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Overview

Monetary Policy Report (p. 6)

Global economic growth has decelerated slightly since mid-2004. While this was due in particular to the surge in oil prices, the economic slowdown in Asia, notably in China, was also a contributing factor. In the EU and – to a lesser degree – in Japan, the softening of the dollar placed an additional burden on the economy. In the US, by contrast, economic growth remained sound. Economic prospects have faded slightly over the past few months. In the short run, the weak dollar and high oil prices are likely to have a dampening effect on the economy. The prerequisites for a sustained global upswing remain intact, however. For one thing, the economic recovery is broadly based; for another, monetary conditions are still favourable.

Switzerland's economy continued to recover in the second half of 2004. Compared with the previous period, however, the increase in real GDP slowed to 1.4% in the third quarter. Furthermore, the composition of the economy's expansion changed. Domestic demand lost some momentum as a result of stagnating private consumption, while export growth accelerated once again after having flattened off in the previous period. According to the survey results, business activity in industry remained favourable at the beginning of the fourth quarter, despite the fact that the growth in the volume of orders slowed. In the period to October, corporate expectations indicated an upturn in economic development. There was, however, still hardly any sign of improvement in the labour market. The seasonally adjusted employment figures stagnated in the third quarter. Following a slight drop in October, the unemployment rate in November held steady at 3.8%. The proportion of job-seekers remained unchanged at 5.6%.

On 16 December 2004, the SNB decided to leave the target range for the three-month Libor rate unchanged at 0.25–1.25% after it had slightly tightened its monetary policy in June and September. The SNB acted in response to the appreciation of the Swiss franc, which had led to a tightening of monetary conditions in recent months. Owing to the slowdown in economic growth and the decline in excess liquidity, the projected inflationary pressure receded somewhat in the longer term.

The economic situation from the vantage point of the delegates for regional economic relations (p. 38)

The talks held between September and November by the SNB's delegates for regional economic relations with companies of various industries showed that the corporate assessment of the economy had changed only slightly. The companies surveyed believed that the economy was still on track for growth. The pace of growth decelerated, however. While hopes of a noticeable pickup in domestic demand went unfulfilled, exports remained buoyant at the last count. Most companies were confident about the prospects for 2005. Nevertheless, some expected lower growth rates in turnover. Despite the weak dollar and the sharp increase in oil prices, sentiment remained optimistic on the whole.

The development of direct investment Switzerland's international investment position

These two reports, which previously appeared in the fourth-quarter Quarterly Bulletin, are now published separately. "Development of direct investment in 2003" and "Switzerland's international investment position in 2003" are available on the internet at www.snb.ch, Publications, Swiss balance of payments and international investment position.

Monetary Policy Report

This report is based primarily on the data and information available as at mid-December 2004. Sections 1–3 were drawn up for the December 2004 quarterly assessment of the Swiss National Bank's Governing Board.

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About this report

The Swiss National Bank (SNB) has the statutory mandate to pursue a monetary policy serving the interests of the country as a whole. It ensures price stability while taking due account of economic development.

It is a particular concern of the SNB that its monetary policy be understood by a wider public. However, it is also obliged by law to inform the public regularly of its policy and to make its intentions known. This Monetary Policy Report performs both of these tasks. It describes economic and monetary developments in Switzerland and explains the inflation forecast. It shows how the SNB views the economic situation and what conclusions it draws from this assessment.

Sections 1–3 of the present report were drawn up for the Governing Board's assessment of December 2004. The survey and section 4 (inflation forecast) take due account of the Governing Board's monetary policy decision of 16 December 2004.

Unless otherwise stated, all rates of change from the previous period are based on seasonally adjusted data and are annualised.

Survey

Global economic growth has decelerated slightly since mid-2004. This was due in particular to the surge in oil prices, but the economic slowdown in Asia, notably in China, was also a contributing factor. In the EU and – to a lesser degree – in Japan, the softening of the dollar placed an additional burden on the economy. In the US, by contrast, economic growth remained sound.

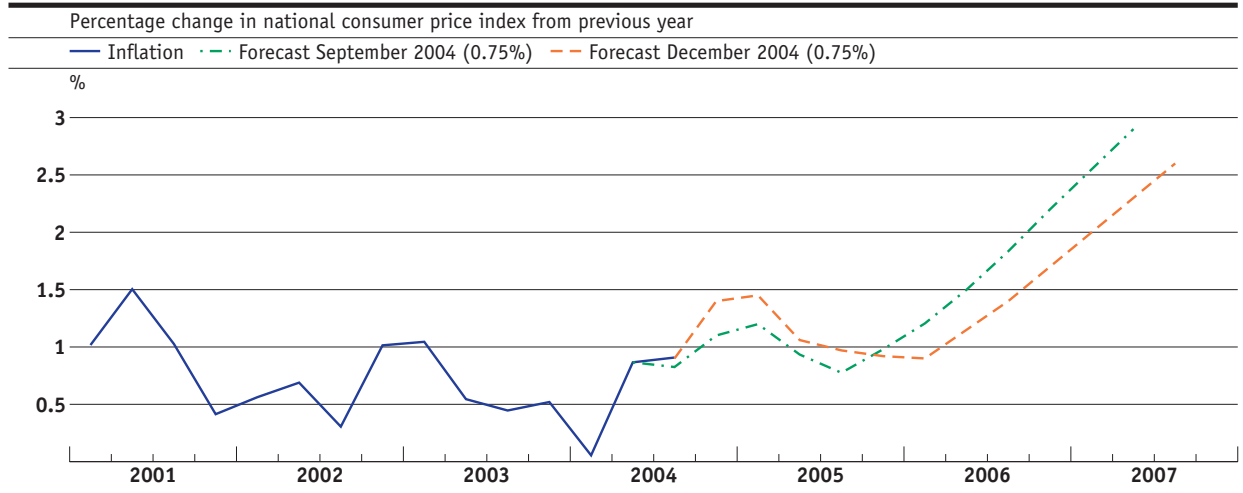
Economic prospects have faded slightly over the past few months. In the short run, the weak dollar and high oil prices are likely to have a dampening effect on the economy. The prerequisites for a sustained global upswing remain intact, however. For one thing, the economic recovery is broadly based; for another, monetary conditions are still favourable.

Switzerland's economy continued to recover in the second half of 2004. Compared with the previous period, however, the increase in real GDP slowed to 1.4% in the third quarter. Furthermore, the composition of the economy's expansion changed. Domestic demand lost some momentum as a result of stagnating private consumption, while export growth accelerated once again after having flattened off in the previous period. According to the survey results, business activity in industry remained buoyant at the beginning of the fourth quarter, but the growth in the volume of orders slowed. There was, however, still hardly any sign of improvement in the labour market. The seasonally adjusted employment figures stagnated in the third quarter. Following a slight drop in October, the unemployment rate in November held steady at 3.8%. The proportion of job-seekers remained unchanged at 5.6%.

According to SNB projections, GDP grew by close to 2% on average in 2004. The SNB assumes that the economic upswing will continue in 2005. As a result of the slightly dimmer outlook for the global economy, however, the upswing is unlikely to strengthen, and real GDP is expected to grow by around 1.5–2%. The economy's production capacity will thus remain underutilised, and a turnaround on the labour market will not materialise before the second half of 2005. Both of these factors will ease inflationary pressures in the medium term. On 16 December 2004, the SNB thus decided to leave the target range for the three-month Libor rate unchanged at 0.25–1.25%, keeping the rate in the middle of the target range at around 0.75%.

In its inflation forecast of December 2004, which is based on the assumption that the three-month Libor remains steady at 0.75% over the following three years, the SNB predicts that the economy will grow by 1.1% in 2005 and by 1.3% in 2006. This projection differs from the September forecast in three respects. Firstly, the projected inflation for 2005 is higher due to the rise in oil prices. Secondly, the inflationary uptrend sets in half a year later. And thirdly, inflationary pressure has decreased in the long term. Nevertheless, with the three-month Libor remaining unchanged at 0.75%, inflation is expected to increase considerably as of mid-2006. This leads to the conclusion that the SNB will have to tighten its monetary policy in the next three years so as to guarantee price stability in the longer term, too.

Inflation forecast of September 2004 with Libor at 0.75% and of December 2004 with Libor at 0.7%



Inflation forecast of December 2004 with Libor at 0.75%

	2004	2005	2006
Annual average inflation in percent	0.8	1.1	1.3

1 Development of the global economy

Global economic growth has decelerated slightly since mid-2004. This was due in particular to the surge in oil prices, but the economic slowdown in Asia, notably in China, was also a contributing factor. In the EU and – to a lesser degree – in Japan, the softening of the dollar placed an additional burden on the economy. In the US, by contrast, economic growth remained sound.

Robust economic growth in the US

In the US, real GDP rose by 3.9% in the third quarter, exceeding the figure for the previous period. Private consumption provided significant stimuli, picking up considerably following the sluggish second quarter. The available indicators suggest that the broad-based upswing will continue in the fourth quarter. The purchasing managers' indices (PMI), which measure business activity in industry and in the service sector, were still in the expansionary zone in November. Towards the end of the year, employment growth also accelerated, which is likely to further stimulate private consumption. Given the high corporate profits and low interest rates, moreover, the strong growth in corporate spending can be expected to continue. Exports, finally, should be bolstered by the dollar's substantial slide.

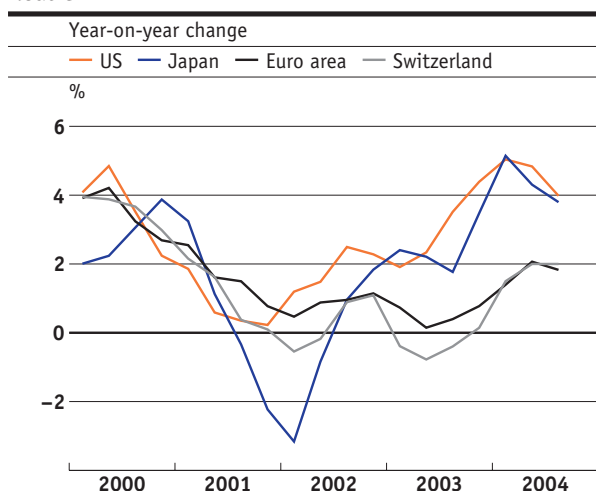
Economic slowdown in Europe...

In the euro area, real GDP growth weakened from 1.9% in the second quarter to 1.2% in the third quarter. Whereas exports lost some momentum, domestic demand picked up. The upswing in investment activity was particularly pleasing. Private consumption, by contrast, still showed no signs of recovery. This is partly due to the persistently high rate of unemployment in the euro area, which stood unchanged at 8.9% in the third quarter. Broken down by country, the economic performance of Germany and France was unexpectedly weak in the third quarter. Italy and many smaller countries, however, exhibited robust growth.

In the fourth quarter, the continued sharp depreciation of the dollar versus the euro caused increasing concern. The latest surveys showed that the producers were less optimistic, but did not anticipate a recession.

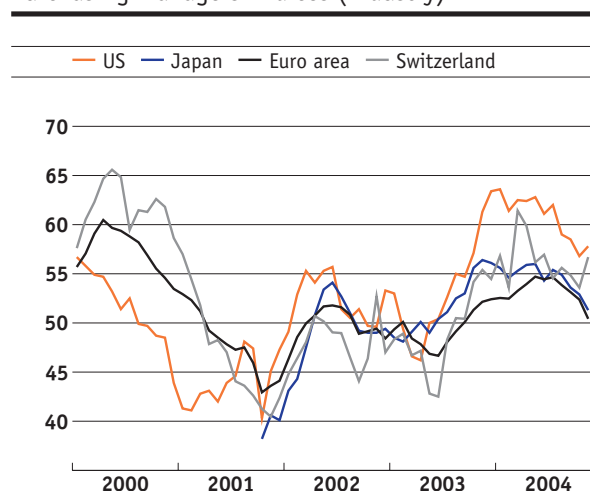
Economic momentum in the UK, too, dwindled significantly in the third quarter. Real GDP rose by 1.8% from the previous period, following a 3.7% increase in the second quarter. As expected, the tightening of monetary policy a year ago cooled down the overheated property market. Despite the significant slowdown, the outlook for the UK economy remained bright. Employment continues to climb, thus underpinning private consumption. Moreover, the price competitiveness of the UK economy improved in the last few months on the back of the weaker pound sterling.

Graph 1.1
Real GDP



Sources: Bank for International Settlements (BIS), State Secretariat for Economic Affairs (seco)

Graph 1.2
Purchasing managers' indices (industry)



Source: Datastream

... and in Japan

Following a vigorous start into 2004, real GDP in Japan stagnated in the second and third quarters. The sluggishness was largely due to lower demand from China and the US; the domestic market continued to underpin the economy. Despite lacklustre growth, the latest corporate and consumer surveys painted an optimistic picture. The economic recovery can thus in principle be expected to continue.

Oil prices boost inflation

The oil price hike was the predominant factor influencing inflation in the industrial countries in the third quarter, too. In October, a barrel of Brent crude oil traded for over USD 50 at times; by mid-December, however, the oil price had fallen back to just under USD 40 per barrel.

