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Swiss National Bank
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Overview

Monetary policy assessment (p. 8)

On 18 September 2003, the Swiss National Bank decided to leave the target range for the three-month Libor rate at 0%–0.75%. For the time being, the three-month Libor is to be kept at the lower end of the target range at 0.25%. Notwithstanding positive signals, global economic development is still subject to certain risks. In Switzerland, a perceptible economic upswing is only to be expected in the course of 2004.

Economic and monetary developments (p. 12)

During the second quarter of 2003, the prospects for a revival of the global economy improved. With the end of the war in Iraq, sentiment in many countries became more upbeat. In the US, economic growth accelerated; Japan and the United Kingdom, too, again exhibited stronger growth. Real GDP, by contrast, once more declined slightly in the euro area. After mid-year, signs of an economic pickup, however, became increasingly evident there, too.

The improved outlook diminished the risk of the economy sliding into deflation. Conversely, there were no signs of an imminent inflationary threat, either. This left the central banks with sufficient leeway to continue underpinning the economy with low interest rates. In July and August, various central banks relaxed their monetary policy further following another round of base rate cuts by the European Central Bank and the US Federal Reserve in June.

In Switzerland, real GDP declined yet further in the second quarter; year-on year, it fell by 1.0%. While private and government consumption continued to support the economy, investment and exports receded once more. At the beginning of the third quarter, the economic situation began to look brighter in Switzerland. In the export sector the order position improved. Stimulated by low interest rates, residential construction picked up while the situation of the financial sector strengthened in the course of the recovery on the financial markets. The economic recovery, which is now becoming discernible, is still fragile, however. The unemployment rate and the rate of jobseekers moved up to 3.9% and 5.5% respectively (seasonally-adjusted) by August. A more broadly supported recovery, which will also lead to an improvement in the labour market situation, can only be expected in the coming year.

The National Bank continued its expansionary monetary policy from June to August, with short-term money market rates still close to zero percent. Whereas the price of the euro in Swiss francs fluctuated between CHF 1.53 and CHF 1.56, the US dollar made significant gains, signalling a return to more favourable monetary conditions. With long-term interest rates rising worldwide, yields in Switzerland have also firmed since June, and the stock markets continued to recover.

The decoupling of rents from mortgage rates: implications of the rent law reform for monetary policy (p. 44)

This research paper uses simulations run on the SNB's econometric macro model to examine the probable monetary policy implications of the rent law revision adopted in December 2002 by the National Council and Council of States. The rent law that is currently still in effect links residential rents to mortgage rates via a transmission algorithm. This coupling of mortgage rates to rents is problematic from the point of view of monetary policy, because a tightening of the monetary reins leads to a rise in the general interest level and, with it, mortgage rates and thus rents. As rents carry a 20% weighting in the consumer price index, consequently feeding into companies' production costs via wage-setting, the reduction in inflation that a restrictive monetary policy is intended to achieve is soon counteracted almost entirely by a rise in the rate of rent inflation. This undesirable countereffect is eliminated by the new law, which foresees the coupling of residential rates to the consumer price index. It will thus be possible to achieve a certain reduction in the rate of inflation with a small rise in interest rates and consequently a smaller loss of growth in real terms. The proposed revision of the rent law is therefore to be regarded as positive in comparison to the regulations currently in force.

Übersicht

Geldpolitische Lagebeurteilung (S. 8)

Die Nationalbank beschloss am 18. September 2003, das Zielband für den Dreimonats-Libor bei 0%–0,75% zu belassen. Der Dreimonats-Libor soll weiterhin im unteren Bereich des Zielbandes bei 0,25% gehalten werden. Die weltwirtschaftliche Entwicklung unterliegt trotz positiver Signale immer noch Risiken. In der Schweiz ist mit einem spürbaren Konjunkturaufschwung erst im Verlaufe von 2004 zu rechnen.

Wirtschafts- und Währungslage (S. 12)

Im Laufe des zweiten Quartals 2003 besserten sich die Aussichten auf eine Belebung der Weltkonjunktur. Mit dem Ende des Irak-Krieges hellte sich die Stimmung in vielen Ländern auf. In den USA beschleunigte sich das Wirtschaftswachstum; auch Japan und das Vereinigte Königreich wiesen wieder ein stärkeres Wachstum auf. Dagegen bildete sich das reale Bruttoinlandprodukt im Euro-Gebiet nochmals leicht zurück. Nach der Jahresmitte mehrten sich jedoch auch dort die Zeichen einer Konjunkturerholung.

Mit den sich bessernden Konjunkturaussichten verringerte sich das Risiko eines Abgleitens in eine Deflation. Umgekehrt deutete nichts auf eine unmittelbare Teuerungsgefahr hin. Dies liess den Zentralbanken Spielraum, die Konjunktur weiterhin durch tiefe Zinssätze zu stützen. Im Juli und August lockerten verschiedene Zentralbanken ihre Geldpolitik weiter, nachdem im Juni die Europäische Zentralbank und die amerikanische Zentralbank ihre Leitzinsen nochmals zurückgenommen hatten.

In der Schweiz nahm das reale Bruttoinlandprodukt im zweiten Quartal nochmals ab; im Vorjahresvergleich sank es um 1,0%. Während der private und der staatliche Konsum die Konjunktur weiter stützten, bildeten sich die Investitionen und die Exporte nochmals zurück. Zu Beginn des dritten Quartals begann sich auch in der Schweiz die Konjunktur aufzuhellen. Im Exportsektor verbesserte sich die Auftragslage. Stimuliert durch die tiefen Zinssätze zog die Wohnbautätigkeit an und die Lage des Finanzsektors hellte sich im Zuge der Erholung an den Finanzmärkten auf. Die sich abzeichnende Konjunkturerholung ist jedoch noch fragil. Die Arbeitslosenquote und die Quote der Stellensuchenden stieg bis August auf 3,9% bzw. 5,5% (saisonbereinigt). Mit einer breiter abgestützten Erholung, die auch zu einer Verbesserung der Arbeitsmarktlage führt, ist erst im nächsten Jahr zu rechnen.

Die Nationalbank setzte in den Monaten Juni bis August ihre expansive Geldpolitik fort; die kurzfristigen Geldmarktsätze lagen weiterhin nahe bei null Prozent. Während sich der Frankenkurs des Euro zwischen 1,53 und 1,56 Franken bewegte, gewann der Dollar deutlich an Wert, so dass die monetären Bedingungen nochmals günstiger wurden. Im Zuge der weltweit steigenden langfristigen Zinssätze zogen auch die Renditen in der Schweiz seit Juni an und die Aktienmärkte erholten sich weiter.

Entkoppelung der Mieten vom Hypozins – Implikationen der Mietrechtsrevision für die Geldpolitik (S. 44)

Dieser Aufsatz untersucht die voraussichtlichen geldpolitischen Implikationen der im Dezember 2002 von National- und Ständerat verabschiedeten Mietrechtsrevision anhand von Simulationen mit dem ökonometrischen Makromodell der SNB. Unter dem zurzeit noch geltenden Mietrecht sind die Wohnungsmieten gemäss einer Überwälzungsregel an die Hypothekarzinsen gekoppelt. Diese Hypozinsbindung der Mieten ist aus geldpolitischer Sicht problematisch. Bei einer Straffung der Geldpolitik steigen mit dem allgemeinen Zinsniveau auch die Hypozinsen und damit die Mieten. Da diese mit einem Gewicht von 20% in den Konsumentenpreisindex und in der Folge über die Lohnbildung in die Produktionskosten der Unternehmungen eingehen, wird die mit der restriktiven Geldpolitik angestrebte Inflationsdämpfung durch den Gegeneffekt der steigenden Mietteuerung in der kurzen Frist fast zunichte gemacht. Mit der neu vorgesehenen Koppelung der Wohnungsmieten an den Konsumentenpreisindex entfällt dieser störende Gegeneffekt. Ein bestimmter Abbau der Inflationsrate lässt sich folglich mit einer geringeren Zinsanhebung und somit auch mit einem kleineren realen Wachstumsverlust verwirklichen. Hinsichtlich der Wirksamkeit der Geldpolitik ist die vorgeschlagene Mietrechtsrevision im Vergleich zur geltenden Regelung somit positiv zu werten.

Sommaire

Appréciation de la situation économique et monétaire (p. 8)

Le 18 septembre 2003, la Banque nationale a décidé de laisser inchangée à 0%–0,75% la marge de fluctuation du Libor à trois mois. Ce dernier sera maintenu dans la zone inférieure de la marge de fluctuation, soit autour de 0,25%. Bien que des signaux positifs soient observés, des risques pèsent encore sur l'évolution de l'économie mondiale. En Suisse, une reprise sensible de la conjoncture n'interviendra qu'au cours de l'année 2004.

Situation économique et monétaire (p. 12)

Les perspectives de reprise de la conjoncture mondiale sont devenues plus favorables au cours du deuxième trimestre de 2003. Après la fin de la guerre en Irak, le climat s'est amélioré dans nombre de pays. La croissance économique s'est accélérée aux Etats-Unis; le Japon et le Royaume-Uni ont eux aussi affiché une expansion plus forte. Par contre, le produit intérieur brut réel a encore reculé légèrement dans la zone euro. Les signes d'une reprise de la conjoncture se sont toutefois multipliés, au sein de cette zone également, à partir du milieu de l'année.

Le risque d'un basculement dans la déflation s'est réduit grâce à l'amélioration des perspectives conjoncturelles. D'un autre côté, rien n'incitait à penser qu'un danger inflationniste était imminent. Les banques centrales ont ainsi bénéficié d'une marge de manœuvre pour continuer à soutenir la conjoncture par des taux d'intérêt bas. En juillet et en août, plusieurs banques centrales ont continué à assouplir leur politique monétaire, après le nouvel abaissement, en juin, des taux directeurs de la Banque centrale européenne et de la Réserve fédérale des Etats-Unis.

En Suisse, le produit intérieur brut réel s'est encore replié au deuxième trimestre; en comparaison annuelle, il a diminué de 1%. Alors que la consommation privée et publique a continué à soutenir la conjoncture, les investissements et les exportations ont marqué un nouveau recul. En Suisse également, l'horizon conjoncturel s'est éclairci au début du troisième trimestre. Les commandes ont progressé dans la branche exportatrice. La construction de logements a gagné en vigueur grâce aux taux d'intérêt bas, et la situation du secteur financier s'est améliorée dans le sillage de la reprise des marchés des actions. Mais le rétablissement conjoncturel qui se dessine est encore fragile. Le taux de chômage et celui des demandeurs d'emploi ont augmenté pour atteindre respectivement 3,9% et 5,5% en août (après correction des variations saisonnières). Ce n'est qu'à partir de l'année prochaine qu'on pourra observer une croissance économique reposant sur une plus large assise et, partant, une amélioration de la situation sur le marché du travail.

De juin à août, la Banque nationale a poursuivi sa politique monétaire expansionniste; les taux d'intérêt à court terme sur le marché monétaire sont restés proches de 0%. L'euro a fluctué entre 1,53 et 1,56 franc, tandis que le dollar s'est nettement revalorisé. De ce fait, les conditions monétaires se sont encore améliorées. Dans le sillage de la hausse des taux d'intérêt à long terme dans le monde, les rendements ont progressé sensiblement sur le marché suisse des capitaux, depuis le mois de juin, et les cours des actions ont continué à se redresser.

Découplage entre loyers et taux hypothécaire: implications de la révision du droit du bail pour la politique monétaire (p. 44)

L'article examine, par le biais de simulations du modèle macroéconométrique de la BNS, les probables implications de la révision du droit du bail, adoptée par le Parlement en décembre 2002, pour la politique monétaire. Sous le régime du droit du bail en vigueur, les variations du taux hypothécaire sont reportées sur les loyers selon une règle bien précise. Ce lien pose problème sous l'angle de la politique monétaire. Lors d'un durcissement de celle-ci, la hausse du niveau général des taux d'intérêt s'accompagne d'une augmentation du taux hypothécaire et, partant, des loyers. Comme ces derniers ont une pondération de 20% dans le calcul de l'indice des prix à la consommation (IPC) et que celui-ci se répercute dans les frais de production des entreprises par l'intermédiaire des salaires, le recul de l'inflation visé par un durcissement de la politique monétaire est à court terme voué à l'échec. Grâce à l'indexation prévue des loyers sur l'IPC, cet effet perturbant est éliminé. Ainsi, une réduction du taux d'inflation est obtenue par un plus faible relèvement des taux d'intérêt ayant pour conséquence un fléchissement inférieur de la croissance. Du point de vue de l'efficacité de la politique monétaire, la révision prévue du droit du bail peut être considérée comme positive par rapport à la réglementation en vigueur.

Sommario

Valutazione della situazione economica e monetaria (p. 8)

Il 18 settembre 2003, la Banca nazionale ha deciso di mantenere il margine di oscillazione del Libor a tre mesi allo 0–0,75%. L'istituto di emissione intende lasciare il Libor a tre mesi nella zona inferiore di questa fascia, allo 0,25%. Nonostante i primi segnali positivi, continuano infatti a sussistere importanti rischi per l'evoluzione economica mondiale. In Svizzera, una ripresa congiunturale sensibile è attesa soltanto nel corso del 2004.

Situazione economica e monetaria (p. 12)

Le prospettive di rilancio della congiuntura mondiale sono migliorate durante il secondo trimestre del 2003. In diversi Paesi, il quadro delle aspettative economiche si è rasserenato al termine della guerra in Iraq. La crescita economica negli Stati Uniti si è accelerata, mentre in Giappone e Gran Bretagna è risultata più consistente. Nell'area dell'euro, invece, il prodotto interno lordo ha subito un'ulteriore leggera contrazione. A partire dalla seconda metà dell'anno, i segni di ripresa si sono tuttavia moltiplicati anche in questa regione.

Con il miglioramento delle prospettive economiche i rischi di deflazione si sono ridotti. Nel contempo, nulla indica che sussista un pericolo d'inflazione imminente. Le banche centrali hanno potuto disporre di margini di manovra per continuare a sostenere la congiuntura con bassi tassi d'interesse. In giugno, la Banca centrale europea e la banca centrale degli Stati Uniti hanno ulteriormente ridotto i loro tassi ufficiali, seguite in luglio e agosto da diverse banche centrali.

In Svizzera, il prodotto interno lordo reale ha subito, durante il secondo trimestre, un ulteriore calo, dell'1,0% rispetto all'anno precedente. Mentre i consumi privati e pubblici hanno continuato a sostenere la congiuntura, gli investimenti e le esportazioni si sono ulteriormente contratti. All'inizio del terzo trimestre si sono manifestati i primi segni di un miglioramento congiunturale anche nel nostro Paese. Il settore delle esportazioni ha beneficiato di una crescita delle ordinazioni, il settore delle costruzioni residenziali ha tratto impulso dal basso livello dei tassi d'interesse e la situazione nel settore finanziario è migliorata in seguito alla ripresa dei mercati finanziari. La ripresa congiunturale che si delinea rimane tuttavia fragile. In agosto, il tasso di disoccupazione è salito al 3,9% e la quota delle persone alla ricerca di un'occupazione al 5,5% (valori destagionalizzati). Per l'anno prossimo si prevede una ripresa fondata su più ampie basi con un conseguente miglioramento della situazione sul mercato del lavoro.

Da giugno ad agosto, la Banca nazionale ha mantenuto una politica monetaria espansiva, con tassi a breve pressoché nulli. Se il corso del franco rispetto all'euro è oscillato tra 1,53 e 1,56, il dollaro statunitense si è nettamente apprezzato, influendo positivamente sulle condizioni monetarie. Sulla scia dell'aumento generalizzato dei tassi d'interesse a lungo termine, a partire dal mese di giugno i rendimenti sono pure cresciuti in Svizzera. La ripresa dei mercati azionari è proseguita.

Scindere le pigioni dal tasso ipotecario – Conseguenze della revisione del diritto di locazione per la politica monetaria (p. 44)

Sulla base di simulazioni svolte con il modello macro-econometrico della BNS, quest'articolo esamina le probabili implicazioni di politica monetaria della revisione del diritto di locazione decretata dalle Camere federali. Secondo il diritto vigente, gli affitti vengono adeguati alle variazioni dei tassi ipotecari. Dal punto di vista monetario, questa relazione tra pigioni e tassi ipotecari è problematica. In un contesto di politica monetaria restrittiva, l'aumento generale dei tassi d'interesse implica un aumento dei tassi ipotecari e quindi delle pigioni. Poiché queste ultime rientrano nel computo dell'indice dei prezzi al consumo con una quota del 20%, esse influiscono attraverso la determinazione dei salari i costi di produzione delle imprese. L'effetto frenante che la politica monetaria restrittiva dovrebbe esercitare sull'inflazione è quindi quasi interamente neutralizzato, a breve termine, dall'aumento dei prezzi di locazione. Il progetto di revisione prevede invece di indicizzare le pigioni all'indice dei prezzi al consumo, evitando in tal modo questo spiacevole effetto. Una determinata riduzione del tasso d'inflazione potrà quindi essere ottenuta con un aumento dei tassi inferiore rispetto al passato, permettendo così di ridurre le conseguenze negative sulla crescita reale. Dal punto di vista dell'efficacia della politica monetaria, la revisione proposta del diritto di locazione è da valutarsi in modo positivo.

Monetary policy assessment

Press release on the quarterly assessment of the situation of 18 September 2003

Libor target range left unchanged at 0%–0.75%

In its monetary policy assessment of 18 September 2003, the Swiss National Bank decided to leave the target range for the three-month Libor rate unchanged at 0.0% to 0.75% and to continue to keep the three-month Libor rate at the lower end of the corridor at 0.25%. Since March 2001, the National Bank has eased its monetary policy substantially, lowering the target range for the three-month Libor in seven steps by a total of 3.25 percentage points. Due to the favourable course of inflation, it was in this way able to react effectively to the decline in economic growth and the upward trends of the Swiss franc. The most recent interest rate reduction of 0.5 percentage points was effected on 6 March 2003.

Notwithstanding positive signals emanating from the US, global economic development is still subject to risks. In Switzerland, a perceptible economic upswing is only to be expected in the course of 2004. The National Bank is adhering to its expansionary monetary policy. The low interest rates are designed to continue keeping Swiss franc investments fairly unattractive. Price stability is currently not threatened. Assuming that the three-month Libor rate will remain stable at 0.25%, average annual inflation is expected to amount to 0.5% this year, 0.2% next year, and 1.0% in 2005. All in all, the National Bank is expecting a moderate decline in real economic activity for 2003.

Economic activity

In Switzerland, real gross domestic product declined again in line with expectations in the second quarter of 2003, and the situation on the labour market deteriorated further. The unsatisfactory economic situation is primarily the result of the stagnating development in Europe. Despite more favourable exchange rate conditions, Swiss exports again fell in the second quarter. Consumer spending had a stabilising effect while investments continued to decline overall.

The economic situation in Switzerland is still difficult at present; it is, however, set to improve gradually. Orders received and the order backlog in industry still fall short of the desired level, and demand for export goods continues to be modest. Consumer sentiment, too, remains at a low level. Nevertheless, there are signs that the trough was reached in the second quarter and that a gradual revival will set in towards the end of 2003. These positive signs include improved corporate expectations, a pickup in residential construction and the change in sentiment on the financial markets. Since the economic recovery will remain very modest until the end of 2003, a moderate decline in real economic activity is to be expected on average in the current year.

With exports rising gradually, followed by an increase in equipment investment, the economic upswing in Switzerland should take hold next year. Unemployment, however, is likely to rise still higher for the time being, and consumption will therefore remain weak. An improvement in the labour market is expected only in the course of 2004.

Inflation forecast

Year-on-year inflation, as measured by the national consumer price index, dropped to 0.5% in the second quarter of 2003 from 1.0% in the first quarter. In July, it contracted to 0.3% and amounted to 0.5% in August. The declining trend of inflation is due mainly to the weakening of economic activity in Switzerland and abroad. Domestic inflation has eased markedly in the past few months. Notably, inflation in the private service sector has receded. Only rents recorded a slight increase in August. Price rises for foreign goods remain very low and also volatile due not least to the fluctuating oil price. The core inflation rate calculated by the National Bank currently amounts to 0.7%.

The graph shows the inflation forecast of June 2003 (the dash-dotted red curve in the graph) as well as the new forecast of September 2003 (dashed red curve). The assumptions on which the new forecast is based differ in various respects from those in June. For one thing, already in the current year, growth in the US will be higher than expected at the time and, consequently, the production gap of the US economy is likely to close by the end of 2004. For another, Europe will suffer another slight delay in the upswing, which will be less marked overall. The European economy will reach its production potential only in the course of 2005. Besides, in the coming years, inflation in Europe is likely to be lower than previously anticipated. The forecast is, moreover, based on the expectation that the oil price will diminish to approximately $25 per barrel in the course of 2004.

On the assumption that the three-month Libor rate will remain steady at 0.25% during the next three years, average inflation should, according to the new forecast, amount to 0.5% in the current year, drop to 0.2% in 2004 and climb to 1.0% in 2005. It is thus projected to remain below 1% until mid-2005. Subsequently, an acceleration will set in and forecast inflation will reach 2.8% in the second quarter of 2006.

