Quarterly Bulletin

2 June 2005

SCHWEIZERISCHE NATIONALBANK
BANQUE NATIONALE SUISSE
BANCA NAZIONALE SVIZZERA
BANCA NAZIUNALA SVIZRA
SWISS NATIONAL BANK

Swiss National Bank
Quarterly Bulletin

June 2/2005 Volume 23

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Overview

Monetary Policy Report (p. 6)

The global economy remained on its moderate growth path in the first half of 2005. The robust growth of the US economy was one of the major contributing factors. Although the euro area and Japan managed to overcome the slump in the fourth quarter of 2004, growth was both unbalanced and fragile. The softening of global economic growth is largely attributable to the sharp rise in the price of oil.

In Switzerland, real GDP practically stagnated in the first quarter compared with the previous period. Exports, in particular, were disappointing; domestic demand, by contrast, advanced slightly following a decline in the previous quarter. The economic outlook brightened somewhat at the beginning of the second quarter. Exports and imports picked up and company surveys did not deteriorate further. This notwithstanding, unemployment figures persisted at a level of 3.8% right into May.

At its quarterly assessment of 16 June 2005, the Swiss National Bank decided to leave the target range for the three-month Libor unchanged at 0.25–1.25%. It intends to keep the rate in the middle of the target range at around 0.75% for the time being.

The economic situation from the vantage point of the delegates for regional economic relations (p. 40)

The talks held between March and May 2005 by the delegates for regional economic relations with roughly 140 representatives of various business sectors and industries revealed a favourable picture on the whole. As compared to the previous round of talks, the general impression was one of economic improvement rather than deterioration. However, there remained considerable differences from one industry to the next.

General Meeting of Shareholders (p. 44)

The President of the Bank Council of the Swiss National Bank, Hansueli Raggenbass, first informed the General Meeting of Shareholders on 29 April about the 2004 financial statement before commenting on the longer-term return expectations. The 2004 annual result of CHF 21.6 billion was unusually high as a result of the provisions that correspond to the proceeds from the sale of the 1,300 tonnes of gold having been written back and released for distribution. Gross income, by contrast, was substantially below the previous year's level. After taking into consideration the operating expenses and the release from the provisions for the assignment of free assets, and after the deduction of the capital required to reach the targeted level of provisions, the result was in fact a loss. In order to cover this loss and carry out the agreed distribution to the Confederation and cantons, a total of CHF 3.3 billion had to be released from the distribution reserve, which was consequently reduced to just under CHF 7 billion. This shows that the current profit distribution considerably exceeds the SNB's profit potential. Overall, the National Bank anticipates a nominal yield of slightly less than 3% on its assets in the longer term. After operating expenses and the legally prescribed allocation of provisions, an annual distributable income of just below CHF 1 billion is all that is likely to remain.

After looking back at the economic developments and monetary policy in 2004, the Chairman of the Governing Board, Jean-Pierre Roth, turned his attention once again to the topic of profit distribution, commenting also on the related Kosa initiative which envisages CHF 1 billion of the SNB's annual net profit going to the cantons and the rest being channelled into the Old Age and Survivors' Insurance Fund (AHV/AVS). This initiative, which will most probably be put to the vote next year, threatens the National Bank's independence, as it creates a direct link between the SNB's profits and the financing of an important pillar of the Swiss social security system. This could potentially force the SNB to manage its reserves with a view to generating as high a profit as possible rather than to pursuing its monetary policy mandate. The credibility of the National Bank and, as a result, that of monetary policy would consequently be called into question. Most importantly, however, is that the Kosa initiative assumes that the SNB can achieve a profit far in excess of CHF 1 billion every year. As the President of the Bank Council explained in his address, this is an illusion.

Swiss National Bank Working Papers (p. 56)

Abstract of the paper by Hasan Bakhshi, Hashmat Khan and Barbara Rudolf, "The Phillips curve under state-dependent pricing", Swiss National Bank Working Paper no. 1, 2005.

Monetary Policy Report

This report is based primarily on the data and information available as at mid-June 2005. Sections 1–3 were drawn up for the June 2005 quarterly assessment of the Swiss National Bank's Governing Board.

Contents

About this report

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

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

Sections 1–3 of the present report were drawn up for the Governing Board's assessment of June 2005. The Survey and Section 4 (inflation forecast) take due account of the Governing Board's monetary policy decision of 16 June 2005.

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

Survey

Following the marked acceleration in the last quarter of 2003 and the first quarter of 2004, the global economy remained on its moderate growth path in the first half of 2005. The robust growth of the US economy was one of the major contributing factors. Although the euro area and Japan managed to overcome the slump in the fourth quarter of 2004, growth was both unbalanced and fragile. With the exception of China, industrialised nations in Asia also saw the pace of expansion slow.

The outlook for global economic growth is cautiously optimistic. While the US economy is likely to continue to grow strongly, a gradual improvement is all that can be expected for Europe. The low real interest rates, in particular, serve to buoy up economic activity. In addition, considerable pent-up demand has accumulated in the areas of private consumption and investment. Developments in oil prices and the dollar exchange rate, however, remain major economic risks.

Expectations of a rapid end to the slow economic growth in Switzerland were dashed. After having fallen slightly in the fourth quarter of 2004, real GDP stagnated in the first quarter of 2005 compared with the previous period. Year-on-year, GDP growth slowed from 1.2% to 0.7%. Exports, in particular, were disappointing.

Nevertheless, signs of a slight improvement began to emerge towards the end of the first quarter, so that an end to the economic softness may be expected for the second quarter of 2005. Exports and imports picked up in March and April and companies expected orders to rise more strongly in the next three months. Moreover, talks with companies conducted by the SNB delegates for regional economic relations revealed a more positive assessment of economic developments, with expectations of an economic upturn rather than a slowdown on the horizon.

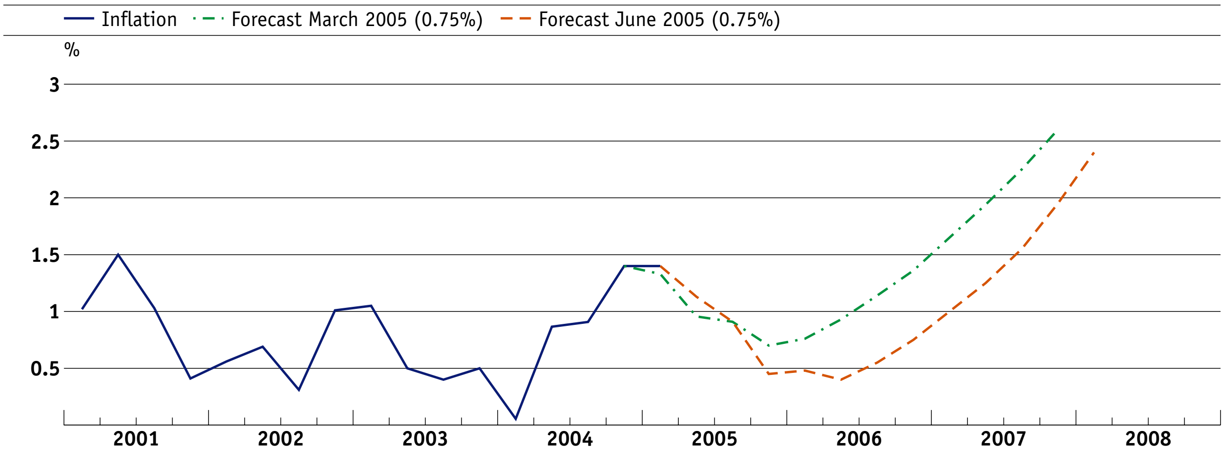
As a result of the weak first quarter, the SNB now forecasts real GDP growth of about 1.0% for the entire year, a downgrade of half a percentage point from the quarterly assessment in March 2005. However, the new forecast continues to work on the assumption that growth will pick up markedly in the second half of 2005. This will depend largely on economic activity in the euro area recovering as expected.

Inflation prospects have again improved slightly since the monetary policy assessment in March. In light of this, the National Bank decided on 16 June 2005 to leave the target range for the three-month Libor unchanged at 0.25–1.25% and to keep the rate in the middle of the target range at around 0.75% for the time being, thereby adhering to its current monetary policy course. It makes use of the leeway available to it to continue to underpin the economy. This should guarantee price stability in the longer term.

In its inflation forecast of June 2005, which is based on the assumption that the three-month Libor will remain steady at 0.75% over the following three years, the SNB predicts that inflation will be 1.0% in 2005 and 0.5% in 2006. Given the continued delay in economic recovery, the anticipated rate of inflation is likely to remain low in the medium term, too. Although inflation is expected to rise towards the end of 2006, it will remain lower than forecast in March. It will exceed the 2% level at the end of 2007, which would signify a breach of price stability. Should the economic outlook improve, a revision of the expansionary monetary policy pursued by the SNB for some time now will be necessary.

Inflation forecast of March 2005 with Libor at 0.75% and of June 2005 with Libor at 0.75%

Percentage change in national consumer price index from previous year



Inflation forecast of June 2005 with Libor at 0.75%	2005	2006	2007
Average annual inflation in percent	1.0	0.5	1.4

1 Development of the global economy

Following the marked acceleration in the last quarter of 2003 and the first quarter of 2004, the global economy remained on its moderate growth path in the first half of 2005. The robust growth of the US economy was one of the major contributing factors. Although the euro area and Japan managed to overcome the slump in the fourth quarter of 2004, growth was both unbalanced and fragile. With the exception of China, industrialised nations in Asia also saw the pace of expansion slow.

The softening of global economic growth that began in 2004 is largely attributable to the sharp rise in the price of oil. In Europe, the appreciation of the euro against the dollar also had a slowing effect. Both of these factors continue to pose considerable economic risks. Oil prices have remained decidedly volatile to date. Given the overly strong focus in the US on foreign trade, a renewed depreciation of the dollar remains a threat. The globally low real interest rates, by contrast, are buoying up economic activity.

US as engine of growth

First-quarter real GDP growth in the US slowed slightly to 3.5% compared with the second half of 2004. While investment activity waned considerably and the high oil prices slowed the strong growth in private consumption, exports picked up. The vigorous growth in exports was assisted by the pronounced slide of the dollar between 2002 and 2004.

Economic prospects for the US remain favourable. Sound corporate earnings continue to shore up investment activity and rising employment figures are expected to boost private consumption. Given the increase in short-term interest rates, however, economic momentum is unlikely to pick up further. This is underpinned, in particular, by the development of the purchasing managers' index (PMI) for the manufacturing sector, which retreated significantly from a high level in recent months.

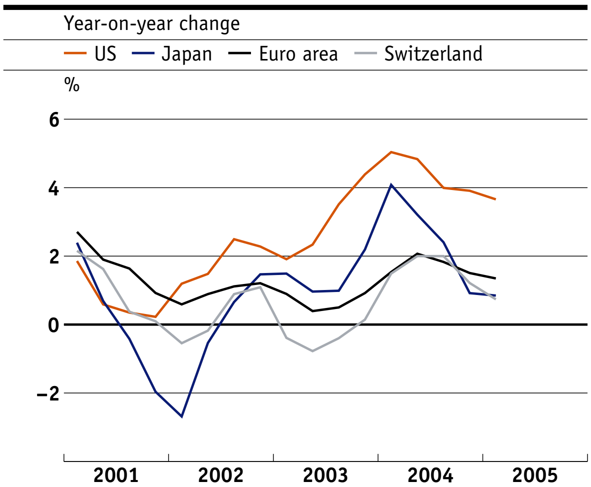
Muted economic outlook for euro area

The new year got off to a good start in the euro area. Real GDP grew in the first quarter by 2.0% on the previous period, compared with 0.6% in the fourth quarter of 2004. However, growth was driven primarily by a highly positive contribution from foreign trade, which resulted from declining imports.

Economic development in the three largest countries in the euro area presented a mixed picture. After a slight hiccup in the fourth quarter of 2004, expansion in Germany gathered pace thanks to vigorous growth in exports (4.2%). The French economy slowed, by contrast, and Italy reported a decline in real GDP for the second time running.

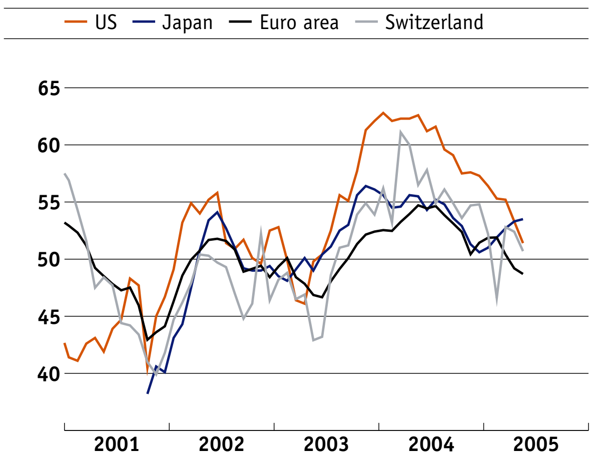
The economic surveys for the euro area tended to deteriorate again in recent months. Given that the level of new orders in industry has declined and manufacturers' expectations have dampened, low growth rates are also likely for the second quarter. The economic downturn in Germany, France and Italy was particularly pronounced.

Graph 1.1
Real GDP



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

Graph 1.2
Purchasing managers' indices (manufacturing)



Source: Thomson Datastream

Nevertheless, the outlook for the second half of 2005 is cautiously optimistic. Growth rates are being driven first and foremost by interest rates which have been at historically low levels for a long time now. In addition, considerable pent-up demand has accumulated in the areas of private consumption and investment.

Weaker economy in Asia

After the economic recovery in Japan began to falter in 2004, real GDP unexpectedly surged in the first quarter of 2005 (5.3%). Growth was propelled primarily by an increase in private sector spending in an effort to make good the recent lull. This notwithstanding, prospects for the rest of the year remain lacklustre. The growth stimuli from abroad are currently quite weak and, judging by the latest surveys conducted, domestic demand is unlikely to experience sustained growth.

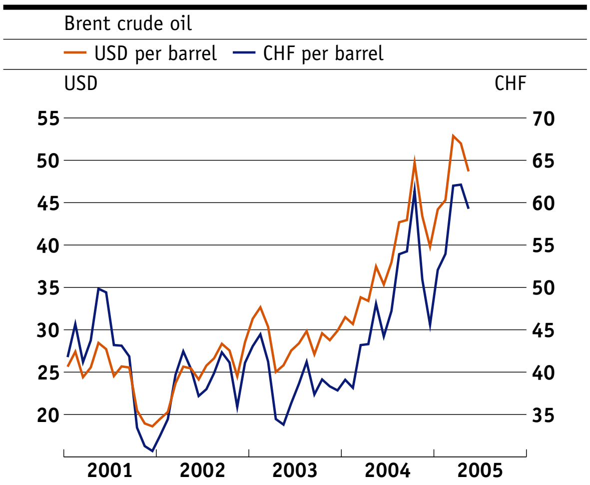
The softness of the global economy has also triggered a cyclical slowdown in Asia's industrialised countries. The highly cyclical IT sector, which accounts for a considerable proportion of exports in many countries, was particularly hard hit. In addition, demand from China fell off sharply in recent months.

Lower rise in inflation

The soaring oil prices had only a minor impact on inflation in most industrialised countries. In the US, annual inflation – as measured by consumer prices – climbed from 2.9% in January to 3.5% in April. Excluding energy and food prices, however, this figure remained almost unchanged at 2.2%. In the euro area, meanwhile, it increased only slightly from 1.9% to 2.1%. Core inflation, which excludes energy prices, food, tobacco products and alcohol, remained within the region of 1.5%. In Japan, the mild deflation persisted.

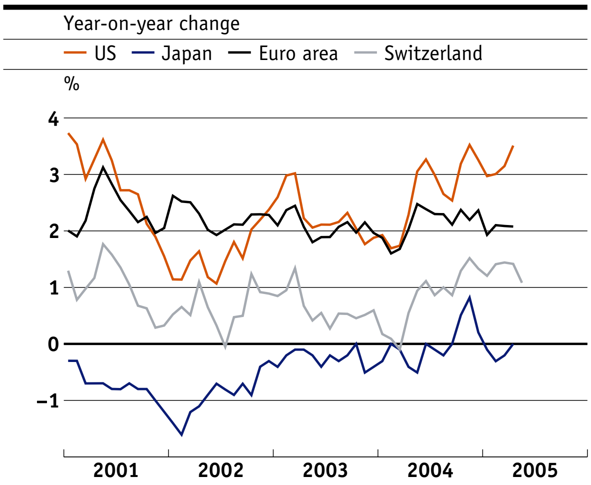
Given that the price of Brent crude retreated by almost USD 10 to USD 47 per barrel between the beginning of April and the end of May, the pressure exerted by oil prices on consumer prices is expected to ease in the second quarter. Prices climbed back up to USD 53 per barrel, however, at the beginning of June.