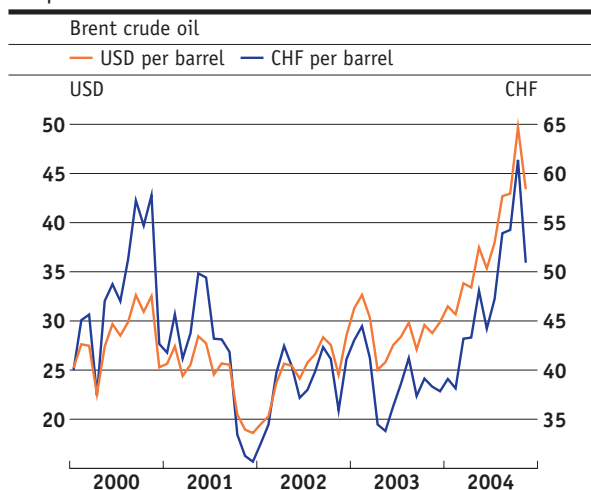
In the US, annual consumer price inflation rose from 2.5% in September to 3.2% in October. In the euro area, it reached 2.4% in October, after having persisted at just over 2% since April. Excluding energy prices, however, inflation edged lower over the past few months. In Japan, the deflationary trend continued in the third quarter; in October, inflation was back on the rise (+0.5%) thanks to an upsurge in food prices.

Tighter monetary policy in the US and UK

The US and UK central banks continued their policy of gradually raising key rates in the second half of the year so as to counter medium-term inflation risks. For the fifth time since June, the Federal Reserve increased the fed funds rate by 0.25 percentage points to 2.25% in December. At the beginning of August, the Bank of England, which had already started to tighten its monetary policy in November 2003, raised its key rate by 0.25 percentage points to 4.75%. It did not lift rates any further until the end of the year, though, as the economy had begun to show signs of slowing in the third quarter.

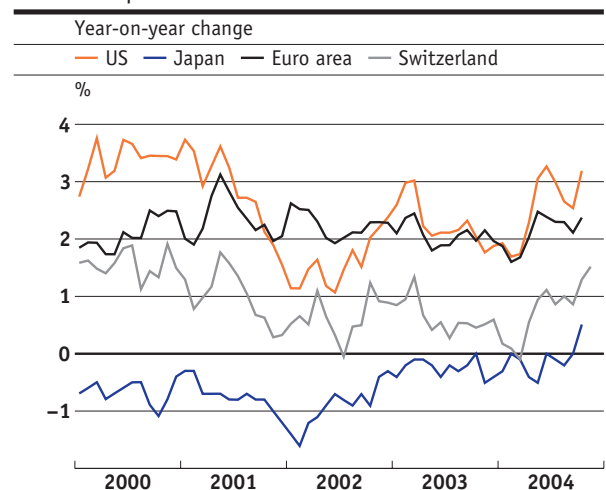
The European Central Bank (ECB) kept its main refinancing rate at 2.0% after having last lowered it by 0.25 percentage points in June 2003. It expressed growing concern over the cooling of the economy in the euro area and the appreciation of the euro. The Bank of Japan, too, adhered to its expansionary monetary policy, leaving the key rate close to zero.

Graph 1.3
Oil prices



Source: SNB

Graph 1.4
Consumer prices



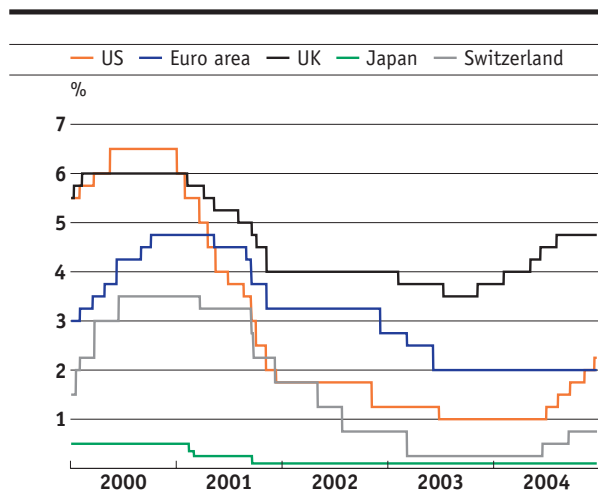
Source: BIS

Economic prospects slightly clouded

International economic prospects have faded slightly over the past few months, which is also reflected in the OECD's leading indicators. Amid the high oil prices and the massive slide of the dollar, uncertainty increased. In the short run, these two factors are likely to slow down global economic growth. The prerequisites for a sustained global upswing remain intact, however. For one thing, the economic recovery is now broadly based; for another, monetary conditions are still favourable. The economy can thus be expected to rebound globally in the course of 2005. This will especially be the case should oil prices decrease substantially.

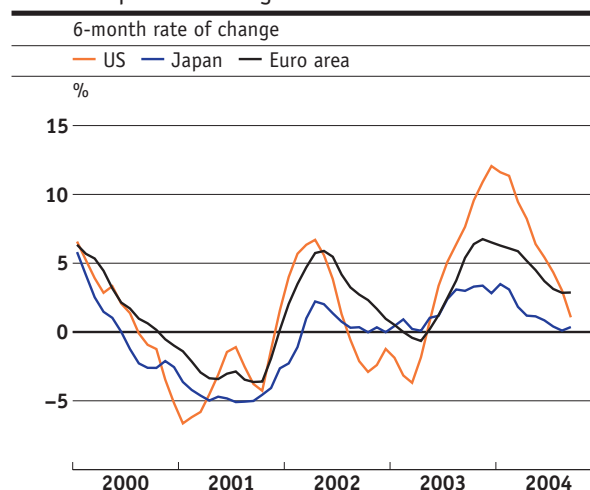
According to the November consensus forecast of Consensus Economics Inc., the economic recovery will continue in 2005. In most industrial countries, however, real GDP will expand at a more leisurely pace than in 2004. The survey suggests that GDP will fall by 2.5 percentage points to 1.8% in Japan, by 1 percentage point to 3.4% in the US, by 0.6 percentage points to 2.6% in the UK and by 0.4 percentage points to 1.5% in Germany. According to the consensus, growth in the euro area will remain unchanged at 1.9% as the economies in Italy and the Netherlands, among others, are set to gain momentum. A very similar picture emerges from the OECD forecasts for 2005. These forecasts largely match the SNB's international assumptions underlying its inflation forecast of December 2004 (cf. chapter 4).

Graph 1.5
Official interest rates



Sources: BIS, SNB

Graph 1.6
OECD composite leading indicators



Sources: OECD

	Economic growth ¹				Inflation ²			
	OECD		Consensus ³		OECD		Consensus ³	
	2004	2005	2004	2005	2004	2005	2004	2005
United States	4.4	3.3	4.4	3.4	2.6	2.4	2.6	2.4
Japan	4.0	2.1	4.3	1.8	-0.1	0.1	-0.1	0.0
Euro area	1.8	1.9	1.9	1.9	2.1	2.0	2.2	1.9
Germany	1.2	1.4	1.9	1.5	1.7	1.3	1.7	1.5
France	2.1	2.0	2.4	2.2	2.3	1.8	2.2	1.8
Italy	1.3	1.7	1.2	1.7	2.1	2.5	2.2	2.2
United Kingdom	3.2	2.6	3.2	2.6	1.3	1.7	1.4	1.7

1 Real GDP, year-on-year change in percent

2 Consumer prices, year-on-year change in percent

3 Consensus forecasts are monthly surveys conducted among over 240 leading companies and economic research institutes in more than 20 countries, covering predictions for the expected development of GDP, prices, interest rates and other relevant economic indicators. The results are published by Consensus Economics Inc., London.

Sources: OECD Economic Outlook, December 2004; Consensus: November 2004 Survey

2 Development of the Swiss economy

2.1 Aggregate demand and output

Economic growth weaker, but still robust

Switzerland's economy continued to recover in the third quarter of 2004. Growth in real GDP slowed slightly to 1.4% compared with the second quarter. The economy grew by 2% year-on-year, which was the same rate as in the previous period.

Compared with the second quarter, the composition of the economy's expansion changed. Domestic demand (excluding stocks) lost some momentum, whereas export growth accelerated. The lower increase in domestic demand was due to virtually flat private consumption. Investment activity, by contrast, continued its uptrend. Overall, aggregate demand rose by close to 4% versus the second quarter, i.e. slightly less than in that period. Nevertheless, imports of goods and services accelerated. Imports of raw materials, semi-manufactures and energy sources staged a particularly steep increase.

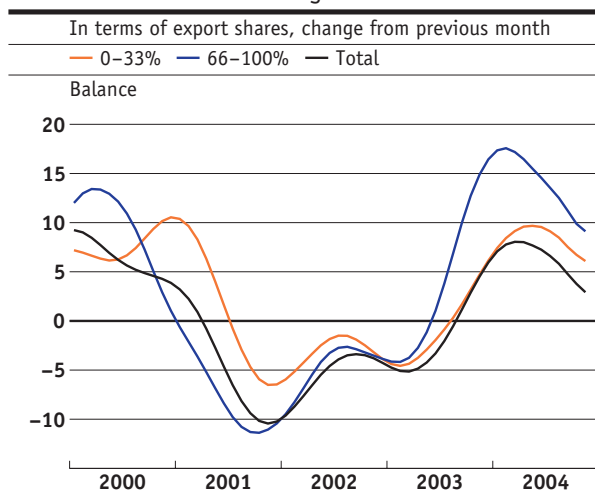
Manufacturing sector recovers further

The manufacturing industry continued on its path of recovery in the third quarter. Industrial output rose by an annualised 0.9% from the second quarter, thus exceeding the year-earlier level by 3.8% following year-on-year growth of 5.5% in the second quarter.

According to the survey results, business activity in industry remained favourable at the beginning of the fourth quarter. In October, incoming orders increased further and the order backlog rose. However, both the KOF/FIT survey and the purchasing managers' index suggested that incoming orders and industrial production would grow at a slower pace.

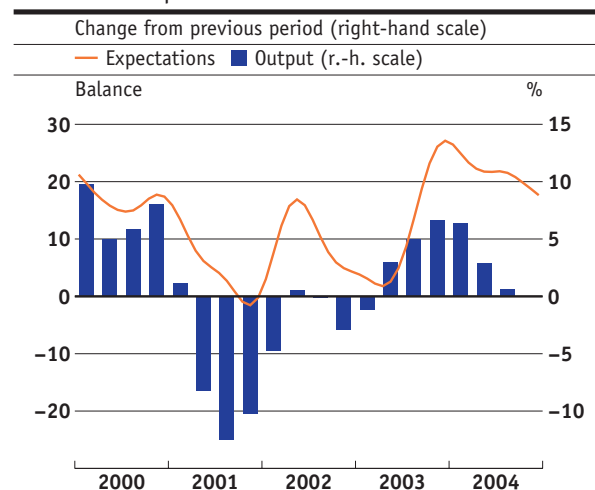
Corporate expectations, which improved greatly in the second half of 2003, have become somewhat less optimistic since the beginning of 2004. Until October, however, they were still within the zone that is indicative of an upturn in economic development. As in the third quarter, companies geared to the home market became slightly more upbeat, whereas the export industry was somewhat more cautious in its assessment of the outlook.

Graph 2.1
New orders in manufacturing



Source: Swiss Institute for Business Cycle Research at the Swiss Federal Institute of Technology (KOF/FIT)

Graph 2.2
Industrial output



Sources: KOF/FIT, Swiss Federal Statistical Office (SFSO)

Real GDP and components
Change from previous period in percent

Table 2.1

	2000	2001	2002	2003	2003				2004			
					Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Private consumption	2.3	2.0	0.3	0.5	-1.2	0.4	1.3	1.3	2.9	2.1	1.4	0.4
Government consumption	2.6	4.2	3.2	1.4	-0.2	0.7	1.9	1.4	1.6	1.7	0.2	-0.2
Investment in fixed assets	4.3	-3.1	0.3	-0.3	-6.7	4.3	-11.7	8.7	11.3	4.3	5.7	4.5
- Construction	2.7	-3.4	2.2	1.8	0.4	1.4	2.9	3.9	5.7	4.0	3.3	3.5
- Capital goods	5.5	-2.9	-1.1	-2.0	-5.4	-3.1	-5.9	5.4	5.4	4.6	7.6	5.3
Domestic final demand	2.8	1.0	0.7	0.4	-3.0	1.6	-1.8	3.0	4.7	2.5	2.2	1.2
Domestic demand¹	2.1	2.3	-0.8	0.2	-3.1	7.5	-9.7	5.9	3.8	-3.5	5.5	4.4
Total exports ¹	12.2	0.2	-0.2	0.0	0.7	-17.6	8.4	9.9	13.1	8.0	2.3	2.6
- Goods ²	11.9	3.7	0.3	0.7	-2.8	-11.3	5.9	9.2	12.9	9.3	3.7	6.4
- Services	13.6	-2.8	-3.8	0.6	-0.2	-9.6	6.8	13.7	6.8	-4.1	1.2	-1.6
Aggregate demand	5.2	1.7	-0.6	0.1	-2.5	-0.4	-2.9	5.3	5.8	0.1	4.5	3.8
Total imports ¹	9.6	3.2	-2.8	1.4	-5.7	5.6	-6.4	11.3	15.5	0.7	6.4	10.6
- Goods ²	9.7	1.6	-2.2	2.7	-7.9	21.3	-19.8	24.3	18.2	-1.3	2.5	13.5
- Services	5.9	11.2	-1.7	-1.4	2.3	-3.1	-0.9	-4.2	-0.7	17.7	-1.4	10.6
GDP	3.6	1.0	0.3	-0.4	0.2	-4.3	0.3	2.2	2.1	1.8	1.7	1.4

1 Including precious metals, precious stones and gems as well as objets d'art and antiques

2 Excluding the above under footnote 1

Source: seco

Little change in corporate assessment of the economy

The talks held last autumn by the SNB's delegates for regional economic relations with companies in various industries showed that the corporate assessment of the economy had changed only slightly overall. The companies surveyed believed that the economy was still on track for growth. The pace of growth decelerated, though, increasing the discrepancy between business activity in the various industries. Despite the high oil price and the weak dollar, most companies were upbeat about the prospects for 2005.