Until the beginning of 2006, the inflation trend according to the new forecast will fall short of that projected in June. In the next few quarters, inflation will drop to close to 0% and might even temporarily be slightly negative. This is the result of the weak economic growth in Switzerland, the generally moderate price pressure abroad and the expected decline in the oil price.

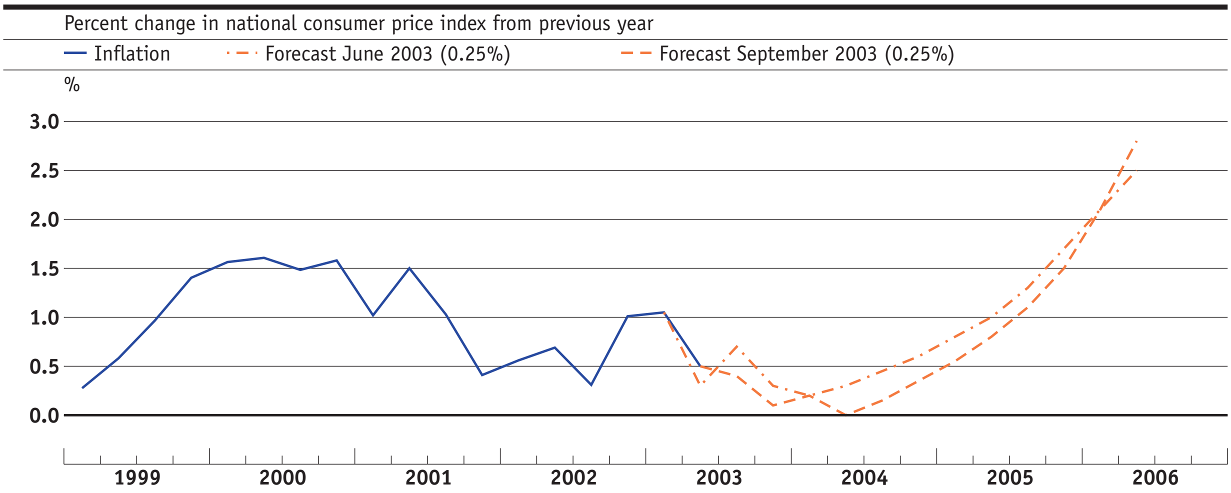
Such a development may not, however, be seen as deflation. The anticipated decline in inflation is very limited as regards both duration and extent. Already from mid-2004 onwards, inflation rates must be expected to rise again. Moreover, falling inflation will not be accompanied by a deterioration in real economic activity; on the contrary, for this period a pickup in growth is to be expected.

Given the considerable time lag with which monetary policy takes effect, the current monetary policy course has little influence on the trend of inflation in the next few quarters. The inflation forecast, however, shows that based on the present expansionary monetary policy, inflation threatens to exhibit a trendlike acceleration from mid-2005 onwards. In 2006, it would no longer be in the range that the National Bank equates with price stability. It should be noted that the forecast is based on the assumption that the key interest rate will remain unchanged over the next three years. Through a tightening of monetary policy at a later stage, the rise in inflation can be slowed. It is also important to understand that the uncertainty of the forecast increases with the duration of the forecasting horizon.

Continuation of expansionary monetary policy

In the past two years, the National Bank has adopted a decidedly expansionary monetary policy. Following the last interest rate reduction in March of this year, the Swiss franc depreciated considerably. Subsequently, monetary conditions were relaxed further. The expansionary monetary policy is also reflected in a marked increase in the money supply. At the same time, there is still considerable uncertainty concerning the economic recovery in Switzerland. The National Bank is watching the expansion of liquidity carefully. Its aim, however, is to prevent a premature changeover to a more restrictive monetary policy, which would endanger the upswing in Switzerland. It will thus continue to conduct an expansionary monetary policy and to support the recovery of the real economy. Investments in Swiss francs must be kept unattractive. As in the past, the National Bank would lead a determined fight against an undesirable tightening of monetary conditions caused by a possible marked appreciation of the Swiss franc vis-à-vis the euro.

Inflation forecast of June 2003 with Libor at 0.25% and of September 2003 with Libor at 0.25%



Inflation Forecast September 2003 with Libor at 0.25%	2003	2004	2005
Annual average inflation in %	0.5	0.2	1.0

Economic and monetary developments in Switzerland

Report to the attention of the Governing Board for its quarterly assessment of the situation and to the attention of the Bank Council.

The report was passed on 18 September 2003.
Data which became available at a later date has been included whenever possible. Unless indicated otherwise, quarter-on-quarter comparisons are based on data adjusted for seasonal and random variations.

1 International environment

During the second quarter of 2003, the prospects for a revival of the global economy improved. With the end of the war in Iraq, sentiment in many countries became more upbeat. The respiratory disease SARS, which had crippled parts of the economy in East Asia and dealt a severe blow to international tourism, was brought under control. Stock markets climbed once again thanks to the improved financial situation at many companies. At around mid-year, producer and consumer sentiment also started to brighten and order intake picked up.

The improved outlook diminished the risk of the economy sliding into deflation. Conversely, there were no signs of an imminent inflationary threat, either. This left the central banks with sufficient leeway to continue underpinning the economy with low interest rates. In July and August, various central banks relaxed their monetary policy further following another round of base rate cuts by the European Central Bank (ECB) and the US Federal Reserve in June.

1.1 Economic activity

Stronger growth in the United States ...

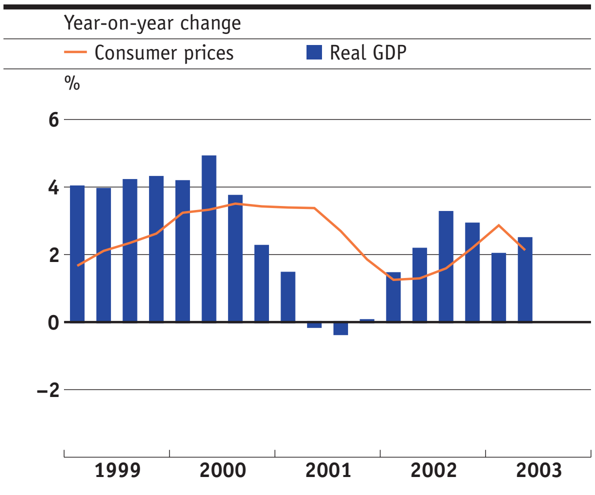
The US economy experienced the most significant improvement, with real gross domestic product (GDP) rising by 3.1% in the second quarter compared with the previous period after an annualised 1.4% in the first three months of the year. Momentum was added mainly by private and government spending. Buoyed by favourable financing conditions, corporate investment recovered as well while exports continued to suffer from weak foreign demand.

The tax cuts which came into effect at mid-year are likely to have further stimulated the US economy during the third quarter. Industrial production increased in July, having contracted in the second quarter. The order intake rose and producer sentiment was more upbeat. Consumer confidence, however, improved only marginally, reflecting the relentlessly difficult situation on the labour market. Unemployment ran at 6.2% in July, unchanged from the second quarter.

... and in the United Kingdom

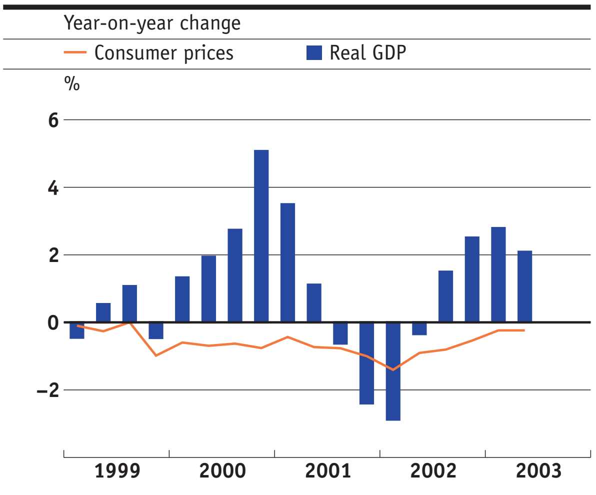
In the United Kingdom, too, the economy gathered steam in the second quarter. Driven by the revival of private and government spending, real GDP advanced by an annualised 1.4%, compared with 0.4% in the previous period. The jobless rate decreased up to the second quarter, ultimately coming in at 5.0%. Economic prospects improved further. Leading indicators suggest that in the second half of the year both investments and – owing to the fall in sterling – exports will have risen.

USA — Graph 1.1



Source: Bank for International Settlements (BIS)

Japan — Graph 1.2



Source: BIS

Economic revival in Japan surprisingly vigorous

In the second quarter, Japan's real GDP grew considerably faster than expected, i.e. at an annualised rate of 3.9% against 2.5% in the first quarter. The recovery was driven by domestic demand as well as exports, which benefited from lively demand especially from the United States and China. Moreover, imports shrank as a result of SARS, which had led to a distinct decrease in foreign travel. The rate of unemployment, however, held steady at 5.4% – a high level for Japan.

Leading indicators point to a further – albeit probably subdued – pick-up in the economy. The labour market situation remains difficult, which is likely to put a damper on private consumption in particular. The structural problems that persist in various sectors of the economy are also having a slowing effect.

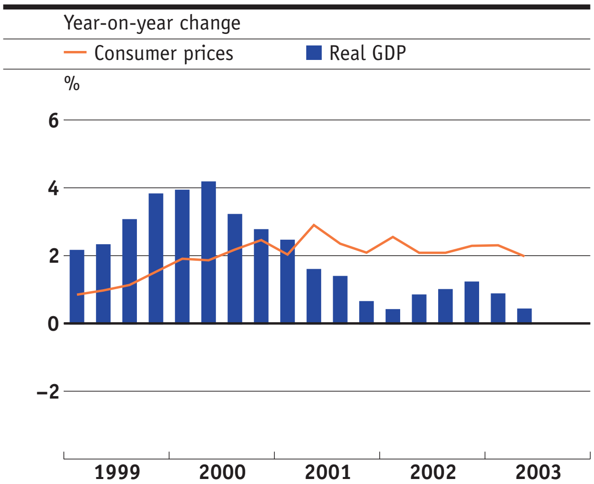
Weak second quarter in the euro area

Unlike the United States and the United Kingdom, the countries in the euro area were unable to overcome economic stagnation in the second quarter. Real GDP sank at an annualised rate of 0.3%, following a modest increase in the previous period. Export activity was hampered not least by the strong euro, and investment continued to contract. Private consumption shored up the economy to some degree, however. The significant differences between the individual euro area countries persisted. Real GDP shrank in Germany, Italy and France, with prolonged strikes slowing the economy further in the latter. Meanwhile, some smaller countries as well as Spain recorded positive growth rates.

First signs of a turnaround after mid-year

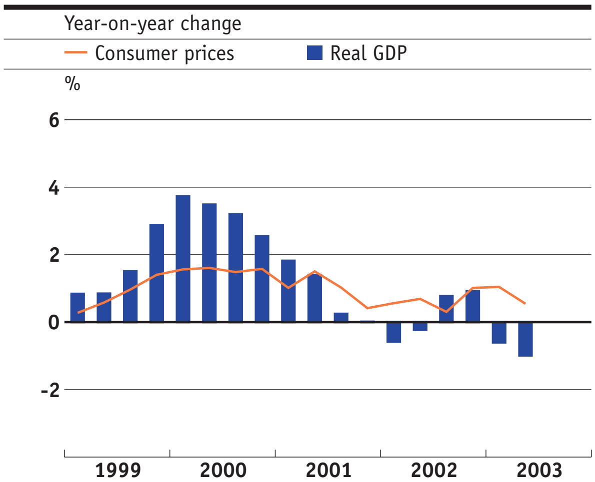
The outlook for the euro area, too, started to improve after mid-year. The purchasing managers' index for manufacturing industries, which had taken a clear dip in the first half of the year, climbed in July and August and corporate sentiment was more optimistic. According to the latest surveys, however, private consumption is likely to remain lacklustre for the time being, partly as a result of persistently high unemployment. Employment fell further in the second quarter, and the unemployment rate rose slightly to 8.9% in July. The expansionary fiscal policies pursued by many countries – reflected in widening budget deficits – should nonetheless bolster the economy.

Euro area — Graph 1.3



Source: BIS

Switzerland — Graph 1.4



Sources: Swiss Federal Statistical Office (SFSO)
State Secretariat for Economic Affairs (seco)

1.2 Monetary policy and interest rates

Slightly lower inflation

Within the OECD (excluding high-inflation countries), average consumer price inflation slipped from 2.0% in April to 1.8% in July. Whereas inflation in the energy segment receded, Europe and the United States saw rising prices for food owing to the severe drought.

In the United States, the rate of inflation dipped from 2.3% in April to 1.9% in July, while core inflation remained steady at 1.5%. In the United Kingdom, too, inflation declined slightly, but at almost 3% it still exceeded the target rate of 2.5%. Euro area inflation contracted from 2.1% to 1.9%, entering the corridor that the ECB equates with price stability. In Japan, the slightly deflationary trend continued until July (–0.2%).

Further relaxation of monetary policy

A number of central banks relaxed their monetary policy further between June and August in order to underpin the economy. At the beginning of June, the ECB lowered the minimum bid rate for principal refinancing operations by 0.5 percentage points to 2.0%, and at the end of June the US Federal Reserve reduced its target Federal Funds rate by 0.25 percentage points to 1.0%. In July, the Bank of England, too, cut the repo rate by 0.25 percentage points to 3.5%. Norway, Sweden, Canada and Denmark also lowered their key rates – substantially, in some instances – and the Bank of Japan continued its expansionary course.

In their referendum on 14 September, the Swedish people rejected the introduction of the euro. Sweden thus remains, like the United Kingdom and Denmark, a member of the EU, yet outside the monetary union.

Rise in long-term interest rates – revival on the equity markets

Long-term interest rates increased considerably in July and August, having plunged to record lows in June. The rise in interest rates in the United States and Japan was significantly stronger than in Europe. The main driving force behind this rise was probably the improved outlook for the economy. By long-term standards, though, yields remained low in the third quarter.

The anticipated pick-up in economic activity and an improvement in the balance sheets and profit situation of many companies also had a positive bearing on equity prices. In August, the MSCI (Morgan Stanley Capital International) international stock market index was an average of 18% higher than this year's low of March.

1.3 Economic outlook

Over the last few months there have been growing signs of a rebound in the global economy. The OECD's composite leading indicators climbed markedly for all three major economic areas, pointing to a further improvement in economic activity in the months ahead. While the United States is expected to experience a surge in growth in the second half of the year, the economic recovery in the euro area will remain subdued until the end of the year and gain steam only next year.

The economic revival is still fraught with considerable risks. The US economy faces the threat that growth, which has been driven predominantly by a fiscal stimulus package, might wane again next year. In Europe and Japan, structural deficiencies still impede a broad-based independently driven upswing, which means that their growth remains dependent on economic momentum in the United States and the development of the US dollar. And last but not least, the sectors that were the main engines of the upswing of 1997–2000 are still struggling with overcapacities. This is true in particular for the ICT and financial industries.

The participants in the consensus survey[1] published in September anticipate 3.9% growth in real GDP for the United States in 2004, 2.6% for the United Kingdom, 1.7% for the euro area and 1.2% for Japan.

The International Monetary Fund (IMF) also expects faster economic growth for 2004. At its autumn meeting in September, it upgraded its 2004 growth forecasts for the United States and Japan by almost half a percentage point each to 3.9% and 1.4% respectively. By contrast, the projection for the euro area was revised downwards by 0.4 percentage points compared with last spring, to 1.9%. According to the IMF, there is still considerable uncertainty as to the magnitude of the economic recovery. Since inflation in the near term is likely to remain low, the IMF is recommending that monetary policy should remain relaxed for the time being to underpin the recovery.

Forecasts Table 1

	Economic growth[2]				Inflation[3]			
	IMF		Consensus		IMF[4]		Consensus	
	2003	2004	2003	2004	2003	2004	2003	2004
European Union	0.8	2.0	0.8	2.0	2.0	1.6	2.0	1.5
Germany	0.0	1.5	0.0	1.6	1.0	0.6	1.0	0.9
France	0.5	2.0	0.4	1.7	1.9	1.7	2.0	1.6
United Kingdom	1.7	2.4	1.8	2.6	2.8	2.5	2.8	2.4
Italy	0.4	1.7	0.5	1.6	2.8	2.0	2.6	2.0
United States	2.6	3.9	2.6	3.9	2.1	1.3	2.3	1.8
Japan	2.0	1.4	1.9	1.2	−0.3	−0.6	−0.3	−0.4
Switzerland	−0.4	1.4	−0.1	1.4	0.4	0.5	0.6	0.5

1 Consensus forecasts are monthly surveys conducted among approximately 200 leading companies and economic research institutes in roughly 20 countries, covering predictions for the development of GDP, prices, interest rates and other relevant economic indicators. The results are published by Consensus Economics Inc., London.

2 Real GDP, change from previous year in percent

3 Consumer prices, change from previous year in percent

4 Inflation EU: euro area; inflation UK: excluding mortgage costs

Sources: IMF: Economic Outlook September 2003; Consensus: September Survey

2 Monetary situation

The National Bank continued its expansionary monetary policy from June to August 2003, with short-term money market rates still close to zero percent. Whereas the price of the euro in Swiss francs fluctuated between CHF 1.53 and CHF 1.56, the US dollar made significant gains, signalling a return to more favourable monetary conditions. With long-term interest rates rising worldwide, yields in Switzerland have also firmed considerably since June, and the stock markets continued to recover from their lows of March.

2.1 Interest rates

Narrowing international interest rate differentials on the money market

Since 6 March 2003, the National Bank has targeted a value of 0.25% within the target range of 0.0%–0.75% for the three-month Libor rate. The three-month Libor rate sank from an average of 0.29% in May to 0.26% in August, thus almost reaching its target. The yield curve on the money market became somewhat steeper as the twelve-month interest rate increased by 0.1 percentage points to 0.5% between the end of May and the end of August. The issuing yield of federal money market debt register claims was an average of 16 basis points below the three-month Libor during this period.

In Europe and the United States, the key rate reductions of June triggered a slide in money market rates. Between May and August, the three-month Libor rate for the US dollar declined from 1.28% to 1.13%, and the three-month Euribor slipped from 2.41% to 2.14%.

Measured by the three-month interest rate, the interest rate differential over the US dollar narrowed from 99 basis points in May to 87 basis points in August. In relation to the euro it decreased from 212 to 188 basis points.

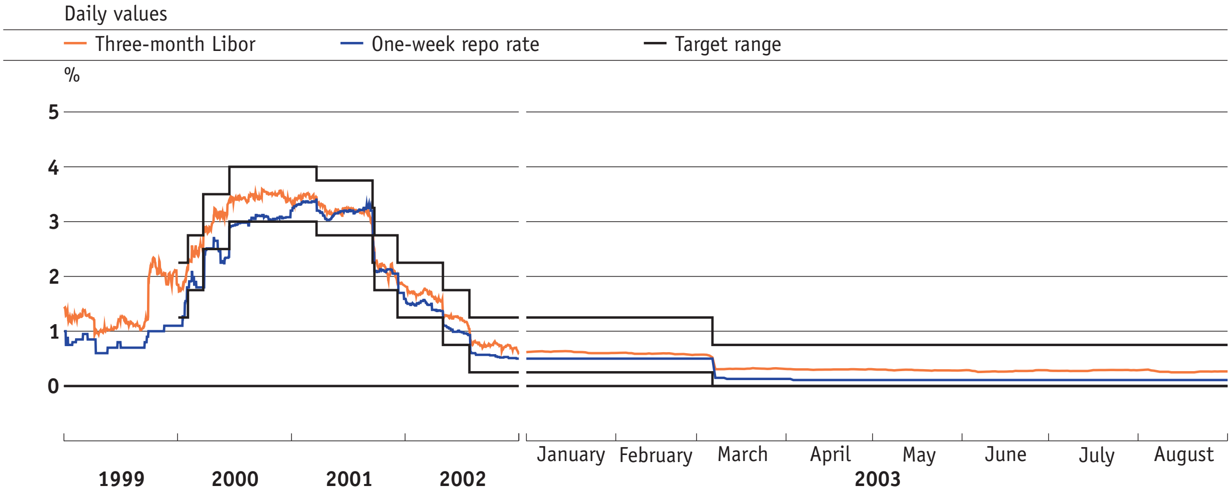
Historic low and swift rebound in bond yields

In mid-June, yields on long-term government bonds hit lows worldwide but have surged upward since. The yield on ten-year US Treasuries initially dropped by around 0.2 percentage points to 3.33% in June before rising to 4.44% in August. Yields on European government bonds followed a similar, albeit less exaggerated, course, dipping from 3.92% in May to 3.72% in June and then climbing to 4.20% by August. In Japan, yields more than doubled from 0.53% in June to 1.12% in August.