Graph 1.3
Oil prices



Source: SNB

Graph 1.4
Consumer prices



Source: BIS

Further tightening of US monetary policy reins

The US Federal Reserve (Fed) tightened its monetary policy further, pushing up short-term interest rates in May for the eighth time by 0.25 percentage points to 3.0%. The Fed cited the brisk pace of economic expansion and the short-term interest rates, which are still low by historical standards, as the reasons for its move.

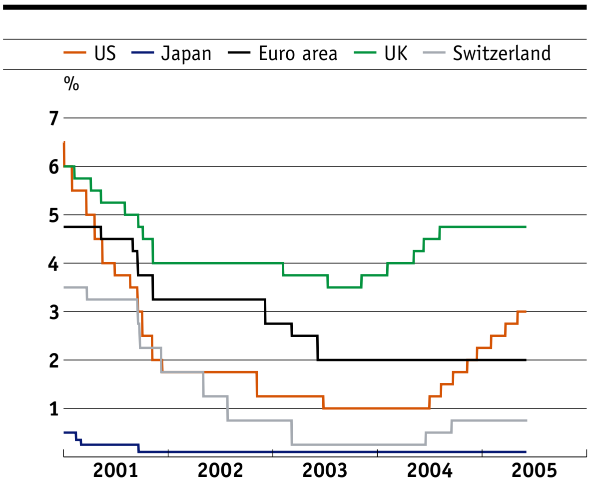
Due to the overall low inflationary pressure, the European Central Bank (ECB) decided to keep its main refinancing rate at its June 2003 level of 2%. It indicated its desire to avoid a further relaxation of monetary policy in view of the high money stock growth and the inflationary risk emanating from oil prices.

Slightly lower growth prospects

Growth forecasts for 2005 were revised downwards after economic data was revealed to be generally weaker than expected. The consensus forecast for the euro area was lowered from 1.7% in February to 1.5% in May. It was reduced for the US to 3.4% (3.5%); and for Japan to 1.0% (1.1%). The OECD also downgraded its forecasts and now expects growth in 2005 to be 1.2% in the euro area and 1.5% in Japan, as compared with 1.9% and 2.1% respectively last autumn. Forecasts for the US were raised slightly to 3.6% (cf. Table 1.1).

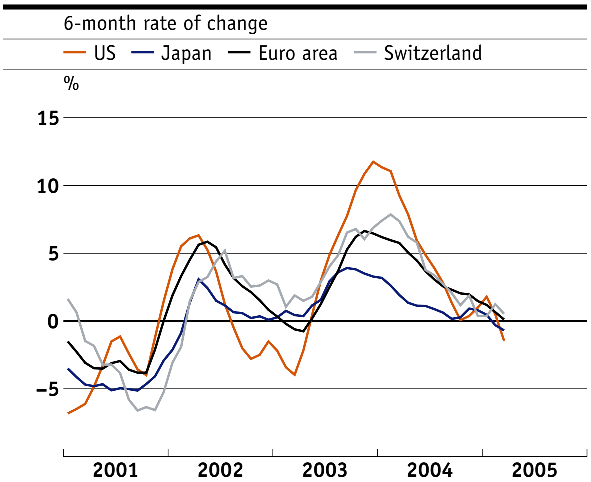
Based on the inflation forecast of June 2005, the National Bank lowered its expectations for GDP development in the EU15 and Japan by 0.5 percentage points each to 1.5% and 0.9% respectively. For the US, it remained unchanged at 3.4%. Projections for GDP growth thus correspond more or less to the consensus forecasts (cf. Section 4.1).

Graph 1.5
Official interest rates



Sources: BIS, SNB

Graph 1.6
OECD composite leading indicators



Source: OECD

Forecasts

Table 1.1

	Economic growth[1]				Inflation[2]			
	OECD		Consensus[3]		OECD		Consensus[3]	
	2005	2006	2005	2006	2005	2006	2005	2006
United States	3.6	3.3	3.4	3.3	2.4	2.2	2.8	2.5
Japan	1.5	1.7	1.0	1.7	−0.9	0.0	−0.1	−0.2
Euro area	1.2	2.0	1.5	1.9	1.5	1.7	1.8	1.7
Germany	1.2	1.8	0.8	1.4	1.3	0.7	1.4	1.3
France	1.4	2.0	1.9	2.1	1.9	1.8	1.7	1.6
Italy	−0.6	1.1	0.9	1.6	2.0	2.3	2.0	1.9
United Kingdom	2.4	2.4	2.5	2.3	1.9	2.1	1.8	1.9

1 Real GDP, year-on-year change in percent
2 Consumer prices, year-on-year change in percent
3 Consensus forecasts are monthly surveys conducted among over 240 leading companies and economic research institutes in more than 20 countries, covering predictions for the expected development of GDP, prices, interest rates and other economic indicators. The results are published by Consensus Economics Inc., London.
Sources: OECD: Economic Outlook, June 2005; Consensus: May 2005 Survey

2 Development of the Swiss economy

2.1 Aggregate demand and output

Stagnating GDP

Expectations of a rapid end to sluggish economic growth in Switzerland were dashed, with real GDP in the first quarter almost unchanged from the previous period (0.2%) according to estimates by the State Secretariat for Economic Affairs (seco). This followed a decline of 0.4% in the fourth quarter of 2004. Year-on-year, GDP growth slowed from 1.2% to 0.7%.

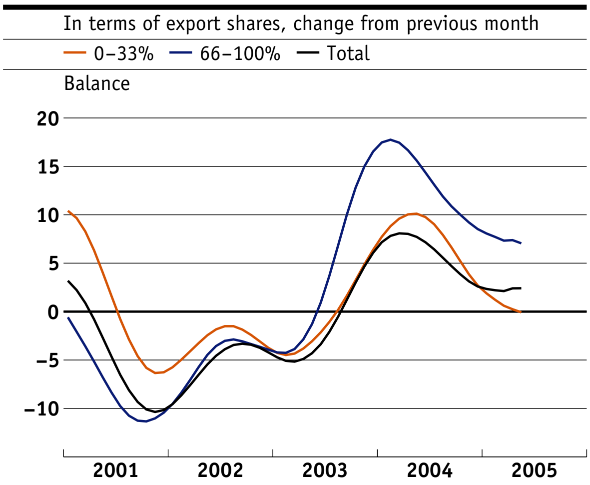
Exports, in particular, were disappointing, dropping significantly below the level of the first quarter. Domestic demand, by contrast, advanced slightly following a decline in the previous period. Private consumption continued to record moderate growth, while public expenditure rose more strongly. Investments stagnated after a significant retreat in the fourth quarter. Altogether, domestic and export demand was down by 1.3%. This development was reflected in imports of goods and services which also declined.

Industrial activity more subdued at beginning of year

The slowdown in the pace of industrial activity, which became evident at the end of 2004, persisted in January and February. Various industry surveys (KOF/FIT, PMI) revealed that the level of new orders had stagnated or increased only slightly. After successive improvements in companies' evaluations of the order situation in the period up to the end of 2004, their assessment once again deteriorated in the period under review. In addition, a larger number of companies regarded their inventories of primary products and finished goods as too high.

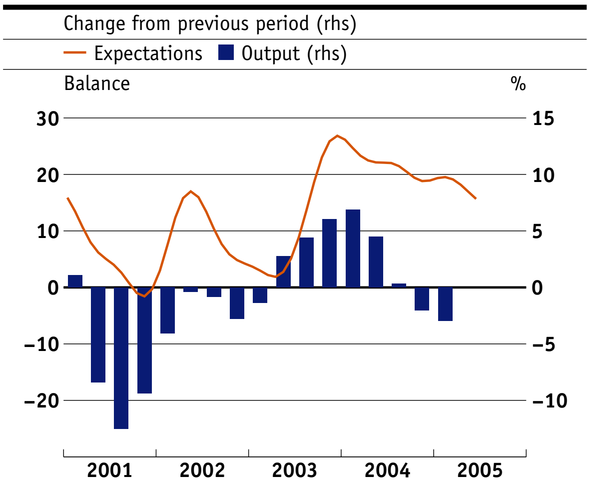
Data on production and the order situation in the manufacturing sector published by the Swiss Federal Statistical Office (SFSO) at the end of June confirm this picture of a stagnation in industrial activity. Manufacturing output declined in the first quarter compared with the previous period and dropped 0.5% year-on-year.

Graph 2.1
New orders in manufacturing



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

Graph 2.2
Manufacturing output



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

Real GDP and components

Year-on-year growth rates, annualised

	2001	2002	2003	2004	2003			2004				2005
					Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Private consumption	2.0	0.3	0.5	1.3	0.7	1.0	1.5	2.2	0.6	0.8	0.8	0.8
Government consumption	4.2	3.2	1.4	1.2	2.2	2.1	1.6	1.7	0.7	−1.3	1.2	2.8
Investment in fixed assets	−3.1	0.3	−0.3	3.4	−11.0	11.7	9.5	−0.8	7.4	2.2	−5.9	0.0
Construction	−3.4	2.2	1.8	3.5	1.0	3.3	8.0	7.8	0.2	1.8	−9.1	1.0
Equipment	−2.9	−1.1	−2.0	3.4	−19.7	19.1	10.8	−7.4	13.7	2.5	−3.2	−0.8
Domestic final demand	**1.0**	**0.7**	**0.4**	**1.7**	**−1.9**	**3.5**	**3.3**	**1.4**	**2.1**	**0.8**	**−0.7**	**0.9**
Domestic demand	**2.3**	**−0.8**	**0.2**	**0.9**	**−2.6**	**1.3**	**3.1**	**−4.7**	**7.3**	**3.3**	**−3.3**	**0.0**
Total exports	0.2	−0.2	0.0	6.6	2.8	10.3	10.6	12.6	−2.0	4.1	1.3	−4.0
Goods	1.4	1.1	−0.2	8.0	2.4	8.5	11.7	18.0	−2.9	5.0	4.0	−6.1
Excluding valuables[1]	3.7	0.3	0.7	7.6	2.5	8.9	13.5	12.2	0.2	7.0	−0.4	−4.5
Services	−2.8	−3.8	0.6	3.2	3.9	15.0	7.9	−0.4	0.4	1.7	−5.6	2.0
Aggregate demand	**1.7**	**−0.6**	**0.1**	**2.7**	**−0.9**	**4.1**	**5.5**	**0.7**	**4.1**	**3.5**	**−1.7**	**−1.3**
Total imports	3.2	−2.8	1.4	5.5	−3.0	10.0	13.8	−2.3	10.3	8.9	−4.9	−4.2
Goods	1.8	−3.0	1.9	6.4	−3.6	12.8	17.5	−4.0	11.9	10.2	−5.1	−8.4
Excluding valuables[1]	1.6	−2.2	2.7	6.4	−17.5	20.6	12.3	4.8	4.1	12.3	−6.4	−4.3
Services	11.2	−1.7	−1.4	1.5	−0.3	−2.8	−3.5	7.4	3.0	2.8	−4.0	19.3
GDP	**1.0**	**0.3**	**−0.4**	**1.7**	**−0.1**	**2.0**	**2.5**	**1.9**	**1.9**	**1.5**	**−0.4**	**0.2**

1 Valuables: precious metals, precious stones and gems as well as objets d'art and antiques
Source: seco

Slight improvement in outlook

Nevertheless, signs of a mild improvement began to emerge in March and April, so that an end to the period of economic softness may be expected for the second quarter of 2005. KOF/FIT survey results indicate that export-oriented companies, in particular, expect orders to rise more strongly and production to increase in the next three months. In March, the purchasing managers' index (PMI) returned to a range consistent with a moderate upswing in manufacturing output.

This picture was confirmed in the talks with companies conducted by the SNB delegates for regional economic relations between March and May 2005. Throughout the economy, these talks gave more of an impression of economic improvement than had been the case in the December to February talks, and less of a deterioration in the economy. The majority of export companies were satisfied with business activity and the outlook. By contrast, however, retailer assessment of the business environment was very reserved (cf. "The economic situation from the vantage point of the delegates for regional economic relations", Quarterly Bulletin 2/2005).

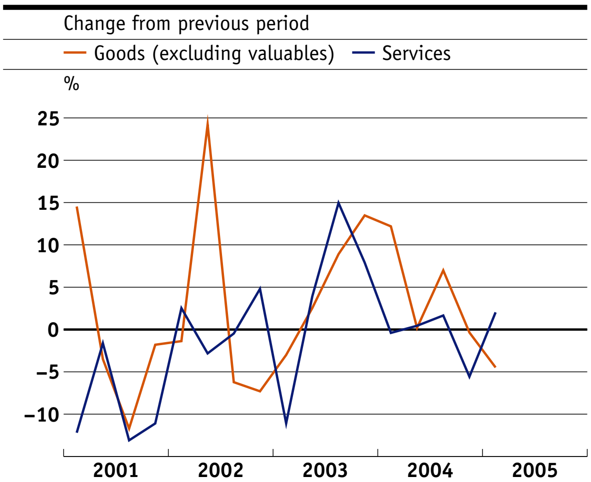
GDP forecast for 2005

As a result of the weak first quarter, the SNB now forecasts real GDP growth for the entire year of about 1.0%, a downgrade of half a percentage point from the quarterly assessment in March 2005. However, the new forecast continues to work on the assumption that the signs of an upswing will prove well-founded and that growth will pick up markedly in the second half of 2005. Exports and investments are likely to be the main growth drivers, while the increase in private consumption will probably remain restrained. Whether this scenario materialises will depend largely on economic activity in the euro area recovering as expected.

Declining exports in first quarter, improvement in April

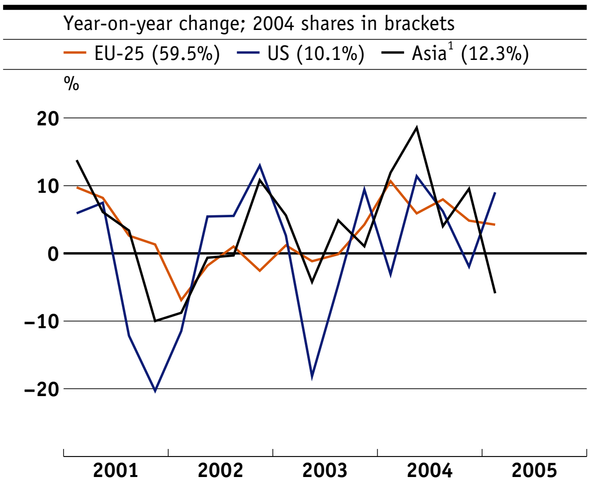
In the first quarter, real exports slipped below the previous period. The decline this time was attributable to goods exports which fell for the first time since the beginning of 2003, while exports of services increased slightly. Year-on-year, real exports of goods and services were unchanged (0.2%).

Graph 2.3
Exports



Source: seco

Graph 2.4
Exports by trading partners



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

Exports of semi-manufactured and capital goods recorded a particularly strong drop. By contrast, exports of consumer goods (especially food products, beverages and tobacco, as well as chemicals and pharmaceuticals) continued to grow rapidly. After the weakness observed at the beginning of the year, goods exports again advanced strongly in April. Growth in deliveries of consumer goods accelerated, while the decline in semi-finished and capital goods exports slowed.

The nominal level of goods exports – used when grouping exports by region – fell marginally in the first quarter so that the figure was only slightly above the corresponding figure for the previous year. Exports to the OPEC states and Russia, in particular – which as oil-producing countries benefit from the high level of energy prices – rose substantially. Exports to the US were also up. However, deliveries of goods to Germany and France continued to stagnate, while there was even a marked decline in deliveries to Italy. Together, these three countries account for almost 40% of Swiss goods exports. Falling exports to Japan and Southeast Asia also had a negative impact on exports overall.

Real exports of services rose again in the first quarter, although they were still slightly below the corresponding figure for the previous year (–0.4%). Income from insurance business and transport services recorded particularly strong growth following a lack of momentum in previous quarters. By contrast, bank commissions and receipts from tourism, which account for roughly one-third of all exports of services, registered a decline.