Export growth recovers slightly

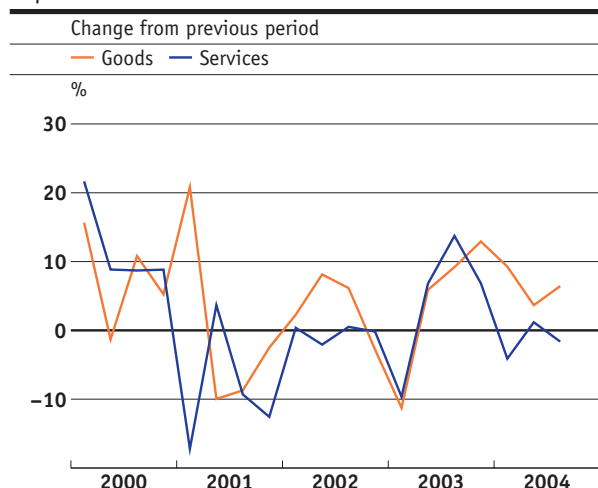
Following the abrupt slackening of growth in the second quarter, real exports rebounded in the third quarter. This was due solely to the development of goods shipments. Exports of services, by contrast, contracted a little. Total exports were up 5.5% year-on-year.

Pharmaceuticals and chemicals, which account for roughly 30% of total goods exports, again expanded at an above-average rate. Exports of semi-manufactures also performed well. Capital goods exports, by contrast, were on the decline, but still topped the year-back level. Growth of goods exports slackened noticeably in October, but rebounded in November.

The breakdown of exports by country changed. Exports to the US and Asia, which had exhibited vigorous growth until mid-year, declined compared with the previous period, whereas shipments to the EU picked up and surpassed the year-back level by 8% (EU-25, in nominal terms). Exports to the different EU countries varied significantly, however. While shipments to the UK and south European countries strengthened considerably, those to Germany and France stagnated. Exports to the new EU member countries fell off.

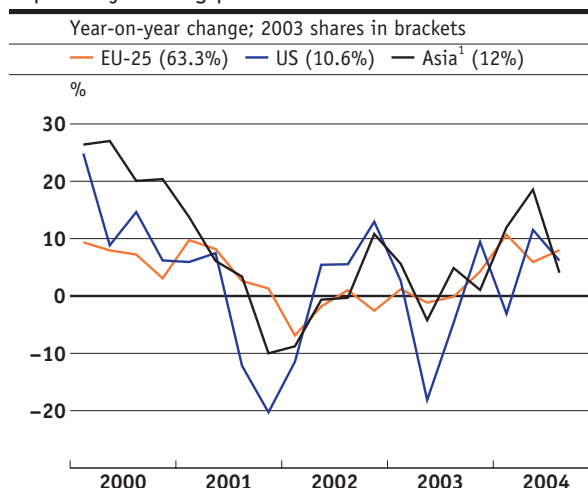
Exports of services again inched lower in the third quarter, thus exceeding the year-earlier level by a mere 0.3%. This decrease was mainly accounted for by the falling income of private insurance companies and transportation firms. Whereas receipts from bank commissions stagnated, revenue from tourism rose further.

Graph 2.3
Exports



Source: seco

Graph 2.4
Exports by trading partners



1 Asia: Japan, China, South Korea, Hong Kong, Singapore, Taiwan, Malaysia, Thailand, Philippines, Indonesia
Source: Federal Customs Administration (FCA)

Surge in imports

Growth in real imports strengthened in the third quarter. Compared with the previous year, imports of goods and services climbed by 7.5%. Goods imports again contributed most to this development, with imports of raw materials, semi-manufactures and energy sources displaying particularly steep growth rates. However, imports of services, too, rebounded vigorously following an interim low in the second quarter. Towards the end of the quarter, and in October and November, growth in goods imports dropped off overall.

Weaker growth in consumption

Private consumption lost considerable momentum in the third quarter. It expanded by a mere 0.4% compared with the previous period, thus falling below its long-term trend rate of 1.3% for the first time since the beginning of 2003. In a year-on-year comparison, private consumption grew by 1.5%.

In real terms, retail sales stagnated in the third quarter, thus topping the year-back level by just 0.6% (1.3% in the second quarter). While demand for household furnishings remained vibrant, spending on other consumer durables (particularly household items) fell off after having surged in the first half of the year. The restrained consumer demand was reflected by imports of consumer goods, which increased at a slower rate in the third quarter than in the previous period. New registrations of motor cars continued their descent, falling 4.3% year-on-year.

According to the results of the KOF/FIT survey in the hospitality industry, the moderate uptrend in the domestic tourist sector continued. The number of overnight stays by Swiss guests in the third quarter is likely to have slightly surpassed the year-ago level.

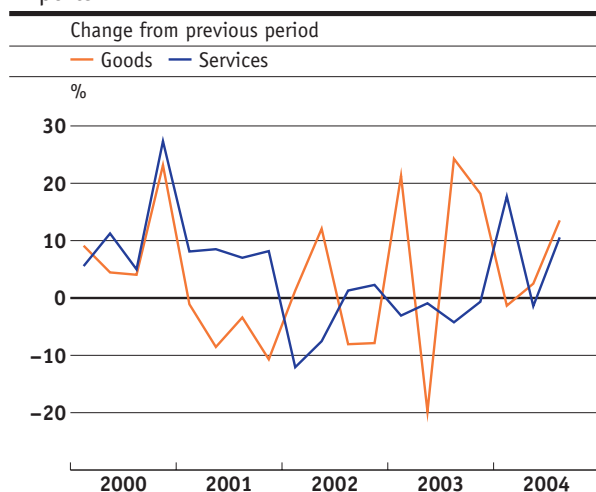
Unchanged consumer sentiment

The consumer sentiment index still trended sideways in October at -13 points (July: -12 points). The households surveyed also considered the economic situation to have worsened since the previous survey. Job security, as assessed by the survey correspondents, also declined further. However, their assessment of their own financial situation, which – as experience has shown – is particularly significant for the consumers' future behaviour, was a shade better than in July.

Cautiously optimistic prospects

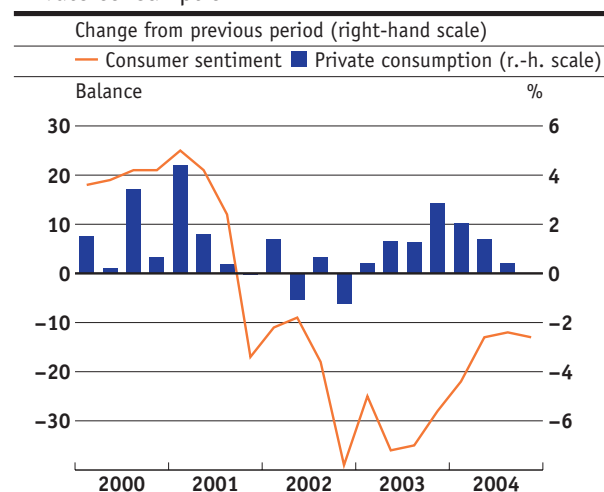
The surveys conducted by KOF/FIT fail to give a uniform picture. Activity and turnover in the retail industry remained sluggish in October, but the outlook for the six months ahead was still optimistic. The third-quarter hospitality survey, by contrast, indicates that optimism in the hotel industry is waning and that the winter season will probably be off to a slow start.

Graph 2.5
Imports



Source: seco

Graph 2.6
Private consumption



Source: seco

Private consumption was bolstered by a high backlog of demand in the first half of 2004, but did not benefit significantly from income effects. In some areas, such as household goods, the demand backlog is almost met. The prerequisite for sustained growth in consumer spending is an increase in disposable income. The SNB anticipates that the real income of employees will rise by 1.1% in 2005 – slightly more than in the previous year (+0.7%) – as a result of the expected increase in wages and salaries. This should shore up private consumption.

Robust and broad-based construction activity

Construction investment continued to be an important pillar of the economy. In the third quarter, it exceeded the year-earlier level by 4.0%. The continuing surge in the number of dwellings under construction indicates that residential construction still provided significant growth stimuli. According to the quarterly survey conducted by the Swiss Association of Builders, commercial construction and the civil engineering market also picked up momentum in the last two quarters, however. For the first time in a long while, therefore, the construction sector is experiencing a broad-based recovery again.

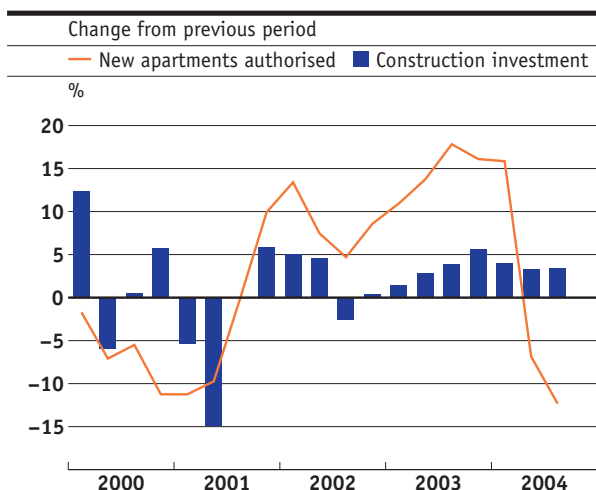
Low interest rates should continue to boost residential construction in the quarters ahead. After two very dynamic years, however, growth in this segment must be expected to slow gradually. The vacancy rate was still creeping up slightly in the third quarter.¹ This is a sign of more ample supply in the residential market, which should dampen residential construc-

tion activity in the medium term. One indication for this development is the dwindling number of residential building permits issued in the third quarter. Commercial construction is likely to revive only modestly, given the high vacancy rate for office property.

Subdued growth in equipment investment

Equipment investment grew by roughly 5% in the third quarter compared with the previous period, exceeding the year-back level by almost 6%. While demand for precision instruments remained robust, demand for IT goods staged a revival. Purchases of industrial machinery, however, which account for about 40% of equipment investment, declined somewhat. Due to the higher utilisation rate of technical capacity and the still optimistic outlook for production levels, equipment investment can be expected to expand slightly faster in the quarters ahead.

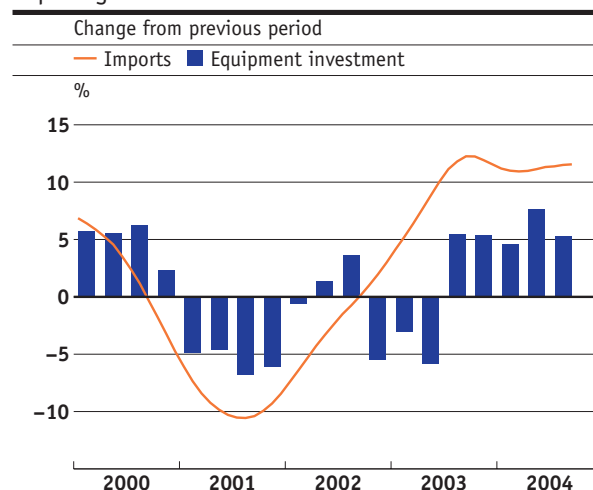
Graph 2.7
Construction



1 Source: Wüest & Partner

Sources: SFSO, seco

Graph 2.8
Capital goods



Sources: FCA, seco

2.2 Capacity utilisation

Smaller output gap

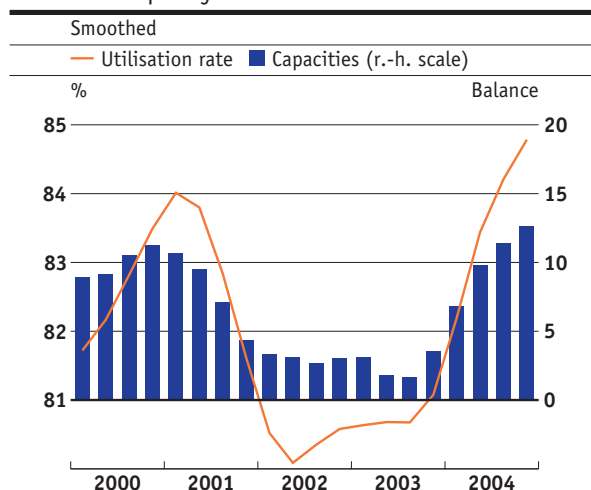
In the first three quarters of the year, Switzerland's economy developed mostly in line with expectations. Real GDP was no longer expanding at an annual rate of over 2% as it had in the second half of 2003, but its trend growth rate of 1.6% on average was still sufficient to narrow the output gap slightly.

The output gap is defined as the difference in percent between actual and potential GDP. The SNB estimates potential output by means of three different methods (cf. Quarterly Bulletin 2/2004, p. 21, for a brief description). According to the HP filter, a technical smoothing method, the gap has steadily narrowed since the third quarter of 2003. It is still negative, though, which indicates that the production factors are underutilised (graph 2.10). The multivariate filter, which additionally takes account of information on the relationship between the output gap and inflation, developed very similarly. The difference to the estimate using the production function approach is more significant. Although this approach suggests that the output gap began to close a little earlier in 2003, the latest figures for the gap are still larger than those computed by the two filter methods.