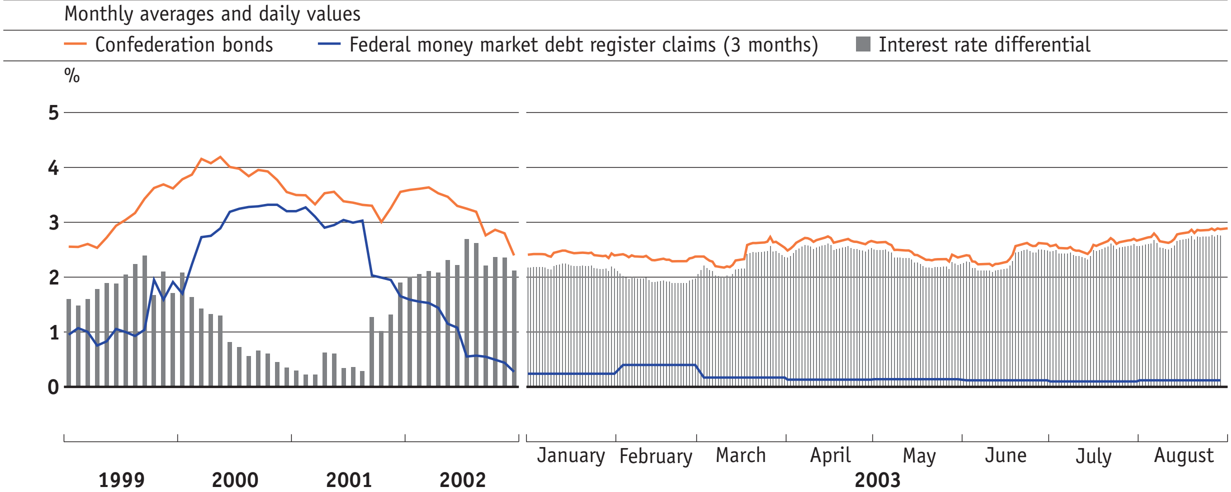
In Switzerland, the yield on a Confederation bond with a residual maturity of ten years moved up from an average of 2.41% in June to 2.79% in August. The maturity premium, i.e. the differential between long and short-term yields, widened from 2.29 percentage points in June to 2.67 percentage points in August.

Between May and August, the average differential to the corresponding yields of foreign government bonds amounted to 1.27 percentage points against US bonds, 1.42 percentage points vis-à-vis European paper and –1.75 percentage points against Japanese bonds.

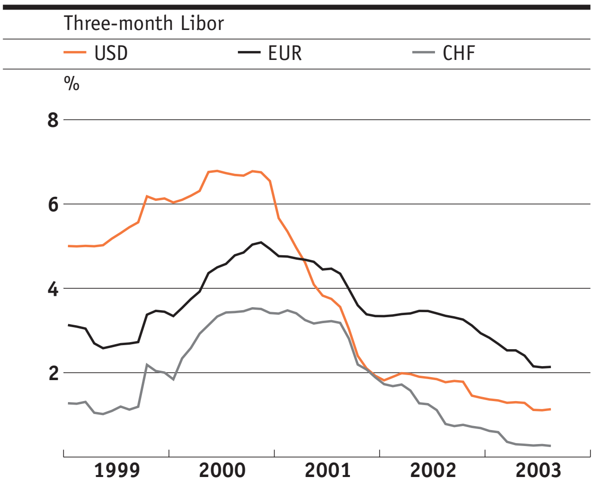
Money market rates Graph 2.1



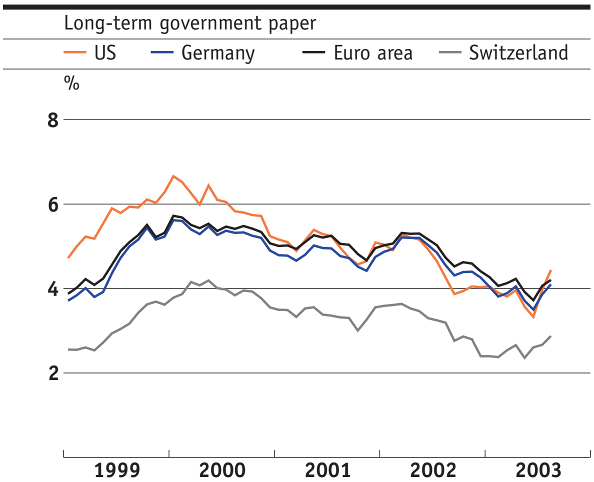
Bond yield and interest rate structure Graph 2.2



Interest rates abroad Graph 2.3



Interest rates abroad Graph 2.4



Graphs 2.1 and 2.3: Source: SNB

Graph 2.2: Confederation bonds: until the end of 2000, average yield calculated by maturity: as of 2001, spot interest rate of 10-year discount bonds.
Money market debt register claims: yield at auction.
If several auctions per month: the last of the month.
Source: SNB

Graph 2.4: US: yield on 10-year US treasury paper, secondary market. Germany: current yield on quoted 10-year German Federal securities. Switzerland: Confederation bonds; see graph 2.2.
Source: BIS

Further decline in rates for medium-term notes, savings deposits and mortgages

Interest rates for medium-term notes, savings deposits and mortgages still trended lower up to August. Although the yield on medium-term notes usually develops roughly in step with the yield on Confederation bonds, which rose markedly, the yield on the big banks' medium-term notes receded from 1.59% at the beginning of May to 1.48% at the beginning of August.

Thanks to more favourable refinancing options, the cantonal banks' rate for new mortgages backtracked from 3.27% at the beginning of May to 3.17% at the beginning of August, while that for existing mortgages slipped from 3.49% to 3.27% during the same period. This means that mortgage rates have decreased by a little more than 4 percentage points over the last ten years. Interest rates on savings deposits at cantonal banks also reached a historic low of 0.53% in August.

Clear revival on the stock markets

From June onwards, stock markets continued the rally started in March to reach highs for the year at the end of August. By then, the Dow Jones index stood at 9400 points, i.e. around 1900 points or 25% above the March low. The Swiss Market Index (SMI) soared by around 40% from its 3700-point low (also March) to 5100 points at the end of August. This is still far below the record highs of over 8000 points recorded in 2000, however.

2.2 Exchange rates

Rebound in the US dollar

Having depreciated almost continuously since the beginning of 2002, the US dollar started to trend higher this June. Its appreciation against the euro was particularly marked, as the euro fell from its peak of USD 1.19 in mid-June to below USD 1.09 in August. Between June and August, the greenback also gained ground against the yen and sterling, by 1.6% and 1.4% respectively.

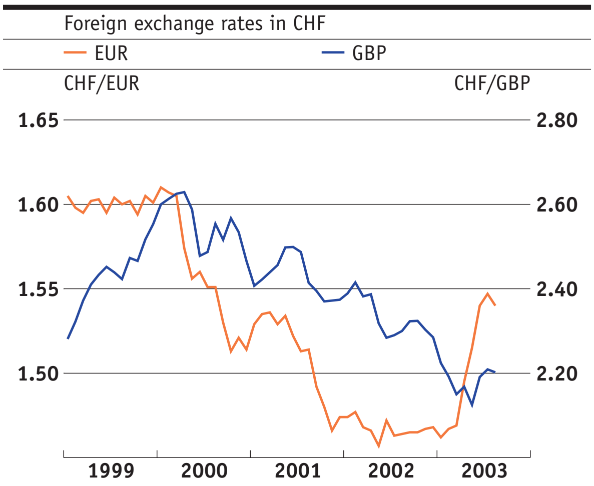
In export-weighted terms, the yen also strengthened. In relation to the US dollar, it moved within a narrow band of 117 to 120 yen/dollar owing to the Bank of Japan's interventions in the foreign exchange market. Against the euro, however, it firmed from 140 yen/euro at the end of May to 128 yen/euro at the end of August.

Further weakening of the Swiss franc

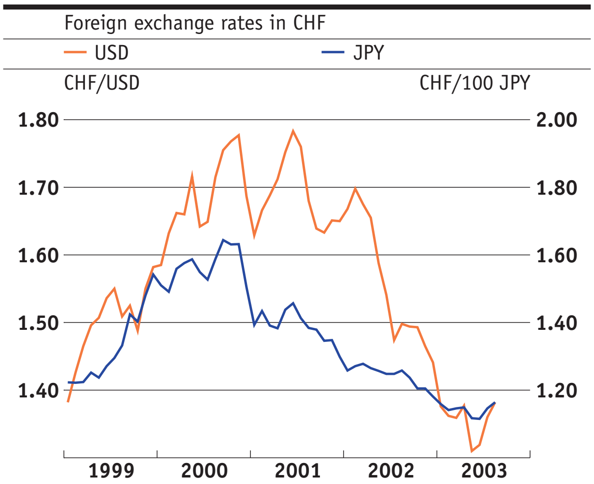
The Swiss franc's external value fell considerably between June and August. Against the euro, it fluctuated between CHF 1.53 and CHF 1.55. Between June and August, the dollar rose from CHF 1.29 to CHF 1.41, the yen from CHF 1.09 to CHF 1.20/100 yen and sterling from CHF 2.13 to CHF 2.23. This development called a halt to the two-year uptrend of the Swiss franc vis-à-vis the US dollar, the yen and sterling.

The export-weighted real value of the Swiss franc declined by 3.4% between May and August, the weakening of the currency thus becoming more pronounced compared with the previous period. The sharpest depreciation was recorded against North America (–5.8%), followed by the Asian trading partners (–5.0%) and Europe (–2.6%).

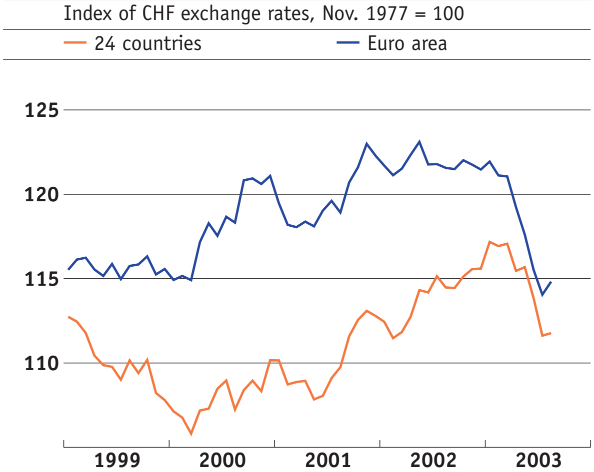
Exchange rates Graph 2.5



Exchange rates Graph 2.6



Real exchange rate indices Graph 2.7



Graphs 2.5, 2.6 and 2.7:
Source: SNB

2.3 Monetary aggregates

Sharp rise in sight deposits

Seasonally adjusted banknote circulation increased in the first half of 2003, having stagnated in the previous year. In the second quarter, it expanded at an annualised rate of 4.8% compared with the previous quarter. In July, however, it edged only marginally higher before contracting again slightly in August.

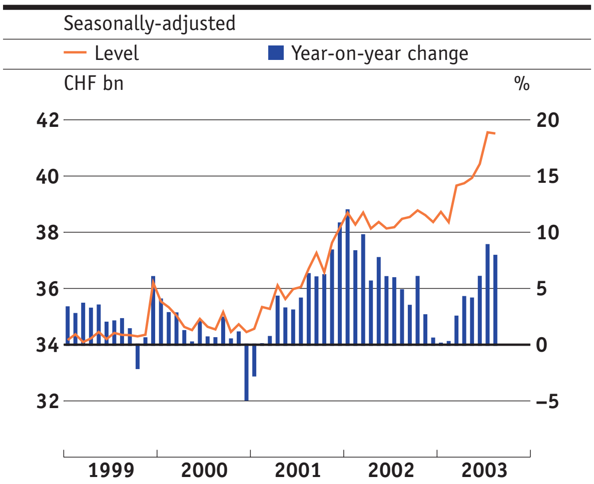
Sight deposits have grown vigorously since the three-month Libor rate was cut this March. In August they amounted to CHF 5.6 billion, i.e. roughly CHF 2.3 billion more than a year earlier. The seasonally adjusted monetary base, which is composed of banknote circulation and the banks' sight deposits, was thus 7.9% higher year-on-year.

Whereas the growth in banknote circulation has been restricted mainly to large-denomination notes (1000-franc notes) in the last few quarters, circulation of the other denominations was also significantly higher in the second quarter. The small denominations (10-franc to 50-franc notes) rose at an annualised rate of 5.2% from the previous quarter, medium denominations (100-franc to 500-franc notes) at 5.4% and the large-denomination notes at 7.0%. In July and August, only large-denomination notes continued expanding, whereas the circulation of small and medium denominations stagnated.

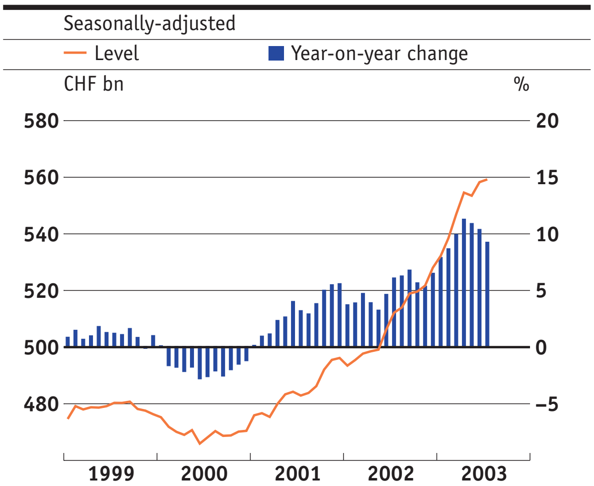
Slower growth of monetary aggregates

The growth rates for the broader monetary aggregates M_1, M_2 and M_3 decelerated considerably between May and July. This also resulted in lower annual growth rates, which had reached multi-year peaks in April and May. In July, the money stock M_1 was 23.8% higher than a year earlier, while M_2 and M_3 rose by 19.8% and 9.2% respectively.

Monetary base — Graph 2.8



Money stock M_3 — Graph 2.9



Graphs 2.8 and 2.9:
Source: SNB

Monetary base and its components

Table 2

	2001	2002	2002			2003				
			Q2	Q3	Q4	Q1	Q2	June	July	August
Banknote circulation[1]	33.0	35.1	34.9	34.4	35.4	35.7	35.5	35.5	35.5	35.2
Change[2]	4.7	6.3	7.3	5.2	2.4	−0.4	2.0	2.8	2.4	2.1
Sight deposit accounts[1]	3.3	3.3	3.3	3.3	3.4	3.6	4.3	4.7	5.5	5.6
Change[2]	0.2	0.4	−0.3	−1.6	3.6	18.4	32.4	37.0	79.6	68.7
MB[1,3]	36.3	38.4	38.1	37.8	38.8	39.4	39.9	40.2	41.1	40.8
SAMB[1,4]	**36.3**	**38.4**	**38.2**	**38.4**	**38.6**	**38.9**	**40.0**	**40.4**	**41.6**	**41.5**
Change[2]	4.1	6.0	6.4	4.7	3.0	0.9	4.8	6.0	8.8	7.9

Broadly defined monetary aggregates and their components[5]

Table 3

	2001	2002p	2002			2003				
			Q2p	Q3p	Q4p	Q1p	Q2p	Junep	Julyp	Augustp
Currency in circulation	5.1	5.1	6.8	3.6	0.1	−0.7	2.2	2.7	2.2	2.5
Sight deposits	−0.7	11.7	6.5	17.5	18.1	27.5	44.5	39.9	36.5	38.8
Transaction accounts	1.6	8.5	8.3	9.7	8.0	9.5	12.8	12.7	14.4	13.9
M_1	**1.0**	**9.6**	**7.2**	**12.5**	**11.6**	**16.6**	**26.6**	**24.7**	**23.8**	**24.8**
Savings deposits	−6.1	9.9	8.7	12.8	14.6	15.3	15.6	15.7	14.9	13.8
M_2	**−2.3**	**9.7**	**7.9**	**12.7**	**12.9**	**16.0**	**21.6**	**20.6**	**19.8**	**19.8**
Term deposits	26.9	−11.0	−9.3	−14.4	−19.0	−18.5	−31.7	−31.5	−34.3	−33.6
M_3	**3.1**	**5.0**	**3.9**	**6.3**	**5.8**	**8.8**	**10.8**	**10.3**	**9.2**	**9.9**

1 In billions of Swiss francs; average of monthly values; monthly values are averages of daily values
2 From previous year in percent
3 MB = monetary base = banknote circulation + sight deposit accounts
4 SAMB = seasonally-adjusted monetary base = monetary base divided by the corresponding seasonal factors
5 Definition 1995, change from previous year in percent
p Provisional

2.4 Lendings and capital market borrowing

Slight rise in domestic lending in the second quarter

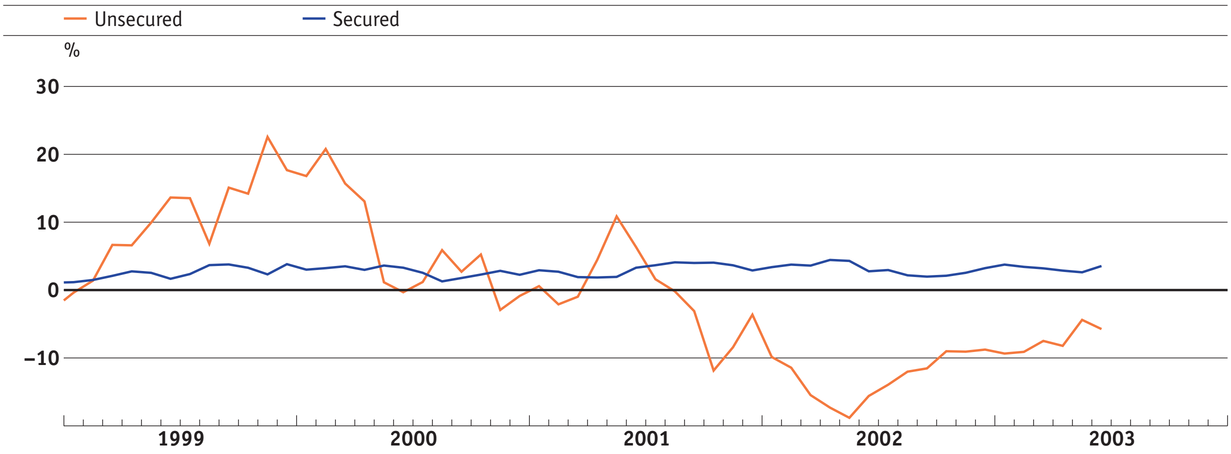
Domestic lending covers loans by banks to borrowers domiciled in Switzerland or Liechtenstein and comprises unsecured and secured customer claims, as well as mortgage claims. At 86%, secured domestic lending (comprising secured customer claims and mortgage claims) accounted for the lion's share of the total; of this figure, 91% was again attributable to mortgage claims.

Total domestic lending rose by 1.0% from the previous period in the second quarter. Unsecured customer claims grew somewhat more markedly by 1.5%, though still falling considerably short of the year-earlier level. Following a slight recovery at the beginning of the year, secured customer claims in the second quarter declined by a further 2.3% down to a level approximately 20% below the peak of February 2002.

The increase in unsecured customer claims compensated for the fall in secured customer claims so that the total of all customer claims in the second quarter remained on the level of the previous quarter. Mortgage claims continued to expand, topping the previous quarter's level by 1.3%.

For the first time in a long while, lending by the big banks once again rose more markedly than lending by the cantonal and regional banks, i.e. by 0.9% quarter-on-quarter. As in the first quarter, the Raiffeisen banks, at 3.9%, exhibited the steepest increase in domestic lending.

Annual rates of change: secured and unsecured loans | Graph 2.10



Foreign borrowers dominate the Swiss bond market

Foreign issuers again constituted the largest category of borrowers on the Swiss bond market in the second quarter, with an issuing volume of CHF 11 billion. New issues by domestic borrowers declined by approximately CHF 3 billion to CHF 7.7 billion quarter-on-quarter. With an issuing volume of around CHF 5 billion, public sector borrowers – Confederation, cantons and municipalities – remained the predominant debtor category in Switzerland. Capital redemptions did not reach the high value of the previous quarter. This is partly a result of far fewer bank bonds falling due for repayment than in the first quarter. Net borrowing on the capital market through the issue of bonds thus increased from CHF 3.5 billion to CHF 5.7 billion compared with the previous quarter. Equity issues amounted to CHF 0.1 billion, the lowest quarterly level in five years. After the capital increases of Zurich Financial Services and Banque Cantonale Vaudoise had shaped events in the two preceding quarters, there were no major equity issues in the second quarter. Including share capital buybacks amounting to CHF 0.8 billion, net borrowing on the capital market in the form of share issues came to CHF –0.7 billion.