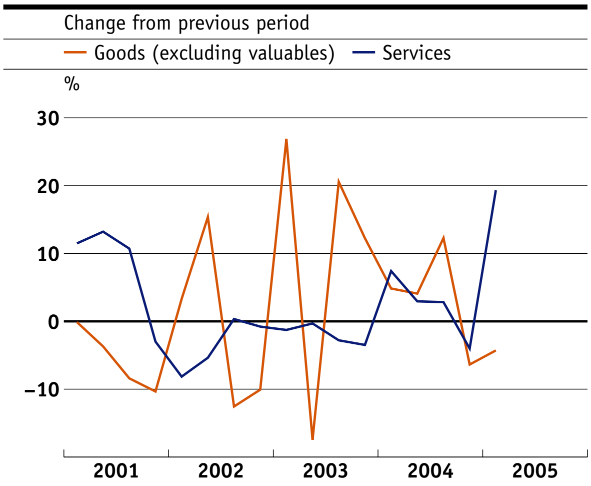
Dwindling imports

In the first quarter, real imports retreated further, with imports of goods and services moving in opposite directions. While goods imports declined substantially, largely as a result of lower imports of capital goods, imports of services advanced strongly. Overall, imports of goods and services were 1.8% up year-on-year.

As the quarter progressed, however, stronger imports of consumer goods and semi-finished products slowed the fall in goods imports. The growth in semi-finished goods imports presages future improvements in exports, since these products are used mainly in the production of export goods. A broad-based acceleration in the overseas sourcing of goods could already be observed for the month of April.

Imports of services were substantially above the figure for the last quarter of 2004 and exceeded the corresponding year-back level by 5.2%. Expenditure on transport services rose particularly strongly in contrast to the previous period. However, spending on tourism receded, although it was still above the year-back level.

Graph 2.5
Imports



Source: seco

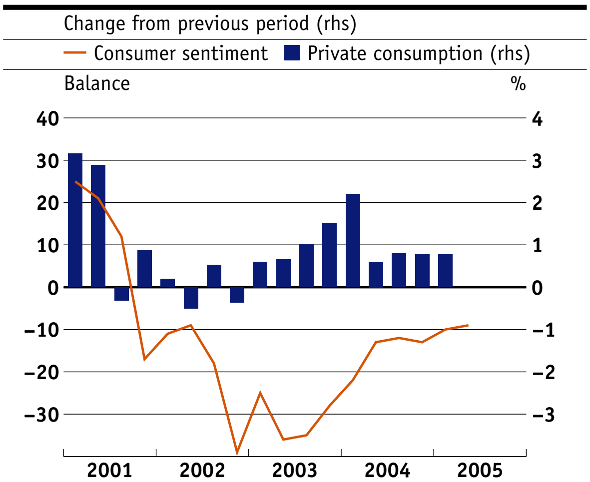
Subdued private consumption

The first quarter also saw only a modest increase in private consumption. At 0.8%, annualised growth remained at the same level as in the second half of 2004, and also amounted to 0.8% in a year-on-year comparison.

Goods consumption continued sluggish. Real turnover in the retail trade slipped below the level of the previous quarter, with the quarterly result a good 2% below the figure for the same quarter in 2004. In particular, households cut back their consumption of fuel and heating oil because of the high prices. Demand for consumer durables also continued weak, as shown by new car registrations which again retreated, reaching a level that was 7.6% below that of the same quarter in the previous year.

The subdued level of consumer spending also impacted on domestic tourism, with a majority of hotels in the second quarter expecting that domestic tourism would contract. In the KOF/FIT survey for the first quarter of 2005, positive and negative expectations had been more or less balanced. The survey results differ from the positive picture obtained in the talks conducted by the SNB delegates with representatives of the tourist industry. It should be noted, however, that these discussions related to all business activity in the tourist industry, including foreign demand.

Graph 2.6
Private consumption



Source: seco

Unchanged consumer sentiment

A ray of hope was provided by the figures for consumer confidence which remained stable despite the deterioration in the economic situation since autumn 2004. In April, the consumer sentiment index stood at −9 points (−10 points in January), thereby persisting at the average level maintained for a long time now. Job security continued to be a source of concern and consumers were also reticent with respect to the timing of large purchases. At the same time, their assessment of future economic developments and their own financial situation remained relatively positive. This view of the financial situation is in line with the SNB’s expectations. Although the growth in real incomes of wage and salary earners is likely to remain moderate this year, it will probably grow somewhat faster than last year (0.6% instead of 0.4%). The upward trend in private consumer spending is therefore likely to become firmer during the course of the year.

Slight increase in construction investment

In the first quarter, construction investment grew slightly compared with the previous period. However, given the unexpectedly strong fall in the fourth quarter, it was still 1.6% down year-on-year.

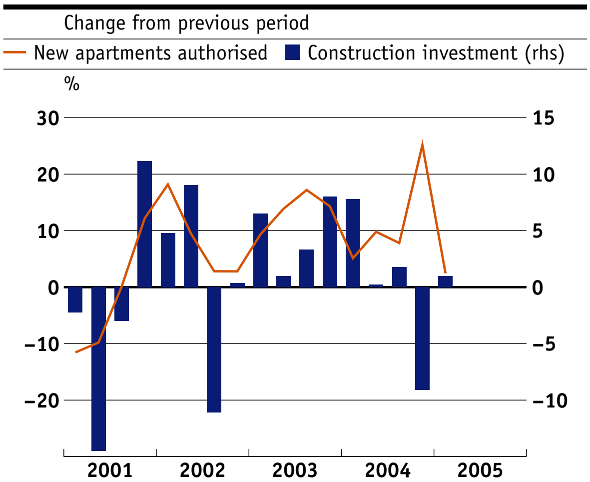
The growth in construction investment is likely to pick up strength over the next few quarters. Until recently, the number of residential building permits has been on the increase, suggesting that residential construction will continue on a path of substantial expansion. Commercial construction is also likely to gather pace – at least for the time being – according to the first-quarter survey conducted by the Swiss contractors' association. In the medium-term, however, a weakening in investment activity in the construction industry may be expected. For a year the number of vacant properties[1] has trended higher, indicating a gradual reduction in excess demand on the housing market and an accompanying decline in the leeway available to housing providers when setting prices. At the same time, construction costs are trending higher. The associated reduction in revenue will probably put a brake on investment activity in the residential construction sector. This gap is unlikely to be compensated by commercial construction, where the level of vacancies remains high.

1 Source: Wüest & Partner

Temporary slowing in equipment investment

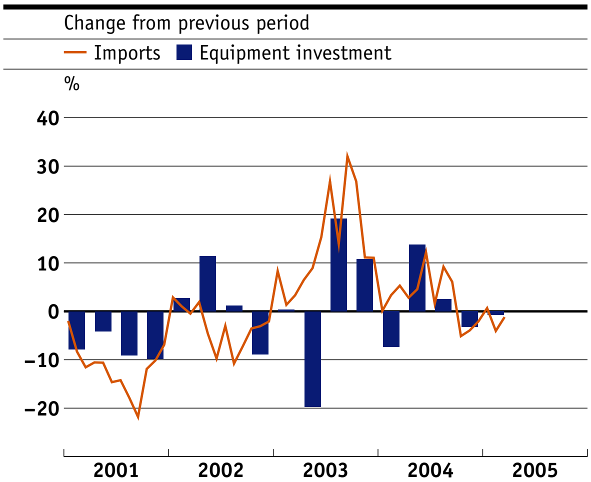
In the first quarter, equipment investment recorded another slight decline, although it was still 2.7% higher than a year previously. Contrary to original expectations, no significant recovery in investment activity can be expected before the middle of the year. Factors curbing investment include, in particular, the deterioration in earnings and a slight drop in capacity utilisation in companies. However, the anticipated improvement in the business situation should push up equipment investment in the second half of the year.

Graph 2.7
Construction



Sources: SFSO, seco

Graph 2.8
Equipment



Sources: FCA, seco

2.2 Capacity utilisation

Capacity utilisation in manufacturing declines

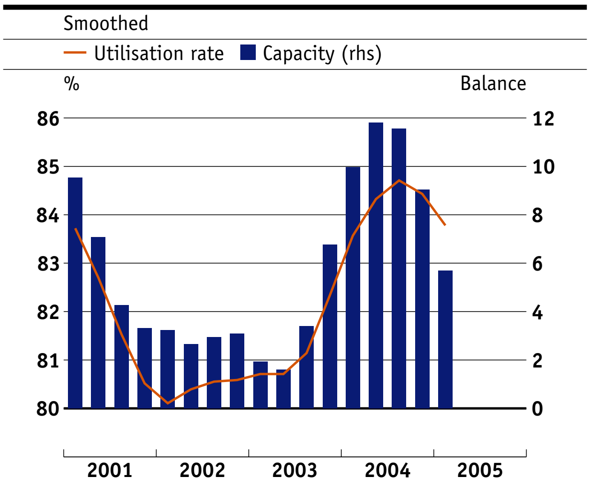
The utilisation of technical capacity in manufacturing dropped slightly in the first quarter, as compared to the fourth quarter of 2004. The KOF/FIT survey conducted in April revealed a level of almost 84% (seasonally adjusted), more or less in line with the long-term average. The increase in technical capacity was less marked than last year. Thus the lower capacity utilisation is mainly attributable to the stagnation in manufacturing output.

Aggregate output gap increases

Although technical capacity is relatively well utilised by historical standards, the labour market is experiencing a sustained period of under-utilisation. This is reflected in the output gap for the economy as a whole. All estimates for the output gap – defined as the percentage difference between real GDP and (estimated) production potential – are negative.

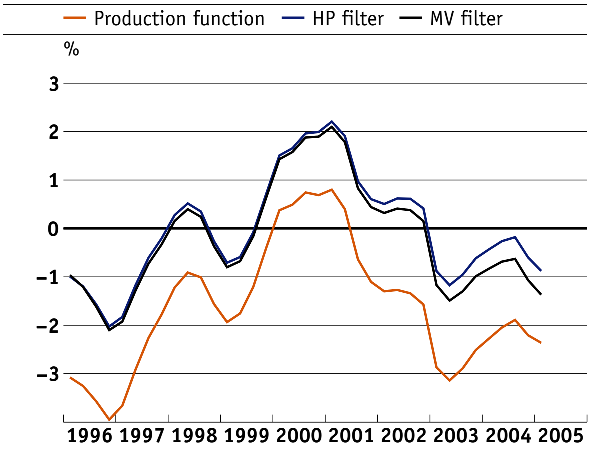
Three estimates of this output gap can be seen in Graph 2.10, each calculated according to a different method (production function, Hodrick-Prescott filter (HP) and multivariate filter (MV)). All three methods suggest that once again, in the first quarter, the gap was greater than in the previous quarter. Thus we see that, following a reduction in the output gap between the second quarter of 2003 and the fourth quarter of 2004, this process stalled in the winter and spring of 2004/2005, reflecting the weak growth in GDP in the two most recent quarters.

Graph 2.9
Technical capacity in manufacturing



Source: KOF/FIT

Graph 2.10
Output gap



Source: SNB

2.3 Labour market

Demand for labour remains weak

In the first quarter, the number of employed persons fell by 0.4% from the previous quarter, reaching a level slightly below that of the corresponding period in 2004. A development of this kind had been expected in view of the economic stagnation experienced in winter and spring of 2004/2005. However, the fact that the fall-off in employment was not greater is a positive sign. It suggests that companies expect the period of economic weakness to come to an end in the near future.

Indeed, employment in industry rose slightly after falling for three years. By contrast, the services sector recorded a drop in employment (–0.3%), the first for a year. The decline in employment was particularly strong in retailing, where 3.2% of jobs have been lost within the period of just one year. Both the hospitality industry and the financial sector recorded lower levels of employment; in the latter case this followed a slight increase in the second half of 2004. Meanwhile, there was a substantial increase in the number of jobs in health care and social services, as well as in public administration. Employment in the construction industry fell in the first quarter, mainly because of bad weather conditions.

The number of full-time employees retreated, as it has done for a long time now, while part-time employment rose. However, a slowdown in part-time job growth was observed.

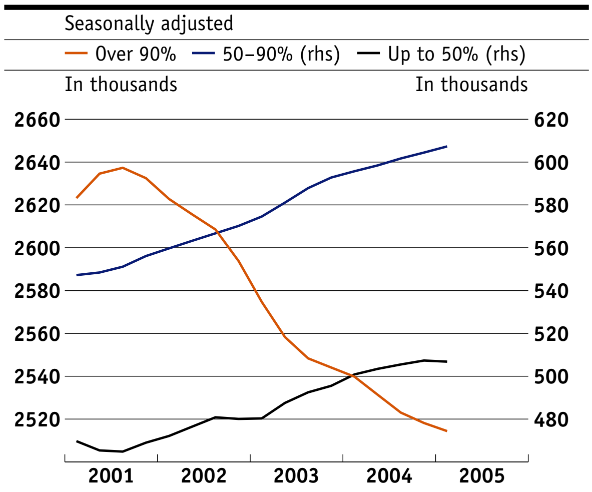
Unemployment rate unchanged

From January to May, the rate of unemployment fell by 0.4 percentage points to 3.7% as the result of favourable seasonal factors. The number of unemployed is now 145,400. However, the seasonally adjusted unemployment rate remained at 3.8% until May and the percentage of job seekers persisted at a level of 5.5%. Unemployment trends varied from one region to another. In Ticino and in French-speaking Switzerland, the unemployment rate climbed to 4.8% and 5.3% respectively, while in German-speaking Switzerland it fell to 3.3%.

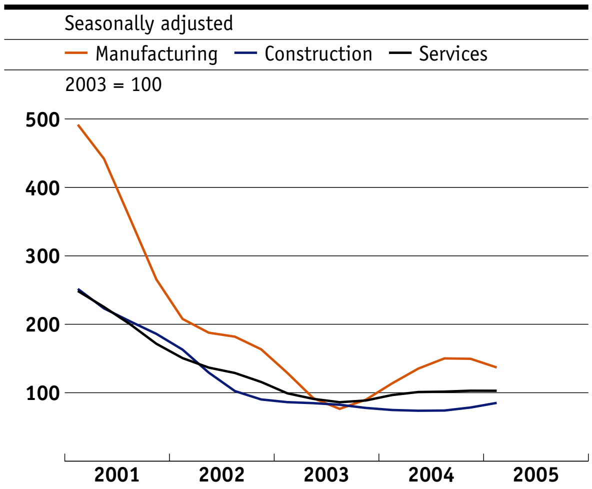
No improvement in sight

The employment indicators suggest that demand for labour will continue weak. The vacancies index published by the SFSO stagnated in the first quarter, while the Manpower Index, which records space devoted to job advertisements in newspapers, again declined slightly in April.

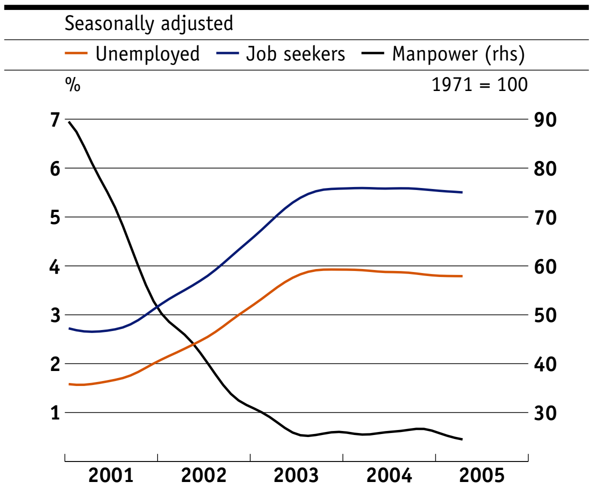
Graph 2.11
Full-time and part-time employment



Graph 2.12
Vacancy index



Graph 2.13
Unemployment rates and vacancies



Graphs 2.11 and 2.12:
Source: SFSO

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

2.4 Goods prices

Higher import prices due to oil price hike

The knock-on inflationary impact of producer and import prices on consumer prices remained modest between January and April. Although the annual rate of inflation for imported goods rose from 1.8% to 2.2% because of the rapid increase in the prices of petroleum products, inflation at producer level diminished by 0.2 percentage points to 0.8%. This was the lowest level since March 2004. The prices of goods destined for domestic sale rose less strongly in April, at 1.1%, than they had in January, but their rate of inflation was higher than that of export goods (0.4%).

Broken down by type of good, there was a slowdown in the price erosion for agricultural products observed since mid-2004 (April: −1.4%). The rate of price rises for intermediate goods had slowed to 1.1% by April as a result of markedly lower inflation in metal goods, while prices for consumer and capital goods remained stable. By contrast, the rate of inflation for energy sources, which include electricity and gas as well as petroleum products, soared to 15.2%.