Good level of capacity utilisation in industry

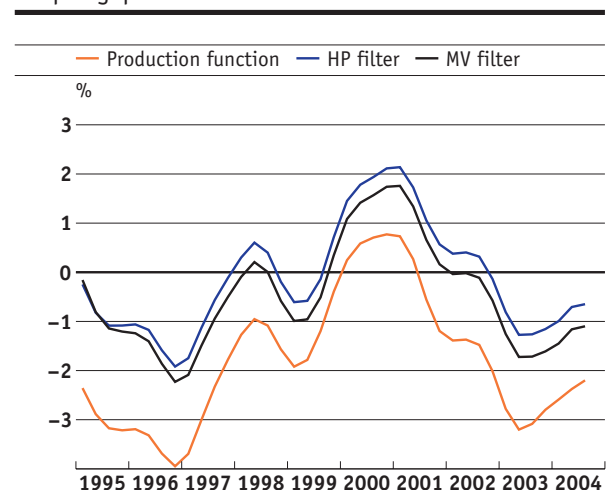
Some of the other indicators paint a brighter picture. The KOF/FIT survey, for instance, demonstrates clearly that the utilisation of technical capacity in industry improved rapidly after its trough in the third quarter of 2003 (graph 2.9). It has in the meantime even slightly exceeded the long-term average of 84%. A similar picture is presented by the answers to the survey question as to whether production was being hampered by insufficient technical capacity. The ratio of industrial businesses considering that this is indeed the case rose again in the third quarter and now is clearly above the recession-induced lows recorded in the previous year. By contrast, the ratio of businesses indicating that output was being constrained by labour shortages decreased from the previous quarter and continues to hover around virtually the same level as a year earlier. The availability of labour, therefore, is still not limiting output.

Graph 2.9
Industrial capacity



Source: KOF/FIT

Graph 2.10
Output gap



Source: SNB

2.3 Labour market

Stagnating employment

Since the beginning of the year, the labour market showed hardly any signs of improvement. Employment held almost steady and topped the year-back level by a mere 0.2% in the third quarter. In the manufacturing sector, it fell at a slightly faster rate of 1.1% compared with the previous period. Employment growth in the service sector came to a halt again after approximately 25,000 new jobs had been created since mid-2003. Job cuts in the wholesale and retail industries were the key factors in this development.

The breakdown of employment by full and part-time jobs has remained much the same for the last three years: while full-time employment has been on the decline, part-time work has staged a vigorous increase. In the third quarter, the number of full-time jobs dropped by 1.5%, whereas part-time work rose by 2.4% from the previous period. In terms of full-time equivalents, employment slipped by 1%. The rise in real GDP thus meant that labour productivity had increased significantly.

Unemployment virtually unchanged

After having stagnated at 3.9% for a year, the seasonally adjusted unemployment rate dropped slightly to 3.8% in October and persisted at this level in November. The proportion of job-seekers remained unchanged at 5.6% until November. With employment still stagnating, October's modest decrease in the jobless rate can hardly be considered a positive turnaround yet.

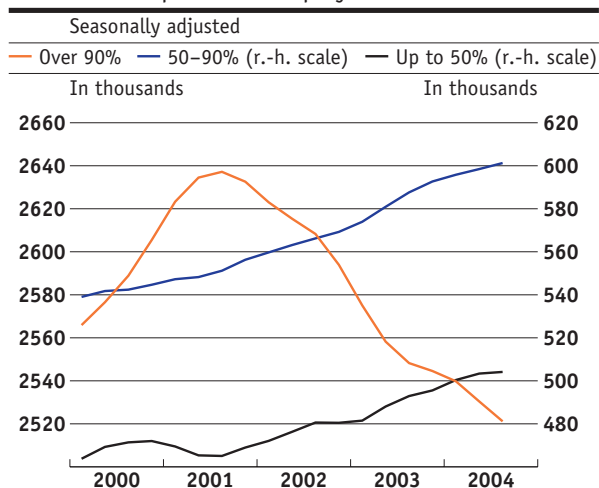
Broken down by region, unemployment showed mixed developments. Whereas the unemployment rate in German-speaking Switzerland has slipped by 0.3 percentage points to 3.3% since the beginning of the year, it has climbed from 4.4% to 5.0% in French-speaking Switzerland and from 4.7% to 5.2% in Ticino.

No rapid turnaround on the horizon

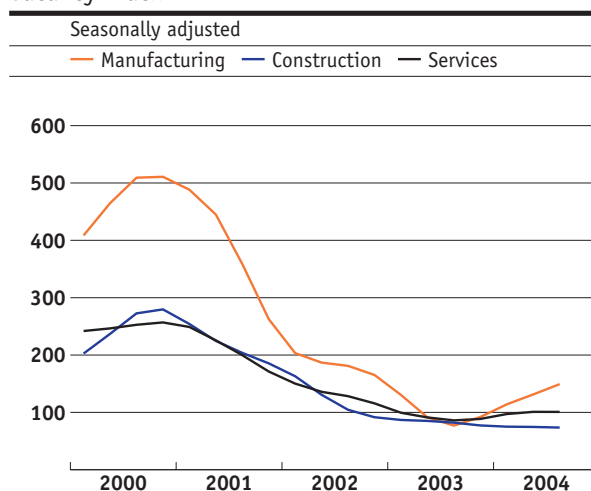
The leading indicators for the labour market are still not signalling any rapid improvement in the employment situation. The SFSO's vacancy index edged higher in the last few months, but was still at a level that militates against any rise in employment. The Manpower Index, which measures the area occupied by job advertisements in newspapers, presents much the same picture.

In 2005, however, the situation on the labour market can be expected to improve gradually. Employment in 2002 and 2003 receded only marginally in comparison with the development of real GDP. Initially, therefore, companies were able to handle the higher production volume with the same staff level. This "catching up" process should soon come to an end. With real GDP expanding at a rate of approximately 1.5–2%, employment is likely to climb slightly and unemployment should gradually drop.

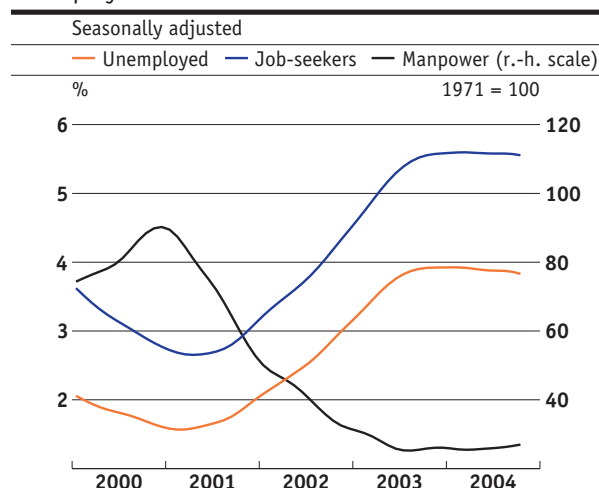
Graph 2.11
Full-time and part-time employment



Graph 2.12
Vacancy index



Graph 2.13
Unemployment rates and vacancies



Graphs 2.11, 2.12:
Source: SFSO

Graph 2.13:
Unemployed and job-seekers registered with the regional employment offices in percent of the economically active population according to the 2000 census (3,946,988 economically active persons)
Sources: Manpower, seco

2.4 Goods prices

Producer and import prices still on the rise

The inflationary pressure exerted by producer and import prices on the downstream consumer level intensified further between July and October. To a significant extent, however, this increase was due to higher prices for mineral oil products. Producer prices topped the year-ago level by 1.7% in October after having risen by 1.3% in July. Once again, prices of products for the domestic market increased more steeply than prices of export goods. Annual inflation for imported goods went up from 1.5% to 2.6%. Price increases of energy sources and metal products were again particularly pronounced. By contrast, prices of imported agricultural products fell by 4.1% on average from July to October compared with the previous year. Prices of capital goods also declined, but not by as much as in the first half of the year.

Higher consumer price inflation

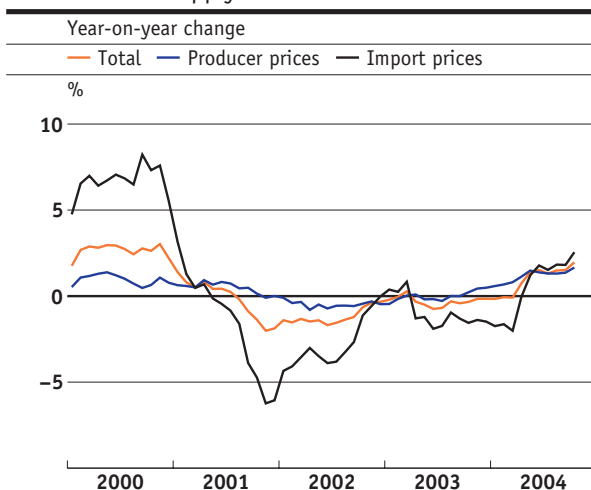
Between August and November, annual inflation, as measured by the national consumer price index, accelerated from 1.0% to 1.5%. It was thus marginally higher than projected by the SNB in its inflation forecast of September 2004. The course of inflation was primarily influenced by price hikes for oil products and the rise in residential rents. Since July, the core inflation rates have signalled a slight increase in the general inflation trend.

Small rise in domestic inflation

Between August and November, the annual inflation for domestic goods and services rose from 0.9% to 1.2%. The quarterly rentals index rose by 0.5% in November versus August, and the annualised rate of rent inflation thus accelerated by 0.5 percentage points to 2.1%. The increase in rents was again partly due to the delayed updating of the sample register. This meant that a larger number of newer and more expensive apartments were taken into account. The latest rise in apartment rents thus comprises quality-induced price increases that had not been adequately considered in the past and are now included in the index after a timelag.

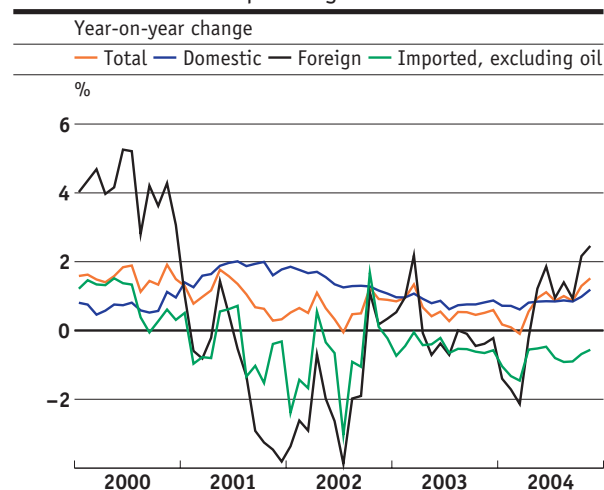
The annual inflation for other private services rose by 0.3 percentage points to 0.9% between August and November. Higher inflation rates were recorded by the hospitality industry and the telecommunications sector in particular. The upward price movement for public services increased from 2.0% to 2.2% due to the adjustment of hospital charges.

Graph 2.14
Prices of total supply



Source: SFSO

Graph 2.15
CPI: Domestic and imported goods and services



National consumer price index, 2000 = 100
Sources: SFSO, SNB

National consumer price index and components
Year-on-year change in percent

Table 2.2

	2003	2004						
		Q1	Q2	Q3	August	September	October	November
Overall CPI	0.6	0.1	0.9	0.9	1.0	0.9	1.3	1.5
Domestic goods and services	0.8	0.7	0.8	0.9	0.9	0.8	1.0	1.2
Goods	0.6	0.9	0.7	0.3	0.1	0.0	0.3	0.2
Services	0.9	0.6	0.9	1.1	1.2	1.1	1.2	1.5
Private services excluding rents	1.0	0.4	0.6	0.6	0.6	0.6	0.7	0.9
Rents	0.3	0.6	0.9	1.4	1.6	1.6	1.6	2.1
Public services	2.1	1.4	2.1	2.0	2.0	2.0	2.2	2.2
Foreign goods and services	0.0	-1.8	0.9	1.1	1.4	0.9	2.2	2.5
Excluding oil products	-0.5	-1.3	-0.5	-0.9	-0.9	-0.9	-0.7	-0.6
Oil products	3.2	-4.5	10.3	12.7	15.1	11.3	191.1	20.9

Sources: SFSO, SNB

Inflation on domestic goods, by contrast, remained low (November: +0.2%), due in part to price reductions for certain food products (e.g. vegetables, fruit, meat) and non-alcoholic beverages. Prices of alcoholic beverages and tobacco products, however, again recorded an above-average rate of growth (November: +4.1%).