Capital marked borrowing in billions of Swiss francs — Table 4

	2001	2002	2002			2003	
			Q2	Q3	Q4	Q1	Q2
Bonds and shares, total							
Price of issue [1]	73.4	77.3	20.5	13.6	19.3	23.2	18.7
Conversions/Redemptions	60.4	60.5	9.4	19.7	17.7	19.2	13.7
Net borrowing	13.0	16.8	11.1	−6.1	1.5	4.0	5.0
Swiss bonds							
Price of issue [1]	27.0	26.2	9.2	5.5	3.4	10.5	7.7
Conversions/Redemptions	21.1	22.5	4.0	5.5	6.0	8.9	4.2
Net borrowing	5.9	3.7	5.3	0.0	−2.6	1.5	3.5
Swiss shares							
Price of issue [1]	12.3	7.4	0.2	0.7	5.1	1.3	0.1
Redemptions	7.3	9.1	0.9	6.6	0.8	0.8	0.8
Net borrowing	5.0	−1.7	−0.8	−5.9	4.3	0.5	−0.7
Foreign bonds [2]							
Price of issue [1]	34.0	43.7	11.1	7.4	10.8	11.5	11.0
Redemptions	32.0	28.9	4.4	7.6	11.0	9.5	8.7
Net borrowing [3]	2.1	14.8	6.7	−0.2	−0.2	2.0	2.2

1 By date of payment
2 Without foreign-currency bonds
3 Without conversions

3 Aggregate demand and output

3.1 GDP and industrial output

Further deterioration in the economic situation in the second quarter

In Switzerland, real gross domestic product contracted once more in the second quarter of 2003 though – at 1.2% – the decline was less pronounced than in the first quarter (revised figures). Year-on-year, real gross domestic product fell by 1.0%, following 0.6% in the first quarter. Private and government consumption continued to shore up the economy, while investments and exports receded once more. Diminishing aggregate demand was accompanied by a further significant drop in imports, thus cushioning the decline in real gross domestic product.

The situation in the manufacturing sector remained depressed in the second quarter. The purchasing managers' index (PMI), averaging 44.2%, remained distinctly below the threshold of 50%, which indicates unchanged output. The monthly surveys by KOF/FIT pointed in the same direction. Orders received showed a continuous weak trend, with most producers reporting a fall in production.

The data published by the Swiss Federal Statistical Office (SFSO) in September corroborated this picture. In the second quarter, manufacturing output declined once more quarter-on-quarter and fell 3.1% short of the year-earlier level.

GDP and its components Table 5

At prices of 1990; percentage-point contribution to year-on-year change in GDP

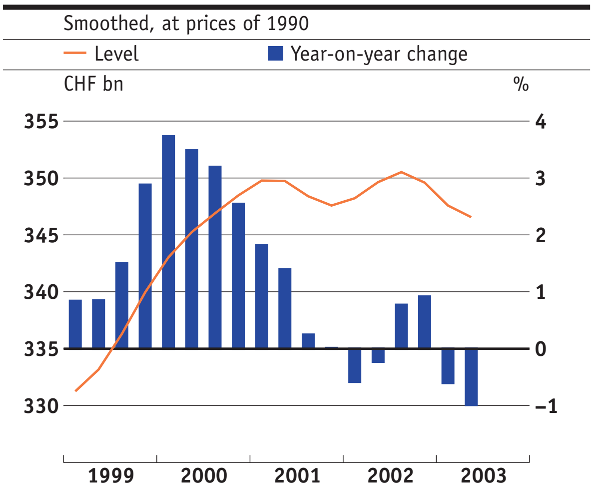
	2001	2002	2002			2003	
			Q2	Q3	Q4	Q1	Q2
Private consumption	1.2	0.4	0.3	0.3	0.2	0.1	0.5
Govt. and social insurance consumption	0.4	0.3	0.4	0.5	0.4	0.3	0.3
Investment in fixed assets	−0.9	−1.0	−1.4	−0.5	−0.4	−0.1	−0.9
Construction investment	−0.4	0.2	0.5	0.3	0.2	0.1	0.0
Equipment investment	−0.5	−1.3	−1.9	−0.9	−0.6	−0.2	−0.9
Domestic final demand	**0.7**	**−0.3**	**−0.7**	**0.3**	**0.2**	**0.2**	**−0.1**
Inventories	0.0	−0.9	0.8	−2.2	−1.2	−0.4	−3.6
Exports, total	0.0	−0.2	−1.3	1.4	0.8	0.3	−0.3
Aggregate demand	**0.7**	**−1.4**	**−1.2**	**−0.5**	**−0.2**	**0.1**	**−4.0**
Imports, total	−0.1	−1.6	−1.0	−1.3	−1.1	0.7	−3.0
GDP	**0.9**	**0.2**	**−0.2**	**0.8**	**0.9**	**−0.6**	**−1.0**

Sources: SFSO, seco

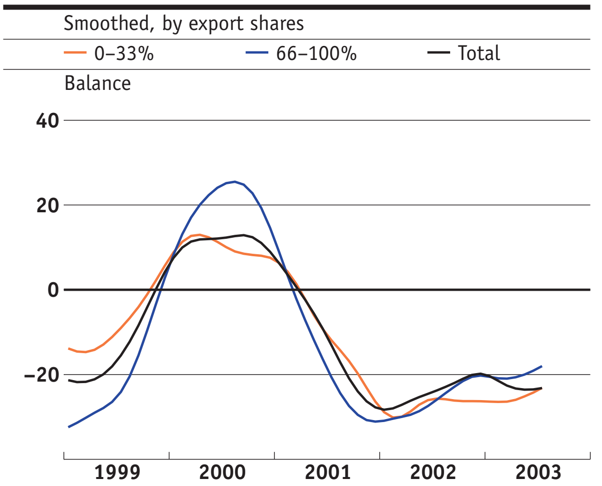
Economic prospects brighten around mid-year

A number of indicators, however, seem to show that the economic nadir in Switzerland was reached in the second quarter. In July and August, the PMI moved up, once more touching the 50% threshold. The monthly industrial survey of KOF/FIT, too, points to an improvement. The composite index of industrial activity that comprises four indicators on the business situation stabilised in July and August. Production declined again, nevertheless the excessive inventories of primary products and finished products were reduced again. In particular, orders did not decline any further. The change in sentiment was especially pronounced in the export industry. This sector reported expanding orders and expected demand to increase significantly in the short and medium term. A breakdown by sector, however, still revealed differences. Whereas sentiment among producers of raw materials and semi-manufactures, of consumer non-durables and of capital goods improved, the mood among manufacturers of consumer durables was still restrained.

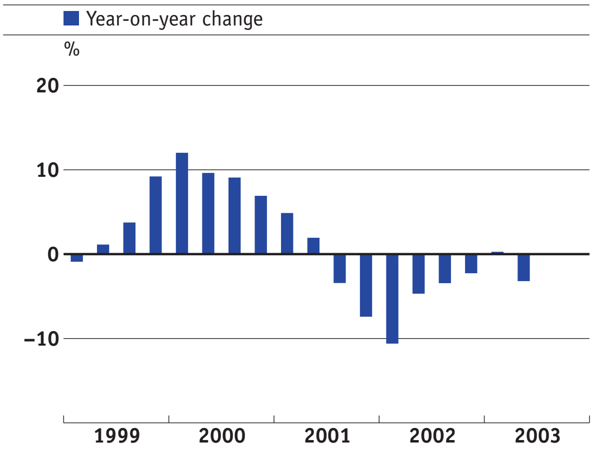
GDP Graph 3.1



Industrial activity Graph 3.2



Industrial output Graph 3.3



Graph 3.1:
Annualised estimate for the quarter
Source: seco

Graph 3.3: Source: SFSO

Graph 3.2: The synthetic index of industrial activity consists of the results of the following four questions: orders received and output compared with the corresponding year-earlier month, as well as evaluation of the order backlog and of the finished goods inventories.
Source: Swiss Institute for Business Cycle Research at the Federal Institute of Technology (KOF/FIT)

3.2 Foreign trade and current account

Exports of goods and services continued their decline in the second quarter in somewhat weaker form compared with the previous period and stood 0.7% below the previous year's level. Goods and services, however, showed varying development. While exports of goods declined year-on-year, service exports topped the year-earlier level for the first time in three years (3.6%). This positive development is largely attributable to the marked recovery in the premium income of private insurance companies and the significantly slower decline in bank commissions.

As a result of weak domestic demand and receding exports, imports of goods and services declined. In a year-on-year comparison, they diminished by 6.8%. A considerable decrease in imported goods (−7.8%) was set off against slightly higher imports of services (2.3%).

Falling goods exports

According to the data of the Swiss General Directorate of Customs, exports of goods in the second quarter fell short of the corresponding year-earlier level by 1.0%.[1] Compared with the previous period, deliveries of consumer goods, notably pharmaceuticals and watches, again underwent an above-average decline. Exports of raw materials and semi-manufactures, too, continued to shrink. Exports of investment goods, by contrast, showed an unexpectedly favourable development. The slight increase was due to some extent to the sale of aircraft by Swiss. Shipments of industrial machinery, electrical appliances and precision instruments, however, continued to decline. Year-on-year, capital goods exports expanded somewhat, while exports of raw materials and semi-finished products, as well as consumer goods, contracted.

Real exports by use[2] Table 6
Change from previous year in percent

	2001	2002	2002			2003	
			Q2	Q3	Q4	Q1	Q2
Total	**2.9**	**1.8**	**0.5**	**5.3**	**5.4**	**−0.4**	**−1.0**
Raw materials and semi-manufactures	−1.5	−0.4	1.6	1.0	5.8	2.5	−0.8
Capital goods	−0.4	−4.4	−5.7	−2.0	2.8	−0.1	3.3
Consumer goods	9.4	8.5	4.9	14.6	7.3	−2.4	−4.4
Export prices	1.2	−2.7	−0.5	−3.9	−4.3	0.6	−3.7

Real imports by use[2] Table 7
Change from previous year in percent

	2001	2002	2002			2003	
			Q2	Q3	Q4	Q1	Q2
Total	**1.1**	**−2.5**	**−0.6**	**−1.3**	**−1.7**	**2.8**	**−6.8**
Raw materials and semi-manufactures	0.1	−2.5	−2.6	0.5	2.8	5.5	−7.2
Energy sources	7.9	−2.1	−0.8	−1.7	−11.1	−11.1	−4.8
Capital goods	−5.0	−6.2	−7.9	−2.0	−2.3	1.5	−3.3
Consumer goods	5.8	0.0	6.2	−2.0	−2.9	3.5	−8.9
Import prices	0.1	−2.9	−2.9	−3.5	−2.2	−1.3	−1.4

1 Real exports of goods, according to the definition of the Swiss General Directorate of Customs (total 1), correspond to real exports of goods reported by seco excluding exports of electrical energy and the "Other goods trade" subcategory.

2 Without precious metals, precious stones and gems as well as objets d'art and antiques (total 1). Source: Swiss General Directorate of Customs

Demand from Europe remains weak

While nominal exports of Swiss goods to the EU gained some momentum, they nevertheless fell 1.4% below the corresponding year-earlier level. Whereas shipments to Germany increased marginally, those to France, Italy and the United Kingdom declined. In contrast, exports to central European countries continued their upward trend, exceeding the year-earlier figure by 4.7%.

Exports of goods to the United States and Asia on the decline

The weak state of the dollar also weighed on trading activities with the United States and countries billing in the US currency in the second quarter. Nominal exports of goods to the United States continued their downtrend and fell distinctly below their previous year's level (–18.1%). Shipments to Asian emerging economies also contracted markedly (–13.8%). Exports to Japan and China still exceeded their year-earlier levels (7.3% and 14.8% respectively), yet lost momentum. Demand from OPEC countries remained muted.

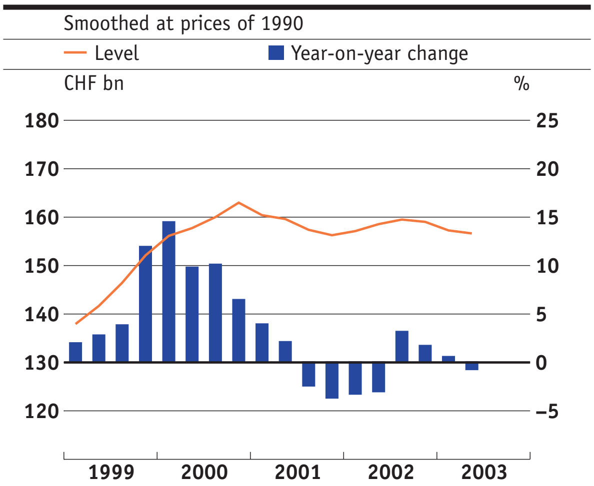
Slump in imports of goods

The decline in real imports of goods, which got under way in March, continued in the second quarter.[3] In a year-on-year comparison it amounted to 6.8%, following a rise of 2.8% in the first quarter. Imports of raw materials and semi-finished goods, as also of capital goods, saw a particularly steep fall. Imports of consumer goods also contracted more markedly compared with the previous period.

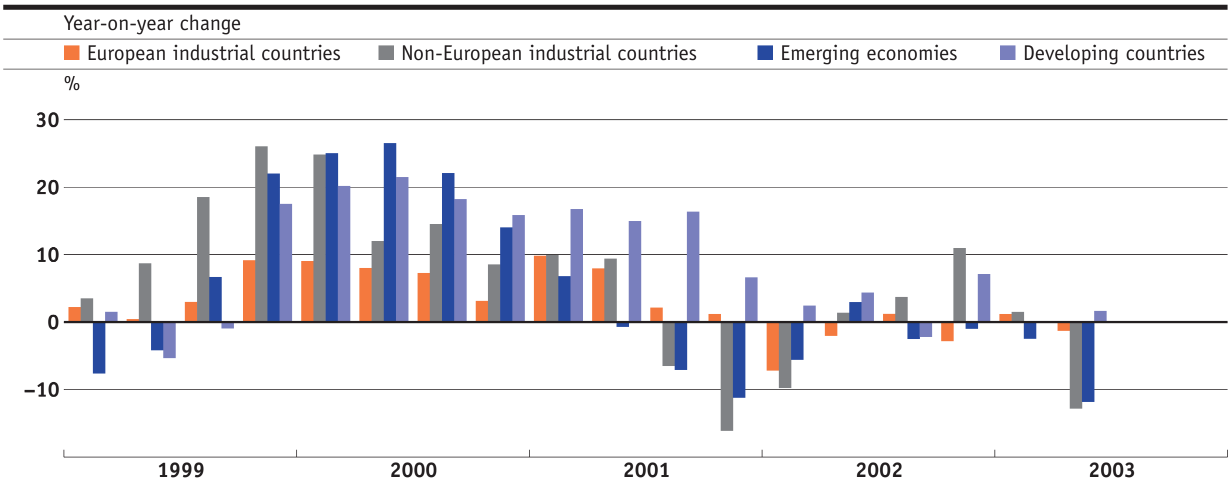
Slide in export and import prices

In the second quarter, export prices (measured by the mean prices of the General Directorate of Customs) fell 3.7% below the corresponding previous year's level following a slight rise in the first quarter. The same applies to import prices measured by mean prices, the quarterly average of which was 1.4% below their year-earlier level. This development led to a deterioration in the relation between export and import prices (terms of trade) from the year-earlier level by 2.3% probably largely as a result of the depreciation of the Swiss franc vis-à-vis the euro.

Exports — Graph 3.4



Exports by trading partners — Graph 3.5



3 Real exports of goods, according to the definition of the Swiss General Directorate of Customs (total 1), correspond to real exports of goods reported by seco excluding exports of electrical energy and the "Other goods trade" subcategory.

Graph 3.4: Annualised estimate for the quarter, without precious metals, precious stones and gems as well as objets d'art and antiques (total 1).
Source: seco

Graph 3.5: Without precious metals, precious stones and gems as well as objets d'art and antiques (total 1).
Source: Swiss General Directorate of Customs

Possible turnaround in the third quarter

Exports of goods seem to have troughed out around mid-year. In July and August they no longer receded from the previous period's level. Their two-month average, however, was 1.6% below the previous year's level (working-day adjusted). Starting in July, as orders picked up somewhat, exporters' assessment of the future also became more confident.

The development of imports was also cause for slightly more optimism. While imports of consumer goods gained some momentum in July and August, imports of raw materials and semi-manufactured goods stabilised. Imports of capital goods, however, fell further. On average during the two months, goods imports remained at the corresponding year-earlier levels (adjusted for working days).

Current account surplus expands slightly

Nominal exports of goods declined by 4.4% year-on-year in the second quarter, while imports fell by as much as 8.1%. The trade balance (special trade, total I) closed with a surplus of CHF 2.5 billion, compared with CHF 1.4 billion a year earlier.[4] The total goods trade – i.e. also including trade in electrical energy plus imports and exports of precious metals, precious stones and gems, etc. – closed with a surplus of CHF 2.2 billion.

The surplus from services rose by CHF 0.4 billion to CHF 4.9 billion from the year-earlier level. The increase is due mainly to higher earnings from cross-border insurance business. The banks' commission income, however, diminished once more albeit at a considerably slower rate. By contrast, the surplus from labour and investment income expanded by CHF 1.1 billion to CHF 5.2 billion. Higher net earnings from direct investment as well as from other investments contributed to this increase. This resulted in a current account surplus of CHF 12.2 billion in the second quarter compared with CHF 8 billion a year earlier. As a percentage of nominal GDP, the current account surplus was 11.7% compared with 7.5% in the same quarter of the previous year.

Current account Balances in billions of Swiss francs — Table 8

	2001[5]	2002[6]	2002[6]			2003[7]	
			Q2	Q3	Q4	Q1	Q2
Goods	−4.6	5.2	0.7	2.0	2.1	−0.2	2.2
Special trade[8]	1.7	7.3	1.4	1.9	3.1	0.5	2.5
Services	22.1	22.1	4.5	5.7	4.7	7.2	4.9
Tourism	2.1	1.9	−0.1	0.3	0.3	1.5	0.0
Labour income and investment income	25.5	17.9	4.1	5.3	4.8	4.6	5.2
Investment income	34.0	27.1	6.4	7.6	7.2	7.2	7.8
Current transfers	−6.7	−6.5	−1.4	−1.5	−1.4	−1.6	−0.1
Total current account	**36.2**	**38.6**	**8.0**	**11.6**	**10.2**	**10.0**	**12.2**

4 According to total 1

5 Revised
6 Provisional
7 Estimates
8 Total 1

3.3 Investment

In the second quarter investment activity continued to decline. While construction investment rose slightly from the previous period, the downtrend in equipment investment accelerated. In a year-on-year comparison, real investment in fixed assets, which comprise investment in equipment and construction, fell by 3.6% following a decline of 0.5% in the first quarter.

Pickup in residential construction

The situation in the building sector remained sluggish overall. Real construction investment, which rose slightly quarter-on-quarter, stagnated compared with the year before. Residential construction was the main engine, as this sector again expanded vigorously in terms of the number of dwellings under construction. By contrast, the survey of the Swiss contractors' association pointed to a further decline in civil engineering and in commercial and industrial building.

All in all, few positive stimuli from the construction sector

No major contribution to growth is to be expected from building investment in the next few quarters. Supported by low mortgage rates and falling building costs, residential construction may, however, pick up further. This is clearly indicated by the number of building permits issued for new homes, which has been rising for some time, and the growing number of building projects reported by the Swiss contractors' association. The pickup in residential construction has nonetheless been offset by a steady decline in other building sectors. Thus, owing to falling employment and the high vacancy rate, investment in commercial property is likely to continue shrinking. Given the tight financial situation in the public sector, civil engineering may not be expected to provide any stimuli either.

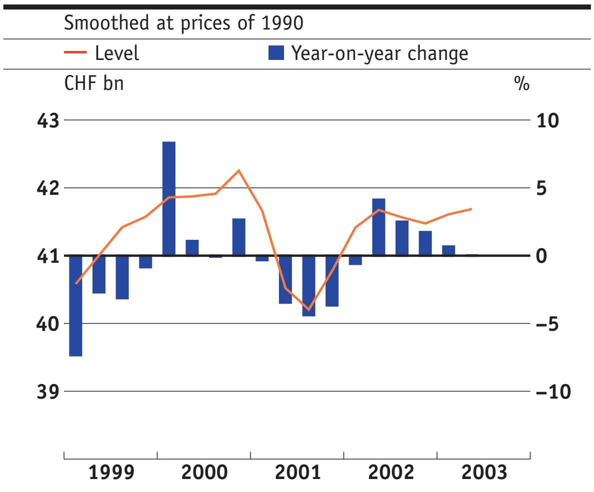
Stronger downtrend in equipment investment

The downtrend in equipment investment became more pronounced in the second quarter, having slowed in the first quarter. In a year-on-year comparison, it shrank by 7.3%, following a decline of 1.5% in the first three months. Imports of capital goods diminished more markedly and stood at 5.2% below the year-earlier level. According to the quarterly survey conducted in Switzerland's capital goods industry (swissmem) in the second quarter, domestic turnover in Swiss capital goods was also on the decline.

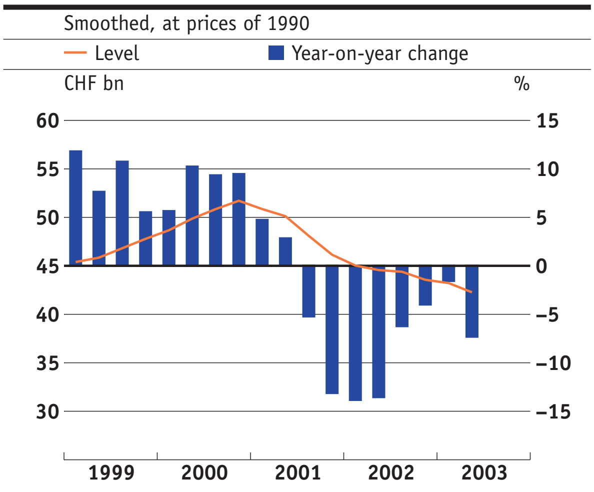
Stabilisation of equipment investment towards year-end

The accelerating downtrend in equipment investment in the second quarter is likely to be a temporary phenomenon. Capacity utilisation in the industrial sector, which has a lead of approximately half a year on equipment investment, was slightly higher in the second quarter than at the end of 2002. According to the swissmem survey, incoming domestic orders slightly exceeded the previous period's volume. While the low interest rate level and the growing replacement need for capital goods with a short operating life are also conducive to an early change in trend in equipment investment, the corporate earnings situation, which is still less than satisfactory, acts as a brake on investment activity.

