Quarterly Bulletin

2

June 2004

SCHWEIZERISCHE NATIONALBANK
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SWISS NATIONAL BANK

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Quarterly Bulletin

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Monetary Policy Report (p. 6)

In the first few months of 2004, the economic recovery in the major economic regions gained further momentum. Overall, growth in the first quarter of 2004 was slightly higher than had been expected in the last Monetary Policy Report. Owing to the economic upturn and to the steep increase in oil prices, many countries saw a slight rise in inflation. In Switzerland, too, the economy continued its recovery at the beginning of the year. In the first quarter, real GDP grew further compared with the previous period and exceeded the year-earlier level by 1.5% – the first significant year-on-year rise since 2001. The negative output gap in the economy as a whole narrowed slightly and the situation on the labour market stabilised.

On 17 June 2004, the SNB decided to raise the target range for the three-month Libor rate by 0.25 percentage points to 0.0%–1.0% and to keep the three-month Libor rate in the middle of the target range at around 0.5% for the time being. By tightening monetary policy slightly, the SNB reacted to the continued strengthening of the economic recovery. Even after this adjustment, the SNB's monetary policy remains expansive and supports the economic upswing.

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

There was a further improvement in corporate sentiment and in the general business situation from March to May. The economic recovery became more broad-based and gradually spread to the domestically-oriented industries. Exports, however, continued to be the main driving force. A number of indicators also point to a gradual rise in investor confidence. In addition, some companies have now increased their workforce or are considering doing so. Many industries were affected by the surge in raw material prices but for the most part were unable to pass on the higher costs.

General Meeting of Shareholders (p. 42)

The President of the Bank Council of the Swiss National Bank, Hansueli Raggenbass, first informed the General Meeting of Shareholders on 30 April about the new National Bank Act (NBA) entering into force on 1 May. In part, the amendments implemented in the NBA reflect the current legal situation regarding private listed stock companies. For example, it abandons the principle of a non-paid-up portion of the share capital and allows for foreign private individuals or legal entities to acquire SNB shares including all rights. The new NBA also strengthens corporate governance by comprehensively reforming the National Bank's statutory bodies. In particular, the Bank Council is reduced from 40 to 11 members and three standing committees are formed from within its own ranks. Moreover, the structural organisation has been reviewed, hierarchical structures have been flattened and an integrated planning and budgeting procedure has been introduced. In the second part of his speech, the President of the Bank Council commented on the 2003 annual financial statements and cautioned against exaggerated expectations with regard to the SNB's future profit distribution potential.

The Chairman of the Governing Board, Jean-Pierre Roth, first commented on economic developments and on monetary policy. After a disappointing 2002, the outlook brightened steadily in 2003. This year has been characterised by guarded optimism. With the environment remaining unstable, the SNB's monetary policy must remain expansionary. The SNB knows, however, that it will have to raise interest rates once the economic recovery has been confirmed. Events in recent years have shown time and again that the Swiss economy cannot remain immune to global economic turbulence. Ensuring that the problems caused by internal structures do not gain the upper hand is thus all the more important. The performance of the economy can only be improved if structural reforms are resolutely implemented.

Swiss National Bank Working Papers (p. 52)

Abstract of the paper by Urs Birchler and Diana Hancock, "What Does the Yield on Subordinated Bank Debt Measure?", Swiss National Bank Working Paper no. 2, 2004.

Monetary Policy Report

This report is based primarily on the data and information available as at mid-June 2004. Sections 1–3 were drawn up for the June 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 in terms of monetary policy.

Sections 1–3 of the present report were drawn up for the Governing Board's assessment of June 2004. The Survey and section 4 (Inflation forecast) take due account of the Governing Board's monetary policy decision of 17 June 2004.

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

Survey

In the first few months of 2004, the economic recovery in the major economic regions gained further momentum. Overall, growth in the first quarter of 2004 was slightly higher than had been expected in the last Monetary Policy Report. In Switzerland, too, the economy continued its recovery at the beginning of the year. Initially driven mainly by exports, the upturn gradually spread to the domestic economy as well. In the first quarter, real gross domestic product (GDP) grew further compared with the previous period and exceeded the year-earlier level by 1.5% – the first significant year-on-year rise since 2001. The negative output gap in the economy as a whole narrowed slightly and the situation on the labour market stabilised.

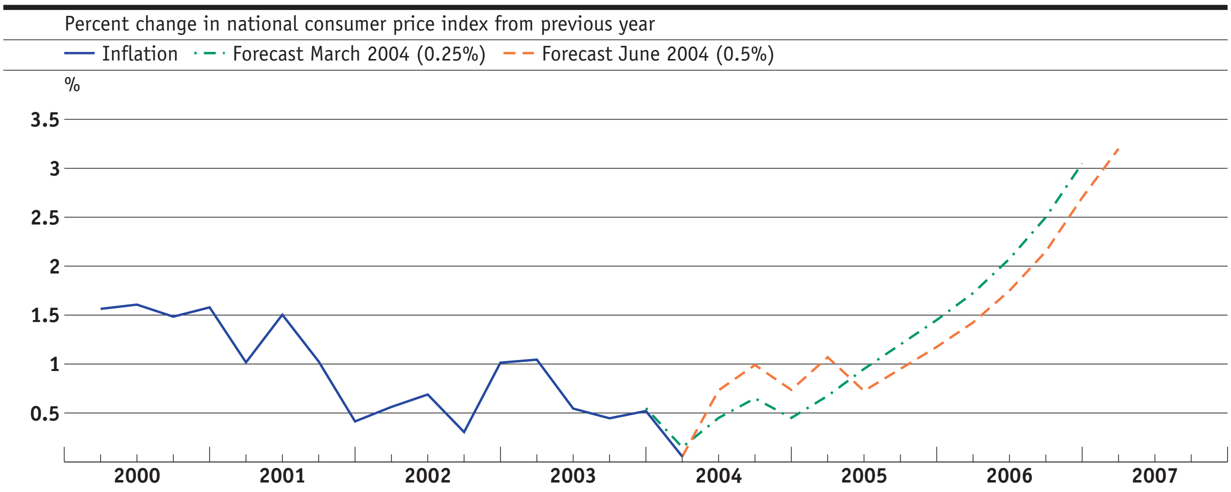
On 17 June 2004, the SNB decided to raise the target range for the three-month Libor rate by 0.25 percentage points to 0.0%–1.0% and to keep the three-month Libor rate in the middle of the target range (i.e. at 0.5%) for the time being. By tightening monetary policy slightly, the SNB was reacting to the continued strengthening of the economic recovery. Even after this adjustment, the SNB's monetary policy remains expansive and supports the economic upswing.

For this year, the SNB anticipates economic growth of close to 2.0%. The increase in oil prices nevertheless casts a shadow over the prospects for the economy, which are otherwise bright overall. The SNB is not of the opinion, however, that the upswing is threatened by this. At the end of 2005, the economy should again be working close to capacity, and this will influence price formation.

The inflation forecast of March 2004 already showed that, given an unchanged interest rate of 0.25%, inflation would exhibit a rising trend as from the second half of 2005. The June forecast, which is based on a three-month Libor of 0.5%, shows slightly lower inflation as from the second quarter of 2005. This demonstrates that the normalisation of monetary policy now initiated has improved the inflation prospects.

With the three-month Libor constant at 0.5% over the entire forecasting horizon, the new forecast puts average annual inflation at 0.6% for this year, at 1% for 2005 and at 2% for 2006. Despite the raising of the interest rate target range on 17 June 2004, the projected annual inflation rate at the end of the forecasting period still exceeds 2%, suggesting that the SNB will have to raise the target range again during this period if it is to ensure price stability.

Inflation forecast of March 2004 with Libor at 0.25% and of June 2004 with Libor at 0.5%



Inflation forecast June 2004 with Libor at 0.5 %	2004	2005	2006
Annual average inflation in %	0.6	1.0	2.0

1 Development of the global economy

International economy continues to recover

In the first few months of 2004, business activity in the major economic regions accelerated further. Overall, growth in the first quarter was slightly higher than had been expected in the last Monetary Policy Report. This was due primarily to the brisker rates of growth in the euro area and in Japan. As expected, the US economy expanded vigorously. The upswing in the UK lost some of its momentum, however. Owing to the economic upturn and to the steep rise in oil prices, many countries saw inflation rise.

Growth remains strong in the US and Japan

In the United States, real GDP was an annualised 4.4% up on the previous period. Growth was driven primarily by private consumption and capital spending. According to the indicators available to date, the second quarter should also see strong and broad-based economic growth. Industrial production rose sharply, and capital spending remained buoyant. While growth in employment levels had previously been limited to the service sector, the manufacturing sector now also began to generate new jobs.

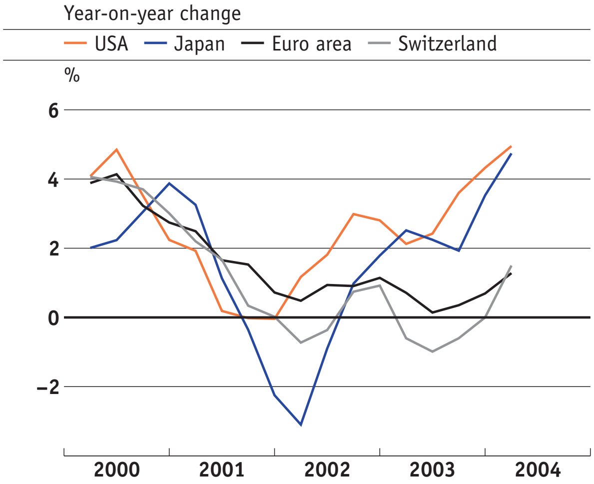
In Japan, too, economic growth rates remained brisk in the first quarter. Real GDP was an annualised 6.1% up on the previous period. As in the second half of 2003, the cyclical recovery was driven both by exports and by domestic demand, the latter accounting for about three quarters of the rise. The indicators available suggest that consumer spending and exports will continue to grow vigorously in the second quarter.

EU economy picking up

In the euro area, real GDP rose by an annualised 2.3% in the first quarter compared with the previous quarter. Growth was propelled by exports and private consumption, whereas investment activity was disappointingly low. As sentiment in industry has continued to improve, however, the second quarter can be expected to see a recovery in capital spending. Nevertheless, growth rates still varied considerably within the euro area. Whereas France, Spain and Belgium posted above-average growth rates, in Germany domestic demand in particular remained weak.

Economic growth in the United Kingdom eased slightly in the first quarter, but the reported figure of 2.5% was still robust. Private consumption continued to provide the main impetus for growth, whereas both investment growth and exports declined. The pound's appreciation against the euro is likely to have played a role in this. Nevertheless, the property sector continued to show signs of overheating – accompanied by a further increase in private debt.

Graph 1.1
Real GDP



Sources: Bank for International Settlements (BIS), seco

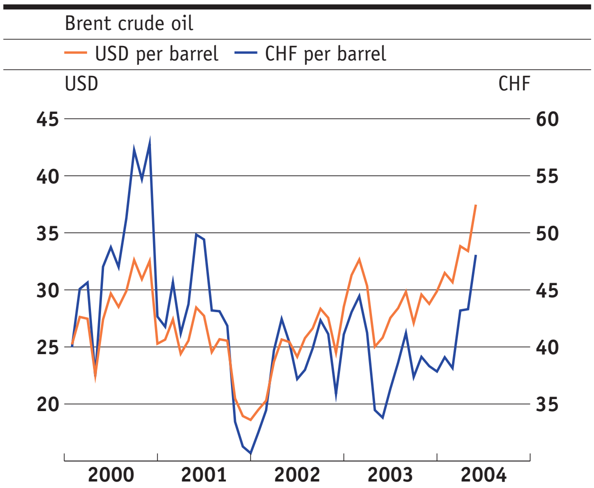
Oil prices move sharply higher

After already having risen in the first quarter, oil prices moved up again in the second quarter. The price of Brent crude topped USD 40 per barrel at times in May, and its monthly average of USD 37.5 was a third higher than its year-back level. The rise was due to a number of factors: for one thing, the quickening world economy – and especially the rapid growth in China – pushed up demand and hence also prices. For another, worries about the political situation in major oil-producing areas also contributed to the price hike.

Higher inflation

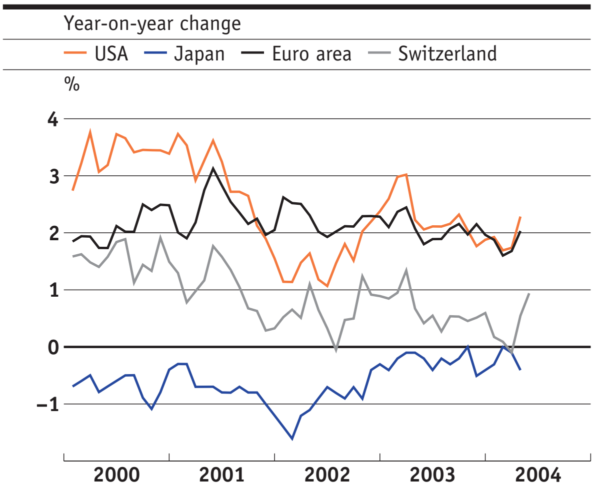
In most industrial countries, the economic recovery, coupled with higher oil prices, resulted in higher annual inflation rates as measured by consumer price indices. In the US, it rose from 1.7% in February to 3.0% in May, while core inflation (which factors out energy and food costs) merely crept up from 1.3% to 1.8%. In the euro zone, too, price rises accelerated. At 2.5%, annual inflation in May was back above the level equated by the European Central Bank (ECB) with price stability after having dropped to 1.6% by February. Even so, core inflation remained almost unchanged at 1.9%. In the UK, annual inflation in May stood at 1.5% – still below the target figure of 2%. In Japan, however, the deflationary trend tapered off.

Graph 1.2
Oil prices



Source: SNB

Graph 1.3
Consumer prices



Source: BIS

Monetary policy still expansionary

The monetary policies pursued by the US and Japanese central banks, as well as by the ECB, remained expansionary. Up to May, the key interest rates for refinancing operations remained unchanged in both the US and the euro area (at 1% and 2% respectively) while short-term rates in Japan were held close to zero as the banking system continued to be supplied with ample liquidity. In its April and May announcements, the Fed prepared the markets for a rise in the key interest rates. These are now expected to take effect at the end of June. The Bank of England raised its key interest rate by 0.25 percentage points in both May and June. These rises, which followed on from a tightening of rates in November and February, brought the interest rate to 4.5%. By contrast, the ECB regarded the current level of interest rates as suitable for maintaining price stability in the medium term, thus indicating that it would not be raising its key rates for the time being.

Outlook

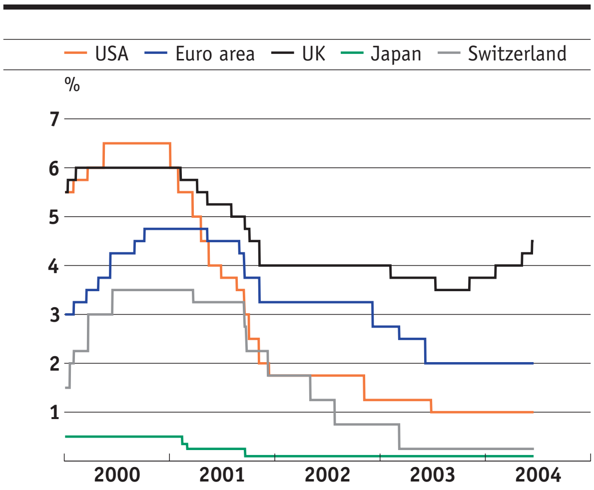
The global economic recovery looks set to continue in the second half of 2004. Economic growth is expected to slow down in the US and Japan but to accelerate slightly in the euro area. This is also evident from the OECD's leading economic indicators shown in Graph 1.5. While the corresponding indicator for Europe is pointing upwards, those for the US and Japan are on their way down again after a sharp rise at the beginning of the year. In the US, high corporate earnings are expected to trigger another surge in investment activity. With employment levels rising, growth in consumer spending should also remain buoyant. The Japanese economy is now more solidly based, and the export-driven recovery seems to be sparking an upturn in domestic demand in the euro area too, especially in terms of private consumption.

The sharp increase in the price of oil is the main threat to the business climate. As oil output is expected to be raised in the next few months, however, a fall in prices is more likely than a further rise. The economic recovery in Europe is also still prone to a number of imponderables. In Germany in particular, it remains vulnerable owing to low private consumption.