Higher import inflation

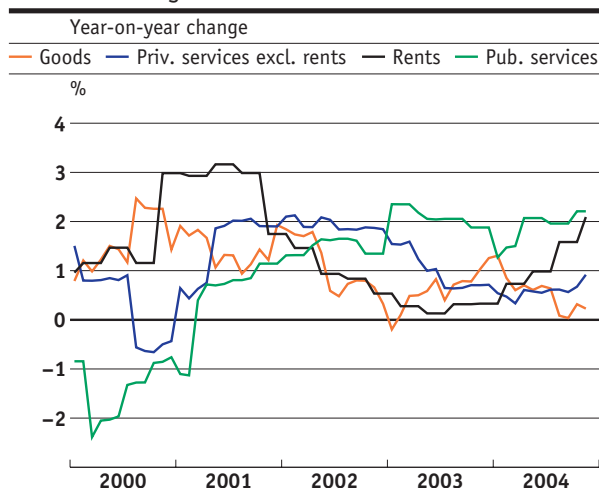
Annual inflation for imported consumer goods was driven upwards again by the sharp price rises for oil products (fuels and heating oil). In November, it hit 2.5%, thus exceeding the August rate by 1.1 percentage points. This is the highest level since December 2000. Averaged between August and November, oil product prices advanced by almost 17% compared with the previous year. In contrast, prices of other imported goods dropped further, albeit at a slower pace. In November, they eased by 0.6% year-on-year, as against a 0.9% decline in August. Price reductions for consumer electronics products (photo and video cameras, PCs, television sets and video recorders) as well as clothing and footwear were again particularly marked.

Further increase in the core inflation rates of the SNB and the SFSO

Inflation, as measured by the national consumer price index (CPI), is subject to numerous short-term influences which may distort perceptions of the general, long-term price trend. The SNB therefore computes a measure for the core inflation rate, which, for any given period, excludes the 15% of goods with the highest annual inflation rate and the 15% of goods with the lowest annual inflation rate from the CPI commodities basket. From August to November, the SNB core inflation rate edged up from 0.9% to 1.1%, after having stood at 0.4% at the beginning of the year. This development mirrors a slight, yet still moderate, general uptrend in inflation.

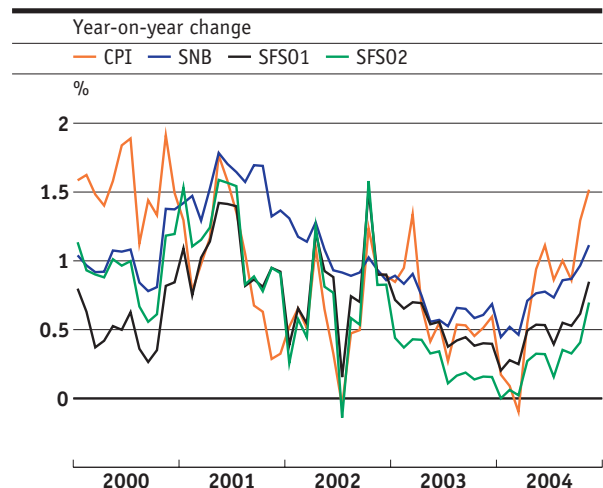
Unlike the core inflation rate calculated by the SNB, the two core inflation rates calculated by the SFSO exclude the same goods from the commodities basket in any given period. In the case of core inflation 1, food, beverages, tobacco, seasonal products, energy and fuels are excluded. Core inflation 2 additionally excludes products with administered prices. The core inflation rates published by the SFSO rose by 0.2 and 0.3 percentage points respectively compared with August. In November, core inflation 1 amounted to 0.8% and core inflation 2 to 0.7%.

Graph 2.16
CPI: Domestic goods and services



National consumer price index, 2000 = 100
Sources: SFSO, SNB

Graph 2.17
Core inflation



Sources: SFSO, SNB

3 Monetary development

3.1 Interest rates

Money market rates on the rise

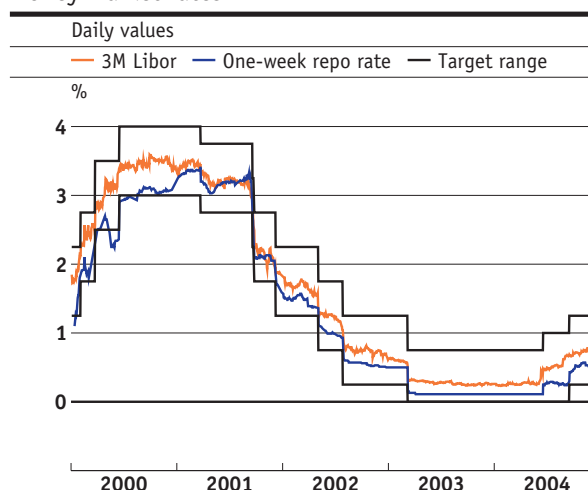
On 16 September, the SNB raised the target range for the three-month Libor rate for the second time this year – again by 25 basis points. Since then, the interest rate range has extended from 0.25–1.25%. The interest rate adjustment did not come as a surprise to the markets. The three-month Libor rate had climbed well beyond the middle of the old target range (0.5%) as early as by the end of August. The SNB tolerated this increase. It kept the repo rates, with which it indirectly steers the three-month Libor rate, under 0.3% until 16 September. On the day after lifting the target range, the SNB set the repo rates at 0.43%. Subsequently, it raised the rates gradually to 0.57% at the beginning of November. At the end of November, however, the repo rates were lower again at 0.5%. The three-month Libor rate reached the new middle of the range of 0.75% at the beginning of November.

In November, markets did not expect an increase in the three-month Libor rate prior to the assessment of 16 December. After the three-month future with a maturity date of 13 December had risen to over 0.9% from mid-November onwards, it fell again towards the end of the month and approached the spot rate up to approximately 10 basis points (graph 3.2).

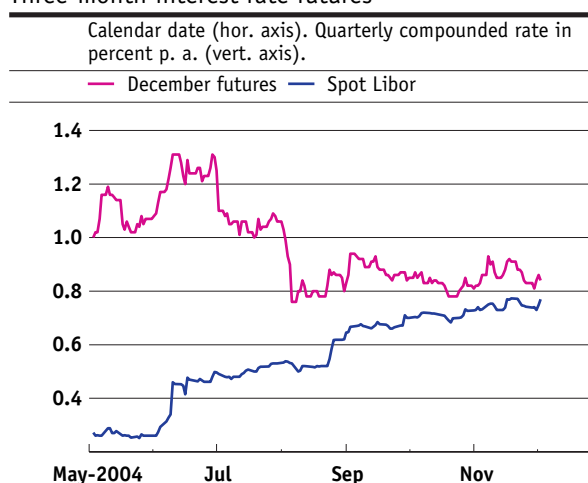
Higher interest rate expectations

According to the March future with a maturity date of 14 March 2005 – prior to the first assessment in the new year – in mid-November 2004 the markets were expecting an increase in the three-month Libor rate to slightly over 1% by mid-March. The forward rate computed in mid-November based on the interest rate structure of the Libor rates leads to the same conclusion, while the calculation on the basis of an empirical estimate of an interest rate structure model resulted in an anticipated three-month Libor rate of just over 0.9%. These observations reflect expectations of a 0.15 to 0.25 percentage point rise in interest rates (graph 3.3) between mid-December 2004 and mid-March 2005.

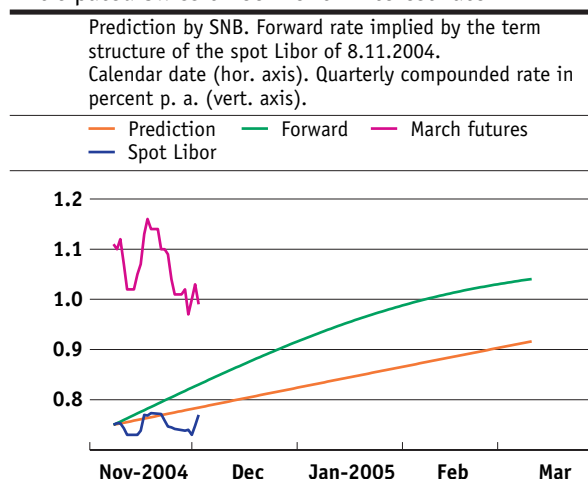
Graph 3.1
Money market rates



Graph 3.2
Three-month interest rate futures



Graph 3.3
Anticipated Swiss three-month interest rate



Graphs 3.1, 3.2, 3.3:
Source: SNB

Lower interest rate differential to the euro

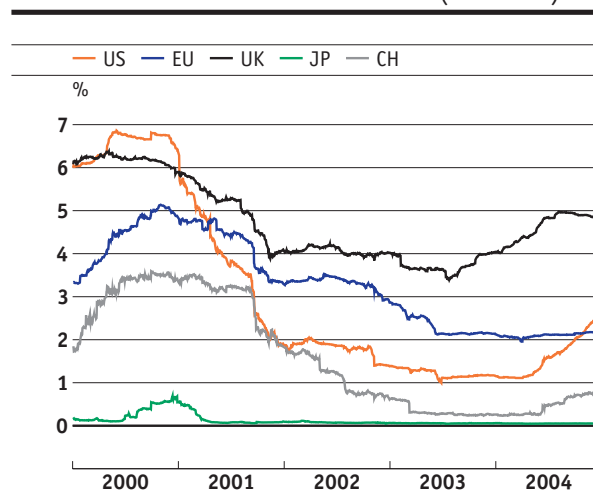
Unlike the SNB, the European Central Bank left its reference interest rate unchanged at 2.0%, while the Fed lifted its key interest rate in four steps by a total of 100 basis points to 2.0% between June and November. This is also reflected in the contrary development of the Swiss franc's interest rate differential to the euro and to the dollar. Measured by the rates on three-month money market investments, the interest rate differential to the dollar widened by an average of 120 basis points in August to 150 basis points in November. During the same period, the differential to comparable euro investments narrowed from 160 to 140 basis points.

Sharp decline in long-term interest rates

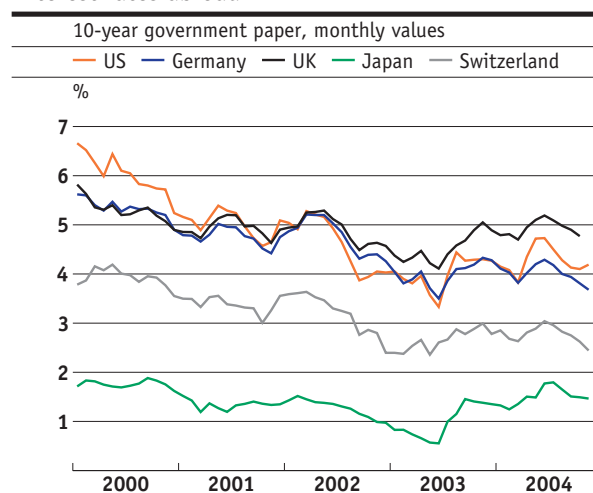
Capital market yields reached their annual peak worldwide in the summer and have been dropping sharply since then. The decline was especially pronounced in Europe (graph 3.5). The yield on ten-year German government paper decreased from 4.0% to 3.6% from mid-August to end-November. Capital market rates in Europe nearly fell back to the record lows reached in the summer of 2003. In Switzerland, the yield on a ten-year Confederation bond receded by 30 basis points to 2.5% (graph 3.7). At 5 basis points, the decline in yields was less marked in the US. While ten-year interest rates in Switzerland still exceeded their record lows of the previous year, yields on bonds with a maturity of 15 or more years tumbled to new lows in November.

The downtrend in long-term interest rates is likely to be a reflection of weaker economic growth expectations. At the same time, it is testimony to the confidence financial markets have in the central banks' ability to keep inflation rates low even in the face of soaring oil prices.

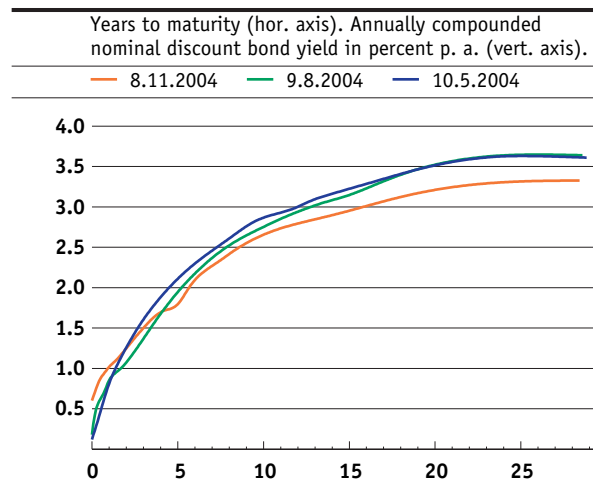
Graph 3.4
International short-term interest rates (3 months)



Graph 3.5
Interest rates abroad



Graph 3.6
Term structure of Swiss Confederation bonds



Graphs 3.4, 3.5, 3.6:
Source: SNB

Credit interest rate spreads still low

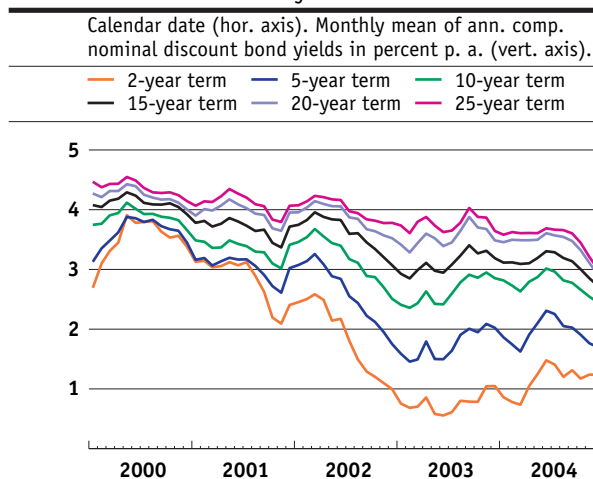
The development of financing conditions for bond issuers with different ratings can be illustrated by means of interest rate spreads. Graphs 3.8 and 3.9 depict interest rate spreads for two-year discount bonds issued by five and four sectors respectively since November last year. The sectors shown are cantons, banks, mortgage bonds, industry and foreign bonds. Top-rated bonds are shown in graph 3.8 and bonds with the second best rating in graph 3.9. The interest rate spread is computed as the difference to the corresponding yield on Swiss Confederation bonds (see "Box: Assignment of bonds to ratings classes", Monetary Policy Report 1/2004, p. 33).

