price rises to consumer prices. The fall in oil prices since July has not yet triggered a substantial drop in the rate of inflation, which amounted to 2.9% in August, after reaching 3.1% in July.

The outlook with respect to inflation remains essentially unchanged. Inflation is likely to continue retreating next year, due to the fall in oil prices in recent months and the forecast slowdown in economic activity. Thus, the current level of inflation is of a temporary nature.

The changes made to the inflation forecast since the June assessment represent, in essence, a technical update. Forecast inflation is slightly higher and more persistent, but the medium-term outlook remains essentially the same.

This inflation forecast involves particular uncertainties. These relate mainly to the assumptions on the outlook for the international economy. Moreover, it is difficult to estimate the extent, duration and impact of the international financial crisis. Finally, it is not possible to precisely assess how inflation will react to the economic slowdown. Due to the high level of demand, the fact that productive resources are currently fully employed, and the continuing high cost of commodities and primary products, there is a risk that inflation could decline less rapidly than currently forecast.

Monetary policy decision

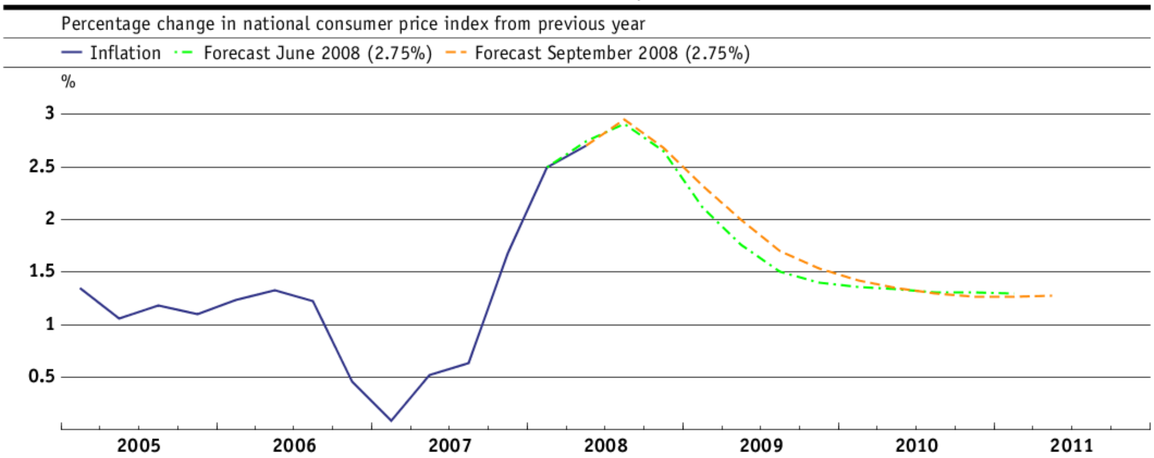
The inflation forecast shows that the rate of inflation will drop below the 2% mark in 2009. The current level of inflation is no more than transitory, since the expected economic slowdown will exert a moderating effect and the impact of the rise in oil prices will ease off gradually over time. Consequently, medium-term price stability is ensured. Moreover, in view of the major uncertainties relating to both the global economy and the fallout from the international financial crisis, the SNB considers that a prudent attitude is appropriate and that the current monetary policy course should be retained. Nevertheless, the high level of inflation at present requires that the SNB remain vigilant. A renewed rise in energy prices, a stronger economy than expected, a weakening of the Swiss franc or an increase in inflation expectations could all threaten medium-term price stability. Conversely, the financial crisis could cause a more marked slowdown in the economy, thereby reducing inflationary pressure. The SNB will therefore continue to keep a close watch on these factors, so as to be able to react quickly should the need arise.

Inflation forecast chart

The new inflation forecast (dashed red curve on the chart) covers the period from the third quarter of 2008 to the second quarter of 2011. Like the previous forecast (dash-dotted green curve), it is based on the assumption that the three-month Libor remains unchanged at 2.75%.

The new forecast indicates that, in the near future, inflation will be slightly more persistent. It will remain above the 2% level until the second quarter of next year. Essentially, this overshooting is due to the previous increases in oil prices and the continued high level of economic activity. However, the forecast shows that the slowing of the economy, the recent fall in oil prices and the associated basis effect will contribute to a drop in inflation in the next few months; it should return to a level compatible with medium-term price stability in 2009.

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



Observed inflation September 2008

	2005				2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	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	2.70		

Inflation forecast of June 2008 with Libor at 2.75% and of September 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 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			
Forecast September 2008, Libor at 2.75%			2.96	2.69	2.32	2.00	1.70	1.54	1.42	1.35	1.30	1.27	1.27	1.28		

Press release