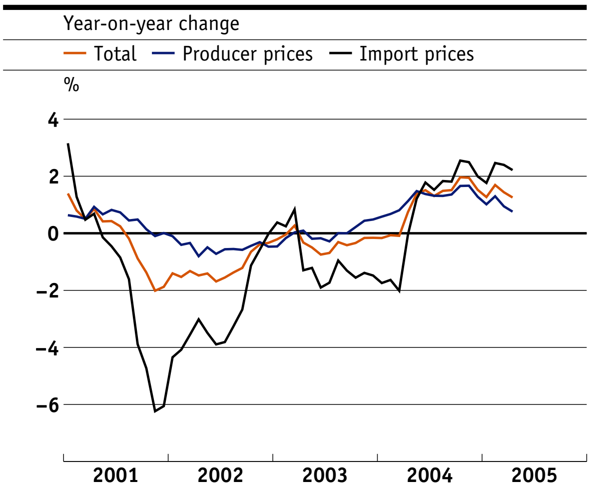
Consumer price inflation declines

Annual inflation measured according to the national consumer price index (CPI) remained unchanged from February to April at 1.4%, falling to 1.1% in May. It was thus only marginally higher than the figure projected by the SNB in its inflation forecast of March 2005. Movements in consumer prices were strongly affected by price trends for oil products. The prices of other goods continued to drop slightly, while the rate of inflation for services declined a little. Accordingly, the parameters used by the SNB to measure core inflation indicated a slight dip in the inflation trend.

Lower domestic inflation

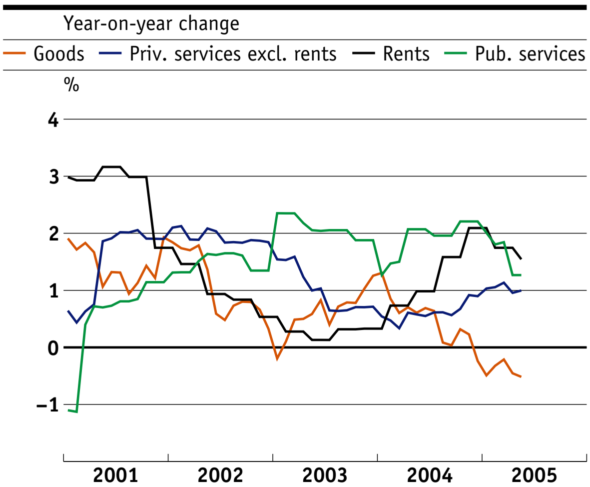
From February to May, annual inflation for domestic goods and services declined by 0.2 percentage points to 0.8%. The slowdown in the rate of inflation for services, which account for 75% of the domestic basket of commodities, had a significant impact. Growth rates of prices for public services slowed from 1.8% to 1.3%, a development largely due to lower price increases in hospital services as well in charges for refuse removal and sewage. The rise in the quarterly rentals index from February to May was 0.1%, a lower rate of increase than in the previous year, and as a result the annual rate of rent increases slowed from 1.7% to 1.5%. Annual inflation for other private services fell slightly to 1.0%, while the price decline for domestic goods gathered pace (May: −0.5%). Thus electricity prices, for instance, were down on last year's levels.

Graph 2.14
Prices of total supply



Source: SFSO

Graph 2.15
CPI: Domestic goods and services



Sources: SFSO, SNB

Brief increase in import inflation

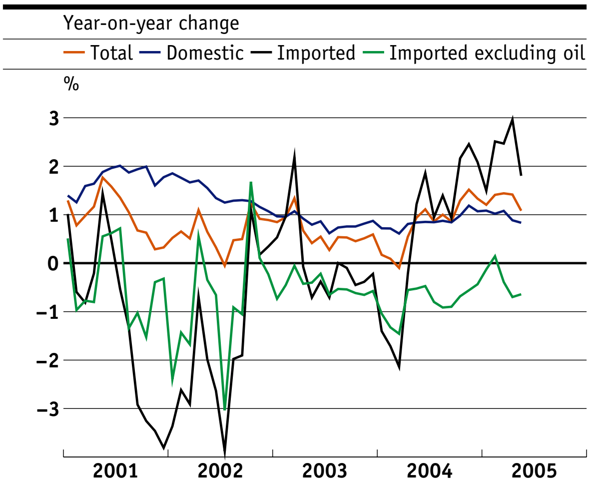
From February to April, the annual rate of inflation for imported consumer goods climbed from 2.5% to 3.0%, the highest rate since December 2000. It fell back to 1.8% in May. This development was largely driven by fluctuating prices for oil products (fuel and heating oil), where the annual rate of inflation still amounted to 13.2% in May, and accounted for almost half of all the inflation in consumer goods. The prices of other imported goods, on the other hand, continued to drop and in May were 0.6% below the corresponding figure for 2004. The slippage in prices was particularly marked in home electronics and clothing.

SNB and SFSO core inflation rates give ground

Inflation, as measured by the CPI, is subject to numerous short-term influences which may distort perceptions of the general long-term price trend. The SNB therefore computes a measure for the core inflation rate, which, for any given month, excludes the 15% of goods with the highest annual price variation and the 15% of goods with the lowest annual price variation from the consumer price index. In May, core inflation computed in this manner amounted to 0.8% and thus remained lower than inflation as a whole. This shows that the special factors driving inflation were stronger than the elements tending to dampen inflation. The 0.2 percentage point fall in core inflation from the February level reflects the slightly lower trend in the general level of prices.

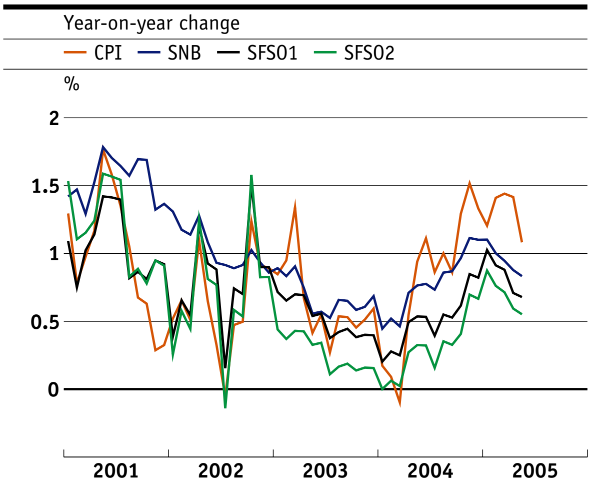
Unlike the core inflation calculated by the SNB, the two core inflation rates calculated by the SFSO exclude the same goods from the commodities basket in any given period. In the case of core inflation 1, food, beverages, tobacco, seasonal products, energy and fuel are excluded. Core inflation 2 additionally excludes products with administered prices. In May, the core inflation rates published by the SFSO were both 0.2 percentage points lower than in February. Core inflation 1 amounted to 0.7%; core inflation 2 to 0.6%.

Graph 2.16
CPI: Domestic and imported goods and services



Sources: SFSO, SNB

Graph 2.17
Core inflation



Sources: SFSO, SNB

National consumer price index and components Table 2.2

Year-on-year change in percent

	2004	2004 Q3	Q4	2005 Q1	February	March	April	May
Overall CPI	**0.8**	**0.9**	**1.4**	**1.4**	**1.4**	**1.4**	**1.4**	**1.1**
Domestic goods and services	0.9	0.9	1.1	1.1	1.0	1.1	0.9	0.8
Goods	0.5	0.3	0.1	−0.3	−0.3	−0.2	−0.5	−0.5
Services	1.0	1.1	1.4	1.5	1.4	1.5	1.3	1.2
Private services excluding rents	0.6	0.6	0.8	1.1	1.1	1.1	1.0	1.0
Rents	1.2	1.4	1.9	1.9	1.7	1.7	1.7	1.5
Public services	1.9	2.0	2.2	1.9	1.8	1.8	1.3	1.3
Imported goods and services	0.6	1.1	2.2	2.2	2.5	2.5	3.0	1.8
Excluding oil products	−0.8	−0.9	−0.6	−0.1	0.1	−0.4	−0.7	−0.6
Oil products	9.3	12.7	19.2	14.0	15.1	16.7	21.8	13.2

Sources: SFSO, SNB

3 Monetary development

3.1 Interest rates

Money market rates in Switzerland unchanged

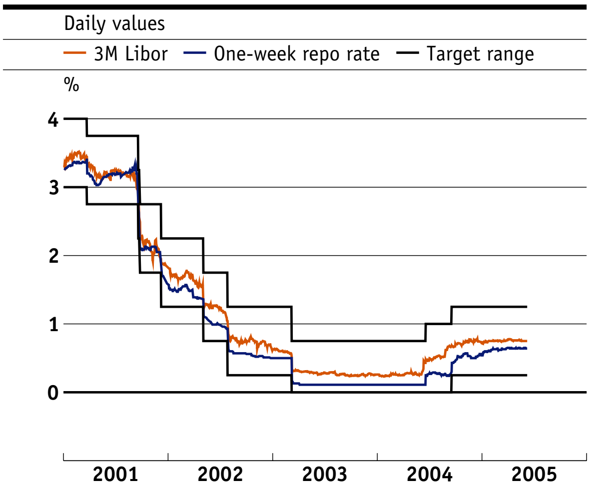
The target range for the three-month Libor has remained unchanged at 0.25–1.25% since the September 2004 assessment. In the reporting period, the three-month Libor fluctuated between 0.74% and 0.78%, averaging at 0.76%. The National Bank steers the three-month Libor by setting the level of repo rates. The maturities of these rates lie between one day and three weeks. The SNB concluded one-week repos in the quarter under review at rates between 0.62% and 0.65%.

Continuation of expansionary monetary policy anticipated

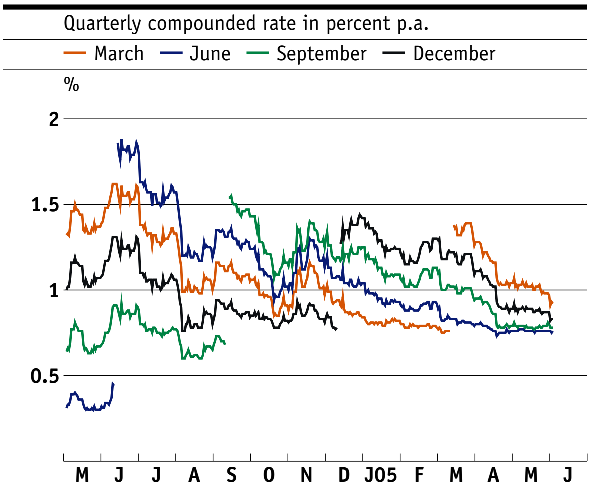
Financial market participants expect the expansionary monetary policy to be continued. As illustrated in Graph 3.2, the futures rates have been slipping since March and have been hovering close to the level of the spot rate since the end of April. The futures contract with a maturity of 6 June 2005 – i.e. shortly before the June assessment – stood at 0.76%. The futures contracts with maturity dates after the assessments of September and December 2005 were also only slightly above this value. Even the March 2006 futures contract was below 1% at the beginning of June, corresponding to an anticipated interest rate adjustment of 25 basis points in the first quarter of 2006 at the earliest. The development of the futures rates since May 2004 can be tracked in the graph. Since May of last year, they have drawn steadily closer together, reflecting the downward revision of the interest rate expectations.

A similar picture is portrayed in Graph 3.3, which charts the forecasts for the three-month interest rate from 9 May 2005 to mid-September. The red line maps the interest rate development based on the empirical estimate of an interest rate structure model. On 9 May 2005, a three-month Libor of 0.77% was expected in mid-June. These expectations will not change until 19 September, shortly after the next monetary policy assessment. On 6 June, the futures contract maturing on 19 September – the end value in the green curve – was at a similar level (0.78%). Graph 3.3 depicts two other curves: the spot rate of the three-month Libor (black curve) and the forward

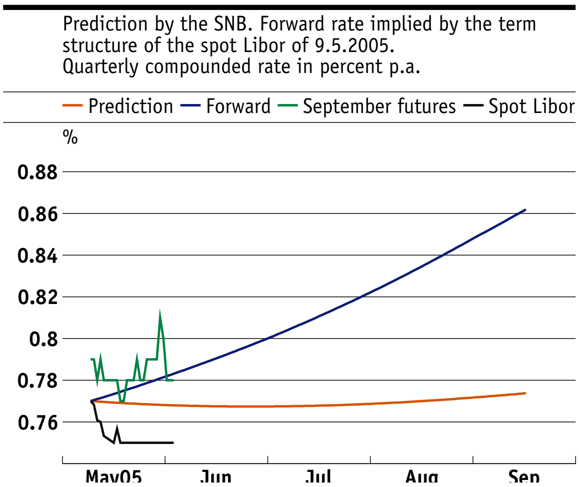
Graph 3.1
Money market rates



Graph 3.2
Three-month interest rate futures



Graph 3.3
Anticipated Swiss three-month interest rate



Graphs 3.1, 3.2, 3.3:
Source: SNB

rate (blue curve) computed on the basis of the term structure of the Libor. Unlike the projected three-month Libor value, the forward rate increases from 0.77% on 9 May to 0.86% on 19 September. The differential of up to 9 basis points between the forward rate and the estimated value of the three-month interest rate corresponds to a risk premium.

Interest rate differential to dollar investments widens

While the short-term interest rates in the euro area and Switzerland remained unchanged, the Fed forged ahead with its cycle of key rate rises to the current level of 3.0%. The interest rate differential has thus widened in favour of dollar investments since the March assessment. In May, the differential to euro investments stood at 1.24 percentage points, as compared with 0.91 percentage points in March; and at 2.61 percentage points to the Swiss franc (March: 2.29). The spread between dollar and euro investments thus considerably exceeds the average of 0.22 percentage points (and has done since the introduction of the euro on 1 January 1999); and that between dollar and Swiss franc investments is significantly above the long-term average of 1.25 percentage points.

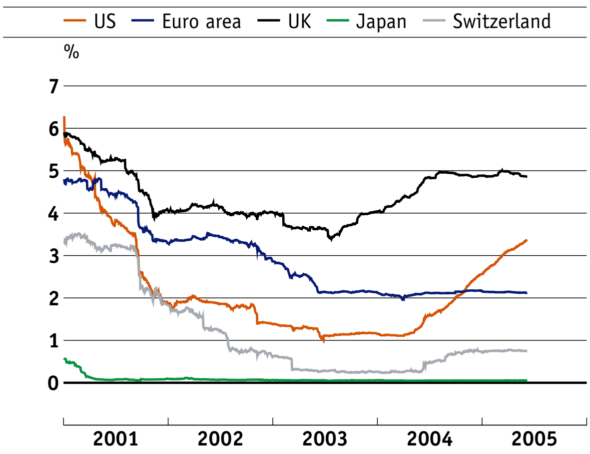
Continued decline in long-term interest rates

Long-term yields around the globe continued their downtrend. The yield on ten-year US Treasury notes in June was around 4%. In Germany, the yield on a ten-year government bond fell to 3.1% at the beginning of June, closing below its all-time low of 3.3% in the summer of 2003. The yield on a ten-year Swiss Confederation bond fell below 2%.

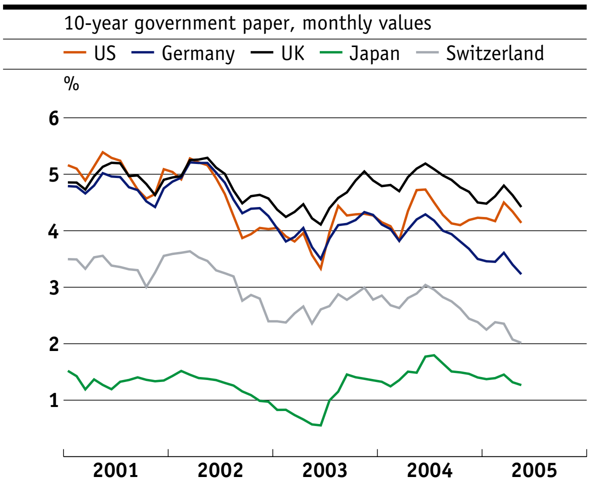
The term structure of Swiss Confederation bonds (cf. Graph 3.6) changed little between February and May 2004, after having fallen considerably between November and February as a result of the sharp decline in the very long-term rates.

The development of long-term interest rates is more consistent with a muted economic recovery, than with a brisk one. It is also in line with low and stable inflationary expectations.