A comparison of the two graphs reveals a different trend between the interest rate spreads of first and second-class bonds since November 2003. Interest rate spreads of industrial bonds and foreign bonds with a Standard & Poor's rating of "A" exhibit a slight downward trend for the top-rated class, while all other interest rate spreads of that class suggest a constant development. By contrast, all credit interest rate spreads of the second-rated class exhibit a slight downtrend.

The interest rate spread serves as a leading indicator for economic activity. The rule of thumb is that a reduced interest rate spread points to an acceleration in economic activity. If the interest rate differential widens, however, this may point to a deterioration of the economic situation in the months ahead. Despite the contrary movements of the interest rate spreads in the top and second-rated classes, the credit risk premiums remain low. This is typical for a phase of economic upswing.

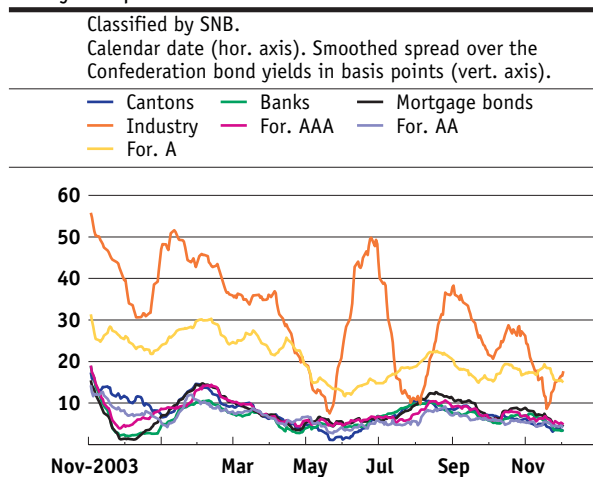
Graph 3.7

Swiss Confederation bond yields



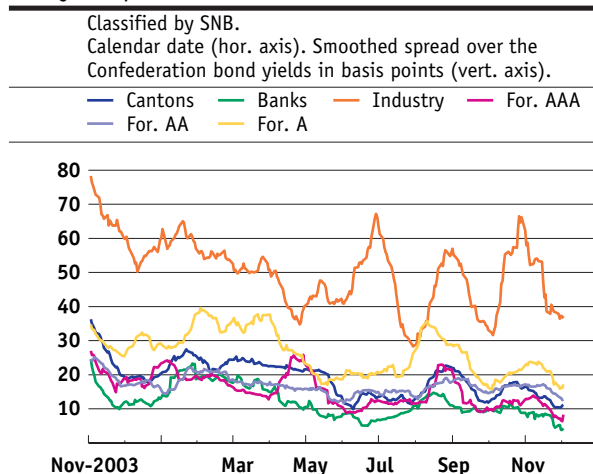
Graph 3.8

Two-year spread of Swiss first-class bonds



Graph 3.9

Two-year spread of Swiss second-class bonds



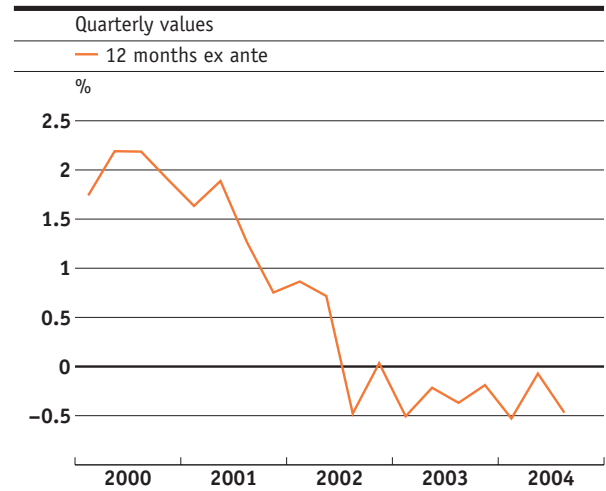
Graphs 3.7, 3.8, 3.9:
 Source: SNB

Real interest rates on the decline

It is not nominal interest rates but real interest rates that are of paramount importance for economic decisions. Graph 3.10 shows the development of the real interest rate with a one-year maturity. The real interest rate is the difference between the twelve-month nominal interest rate and the expected rise in consumer prices for the same period. These inflation expectations correspond to the average expectations of 14 forecasting institutions that are published quarterly as "consensus forecasts".²

The real annual interest rate has been fluctuating within a band of between 0.0% and -0.5% since mid-2002. In the third quarter of 2004, it stood at the lower end of this band. Real financing conditions were thus still at the level they had reached approximately two years ago. Since the 12-month nominal interest rate remained virtually unchanged compared with the second quarter, the decline in the real interest rate essentially reflects a rise in inflation expectations for the third quarter of 2005. Compared with the forecasts in June, the consensus forecast also suggests a longer-lasting effect of the increase in oil prices on the national consumer price index. The upward adjustment of the inflation outlook amounts to 0.4 percentage points.

Graph 3.10
Estimated real interest rates



Source: SNB

² Cf. table 1.1, footnote 3.

3.2 Exchange rates

Weak dollar

Recent months were characterised by a marked decline of the US dollar, which began in September and accelerated in mid-October. While one euro was still equivalent to USD 1.21 at the beginning of September, it cost USD 1.32 at the end of November. At the same time, the Swiss franc firmed slightly vis-à-vis the euro, which accentuated its appreciation versus the dollar. While the exchange rate in relation to the euro dropped from CHF 1.54 in September to CHF 1.51 at the end of November, the rate to the USD fell from CHF 1.27 at the beginning of September to 1.14 at the end of November. The dollar thus reached its lowest level in nine years. The weakening of the dollar witnessed in spite of the rising interest rate differential is associated with the high budget and current account deficit in the US.

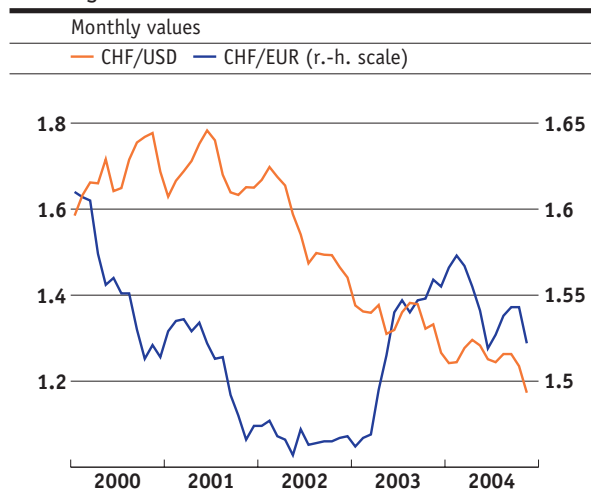
These exchange rate fluctuations reflect a rise in the export-weighted exchange rate of the Swiss franc vis-à-vis the 24 leading trading partners of 1.5% in October compared with September, or 1.3% vis-à-vis the corresponding year-earlier level. Compared with Europe – the largest sales market for the Swiss export industry – the franc exceeded its month-earlier level by 1% in October, but fell 0.4% short of its previous year's level. In October, the franc appreciated by 3% month-on-month versus the currencies of the North American trading partners (US and Canada). The real year-on-year appreciation amounted to 5.3%. A higher real franc rate results in higher prices of Swiss exports. At the same time, imports billed in US dollars (in particular oil products) become cheaper.

Higher Monetary Conditions Index

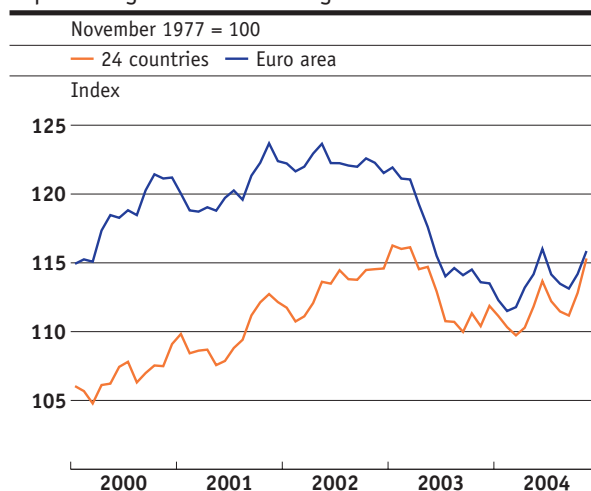
Whether the monetary conditions to which the Swiss economy is exposed are to be considered expansionary or restrictive depends not only on interest rates but also on the Swiss franc's exchange rate. The Monetary Conditions Index (MCI) combines these two factors, i.e. the three-month Libor rate and the nominal trade-weighted Swiss franc index with a weighting of 5:1 and 3:1 respectively in one indicator (see "Box: The Monetary Conditions Index (MCI)", Monetary Policy Report 1/2004, p. 27). Depending on the weighting of the Swiss franc rate, the MCI rose by 70–110 basis points in October and November, which corresponds to a considerable tightening of the monetary conditions. Since the three-month Libor rate only changed marginally in October and November, the increase is mainly attributable to the exchange rate (graph 3.13).

In November, the MCI exceeded the record lows reached in the previous year by 130–200 basis points. Of this, 50 basis points can be attributed to the two interest rate hikes carried out since then.

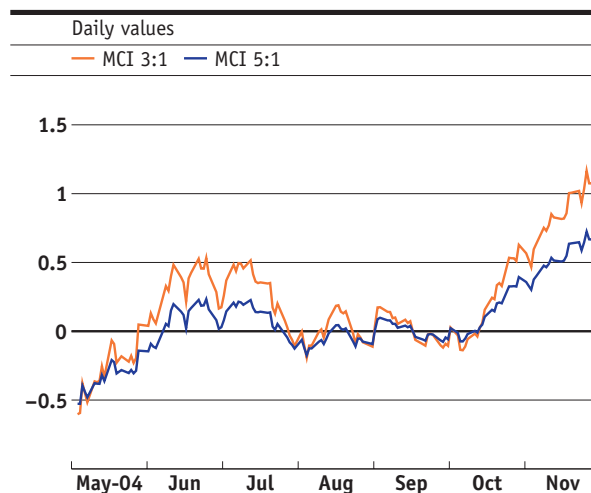
Graph 3.11
Exchange rates



Graph 3.12
Export-weighted real exchange rate of the Swiss franc



Graph 3.13
MCI nominal



Graphs 3.11, 3.12, 3.13:
Source: SNB

3.3 Share and real estate prices

Slight rise in stock indices

After a marked decline in July, prices on the international stock markets have recovered appreciably since mid-August. The SPI reached its annual peak of 4330 points in May, subsequently fell below 4000 points by mid-August, and has edged up since then. At the end of November, it stood at 4053 points. The different sector indices have shown a similar development since August. What is striking is the sharp increase in bank stocks since the end of October, which is probably due to the favourable quarterly results of the big banks. Construction sector shares exhibited below-average development. In August, this brought to a halt the upward trend observable since the beginning of 2003.

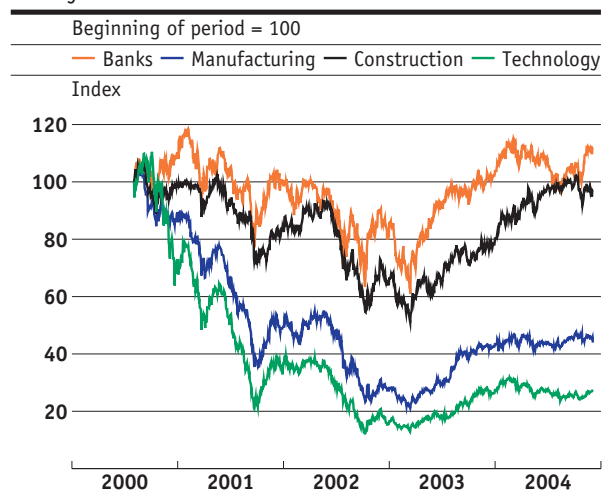
Higher rents and real estate prices

In addition to the indices for apartment and office rents and for prices of single-family homes and owner-occupied apartments computed by Wüest & Partner, graph 3.15 now also shows the hedonic rent index compiled jointly by the real estate portal "homegate.ch" and the Zurich Cantonal Bank. This index of rents for currently vacant properties has been computed since 2002. The price development is adjusted for the influence of the varying quality standards of different apartments. The sharper rise in the Wüest & Partner rent index compared with the hedonic rent index suggests that a large proportion of the increase in apartment rents can be attributed to improved quality.