The GDP consensus forecast for US growth in 2004 published in May turned out as high as it had been in February (4.6%). That for Japan, however, was adjusted upwards by almost one percentage point. At 3.1%, it is now just as high as the forecast for the UK and almost double the rate predicted for the euro zone (which, however, was adjusted downwards slightly). Compared with the consensus forecast, the OECD forecast is lower for Germany but slightly higher for France. Both sets of forecasts are more upbeat for the euro area in 2005, though the growth gap versus the US is expected to persist.

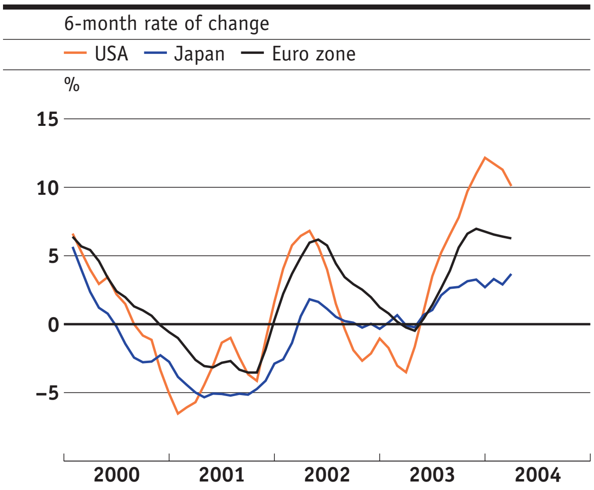
The consensus inflation forecasts for 2004 were adjusted upwards for all countries except Japan and now range between −0.2% (Japan) and 2.4% (UK). Most of the OECD's inflation forecasts, however, are slightly lower than the consensus.

Graph 1.4
Official interest rates



Sources: BIS, SNB

Graph 1.5
OECD Composite Leading Indicators



Source: OECD

Forecasts Table 1.1

	Economic growth[1]				Inflation[2]			
	OECD		Consensus[3]		OECD		Consensus[3]	
	2004	2005	2004	2005	2004	2005	2004	2005
United States	4.7	3.7	4.6	3.8	1.7	1.6	2.2	2.1
Japan	3.0	2.8	3.1	1.8	−1.8	−1.1	−0.2	−0.2
Euro area	1.6	2.4	1.6	2.0	1.7	1.7	1.8	1.6
Germany	1.1	2.1	1.6	1.7	0.8	0.8	1.3	1.2
France	2.0	2.6	1.8	2.1	1.6	1.6	1.9	1.6
Italy	0.9	1.9	1.0	1.8	2.5	2.4	2.2	2.1
United Kingdom	3.1	2.7	3.1	2.7	2.3	2.1	2.4	2.4

1 Real GDP, change from previous year
2 Consumer prices, change from previous year in percent
3 Consensus forecasts are monthly surveys conducted among approximately 200 leading companies and economic research institutes in some 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 (May preliminary) 2004; Consensus: May 2004 Survey

2 Development of the Swiss economy

2.1 Real GDP and its components

Economic growth slower but still robust

At the beginning of this year, the Swiss economy continued its recovery. In the first quarter of 2004, real GDP grew by an annualised 1.6% versus the previous period. This was slightly less than in the fourth quarter of 2003 (2.2%). The growth slowdown can be ascribed to smaller rises in both domestic demand (excluding inventories) and exports. Compared with the previous year, real GDP was up by 1.5% – the first year-on-year rise of over 1% since 2001.

The lower level of domestic demand is reflected primarily in private consumption, which slowed down slightly after the unexpectedly sharp rise in the fourth quarter. Investment activity, however, was uneven. Whereas equipment investment declined slightly, spending on construction rose thanks to an upturn in house-building activity. The easing in export growth was due mainly to lower exports of services; by contrast, shipments of goods continued to show robust growth. As imports registered a small decline, the external contribution to economic growth was positive.

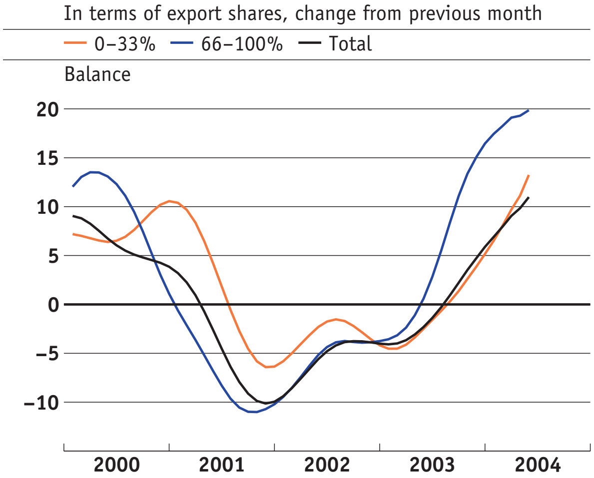
Industry continues to recover

Thanks to buoyant exports, industrial production in the first quarter of 2004 was almost 8% up on the previous quarter on an annualised basis, and was 5.3% higher than a year previously. Utilisation of technical capacity also recovered, rising back to its long-term average of 84%.

According to the monthly survey of the Institute for Business Cycle Research at the Swiss Federal Institute of Technology (KOF/FIT), the uptrend in the industrial sector gained fresh impetus in April. Incoming orders and orders in hand rose substantially, both in the export sector and at companies oriented to the domestic market. Moreover, inventories of primary products and finished goods continued to decline. As stocks of primary products in particular are now regarded as being too low, demand in this area should start to firm.

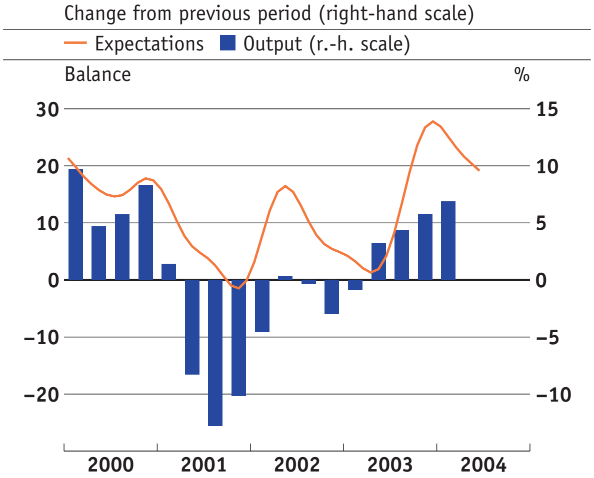
Following a sharp improvement in companies' expectations in the second half of 2003, forecasts have been adjusted downward slightly in the last few months. Nevertheless, companies are still optimistic and take an upbeat view of future developments in demand and output. This applies both to the export industry and to companies focusing primarily on the domestic market.

Graph 2.1
New orders in manufacturing



Source: KOF/FIT

Graph 2.2
Industrial output



Sources: KOF/FIT, SFSO

Real GDP and components Table 2.1

Year-on-year growth rates

	2000	2001	2002	2003	2002			2003				2004
					Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Private consumption	2.5	2.0	0.7	0.9	0.6	0.6	0.4	0.2	0.8	0.9	1.7	2.3
Government consumption	2.4	4.0	0.8	0.9	1.3	1.6	1.2	1.0	1.1	0.5	0.8	1.4
Investment in fixed assets	4.4	−3.1	−4.8	0.1	−6.1	−2.7	−2.1	0.1	−3.5	−1.3	4.9	0.6
– Construction	2.7	−3.4	2.2	0.9	4.2	2.6	1.8	0.7	0.0	1.1	1.8	2.8
– Capital goods	5.6	−3.0	−10.1	−0.7	−14.5	−7.3	−4.9	−0.3	−7.1	−3.8	7.5	−1.1
Domestic final demand	**2.9**	**1.0**	**−0.6**	**0.7**	**−1.0**	**0.0**	**−0.1**	**0.3**	**−0.2**	**0.2**	**2.4**	**1.8**
Domestic demand[1]	**2.1**	**1.9**	**−0.9**	**−0.1**	**1.0**	**−1.1**	**0.2**	**1.2**	**−3.7**	**0.7**	**1.6**	**−0.5**
Total exports[1]	12.2	0.2	−0.5	−1.4	−2.8	3.4	2.2	−2.4	−2.3	−3.5	2.5	7.4
– Goods[2]	11.9	3.7	0.3	−1.1	−0.5	3.7	3.1	−1.8	−3.1	−2.1	2.4	9.2
– Services	13.6	−3.2	−4.9	1.2	−12.3	−1.4	−6.3	−3.6	2.0	−0.4	8.2	0.6
Aggregate demand	**5.2**	**1.4**	**−0.8**	**−0.5**	**−0.1**	**0.2**	**0.8**	**0.1**	**−3.2**	**−0.6**	**1.9**	**2.0**
Total imports[1]	9.5	2.2	−3.1	−0.1	−0.3	−1.5	0.1	1.7	−6.3	−0.5	5.1	2.5
– Goods[2]	9.7	1.6	−2.8	0.3	−1.1	−2.4	−2.2	1.5	−7.4	0.1	7.1	2.2
– Services	5.3	4.3	−0.1	1.2	−0.6	−0.4	−0.5	2.9	2.3	0.4	−0.4	−0.1
GDP	**3.7**	**1.0**	**0.2**	**−0.5**	**−0.4**	**0.7**	**0.9**	**−0.6**	**−1.0**	**−0.6**	**0.0**	**1.5**

1 Including precious metals, precious stones and gems as well as objets d'art and antiques
2 Excluding the above under FN1

This impression of an economic recovery spread more evenly across the various industries was confirmed by talks held between the delegates for regional economic relations and companies in various industries. In contrast to the KOF/FIT survey, statements about the development of business in 2004 were rather less optimistic. However, the concern about the sustainability of the economic recovery which had been expressed at the beginning of the year receded.

Goods exports continuing to grow

In real terms, exports were 7.4% up on their year-back level in the first quarter. The growth rate was well down from the previous quarter, however. Exports of services, which dropped back to their year-ago level after a sharp rise in the fourth quarter, exerted an adverse effect on the figures. Almost all service-sector companies were affected by the decline, though tourism, insurance and aviation were hardest hit.

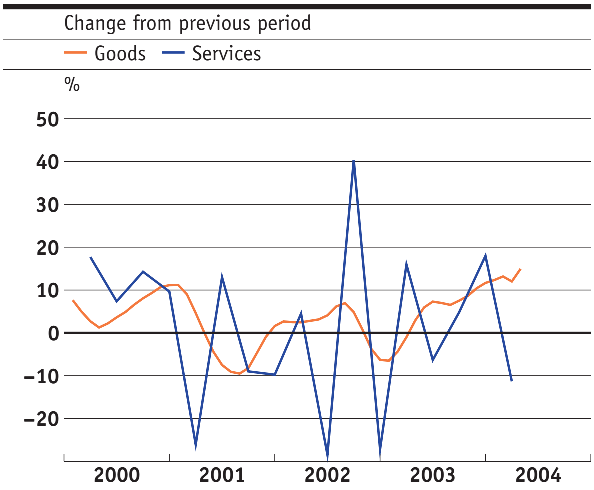
In contrast to exports of services, goods exports continued to expand vigorously. While growth eased towards the end of the first quarter, it already rebounded again in April. The biggest rises were recorded in exports of capital goods, especially those of industrial machines and electronic devices, plus raw materials and semi-manufactures (in particular plastics). Goods exports were boosted additionally by sales of aircraft.

In terms of the geographical markets, export demand from the US tapered off noticeably in the first four months of the year. This was probably due to the previous year's weakening of the dollar against the Swiss franc.[1] Exports to the UK were also sluggish. These growth-retarding forces, however, were offset by the consistently high growth in exports to Asia (especially China) and rising demand from other EU countries. Shipments to Germany in particular were boosted significantly, while exports to the east European countries that joined the EU on 1 May 2004 still recorded above-average gains.

Import growth down

Following the strong growth in the fourth quarter of 2003, imports eased slightly in the first quarter but were still 2.5% above their level a year earlier. The fall-off can be ascribed to goods imports. Although private consumption made rapid headway, imports of consumer goods in particular were down. The April figures, however, suggest that this decline may only have been a blip. Imports of services recovered further in the first quarter. Travel expenditure by Swiss residents abroad – which accounts for almost a third of total imports of services – rose by a particularly wide margin.

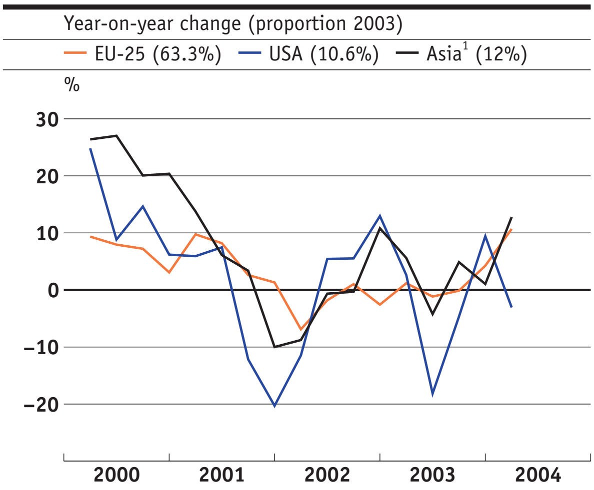
Graph 2.3
Exports



Sources: Swiss Federal Customs Administration (FCA), seco

1 Only nominal figures are available for the country breakdown of exports.

Graph 2.4
Exports by trading partners



1 Asia: Japan, China, South Korea, Hong Kong, Singapore, Taiwan, Malaysia, Thailand, Philippines, Indonesia

Robust growth in private consumption

Private consumption, which accounts for some 60% of Switzerland's GDP, was 2.3% above its year-back level in the first quarter. Along with goods exports and construction investment, it was thus one of the biggest factors driving economic growth. Compared with the previous quarter, the upward trend slowed only modestly.

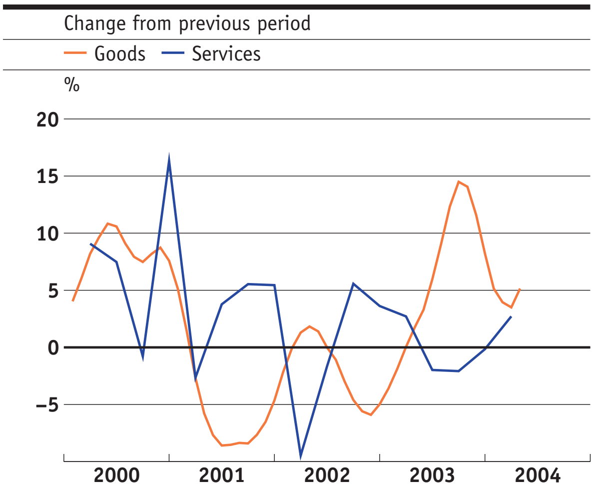
The revival of goods consumption was especially conspicuous. In real terms, retail sales were 4.1% higher than a year previously after having exhibited a slight decline in the preceding period. For the first time in two years, the number of newly registered passenger cars was higher than the year-back figure (+1.8%). By contrast, domestic tourism – an indicator of consumption of services – continued to act as a negative stimulus. The number of overnight stays within Switzerland saw a further year-on-year decline in the first quarter.

Consumer sentiment continues to improve

The improved consumer climate was reflected in the consumer sentiment index, which rose from −22 points to −13 points between January and April. It thus exceeded the ten-year average again for the first time in almost two years. Households are taking a less pessimistic view not only of the economic situation but also of job security and of the timing for major purchases. The surveys conducted by the KOF/FIT confirmed this trend. The retail trade considered the level of business to have improved again in May, and continued to take an optimistic view of the future. The catering trade, and especially the hotel business, was expecting a gradual recovery in domestic demand.