Construction investment — Graph 3.6



Equipment investment — Graph 3.7



Graphs 3.6 and 3.7:
Annualised estimate for the quarter
Source: seco

3.4 Consumption

Weak private consumption

In the second quarter, private consumption rose at an annualised rate of 0.7% – a little more markedly than in the previous periods – and stood at 0.8% above the corresponding previous year's level, following 0.1% in the first quarter. Growth, however, was mainly attributable to robust expenditure on living expenses, health and foodstuffs, which are not very sensitive to economic conditions. By contrast, consumers continued to exercise considerable restraint when purchasing durables and luxury goods.

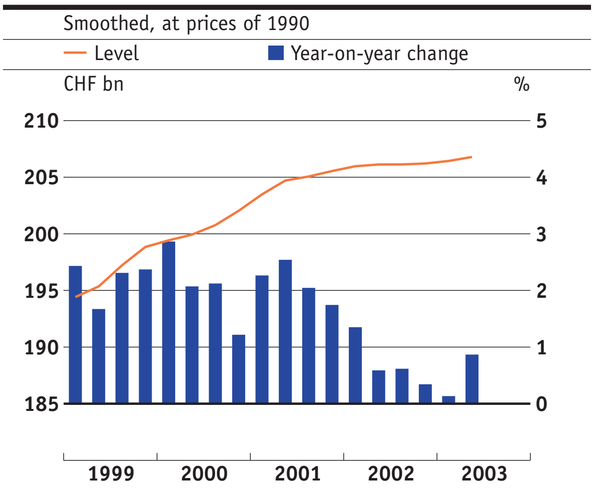
This spending behaviour was mirrored by real retail trade turnover. In the second quarter, turnover fell marginally short of the corresponding year-earlier level (–0.1%), having contracted by as much as 3.4% in the first quarter. Notably, spending on foodstuffs and health care increased. Conversely, the decline continued in the personal apparel segment, owing mainly to decreasing expenditure on watches and jewellery. Motor vehicle sales also receded. This was reflected to some extent by the number of newly registered automobiles, which fell 7.2% short of the previous year's level. Domestic tourism, by contrast, saw comparatively favourable growth. After a decline in the winter half-year, the number of overnight hotel stays in Switzerland exceeded the year-earlier level by 1.9% in the second quarter.

Consumer sentiment remains depressed

In July, the consumer sentiment index remained at the low level of April. Whereas households expected their financial prospects in the next twelve months to remain practically unchanged, they were somewhat less pessimistic than in April as regards the future economic situation. The time for large-value acquisitions was also considered to be rather less unfavourable than three months previously. The households questioned, however, held the view that job security had deteriorated.

The low-key prospects for private consumption were also reflected in the KOF/FIT surveys. The retail trade judged business in July and August to have been largely unsatisfactory, while expectations regarding turnover in the near future improved slightly. In the hotel and restaurant industry – particularly in the hotel segment – the outlook remained dim. In the second quarter, too, the majority of enterprises expected domestic demand to shrink in the coming months.

Private consumption Graph3.8



Annualised estimate for the quarter
Source: seco

3.5 Capacity utilisation

A significant indicator for assessing the economic situation and inflation risks is the degree of utilisation of the production factors of a national economy. Fully utilised production factors are a sign of an overheating economy and inflation risks, while below-average utilisation of production factors points to recession and easing price pressure. Two indicators serve to assess capacity utilisation: the macroeconomic output gap and utilisation of technical capacities in industry.

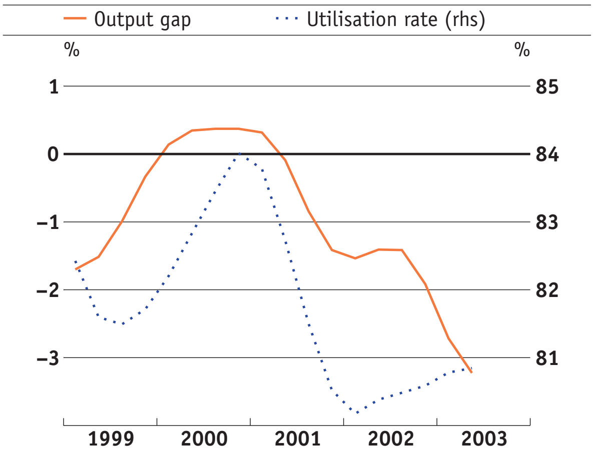
Output gap continues to widen

The output gap is the difference in percent between actual real GDP and the estimated output potential.[1] This, in turn, indicates the level of production which may be achieved in the long term without inflationary pressure. A negative output gap signifies under-utilisation of capacity, while a positive output gap is a sign that the production factors are being over-utilised. In the second quarter, Swiss economic activity weakened further, and the macroeconomic output gap, which had been negative since the first half of 2001, widened to 3.2%. It was thus almost as large as in the economic trough at the end of 1996 (3.3%).

Capacity utilisation in industry stagnating

Capacity utilisation in industry is measured by the quarterly KOF/FIT survey. In this survey, companies are asked to indicate the average utilisation of their output capacity in the corresponding quarter; according to the questionnaire, it may range from 50% to 110%.

Capacity utilisation | Graph 3.9



Source: KOF

1 The output potential may be assessed by various procedures. In the present case, the production function valuation was applied.

In the second quarter, capacity utilisation remained unchanged at just under 81%. It thus continued to fall distinctly short of the long-term average of 84%. The majority of enterprises judged technical capacities to be sufficient and left them unchanged from the previous quarter. More than half the enterprises regarded the lack of demand as the chief obstacle to production.

3.6 Economic outlook and forecasts

Around mid-year, the signs of an economic recovery increased in Switzerland, too. In the export sector which, historically, has ushered in the economic turnaround, the order position improved somewhat. Stimulated by low interest rates, residential construction also picked up while the situation of the financial sector improved in the course of the recovery on the equity markets. The National Bank expects real GDP to stabilise in the third quarter and to rise slightly in the fourth quarter. This development will not, however, be adequate to compensate the setback of the half-year. On an annual average for 2003, the National Bank thus expects a moderate decrease in real GDP. More broad-based economic growth, which will also lead to an improvement in the labour market situation, cannot be expected until next year. The nascent economic recovery is still fragile. Numerous sectors – including in particular tourism and the ICT sector – are still suffering from overcapacities. A turnaround in exports is of decisive importance for a sustained economic recovery, which will also lead to increasing corporate investment. This turnaround is only just beginning to emerge and depends strongly on the expected economic recovery in the euro area. Since unemployment will continue to rise for the time being, no stronger stimuli – from private consumption, in particular – will be forthcoming in the next few quarters. Together with government spending, however, private consumption is likely to remain an engine of growth.

4 Labour market

4.1 Employment

Further fall in employment

Employment was down by 0.7% (annualised) in the second quarter compared with the previous period, falling 0.9% short of the corresponding year-earlier level. Jobs continued to be cut in the industrial, construction and services sectors alike. Year-on-year, the decline amounted to 2.8%, 1.2%, and 0.4% respectively.

Almost all sectors of industry were affected by the fall-off in employment. Employment was up in the service industry, retailing, insurance companies, as well as in health care and social services. This was not enough, however, to offset the declining figures in most other industries, notably among the banks.

The number of persons in full-time employment fell at an above-average rate as against the previous period and year-on-year (−2.8% and −2.3% respectively). By contrast, part-time employment I, which comprises persons working 50%–89%, shot up (+5.8%), surpassing the previous year's level by 1%. The number of persons with part-time jobs working up to 50% (part-time employment II) also moved up significantly. As a result of receding full-time employment, employment figures converted into full-time positions dropped more sharply than the number of employees. The number of jobs diminished by 1.5% quarter-on-quarter, coming to rest 1.4% short of the corresponding year-earlier level.

Labour market Figures not seasonally-adjusted — Table 9

	2001	2002	2002			2003			
			Q2	Q3	Q4	Q1	Q2	July	August
Full- and part-time employed [1]	1.1	−0.4	−0.3	−0.2	−0.8	−1.1	−0.9	–	–
Full-time employed [1]	0.7	−1.3	−1.3	−1.3	−1.6	−2.0	−2.3	–	–
Unemployment rate [2]	1.7	2.6	2.3	2.5	3.1	3.6	3.6	3.6	3.6
Unemployed [3]	67.2	100.5	91.2	97.1	120.2	140.9	140.9	141.7	143.7
Jobseekers [3]	109.4	149.6	139.7	146.3	172.6	196.6	201.2	203.7	205.6
Persons on short working hours [3]	2.4	9.1	11.6	4.4	6.8	10.6	11.2	5.6	–
Registered vacancies [1]	−18.1	−40.4	−46.3	−39.5	−35.9	−39.5	−31.7	–	–

1 Change from previous year in percent
2 Unemployed registered until April 2003 in percent of the economically active population according to the 1990 national census (working population: 3,621,716 persons); from May 2003: in % of the economically active population according to the 2000 national census (working population: 3,946,988 persons)
3 In thousands; yearly and quarterly values are averages of monthly values
Sources: SFSO, seco

4.2 Unemployment

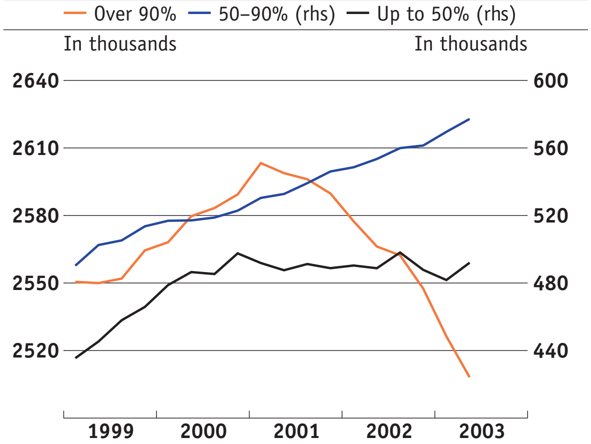
Up to August, the number of unemployed persons rose to 154,200, and that of job-seekers to 216,900 (seasonally adjusted). The unemployment rate and the proportion of job-seekers thus climbed by 0.3 and 5.5 percentage points respectively to 3.9% and 5.5% respectively between April and August. The increase in the unemployment rate was particularly pronounced in the cities of Basel, Geneva and Zurich. The jobless rates in French-speaking Switzerland and in the canton of Ticino amounted to 4.8% and 4.3% respectively, while the rate in German-speaking areas was 3.6%.

On 1 July, the revised federal unemployment insurance law entered into force. One of the revisions foresees a reduction from 520 to 400 days of the period in which benefits can be claimed. According to initial estimates by the State Secretariat for Economic Affairs (seco), as a result of this change, approximately 2,700 unemployed persons lost their claim to benefit payments in July. Unemployed persons no longer eligible for benefit payments are included in the unemployment figures provided that they continue to register as unemployed with regional employment offices. Experience has shown, however, that this is not the case after a certain time has elapsed. If the unemployed persons no longer eligible for benefits failed to find new jobs, the jobless rate is distorted downward.

Employment indicators point to a further rise in unemployment up to the end of the year. The number of vacancies continued to decrease markedly from April to July. This was evidenced by the Manpower index, which measures the space occupied by job advertisements in Swiss newspapers, trends in job advertisements in the Internet (jobpilot index), as well as the quarterly survey on job vacancies published by the Swiss Federal Statistical Office. While employment prospects in the industrial and service sectors, in particular, remained gloomy, the construction sector reported an improvement in the employment situation.

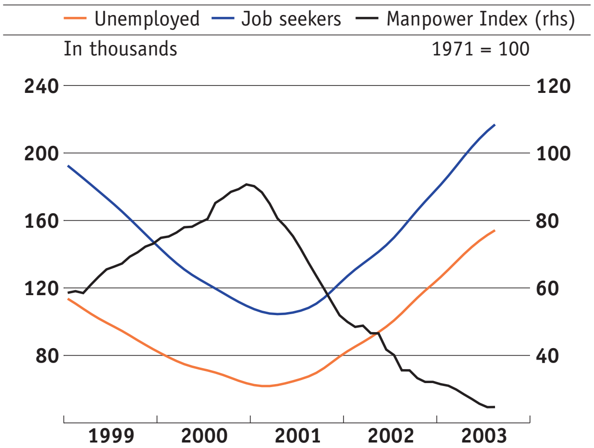
Full- and part-time employment — Graph 4.1

Seasonally-adjusted



Unemployment and vacancies — Graph 4.2

Seasonally-adjusted



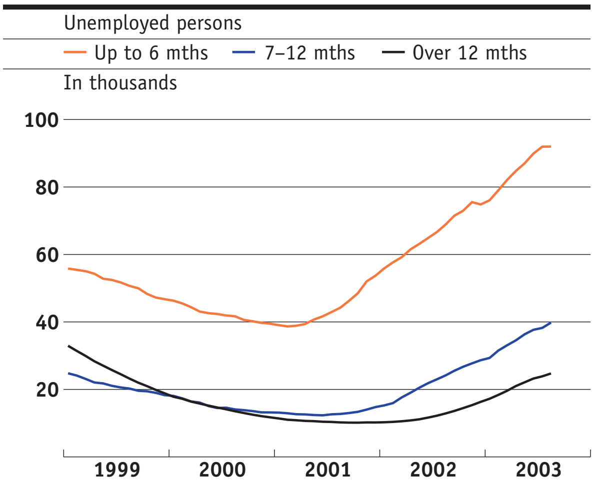
Graphs 4.1, 4.2:
Source: SFSO

4.3 Wages and salaries

According to the Swiss wage index, nominal wages (annual employee earnings) surpassed the corresponding year-earlier level by 1.4%. A country-wide survey on the collective labour agreements in force in 2003 showed pay rises at the same level. The survey includes the results of wage negotiations within the framework of collective labour agreements, which cover roughly one-third of persons in employment. The results of the survey thus confirmed the annual wage survey conducted by UBS in March, which showed a nominal wage increase of 1.3%.

The nominal income of wage and salary earners, calculated on the basis of the number of persons in employment and the average pay, is likely to increase considerably less than the 0.4% that had been expected back in May. The reason for this lies in a faster-than-expected fall in employment. Real disposable income is likely to grow by just over 1% in 2003. Particularly important here is the slight year-on-year reduction in levies, which is the result of lower unemployment insurance contributions.

Duration of unemployment | Graph 4.3



Source: SFSO

5 Prices

5.1 Consumer prices

Between May and August the annual inflation rate as measured by the national consumer price index remained more or less stable. Affected by the slower price rises for services and the low clearance sale prices in the "clothing and shoes" category, the inflation rate temporarily fell to 0.3% in July. In August, it rose to 0.5% and thus remained slightly above its May level. As a result of the weak economic situation, increases in the prices of domestic goods have remained low since then. Even though the export-weighted external value of the Swiss franc fell, imported consumer goods made a negative contribution to inflation. The persistently low general inflation trend was also apparent in the low core inflation rate.

Domestic inflation slightly lower

At 0.7%, annual inflation in domestic goods and services in August was only slightly below its level in May. Inflation on services, which account for approximately three-quarters of the domestic commodities basket, declined from 0.9% to 0.7%. Private services, excluding residential rents, registered the sharpest drop. In August, the annualised price rise amounted to 0.6%, following 1.0% in May. After remaining stable for a year, the quarterly residential rents survey in August showed that annual rent inflation had gone up slightly from 0.1% to 0.3%. The rise in the cost of public services remained unchanged at 2.1% in August. Having risen somewhat in the period from January to June, inflation on domestic goods stabilised in July. In August, their prices climbed by 0.7% year-on-year. In addition to certain foodstuffs, prices for beverages and tobacco, in particular, rose at an above-average rate.

Stabilisation of foreign goods prices

The decline in the prices of goods of foreign origin came to a halt in August. This development was largely driven by volatile prices for oil products (fuel and heating oil). After falling in the three previous months, prices for these products saw a 3.2% increase year-on-year. Inflation for other imported goods, however, was slightly in the negative zone (–0.5%) up to August. A significant proportion of the price decline was accounted for by the "clothing and shoes" category – roughly 85% of which is imported. This development mainly reflects aggressive pricing during the final summer clearance sales and is not attributable to a general deflationary trend from abroad.

Breakdown of the national consumer price index Table 10
Change in percent

	2002	2002	2003					
		Q4	Q1	Q2	May	June	July	August
National consumer price index total	**0.6**	**1.0**	**1.0**	**0.5**	**0.4**	**0.5**	**0.3**	**0.5**
Domestic goods and services	1.4	1.2	1.0	0.9	0.8	0.9	0.6	0.7
Goods	1.1	0.6	0.1	0.6	0.6	0.8	0.4	0.7
Services	1.5	1.3	1.3	0.9	0.9	0.9	0.7	0.7
Private services without rents	1.9	1.9	1.6	1.1	1.0	1.0	0.6	0.6
Rents	1.0	0.6	0.4	0.2	0.1	0.1	0.1	0.3
Public services	1.5	1.3	2.4	2.1	2.1	2.0	2.1	2.1
Imported goods and services	–1.7	0.5	1.2	–0.4	–0.7	–0.4	–0.7	0.0
Without oil products	–0.8	0.5	–0.4	–0.3	–0.4	–0.2	–0.7	–0.5
Oil products	–6.8	0.2	11.7	–1.0	–3.0	–1.9	–1.3	3.2

Sources: SFSO, SNB

5.2 Core inflation

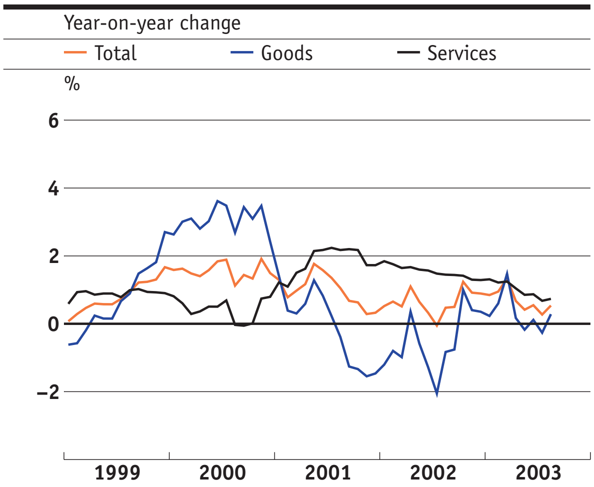
SNB's core inflation remains low

Inflation, as measured by the national consumer price index, is subject to numerous short-term influences which may distort perceptions of the general price trend. The National Bank therefore calculates a core inflation rate. For any given period, this core inflation rate excludes the 15% of goods with the highest annual inflation rate and the 15% of goods with the lowest annual inflation rate from the consumer price index commodities basket. From May to July, the core inflation rate fell by 0.1 percentage point to 0.5%, reaching its lowest level since January 1999. The persistently low level of core inflation reflects a still-low general inflationary trend. Moreover, the fact that core inflation exceeds inflation as measured by the overall national index shows that the inflation-dampening special factors carry somewhat more weight than the influences that are driving prices higher.

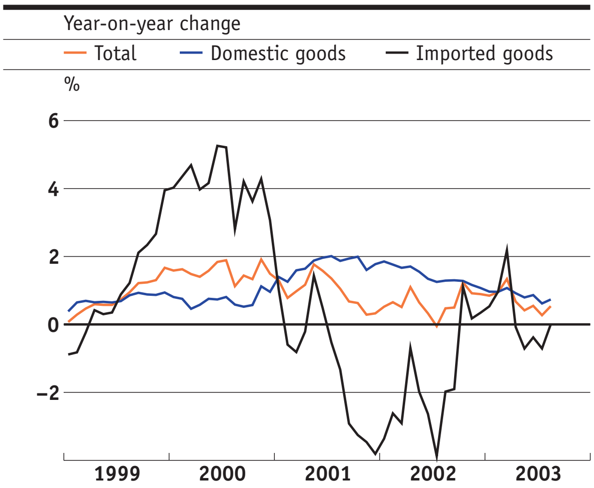
Decline in SFSO core inflation rates

Unlike the core inflation rate of the National Bank, the two core inflation rates calculated by the SFSO always exclude the same goods from the commodities basket in any period. In the case of core inflation 1, these are foodstuffs, beverages, tobacco, seasonal products, energy and fuel. Core inflation 2 additionally excludes products with administered prices. Having remained at 0.7% and 0.4% respectively between January and April, the two core inflation rates have levelled off since May. In August, core inflation 1 stood at 0.4% and core inflation 2 at 0.2%.

