Press conference

Zurich, 11 December 2008

Introductory remarks by Jean-Pierre Roth

Our assessment of the economic and monetary situation has changed considerably since our last assessment of 18 September 2008. Already back then, we had emphasised that there were substantial risks attached to developments in the global economy, in financial markets and in energy prices. We had also stressed that our forecasts for economic activity and inflation in Switzerland involved considerable uncertainties. We had announced our intention to monitor developments closely, in order to react swiftly should the need arise. As you know, this eventuality did indeed materialise. This led us to relax monetary policy decisively as the uncertainties faded and the deterioration in the economic situation became more concrete. We first lowered the Libor target range on 8 October, by 25 basis points; then on 6 November, by 50 points; and a third time on 20 November, by 100 points. With the new cut announced today, the Libor target range now lies between 0% and 1%, reflecting a firmly expansionary monetary policy. Today's press conference gives me the opportunity to explain in detail the rationale behind our actions.

Since our assessment of 18 September, the situation has changed in three key areas. First, the international economic outlook has deteriorated markedly, impacting heavily on forecasts for the Swiss economy. Second, the financial market crisis has intensified since mid-September. Finally, prices for raw materials and oil have plummeted and this, combined with the worsening of the economic outlook, has led to a marked improvement in the inflation outlook. I will deal with these three points in turn.

Global economic outlook

In September, our main focus was the possibility of sharply contracting growth in the most advanced economies. Now, we know that economic activity will decline simultaneously in the US and Europe, while it will slow appreciably in emerging economies. Whether one can call this a recession or not depends on the definition used, and is now merely a question of semantics.

In the US, GDP is likely to decline substantially during the current quarter, following its slight contraction in the third quarter. Industrial production, which had hitherto been remarkably stable, fell sharply by 4% between July and October. Moreover, unemployment, which had also been stable for some time, rose rapidly, reaching 6.7% in November – a level not seen since 1994.

The sudden worsening of the situation is above all due to the fall in household spending. Households saw their financial situation deteriorate sharply due to the loss in value of their real estate and financial assets, while also suffering – until recently – a progressive erosion of their purchasing power through the continuous rise in fuel prices. Although fuel prices have since receded, the effects of the price correction in the real estate sector – the root cause of the financial crisis – as well as the fall in stock market prices continue to be felt.

In Europe in the third quarter, GDP recorded a second successive fall. Despite the recent depreciation of the euro, exports have been hit by the slowdown in global demand. This is especially true of Germany, which is highly export-dependent. By prompting a revision of plans to expand production capacity, first in the export industry and then in the upstream production chain, the fall in exports has led to a downturn in demand for equipment investment. Moreover, in some countries, for instance Spain and Ireland, construction activity has been affected by a significant correction in property prices.

The picture is more mixed in Asia. Japan and some emerging economies in the region will probably not be able to escape a brief recession, but on the whole economic activity should continue to advance, albeit less strongly than previously expected. In addition, the emerging economies in Latin America and Eastern Europe, which until now have been heavily dependent on capital inflows, could experience a marked slowdown in growth.

Thus, what was merely a risk scenario at our September assessment is now becoming reality. The advanced economies have more or less moved into recession simultaneously. The crisis in the financial sector has finally spread to the rest of the economy. With the decline in global demand, prices for food, raw materials and oil have fallen sharply. This is the positive flipside of the coin, since this development will boost real incomes and consumption in most countries.

Swiss economic outlook

The Swiss economy is of course affected by this worsening of the international environment. At our September assessment, we were still projecting a marked slowdown in activity, but with growth remaining positive in 2009. We are now forecasting that GDP growth will be negative, not only during the first two quarters of next year, but also on average for 2009 as a whole. With the probable exception of consumption, all demand components should decline.

Exports of equipment goods, demand for which is known to be cyclical, will be affected. In most countries, difficulties in sales and distribution, on the one hand, and restrictions on lending conditions, on the other hand, have prompted a downward revision of investment plans. The US and Europe are cases in point, but a loss of momentum is also being observed in emerging markets. These developments will weigh heavily on our exports of equipment and intermediate goods. The substantial decline in demand for vehicles made by US and European manufacturers will also impact on their Swiss-based suppliers. The metals, machinery and electronics industry was the first to experience a sharp correction in new orders.

