

**Communications**

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## **Monetary policy assessment of 14 September 2006**

**National Bank raises the target range for the three-month Libor by 0.25 percentage points to 1.25%–2.25%**

The Swiss National Bank (SNB) is raising the target range for the three-month Libor with immediate effect by 0.25 percentage points to 1.25%–2.25%. It intends to hold the rate in the middle of the target range for the time being.

The economy continues to develop favourably. The recovery is broadly based and this is having a positive effect on the labour market. The SNB is raising its forecast for GDP growth in 2006 to just under 3% and expects average inflation for the year to attain 1.3%.

By raising the target range, the National Bank is further adjusting its monetary policy stance to developments in the economy. With this move, the SNB is ensuring that the inflation outlook remains favourable. On the assumption of an unchanged three-month Libor of 1.75%, annual inflation is expected to reach 1.1% in 2007 and 1.6% in 2008. If the economy performs as expected, the SNB will further pursue the gradual adjustment of its monetary policy.

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## **International environment**

The economic outlook for Switzerland is affected by the international environment. For this reason, the SNB's inflation forecast is embedded in a global economic scenario. Two modifications to our June assessment of the global economy should be noted. First, growth in the United States is more moderate than we were expecting in June. Second, the European economy is recovering a little more strongly. For 2007, the outlook remains favourable. However, growth is likely to be somewhat more moderate than in 2006. Our modifications to the assumptions on the global economy are relatively minor and have no significant impact on the outlook for inflation.

## **Economic outlook**

With the global economy remaining dynamic but slowing, the outlook for the Swiss economy is as follows: Exports are likely to continue increasing, but less strongly. In addition, equipment investment is expected to grow further due to the healthy level of capacity utilisation. Construction investment, however, will probably ease. The increase in employment will fuel robust growth in consumption. GDP growth in the second quarter was 3% and overall the SNB forecasts GDP growth of almost 3% in the current year. Consequently, the economy is progressing faster than its long-term average potential, with a high level of resource utilisation. Next year, growth is likely to decline slightly, but should nevertheless remain above potential. An increase in inflation is not to be expected. A number of special factors whose individual significance is hard to assess are easing the pressure on prices. They include strong competition from new providers in the transition countries and emerging economies of Asia, the latest drop in oil prices, as well as the fact that the Swiss labour market has been opened up to foreign nationals.

## **Monetary developments**

The policy of gradual adjustments to the interest rate pursued to date has had a dampening effect on monetary aggregates. The broadest aggregate – M3 – has recorded only a slight increase while the annual growth rates for M1 and M2 have been negative over the past few months. The impact of changes in money stocks on prices is subject to a considerable lag, due to the fact that these changes initially affect activities in the real economy. Only subsequently do these activities, in their turn, determine the level of prices. The latest movements in money stocks suggest that the inflation outlook for 2008 and 2009 has improved.

The SNB expects that the rate of increase in mortgage loans will settle below the current level of 5%. There are already a few indications that the construction sector is softening. The SNB is expecting the real estate market to settle down, although it continues to keep a careful eye on developments.

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## **Reasons for the monetary policy decision**

As compared to our June assessment, the outlook for inflation has remained largely unchanged, with the exception of the end of the three-year forecast period. Based on our current assessment, we expect a slight reduction in the inflationary trend over the longer term. On this basis, the SNB is maintaining its policy of a gradual normalisation in monetary conditions. It is raising the target range for the three-month Libor by a further 25 basis points to 1.25%–2.25%.

## **Inflation forecast following the monetary policy decision**

This increase in the interest rate will dampen the anticipated inflationary pressure. The inflation forecast published by the SNB shows its assessment of the inflation outlook in the light of the new data and already factors in the latest interest rate decision.

The inflation projection published after the interest rate increase in June was based on an unchanged three-month Libor of 1.50% (green curve). The new forecast calculated with a constant interest rate of 1.75% is shown in red. Through to the second quarter of 2007, this curve is a little higher than for June. This is because the utilisation of resources is somewhat higher. After the fourth quarter of 2007, the new inflation forecast lies below the previous one. One reason for the change is the dampening effect of the interest rate increase in the longer term. The other reason is that new data have resulted in a slight downward adjustment in projected inflation from mid-2008.

The forecast shows that there is no immediate inflation risk. At 1.1%, the level of inflation expected in 2007 is low. However, inflation dynamics show that, even with a three-month Libor of 1.75%, monetary policy continues to have an expansionary effect.

## **Normalisation policy to be pursued further**

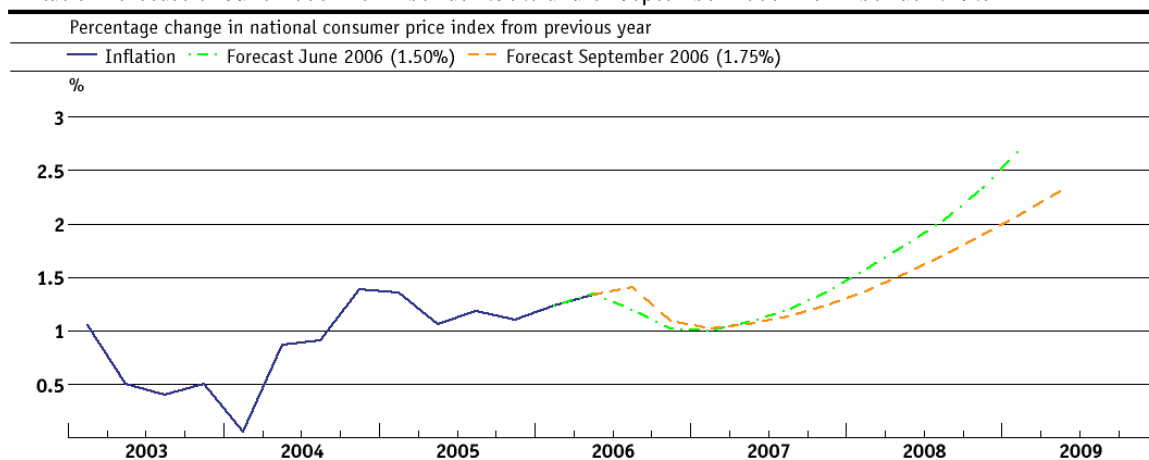
With today's decision to increase the three-month Libor by 25 basis points, the SNB is maintaining its monetary policy course of gradual normalisation. This should guarantee price stability in the longer term. If the economy performs as expected, the SNB will further pursue the gradual adjustment of its monetary policy.



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Inflation forecast of June 2006 with Libor at 1.50% and of September 2006 with Libor at 1.75%



Observed inflation September 2006

	2003				2004				2005				2006			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Inflation	1.05	0.50	0.40	0.50	0.06	0.87	0.91	1.38	1.35	1.06	1.18	1.10	1.23	1.33		

Inflation forecast of June 2006 with Libor at 1.50% and of September 2006 with Libor at 1.75%

	2006				2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Forecast June 2006, Libor at 1.50%	1.34	1.19	1.02	1.00	1.08	1.20	1.35	1.57	1.79	2.03	2.33	2.70				
Forecast September 2006, Libor at 1.75%	1.40	1.09	1.02	1.06	1.13	1.23	1.36	1.53	1.70	1.89	2.09	2.30				