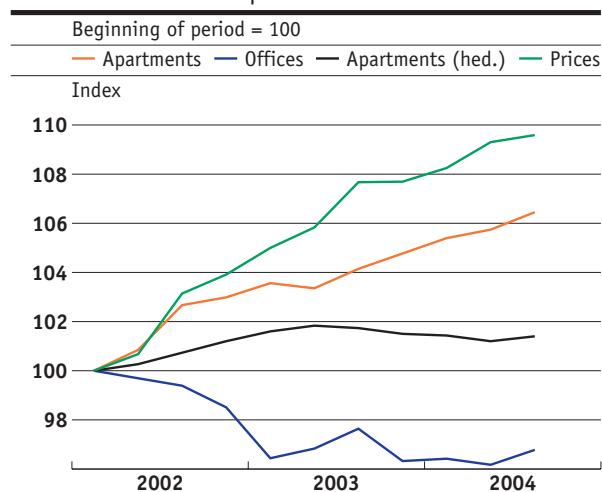
The price increase in single-family homes and owner-occupied apartments eased from 4.0% in the previous quarter to 1.1%. Two contrary movements are responsible for this development: while single-family home prices moved up by 4.0%, prices for owner-occupied apartments receded by 1.8%. In a year-on-year comparison, prices for single-family homes went up by 2.2%, those of owner-occupied apartments by 1.4%.

While the Wüest & Partner rent index continued to rise in the third quarter – exceeding its previous year's level by 2.2% – the hedonic price index fell by 0.3%. Office rents registered a slight increase in the third quarter, yet they still fell 0.9% short of their year-earlier level.

Graph 3.14
SPI by sector



Graph 3.15
Rents and real estate prices



Graph 3.14:
Source: Swiss Exchange (SWX)

Graph 3.15:
Sources: Wüest & Partner, homegate.ch

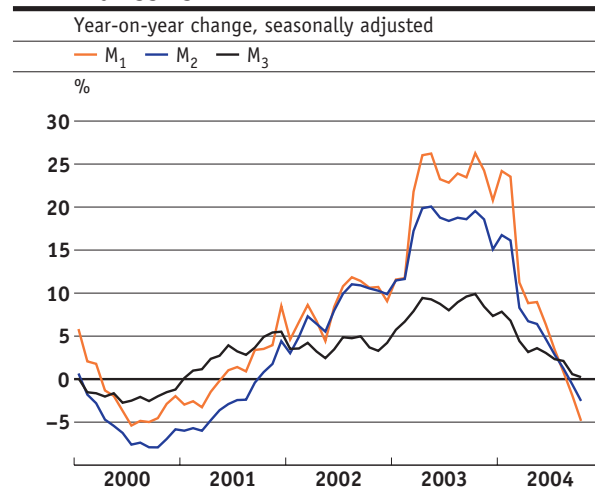
3.4 Monetary aggregates

Excess liquidity down further

While all three monetary aggregates exhibited excessively strong growth in the course of last year, a reverse trend began to set in this year. M_1 , which is composed of currency in circulation, sight deposits and transaction accounts, fell by 5.4% in November compared with the previous year. M_2 (M_1 plus savings deposits) receded by 3.0%, while M_3 (M_2 plus time deposits) only registered a slight increase (1.4%). Based on the record levels reached in February 2004, M_1 declined by 6.3%, M_2 by 4.2% and M_3 by 0.2%. The decline of M_1 and M_2 in November was due to the fact that sight deposits fell by 9.0% month-on-month. By contrast, time deposits rose by 42.1% compared with November of the previous year. These reallocations are likely due to the higher short-term interest rates.

In interpreting money stock growth, it must be borne in mind that the comparison is made with an unusually high level reached in the previous year. Consequently, slower growth merely signifies a return to the long-term trend. Moreover, this normalisation is supported by a statistical effect because the level of monetary aggregation for the first half of 2004 was corrected downwards – in part significantly – following the data revision of August this year. If average growth during the past two years is taken into account, annual growth rates are still relatively high: 9.0% for M_1 , 6.6% for M_2 and 4.1% for M_3 .

Graph 3.16
Monetary aggregates



Source: SNB

Monetary aggregates¹

Table 3.1

	2002	2003	2003		2004			September	October	November
			Q3	Q4	Q1	Q2	Q3			
Monetary base²	38.4	40.4	41.0	41.5	42.2	41.7	41.1	40.9	40.7	41.4
<i>Change³</i>	5.7	5.3	8.6	7.4	7.7	4.5	0.2	-0.7	0.2	1.7
$M_1$²	224.4	273.5	279.0	293.1	297.2	295.0	281.2	277.6	277.5	281.2
<i>Change³</i>	8.7	21.9	23.5	23.7	19.3	8.0	0.8	-1.9	-4.9	-5.4
$M_2$²	404.8	475.1	482.5	498.1	505.2	503.3	488.1	484.0	483.2	487.5
<i>Change³</i>	8.1	17.4	18.6	17.7	13.6	6.0	1.2	-0.6	-2.5	-3.0
$M_3$²	503.0	544.9	547.4	556.9	563.5	562.9	556.6	556.5	558.3	564.5
<i>Change³</i>	3.8	8.3	8.9	8.6	6.3	3.2	1.7	0.6	0.2	1.4

1 1995 definition

2 Level in CHF billions

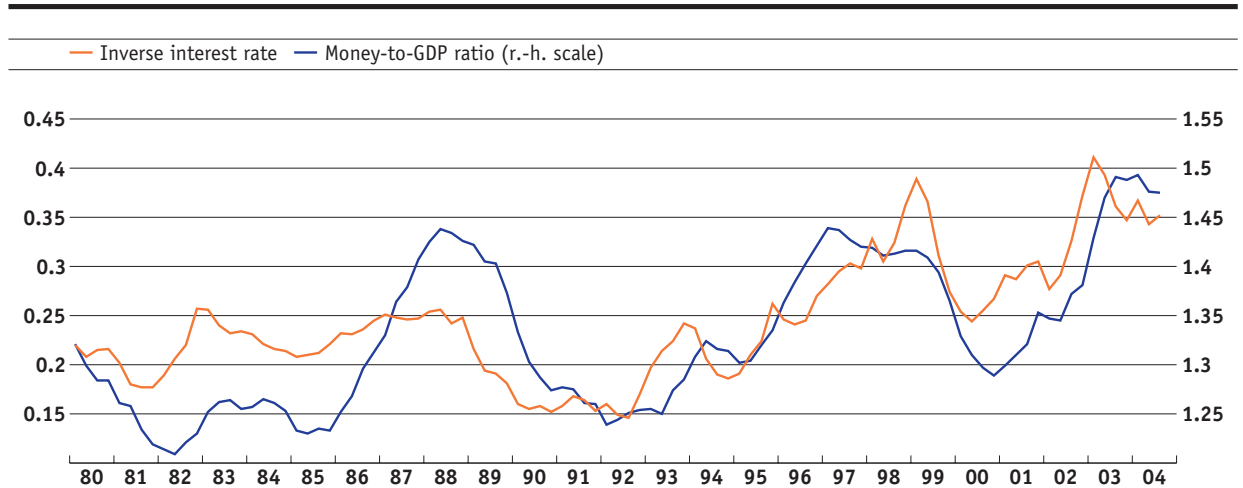
3 Year-on-year change in percent

Source: SNB

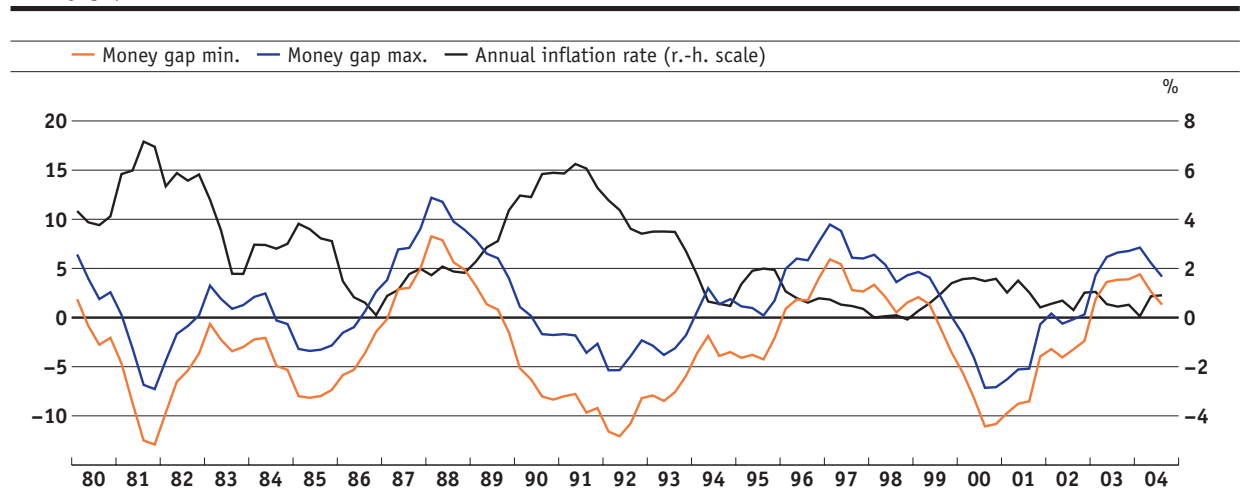
This trend is reflected in the analysis of the level of liquidity in the economy by means of the money-to-GDP ratio. The money-to-GDP ratio indicates the relation of money stock to the transaction volume in the economy which is measured by nominal GDP. Since holding M_3 generates opportunity costs in the form of lost interest earnings, the money-to-GDP ratio should move inversely to long-term interest rates. As shown in graph 3.17, this was mostly the case in the past. In mid-2002, the low interest rate level pushed up the money-to-GDP ratio sharply. As long-term interest rates have moved up since the beginning of 2003, the money-to-GDP ratio has again fallen somewhat.

Excessive money supply growth creates a potential for inflation. An equilibrium money stock can be determined by means of nominal GDP and the opportunity costs for holding money. If the current money stock in the economy exceeds the equilibrium value, this is referred to as a positive money gap, while the reverse is known as a negative money gap. Graph 3.18 shows two estimates of the percentage deviation of M_3 – expanded by the domestic fiduciary balances – from its equilibrium value. It is evident that the deviation of M_3 from its equilibrium value has a strong correlation with future inflation. The strong money supply growth in the past has resulted in a money overhang, which is now being restored to zero. Even though this indicator suggests a certain inflation potential, it has fallen compared with the previous quarter.

Graph 3.17
Money-to-GDP ratio



Graph 3.18
Money gap & annual inflation rate



Graphs 3.17, 3.18:
Source: SNB

3.5 Loans

Credit growth continues

At the end of September, bank loans exceeded their year-back level again. The market for bank credit continued to be influenced by two opposing trends. On the one hand, the third quarter saw a 6.8% rise year-on-year in lending to households, which accounts for approximately two-thirds of total bank loans. But on the other hand, loans to companies – which have been contracting continuously since the third quarter of 2001 – declined by a further 4.3%.

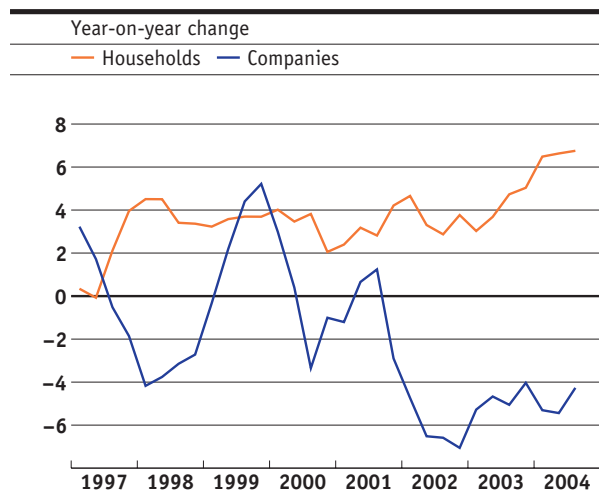
The breakdown by types of loans (mortgage claims versus other loans) presents a similar picture. Signs of a turnaround are starting to appear, however. Mortgage claims showed further year-on-year growth in the summer. Accounting for four-fifths of

bank loans, mortgages are the most important loan category and are granted primarily to households. At the same time, the negative trend among other loans (extended mainly to companies) gradually eased. In September, they were above their year-back levels for the first time since August 2001. In October, however, they were back in the negative zone.

As hitherto, other bank loans can be divided into secured and unsecured credit. Two opposing trends are observable in this area, too. While secured bank loans rose sharply in the summer, unsecured loans continued to decline.

At the end of October, the volume of mortgage claims was 5.2% higher than a year earlier. Other loans decreased by 2.7%. This decline can be ascribed to the fact that the 2.5% growth in secured loans was easily outweighed by a 6.1% drop in unsecured credit. Bank lending overall expanded by 3.6% in October. The growth in lending is attributable to the continued improvement in the economic situation.

Graph 3.19
Bank loans



Source: SNB

Bank loans¹

Year-on-year change in percent

Table 3.2

	2002	2003	2003		2004			2004	2004	2004	2004
			Q3	Q4	Q1	Q2	Q3	August	September	October	
Total	0.5	2.1	2.3	2.9	3.2	3.4	4.0	3.8	4.4	3.6	
Mortgage claims	3.9	5.6	5.6	5.5	5.4	5.4	5.4	5.4	5.4	5.2	
Other loans	-9.3	-8.7	-8.3	-6.1	-4.6	-3.8	-1.2	-2.2	1.0	-2.7	
of which secured	-3.2	-10.7	-9.4	-4.3	-1.6	3.5	7.2	8.5	9.8	2.5	
of which unsecured	-12.9	-7.4	-7.6	-7.3	-6.5	-8.4	-6.6	-8.9	-4.6	-6.1	

1 Bank balance sheets, level of data collection: parent company, all currencies, Switzerland; annual and quarterly values expressed as averages of month-end values

Source: SNB

4 Inflation forecast of the SNB

Monetary policy acts on production and prices with a considerable time lag. In Switzerland, the average time lag with which it impacts on prices is approximately three years. For this reason, the National Bank is guided in its monetary policy not by current inflation but by the inflation that is to be expected in two to three years if monetary policy remains unchanged. In so doing, it also contributes to the stabilisation of employment and production. The inflation forecast is thus an important part of the SNB's monetary policy concept (cf. "Box: Inflation forecasting as part of the monetary policy concept").