The worsening outlook for sales will lead to an adjustment of investment plans in Switzerland as well. Domestic demand for equipment goods could even turn out to be the most severely affected component of final demand. Developments have been slightly different for the construction sector and its most important component, residential investment. Housing construction has been in decline for the past few years, although the cut in interest rates could now halt this trend.

All these factors have brought about a sharp deterioration in business confidence, which should put a damper on job creation in our country. Unemployment will start to rise again.

Consumption should continue to grow, but at a considerably slower pace. The household sentiment indicator was sharply down at the beginning of the fourth quarter, reflecting expectations of greater job insecurity. In contrast, the unexpected fall in inflation will contribute to an increase in real income, which will support consumption.

For 2009 as a whole, the SNB is forecasting a decline in real GDP. This decline is likely to lie between 0.5% and 1%.

Changes in monetary and financial conditions

As I mentioned in my opening remarks, the target range for the three-month Libor has already been cut by 175 basis points in three steps since our September assessment. These successive cuts were rendered necessary by a number of factors that contributed to a tightening of monetary conditions, whereas the deteriorating general economic environment called for relaxation. I need only mention, in this regard, the brief but rapid ascent of the Swiss franc in October, or the surge in credit risk premia on the bond markets. These movements have since been partly reversed, but tensions remain. These remarks serve to illustrate a more general observation: unfavourable economic developments combined with a financial crisis can impair the transmission of monetary policy, and hence compromise its effectiveness. The expansionary effect of an interest rate cut can be diluted. When confronted with such a risk, monetary authorities have to take rapid and decisive action in order to exert the desired influence on final demand. This is what we have done over the past few months.

In order to monitor lending conditions since the outbreak of the financial crisis, the SNB has been conducting regular surveys of the 20 major Swiss banks. By providing us with information on these banks' intentions and expectations, the survey complements the analysis of lending volumes. In the vast majority of the institutions surveyed, no lending restrictions were announced in the third quarter. Only 15% of the banks reported that their lending practice had become slightly more restrictive.

Data for October on lending volumes in Switzerland confirm this picture. Mortgage lending is growing steadily, most recently at a rate of 3.4%. Growth in other lending remains strong, albeit advancing at a slightly slower pace. Large companies have increasingly drawn down their lines of credit, owing to difficulties in sourcing financing on the capital markets. All in all, there is, at present, no reason to speak of a credit crunch. However, this favourable situation could soon worsen, as has been observed in other countries.

I will now conclude this second section with a few brief remarks on movements in monetary aggregates. Having declined until recently, monetary aggregates are now rising slightly. Following the interest rate cuts, we expect that growth in monetary aggregates will gather pace over the coming months. Given the current heavy demand for liquidity, higher money growth does not, of itself, indicate an increase in inflation risks. Only if money growth were to become excessive over a longer period would this pose a threat to price stability in the medium term.

Inflation outlook

In addition to the rapid worsening of the global economy and the financial crisis, the third factor behind our policy of successive rate cuts since October is the radical change in the inflation outlook. Inflation risks have largely dissipated since our last quarterly assessment on 18 September, leaving considerable room for manoeuvre in monetary policy, which we have firmly exploited.

As you know, last December inflation breached the 2% ceiling above which the SNB considers that the conditions for price stability are no longer met. The rapid rise in inflation – indeed, at the beginning of 2007, we still had zero inflation – was due to the combined effect of a virtually unbroken rise in oil prices and the healthy state of the economy. In July this year, inflation reached 3.1%, a level not seen for 15 years. This was a matter for concern, as there was a risk that such a level would alter households' inflation expectations, potentially leading to a sharp rise in nominal wages at year-end and resulting in a certain stickiness of inflation.

However, these two elements behind the recent rise in inflation have since reversed. First, oil prices collapsed, falling below the USD 50 mark in mid-November after peaking at USD 145 in early July. The plummeting oil price can be explained both by a drop in global demand as a result of the economic slowdown we have just described, and by the unwinding of speculative positions. Second, the Swiss economy will soon be operating below potential, and we will see a renewed rise in unemployment. This situation will have a moderating effect on both price and wage-setting behaviour.

Thus, we are now forecasting – as the graph presentation will show in just a moment – that inflation will decline almost continuously throughout 2009. Despite the interest rate cuts made since October and the cut announced today, inflation will remain low in 2010 and 2011. As of now, and for the current forecast horizon, upside and downside inflation risks have become symmetrical.