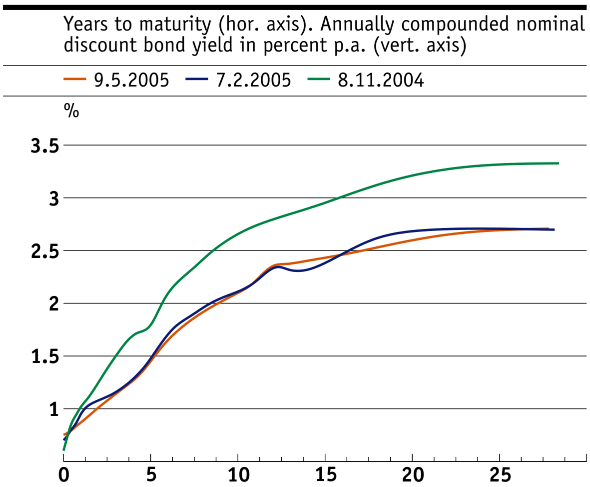
Graph 3.4
International short-term interest rates (three months)



Graph 3.5
Interest rates abroad



Graph 3.6
Term structure of Swiss Confederation bonds



Graphs 3.4, 3.5, 3.6:
Source: SNB

Mixed development of credit spreads

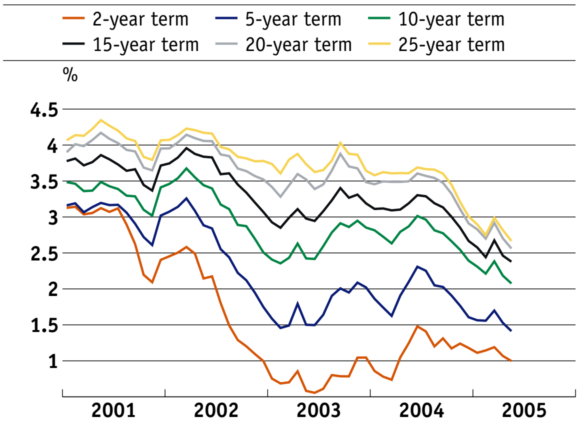
Changes in the financing conditions for bond issuers with different ratings can be illustrated by means of credit spreads. Such a spread, which can be interpreted as a measure of credit risk, is the differential between the yield on a corporate bond and the corresponding yield on Swiss Confederation bonds (cf. "Box: Assignment of bonds to ratings classes", Monetary Policy Report 1/2004, p. 33). Graphs 3.8 and 3.9 depict spreads for ten or five-year discount bonds since May 2004. The sectors shown are cantons, banks, mortgage bonds, industry and foreign bonds. First-class bonds enjoy the highest rating and are shown in Graph 3.8, while Graph 3.9 shows interest rate spreads for bonds with the third highest rating.

The development of credit spreads remained moderate overall. Bond spreads in the highest rating category shed a few basis points up to the beginning of April 2005 and edged up once again in May. Highly volatile corporate bond spreads in the third best category, by contrast, firmed by over 20 basis points. By the start of June, however, they had once again reached their level of early March. The remaining third-class bond spreads, meanwhile, continued the downward trend first observed at the beginning of 2005. This suggests that international events surrounding the credit downgrading of General Motors (GM) and Ford and the rumours of a potential major hedge fund blowout have had little impact on the Swiss market.

The interest rate spread serves as a leading indicator for economic activity. A widening of this spread often points to a cyclical slowdown, while a narrowing could indicate an upswing. Measured by the low credit risk premiums in the Swiss capital market, which have remained unchanged overall, it appears as though the chances of an economic recovery are still intact.

Graph 3.7
Swiss Confederation bond yields

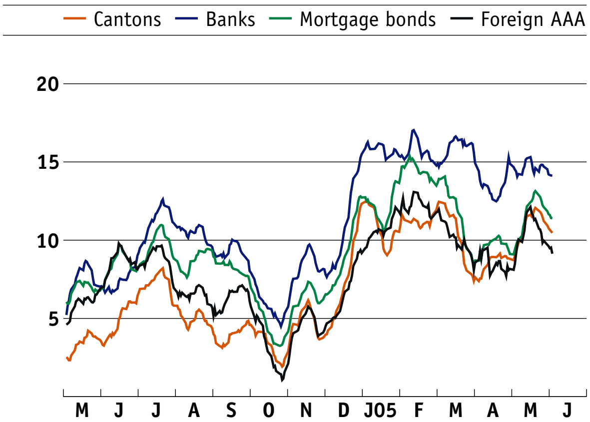
Monthly mean of annually compounded nominal discount bond yields in percent p.a.



Source: SNB

Graph 3.8
Ten-year spread of Swiss first-class bonds

Classified by the SNB. Smoothed spread over the Swiss Confederation bond yields in basis points



Source: SNB

Short-term real interest rates still negative

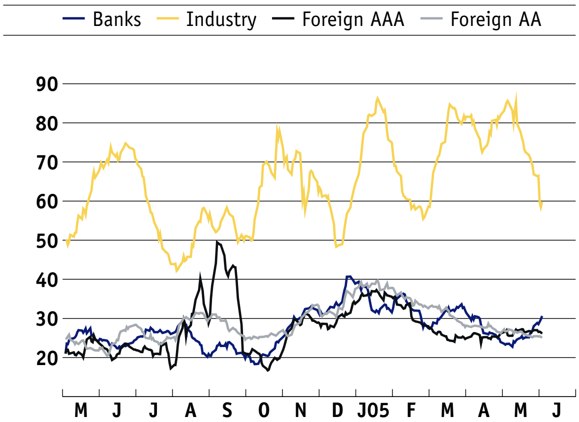
Graph 3.10 shows the development of the real interest rate with a one-year maturity. The real interest rate is defined as the differential between the twelve-month nominal interest rate and the expected rise in consumer prices for the same period. Inflation expectations are calculated as the average of the relevant forecasts prepared by a number of different forecasting institutions (Consensus Forecast, May 2005).[2]

Compared with the previous period, the real annual interest rate dropped in the first quarter by 15 basis points to –0.2%, making it the tenth quarter in succession to have a negative value. This is the longest phase of negative real interest rates in Switzerland in the last 25 years. Even though the record lows from the beginning of the 1980s have not been reached, these negative rates point to an expansionary monetary policy.

2 Cf. Table 1.1, footnote 3

Graph 3.9
Five-year spread of Swiss third-class bonds

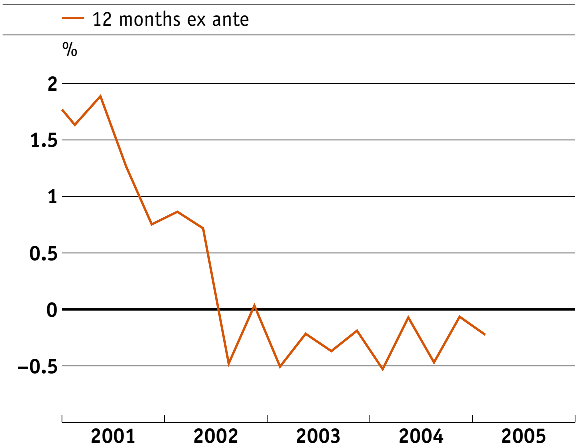
Classified by the SNB. Smoothed spread over the Swiss Confederation bond yields in basis points



Source: SNB

Graph 3.10
Estimated real interest rate

Quarterly values



Source: SNB

3.2 Exchange rates

Dollar on the rise

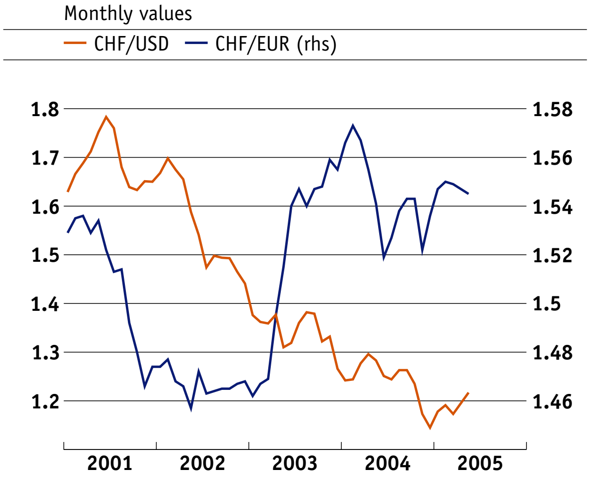
The dollar's external value firmed considerably in the period under review, having benefited in May from surprisingly positive labour market figures and from a much lower-than-expected trade deficit, as well as from the uptrend in the US equities market and the wider interest rate differential in favour of dollar investments. The dollar rose against the Swiss franc from CHF 1.19 in February to CHF 1.22 in May and against the euro from EUR 0.77 to EUR 0.79 in the same period, thus hitting a seven-month high in May against both the franc and euro. After France and the Netherlands voted "no" to the EU constitution, the dollar continued to appreciate against the euro and the franc in June. The Swiss franc moved within a narrow fluctuation margin of CHF 1.53 to CHF 1.55 against the euro.

The real export-weighted external value of the franc remained virtually unchanged between January and May 2005. Despite the fact that, in a long-term comparison, the value of the franc to the dollar is nominally high, the overall real external value of the franc corresponds almost exactly to last year's average. Looking solely at developments vis-à-vis the major European trading partners, the real value of the franc has in fact slipped slightly since the introduction of the euro in 1999 as a result of the comparatively low level of inflation in Switzerland.

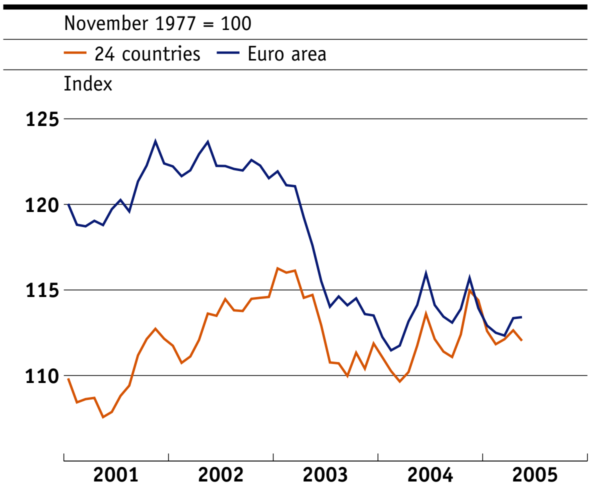
Monetary conditions more expansionary

The Monetary Conditions Index (MCI) combines the three-month interest rate and the nominal trade-weighted external value of the Swiss franc to measure the degree of monetary expansion. It identifies the monetary conditions faced by the Swiss economy. In order to take the uncertainty regarding the significance of interest rates and exchange rates into account, two weighting methods are used for both variables in the MCI (5:1 and 3:1). The MCI is reset to zero at the time of each monetary policy assessment. An increase to positive values (decline to negative values) signifies a tightening (loosening) of monetary conditions (cf. "Box: The Monetary Conditions Index (MCI)", Monetary Policy Report 1/2004, p. 27). At the end of May, the MCI stood at –40 basis points (at a 5:1 weighting) and –60 basis points (at a 3:1 weighting). With the three-month interest rate practically unchanged, the indicated easing of monetary conditions is attributable to the depreciation of the Swiss franc since the last monetary policy assessment.

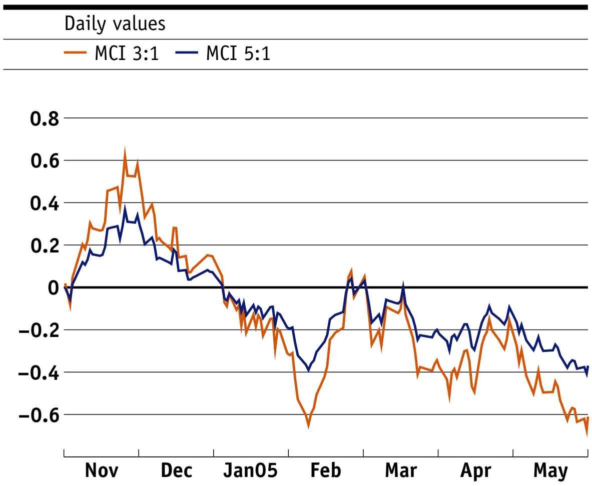
Graph 3.11
Exchange rates



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



Graph 3.13
MCI nominal



Graphs 3.11, 3.12, 3.13:
Source: SNB

3.3 Share and real estate prices

Continuing rise in Swiss share indices

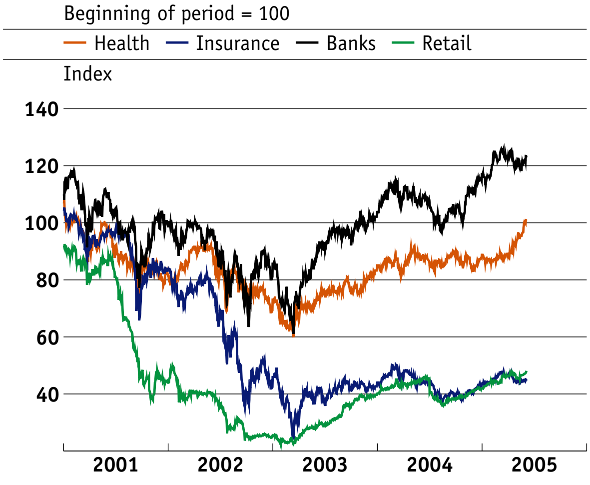
The Swiss equity market successfully weathered declining stock prices worldwide. It was unscathed mainly because of the favourable performance of some big-name equities. The Swiss Performance Index (SPI) increased from 4,500 points at the beginning of March to 4,700 points at the end of May. Pharmaceutical and retail stocks were the top performers during the period under review, while banks and insurance companies put in a somewhat below-average showing. The Swiss Market Index (SMI), which tracks the Swiss blue chips, rose from 5,800 points at the beginning of February to 6,100 points at the end of May. This marked a three-year high. The rise in the SMI since the beginning of the year has therefore clearly surpassed that of the major European and US indices. While the SMI 50 gained nearly 8%, the UK's FTSE 100 rose by a mere 3.0% and Germany's DAX by 4.8%. In the United States, the S&P 500 slipped by 1.8% during the same period. The fact that big advances were posted not only by the SMI – which gives a high weighting to a small number of stocks – but also by the broad-based SPI suggests that share price movements reflect the market's increased confidence in the Swiss economy.

Upward price trend of owner-occupied apartments

Prices on the real estate market continued to rise. This trend is evidenced both by the indices published by property consultants Wüest & Partner and by the hedonic rent index computed by the real estate portal "homegate.ch" and Zürcher Kantonalbank. Prices of owner-occupied apartments in particular climbed. According to Wüest & Partner, compared with the previous period, they rose at an annualised rate of 7.1% in the first quarter and by 4.2% year-on-year. Prices of single family homes have risen at a much slower pace than those of owner-occupied apartments, a trend observed for some time now. This contrasts greatly with the price rises witnessed in the 1980s, when the rate of increases was practically on a par in both categories.

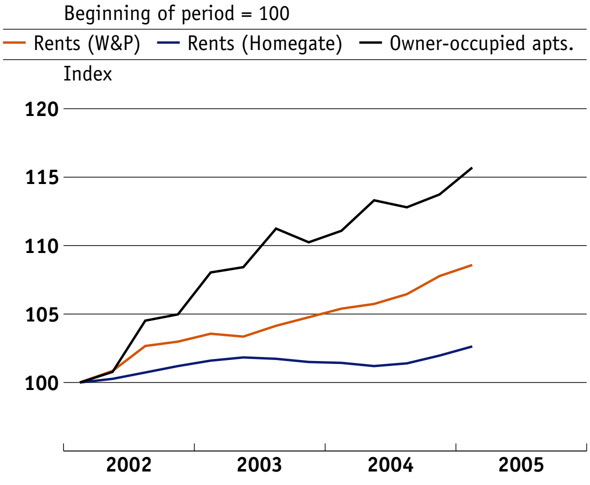
According to Wüest & Partner, rents exceeded their year-earlier level by 3% in the first quarter (new rentals: +4.8%). The hedonic rent index computed by homegate has exhibited a marked upward trend since July of last year and has since surged ahead at an annualised rate of 3.6%. The rise is discernible in all regions of Switzerland and is most pronounced in the case of large and new apartments. The first quarter not only saw rising apartment rents, but commercial and office space became more expensive as well. However, since commercial and office space indices are relatively volatile and have stagnated since 2000, the first-quarter rent increases do not imply a trend reversal to the upside.