Consumer prices — Graph 5.1



Consumer prices — Graph 5.2



Graphs 5.1 and 5.2:
Source: SFSO

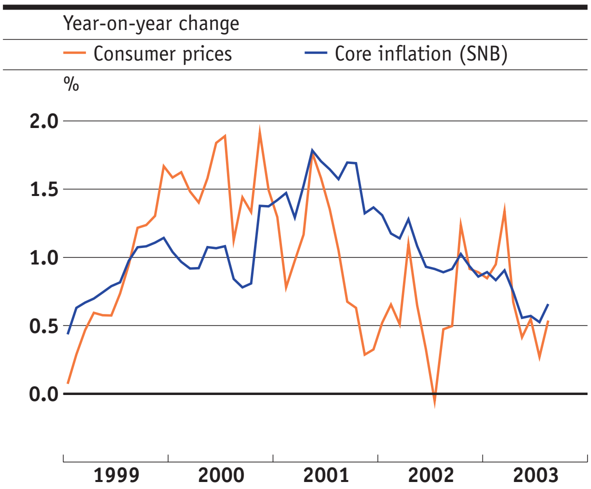
5.3 Prices of total supply

Declining total supply prices

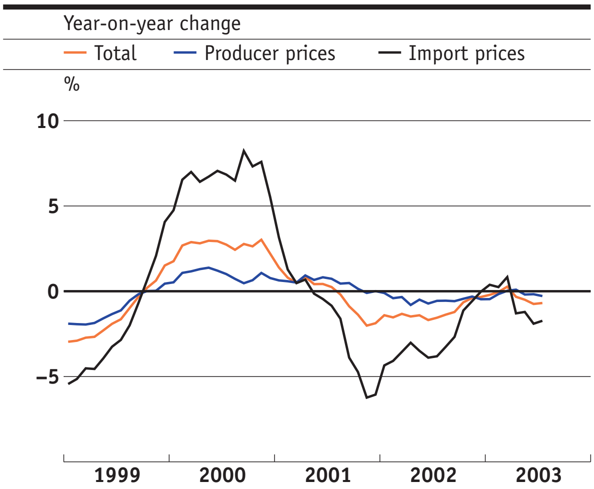
In June, May 2003 was selected as the new base for which the producer and import price index (PPI) is calculated (May 2003=100). The revised index will henceforth be computed on the basis of an updated commodities basket, which comprises product groups not previously included. Certain segments of the services sector, such as freight, are among them.

Negative price pressure on the downstream consumer level emanated from producer and import prices between April and July. Annual inflation on producer prices eased by 0.3 percentage points to −0.2% in May, remaining at that level until July. Goods destined for export registered somewhat sharper price falls than those products sold domestically. The prices of imported goods also declined more substantially. In July, they decreased by 1.7% year-on-year, after registering a 1.3% fall in May. Imported capital goods, such as office machines and IT equipment, saw an above-average price drop.

Core inflation Graph 5.3



Prices of total supply Graph 5.4



Sources: SFSO, SNB

6 Inflation prospects

6.1 International price development

No inflationary impulses from abroad

Contrary to the National Bank's expectations, the price per barrel of Brent crude oil advanced from approximately 24 dollars to roughly 30 dollars between May and August. Continuously tight supplies as a result of delayed oil deliveries from Iraq and unrest in Nigeria are the likely causes for this increase. However, part of the price increase was offset by the dollar's depreciation vis-à-vis the Swiss franc. Expressed in Swiss francs, the price for crude oil in August was 3.3% above the year-back level. Given the low oil reserves in industrial countries and the seasonally induced increase in demand in autumn, the National Bank is not expecting any sudden drop in the price of oil. It is therefore likely to remain above the previous year's level in the months ahead. As a result of the sluggish global economy, however, other imported goods will probably continue to exert a slightly negative inflationary effect in the near future.

6.2 Price development in Switzerland

Economic trends generating little cost pressure

Domestic inflationary pressures are likely to stay subdued over the months to come, as overcapacities will be reduced only slowly even if economic activity picks up. Since the situation on the labour market is not expected to improve until next year, there will be no cost pressures from wages, either, for the time being. According to the KOF/FIT survey of Swiss industrial companies with a domestic focus, price expectations continued to trend lower in the second quarter. And with competition remaining tough, there is still only very limited scope for supply-side price adjustments.

Rising residential rents

At just under 20%, residential rents have the highest weighting in the commodities basket on which the consumer price index is based. Consequently, anticipated rent levels are a particularly important factor in assessing the inflation outlook. The quarterly survey in August reported a 0.2 percentage point increase to 0.3% in the annualised rate of rent inflation, and the National Bank expects rents to rise again in the short term. Although the reductions in mortgage rates that have taken place since mid-2002 will hold down rents under existing leases, the accommodation shortage in many areas is driving up rents for new leases. According to Wüest & Partner, new tenants found themselves paying more than the previous tenants in four out of ten cases during the second quarter. At 1.7%, the vacancy rate as calculated by Wüest & Partner reached a new low during the same period. Given the extreme tightness of the housing market, the trend towards higher costs for new rentals looks set to continue in the near future.

6.3 Inflation forecast for 2003–2005

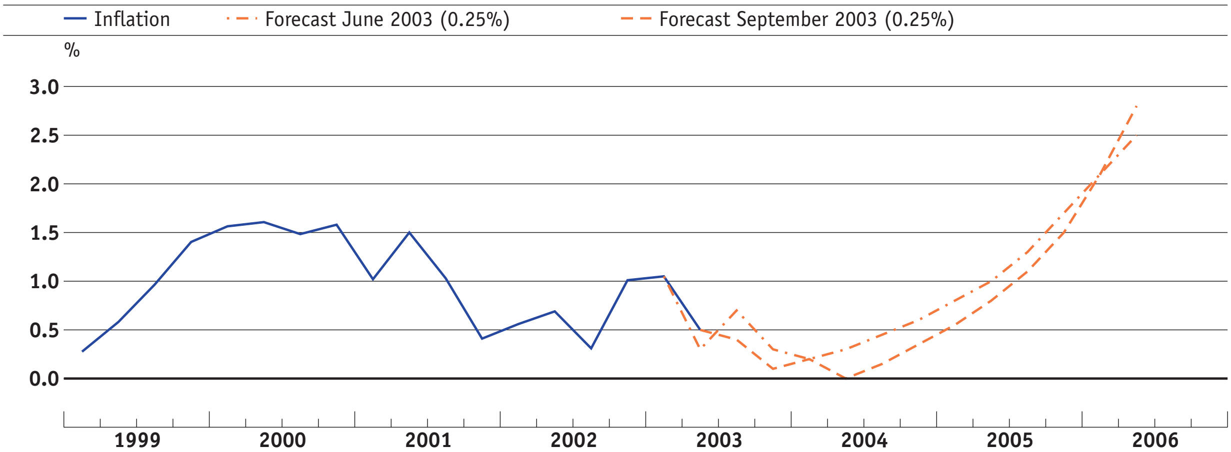
At its quarterly assessment of 18 September 2003, the National Bank reviewed its medium-term inflation forecast, and adjusted its assumptions for the world economy in a number of respects from those on which the June outlook was based. Anticipated economic growth this year and next in the United States was revised upward, foreseeing the closing of the US economy's output gap by the end of 2004. By contrast, the National Bank believes that Europe's economic recovery will emerge slightly later and display rather weaker momentum. It also expects the oil price to backtrack to around 25 dollars a barrel in the course of 2004, after its sharp rise in July and August 2003.

On the assumption that the three-month Libor rate will remain steady at 0.25% over the next three years, average inflation should, according to the new forecast, amount to 0.5% for this year, drop to 0.2% next year and climb to 1.0% in 2005. These average inflation rates are 0.1 and 0.2 percentage points lower respectively than the figures forecast in June for a three-month Libor of 0.25%.

As graph 6.1 shows, until the beginning of 2006, the inflation trend according to the new forecast will fall short of that projected in June. Inflation will sink to almost 0% in the period up to the second quarter of 2004 and might even briefly become slightly negative. This expected decline in the rate of price rises reflects Switzerland's weak economic growth, generally low inflationary pressures from abroad and the forecast reduction in the price of oil. It will be limited in both duration and scope, however, and should not be regarded as deflation. In fact, inflation is forecast to pick up as early as mid-2004, remaining under 1% until mid-2005 before accelerating to 2.8% by the second quarter of 2006.

Inflation forecast of June 2003 with Libor at 0.25% and of September 2003 with Libor at 0.25% Graph 6.1

Percent change in national consumer price index from previous year



7 Assessment of the economic situation from the regional vantage point

The offices of the National Bank are constantly in touch with a large number of enterprises from various sectors of the economy. Their reports, which contain the subjective evaluations of the enterprises, are an important additional source of information for assessing the economic situation. In the following, the main results of the talks held from May to August on the current and future economic situation are summarised.

7.1 Production

The business climate deteriorated again during the second quarter for the majority of companies, with only a few reporting rising demand and an improving earnings situation. Sentiment brightened after the mid-year point, however, as there was talk of a waning in downward momentum and a hoped-for stabilisation in sales during the second half of the year. By the end of August, there were still no tangible signs of a revival in economic activity, though, but most companies said that they were cautiously optimistic about prospects for 2004.

Some companies have been able to improve their competitiveness, having reduced overcapacity, optimised production processes and developed new products in recent years. However, many of the small and medium-sized enterprises which have already been working to very tight margins for some time have found themselves in dire financial straits in the last few months. Any further delay to the economic recovery would hit these companies especially hard.

Given weak demand and low capacity utilisation rates, most companies have restricted investment to where replacement and rationalisation are most urgently needed. No turnaround in equipment investment can be expected this year. When the economy begins to gather momentum, however, non-durable capital goods in particular will probably exhibit a "catching-up effect".

Manufacturing

Manufacturing continued to suffer from markedly weak demand from abroad, with the lack of momentum from Germany a particularly weighty factor. A few exporters benefited from a revival in demand from the United States and Asia, although some of their rise in income was wiped out by the weak dollar.

Companies in the capital goods segment were still feeling the effects of their customers' unwillingness to spend – many firms in the mechanical engineering, electrical engineering and electronics and metalworking industries, as well as suppliers of semi-finished goods, reported a worsening business climate and falling prices. No improvement is in sight before the end of the year. By contrast, other sectors (especially suppliers to the automotive industry and manufacturers of power generation machinery and medical technology devices) experienced rising orders. The situation for manufacturers of near-consumer products was mixed. Despite price concessions, demand in the textile, furniture and paper industries remained weak for the most part. The otherwise defensive foodstuffs industry also suffered from subdued sales. The pharmaceutical sector, however, further raised turnover and the watchmaking industry saw orders from abroad pick up somewhat.

Services

Consumers' unwillingness to spend and the fact that foreign guests have been staying away continued to weigh heavily on retailing and the hotel and restaurant trade. There has been a further shift in demand away from expensive products towards cheaper ones virtually across the board. Sales of consumer durables have remained subdued, while the luxury goods sector has keenly felt the absence of high-spending visitors from abroad. Sales of foodstuffs and convenience goods could be maintained thanks to price cuts – significant in some areas – and high beverage turnover owing to the hot summer. Like the travel industry, the hotel and restaurant trade recorded falling sales overall. As retailing is not expecting consumer demand to pick up just yet, costs have been cut to take account of the pressure on margins, with the main savings being made on rental and logistics costs and personnel expenses.

Many service providers to the corporate sector have also been facing lacklustre demand. This is particularly true of the advertising industry, where there are still no signs of recovery. Demand for IT services, too, fell once again as customers stuck with their old software and bought new only where there were potential cost savings to be made. However, in the light of the short life cycles of its products, the sector believes that demand will rise as companies are forced to bring their systems up to date.

By contrast, the situation in the banking sector is looking brighter: the uptrend on the financial markets has led to a recovery in commission income, while demand for personal loans (and mortgages, in particular) has been rising. By contrast, corporate customer business has remained at a modest level.

The tourism industry reported falls in the number of guests not only from Germany but also from the United States and Asia during the second quarter. The outbreak of the respiratory disease SARS was one of the main factors, alongside a generally sluggish economy. Stronger domestic tourism activity failed to make up for the absence of guests from abroad. Price consciousness was the order of the day as people saved on optional extras. The hot summer nonetheless boosted day-trip tourism in the mountains. The business travel segment continued to suffer under corporate spending cutbacks. On the basis of current bookings, hoteliers are guarded about their prospects.

Construction

Each sector of the heavily segmented construction industry developed along a different path. All in all, the situation improved thanks to resurgent residential construction, with demand for new single-family homes particularly pleasing. Activity in the cyclical industrial and commercial construction segment fell off almost everywhere, however, against a backdrop of widespread overcapacity and a subdued earnings outlook. Civil engineering projects suffered from public-sector savings programmes. In the different regions, the situation depended largely on the status of a small number of major projects. While construction prices remained under pressure, many construction companies complained of rising costs, resulting in earnings being squeezed from this direction, too.

7.2 Labour market

Uncertainty about the economic outlook and depressed earnings prompted companies to trim their production costs further. Most companies continued to downsize at all levels and they foresee a continued reduction in headcount – albeit at a slower rate – over the months to come.

7.3 Prices and margins

The earnings situation for many companies appears to have deteriorated once again in recent months. With the exception of a few niche segments, prices remained under pressure. In the construction and hotel and restaurant industries, price competition once more led to shrinking margins. In the retail trade, too, earnings contracted following sharp price cuts in connection with promotional campaigns and the summer sales. The weakening of the franc against the euro brought exporters a degree of relief, although some of their gains were wiped out by the weaker dollar.

The decoupling of rents from mortgage rates: implications of the rent law reform for monetary policy

Peter Stalder, Research, Swiss National Bank, Zurich

Introduction

In December 2002, after many years of controversies, the Swiss Parliament voted in favour of a thorough reform of rent law. The amendment represented an indirect counter-proposal to the Tenants Association's "Yes to fair rents" initiative, which was rejected in a public vote on 18 May this year. While the initiative would have linked rent adjustments to a smoothed mortgage rate, the proposed amendment decouples housing rents completely from mortgage rates and links them instead to the overall Consumer Price Index (CPI). House owners are allowed to pass the general rise in prices as measured by the CPI onto housing rents each year, provided that the increase does not exceed the average annual rise in consumer prices of the previous two years. In addition, rent increases may be justified by other factors, such as investment enhancing the value of housing. As a second plank of the rent reform, the government is obliged to conduct a regular statistical survey of comparative rents. Rent tribunals will draw on these statistics to decide whether a particular rent is unfair. If a rent agreed on in a tenancy contract is more than 15% above that of a comparable apartment, the tenant can appeal against it after signing the contract. Tenants are also entitled to have their rents reviewed at any time during the tenancy agreement to establish whether they exceed the upper limit (comparable rent plus 15%) and are thus unfair. If ownership of a property changes hands, the rents may be raised to the permitted upper limit, although any increase is limited to a maximum of 10% per year.[1]

The Tenants Association invoked the referendum process against the new rent law even before its "Yes to fair rents" initiative was rejected, claiming that the new legislation might trigger a rent spiral and moreover did nothing to improve security of tenure. The referendum vote is expected to take place in February 2004.

From an economic viewpoint, the most relevant aspect of the new rent law is the stipulation that rents should no longer be linked to mortgage rates but to the CPI. Although such indexation hardly conforms to the principle of market rents that many economists have called for, it offers a number of clear advantages over present rent law:

– Firstly, the interest rate risk is shifted from the tenant to the investor, which can be considered the better place for it in a market economy. For example, increases in mortgage rates would no longer be reflected in a loss in tenants' real incomes but in a reduction in earnings from housing investment. In the longer term, however, the greater volatility of investment earnings could result in a risk premium being factored into rents. But this should be acceptable to tenants, since in return they benefit from more stable rents.
– Secondly, the new rent law can be expected to reduce the volatility of consumer price inflation to some extent. Under the present system, rising mortgage rates in inflationary boom periods typically result in large rent increases, which, given a weight of around 20% in the CPI, further boosts overall consumer price inflation. If rents are linked to the CPI instead, this leverage effect will disappear.
– Thirdly, the new rent law can be expected to enhance the efficiency of monetary policy. If monetary policy is tightened to combat inflation, higher short-term interest rates in general drive mortgage rates up as well. Under current rent law, the intended inflation-reducing effects of higher interest rates (appreciation of the Swiss franc, contraction of aggregate demand) are thus accompanied by a disturbing counter-effect in the form of rising housing rents. This mechanism, which impairs the effectiveness of monetary policy considerably in the short term, would be eliminated if rents were linked to the CPI. Inflation should therefore decline more rapidly in response to monetary tightening.

This paper focuses on this third aspect of the proposed new rent law. In particular, it shows by means of simulations with the SNB's econometric macro-model how the monetary policy transmission mechanism is likely to change with the alternative link of rents to the CPI. A comprehensive appraisal of the new law based on welfare criteria is beyond the scope of this study. Hence, the results do not permit of any assessment as to whether the new rent law is preferable to the present system from an overall macroeconomic perspective.

1 Cf. Fontana (2003) and Federal Council (1999).

The article is structured as follows: Section 1 contains a brief description of the basic structure of the model. Section 2 looks in somewhat greater detail at the mortgage rate and housing rent equations. It also examines the frequently expressed claim that under present rent law increases in mortgage rates regularly result in sizeable rent increases while reductions in mortgage rates are not passed on to tenants in full. Section 3 shows what impact a tightening of monetary policy has on gross domestic product (GDP), its expenditure-side components, housing rents and overall consumer price inflation (the monetary policy transmission mechanism) under present rent law. This baseline simulation is then compared with an alternative in which, on otherwise identical assumptions, housing rents are linked to the CPI. Section 4 provides a summary of the main findings of the study.

1 Basic structure of the model

The macro-model used for the following simulations consists of 30 behavioural equations[2]. A first block of the model contains the equations for the components of aggregate demand. Consumer demand is a function of disposable household income and the real interest rate. Housing investment depends on income and population growth and a profitability indicator which includes construction prices, housing rents and long-term interest rates. Investment in plant and equipment is determined by capacity utilisation and the factor price ratio. Exports and imports are a function of foreign and Swiss economic activity respectively and a measure for the price competitiveness of Swiss suppliers. In their sum, these aggregate demand components together with exogenous government spending define GDP.

GDP determined this way from the demand side of the economy is confronted in the supply block of the model with potential output. This comparison on the one hand results in a measure for the tightness of the goods market (capacity utilisation), which in turn affects investment in the model's demand block. On the other hand, it defines via the production function the demand for labour, which meets a particular supply of labour. This comparison produces a measure for the tightness of the labour market. The two tightness measures represent the driving forces in the wage-price dynamics of the model. A long-run equilibrium with a stable inflation rate is characterised by a certain under-utilisation of the available factors of production, according to the so-called NAIRU concept[3].

Finally, various interest rates and the Swiss franc exchange rate are determined in the model's monetary block. The short-term interest rate (3m Libor) is governed by monetary policy as a function of the cyclical situation of the Swiss economy and movements in the Swiss franc exchange rate. Swiss long-term interest rates are connected to international long-term rates and also influenced by Swiss short-term interest rates. Mortgage rates react to Swiss short and long-term interest rates. Movements in the Swiss franc against the euro are explained by the relative tightness of monetary policy and inflation differentials. In the framework of the complete model, the monetary block plays a stabilizing role. For example, if a positive demand shock were to result in over-vigorous GDP growth and thus an unwanted rise in inflation, monetary policy reacts by tightening. Higher interest rates then curb domestic consumption and investment. At the same time, the restrictive move of

2 The model is described in more detail in Stalder (2001).

3 Cf. Layard, Nickel and Jackman (1991).

monetary policy causes the Swiss franc to appreciate, which also has a negative impact on aggregate demand via foreign trade. However, under the present rent law, the inflation-dampening effect of monetary tightening is hampered by the fact that rising mortgage rates result in higher housing rent inflation.

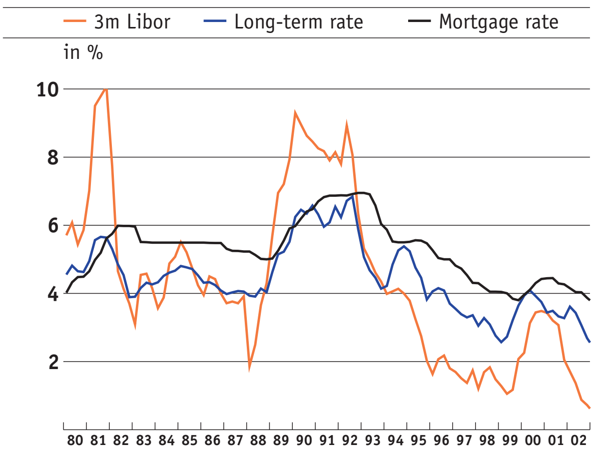
Housing rents play an important role in the inflation process in that they may drive a wedge between firms' selling prices, which influence the profitability of production, and consumer prices, which are crucial for the real purchasing power of wage earners, and so may give rise to an inflationary income conflict. Since wage formation is geared relatively strongly to movements in consumer prices, an increase in consumer prices (pc) due to higher rents (ph) causes wages (w) to rise relative to firms' selling prices (p), implying a deterioration in firms' profitability (the producer real wage w/p rises). But as wages are adjusted only partly to the increase in consumer prices, at the same time wage earners suffer a loss of real purchasing power (the consumer real wage w/pc falls). Firms react to the increase in the producer real wage by raising prices, while wage earners try to offset the deterioration in their real income position by making higher wage claims. If monetary policy is accommodating, this distribution conflict sets off an inflationary spiral. However, if the increase in rents assumed in this thought experiment is caused by a tightening of monetary policy, the moderating influence of lower capacity utilisation on price-setting and of higher unemployment on wage claims ultimately brings the rate of inflation down. But the decline in inflation in response to lower economic activity is impeded by the opposing influence of increasing housing rents on wage and price formation.