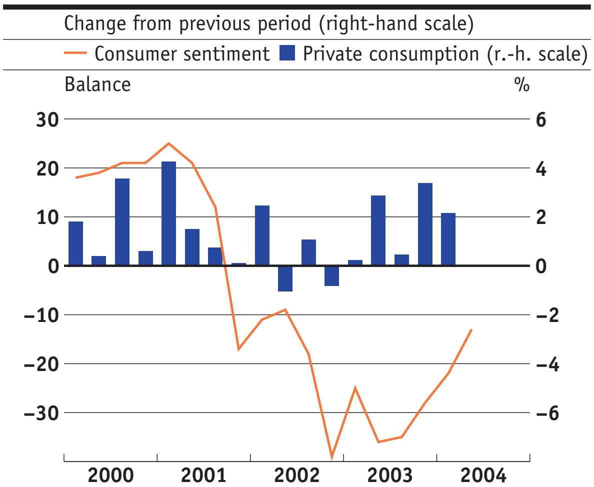
In addition to the sentiment indicators, macroeconomic conditions were also pointing to a sustained upturn in private consumption. This year, the nominal income of employees is set to rise by 1.8% – twice the 2003 rate. Moreover, unemployment looks set to fall off gradually in the second half, which should also help to boost private consumption. This should stimulate demand for consumer durables in particular, as two slack years have led to a considerable backlog in this area.

Graph 2.5
Imports



Sources: FCA, seco

Graph 2.6
Private consumption



Source: seco

Investment in construction rising strongly

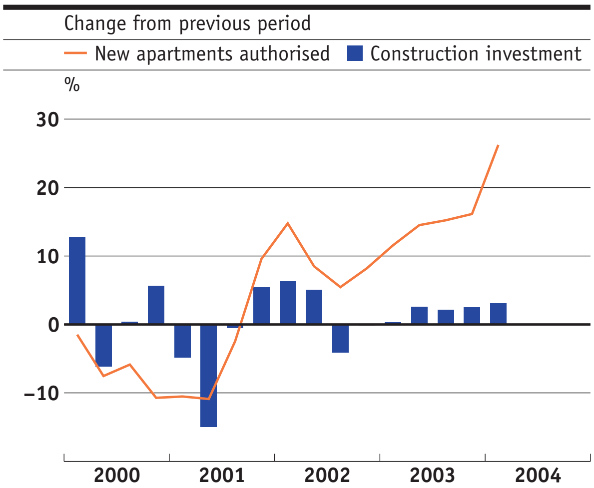
Construction investment also contributed to economic growth in the first quarter, increasing faster than in the preceding quarter and by 2.8% year-on-year. Housebuilding was the driving force: in the first quarter, the number of dwelling units under construction was 12.6% higher than a year earlier. According to a survey by the Swiss contractors' association, however, construction of commercial property eased again, and the civil engineering sector saw sluggish growth.

Given the very favourable interest rate situation, the uptrend in residential construction should continue. The first quarter saw a further sharp increase in the number of dwellings for which building permits have been issued. Moreover, the continuing rise in the cost of accommodation (see Graph 3.14) and the persistently low vacancy rate for rented apartments suggest that demand for housing will remain strong. By contrast, there are no signs of an imminent improvement in the commercial building sector, which is impacted by an unrelentingly high vacancy rate.

Temporary dip in equipment investment

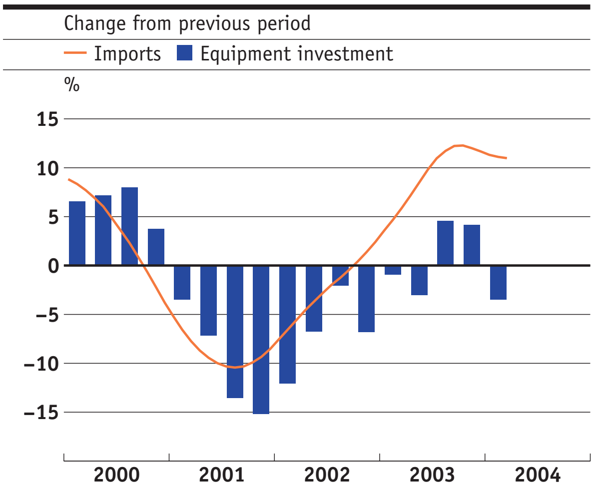
In contrast to investment in construction, equipment investments were slightly lower in the first quarter than in the preceding period. Due partly to extraordinary factors, they were 1.1% lower than a year previously. Factoring out these effects still produces a lower figure than expected. According to the available indicators, however, investment should rise appreciably in the next few quarters. The quarterly survey of industry conducted by KOF/FIT revealed an improved earnings situation and higher capacity utilisation. Moreover, a growing proportion of companies consider that they do not have sufficient technical capacity and, finally, demand for replacement investments is still high. The next few quarters are thus likely to see a revival in investment activity. Low interest rates and falling prices of imported capital goods should lend further impetus to this trend.

Graph 2.7
Construction



Sources: SFSO, seco

Graph 2.8
Capital goods



Sources: FCA, seco

2.2 Capacity utilisation

Slightly narrower output gap in the economy as a whole

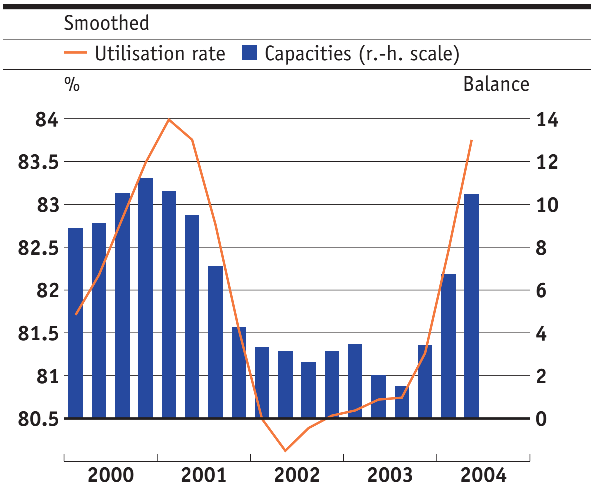
Information on the utilisation of output factors in the economy as a whole is important for assessing the economic situation and the inflation outlook. The degree of capacity utilisation is, however, not directly observable. The SNB therefore relies on various approaches in order to estimate the output gap (see box). The assessment of potential output, on which the calculation of the output gap rests, indicates the level of production that can be achieved in the event of normal utilisation of the output factors. The output gap then represents the percentage difference between actual real GDP and estimated potential output. A positive (negative) output gap is therefore a sign of over-utilisation (under-utilisation) of the production factors.

In the first quarter, real GDP adjusted for seasonal and random fluctuations grew somewhat more markedly than estimated potential output. As a consequence – and regardless of the estimation methods used – the negative output gap narrowed. Graph 2.10 shows that the output gap increased until the second quarter of 2003, thereafter slowly receding again in the wake of the emerging economic recovery. In the first quarter, the HP filter put under-utilisation of economic capacity at −1.3%, the MV filter at −1.7%, and the production function approach put this figure at −2.6%.

Higher capacity utilisation in industry

Utilisation of technical capacity in industry as measured by the quarterly KOF/FIT survey rose by 1.4 percentage points to 84% in the first quarter. It was thus back to the long-term average, which corresponds to normal capacity utilisation. The differential to the still negative output gap in the economy as a whole is due primarily to the fact that the capacity utilisation measured by KOF/FIT only refers to technical capacity in industry. Neither utilisation of the production factor labour nor the development of the service sector is considered. Moreover, the industrial sector invested very little in recent years and has hardly effected the replacement investments required for maintaining the capital stock. With production expanding, this has led to a rapid rise in capacity utilisation. As already mentioned, equipment investment can be expected to rise significantly in the next few quarters. This is liable to lead to an accelerated increase in technical capacity (graph 2.9) and to slow down a further rise in capacity utilisation in industry in the next few quarters.

Graph 2.9
Industrial capacity



Source: KOF/FIT

Box: Three approaches to estimating production potential and the output gap

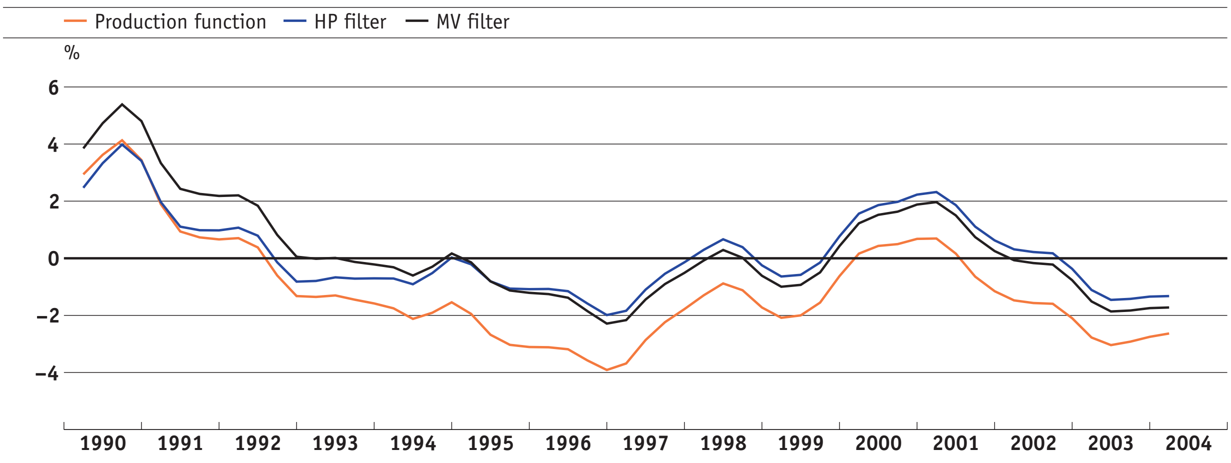
Production potential and therefore also the output gap are not directly observable and must be estimated by means of econometric procedures. The SNB uses three different approaches for calculating production potential, viz. (1) a Hodrick-Prescott filter, (2) a multivariate filter and (3) a production function approach.

The Hodrick-Prescott filter (HP filter) is a univariate procedure since it only uses time series information of the production observed for calculating the potential production level. With this method, the observed output (in terms of real GDP) is broken down into a trend component and a cyclical component. The trend component reflects potential production and the cyclical component the output gap.

The multivariate (MV) filter is an HP filter where – alongside the breakdown of real GDP into its trend and cyclical components – information on the correlation between output and inflation is additionally used, thus taking advantage of the correlation of the so-called Phillips curve.

In the production function approach, production potential is estimated based on an economic production function covering the whole economy. The production function describes the correlation between production and the production factors used, i. e. labour and capital. Based on assumptions of the long-term development of the production factors and technical progress, production potential can then be calculated by simulating the production function.

Graph 2.10
Output gap



Sources: seco, SNB

2.3 Labour market

Stabilisation of employment

The employment figures for the first quarter confirmed the stabilisation emerging on the labour market since mid-2003. The number of employed persons increased by an annualised 0.5% as in the previous period. For the first time in five quarters this figure thus slightly exceeded the corresponding year-back level. The slight growth compared with the previous period is attributable to rising employment in the service sector and in the construction sector (+0.9% each). In manufacturing industry, by contrast, the decline continued albeit at a lesser rate than in the previous quarters (–1.5%).

The marked differences in the development of full-time and part-time employment, which have been observable for a year, narrowed in the first quarter. The number of full-time employees only dropped slightly this time. Conversely, part-time employment increased more slowly. In terms of full-time jobs, too, employment thus stabilised after having declined sharply in the previous period.

Unemployment rates unchanged

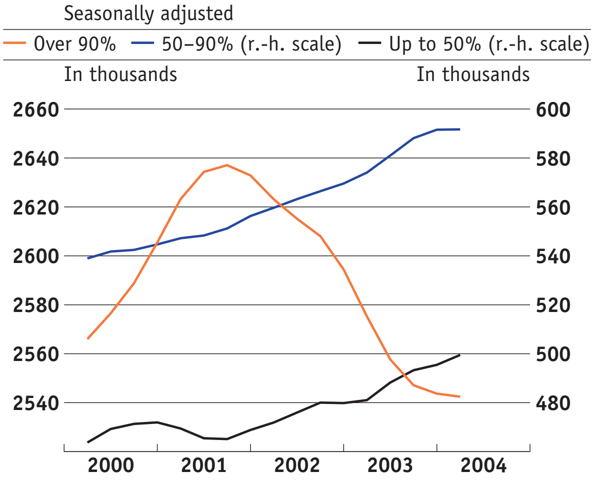
The unemployment rate adjusted for seasonal factors remained unchanged at 3.9% until May. Since the beginning of the year, the number of unemployed has nevertheless declined slightly to 152,500 persons. Job-seekers totalled 219,200 persons in May, equivalent to a rate of 5.6%.

In the different regions, unemployment has shown varying development since the start of the year. While the unemployment rate dropped in German-speaking Switzerland, it continued to rise in western Switzerland and in Ticino. In May, the unemployment rates for these regions amounted to 3.4%, 4.5% and 5% respectively.

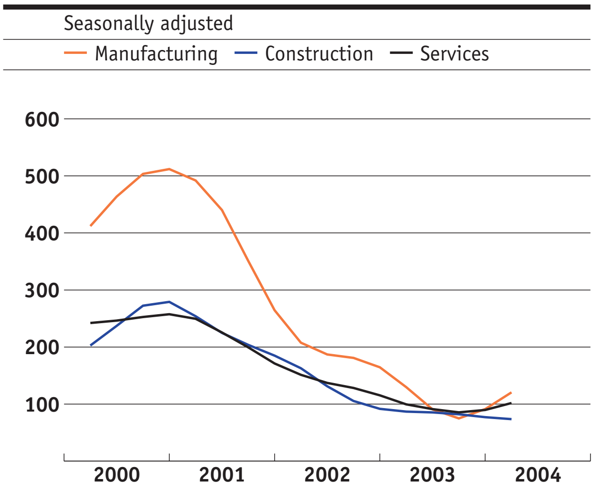
Gradual rise in employment in sight

Since the beginning of the year, a number of indicators have shown that the demand for labour is gradually rising. The first quarter saw rises in both the job vacancies index Jobpilot, which measures job advertisements in the Internet, and in the job vacancies index compiled by the Swiss Federal Statistical Office (SFSO). The surveys of KOF/FIT also showed an improvement.

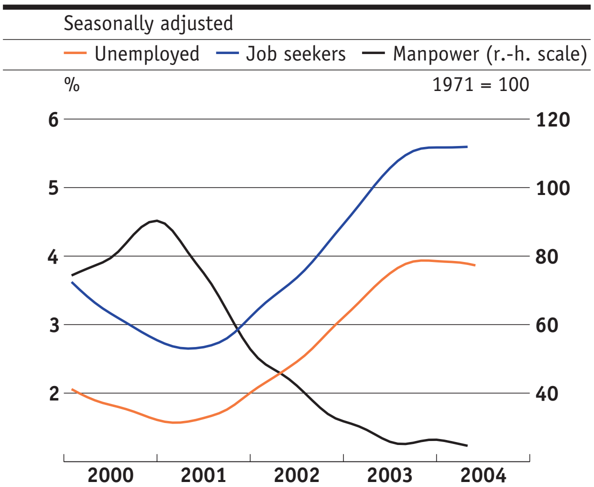
Graph 2.11
Full- and part-time employment



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 Prices

Continuing rise in producer prices

Producer and import prices, which generate inflationary stimuli for the downstream consumer level, increased moderately between January and April. Annual inflation for producer prices continued to rise, reaching 1.1% in April (January: +0.6%). Registering a 1.8% increase, the prices of goods destined for the domestic market rose at a markedly faster pace than those of exported goods (+0.3%). The slide in prices of imported goods, which had continued steadily for a year, came to a standstill in April. In particular, metal und mineral oil products became considerably more expensive. The price decline for imported capital goods (office machines and other IT equipment) continued, albeit at a slightly weaker pace.

Slightly higher inflation at the consumer level

After annual inflation measured by the national consumer price index (CPI) had slipped into the negative range in March, it increased to 0.5% and 0.9% respectively in April and May. This rise in inflation was stronger than the SNB had anticipated in its inflation forecast in March. Prices for oil products (heating oil and petrol), in particular, moved up more markedly than expected.

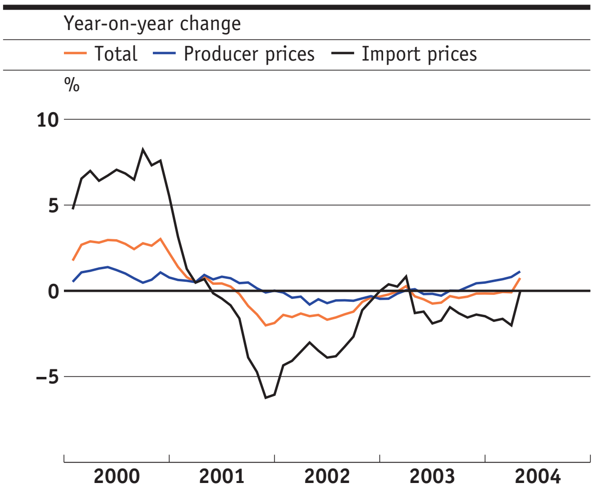
Slightly higher domestic inflation

At 0.8%, annual inflation in domestic goods and services in May was only slightly above its level in February. While inflation in services, which account for three-quarters of the domestic basket of commodities, increased by another 0.2 percentage points to 0.9%, prices for goods moved up less sharply.