Graph 3.14
Selected SPI sectors



Source: Swiss Exchange (SWX)

Graph 3.15
Rents and prices of apartments



Sources: Wüest & Partner, homegate.ch

3.4 Monetary aggregates

Money supply growth back to normal

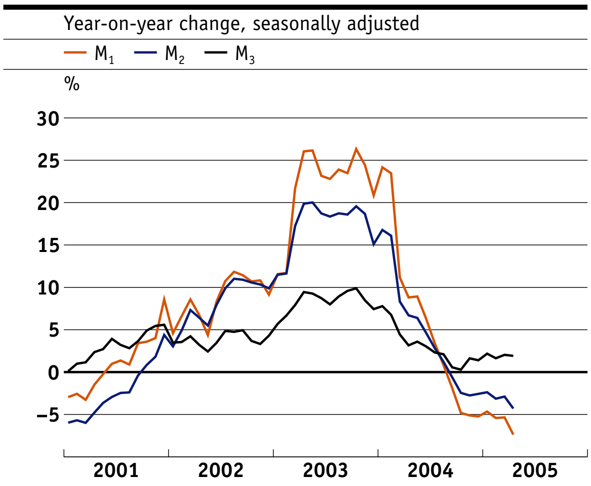
M_1, which is composed of currency in circulation, sight deposits and transaction accounts, fell by 7.3% in May compared with the previous year. M_2 (M_1 plus savings deposits) receded by 4.2%, while M_3 (M_2 plus time deposits) only registered a slight increase (2.3%). The shift from sight deposits to term deposits observable in the past few months continued. Unlike M_1 and M_2, growth in M_3 has not been affected by these switches. This is because M_3 comprises both sight and time deposits. The substitution of sight deposits with term deposits – a trend we have been witnessing since last year – was previously observed during the 1999–2000 upswing phase.

The annual growth rates M_1 and M_2 are currently influenced by the statistical effect of baseline figures: they reflect changes from the record-high aggregates figures reached at the beginning of last year. Tracking the growth rates over a longer period of time produces a more representative picture. In the past five years, the annual average growth rate of M_1 and M_2 was relatively robust (6.0% and 5.5% respectively). The current decline of both aggregates must therefore be interpreted as a return to normal.

In the discussion below, M_3 money supply is extended by the inclusion of fiduciary transactions of Swiss residents, which closely approximate to money holding. In addition to interest rates, demand for money is mostly determined by the transaction volume in the economy. The money-to-GDP ratio indicates the ratio of money stock to the transaction volume in the economy as measured by nominal GDP. Since holding M_3 generates opportunity costs in the form of lost interest earnings, the money-to-GDP ratio should move inversely to long-term interest rates. Graph 3.17 plots the money-to-GDP ratio against the reciprocal value of long-term interest rates. There was a close correlation between these two variables in the past. The increase in the inverse interest rate since 2000 is reflected in a sharp rise in the money-to-GDP ratio. With long-term interest rates low, the money-to-GDP ratio remains at a high level.

An equilibrium money stock can be determined based on the transaction volume and the opportunity costs for holding money, which serves as a benchmark for an appropriate supply of money to the economy (cf. "Box: Money supply growth and inflation", Monetary Policy Report 1/2005, p. 33). If the current money supply exceeds this equilibrium money supply,

Graph 3.16
Monetary aggregates



Source: SNB

the economy has ample liquidity. A money overhang by this definition (ECM concept) entails a risk of higher inflation rates in the subsequent four to six quarters. Graph 3.18 shows the percentage deviations of M_3 money supply from its equilibrium value, taking into account the statistical error of the estimate. As the maximum and minimum money gap curves run above and below the zero line, M_3 money stock does not currently display any statistically significant deviation from its equilibrium value.

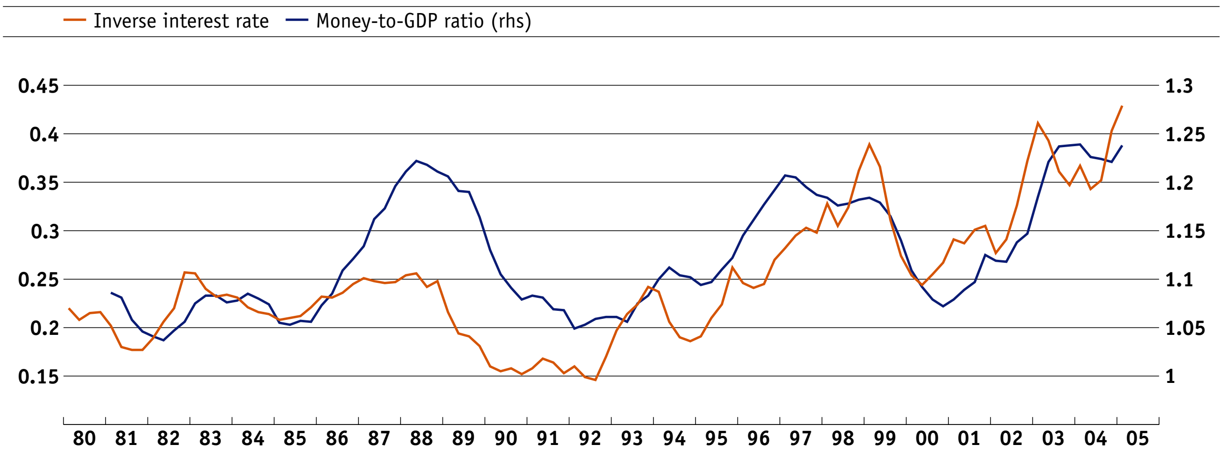
Aside from the ECM money gap concept, another model examines inflationary risks in one and a half to three years. According to this model, there is currently an overhang. If interest rates are lifted too late, this money overhang represents inflationary potential.

Monetary aggregates[1] Table 3.1

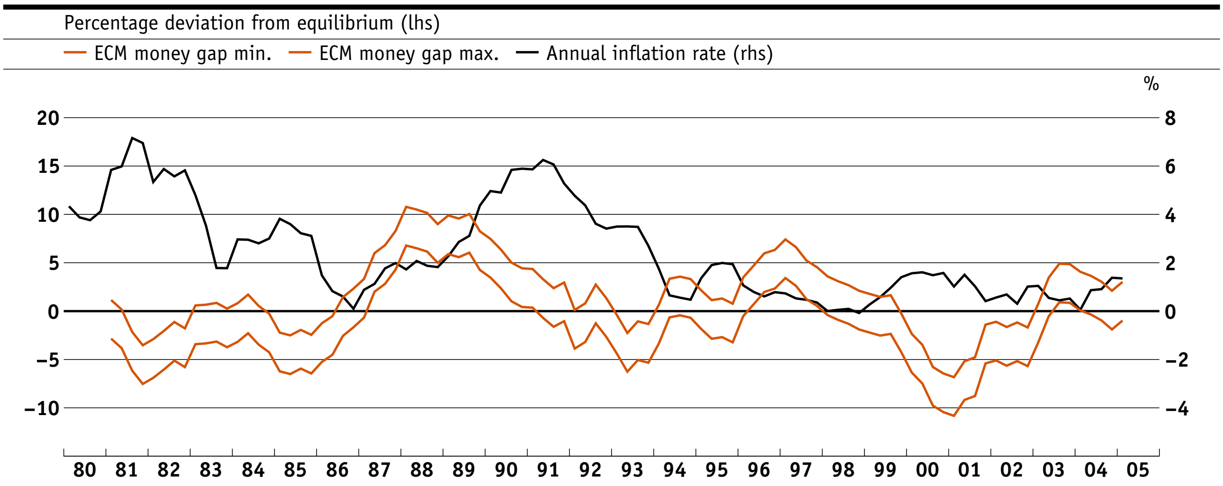
	2003	2004	2004				2005			
			Q1	Q2	Q3	Q4	Q1	March	April	May
Monetary base[2]	**40.4**	**41.7**	**42.2**	**41.7**	**41.1**	**41.8**	**42.1**	**41.5**	**41.7**	**41.6**
Change[3]	*5.3*	*3.2*	*7.7*	*4.5*	*0.2*	*0.7*	*−0.5*	*−0.3*	*−0.6*	*0.5*
M_1[2]	**273.5**	**287.9**	**297.2**	**295.0**	**281.2**	**278.1**	**282.0**	**278.9**	**275.5**	**275.9**
Change[3]	*21.9*	*5.2*	*19.3*	*8.0*	*0.8*	*−5.1*	*−5.1*	*−5.3*	*−7.3*	*−7.3*
M_2[2]	**475.1**	**495.4**	**505.2**	**503.3**	**488.1**	**485.0**	**490.9**	**487.7**	**484.7**	**485.0**
Change[3]	*17.4*	*4.3*	*13.6*	*6.0*	*1.2*	*−2.6*	*−2.8*	*−2.9*	*−4.2*	*−4.2*
M_3[2]	**544.9**	**561.5**	**563.5**	**562.9**	**556.6**	**562.9**	**574.5**	**572.7**	**574.9**	**576.9**
Change[3]	*8.3*	*3.0*	*6.3*	*3.2*	*1.7*	*1.1*	*1.9*	*2.0*	*1.9*	*2.3*

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

Graph 3.17
Money-to-GDP ratio



Graph 3.18
Money gap and annual inflation rate



Graphs 3.17 and 3.18:
Source: SNB

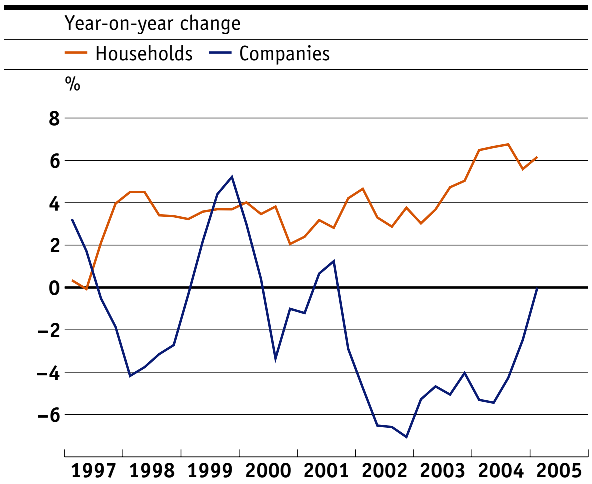
3.5 Loans

Broader-based credit growth

Bank loans increased by 3.6% year-on-year. While corporate loans stagnated rather than declined for the first time since mid-2001, loans to households have accelerated somewhat since the last quarter of 2004.

For the second time since August 2001, other loans – which consist of secured and unsecured loans – were slightly up on their year-earlier level. In April, however, they fell again by 1.5%. While secured "other loans" registered the weakest growth since April (1.9%), unsecured "other loans" dropped by 3.8% compared with 2.8% in March. In the first four months of 2005, other loans decreased by 1.8% year-on-year. By contrast, mortgage loans, which are mainly granted to households, grew by 5.1% in the first quarter, thus continuing the robust growth witnessed since the end of 2002.

Graph 3.19
Bank loans



Source: SNB

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

Table 3.2

	2003	2004	2004 Q1	Q2	Q3	Q4	2005 Q1	February	March	April
Total	**2.1**	**3.6**	**3.2**	**3.4**	**4.0**	**3.6**	**3.6**	**3.6**	**4.1**	**3.7**
Mortgage claims	5.6	5.4	5.4	5.4	5.4	5.2	5.1	5.1	5.0	5.0
Other loans	−8.7	−3.1	−4.6	−3.8	−1.2	−2.6	−1.9	−2.2	0.4	−1.5
of which secured	−10.7	3.2	−1.6	3.5	7.2	4.0	3.5	3.3	5.1	1.9
of which unsecured	−7.4	−7.1	−6.5	−8.4	−6.6	−6.8	−5.7	−6.0	−2.8	−3.8

1 Bank balances, reporting entity "parent company", all currencies, Switzerland; annual and quarterly values expressed as averages of month-end values
Source: SNB

4 Inflation forecast of the SNB

Monetary policy impacts on production and prices with a considerable time lag. In Switzerland, monetary policy stimuli have their maximum effect on inflation after a period of 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 were to remain unchanged. The inflation forecast thus forms one of the pillars of the SNB's monetary policy concept, together with the definition of price stability and the operational target (cf. "Box: Inflation forecasting as part of the monetary policy concept", p. 37).

4.1 Assumptions for global economic development

Economic recovery in Europe slightly delayed

The SNB's inflation forecasts are based on an international economic scenario that reflects the Bank's assessment of the most likely development of the global economy in the next three years. Table 4.1 shows the major external assumptions in comparison with those at the March forecast.

On the whole, global economic expectations are less favourable than they were at the March 2005 assessment. The price of oil, in particular, has climbed further since February. The latest assumption for the second quarter of 2005 is USD 51 per barrel, with a slow decline to around USD 40 per barrel. In connection with the higher oil prices, growth in Europe is expected to remain soft this year, followed in 2006 by somewhat better growth rates than projected in the previous forecast. While a temporary slowdown is also on the cards in the US, the pace of expansion is expected to pick up significantly again as early as from the third quarter of 2005. Lastly – as a technical assumption for model simulations – the dollar/euro exchange rate was fixed at 1.30 for the entire forecasting horizon of three years.

Assumptions for inflation forecasts Table 4.1

	2005	2006	2007
Inflation forecast of June 2005			
GDP US[1]	3.4	3.6	3.4
GDP EU-15[1]	1.5	2.1	2.4
Exchange rate USD/EUR[2]	1.3	1.3	1.3
Oil price in USD/barrel[2]	49.0	45.4	42.8
Inflation forecast of March 2005			
GDP US[1]	3.4	3.4	3.4
GDP EU-15[1]	1.9	2.3	2.1
Exchange rate USD/EUR[2]	1.3	1.3	1.3
Oil price in USD/barrel[2]	44.9	41.9	40.2

1 Change in percent
2 Level

Box: Inflation forecasting as part of the monetary policy concept

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

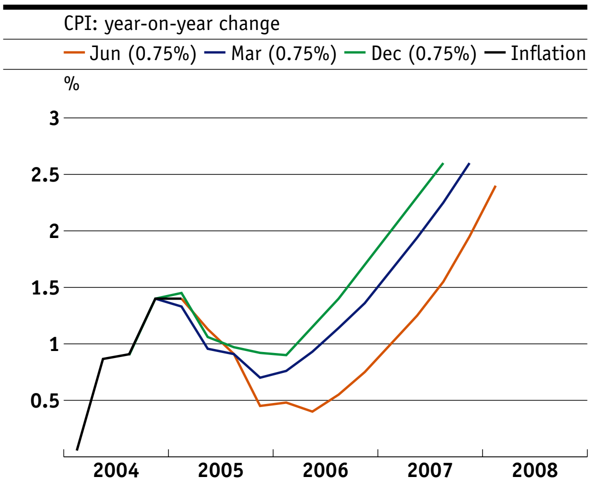
It has laid down the details of the exercise of this mandate in a three-part monetary policy concept. First, the SNB regards prices as stable when the national consumer price index (CPI) rises by less than 2% per annum. It thus takes account of the fact that the CPI slightly overstates actual inflation. At the same time, it allows inflation to fluctuate somewhat with the economic cycle. Second, the SNB summarises its assessment of the situation and of the need for monetary policy action in a quarterly inflation forecast. This forecast, which is based on the assumption of a constant short-term interest rate, shows the CPI development expected by the SNB over the next three years. Third, the SNB sets its operational goal in the form of a target range for the three-month Swiss franc Libor rate. The target range provides the SNB with a certain amount of leeway, enabling it to react to unexpected developments in the money and foreign exchange markets without having to change its basic monetary policy course.

4.2 Inflation forecast Q2 2005 to Q1 2008

The inflation forecast is derived from the analysis of different indicators, model estimates and the assessment of any special factors. Graph 4.1 depicts the inflation forecast of June 2005 alongside those of March 2005 and December 2004. The new forecast, which extends from the second quarter of 2005 to the first quarter of 2008, is based on a steady three-month Libor of 0.75%, i.e. the mid-point in the 0.25–1.25% target range which the SNB confirmed for the three-month rate on 16 June 2005.

Until this summer, the new inflation forecast will remain higher than that of the March 2005 and December 2004 assessments. However, based on the assumption that oil prices will fall, pricing pressure on the oil products (fuel and heating oil) listed in the consumer price index will ease noticeably. Other imported consumer goods, too, are likely to make a slightly negative contribution to inflation in the coming months. Given the negative output gap, the SNB still expects that the cost of domestic goods will retreat on the whole. Pressure on prices of basic necessities, in particular, is likely to persist due to the highly competitive retail market. Furthermore, the SNB predicts price increases for services to moderate, but to remain at an above-average level overall. The forecast inflation thus recedes from 1.4% in the first quarter of 2005 to 0.5% in the last quarter. The average annual inflation rate for 2005 is put at 1%.

Graph 4.1
SNB inflation forecasts: a comparison



In the medium term, i.e. for a period of one to two years, the development of inflation hinges on the economic outlook. The anticipated continued delay in European economic growth this year will also have an impact on the Swiss economy. The SNB now expects real GDP growth to be within the region of 1% in 2005, having still estimated it at around 1.5% three months ago. The negative output gap is thus likely to close later and the projected inflationary pressure to ease in the medium term. With the three-month Libor constant at 0.75%, the forecast puts the inflation rate at 0.5% for 2006, compared with the March projection of 1.0%.