2 The modelling of mortgage interest rates and residential rents

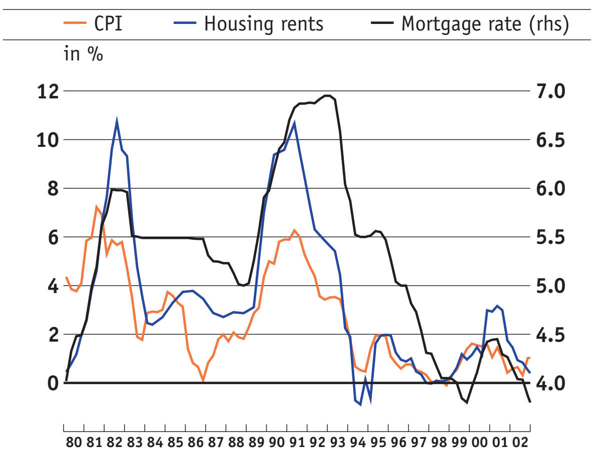
Figure 1 shows the development of short-term interest rates (3m Libor), long-term interest rates (10-year government bonds) and mortgage interest rates (existing mortgages) over the period 1980 Q1 to 2003 Q1. Mortgage rates are generally around one percentage point higher than long-term interest rates. Over time, they follow short and long-term interest rates with a certain lag. From Figure 2 it can be seen that rent inflation was for the most part somewhat higher than general consumer price inflation as measured by the CPI and much more volatile than the latter. The fluctuations in rent inflation appear to be due to mortgage rates.

More formally, these empirical regularities are confirmed by the econometric estimates for the mortgage rate and housing rent inflation.

Interest rates Figure 1



Inflation (yoy) & mortgage rate Figure 2



Equation for mortgage rates — Box 1

(1) $\Delta rhypo_t = b_1 \Delta rl_{t-1} + b_2 \Delta rs_{t-1} - \gamma(rhypo_{t-1} - \alpha - \beta_1 rl_{t-2} - \beta_2 rs_{t-2})$

rhypo: Interest rate on existing mortgages (%)
rl: 10-year government bond yield (%)
rs: 3m Libor (%)

Estimation period: 1981 Q1 to 2002 Q4

$R^2 = 0.729$ Durbin-Watson = 1.800

Standard error of equation = 0.0844

Parameter estimates (standard errors):

$b_1 = 0.1946$ (0.0378)	$\beta_1 = 0.6344$ (0.1154)
$b_2 = 0.0509$ (0.0123)	$\beta_2 = 0.1882$ (0.0546)
$\gamma = 0.1892$ (0.0256)	$\alpha = 1.6143$ (0.4019)

Mortgage rates are a function of long and short-term interest rates in the form of an error correction equation (Box 1). An increase in long-term interest rates (short-term interest rates) by one percentage point has the effect of raising mortgage rates by $b_1 = 0.1946$ ($b_2 = 0.0509$) percentage points in the short run (in the next quarter). The corresponding long-term effects, measured by $\beta_1 = 0.6344$ ($\beta_2 = 0.1882$), are much stronger. Long-term equilibrium is defined by the relation

$$rhypo = 1.6143 + 0.6344\, rl + 0.1882\, rs$$

Deviations in the mortgage rate from this equilibrium relation are reduced at a rate of 18.92% per quarter (error correction parameter γ). With a standard error of 0.0844 percentage points and an R^2 of 0.729 (with reference to the quarterly change in mortgage rates), the equation's fit can be regarded as good.

The relationship between housing rent inflation, general consumer price inflation and mortgage rates is also specified in the form of an error correction equation (Box 2). An increase in mortgage rates by one percentage point has the effect of raising rents by 2.33% in the the current quarter (b_2). Around 26% of general consumer price inflation is passed on to rents in the short term (b_1). The long-term elasticity of rents with reference to the CPI is constrained to $\beta_1 = 1.0$, since an unconstrained estimate deviates only marginally from this value. Long-term equilibrium is defined by the relation

$$\ln(ph) = 0.3693 + \ln(pc) + 4.9229\, rhypo + 0.00326\, t.$$

On unchanged mortgage rates, rents rise in the long term by 0.326% more than consumer prices overall (β_3) per quarter. An increase in mortgage rates by one percentage point has the effect of raising the level of rents by 4.9229% in the long term (β_2). Rent deviations from this long-term relation are reduced at a rate of about 17% per quarter (error correction parameter γ). With a standard error of 0.343 percentage points and an R^2 of 0.839 (with reference to the quarterly change in rents) the equation's fit is reasonably good as well.

Equation for residential rents — Box 2

(2) $\Delta \ln(ph_t) = b_1 \Delta \ln(pc_t) + b_2 \Delta rhypo_t + b_3 \Delta \ln(ph_{t-1}) - \gamma(\ln(ph_{t-1}) - \alpha - \beta_1 \ln(pc_{t-1}) - \beta_2 rhypo_{t-1} - \beta_3 t)$

ph: Residential rents
pc: Consumer Price Index
rhypo: Interest rate on existing mortgages/100

Estimation period: 1981 Q1 to 2002 Q4

$R^2 = 0.839$ Durbin-Watson = 2.109

Standard error of equation = 0.00343
Residual sum of squares = 0.000955

Parameter estimates (standard errors):

$b_1 = 0.2604$ (0.0962)	$\beta_1 = 1.0$ (Restriktion)
$b_2 = 2.3299$ (0.3017)	$\beta_2 = 4.9229$ (0.4564)
$b_3 = 0.1581$ (0.0801)	$\beta_3 = 0.00326$ (0.00011)
$\gamma = 0.1705$ (0.0379)	$\alpha = 0.3693$ (0.0756)

Different reactions to increases/reductions in mortgage rates
$b_{21} = 2.9777$ (0.476499) $b_{22} = 1.8822$ (0.3935)

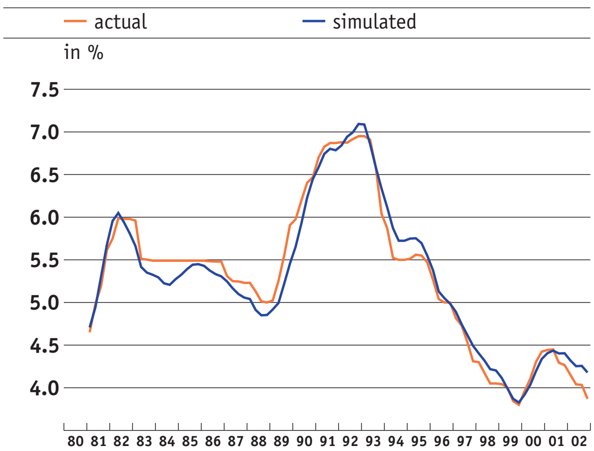
Residual sum of squares = 0.000920
H_0: $b_{21} = b_{22}$ F-value = 2.8840 P-value = 0.0896

The question of a possible asymmetry in rent adjustments when mortgage rates rise or fall can be addressed econometrically as follows. The variable $\Delta rhypo$ is divided into two variables: $\Delta rhypo^+ = \max(\Delta rhypo, 0)$ and $\Delta rhypo^- = \min(\Delta rhypo, 0)$. When mortgage rates rise, $\Delta rhypo^+$ measures the rise and $\Delta rhypo^-$ is zero. When mortgage rates fall, $\Delta rhypo^-$ measures the decline and $\Delta rhypo^+$ is zero. The estimation of an equation expanded in this way actually shows a somewhat stronger reaction of housing rents to increases in mortgage rates ($b_{21} = 2.9777$) than to reductions in mortgage rates ($b_{22} = 1.8822$) (cf. Box 2). Under the constraint $b_{21} = b_{22}$ the expanded equation coincides with the original one. This constraint is not rejected in an F-test with a P-value of 0.0896 at the 5% significance level. The empirical evidence for an asymmetric reaction is therefore rather weak[4]. The fact that the public does nonetheless feel that there is a marked asymmetry may be due to the fact that rent inflation shows a positive mean value of around 3.6% in the period 1980–2002, which can be explained by increases for other reasons. Consequently, even with completely symmetrical reactions to increases and reductions in mortgage rates, rent inflation hardly ever falls below zero. In other words, reductions in mortgage rates result only in rent inflation becoming lower than the long-term average.

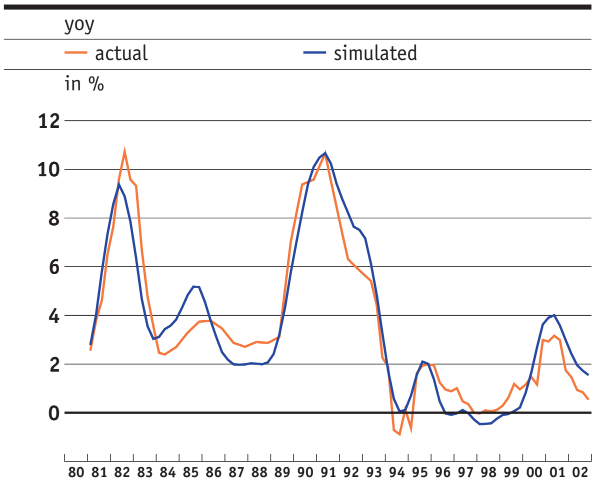
Taken together, Equations (1) and (2) describe the reaction of mortgage rates and rents to changes in short and long-term interest rates and consumer prices. The properties of this sub-system are illustrated in Figures 3 and 4. Figure 3 shows the fit of the two equations in a dynamic simulation using historical values for the three explanatory variables rs, rl and pc.[5] The actual paths of mortgage rates and housing rent inflation are reproduced by the model with satisfactory accuracy (baseline simulation).

Figure 3: Dynamic fit of the equations for mortgage rates and housing rents

Mortgage rates Figure 3a



Rent inflation Figure 3b



4 A similar distinction between increases and reductions in mortgage rates can also be made with respect to long-term rent developments by cumulating the $\Delta rhypo^{+}$ and $\Delta rhypo^{-}$ variables over the estimation period to $rhypo^{+}$ and $rhypo^{-}$ level variables and measuring the reaction of rents to these variables with two separate parameters (β_{21} and β_{22}). Statistically, this distinction proves completely insignificant. With values of 4.579 and 5.133 respectively, the estimated values for β_{21} and β_{22} differ only by little and the constraint $\beta_{21} = \beta_{22}$ is readily accepted by the data with a P-value of 0.639.

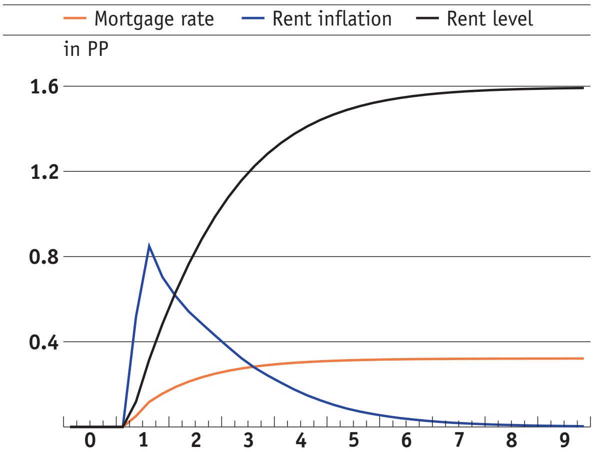
5 The explanatory variables rs, rl and pc, which are treated here as exogenous, will be endogenous in the simulations based on the complete model.

Figure 4 shows the reaction of mortgage rates and housing rents to an increase in short and long-term interest rates over a time-horizon of nine years (deviations from baseline). Short-term interest rates are raised by one percentage point and long-term interest rates by 0.21 percentage points, corresponding to the average pass-through of changes in short-term rates into long-term rates according to the model's rate term structure equation (not described here). Mortgage rates rise in the first year after the interest rate shock by about 0.2 percentage points and converge in the longer term to a level that is 0.3 percentage points higher compared to the base simulation. Housing rent inflation is driven up strongly by the rise in mortgage rates and, two quarters after the interest rate increase, reaches a peak deviation from baseline of 0.85 percentage points. Thereafter, the effect on housing rent inflation eases off as the mortgage rate increase flattens out. In terms of levels, rents rise in the longer term by slightly less than 1.6% above the baseline path.

Under present law, housing rents may be increased by 2.5% for every quarter percentage point rise in mortgage rates (by 2% when mortgage rates are above 6%, by 3% when mortgage rates are below 5%). In the above simulation exercise, mortgage rates rise by 0.3 percentage points and rents by 1.6%, which implies that a quarter percentage point rise in mortgage rates entails a rent increase of around 1.2%. This corresponds to only about half the statutorily permitted adjustment. One explanation for this might be that a certain proportion – possibly growing over time – of homes are let at market prices and are therefore, even under present law, de facto largely decoupled from the interest costs borne by house owners.

Reaction to a rise in interest rates — Figure 4

3m Libor + 1PP



3 The monetary transmission mechanism – present versus new rent law

3.1 Present law

The simulation outlined above is only a partial analysis. It describes the counter-effect of higher rent inflation under present rent law when monetary policy is tightened. If the move to a restrictive monetary policy is simulated with the overall model, then there are two additional effects: On the one hand, higher rent inflation enters into general consumer price inflation with a weight of 20%, which further boosts rent inflation. On the other hand, higher interest rates have a dampening effect on economic activity through other channels, which counteracts the increase in rent inflation and ultimately leads to lower consumer price inflation. Not only do the higher interest rates curb the domestic components of aggregate demand and thus reduce inflationary pressure; they also cause the Swiss franc to appreciate, which directly reduces imported inflation and at the same time has a negative effect on aggregate demand via foreign trade, thereby further reducing domestic inflationary pressure.

This transmission mechanism is depicted in Figure 5. Again a baseline simulation is compared with an alternative of monetary tightening in which short-term interest rates are raised by one percentage point above baseline values. The figure shows deviations from the baseline simulation in percentage points over a time horizon of 5 years. Long-term interest rates react immediately, rising by 0.2 percentage points, while mortgage rates increase with a lag of one quarter, exceeding baseline values by 0.3 percentage points in the longer term. Thus far, this just replicates the partial analysis described above. In the complete model, the aforementioned effects on aggregate demand reduce GDP growth by a maximum of slightly more than 0.6 percentage points one year after the interest rate increase. Consumer price inflation falls in the first quarter of the simulation by around 0.2 percentage points owing to the appreciation of the Swiss franc caused by the interest rate rise, but increases somewhat in the following two quarters as higher mortgage rates feed through into rents. As a result, one year after monetary tightening, the outcome of the simulation looks rather disappointing from a monetary policy perspective: GDP growth has been reduced by 0.6 percentage points while inflation has fallen by 0.15 percentage points only.

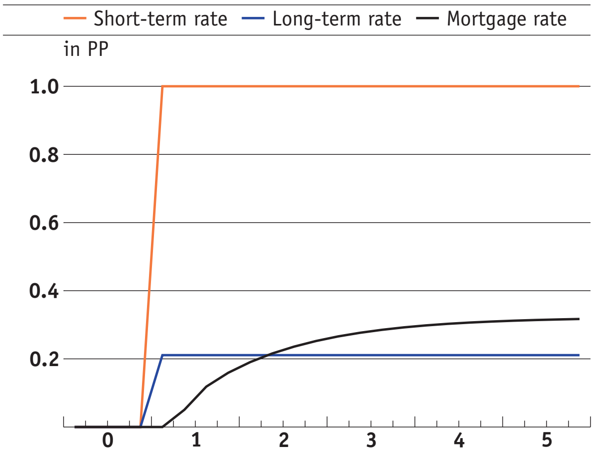
Of the various expenditure components, exports are curbed the most rapidly (appreciation of the Swiss franc) and housing construction investment the most strongly (higher interest rates). The corresponding declines in growth rates reach maxima of 1.2 and 2.9 percentage points respectively. The growth rate of business investment (investment in plant and equipment and business construction) contracts by a maximum of 1.4 percentage points (lower capacity utilisation, higher capital costs). Private consumption reacts sluggishly and suffers comparatively little loss of growth – a maximum of just under 0.5 percentage points (higher interest rates, lower real household incomes); however, lower growth rates persist for several years.

Consumer price inflation as measured by the CPI is subject to opposing influences, in particular at the beginning of the simulation period. On the one hand, imported inflation falls rapidly by 2.3 percentage points. On the other hand, rent inflation increases by around 0.7 percentage points. Inflation on domestically produced value-added as measured by the GDP deflator shows virtually no reaction in the short term. It is not until the output gap widens and unemployment rises that this measure of inflation also begins to fall. In the longer term, the dampening effects of monetary tightening on the various inflation rates converge. Raising 3m Libor by one percentage point reduces consumer price inflation, which is central to the SNB's monetary policy strategy, by around 0.5 percentage points in the longer term (after five years), once the counter-effect of higher interest rates on housing rents has been overcome[6].

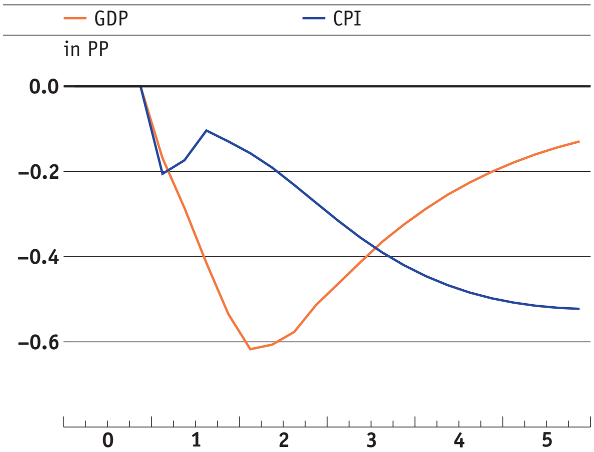
6 The model describes wage-price dynamics in the form of a convex Phillips curve. This reflects the fact that in times of capacity under-utilisation it is mainly real growth that is affected by changes in demand, whereas when capacity utilisation is high it is mainly prices and wages that react to changes in demand. Consequently, the effects of monetary policy on real growth and inflation depend on the state of the economy at the outset. The simulation described here assumes a slightly above-average economic situation. If the economy were in a extreme boom phase, the inflation-reducing effect of the tightening of monetary policy would be somewhat greater and the loss of GDP growth somewhat smaller.

Figure 5: Monetary transmission mechanism under the present rent law
Increase in short-term interest rate (3m Libor) by one percentage point
Deviations from baseline simulation in percentage points

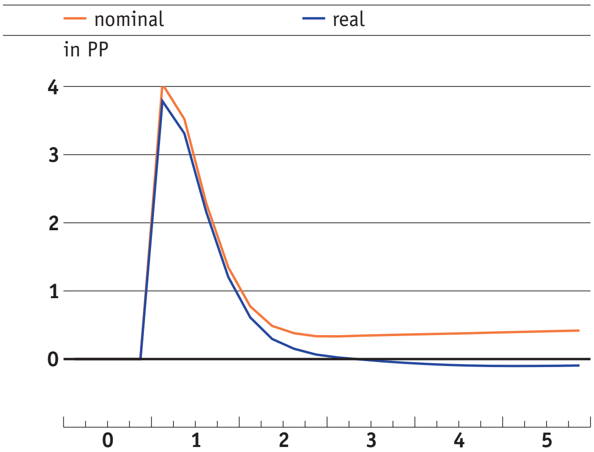
Interest rates — Figure 5a



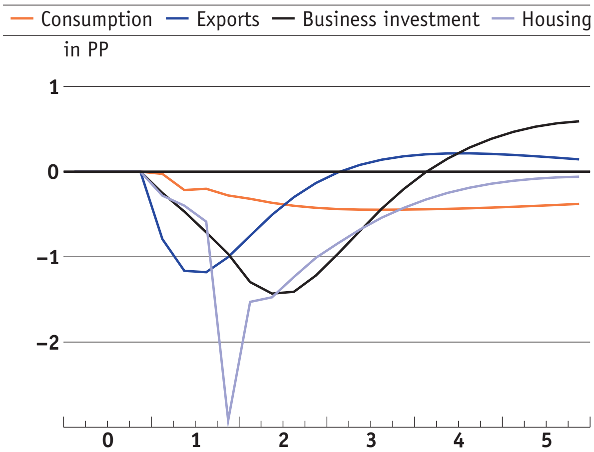
GDP growth & consumer price inflation — Figure 5b



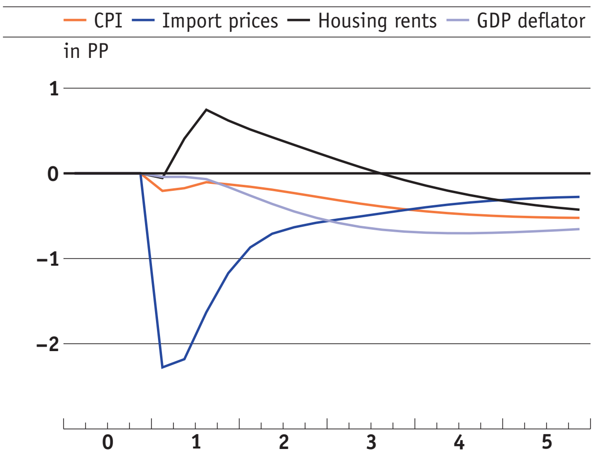
Appreciation of Swiss franc — Figure 5c



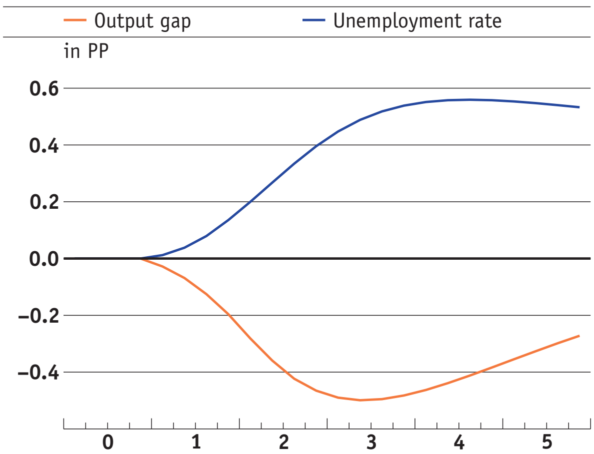
Growth: various demand components — Figure 5d



Various inflation rates — Figure 5e



Output gap & unemployment rate — Figure 5f



3.2 New law

Turning to the simulation of the monetary transmission mechanism under the new rent law, the econometrically estimated Equation (2) for housing rents must be replaced by an equation which takes account of the changes in the law. Of course, in the absence of an empirical database, it is difficult to figure out how the new regulations will impact upon rent formation in practice. In particular, the implications of the criterion proposed to decide whether rents are unfair or not (rents of comparable apartments) are controversial. From a purely monetary policy perspective, however, this aspect of the new rent law seems rather unimportant. If the procedure used to assess the fairness of housing rents was to result in higher rent inflation – as feared by the Tenants Association, for example – this process would take place independently of monetary policy and have hardly any impact on the monetary transmission mechanism itself. In other words, higher rent inflation would be included in the baseline simulation and the effects of a changed monetary policy stance relative to this baseline would not be affected. What is highly important for monetary policy under the new rent law, however, is the fact that housing rents are no longer linked to mortgage rates but to the CPI instead. This removes the counter-effect of higher housing rent inflation associated with a tightening of monetary policy.