Public services saw a rise in annual inflation from 1.5% to 2.1%; this was due mainly to higher tariffs for hospital services and higher rates for refuse removal and sewage. The quarterly rents survey conducted in May revealed an 0.3 percentage point rise to 1.0% from the level in February. At 0.6%, inflation in other private services was not significantly higher than three months earlier.

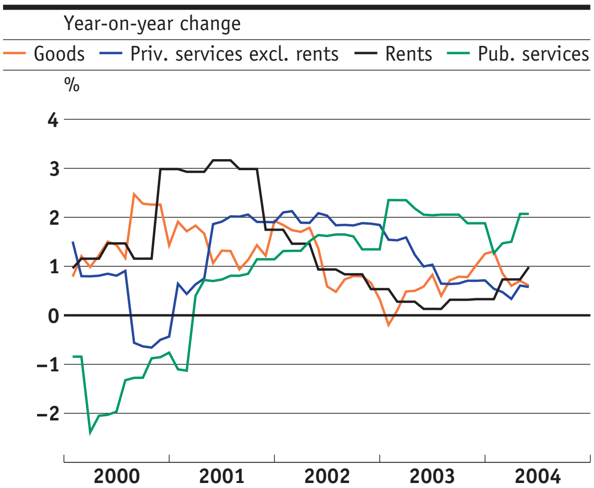
Price increases for domestic goods slowed by 0.3 percentage points to 0.6% between February and May. Prices for foodstuffs, beverages and tobacco again rose at an above-average rate.

Graph 2.14
Prices of total supply



Source: SFSO

Graph 2.15
CPI: Domestic goods and services



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

End of the slide in imported goods prices

After goods of foreign origin had become cheaper since September 2003, the price decline came to a standstill in May. Year-on-year, inflation amounted to 1.2%. Of particular significance was the development of oil products (fuel and heating oil), which soared by 12.5% in May compared with the year-earlier level. The prices of the other imported goods continued to fall; however, the price decline weakened from –1.3% in February to –0.5%. The price reductions in the consumer electronics industry were again particularly striking: PCs were down 11.5%, telephones 9.1% and TV sets and video recorders 7.8%. Disinflationary stimuli, moreover, emanated from goods in the "clothing and footwear" category, which are also mostly imported.

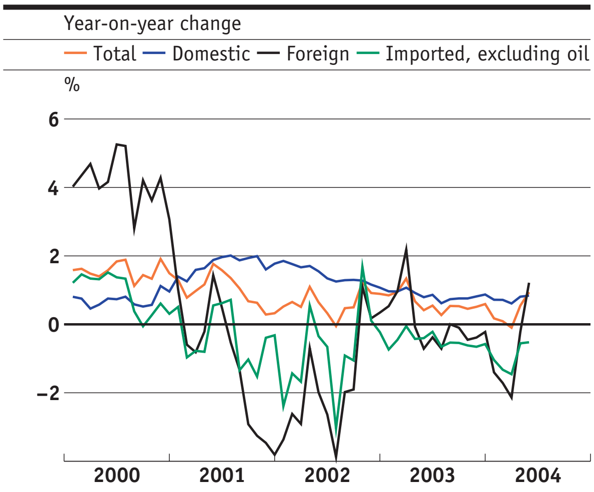
Higher core inflation calculated by the SNB ...

Inflation, as measured by the national consumer price index, is subject to numerous short-term influences which may distort perceptions of the general price trend. The SNB therefore calculates a core inflation rate. For any given period, this core inflation rate excludes the 15% of goods with the highest annual inflation rate and the 15% of goods with the lowest annual inflation rate from the national index basket of goods. Between February and May, the core inflation rate increased by 0.3 percentage points to 0.8%. In May, core inflation thus differed only insignificantly from consumer inflation. This shows that inflation-dampening special influences and inflationary factors more or less balanced each other out. The rise in core inflation, however, reflects a slight uptrend in inflation since February.

... and by the SFSO

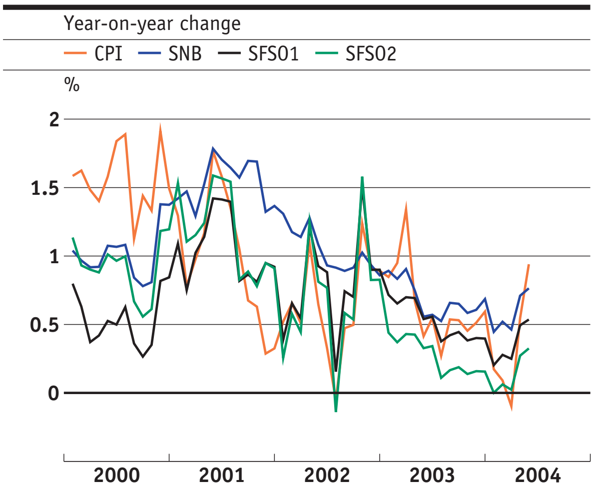
Unlike the core inflation rate calculated by the SNB, the two core inflation rates calculated by the SFSO exclude the same goods from the basket of goods in any given period. In the case of core inflation 1, these are foodstuffs, beverages, tobacco, seasonal products, energy and fuel. Core inflation 2 additionally excludes products with government-controlled prices. The core inflation rates published by the SFSO rose by 0.2 percentage points each compared with February. In May, core inflation 1 amounted to 0.5% and core inflation 2 to 0.3%.

Graph 2.16
CPI: Domestic and imported goods and services



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

Graph 2.17
Core inflation



Sources: SFSO, SNB

National consumer price index Table 2.2

Changes from previous period in %

	2002	2003		2004				
		Q3	Q4	Q1	February	March	April	May
Overall CPI	**0.6**	**0.4**	**0.5**	**0.1**	**0.1**	**−0.1**	**0.5**	**0.9**
Domestic goods and services	0.8	0.7	0.8	0.7	0.7	0.6	0.8	0.8
Goods	0.6	0.6	1.0	0.9	0.9	0.6	0.7	0.6
Services	0.9	0.7	0.7	0.6	0.7	0.6	0.9	0.9
private services excluding rents	1.0	0.6	0.7	0.4	0.5	0.3	0.6	0.6
rents	0.3	0.3	0.3	0.6	0.7	0.7	0.7	1.0
public services	2.1	2.1	1.9	1.4	1.5	1.5	2.1	2.1
Foreign goods and services	0.0	−0.3	−0.4	−1.8	−1.7	−2.1	−0.2	1.2
excluding oil products	−0.5	−0.6	−0.6	−1.3	−1.3	−1.5	−0.6	−0.5
oil products	3.2	1.5	1.0	−4.5	−3.9	−6.1	1.9	12.5

Sources: SFSO, SNB

3 Financial conditions

3.1 Interest rates

Monetary policy still expansionary

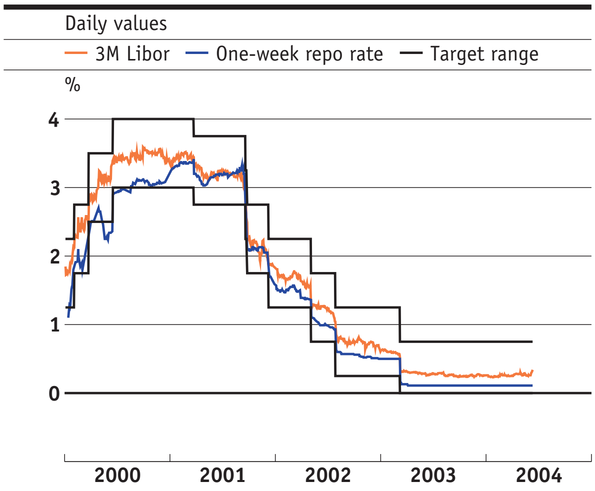
The SNB adhered to its expansionary monetary policy. The targeted level of the 3-month Libor has remained unchanged at 0.25% since March 2003, and repo rates for all maturities stand at 11 basis points.

Since the last assessment in March, the interest rate differential to the euro measured by the three-month money market rate was unchanged at 180 basis points. The spread in relation to the dollar rose from less than 90 to more than 100 basis points.

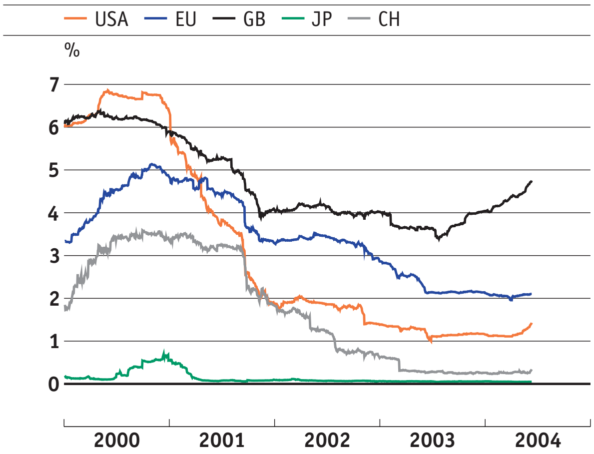
Graph 3.3 shows the expectations for the 3-month Libor on the futures market with maturity prior to the SNB's quarterly assessment in mid-June. By the end of March, interest rate expectations had fallen to almost the level of the spot rate for the three-month Libor. After again having risen to 0.45% in April, the rate for June futures fell back slightly by early June.

Financial market participants expect interest rates to rise in the next three months (graph 3.4). On 10 May, a three-month Libor of 0.81% was predicted by the futures market as at 10 September, i.e. one week prior to the quarterly assessment. The forward rate implied by the interest rate structure of Libor rates with a maturity of 1–12 months was practically at the same level. The SNB's calculation on the basis of an empirical estimate of an interest structure model resulted in an expected three-month Libor of 0.63% on the same maturity date. While the market's interest rate expectations according to the September futures receded by approximately 20 basis points in May, they again rose to the same extent until shortly before the quarterly assessment in June. This means that in mid-June the markets were anticipating an interest rate increase of approximately 50 basis points by December.

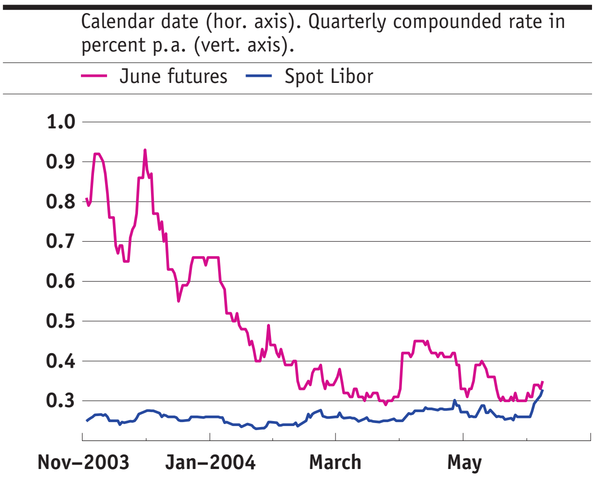
Graph 3.1
Money market rates



Graph 3.2
International short-term interest rates (3 months)



Graph 3.3
Three-month interest rate futures



Graphs 3.1, 3.2, 3.3:
Source: SNB

In an historical comparison, real financing conditions in Switzerland continued to be extremely favourable in the first quarter. This is shown by the development of the real Swiss franc Libor with a one-year maturity (graph 3.5) which – at 0.53% – was lower than in the previous quarter (–0.19%). Since mid-2002, it has been fluctuating approximately between 0% and –0.5%. The real interest rate results from the differential between the 12-month Libor and the inflation rate predicted for the next 12 months. Expected inflation rates reflect the average assessment of 14 institutes published each quarter as a "Consensus Forecast". The decline in the real interest rate in the first quarter is primarily the result of higher inflationary expectations for the next twelve months. These rose from 0.7% in December 2003 to 0.9% in May.

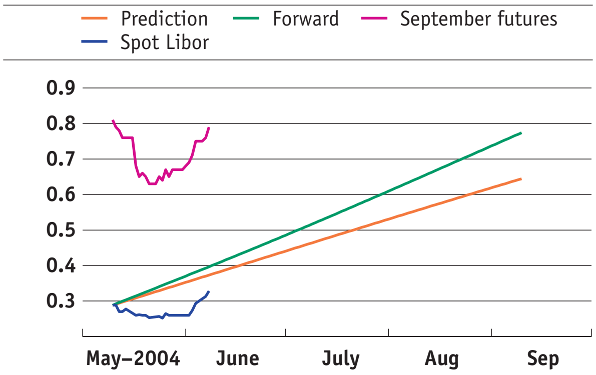
Rise in capital market yields

Since March, capital market yields for maturities of less than ten years have seen a particularly significant rise. The ten-year Confederation bond moved up by approximately 50 basis points to 3% between mid-March and the beginning of June. The SNB's calculations indicate that this is due to a rise in real interest rates, while long-term inflationary expectations on the financial markets have remained unchanged. The higher real interest rates are probably the result of improved economic prospects and an anticipated tightening of monetary policy. Yields for maturities of more than 20 years, however, have remained at the February level. They are thus still well below their level in November 2003.

Capital market rates abroad also recorded a rise (graph 3.8). In the US, they showed the strongest increase, with the rates for ten-year government bonds climbing from below 4.0% in mid-March to more than 5% in May. Like in Switzerland, the rates in Germany exhibited a comparatively modest rise, i.e. from 4.1% to 4.5%. The slight decoupling of European interest rates from US rates may be seen not least of all as reflecting the differing tempo of economic momentum.

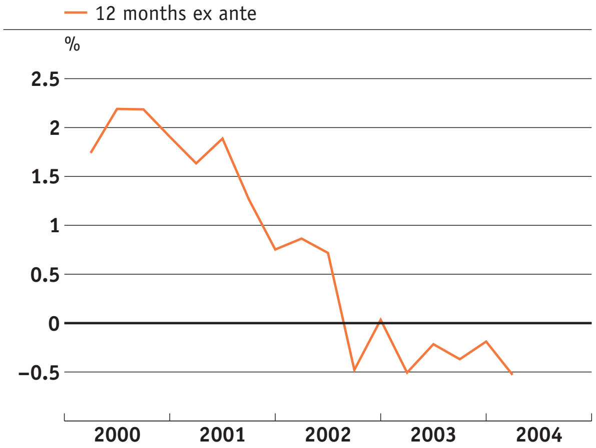
Graph 3.4
Anticipations of the Swiss three-month interest rate

Prediction by SNB. Forward rate implied by the term structure of the spot Libor of 10.5.2004.
Calendar date (hor. axis). Quarterly compounded rate in percent p.a. (vert. axis).



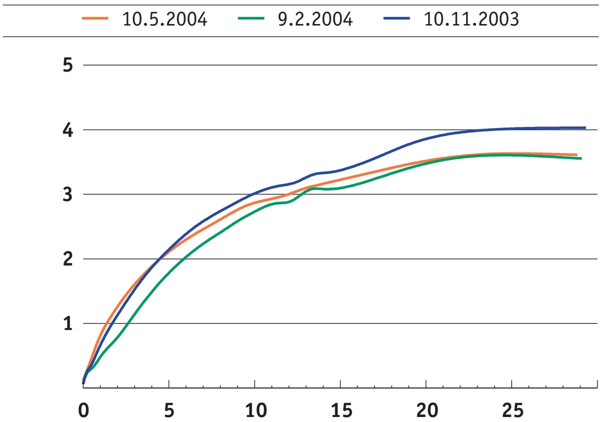
Graph 3.5
Estimated real interest rates

Quarterly values



Graph 3.6
The term structure of Swiss Confederation bond yields

Years to maturity (hor. axis). Annually compounded nominal discount bond yield in percent p.a. (vert. axis).