As was also the case in March, the forecast indicates a rise in inflation in the longer term. This increase can be attributed to the expected improvement in the utilisation of economic resources. Moreover, liquidity levels are still high. Experience has shown, however, that the availability of ample liquidity can pose a risk to price stability. The higher the liquidity levels in an economy, the greater the number of transactions that can be processed in the course of economic recovery. At the same time, more possibilities for price hikes present themselves. The longer-term inflationary risk from the monetary side remained unchanged.

According to the June inflation forecast, price stability would be in jeopardy as of the end of 2007. This assumes an unchanged three-month Libor of 0.75% over the next three years. The forecast shows that the current level of interest rates cannot be maintained in the event of a normalisation of the economic situation. Since monetary policy has been expansionary for a long time now, the inflationary risk will intensify in the future. If the economic outlook continues to improve, it will be necessary to make adjustments to monetary policy.

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 2005

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 most important results of the talks held from March to May 2005 on the current and future economic situation are summarised.

Summary

The talks held with the delegates for regional economic relations with about 140 representatives of different business sectors and industries revealed a basically favourable picture. As compared to the previous round of talks, the general impression was one of economic improvement rather than deterioration. However, large variations from one industry to another persisted.

While a majority of exporters and construction companies were satisfied with business developments and prospects, the situation in services remained mixed. Slack consumer demand and falling prices continued to create difficulties for retailers. By contrast, the tourism industry and various areas within company-related services were more upbeat. This was particularly true of the transportation and logistics industries as well as IT services.

Although the business situation was satisfactory, investments remained restrained. Plans to invest in expansion were few and far between, and the same applied with respect to employment. Very few companies planned to increase staff numbers, although there was also very little mention of laying off staff either.

1 Production

Manufacturing

Almost all of the strongly export-oriented manufacturing companies surveyed reported good sales results for the period from March to May. In some cases these results exceeded expectations; indeed they appeared to have gained a little additional momentum towards the end of the period under consideration. Asia, the US and Eastern Europe remained the most important sources of this momentum, although a slowdown in the stimulus emanating from Asia was noted here and there. Most companies rated business with European countries, especially with Germany and France, as modest to poor.

Export activities remained firm across a broad range of sectors. Exports from the watchmaking, chemical/pharmaceutical and medical industries remained particularly brisk. Business results in the special machinery and metalworking sectors were extremely good, as were those recorded by electrical engineering companies, which benefited from the substantial increase in world production of electricity. Companies in the textile industry expressed grave concerns about Switzerland as a manufacturing location, and were considering outsourcing these activities abroad – in many cases to Asia. Some representatives of the food industry were also facing increasing competition from abroad.

Services

The retail industry experienced a poor start to the year. Survey respondents described buyer behaviour as reticent, selective and extremely price-conscious with no more than the occasional sign of a gradual upturn in consumer demand. Pressure from competitors forced major retail chains to reduce the prices of substantial portions of their product ranges, but this did not generate any appreciable increase in overall demand. Most respondents were gloomy in their assessment of future prospects, with both the lack of any sense of direction in consumption patterns and the strong pressure for structural adjustment causing concern. The favourable results obtained in the luxury sections of food products, beverages and tobacco, as well as the successful watch and jewellery fairs in Basel and Geneva represented a marked contrast to the depressed mood in the retail industry.

The improvements in the tourism industry that were beginning to become apparent in the previous round of talks were confirmed in the most recent interviews. A majority of survey respondents in the hotel business were optimistic about the winter sports season. Most catering and hotel businesses in towns reported increased numbers of guests and higher spending, especially among companies. However, the talks also revealed that the high-price segment is the main area to benefit from the economic upturn and that capacity utilisation in other businesses continues unsatisfactory. Establishments located outside town centres suffered considerable pressure on margins following the reduction in maximum permissible blood-alcohol levels for drivers under Swiss law.

The transportation industry registered excellent business results. This applied to both passenger travel and freight. For the first time in quite a while the IT sector, too, was more optimistic. Investments appear to be picking up gradually, a development that had been expected for some time because of the pressing need for replacements. As a result, both IT wholesalers and IT consultants benefited. The willingness to embark on additional investments in new technologies – such as broadband technology – has also grown in the past few months.

Banks were satisfied with business developments. While commercial loans remained sluggish and many credit lines were not used, mortgage business grew substantially. Once again, the waning risk consciousness of banks was a topic that was frequently mentioned. This was reflected in higher lending levels and rising appraisals. Asset management companies surveyed described business developments as good although competition is very tough and this – together with a higher level of customer price-consciousness – is placing commissions under considerable pressure.

Construction

A majority of construction companies surveyed regarded the business situation as sound although this favourable assessment still applied only to residential construction, which is growing strongly. Survey respondents continued to describe the situation in other sectors of the construction industry as flat. Most companies expected that impulses derived from residential construction would gradually wane and that other areas of construction would be unable to fill the gap.

2 Labour market

There were scarcely any signs of improvement in the labour market. Most companies from the manufacturing and service sectors surveyed had sufficient staff and were not planning to hire any more personnel. Those companies intending to recruit staff often failed to find candidates with the right qualifications. There was a hesitant improvement in the demand for management staff. Survey respondents were asked about the free movement of labour between Switzerland and the EU countries. Here the hospitality industry, in particular, reported marked improvements in the staff situation due to the availability of a large supply of well-qualified staff – especially from neighbouring countries.

3 Prices, margins and earnings situation

The pressure on prices remained strong in all industries and although survey respondents from manufacturing still saw the earnings situation in a positive light, retailers were recording lower margins because of price reductions. In addition to flat consumer demand, stiff price competition in retailing is due, in particular, to the imminent entry of German discounters into the Swiss market, but also fewer trade barriers. The construction sector also reported continued strong pressure on prices. Pricing pressure on construction-related industries seems to have mounted. This is because a growing number of foreign workers from neighbouring countries are offering their services at considerably more favourable conditions than the local trade.

The euro did not give any cause for concern. After the dollar had rallied again in the last few months, uneasiness surrounding a weak greenback slipped into the background somewhat. This notwithstanding, many industries still cite the dollar exchange rate as a major worry.

2005 General Meeting of Shareholders
Opening Speech by the President of the Bank Council

Hansueli Raggenbass
Berne, 29 April 2005

Dear Shareholders, dear Guests,
Ladies and Gentlemen

I will begin my address today with a look at the 2004 annual result, before moving on to say a few words about the volatility of the earnings and the long-term return expectations. To conclude, I will briefly review the impact of the new National Bank Act.

Please allow me now to make a few remarks on the 2004 financial statements.

Gross income

As you are aware, the provisions for the assignment of free assets, which correspond to the proceeds from the sale of the 1,300 tonnes of gold, were written back and released for distribution. The unusually high annual result for 2004 of CHF 21.6 billion must be regarded in this context.

In fact, the gross income came to only CHF 0.6 billion, which is considerably lower than the previous year's result of CHF 4.3 billion. The decline is primarily attributable to the influence of the valuation of gold in Swiss francs. In 2003, the gold price had increased by almost 9% and had led to valuation gains of CHF 2.2 billion. While the price of gold initially climbed further in the first quarter of 2004, it ended up losing around 4% year-on-year. This fall was reflected in the income statement, with valuation losses of just under CHF 1 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 depends strongly on the fluctuations in interest rates and exchange rates. In 2004, it amounted to CHF 1.2 billion, which was roughly 20% below the year-earlier level. In most markets in which the National Bank invested, the interest rate level dropped last year. This resulted in rising bond prices, which in turn led to valuation gains in the National Bank's investment portfolio. At more than CHF 3 billion, investment performance before exchange rate influences was quite gratifying. Foreign exchange rate movements narrowed this result significantly, however. At the end of 2004, exchange rates for foreign currency holdings were lower across the board compared with the previous year and resulted in valuation losses to the value of CHF 2 billion. Dropping by nearly 9%, the US dollar exhibited an especially pronounced decline.

Swiss franc investments contributed CHF 0.3 billion to the gross result. The Swiss franc bond portfolio accounted for most of this amount. As was already the case in 2003, the income from repo transactions was comparatively modest. Although the National Bank pushed up the repo rates slightly both in June and September, they were still a very low level – of around 0.6% – at the end of the year.

Declining operating expenses

Operating expenses decreased by approximately CHF 10 million to just over CHF 200 million. Banknote expenses and general overheads registered a marked decline, while personnel expenses increased by around 1%. The reason for the drop in banknote expenses was that, compared with the previous year, far fewer banknotes needed to be taken out of circulation and replaced.

Distribution of the proceeds from the gold sales

As announced, the proceeds from the sale of the 1,300 tonnes of gold are to be distributed from the 2004 annual result, with one-third going to the Confederation and two-thirds to the cantons. To this effect, a special distribution agreement was concluded between the Federal Department of Finance and the Swiss National Bank. The proceeds amount to a little more than CHF 21.1 billion.

After the Council of States' decision on 16 December 2004 not to consider the bill on the appropriation of the surplus gold reserves, it was to be assumed that there could be no majority in Parliament supporting another such bill from the Federal Council. Given the Federal Council's decision of 2 February 2005 to distribute the gold assets to the Confederation and the cantons, the Council of State's non-consideration of December 2004 became effective. The Bank Council and the Governing Board of the National Bank decided therefore that the continued retention of the SNB's gold assets was no longer justifiable. The swift distribution of these assets will release the National Bank of its dual role as a monetary policy authority and an asset manager for the state.

Mr Jean-Pierre Roth, Chairman of the Governing Board, will go into the details in his address.

Ordinary distribution of profit

I would now like to move on to discuss a change to the Financial Report. This change concerns the treatment of the provisions which permit the National Bank to maintain the currency reserves at a level necessary for monetary policy. These provisions are made up of retained profits. In accordance with the law, the required level of provisions is determined by economic growth in Switzerland. Furthermore, in the second half of the 1990s, considerable additional provisions accumulated owing to the National Bank's excellent earnings power. These have been steadily reduced since the 2003 financial year. In this year's accounts, the targeted level of provisions and the surplus provisions are being reported for the first time as two separate positions. In so doing, the National Bank is presenting the required level of provisions and the distributable amount in a transparent manner.

This time last year, I pointed out that the distribution of profit is a long-term issue which causes the National Bank a certain degree of concern. Nothing has changed in the meantime. On the contrary: in 2004, the National Bank generated a gross income of CHF 0.6 billion. After taking into consideration the operating expenses and the release from the provisions for the assignment of free assets, and after the deduction of the CHF 0.9 billion needed to reach the targeted level of provisions, the result was a loss of CHF 0.4 billion. In order to cover this loss and carry out the agreed distribution of CHF 2.9 billion to the Confederation and cantons, a total of CHF 3.3 billion had to be released from the distribution reserve, which is the new term to refer to surplus provisions. Following this release, the total in the distribution reserve is now just under 7 billion. In other words, it is now only double the amount being released this year! The 2004 financial result reflects this clearly: the current profit distribution considerably exceeds the National Bank's profit potential. When budgeting its expenses, the public sector should not come to expect distributions of this size, but should be prepared to receive lower distributions in the future. The current agreement, which is valid until the 2012 financial year, will be reviewed after five years, namely in 2007. Given the circumstances already mentioned, an adjustment of the annual profit distribution could then become necessary.

Allow me now to move on to the earnings fluctuations and prospects.

Earnings fluctuations and prospects

The results of the past 15 years show that the National Bank's earnings can fluctuate dramatically. The annual results – not including extraordinary income – seesawed between minus 1.6 billion Swiss francs in 1995 and plus 6.4 billion in 1996. Bear in mind that the gold reserves were valued up until 1999 at the then applicable statutory parity rate. Market-driven changes to the gold price have thus only been reflected in the annual result since 2000. Had the gold reserves been valued at market price already at an earlier date, the annual fluctuations in earnings would have been far greater, namely between minus 11.1 billion francs in 1990 and plus 10.8 billion in 1996. Not only that, the reported earnings would have been generally lower, as the gold price in Swiss francs declined during this period.

Since the 1997 revision of the National Bank Act and the suspension of the official gold parity in 2000, the National Bank has been better able to manage its assets. Owing to the targeted diversification of foreign exchange reserves, the dependency on the US dollar was reduced in particular. At the same time, the development of more long-term bond investments led to an increase in the earnings potential. With the revision of the National Bank Act in 2003, the investment provisions were extensively liberalised, with the result that the yield potential of investments was strengthened yet a little further.

This notwithstanding, the return on the National Bank's assets is likely to remain relatively moderate and earnings fluctuations comparatively strong. This is both due to the fact that the nominal yield level in the markets is currently quite low, and that, where asset management is concerned, monetary policy always has priority over income considerations. First and foremost, the National Bank's assets must fulfil monetary policy functions. Swiss franc investments are used primarily for the conduct of monetary policy and are hence largely made up of money market investments. Likewise, the currency reserves – in the form of foreign exchange and gold – held by the National Bank do not serve in the first instance as a source of income, but rather help prevent and overcome crises. Given the primacy of monetary policy, the National Bank does not use just any method to hedge against risks to its assets – particularly those to gold and foreign exchange reserves. It also means that when it comes to selecting its investment instruments, the Bank weights criteria such as security and liquidity more heavily than return.

The return perspectives of the National Bank depend on its asset level and the yield potential of its investments. With the distribution of the proceeds from the gold sales, the assets will contract by CHF 21.1 billion. The reduction of the distribution reserve by almost CHF 7 billion as part of the regular profit distribution will cut the income-yielding assets yet further. Above-average yields on bond investments are not anticipated in the foreseeable future. Interest rates are so low globally, that they are bound to increase sooner or later. However, a rise in interest rates would initially lead to capital losses on the National Bank's bond investments. The fluctuations in the gold price and exchange rates, which continue to have the strongest influence on the National Bank's earnings, cannot be forecast with any degree of reliability.

Overall, the National Bank anticipates a nominal yield of slightly less than 3% on its assets in the longer term. However, after operating expenses and the legally prescribed allocation of provisions, an annual distributable income of just below CHF 1 billion is all that is likely to remain. In addition, relatively large fluctuations in earnings can also be expected going forward. Alone the normal spread of the annual yield has to be estimated at between minus 2% to plus 7%. Depending on how the financial markets perform, yield spreads are likely to be even greater. Fluctuations in earnings should thus continue to remain comparatively sharp.

I would now like to take a look at the impact of the new National Bank Act.

New National Bank Act

As you know, the new National Bank Act entered into force one year ago – on 1 May 2004. It brought with it a whole range of changes for the National Bank. These primarily concern the detailed formulation of the central bank mandate, the definition of independence and duty of accountability, and the extension of autonomy in monetary and investment policy activities.

The new Act did not change anything about the National Bank's legal form – which is that of a special statute joint-stock company. The legal structure underpins the Bank's constitutional independence in an institutional sense.

However, the new Act now also reflects the current legal situation of private listed stock companies. In this regard, the share capital – which, given the National Bank's much higher balance sheet total and its level of provisions today, is no longer significant as a risk-bearing element – was reduced to the paid-up amount of CHF 25 million. The nominal value of one SNB share has consequently now been reduced from CHF 500 to CHF 250.

In this context, the Bank Council decided in spring 2004 to completely waive the issue of share certificates in the future. In the meantime, the so-called registered share model – where the shares are not printed – has become established at the SNB. Numerous shareholders have availed themselves of the opportunity to have their value rights held free of charge by the National Bank.

The new Act has also simplified the structure of the Bank's bodies. For instance, the number of bodies was lowered from seven to four: the General Meeting of Shareholders, the Bank Council, the Governing Board and the Audit Board. Also, the Bank Council, which is responsible for overseeing the business activity, was reduced from forty to eleven members. In line with corporate governance, the Bank Council also appointed four committees from its members. An Audit Committee supports the Bank Council in supervising financial accounting and financial reporting. It also supervises the activity of the external and internal auditors. A Risk Committee supports the Bank Council in overseeing the investment process and risk management. A Compensation Committee assists the Bank Council in determining the principles of the National Bank's compensation and salary policy. And finally, a Nomination Committee prepares proposals for the election of Governing Board members and their deputies and submits these to the Bank Council and the Federal Council.

The new Act thus provides the National Bank with a modern statutory basis. Corporate governance was strengthened and the relationship between management and supervision improved. In my opinion, the new structure of the Bank's bodies and the new procedures have proved highly successful.

Concluding remarks

To conclude, I would like to express my sincere thanks to the Governing Board and the staff of the National Bank for their competent and dedicated service.

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

Jean-Pierre Roth, Chairman of the Governing Board
Berne, 29 April 2005

Dear Shareholders, dear Guests

2004: the economic upswing continues

The economic upswing that began in summer 2003 continued last year. Economic growth moved into the positive zone and came close to its potential level once again. While growth was slightly negative in 2003, it reached 1.7% for 2004 as a whole.