A strict indexation of housing rents to the CPI could be represented in the simulation model by replacing Equation (2) with

(2′) $\Delta \ln(ph_t) = \alpha + \Delta \ln(pc_t)$.

A small positive value would have to be assumed for intercept α – as a counterpart to parameter β_3 in Equation (2) – because historically rent inflation has been somewhat more than one percentage point higher than CPI inflation on average. This would ensure that Equation (2′) produces a baseline simulation which in the long term matches the baseline simulation obtained under Equation (2).

Equation (2′) does not, however, reflect the new rent legislation perfectly, because it is the average annual CPI increase recorded over the previous two years that may be passed to housing rents. Consequently, the new law is probably better expressed by an equation like

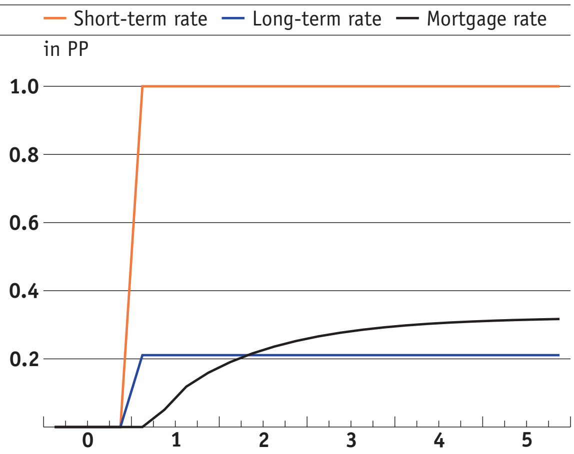
(2″) $\Delta \ln(ph_t) = \alpha + \ln(pc_{t-1}/pc_{t-9})/8$

Compared to (2′), this equation looks somewhat less attractive from a monetary policy perspective since, when monetary policy becomes restrictive, housing rent inflation follows the decline in general consumer price inflation only with a certain lag. With a weight of 20% in the CPI, this lagged response of housing rents will slow down the decline in overall CPI inflation to some extent.

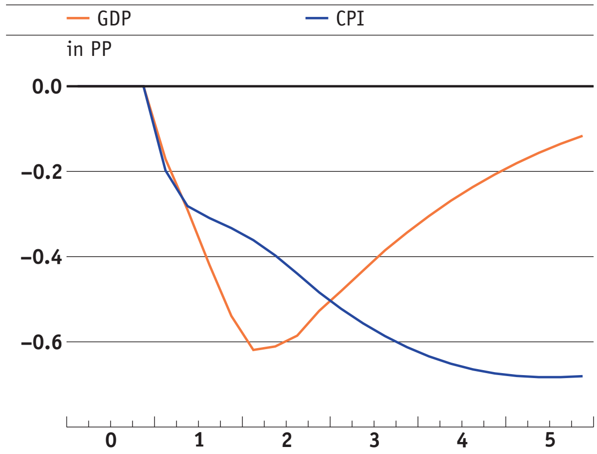
The transmission mechanism using Equation (2″) is shown in Figure 6. What is simulated is again an increase in short-term interest rates of one percentage point. All other assumptions are the same as in the previous simulation as well (Figure 5). As can be seen from a comparison of the two Figures, the transmission mechanism is not fundamentally altered by the new rent legislation but becomes more efficient: With the same monetary policy tightening (an increase in short-term interest rates by 1 percentage point) inflation contracts more rapidly and more strongly. The inflation dampening effect after three quarters is 0.3 percentage points (compared to 0.1 percentage points under present rent law), while after three years it amounts to 0.6 percentage points (0.4 percentage points). In the longer term, inflation is reduced by nearly 0.7 percentage points (instead of 0.5 percentage points under the current legislation).

Figure 6: Monetary transmission mechanism under new rent law
Increase in short-term interest rate (3m Libor) by one percentage point
Deviations from baseline simulation in percentage points

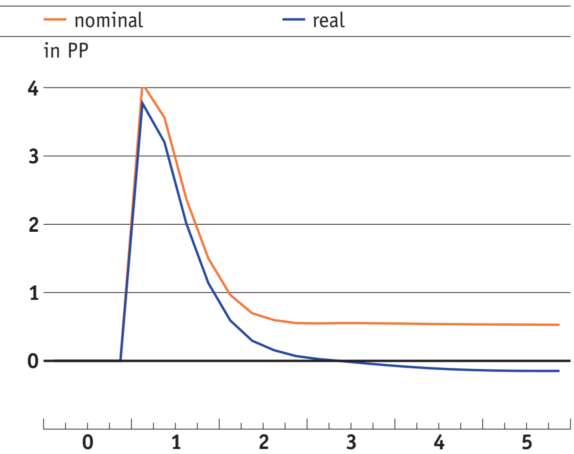
Interest rates — Figure 6a



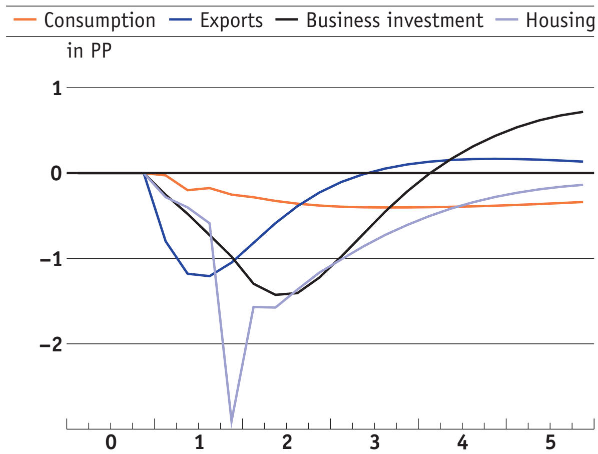
GDP growth & consumer price inflation — Figure 6b



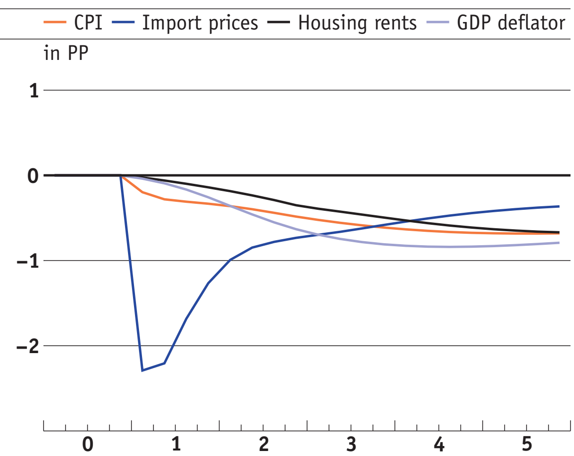
Appreciation of Swiss franc — Figure 6c



Growth: various demand components — Figure 6d



Various inflation rates — Figure 6e



Output gap & unemployment rate — Figure 6f

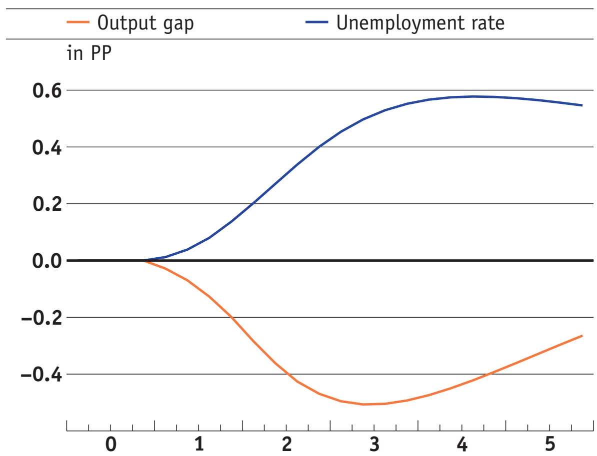
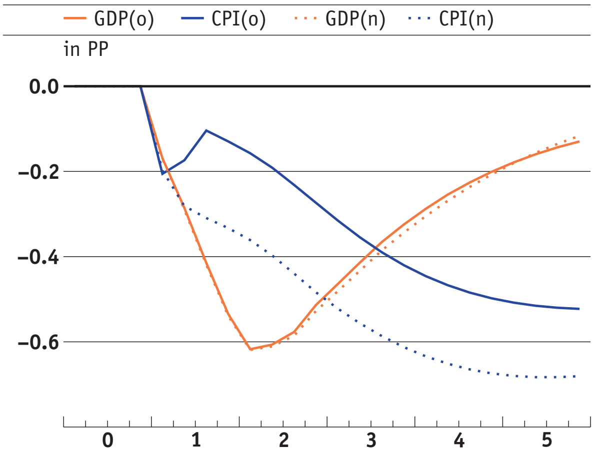
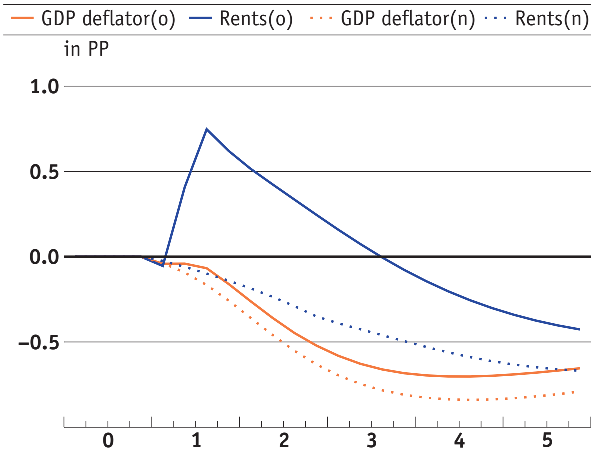


Figure 7: Monetary transmission mechanism: Present (o) versus new (n) rent law
Increase in short-term interest rate (3m Libor) by one percentage point
Deviations from the baseline simulation in percentage points

GDP growth & consumer price inflation Figure 7a



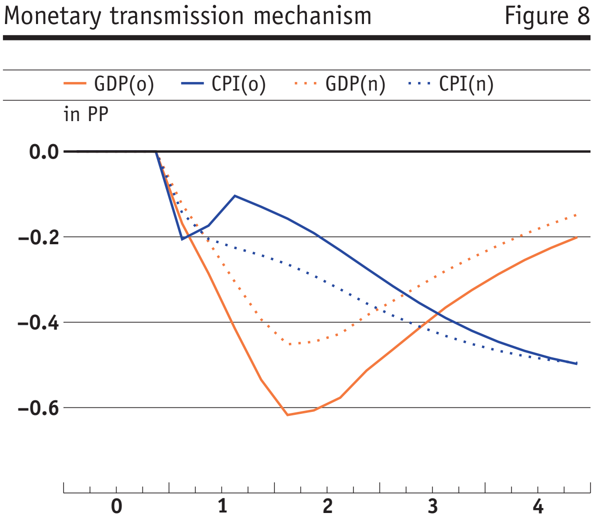
Inflation: GDP deflator & housing rents Figure 7b



The changes in the monetary transmission mechanism brought about by the new rent law can be seen more clearly from Figure 7, which compares the two simulations for selected variables. The constraining effects of a restrictive move of monetary policy on overall GDP growth under the two rent regimes are virtually identical. Considering the various components of GDP, private consumption is reduced by somewhat less under the new regime because households suffer a smaller loss in real disposable income when housing rents are decoupled from mortgage rates. Conversely, since higher mortgage rates can no longer be passed on to housing rents, monetary tightening depresses the profitability of rented housing more strongly. Therefore, the dampening effect on housing construction is more pronounced under the new rent law. Overall, however, the differences in the monetary transmission mechanism with respect to the real economy are fairly small. The main difference pertains to the behaviour of housing rent inflation, which rises strongly in case of monetary tightening under the present system, whereas under the new rent law it follows the decline in general consumer price inflation with a certain lag, resulting in a quicker and also somewhat stronger reduction of overall CPI inflation. Inflation on domestically produced value-added as measured by the GDP deflator also reacts somewhat more rapidly and more strongly to monetary tightening under the new rent law.

Instead of simulating an identical increase in 3m Libor under both rent regimes, one can also solve the model for the degree of restrictiveness that is necessary under the new rent law in order to achieve the same reduction in inflation as under the present legislation for a one percentage point increase in 3m Libor. As can be seen from Figure 8, under the new rent law an interest rate increase of 0.725 percentage points reduces the inflation rate within four years by the same amount of 0.5 percentage points as a one percentage point interest rate increase does under present rent law. Since the rate of inflation falls more evenly under the new law, the effect on the level of consumer prices on a four year horizon is nonetheless a little stronger (1.4% versus 1.2%). More importantly, though, the decline in inflation under the new rent law is accompanied by a significantly smaller constraining effect on the real economy (lower sacrifice ratio). The maximum loss in GDP growth is limited to 0.45 percentage points, compared to 0.62 percentage points under present rent law. In terms of levels, GDP falls only by 1.1% below its baseline value after four years, instead of 1.5% in case of the present rent law.

Figure 8: Monetary transmission mechanism: Present (o) versus new (n) rent law
Increase in 3m Libor of 1 percentage point (o) and 0.725 percentage points (n)
GDP growth and consumer price inflation: deviations from the baseline simulation in percentage points



The simulation results illustrated in Figures 7 and 8 support the decoupling of housing rents from mortgage rates that the SNB has been advocating since years[7]. When raising interest rates under the present regime, the SNB had always to explain to the public that its efforts to combat inflation must be expected to create through higher mortgage rates a disturbing counter-effect on rent inflation in the short run. This is not only a rather delicate communication problem but moreover likely to affect the public's inflation expectations in a manner that detracts from the effectiveness of monetary policy. With the decoupling of housing rents from mortgage rates as proposed by the new rent law, monetary tightening will produce a more rapid decline in the inflation rate. This facilitates the communication of monetary policy decisions to the public and at the same time may be expected – by curbing inflation expectations – to further enhance the intended dampening effects on inflation via the formation of expectations. As the model makes no allowances for such expectation effects, it is likely to underestimate the benefits of the new rent law for the efficiency of the monetary transmission process.

4 Summary

This article examines the monetary policy implications of the rent law reform passed by Swiss Parliament in December 2002. The analysis is carried out on basis of simulations with the SNB's macro-model. Under the present rent law, housing rents are linked to mortgage rates according to a pass-through rule. Contrary to the widespread public impression that house owners pass increases in mortgage rates quickly to housing rents but are reluctant to let tenants benefit from reductions in mortgage rates, the paper does not find clear empirical evidence for such an asymmetry. Irrespective of this result, however, the dependence of housing rents on mortgage rates turns out to be a rather disturbing element in the monetary transmission mechanism. If monetary policy is tightened, the rise in interest rates pushes up mortgage rates and thus housing rents. Since the latter enter the CPI with a substantial weight and consequently feed through quite strongly into wages and firms' production costs, the reduction in inflation that a tighter monetary policy is intended to deliver is almost wiped out in the short run, while real GDP growth is at the same time depressed quite substantially.

Under the proposed new rent law, housing rents are linked to the CPI. Rent inflation will therefore not increase if monetary policy is tightened but decline with a short time-lag on CPI inflation. The simulation shows that the inflation dampening effect of a restrictive move of monetary policy materialises more rapidly and evenly. Hence, a certain reduction in the inflation rate can be achieved by a smaller increase in interest rates and thus a less pronounced loss in real GDP growth. As far as the monetary policy transmission mechanism and the dissemination of information about monetary policy are concerned, the linking of housing rents to consumer prices instead of mortgage rates as proposed in the new rent legislation is therefore to be welcomed.

7 Cf. Lusser (1990), Rich (1993) and Roth (2002).

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Chronicle of monetary events

Message on the use of 1300 tonnes of National Bank gold and on the people’s initiative “National Bank profits for the Old Age and Survivors’ Insurance”

On 20 August 2003, the message on the use of 1300 tonnes of National Bank gold and on the people’s initiative “National Bank profits for the Old Age and Survivors’ Insurance (OASI)” was passed by the Federal Council and submitted to the Federal Assembly. On 29 January 2003 already, the Federal Council had taken some decisions in principle regarding the use of assets no longer required by the Swiss National Bank (“free assets”) and on the people's initiative “National Bank profits for OASI”, and it had commissioned the Federal Department of Finance to draft a message on these issues.

The Federal Council proposes that the National Bank’s assets no longer required for monetary policy purposes be maintained and managed by a fund outside the SNB. One-third of real investment income would be distributed to the Confederation and two-thirds to the cantons over a period of 30 years. If, upon expiry of this period, it is decided not to extend this agreement, the assets would be distributed to the Confederation (one-third) and to the cantons (two-thirds). A transitional provision in the Federal Constitution (art. 197, new, FC) would be the legal basis for this appropriation.

With regard to the second bill, the Federal Council recommends that the people's initiative “National Bank gold for OASI” be rejected. The initiative proposes that the SNB’s profits, minus an annual amount of CHF 1 billion to be distributed to the cantons, should be allocated to OASI. The Federal Council believes that the long-term financial consolidation of OASI cannot be achieved by the initiative. Moreover, the Federal Council fears that incorporating a financing target for OASI in the monetary article of the Federal Constitution (art. 99, section 4 of the FC) might compromise the SNB’s credibility and subject the Bank to increased political pressure.

The two bills are designed as separate federal decrees and can be approved or rejected irrespective of each other. The Federal Council submitted them to parliament through one single message since the decrees, in the widest sense, both deal with the allocation of the National Bank’s assets.

Total revision of the National Bank Law

Federal Parliament passes new law

On 15 September 2003, the National Council deliberated on the Federal Council’s message and draft for a total revision of the National Bank Law (NBL; cf. Quarterly Bulletin 1/2003, p. 59). It accepted the Federal Council’s bill virtually in its entirety and thereby advocated two material departures from the version submitted by the Council of States. Firstly, it rejected the proposal to include the banks’ postal account balances when calculating the minimum reserve requirements. Secondly, it advocated retaining the Bank Council’s right to nominate members of the Governing Board and their deputies for election by the Federal Council.

In the subsequent conciliation procedure, the Council of States already fell in with the National Council’s view on the procedure for appointing members of the Governing Board and their deputies during the first round of discussions. However, the question of how to treat the postal account balances with regard to the minimum reserve requirements had to be submitted to a conciliation conference of the two chambers. This conference proposed that the postal account balances be excluded from the banks’ minimum reserve calculations, and both chambers voted in favour of this motion. On 3 October 2003 a final vote was taken, and the draft law – amended in accordance with the conciliation procedure – was adopted by a large majority of votes in both chambers of Parliament.

The parliamentary deliberations ultimately resulted in only one material change to the Federal Council’s bill – namely, that the Swiss National Bank’s duty to report to the Federal Assembly be made more formal: in future, the Governing Board will have to submit to Parliament a written annual report on the fulfilment of the SNB’s statutory tasks. Unless a petition for a referendum is submitted within the statutory three-month period, the new National Bank Law can be expected to take effect in spring 2004.

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