Graphs 3.4, 3.5, 3.6:
Source: SNB

Further decline in credit interest rate spreads

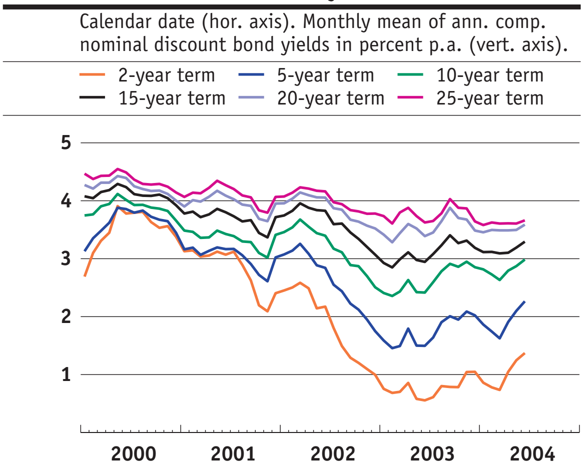
Graph 3.9 shows the credit ratings for prime bonds with two-year maturities from six sectors. Credit ratings are measured in terms of the interest rate spread between a discount bond from one of these sectors versus the corresponding yield on Swiss Confederation bonds (see "Box: Assignment of bonds to ratings classes", Monetary Policy Report 1/2004, p. 33). The sectors chosen are the cantons, banks, mortgage bond institutions, industry and two groups of foreign borrowers rated AAA and AA by Standard & Poor's.

The interest rate spread illustrates the change over time in credit ratings and hence also in the financing terms on the Swiss capital market for bond issuers. Beyond this, it serves as a good leading indicator for economic activity. The rule of thumb is that a narrower interest rate spread points to an acceleration in economic activity.

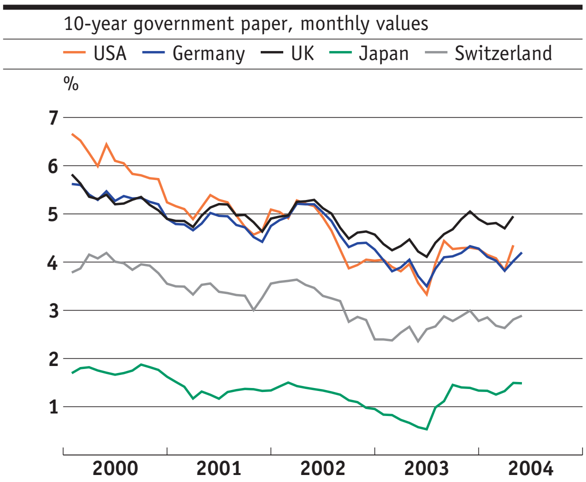
As can be gathered from the graph, the interest rate spreads of all six borrower sectors have contracted markedly. The same applies to bonds with similar credit ratings equipped with a longer maturity and to bonds with a lower credit rating. A counter movement – which began in May – was confined to industrial bonds. Despite a widening for industrial bonds, the development of interest rate spreads overall indicates growing investor confidence in borrowers, which in turn reflects a favourable assessment of economic activity.

Credit interest rate spreads have also narrowed abroad. Since May, they have, however, again widened somewhat in the US. Like Switzerland, the other European countries were also spared this reverse trend. Here interest rate spreads have remained stable.

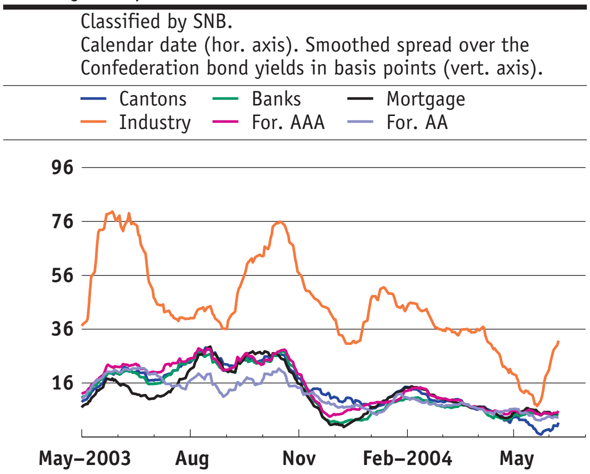
Graph 3.7
The Swiss Confederation bond yields



Graph 3.8
Interest rates abroad



Graph 3.9
The 2-year spread of Swiss first-class bonds



Graphs 3.7, 3.8, 3.9:
Source: SNB

3.2 Exchange rates

Weaker euro, stronger dollar

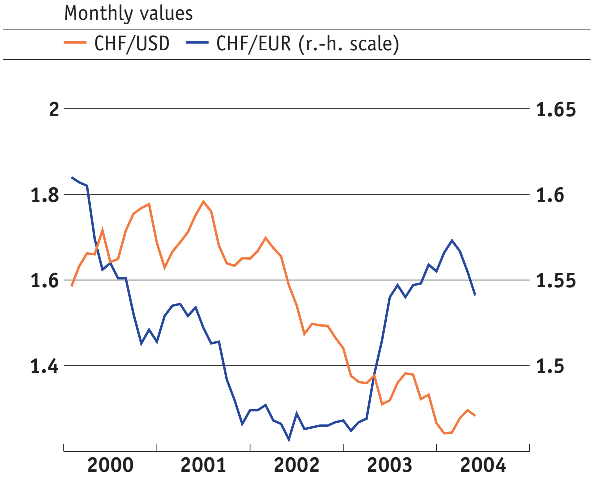
After having appreciated against the dollar for quite some time, the euro has depreciated slightly again since the last assessment in March. Between the start of the year and April, the dollar emerged from the weak trend, which had persisted for three years, and staged a marked recovery. In May, however, it again declined somewhat. The Swiss franc benefited from the euro's fall against the dollar and also moved up in relation to the single currency. While a euro was still equivalent to CHF 1.57 in February, it averaged a mere CHF 1.54 in May. The Swiss franc developed in an opposite relation to the dollar, weakening from CHF 1.24 to CHF 1.28. The prospect of an early interest rate increase by the Fed and the marked rise in US capital market yields may be seen as the reasons for the relative strength of the dollar. This enhanced the relative appeal of dollar investments.

Parallel to the nominal loss in value of the euro, the real external value of the Swiss franc moved up significantly against the euro area. Real appreciation turned out to be somewhat weaker vis-à-vis a broader index with 24 countries including the dollar area. Despite the most recent uptrend, the real external value of the Swiss franc in May was still below the previous year's level. It was 2.8% down on its year-earlier level against its European trading partners, and 2.0% down vis-à-vis the 24 major trading partners.

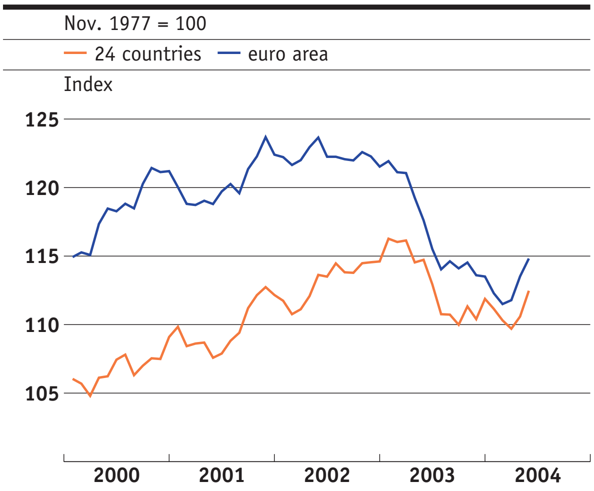
MCI

The Monetary Conditions Index (MCI) combines short-term interest rate and exchange rate developments in an indicator of monetary conditions (see "Box: The Monetary Conditions Index (MCI)", Monetary Policy Report 1/2004, p. 27). After having fallen slightly in April, thus signalling a loosening of the monetary conditions compared with the last assessment of 18 March, the MCI rose to between 40 and 70 basis points (5:1 and 3:1 weighting respectively) in May following the appreciation of the Swiss franc versus the euro. Since short-term interest rates have remained virtually unchanged for more than a year, exchange rate changes were responsible for these movements. As from the end of May, the rise of the three-month Libor also contributed to a tightening of monetary conditions.

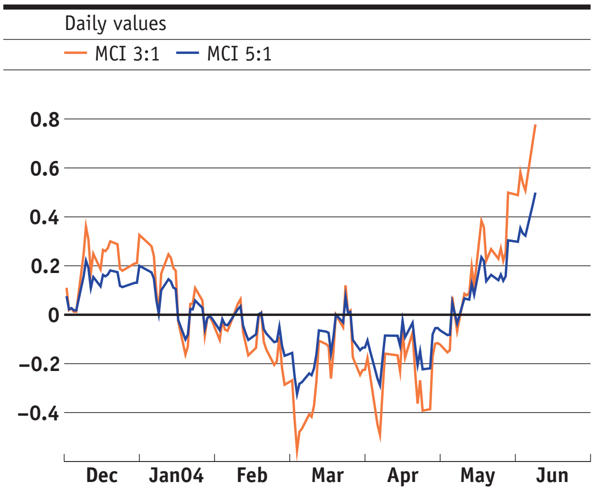
Graph 3.10
Exchange rates



Graph 3.11
Export-weighted real exchange rate of the Swiss franc



Graph 3.12
MCI nominal



Graphs 3.10, 3.11, 3.12:
Source: SNB

3.3 Share and real estate prices

Consolidation on the equity market

The rally observable on the equity markets since March 2003 has levelled off. In March, the Swiss equity market suffered a first setback, from which it recovered completely in April. By the end of May, however, it fell by another approximately 5%. So far this year, construction stocks have been the only ones to post a net gain, advancing some 20% above their turn-of-the-year level by the end of May. At the same point in time, securities of banks, industry and technology were more or less at their end-2003 levels.

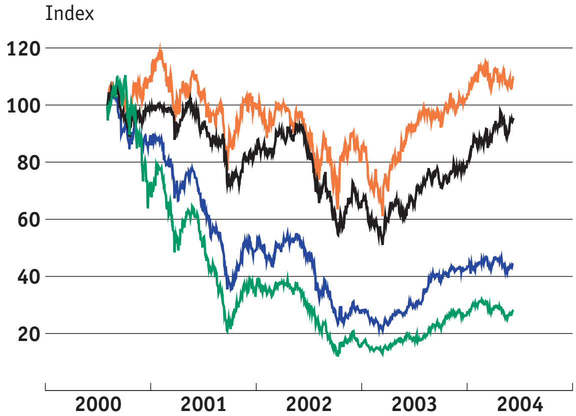
Continued rise in rents and real estate prices

While rents and prices of single family houses and owner-occupied apartments have been rising for a number of years, rents for office space have been stagnating. This development continued in the first quarter. In this period, residential rents increased by 1.8% and prices for single-family houses and owner-occupied apartments by 3.1% year-on-year; concomitantly, rents for office space stagnated again.

Graph 3.13
SPI by sectors

Beginning of period = 100

— Banks — Manufacturing — Construction — Technology

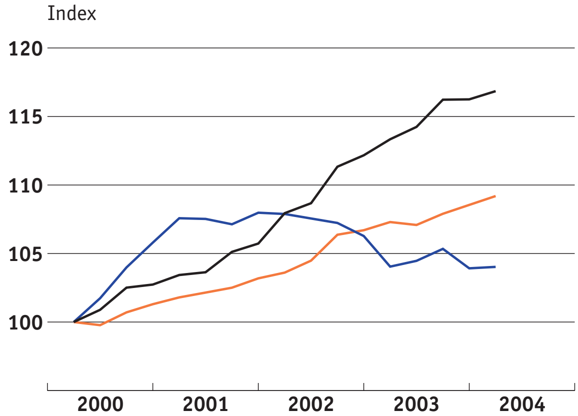


Source: Swiss Exchange (SWX)

Graph 3.14
Rents and real estate prices

Beginning of period = 100

— Residential rents — Offices — Single family home & apt. prices



Source: Wüest & Partner

3.4 Monetary aggregates

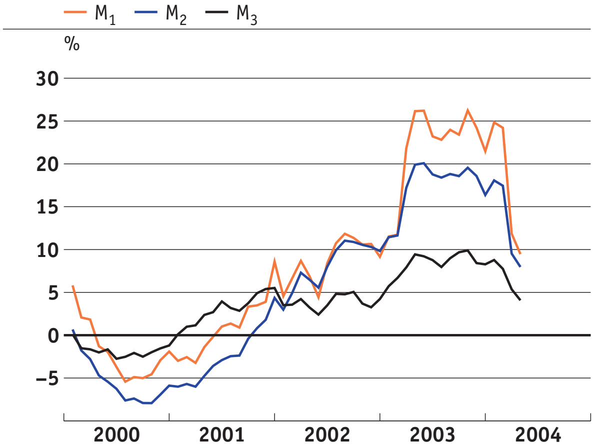
Slower growth in monetary aggregates

Immediately after the last interest rate reduction of 6 March 2003, the monetary aggregates expanded markedly. Since the beginning of the year, however, growth rates have receded considerably from their year-earlier levels. Yet compared with the historical average, they remain high. The monetary aggregate M_3, comprising currency in circulation, sight, savings and time deposits, widened by 7.3% in the first quarter. In May, the annual growth rate amounted to a mere 4.3% compared with 7.7% in February. The annual rate of increase of M_2 (M_3 minus time deposits) receded from 17.4% in February to 7.5% in May. The growth rate of the monetary aggregate M_1, which comprises currency in circulation plus sight deposits, declined from 24.2% to 9.4%.

The economic entities' demand for money depends on the nominal transaction volume and on the opportunity costs for holding money. In macroeconomic analyses, a proportionality to nominal GDP is usually assumed for the transaction volume, while opportunity costs for M_3 money holding are measured by the long-term interest rates. The relation of the money stock to nominal GDP is known as the money-to-GDP ratio. As a rule, this ratio reacts inversely to the opportunity costs because high (low) long-term interest rates induce the public to limit (expand) its cash on hand. As graph 3.16 illustrates, the money-to-GDP ratio has increased since the early 1990s; the monetary aggregate M_3 has thus expanded more markedly than nominal GDP. The reason for this was that long-term interest rates were on the decline during this period.

Graph 3.15
Monetary aggregates

Change from previous year, seasonally adjusted



Source: SNB

Monetary aggregates[1] Table 3.1

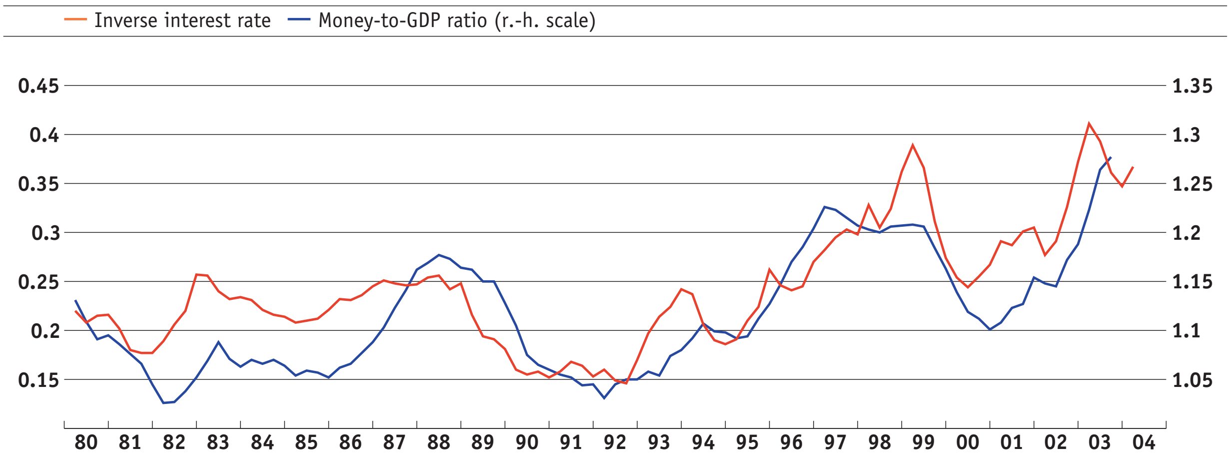
	2002	2003	2003 Q1	Q2	Q3	Q4	2004 Q1	March	April	May
Monetary base[2]	**38.4**	**40.4**	**39.2**	**39.9**	**41.0**	**41.5**	**42.2**	**41.6**	**42.0**	**41.4**
Change[3]	*5.7*	*5.3*	*0.7*	*4.6*	*8.6*	*7.4*	*7.7*	*4.5*	*5.8*	*4.1*
M_1[2]	**224.4**	**273.7**	**249.0**	**273.0**	**279.0**	**293.6**	**298.9**	**296.1**	**298.9**	**298.7**
Change[3]	*8.7*	*22.0*	*15.0*	*25.2*	*23.5*	*23.9*	*20.0*	*11.9*	*9.4*	*9.4*
M_2[2]	**404.8**	**475.6**	**444.8**	**475.0**	**482.5**	**500.0**	**511.0**	**508.0**	**512.0**	**511.4**
Change[3]	*8.1*	*17.5*	*13.4*	*19.6*	*18.6*	*18.1*	*14.9*	*9.6*	*8.0*	*7.5*
M_3[2]	**503.0**	**545.3**	**530.1**	**545.2**	**547.4**	**558.6**	**568.6**	**566.2**	**569.1**	**568.2**
Change[3]	*3.8*	*8.4*	*6.8*	*9.1*	*8.9*	*8.9*	*7.3*	*5.4*	*4.1*	*4.3*