Monetary policy decision

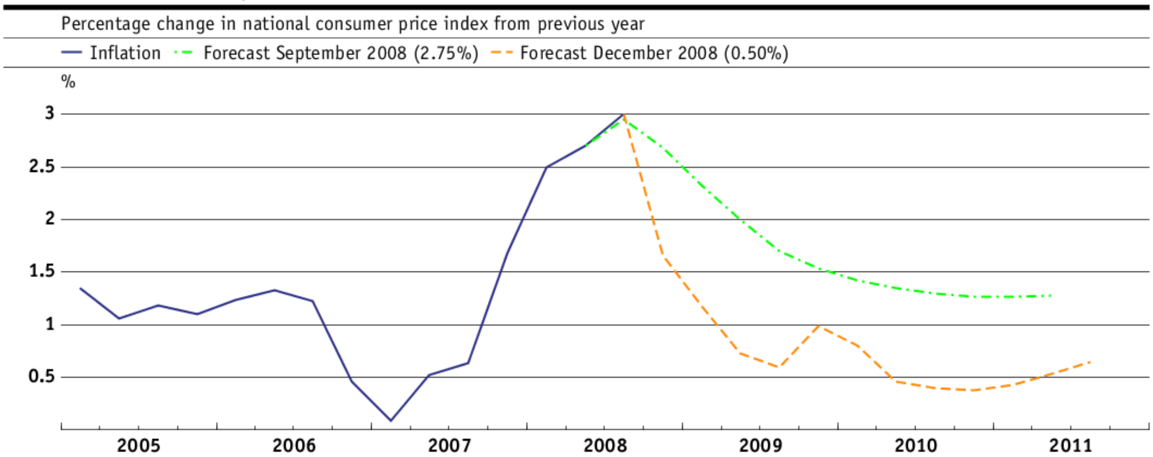
We have just explained the rationale behind our recent monetary policy: first, the global economic situation has worsened, which will hit the Swiss economy as from this quarter, and in particular next year. By contrast, the inflation outlook has improved appreciably. This has increased the SNB's room for manoeuvre. Finally, there is a risk that the financial crisis will cause a deterioration in financing conditions for the economy as a whole. These are the considerations that have prompted today's decision to cut the three-month Libor target range by another 50 basis points. Given the expected deterioration in the Swiss economy and the imponderables linked to the long and variable monetary policy transmission lags, a further rate cut appears appropriate. With this action we are reducing, to the extent possible, the risk of an even more pronounced economic downturn.

Inflation forecast chart

How has our inflation forecast been revised? The dashed red curve on the chart represents the new forecast. It covers the period from the fourth quarter of 2008 to the third quarter of 2011, and maps the future development of inflation on the assumption that the three-month Libor remains unchanged at 0.5% over the forecasting period. For purposes of comparison, the dash-dotted green curve shows the inflation forecast of the September monetary assessment, based on a three-month Libor of 2.75%.

The new forecast shows a rapid fall in inflation over the next few quarters. It drops back below the 2% mark as from the fourth quarter of this year. In the light of economic developments, it will continue to decline until the end of the third quarter of 2009, and will then rise slightly over the next two quarters as a result of the base effect caused by oil price movements. Inflation will subsequently fall even further, to lie around 0.5% in 2010, before increasing somewhat over the course of 2011. This slight uptick in inflation at the end of 2011 is explained by the fact that a Libor of 0.5% does not represent an equilibrium level capable of guaranteeing price stability in the long term.

Inflation forecast of September 2008 with Libor at 2.75% and of December 2008 with Libor at 0.50%



Observed inflation December 2008

	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2005	2006	2007
Inflation	1.35	1.06	1.18	1.10	1.23	1.33	1.22	0.46	0.09	0.52	0.63	1.68	2.50	2.70	3.00		1.2	1.1	0.7

Inflation forecast of September 2008 with Libor at 2.75% and of December 2008 with Libor at 0.50%

	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2008	2009	2010
Forecast September 2008, Libor at 2.75%			2.96	2.69	2.32	2.00	1.70	1.54	1.42	1.35	1.30	1.27	1.27	1.28			2.7	1.9	1.3
Forecast December 2008, Libor at 0.50%				1.66	1.17	0.73	0.59	0.99	0.80	0.45	0.40	0.38	0.43	0.54	0.64		2.5	0.9	0.5