The recovery in Switzerland is due in large part to the rebound in global economic growth, which reached its highest level since 1976. Swiss companies have benefited from this situation: last year, exports rose by 6.7% – a significant increase compared with the 2003 figure. This figure reflects our exporters' continuing wish to adapt to changes in demand, as well as the untiring efforts to streamline Swiss industry and maintain Switzerland's appeal as a location for business.

The Swiss economy's strong presence on the international markets has been a reality for a long time. As our direct investments abroad have grown, however, it has taken on a new dimension in recent years. Not everyone is aware that while Switzerland is a champion in savings, it also boasts a performance in the area of foreign investments that is unrivalled. In 2003, we invested some CHF 20 billion abroad – a sum equivalent to almost 20% of national savings. Roughly half of these investments were concentrated in the European continent. Over the years, and given Switzerland's trade surplus, our companies have thus developed an extremely dense international network of production facilities. In addition to the 4 million jobs within the domestic economy, Swiss companies employ a further 1.8 or so million people abroad. Of these, 1 million work in European countries.

These figures show that Switzerland has by no means resigned itself to low growth, but has seized the opportunities created by the opening-up of borders and markets. These days, a lot of people worry about competition from low-wage countries and the resulting relocations. However, they overlook the fact that our country is a major beneficiary from the more pronounced international division of labour brought about by globalisation. The relocation of certain production stages is inevitable. It allows our companies to stay competitive in the face of high Swiss labour costs. In some respects, the jobs created abroad secure those at home with more added value.

"One out of every two francs is earned abroad" is the phrase that comes to mind when the performance of our exporters is being discussed. This also means, however, that one out of every two francs is still earned in Switzerland. Put another way, the domestic economy plays a crucial role in our country's economic development both on a demand and production level. In 2004, domestic turnover grew more slowly than sales abroad. The growth figure of 1.8%, however, was still higher than in the previous year.

Household consumption played a central role in this respect: this began to recover towards the end of 2003 in the wake of the general economic upturn and the rise in earnings. A good showing by the construction sector also contributed to higher demand for household equipment. In contrast to their counterparts in Germany, Swiss consumers remained relatively optimistic in 2004, and this helped to sustain the level of business activity.

Where public-sector demand is concerned, the financial constraints imposed by the Confederation and cantons put a brake on the growth in spending in 2004. For the first time in several years, public-sector demand rose less quickly than the other components of domestic demand.

In this initial phase in the economic cycle, the return of confidence would normally have triggered growth in investments aimed at adapting the means of production to future needs. But such an upsurge has so far been largely absent, both in Switzerland and in other European countries. Although the profitability of companies has improved, they have given priority to raising the utilisation of existing capacity rather than expansion or modernisation, as the latter are considered to entail substantially more risks. As a result, growth in capital spending was modest in 2004.

This cautious approach by companies also affected the development of the labour market: contrary to expectations, unemployment fell only slightly in the past year. This can be ascribed, on the one hand, to weak growth and large productivity gains and, on the other, to a lack of confidence in the soundness of the recovery.

Monetary situation starts to normalise

Thus, 2004 saw the economic situation starting to return to normal. Our aim was therefore to modify our policies so as to gradually bring the monetary framework into line with the new environment. A normalisation of the monetary situation should go hand in hand with an economic normalisation in order to ensure that price stability is maintained in the medium term.

We waited until June – when the signs of a recovery became manifest – for an initial quarter-point rise in the target range for the three-month Libor. This decision did not really come as a surprise. In fact, the markets were expecting corrective action to be taken during the year. We proceeded to adjust rates again in September, but decided to leave them unchanged in December 2004 and March 2005 when it became increasingly clear that the economy was slowing down. Our three-month rate is 0.75%. Meanwhile, long rates fell during 2004, but have risen slightly since.

The current interest rate reflects the fact that we are still pursuing an expansionary monetary policy: in view of the prospects for growth and inflation, our rates are relatively low. However, this phase of normalisation of monetary policy is not yet over. It will be continued according to the requirements for maintaining price stability in the medium term.

Where prices are concerned, 2004 was another year of stability despite the spectacular price rise of oil products. Inflation rose to 0.8% over the year as a whole, and peaked at 1.5% in November. The low inflation rate gave Swiss companies a further competitive advantage on the international marketplace.

The dollar and the oil price as disruptive elements

The foreign exchange and commodity markets experienced the most turbulence in 2004. The US dollar, which had been falling since 2001, accelerated towards the end of the year, when it hit a record low against the euro. Switzerland was affected in much the same way as the other European countries: the Swiss franc appreciated by about 7% against the US currency during the last three months of the year. This development has since improved somewhat.

Despite the dollar's sharp drop over the last few months, its current exchange rate is still higher in real terms than it was in the mid-1990s. The current situation is particularly difficult, however, as a whole series of Asian currencies, including the Chinese renminbi, are pegged to the dollar. The greenback's fall has thus reinforced the competitiveness of numerous emerging markets versus the European economies. For us here in Switzerland it has been positive to note that the nose-diving dollar has not unleashed any speculation on the Swiss franc. The Swiss franc-euro exchange rate has remained remarkably stable at around CHF 1.55 per euro. Since the single European currency was introduced on 1 January 1999, the Swiss franc's nominal appreciation has been more than offset by the inflation differential between Switzerland and the euro area. The competitive position of our exporters has thus improved against their European counterparts.

The dynamism of the Asian economies has boosted demand for commodities, notably oil. The soaring price of this "black gold" continues to pose a serious threat to the recovery of the industrialised economies.

Guardedly optimistic outlook for 2005

As it is benefiting from price stability, low interest rates and a strong competitive position, the Swiss economy is well placed to profit from the world economic upturn. However, the outlook for the global economy in 2005 is not quite as good as it was in the past year: growth is put at around 4%, down from 5% in 2004. Growth will continue to be driven by Asia and America. Europe – and especially Germany, our biggest market – will continue to chug along with a growth rate of between 1.5% and 2%.

In this slightly less dynamic environment, the Swiss economy is unlikely to exceed its 2004 growth figure. Business activity has fallen off slightly since the autumn but should slowly gain momentum again in the next few months. Overall, we are expecting GDP to grow by about 1.5%. The labour market should see a gradual decline in the number of jobseekers in the second half of the year as companies gradually use up the resources currently available.

A much-debated question is the extent to which monetary policy contributes to long-term growth. It would appear that the growth of an economy depends first and foremost on the development of its resources and then on their productivity. Monetary policy cannot change this situation; it can only be vigilant in maintaining a stable framework that is conducive to the efficient development of productive activities.

The National Bank succeeded in doing this in 2004. Moreover, our forecasts suggest that price stability should continue in 2005 and 2006, with inflation averaging around 1%.

Completion of the gold sales

On 31 March, we completed our sales of the 1,300 tonnes of gold no longer required for monetary policy purposes. These sales had begun on 1 May 2000. The fears expressed in some quarters that our gold sales would destabilise the market have proven to be unfounded. By selling the gold in small instalments and according to a fully transparent schedule, we succeeded in assuaging the market's fears. Moreover, our sales strategy and risk hedging also proved effective in financial terms: the 1,300 tonnes of gold were sold at an average price of CHF 16,241 per kilo. This was CHF 700 more than the average market price during the same sales period. An additional profit of more than CHF 900 million was therefore realised.

At the end of the sales programme, the National Bank still held 1,290 tonnes of gold, corresponding to one third of the value of its currency reserves.

Even though it has been demonetised, the yellow metal still plays an important role in our reserves. It is an asset category that traditionally affords good protection in times of crises in the international monetary system. It also allows us to hold part of our reserves on our own country, which is not possible with financial assets. Moreover, as expressly requested by Parliament, Article 99 of the Federal Constitution requires the National Bank to hold part of its currency reserves in gold. The Governing Board considers that the holdings of 1,290 tonnes are appropriate to the current international environment. It does not intend to proceed with further sales of gold.

Distribution of profit

This General Meeting of Shareholders will find a special place in the National Bank's annals, as you are going to decide on how the proceeds of the gold sales are to be distributed. This will close a chapter first opened in 1997, when a group of experts came to the conclusion that the SNB's currency reserves were larger than required for the execution of its mandate and that it could thus consider selling half its gold holdings, once the Swiss franc's gold parity was discontinued.

As you know, the Governing Board adopted the expert group's conclusions and indicated to the Federal Council that, based on the profit figure following revaluation, an amount corresponding to half the gold holdings could be earmarked for purposes other than monetary policy.

The possible uses for the sales proceeds have been the subject of much political debate. None of the proposed solutions have succeeded in attracting a consensus among the population or in the Federal Parliament. On 16 December, the parliamentary debate was concluded without an agreement being reached. Thus, a sum of CHF 21.1 billion, corresponding to the proceeds of the gold sales, has been included in the usual profit distribution procedure.

Some people fear that, following this transfer, the National Bank will no longer have sufficient currency reserves. I have a word of reassurance for them. This issue has been examined in depth and has been discussed by our Bank Council. Our currency reserves total CHF 60 billion – an amount which may be considered appropriate by comparison with other industrialised countries.

But nor are these reserves excessive. Furthermore, it is important that the currency reserves evolve over time, in tandem with the size of our economy. This is why, in accordance with Article 99 of the Constitution and Article 30 of the National Bank Act, the SNB has adopted a provisioning policy that provides for gradual growth in its currency reserves. This year, CHF 885 million have been reserved for this purpose, and similar sums will have to be set aside in the future.

The closing of our accounts for 2004 thus brings with it an extraordinary allocation of profit to the Confederation and the cantons. It is important to emphasise that – paradoxically – the distribution of the CHF 21.1 billion accruing from the gold sales does not actually make them any richer. Up to now, the public sector received the income earned on this capital: a sum of CHF 400 million will also be allocated to them from this source this year. As of the beginning of next year, this income will no longer be distributed. As a result, the Confederation and the cantons will gain in terms of capital, but will lose in terms of transfers of interest income. If they use the proceeds of the gold sales to repay their debts, the reduction in financing charges will correspond approximately to the reduction in the profits paid to them by the SNB.

In net terms, there will be few – if any – additional funds available for new expenditures. It is therefore important that decision-makers at all levels maintain a rational approach.

The KOSA/COSA initiative

The distribution of the gold sale proceeds will not put an end to the political debate about the distribution of the National Bank's profits. Next year, the Swiss electorate will probably be asked to vote on the "KOSA/COSA initiative", which proposes allocating the first billion Swiss francs of our current profit to the cantons, with the balance going to the state Old Age and Survivors' Insurance scheme (AHV/AVS).

The National Bank has consistently taken the line of not intervening in domestic political debates unless the fulfilment of its constitutional mandate is in jeopardy. Two years ago, I mentioned to you that the KOSA/COSA initiative threatened to undermine our autonomy. Linking the National Bank's profits to the financing of a key element in our country's social security system would create a mechanism that would force the SNB to manage its reserves for the purpose of generating the highest possible returns rather than for performing its monetary mandate. This would weaken our international credibility and hence also the credibility of our policies. No other central bank of an industrialised country is faced with a similar situation. All of these banks deliver their profits to the state, and the SNB is no exception.

Our main argument against the KOSA/COSA initiative, however, is that it rests on an illusion – namely, that a central bank is able to transfer profits of over CHF 1 billion every year. Once this illusion has been dispelled, it will become clear that the initiative makes no sense, as nothing would remain for the state pension scheme.

And, as we have often stated in the past, the current disposable profit of CHF 2.5 billion Swiss cannot be sustained. As the President of the Bank Council pointed out just now, our annual disposable profit averages about CHF 1 billion. As this year's negative result shows, it is subject to sharp fluctuations.

The fact that we are now distributing more than this amount is because we are gradually releasing the provision for future profit distributions. This provision amounted to CHF 13.4 billion in 2001, but had dropped to CHF 6.9 billion by the close of our 2004 accounts. This development does not come as a complete surprise. A progressive fall in the provision had been predicted, though the speed of the decline – a result of the current low interest rates – had not been expected. Our profit distribution may already have to be reduced in 2007, when the agreement we concluded in 2002 with the Federal Department of Finance on the distribution of profits is revised. Our profit distributions will gradually decrease towards the CHF 1 billion level.

2004 was a relatively favourable year for the Swiss economy. A few clouds have recently appeared on the horizon. The recovery has unfortunately weakened, so a fall in unemployment is not imminent. We will continue to pursue a monetary policy aimed at maintaining the level of economic activity, though we will keep a careful watch on the general level of prices.

With prices remaining stable, interest rates low and a good level of competitiveness, our economy is well equipped to resume a brisker growth trajectory in line with the global economy.

As in the past, however, the international environment remains fraught with uncertainty at both the economic and monetary level. The independent course steered by the National Bank has made it possible to create a monetary framework conducive to the development of our economy. This success hinges not only on the correct interest rate decisions, but also on the credibility conferred upon us by our autonomy of action and by sufficient resources for intervening in the markets. It is in the nation's interest to preserve this achievement.

Thank you for your attention, and for your interest in the Swiss National Bank and its activities.

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The Phillips curve under state-dependent pricing

Hasan Bakhshi, Hashmat Khan, and Barbara Rudolf

Working Paper no. 2005-1
(identical content as in Bank of England Working Paper no. 227)

Since the 1990s many industrialised economies have witnessed a move to low-inflation environment. In presence of such structural changes the price-setting behaviour of firms may change and affect inflation dynamics. From a policy perspective, therefore, two important issues arise. First, how sensitive are short-term inflation dynamics to such shifts in the economic environment? Second, how well does a Phillips curve based on the assumption of unchanged price-setting behaviour of firms describe inflation dynamics of an economy where this assumption does not hold?

One approach to modelling firms' price-setting behaviour is to assume that firms choose their prices optimally, while the timing of their price changes is exogenous (time-dependent pricing). This approach underlies the New Keynesian Phillips curve (NKPC), which suggests that current inflation is determined by the expectation of next period's inflation and a measure of current economic activity. The time-dependent pricing assumption implies that firms may not adjust the time pattern of their price adjustments in response to changes in macroeconomic conditions. This is hardly plausible if we think of an environment with shifts in trend inflation, for example, and therefore it may limit the value of these models for monetary policy analysis. In response to this problem, approaches with an endogenous timing of price changes have been developed. These approaches allow the firms' time pattern of price changes to respond to the state of the economy (state-dependent pricing).

This paper derives a closed-form solution for short-term inflation using a state-dependent pricing model. The resulting equation is more general than the NKPC and it nests the latter as a special case. It relates inflation to lagged inflation, expected future inflation, and current and expected future real marginal costs. The number of leads and the coefficients are endogenous and depend on the level of steady-state inflation and on firms' beliefs about future adjustment costs associated with price changes. This structural equation is referred to in this paper as the state-dependent Phillips curve (SDPC).

In contrast to the NKPC, the SDPC allows lagged inflation terms to affect current inflation. This is an interesting feature since recent empirical evidence suggests that the NKPC extended by a lagged inflation term provides a better description of inflation dynamics than the purely forward-looking NKPC for several countries. In fact, specifications with lagged inflation terms have been derived before by several authors. But all these studies are based on the assumption of an exogenous timing of price changes.

The paper examines whether a hybrid NKPC (NKPC extended by a lagged inflation term) can adequately describe inflation dynamics of a realistically calibrated state-dependent pricing economy. To explore this issue, artificial data sets for a state-dependent pricing economy are generated based on various calibrations of price adjustment costs under both low and high trend inflation environments. We use these data to estimate the hybrid NKPC and to assess the specification by examining both the estimated coefficients and the correlations between the simulated inflation and the inflation predicted by the hybrid NKPC. The findings suggest that the hybrid NKPC provides a good reduced-form description of inflation dynamics for a wide range of state-dependent pricing behaviours, particularly in the low-inflation environment. The fit of the hybrid NKPC is similar to that reported in the literature for estimations using real-world data. An interpretation of this finding is that the hybrid NKPC may be a good proxy for inflation dynamics implied by more realistic models of price-setting. Consequently, structural interpretation of its parameters may not be straightforward.

Target range for the three-month Libor rate left unchanged

Following its quarterly assessment on 16 June 2005, the Swiss National Bank left the target range for the three-month Libor rate unchanged at 0.25–1.25%. It intends to keep the rate in the middle of the target range at around 0.75% for the time being.

Published by
Swiss National Bank
Economic Affairs
Börsenstrasse 15
P.O. Box
CH-8022 Zurich

Design
Weiersmüller Bosshard Grüninger WBG, Zurich

Composition
Neidhart + Schön AG, Zurich

Internet
www.snb.ch