1 1995 definition
2 Level in CHF billions
3 Year-on-year change in percent
Source: SNB

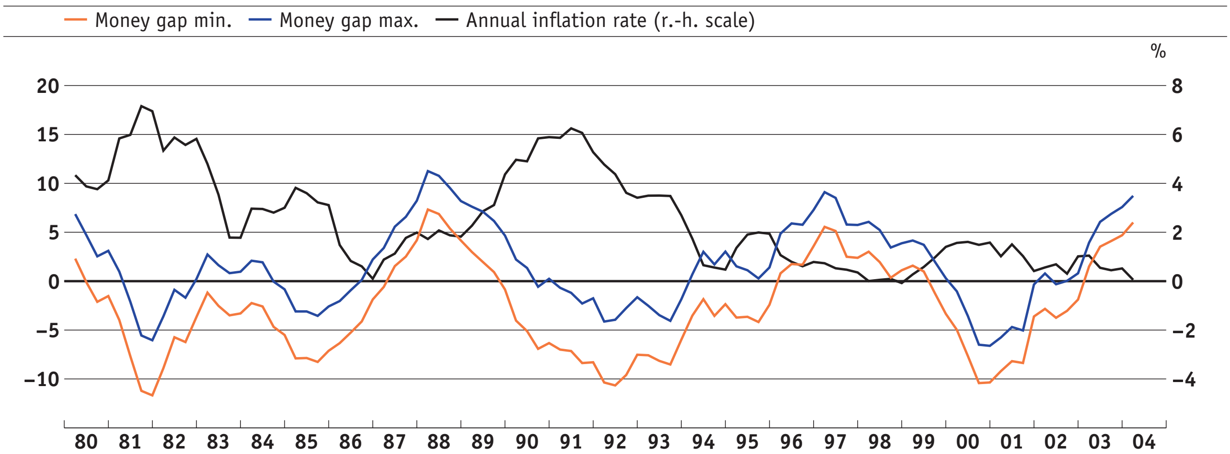
The money stock actually at the disposal of the economy can, however, deviate from the equilibrium money stock determined by nominal GDP and long-term interest rates. Such deviations are known as money gaps. Should the actual money stock exceed the equilibrium money stock, this is called a positive money gap, and the converse a negative money gap. Graph 3.17 shows the annual inflation rates as well as two estimates of the money gap since 1980. These are expressed in percent of the monetary aggregate M_3 expanded by the domestic fiduciary balances. Fiduciary credit balances are taken into account because they are near substitutes for time deposits.

As graph 3.17 clearly shows, money gaps cause inflation rates to fall and money overhang leads to a rise. There are, however, exceptions to this rule. Thus, for example, the money overhang in the second half of the 1990s only led to an insignificant price rise because the real appreciation of the Swiss franc at this time had an inflationary effect both directly and also by weakening economic activity. In the immediate past, the money overhang has continued to expand at a slower rate even though the growth rates of the monetary aggregates have weakened considerably since the start of the year. The overhang of the expanded monetary aggregate M_3 is estimated to have amounted to 6%–8.8% in the first quarter. Should monetary policy remain unchanged, this points to an inflation potential in the longer term (cf. chapter 4.2).

Graph 3.16
Money-to-GDP ratio



Graph 3.17
Money gap & annual inflation rate



Graphs 3.16, 3.17:
Source: SNB

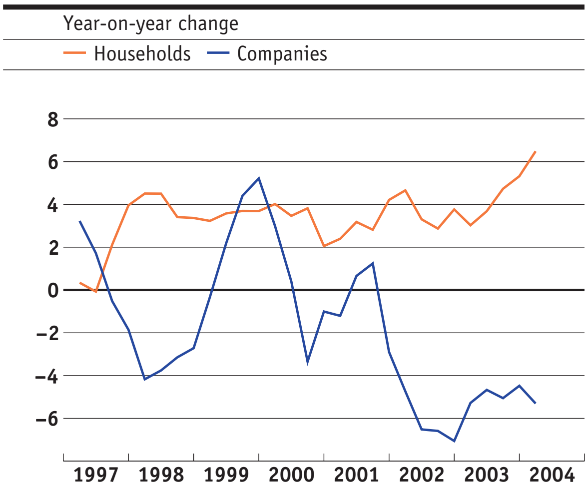
3.5 Credit aggregates

Higher growth of loans to private households

At the end of May, bank loans exceeded the previous year's level by 3.3%. Swiss franc loans increased by 2.0%.

Credit growth is the result of two conflicting trends. Loans to households, which account for approximately two-thirds of total bank loans, increased steadily in recent years too. By contrast, corporate loans, which are more strongly affected by economic activity, were down considerably. This divergent trend has been observable since 2000. In the last few quarters corporate loans have contracted only negligibly, but there has not yet been any stabilisation – much less a renewed rise.

Graph 3.18
Bank loans



Source: SNB

A similar difference to that between loans to households and corporate loans is evident in the breakdown of loans by type of credit. While mortgage loans, which account for around four-fifths of total bank loans, are rising steadily, the other categories have fallen considerably. This is partly due to the fact that mortgage loan borrowers are mainly households, while other types of lending are primarily accounted for by enterprises. Households, however, show an increase not only for mortgage loans, but also for the other loan categories. Conversely, not only the other loans, but also mortgage loans to enterprises declined from the previous quarter.

At the end of May, the banks' mortgage loans exceeded the year-earlier level by a total of 5.4%. During the same period, other lending declined by 4.1%. If the other loans are divided into secured and unsecured loans, this again confirms the fact that cyclically sensitive credit areas have so far hardly benefited from the recovery. While secured loans increased by 3% year-on-year, unsecured loans – which as a rule are more sensitive to economic conditions than secured loans – have not yet undergone any change in trend. In the last quarters, too, they declined from the previous quarter's level and were down year-on-year by 8.6% at the end of May.

Bank loans[1]
Year-on-year change in percent

Table 3.2

	2002	2003	2003				2004			
			Q1	Q2	Q3	Q4	Q1	March	April	May
Total	**0.5**	**2.1**	**1.6**	**1.7**	**2.3**	**2.9**	**3.2**	**3.5**	**3.5**	**3.3**
Mortgage claims	3.9	5.6	5.7	5.4	5.6	5.5	5.4	5.5	5.5	5.4
Other loans	–9.3	–8.7	–10.6	–9.7	–8.3	–6.1	–4.6	–3.8	–3.6	–4.1
of which secured	–3.2	–10.7	–13.4	–14.9	–9.4	–4.3	–1.6	0.6	–0.1	3.0
of which unsecured	–12.9	–7.4	–8.7	–6.1	–7.6	–7.3	–6.5	–6.6	–5.9	–8.6

1 Bank balances, level of data collection: parent company, all currencies, Switzerland; yearly and quarterly values expressed as averages of month-end values
Source: SNB

4 Inflation forecast

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 (see "Box: Inflation forecasting as part of the monetary policy concept").

4.1 Assumptions for global economic development

The SNB's inflation forecast is embedded in a worldwide economic scenario which, according to the SNB, represents the most likely development. Table 4.1 summarises the main assumptions for the current inflation forecast and the one published in the previous quarter. The values indicated, which cover a forecasting horizon of three years, are annual averages for real GDP growth in the US and the EU countries, the oil price and the dollar/euro exchange rate.

For the US, robust growth is assumed, and for Europe a moderate economic recovery. The anticipated period-on-period growth rates in the US very minimally exceed 4% for 2004 and fall slightly short of 4% for 2005. After that, growth is set to fall to the potential of 3% until the beginning of 2006. Because strong growth in potential output is also assumed, the production gap will only close slowly.

In Europe, period-on-period growth is expected to increase to just under 2.5% in the course of 2004. In the medium term, growth just slightly exceeding the potential of 2.1% is anticipated, and the output gap will narrow very gradually.

The oil price trended higher than expected at the beginning of 2004. Demand-dependent factors, a more critical assessment of the geopolitical situation and speculative reasons have contributed to this. The SNB assumes that the oil price will gradually fall. The dollar stabilised against the euro in the first quarter. The entire forecasting horizon is based on an unchanged exchange rate conforming to its current rounded level. For the current forecast, this means a dollar/euro exchange rate of 1.20 as of the second quarter of 2004.

Global assumptions Table 4.1

	2004	2005	2006
Inflation forecast of June 2004			
GDP USA[1]	4.6	4.0	3.6
GDP EU-15[1]	2.0	2.3	2.3
Exchange rate USD/EUR[2]	1.21	1.20	1.20
Oil price in USD/barrel[2]	33.7	30.2	27.2
Inflation forecast of March 2004			
GDP USA[1]	4.7	4.0	3.6
GDP EU-15[1]	2.1	2.4	2.3
Exchange rate USD/EUR[2]	1.25	1.25	1.25
Oil price in USD/barrel[2]	28.1	26.1	26.4

1 Change in %
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 development.

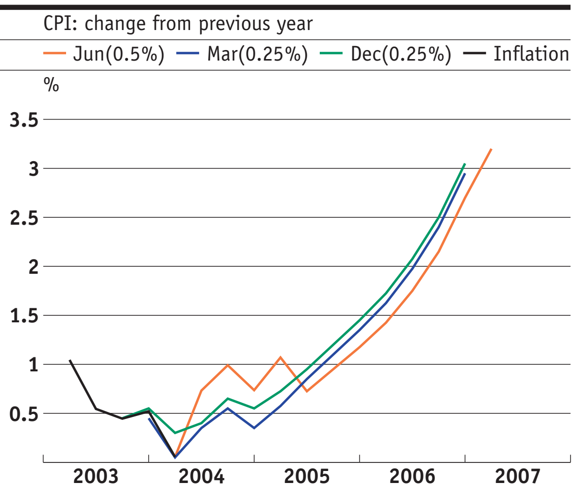
The SNB has laid down the details of the exercise of this mandate in a three-part monetary policy concept. First, the SNB regards prices as stable when the national consumer price index (CPI) rises by less than 2% per annum. It thus takes account of the fact that the CPI slightly overstates actual inflation. 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 2nd quarter 2004 to 1st quarter 2007

The inflation forecast ensues from the analysis of the indicators and from model simulations. The results are summarised in graph 4.1. The graph shows the new forecast (June 2004), which rests on the assumption of the three-month Libor remaining constant at 0.5% over the entire three-year forecasting period. This level of the three-month Libor corresponds to the mid-point of the 0%–1% target range valid since 17 June. The same graph also shows the last two inflation forecasts (December 2003 and March 2004). Unlike the new forecast, these forecasts were based on the assumption of a constant three-month Libor of 0.25%, which corresponds to the level aimed at by the National Bank as long as the target range was 0%–0.75%.

As can be seen from the graph, predicted annual inflation will be around 1% in the coming months, aside from temporary fluctuations triggered by statistical effects. On an annual average, it will amount to 0.6% in 2004. Despite a rise in the interest rate by 25 basis points, the new forecast slightly exceeds the level of the two former forecasts until mid-2005. This is due mainly to a rise in the oil price. An inflation-dampening effect will, however, tend to emanate from the other imported consumer goods. Inflation in the goods sector should remain low against the backdrop of continuously under-utilised production capacities. By contrast, price pressure in the service sector must be expected to increase slightly.

Graph 4.1
SNB inflation forecasts: a comparison



From 2005 onwards, the inflation forecast indicates a rise. The average rate for 2005 is put at 1.0%. Economic activity is of decisive importance for the inflation rate predicted for this period of time. The economic prospects have progressively improved, so that in the next few quarters a further reduction in the output gap may be expected in Switzerland. At the end of 2005, the output gap should be closed. This provides additional leeway for enterprises to raise their prices, while it will become easier for employees to push through real wage increases.

In the second half of 2006, forecast inflation will exceed the upper limit for price stability (2%). Over the year, it will average 2.0%. In the first quarter of 2007, i.e. at the end of the forecasting period, it will stand at 3.2%. This development, predicted for the later phase of the forecasting period, depends decisively on monetary factors. While long-term forecasts are fraught with major uncertainty, experience shows that ample liquidity poses a risk for price stability. Since last year, cash stocks in the Swiss economy have increased considerably. This provides scope – in the course of the economic recovery – not only for additional transactions, but also for price increases. With the interest rate adjustment of June 2004, however, the SNB is helping to ensure that excess liquidity is gradually siphoned off. The inflation forecast reflects this by putting inflation from the second quarter of 2005 onwards 20–30 basis points lower than in the two earlier forecasts.

Similar to the two earlier forecasts, the June prognosis also shows that the SNB cannot maintain price stability in the long term if the three-month Libor rate is kept at the current level. This suggests that the short-term interest rate will probably have to be increased further in the next three years.

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 June 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. In the following, the main results of the talks held from March to May 2004 on the current and future economic situation are summarised.

Summary

There was a further improvement in corporate sentiment and in the general business situation from March to May. The economic recovery became more broad-based and gradually spread to companies that focus on the domestic market. Exports, however, continued to be the main driving force. In the service sector, the turnaround in tourism – and, to a lesser extent, in the company-related services segment – was confirmed. The retail trade benefited from the gradual improvement in the consumer climate, which resulted above all in rising sales of consumer durables. The construction companies were satisfied with the level of residential construction but have not yet seen any rebound in commercial construction.

A number of indicators point to a gradual rise in investor confidence. The earnings situation has improved and some companies have now reached their capacity limits. In addition, some companies have already increased their workforce or are considering doing so. Many industries were affected by the surge in raw material prices but for the most part were unable to pass on the higher costs.

The companies surveyed were still guardedly optimistic in their outlook for the economy; for the current year, most of them are expecting stable or rising turnover. Scepticism about the sustainability of the economic pickup, which was still widespread at the beginning of the year, has waned.

1 Production

Manufacturing

Most export-oriented industries have recorded a further pickup in business activity since the talks held in February. A number of companies are now working to capacity and have a solid orders backlog. Demand from Asia remained brisk while incoming orders from the US were rather disappointing for many companies. After the dollar had regained some ground, complaints about the low dollar exchange rate declined. Increasingly, the companies reported higher demand from the EU, particularly from southern Europe; in some areas, demand from Germany has also revived somewhat recently.

In addition to the relatively non-cyclical chemicals/pharmaceuticals industry, the representatives from the specialty chemicals and plastics industries now also reported a pickup in business. The medical technology segment has continued to develop favourably, though this industry is beginning to be affected by cost-cutting pressures in the health care sector.

The metal manufacturing industry is on the road to recovery. It has benefited from the vibrant demand for concrete-reinforcing and quality steel from Switzerland and abroad (China). Business activity in the electronics segment has also trended stronger. The mechanical and electrical engineering industries, by contrast, are recovering at a somewhat slower pace. However, suppliers for the automotive industry in particular saw a surge in incoming orders. Manufacturers of textile machinery, which are heavily geared to the Asian market, were still very positive in their assessment. In general, the mechanical engineering industry faces fierce competition from increasingly high-quality imports and has to contend with extremely price-conscious customers. The watch-making industry was also satisfied with the business situation, as it was able to increase its first-quarter exports significantly; this also benefited the suppliers. Stocks of finished products and components in the watchmaking industry have now been reduced to a normal level.

Services

In the retail trade, signs of a rebound multiplied in April and May, but consumers remained price-conscious and selective. The big trade fairs in Basel and Geneva yielded much better results than expected. In general, demand for consumer durables and luxury items seems to be reviving gradually. On the back of the weaker CHF/EUR exchange rate, shopping in the regions bordering Switzerland has become somewhat less attractive.

The situation in tourism is brightening slowly. While the number of visitors from Asia and the US has risen, demand from the EU has remained slack as yet. Overall, the catering trade's summer-season predictions were guardedly optimistic. The pickup in tourism has also benefited the airlines, which reported rising passenger numbers.