4.1 Assumptions for global economic development

Growth slowdown

Given the high degree of internationalisation of the Swiss economy, the SNB's inflation forecast is embedded in a global economic scenario reflecting the Bank's assessment of the most likely development in the next three years. Table 4.1 shows the major external assumptions underlying the current inflation forecast compared with the September forecast in the form of annual averages.

Compared with the previous forecast, assumptions for the global economy have changed significantly in three respects. Firstly, the oil price defied the SNB's September prediction and continued to rise. The Bank still expects it to gradually fall back to USD 30, but the high price of oil will, secondly, result in a noticeable slowdown in the industrial economies in the near term. Consequently, current assumptions for the European economies and the US for the fourth quarter of 2004 and the first quarter of 2005 are below the August assumptions. The subsequent quarters are not expected to see any substantial recovery in growth. Annualised growth in the US is put at 3.5% for the fourth quarter of 2004 and 3.4% for the first quarter of 2005. After a 3.8% rise in the second quarter of 2005, GDP growth will drop back to its potential level of 3%. In the EU, where growth receded to 1.2% in the third quarter of 2004, annualised growth is expected to rise to 2.3% in the third quarter of 2005, subsequently dropping back to the equilibrium rate of 2.1%. As a result, the negative output gaps in the US and Europe will close only slowly. The third assumption, which was adjusted substantially from the previous quarter's inflation forecast, relates to the trend in the US dollar. Since September, the dollar has weakened sharply. By the end of November, the euro was fetching more than USD 1.30. The December 2004 inflation forecast took this into account by fixing the dollar/euro exchange rate at 1.28, as against 1.20 in the previous quarter's forecast. The constant dollar/euro rate is not an SNB prediction but a technical assumption for the model simulations.

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Assumptions for inflation forecasts

Table 4.1

	2004	2005	2006
Inflation forecast of December 2004			
GDP US ¹	4.3	3.5	3.5
GDP EU-15 ¹	2.0	2.0	2.2
Exchange rate USD/EUR ²	1.20	1.28	1.28
Oil price in USD/barrel ²	39.0	42.0	34.0
Inflation forecast of September 2004			
GDP US ¹	4.4	3.8	3.5
GDP EU-15 ¹	2.2	2.3	2.2
Exchange rate USD/EUR ²	1.20	1.20	1.20
Oil price in USD/barrel ²	36.9	35.6	31.4

1 Change in percent

2 Level

Box: Inflation forecasting as part of the monetary policy concept

The SNB has the statutory mandate to ensure price stability while at the same time taking due account of economic developments.

It has laid down the details of the exercise of this mandate in a three-part monetary policy concept. First, the SNB regards prices as stable when the national consumer price index (CPI) rises by less than 2% per annum. It thus takes account of the fact that the CPI slightly overstates actual inflation. At the same time, it allows inflation to fluctuate somewhat with the economic cycle. Second, the SNB summarises its assessment of the situation and of the need

for monetary policy action in a quarterly inflation forecast. This forecast, which is based on the assumption of a constant short-term interest rate, shows the CPI development expected by the SNB over the next three years. Third, the SNB sets its operational goal in the form of a target range for the three-month Swiss franc Libor rate. The target range provides the SNB with a certain amount of leeway, enabling it to react to unexpected developments in the money and foreign exchange markets without having to change its basic monetary policy course.

4.2 Inflation forecast 4th quarter 2004 to 3rd quarter 2007

The inflation forecast derives from the analysis of different indicators, model estimates and the assessment of any special factors. Graph 4.1 shows the new forecast (December 2004) together with the inflation forecasts produced in the last two quarters (September and June 2004). The new forecast, which extends from the fourth quarter of 2004 to the third quarter of 2007, is based on a three-month Libor of 0.75%, i.e. the mid-point in the 0.25–1.25% target range which the SNB confirmed for the three-month rate on 16 December 2004. Last September's inflation forecast was also based on a fixed three-month Libor of 0.75%. The June forecast was, by contrast, based on a three-month rate of 0.5%, i.e. the level which the SNB was targeting while the target band was still 0–1.0%.

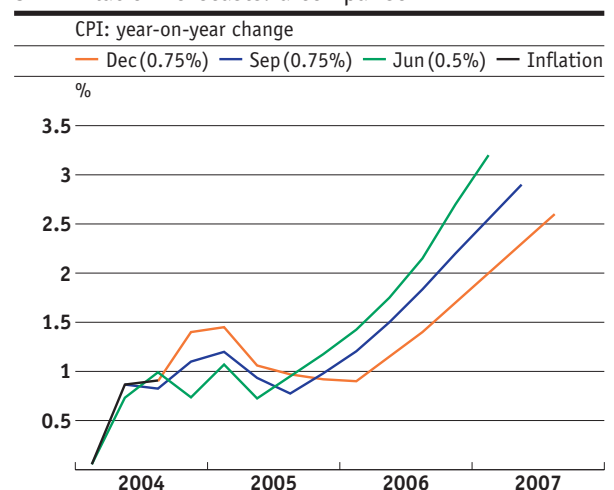
As can be seen from graph 4.1, the short-term predictions issued as part of the new inflation forecast are higher than those in the two previous forecasts. This is due to the rise in the oil price. The prices of the oil products included in the CPI (fuels and heating oil) will probably still be well above their year-back levels in the next few months as well. However, the SNB expects the price of oil to gradually fall again in 2005. In the near term, a moderate inflation-dampening effect should continue to emanate from the other imported consumer goods. The SNB does not expect any significant price rises for domestic consumer goods, as ample production capacity is still available in the economy as a whole and competition is stiff. This view is confirmed by the latest KOF/FIT quarterly survey of industry: a large majority of the domestically oriented companies surveyed expect selling prices to remain unchanged or even fall. Inflation in services is likely to stabilise at the present level after having been driven up by an accelerated rise in residential rents and public service charges in particular. The forecast inflation rate will peak at just under 1.5% in the first quarter of 2005. With oil prices expected to recede, it will then fall back to 0.9% at the beginning of 2006. The average annual inflation rate for 2005 is put at 1.1%.

In the medium term, i.e. for a period of one to two years, the development of inflation hinges on the economic outlook. The slowdown in economic growth abroad expected for next year will have a general dampening effect on the business climate in Switzerland. Consequently, real GDP should continue growing at a leisurely pace only, and utilisation of capacity in the economy as a whole will rise less quickly than was assumed in the September inflation forecast. As a result, rather less inflationary pressure is to be expected in the medium term. The inflation rate forecast for 2006 is down to 1.3%.

In the longer term, price developments will be determined in large measure by monetary factors. The reliability of longer-range inflation forecasts is limited. Experience has shown, however, that the availability of ample liquidity can pose a risk to price stability as – in the course of an economic recovery – it creates scope not only for additional transactions but also for price increases. In the last two years, liquidity levels in Switzerland increased steadily and gave rise to a growing money overhang. As the overhang has recently receded (see section 3.4), the longer-term inflation risk is no longer so acute from this angle. Hence the fact that the new inflation forecast is lower than the September one at the long end, even assuming a constant three-month Libor.

According to the December inflation forecast, price stability would be in jeopardy as of the beginning of 2007. This assumes an unchanged three-month Libor of 0.75% over the next three years. The current inflation forecast thus suggests that the normalisation of interest rates initiated in June and September 2004 will have to be continued for the next three years if the target of price stability is to be met.

Graph 4.1
SNB inflation forecasts: a comparison



The economic situation from the vantage point of the delegates for regional economic relations

Summary report to the attention of the Governing Board of the Swiss National Bank for its quarterly assessment of December 2004

The Swiss National Bank's delegates for regional economic relations are constantly in touch with a large number of enterprises from the different industries and economic sectors. Their reports, which contain the subjective evaluations of these companies, are an important additional source of information for assessing the economic situation. The main results of the talks held between September and November 2004 on the current and future economic situation are summarised below.

Summary

Overall, talks held with almost 120 companies and industry associations between September and November indicate that there has been very little change in the general economic situation. The economy continued to grow, but momentum declined, increasing the discrepancy between business activity in the various industries. While hopes of a noticeable pickup in domestic demand went unfulfilled, exports remained buoyant at the last count.

A rising number of companies with good business activity were planning to raise capacity. At the same time, more companies than previously reported that they intend to increase staff numbers. Nevertheless, relocating production abroad, which often entails a reduction in jobs in Switzerland, remained an issue, especially in the manufacturing sector.

The majority of respondents were confident about the outlook for 2005. Although many companies expect sales growth to slow slightly, underlying sentiment remains generally positive despite the weakness of the dollar and the sharp rise in oil prices.

1 Production

Manufacturing

Most of the export companies surveyed said that order intake and orders on hand were still good even though order growth has slowed. The main impetus continued to emanate from Asia, especially China, and from the US. The assessment of demand from the EU was somewhat more optimistic than in the summer. However, Germany was again the exception as business remained sluggish.

Export-oriented companies rated the situation much the same as in the summer. The chemical, pharmaceutical and watchmaking industries again reported a sound business performance. Producers of metal goods, energy and automation technology and textile machinery were extremely satisfied with the situation. Following a rapid recovery, the semiconductor sector in particular is once again suffering from global overcapacity and the resultant price erosion, however. Companies focused on the domestic market are struggling much harder as they have to contend with both foreign competition and high pressure on prices and margins.

Services

Thanks to the return of visitors from Asia and the US and a slight improvement in business travel, the tourism industry is doing far better than a year ago. However, the upward impetus has declined slightly in many areas in recent months, partly because of the weak dollar. Moreover, many tourist areas suffered from the persistently low demand from Germany and the general drop in spending per visitor. Hotels in Ticino formed an exception: in the summer and autumn they reported a substantial rise in visitors from Germany, France and the Netherlands who decided to spend their holidays in southern Switzerland as a result of the sharp price rises in Italy and the south of France. Nevertheless, the situation in the hospitality trade in Ticino remained difficult overall; this was also evident from the large number of business closures.

In the corporate services sector, business trends picked up in the transport (including air freight) and logistics segments. Consultancy also registered an uptrend. By contrast, the majority of IT service-providers complained that business was listless.

Following a promising start to the year, business at asset management banks proved disappointing up to the autumn. The inflow of funds stagnated or increased only slightly, and the weakness of the

stock market meant that commission income was thin. Competition and pressure on margins therefore remained keen. Competitive pressure for lending business is now also very stiff, especially in the mortgage sector. This is partly due to the rise in lending limits.

Most retail companies reported that business was still sluggish and lacking in direction. Some reported a considerable drop in sales since the summer months. Larger retailers did better than smaller businesses, which were hit by low consumer confidence and increased competition from big stores. In the first six months of this year, retailers in Ticino and in the Lake Geneva region benefited from the reduction in price benefits in nearby French and Italian shopping areas, but this impetus now seems to have tailed off again. The market for textiles remained very difficult. By contrast, sales of IT products picked up.

Construction

Sentiment in the construction sector improved slightly as many companies continued to benefit from buoyant housing construction and robust demand for refurbishments. By contrast, commercial and public-sector construction remained weak following signs of a slight improvement in the summer. The sector reported pressure on prices – and thus on earnings at many companies. There are now growing signs that a shake-out is under way in the construction industry. In border areas such as Ticino, as well as in western Switzerland, construction companies are noticing keener competition from neighbouring countries.

2 Labour market

Readiness to increase staff numbers seems to have increased slightly in recent months, but that does not mean that headcount reductions are over. However, unlike a year ago, the situation is now no longer dominated by cyclical considerations. In most cases, staff reductions are due to strategic decisions to relocate production to other countries, mainly in Asia or Eastern Europe. The service sector is still not able to provide a perceptible impetus for the labour market. This is equally true for the banking industry and commerce, both of which are facing hefty cost pressure.

3 Prices, margins and earnings situation

More companies than at the start of the year felt they were able to pass on higher procurement costs to customers by raising prices. Generally, though, price pressure remains high. This is primarily affecting intermediate suppliers. Increased competition from abroad has actually stepped up price pressure on some goods in Switzerland, especially in the retail trade and construction-related areas such as sanitary fittings.

The exchange rate is a source of increased concern. The massive drop in the dollar has meant a painful decline in margins at many companies. Worst affected is the watchmaking industry, but many companies producing for the Asian market have also been hard hit. Conversely, in some sectors the weakness of the dollar has lessened the impact of the rise in raw material and energy costs.

Chronicle of monetary events

Target range for the three-month Libor rate left unchanged

On 16 December 2004, following its quarterly assessment, the Swiss National Bank left the target range for the three-month Libor rate unchanged at 0.25–1.25%. It intends to keep the rate in the middle of the target range at around 0.75% for the time being.

Federal Act on International Monetary Assistance enacted by the Federal Council

As no referendum was sought within the statutory period expiring at the beginning of July, the Federal Council put the Federal Act and the Decree on International Monetary Assistance (cf. Quarterly Bulletin 2/2004, p. 57) into effect as of 1 October 2004.

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