The business situation of trading and consulting companies in the IT and computer segment has started to brighten. This industry is expecting demand to pick up significantly as a large amount of pent-up demand has accumulated since the pre-Millennium investment boom. Likewise, the fields of company and project financing have seen gradual signs of a recovery. By contrast, the advertising industry has not yet turned the corner.

The level of business reported by the banks ranges from good to excellent; at the same time, though, they have encountered fiercer competition. The banks have benefited in particular from the vibrant demand for mortgages and from the recovery on the financial markets. Demand for corporate loans, however, hardly strengthened. Banks in Ticino in particular have felt the strong pressure on commissions and have been confronted with increasingly price-sensitive customers from abroad.

Construction

The construction industry has felt the revival in residential construction, which had already been signalled by the rising number of building permits last year. Commercial construction still failed to provide any stimuli. A number of public construction projects have been approved, but their implementation has in many cases been delayed by pressure to cut public spending. Construction activity is still strongest in the agglomerations; moreover, the harsh price competition has continued unabated. Owing to the large amount of renovation work in progress, construction-related industries have enjoyed a healthy level of business.

2 Labour market

With business activity more lively, some companies have hired new staff, albeit partly on a temporary basis. While a number of the companies surveyed considered increasing their workforce, a recruitment wave is not yet imminent.

3 Prices, margins and earnings situation

The earnings situation of many companies has improved. In general, however, companies were still not reporting much scope for price increases. Many of them mentioned the surge in energy and raw materials prices (oil, steel, cellulose and raw cotton). Only few companies were able to pass on the higher costs. An exception was the metals industry, which – given the brisk demand – had no problem pushing through higher steel prices.

The favourable CHF/EUR exchange rate has had a positive effect on the export sector and lowered the pressure from imports. Many companies were nevertheless exposed to relentlessly strong price competition, which they tried to counter by increasing volumes and productivity. Shifting production to Eastern Europe or Asia was mentioned repeatedly.

Annual General Meeting 2004
Opening Speech by the President of the Bank Council

Hansueli Raggenbass

Berne, 30 April 2004

The new National Bank Act will enter into force tomorrow. At this year's Annual General Meeting, I would like to briefly inform you of its implications for you as shareholders. Moreover, I will present some reflections on corporate governance, which is becoming increasingly important also for the National Bank. I shall conclude with a few remarks on the 2003 annual financial statements.

New National Bank Act enters into force

The new Act will provide the Swiss National Bank with a modern statutory basis. The Bank's legal form, which is that of a joint-stock company governed by special provisions of law, will not change. This underpins the Bank's constitutional independence. It is therefore also you, as shareholders of the National Bank, who guarantee the independence of Switzerland's central bank. For this, you deserve thanks and recognition! But let us see now how the revised Act concretely affects the shareholders.

Implications for the shareholders

The last comprehensive revision of the National Bank Act dates back more than 50 years. The National Bank Act has a similar function for the National Bank as by-laws for a private stock company. The Act therefore contains not only innovations in the key area of monetary policy – defining the central bank mandate, specifying independence and accountability, extending the scope of action for monetary policy – but also adjustments to the legal reality in relation to private listed stock companies. In particular, this includes abandoning the non-paid-up part of the share capital. The share capital of the SNB currently amounts to CHF 50 million, but only half has ever been paid up. In the Bank's early days, the share capital was still in an adequate relation to the scope of business. Given the SNB's much higher balance sheet total and its level of provisions today, however, the share capital is no longer significant as a risk-bearing element. The share capital will therefore be lowered to the paid-up amount of CHF 25 million. The nominal value of one SNB share will consequently be reduced from CHF 500 to CHF 250 and will be paid up completely. The share's net value will not be affected. Registration with voting rights is still limited to 100 shares per private shareholder. In future, foreign private individuals or legal entities can also acquire SNB shares including all rights. We have informed you of these changes in the shareholders' letter. We have also notified you that we will no longer print and deliver the share certificates. The Act allows for this possibility, enabling us to simplify the administrative procedure considerably.

Corporate governance to be strengthened

The revised National Bank Act will also strengthen corporate governance. You will ask – and justifiably so – what exactly this is supposed to mean in the case of the National Bank. Corporate governance, i. e. the relationship between the management of a company and supervision, has become increasingly important in recent years. In Switzerland, however, it was only in the mid-1990s that the topic became the focus of public attention. Nevertheless, when company law was revised a decade ago, it already incorporated some aspects of corporate governance, such as a clear definition of the board's tasks or the formation of board committees for specific tasks. Two years ago, the guidelines of the Swiss Stock Exchange SWX and the Swiss Code of Best Practice published by economiesuisse, the Swiss Business Federation, established the principles of corporate governance even more firmly. The new National Bank Act takes account of these developments. Let me give you some examples to illustrate the consequences for the organisation of the National Bank.

Reduction of statutory bodies

The revised National Bank Act provides for a comprehensive reform of the statutory bodies of the Swiss National Bank. For one thing, the number of statutory bodies will be lowered from currently seven to four: the Annual General Meeting, the Bank Council, the Governing Board and the Audit Board. For another, the Bank Council, which is responsible for administrative supervision, will be reduced in number from 40 to eleven members. Its tasks are designed to strengthen the supervisory, organisational and financial responsibilities. This increases the significance of its decision-making, which is why opinion-forming discussions in this body play a more important role. Economic expertise, a deep insight into the financial markets in Switzerland and abroad coupled with broad experience in business management will be even more essential in the new Bank Council than in the past. In particular, the new Bank Council will be responsible for the following tasks: laying down the internal organisation of the Bank, approving the level of provisions, overseeing the investment of assets and risk management, approving the annual report and the annual accounts for submission to the Federal Council and the Shareholders' Meeting, drawing up the proposals for the election of the members of the Governing Board and their deputies to the Federal Council, and laying down the remuneration of its members and the salaries of the members of the Governing Board and their deputies. For the purposes of corporate governance, the Bank Council will additionally set up three standing committees of its own members: an auditing committee as a link between the external Audit Board and Internal Auditors, a risk committee for supervising the investment of assets and risk management, and a remuneration committee for controlling remuneration and salaries. Today's Annual General Meeting of Shareholders will have to elect five members to the future Bank Council. Under the new Act your vote will carry even greater significance.

Reorganisation of the organisational structure

The National Bank not only adjusted its statutory bodies to the new reality and requirements, but also assessed the organisational structure, which is no longer laid down in detail in the Act. The tasks were, with some changes, reallocated to the three Departments. The potential for synergies was used and functions that had become operationally incompatible were separated. Asset management, banking operations and banking services for the Confederation were concentrated in Department III in Zurich. The cash distribution services of the head offices and the branch offices were allocated to Department II in Berne, and Controlling was separated from Central Accounting. The hierarchical structures were flattened. The reorganisation will be concluded in the course of this year.

Introduction of an integrated planning and budgeting procedure

The National Bank has also fundamentally revised its planning and budgeting procedure. Strategic and operational planning was linked, i.e. a comprehensive planning procedure will be introduced in 2004. The entire planning procedure will be coordinated by one person in future. Thereby, management information can be processed for specific purposes and the business management of the National Bank will be improved at all levels.

Recognition

As you can see, the National Bank is already well prepared for the entry into force of the revised National Bank Act. Implementing all changes will still require some more time and effort, though. Yet I am happy to say that we are on the right track!

Please allow me now to make a few remarks on the 2003 annual financial statements.

Gross income in the 2003 financial statements

The result of the 2003 annual financial statements is gratifying. Gross income amounted to CHF 4.3 billion last year, thus clearly surpassing the year-earlier figure of CHF 2.6 billion. The rise can be attributed to higher gains on gold and foreign currency investments. Gains on gold alone reached the level of the year-earlier gross income. This rise is primarily due to the 8.5% increase in the price of gold, which alone resulted in valuation gains of just over CHF 2 billion. Approximately half the balance sheet total is invested in foreign currency, mostly in euros and US dollars. The gain or loss on these investments strongly depends on the fluctuations in interest rates and in exchange rates. In 2003, a gain of CHF 1.6 billion resulted. On most markets on which the National Bank invests, the interest rate level moved up last year. The resulting capital losses lowered the current interest income. With exchange rate influences not taken into consideration yet, the investment result was nevertheless positive across all currencies. The exchange rates exhibited mixed development. While the US dollar depreciated by nearly 11% year-on-year against the Swiss franc, the euro firmed by over 7%. On balance, the gain and loss from these opposite developments almost offset each other. The gain on financial assets denominated in Swiss francs came to a mere CHF 0.2 billion. The relatively modest result can be attributed to two factors: on the one hand, the National Bank kept repo rates at a very low level throughout the year, which reduced the income from repo transactions significantly. On the other hand, the interest rate level on the Swiss capital market moved up in the course of the year, resulting in capital losses on the CHF bond portfolio.

Decline in ordinary expenses

Ordinary expenses declined by approximately CHF 40 million to less than CHF 300 million. The expense items decreased thanks to the significantly lower interest expenses. The increase in the average banknote circulation and higher acquisition costs boosted banknote expenses to CHF 45 million – an increase that the National Bank cannot influence directly. Personnel expenses grew by 11% to around CHF 100 million. This rise can be attributed to the following two influencing factors in particular: the higher year-on-year staff number is primarily due to the filling of positions that had remained vacant in previous years and to the assumption of new tasks by some organisational units. Moreover, the beforementioned restructuring caused jobs to be shifted from Berne to Zurich, and this was associated with one-off reorganisation costs.

Free assets

Since May 2000, the National Bank has continuously been selling gold from the 1,300 tonnes no longer required for monetary policy purposes. In 2003, 283 tonnes of gold were sold at an average price of about CHF 16,000 per kilogram. Of the initial total of 1,300 tonnes of gold, approximately 950 tonnes were thus sold by the end of last year. The proceeds from the gold sales are invested in various financial assets. While managed separately, these investments are not shown separately in the National Bank's balance sheet. Under an Agreement concluded between the SNB and the Federal Department of Finance last year, the National Bank will continue to distribute the earnings from the invested income from the gold sales until different legislation on the use of free assets has come into force. Accordingly, an amount of CHF 300 million is distributed this year.

Profit distribution

Finally, I would like to raise a topic that, with a view to the long term, causes the National Bank a certain amount of concern. This can be illustrated by means of a simple calculation: after the deduction of ordinary expenses from the 2003 gross income, an aggregate income of just under CHF 4.1 billion remained. Of this considerable amount, the allocation to the provision for the assignment of free assets must be deducted. This provision had to be increased by CHF 0.9 billion, which lowers the income to CHF 3.2 billion. Of this amount, another CHF 0.9 billion must be subtracted to achieve the targeted level of provisions for market, credit and liquidity risks. This lowers the income to CHF 2.3 billion – still an impressive amount. However, the profit distribution agreement concluded with the Federal Department of Finance in 2002, together with the supplementary agreement of 2003 relating to the distribution of the income on the free assets, provide for a distribution of CHF 2.8 billion in total. In other words, the National Bank will distribute more money for the 2003 financial year than it can actually afford. However, this is in line with our intention of reducing excess provisions that have accumulated over the years. The shortfall of half a billion Swiss francs will be taken from the residual surplus for future distributions. The surplus remaining for future distributions thus comes to CHF 10.3 billion. This calculation shows one thing: profit distributions of this magnitude are possible only because the National Bank reduces excess provisions, but they cannot be sustained in the longer term. Thanks to the gratifying result of the annual financial statements, the surplus was reduced only moderately this year, but if the coming years yield worse results, the surplus might be reduced at an accelerated pace. The public sector therefore must not get used to distributions of this size or even count on additional money from the National Bank when budgeting its expenses.

Concluding remarks

To conclude, I wish to express my sincere thanks to the Governing Board and the staff of the National Bank for their competent and dedicated service to the Bank, especially in view of the many special efforts required last year.

Speech given at the Annual General Meeting of Shareholders of the Swiss National Bank

Jean-Pierre Roth, Chairman of the Governing Board

Berne, 30 April 2004

2003: a year of renewal

As I told you a year ago, 2002 was a year of disappointments. But today I am glad to report that in 2003 the outlook brightened steadily.

2003 got off to an inauspicious start, however. The prospect of war in Iraq gave rise to uncertainty and apprehension, gravely undermining confidence among both households and companies. Then investors' confidence was shaken by a number of financial scandals, triggering a sharp fall in the stock markets in the third quarter. Even the rapid military outcome to the conflict in Iraq did not resolve the situation. In addition to this, the threat of a SARS epidemic exacerbated the problems already being experienced by greatly weakened sectors such as transport and tourism.

Only in the summer did a measure of calm start to return as the international business cycle gradually picked up. Not only did economic growth in the United States steadily gain momentum, but the Japanese economy experienced an almost unhoped-for rebound while the emerging economies of Asia – led by China – cast off their SARS fears and resumed their dynamic growth. This contributed in no small part to the upswing in the world economy. Closer to home, the European economies slowly emerged from their lethargic state. Switzerland's neighbours saw an upswing in industrial output and exports, although domestic demand in these countries remained – and still remains – sluggish.

In Switzerland, too, the long-awaited but oft-delayed upswing finally began to make itself felt. The first signs of the upturn became apparent in the summer. These were initially in isolated areas but then became increasingly widespread. The confidence indicators began rising, and order books swelled. The turnaround was facilitated by a marked weakening of the Swiss franc, which was itself triggered by a renewed easing of our monetary policy in March. This downward correction in the franc, which continued for the rest of the year, came as a welcome respite for Switzerland's export industry, which had been buffeted by the weak global economy and the fall-off in international trade.

The Swiss franc's slide against the European currency was gradual, extending over almost a year. Our currency's exchange rate dropped from CHF 1.46 against the euro in March 2003 to CHF 1.55 today, thus depreciating by about 6%. The franc's fall is even greater in real terms owing to the higher inflation rate which prevailed – and still prevails – in the euro zone. Also in real terms, the Swiss franc is worth less in euros than when the single currency was launched five years ago. This development shows that, as the new European currency has gained in stature, the markets have taken a different view of the safe-haven role traditionally played by the franc. It is probably also to the euro's existence that we owe the Swiss franc's reduced volatility and its rather controlled weakening, whereas the dollar experienced difficulties. This is a reaction to which we were not accustomed; moreover, it is good news for our economy. While it may be justified by the United States' huge external deficit, the slide of the greenback has nevertheless exerted an asymmetrical impact: it has hit European exporters hard, but has not affected Asian currencies that have been kept artificially low by massive intervention. The Swiss franc's fall against the single currency has sheltered us somewhat from these upheavals.

Guarded optimism for 2004

Our economic forecasts for the current year are marked by cautious optimism. The recovery that began in the third quarter of 2003 is set to continue. The production gap, which measures the difference between actual production and its potential level, is expected first to stabilise and then to gradually narrow. However, this will take time.

As usual, the first signs of an economic recovery appeared in the industries geared to exports. Next, capital goods investment began to pick up, driven by the high rate of depreciation in new technologies; there is therefore significant pent-up demand. To a large extent, these investments feed on imports, so that the immediate impact on our economy is limited. Moreover, as investment is also gaining steam among our neighbours, our own capital goods industry, with its strong export bias, has improved.

While consumer spending has held up well in the past two years, it is expected to gain momentum as the economic environment brightens. Consumption will thus continue to support growth, though it will probably cede pride of place to more cyclical components such as capital expenditure and exports. It will benefit, in particular, from the gradual improvement that will be seen on the labour market. At this stage of the economic cycle, of course, we must first expect gains in productivity, which means that unemployment will only decline slowly. Nevertheless, here too, the medium-term outlook is now good.

The scenario for a recovery that I have presented is, needless to say, full of imponderables. The risks are everywhere. They may take the shape of an uptrend or a downtrend. We can thus not rule out the possibility that the international economy will show more robust growth than anticipated. A swift build-up of inventories, for example, would appreciably accelerate the cycle. But the downside risks could also be triggered at any time by new political disorders. Given the significant internal and external imbalances throughout the world, such unrest could fuel greater volatility on the currency and equity markets. The strength of the recovery is also uncertain. In the United States, the economic recovery, which has been driven largely by tax breaks, is not yet firmly in place; households, labouring under a heavy debt burden, may be frightened by the slow pace of job growth. Should confidence be lost, a renewed fall in the dollar or a correction in the prices of financial assets would deliver another blow to the global economy. The situation in some emerging economies is likewise precarious. Lastly, we must bear in mind the difficulties currently being encountered by some of our neighbours, difficulties that could weaken or even delay the start of the upswing on our continent.

Monetary policy

In the unstable environment we are still experiencing, our monetary policy must remain expansionary. We know that our interest rates, currently at an historically very low level, will have to be increased if we wish to maintain price stability once the economic situation has been confirmed. The inflation outlook we published last March shows this clearly. However, we believe that it is not yet the moment to return to normalisation:

- Admittedly, the Swiss economy is now on a path of modest growth, but it has considerable idle resources and competition on the international markets is fierce. In the present circumstances, therefore, there is little risk of overheating.
- Growth in money supply is strong, but the preference for liquidity is unusually high against the current background of uncertainty and lending is showing only moderate expansion. Moreover, monetary aggregates have been somewhat inflated by the repatriation of funds which have until now been placed on the Swiss franc Euromarket.
- Lastly, even if some regions of the country are experiencing a scarcity of housing, there is no evidence of a real estate bubble developing such as we saw at the end of the 1980s.

The inflation outlook thus remains positive. We are projecting an inflation rate of about 0.5% this year and 1% next year. It is unlikely that, in the months ahead, we will again see inflation rates below zero, as we did last March. Negative inflation would require a steep fall in the price of oil. The debate over deflation, which was so topical barely a year ago, is by and large no longer one of our concerns and has disappeared from the discussions among central bankers. Our interest rate cut in March 2003 was intended to protect us against such a development. The goal has been achieved.

The need for reforms

Events in recent years have shown once again that there is no way we can make ourselves impervious to disturbances emanating from the world's markets. Such disturbances will inevitably impact on the development of our economy. This does not mean, however, that we are completely at their mercy: for a small country such as Switzerland, the best defence against external shocks is an efficient and flexible economy, capable of standing up to competition and adapting swiftly to changes in the international environment.

However, we must also ensure that the problems caused by our internal structures, which are sometimes not ideally suited to current challenges, do not gain the upper hand. Our economy must be able to benefit from favourable domestic conditions that will allow it to develop and flourish. We have all witnessed its disappointing performance throughout the 1990s. This situation can only be corrected by the resolute implementation of structural reforms aimed at improving its long-term potential for growth.

The issue is all the more pressing as we are witnessing the gradual ageing of the Swiss population. The problems caused by this trend have been identified by and large, and the measures needed have been repeatedly analysed. The goal is simple: everything must be done to increase our economy's trend rate of growth in order to ensure better financing of its future needs. The solutions are complex because there is no magic potion. On the contrary, there are any number of different steps we can take to enhance our productivity: they range from promoting competition to repealing unnecessary regulations. Moreover, they have to be backed up by stringent control of public spending and deficits in order to ensure the efficient use of our resources and – above all – to avoid passing on a negative financial legacy to future generations. The Federal Council has adopted a legislative programme that gives priority to economic growth and a restructuring of the federal finances. We hope that Parliament will debate this programme in a spirit of intergenerational solidarity, keeping in mind the long-term interests of our country. Measures to promote growth would certainly be instrumental in ensuring the smooth future functioning of our economy, but they would also allow us to develop a climate of confidence necessary for today's investment and consumption decisions. Their impact on the economy would thus not be negligible. As for monetary policy, its role in this area can only be to provide price stability, an essential factor for confidence and macroeconomic efficiency.

Dawn of a new era

Ladies and gentlemen, as the President of the Bank Council indicated earlier on, the National Bank is at an historic turning point today. As of tomorrow, our institution will be governed by new legislation. The new National Bank Act will enter into force in less than 24 hours. Our operational framework, our range of instruments, our organisation and our duty of notification will all be affected.

Likewise, our mandate will be – perhaps not modified – but at least made more explicit. Article 5 of the new Act stipulates that "The National Bank shall pursue a monetary policy serving the interests of the country as a whole. It shall ensure price stability. In so doing, it shall take due account of the development of the economy".

The objective of price stability is not new. In fact, the National Bank has always been guided by this goal in its activities. The desire to guarantee the purchasing power of our currency underpinned the link established in the past between the franc and gold, and it was this same concern that led Switzerland, in 1973, to abandon the fixed exchange rates of the post-war period, which were undermined by widespread lack of discipline. The objective of price stability is now inscribed in law, which reinforces its legitimacy. Our monetary system is thus now as clearly defined as it used to be under the gold standard.

We define price stability as an annual rate of inflation of less than 2%. We were able to maintain such stability in the course of the past year, and I am pleased to note that this objective has been reached in each of the past ten years – an unparalleled achievement internationally. It is a modest, but highly important, contribution to the prosperity of our country. Our history has shown that inflation – or deflation – can have damaging effects that often cause suffering to the most vulnerable members of our society.

One of Switzerland's traditional values is this concern for price stability. It is a significant achievement that the National Bank will endeavour to preserve in the years to come.

The new Act also stipulates that we must take due account of the development of the economy in setting any course of action. There can be no doubt that monetary policy has short-term repercussions on economic activity. A tighter monetary policy designed to combat a flare-up of inflation tends to cause business activity to slow down. Such a slowdown may be necessary, for instance to reduce the likelihood of overheating, but it has painful side effects on various sectors of the economy. In pursuing price stability, we must be careful not to lose sight of the costs, and must use tact and discretion. The obligation to take account of the economy is now inscribed in law, but in reality this is nothing new: we have always made the state of economic activity in Switzerland one of our prime concerns. Our massive interest rate cuts in recent years while the economy was in the doldrums is ample proof of this stance.

Having to take account of the economy also means that we cannot be dogmatic in our pursuit of price stability, which must be seen as a medium-term goal. As a small, open economy, we are constantly exposed to external shocks. As our inflation rate tends to be more volatile than that of large countries or economic zones, temporary movements beyond the bounds of price stability cannot be ruled out. Trying to keep too tight a lid on prices would have adverse effects on the economy and would be counterproductive. It is just as obvious, though, that monetary policy has its limits. While it can contribute to the development of the economy by providing a stable, transparent and efficient monetary framework, we must not expect that it will be able to increase its long-term potential, or that it will succeed in energising the economic machinery and forcing it to perform beyond its technical capacity.

The new legislation now requires us to give an account of the management of our mandate to Parliament and the Federal Council. This obligation towards Parliament is new. It is the logical counterweight of our independence, an independence which has been guaranteed by the federal Constitution since 2000. We are free to choose – within the limits of the law – the means necessary to carry out our mandate; on the other hand, though, the country is entitled to expect us to be able to justify our actions.

Lastly, the new Act grants us greater freedom in the choice of instruments to manage our monetary reserves. As you know, the National Bank has considerable monetary reserves. These reserves, which are a national asset, are essential for pursuing an independent monetary policy by reinforcing confidence in our currency. They are thus instrumental in ensuring its stability. It is crucial, however, that these reserves be managed effectively and with due regard to liquidity and security requirements.

Over the next few weeks, we will define to what extent we wish to take advantage of the investment possibilities offered by the new Act. We will present our plans on this matter at our press conference on June 17.

Conclusion

The Swiss economy has enjoyed a high degree of monetary stability for some years now, and this advantageous situation should last for a number of years to come. While the international environment in which we operate has improved, it remains unstable. We cannot rule out fresh setbacks. However, we can count on the significant adaptability of our companies and look to the future with confidence.

Nevertheless, our high standard of living in international terms should not lull us into complacency. In recent decades, we have seen our position among the leaders of the most highly developed countries eroded. Corrective measures are necessary. Let's be clear: the main threat to our prosperity does not come from abroad, where the "made in Switzerland" label is still a success when it is associated with quality. The threat comes from within Switzerland. Take, for instance, our excessive predilection for regulations – often an invisible barrier to the free play of competitive forces – and our hesitation to fully accept an international environment that is more competitive and innovative than it was 20 years ago. The guiding principle for our structural reforms should be: more competition and fewer regulations. We have to have the courage to take this path in order to durably enhance our economic growth. This is essential to the balanced development of our economy and to the confidence that each of us feels in the future.

It is with this wish that I conclude my remarks. Thank you for your attention and for the interest you show in the National Bank and its activities.

Swiss National Bank Working Papers and Swiss National Bank Economic Studies: Summaries

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What Does the Yield on Subordinated Bank Debt Measure?

Using the example of subordinated debt, the article illustrates that the pricing of an asset cannot be understood without an understanding of its design. Conventional wisdom sees the yield (more precisely: the yield spread, i. e. the differential to a risk-free rate of return) on subordinated bank debt as a direct measure of a bank's default risk. The rationale behind this view is that subordinated debt is bought by sophisticated investors with superior knowledge ("informed investor hypothesis"); the yield on subordinated debt should thus reflect the best information available.

The authors claim, however, that this is not true. They use a model in which subordinated debt is indeed designed for sophisticated investors. It is shown that the yield spread on such debt does not directly measure these investors' risk perception. By definition, subordinated debt only exists in conjunction with some more senior debt. Thus the yield spread on subordinated debt must not only compensate investors for expected losses; in addition it must give them an incentive not to prefer senior debt (technically speaking: for sophisticated investors the incentive constraint binds, not the participation constraint). The yield on subordinated debt thus includes an incentive premium, the size of which depends on risk perceptions of less informed investors, that drives a wedge between the yield spread and the default risk perception of sophisticated investors.

The authors present strong empirical evidence in favour of the "informed investor hypothesis" and of the existence of the incentive premium predicted by the model. Using data on the timing and pricing of public debt issues made by large US banking organisations during the 1985–2002 period, they find that banks issue relatively more subordinated debt in good times, i. e. when informed investors have good news. Spreads at issuance (corrected for sample selection bias) react to (superior) private information but also to measures of publicly perceived risk (like general bond market volatility or stock market excess returns), in line with the comparative statics of the postulated incentive premium. Interestingly, as the model predicts, the influence of sophisticated investors' information on the subordinated yield spread became weaker after the introduction of prompt corrective action and depositor preference reforms, while the influence of public risk perception became stronger.

Finally, the results also explain some hitherto unexplained anomalies from the empirical literature on subordinated debt pricing and from market interviews (e. g. limited sensitivity of spreads to bank-specific risk and the "ballooning" of spreads in bad times). This again confirms how important it is to account for security design and for the security's role in the issuers' liability structure to understand its pricing.

The authors conclude that a bank's subordinated debt yield spread, even though not a straightforward measure of a bank's default risk, conveys important information if interpreted together with its senior debt yield spread and with other banks' subordinated debt yield spreads. Moreover, the decision (or ability) to issue is a positive signal for bank safety. Finally, the excess return sophisticated holders of subordinated debt earn in expected terms should not be seen as an anomaly. In an equilibrium in the market for information, the incentive premium that enters the subordinated spread could be seen as a remuneration to become a sophisticated investor in the first place and thus as a potential agent of market discipline.

Chronicle of monetary events

Increase in the target range for the three-month Libor

On 17 June 2004, following its June quarterly assessment, the Swiss National Bank increased the target range for the three-month Libor with immediate effect by 0.25 percentage points to 0.0%–1.0%. It intends to keep the three-month Libor rate in the middle of the target range at around 0.5% for the time being. After this step, the interest target range again exhibits a spread of 100 basis points.

New National Bank Act enacted by the Federal Council

On 24 March 2004, the Federal Council enacted the totally revised National Bank Act (NBA; cf. Quarterly Bulletin 3/2003, p. 59) with effect from 1 May 2004 after the statutory period for a referendum had expired at the end of January 2004 and no referendum had been instituted. At the same time, the Federal Council amended the Ordinance to the Banking Act in line with the new NBA. On 18 March 2004, in a new Ordinance to the National Bank Act (National Bank Ordinance, NBO), the Governing Board of the National Bank had already issued implementation provisions on the SNB's authority to compile statistics, on the minimum reserve requirements and on the oversight of payment and securities settlement systems.

The new National Bank Act defines in more precise terms the constitutional central bank mandate and the SNB's independence; it now stipulates in formal terms the SNB's accountability to the Federal Council, Parliament and the public. Furthermore, the new NBA extends the SNB's scope of business, defines its monetary policy powers, stipulates in more detail the determination of profits and simplifies the structure of the statutory bodies.

In the chapter "Statistical surveys", the new National Bank Ordinance spells out the principles of data collection as well as the rights and obligations of the financial market participants who are required to submit data. The collection of statistical data must adhere to the principles of necessity and reasonableness. The coverage and frequency of statistical surveys as well as the parties required to report statistical data are described in the annexes to the NBO.

The "Minimum reserves" chapter of the NBO determines the prerequisites and extent of the banks' minimum reserve requirement. The purpose of minimum reserves is to secure a minimum level of demand for base money. The implementation provisions in the NBO closely follow the provisions on cash liquidity previously contained in the Banking Ordinance. In particular, the applicable cash liquidity ratio of 2.5% remains unchanged. To give the banks sufficient time to make the necessary adjustments to their information systems, the implementation provisions on minimum reserves and the (associated) amendments to the Banking Ordinance relating to liquidity will be put into force only as of 1 January 2005.

Finally, the chapter "Oversight of payment and securities settlement systems" of the NBO describes the minimum requirements for systemically important payment and securities settlement systems. These requirements are aligned to international standards. To enable the National Bank to identify systems that could jeopardise system stability, all securities settlement systems and payment systems with payments of at least CHF 25 billion per annum are subject to an extended disclosure obligation.

Guidelines on monetary policy instruments

In May 2004, the Swiss National Bank for the first time published guidelines on the use of its monetary policy instruments. The "Guidelines of the Swiss National Bank on Monetary Policy Instruments" are directed both at interested members of the general public and at the National Bank's counterparties. These Guidelines, together with the associated instruction sheets, are available in German, French and English and can be viewed on the National Bank's website (cf. www.snb.ch, The SNB, Legal basis).

The Guidelines set out in more concrete form the transactions described in art. 9, para. 1 of the National Bank Act that are at the National Bank's disposal for performing the monetary policy tasks assigned to it. In particular, they specify the terms on which the National Bank concludes transactions and the procedures that are to be observed in such cases. They also define the types of collateral that are admissible in monetary policy operations involving the National Bank.

In connection with the release of these Guidelines, some of the National Bank's money market operations are being redefined and new terminology is being introduced. For the first time, the Bank now explicitly states the conditions under which it is willing, under extraordinary circumstances, to supply liquidity in its capacity as lender of last resort.

The issuing of the new Guidelines on Monetary Policy Instruments also affects the publication of data relevant to monetary policy: instead of the "bank return" issued up to now, the National Bank henceforth publishes figures on the first working day of each week for those assets and liabilities in which monetary policy measures are reflected, plus the daily results of monetary policy transactions effected in the preceding week, along with reference interest rates.

Investment policy guidelines

The management of monetary reserves as a task of the Swiss National Bank is explicitly mentioned in the new NBA for the first time. The management of monetary reserves is subject to the primacy of monetary policy and implemented according to the criteria of security, liquidity and return.

In June 2004, the National Bank for the first time published guidelines on investment policy. The "Investment Policy Guidelines of the Swiss National Bank" apply to all managed assets of the National Bank. These Guidelines are available in German, French and English and can be viewed on the National Bank's website (www.snb.ch, The SNB, Legal basis).

The Guidelines define the scope of the National Bank's investment activity and render this scope transparent to the public. They set out in more concrete form the transactions described in art. 9, para. 1 of the National Bank Act that are at the National Bank's disposal for performing the investment policy tasks assigned to it. In particular, the Guidelines lay down the investment policy principles, the investment instruments and the investment and risk control process to be followed.

The National Bank already provides information on the investment structure of its assets in its Annual Report, including details on currency allocation, on allocations to the different investment categories, and on the major risk and return indicators. In future, these quantitative data will be made available also on a quarterly basis.

Federal Act on international monetary assistance

Federal Parliament passes Act

On 19 March 2004, the Council of States and the National Council accepted the Federal Act on international monetary assistance (cf. Quarterly Bulletin 2/2003, p. 119). A day earlier, on 18 March 2004, the Federal Parliament had adopted the Federal Decree on international monetary assistance. Deviating from the Federal Council's bill, the two chambers limited the CHF 2,500 million credit line (a facility included in the Federal Decree which serves to finance international monetary aid operations) to a five-year term, and obliged the Federal Council to report annually on the appropriation of funds. Unless a referendum is sought within the statutory three-month period, both the Act and the Decree on monetary assistance can be expected to enter into force in the early autumn of 2004.

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