23. 7.82

MR BALFOUR
THE GOVERNOR'S PRIVATE SECRETARY

Copies to: Mr MacDonald O/R
The Deputy Governor's
Private Secretary
Group 6

ADL
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SPZ will ADL plse read this, clean up as necessary & despatch via you to Sil dan

SWITZERLAND

for P/M Mtg 29/7

The Governor asked for a brief on recent economic developments and monetary policy in Switzerland. A note is attached.

On 2/8

Mr Colleyfer 3/8

without knowing what was asked for, this looks OK to me. I suggest the first part on the economy might be more easily digestible if the bits I have underlined in the [illegible] were underlined in type ADL 2/8

23 July 1982
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SWITZERLAND

1 The Economy

Real GDP rose by 2% last year - less than half as fast as in 1980 - and this year is expected to fall by 1-1½% as the effects of the world recession work through (the Swiss business cycle usually lags that of the major industrialised countries by around 18 months). The weakest component of demand is expected to be fixed investment which is forecast to fall by 3½%; but private consumption also declined in the first quarter, leading to involuntary stockbuilding which in turn will tend to depress the growth in GDP later in the year.

Total industrial production, which stagnated last year, is forecast to fall by some 2½% this year. Even so, unemployment was no higher than 0.4% of the labour force in June (compared with 0.1% a year earlier), thus remaining insignificant by international standards. However, vacancies are at their lowest level for several years; and employment has fallen particularly sharply in the watch-making industry, where production fell by over 10% in 1981.

The 1981 trade deficit, at $3.7 bn (4¼% of GDP), was almost half as small as in 1980, and a further reduction is expected this year: this largely reflects an improvement in the terms of trade, but weaker economic activity has also reduced the volume of imports. The current account, which went into a small deficit in 1980, returned to a sizeable surplus (about $2 bn) last year and may reach $3-3½ bn this year.

Consumer price inflation fell rapidly from 7½% in September 1981 (the highest for seven years) to 4.7% in March this year, but subsequently rose again to average nearly 6% in the second quarter. Wholesale prices continue to rise only slowly - by around 3% - but the recent strengthening of the dollar, together with the prospect of higher food prices later in the year, makes the forecast of a slowdown in consumer price inflation to 4% (year-on-year) by December now seem somewhat optimistic.

The acceleration in inflation last year prompted the SNB to raise discount rate in stages from 3½% to 6%. When inflation slowed down again early this year, the central bank cut the rate to 5½% in March, while money market rates fell sharply: for example, the three-month interbank rate declined from 10% at the beginning of the year to just over 3% by early May. Subsequent developments - the weakening of the franc to 85 centimes to the DM by mid-May (compared with 80 centimes in early April), faster inflation, and rapid growth in the monetary base, led for a time to a renewed tightening of monetary policy and higher interest rates. But more recently three-month interbank money has declined from 5% at the beginning of July to 3½% at present.

2 Monetary Targetry

From 1975 to mid-1978, the targeted monetary aggregate in Switzerland was M1, which was controlled via the monetary base, as there was found to be a fairly stable short-term relationship between the two. Only in one of the first three years was the outturn close to target, owing to constraints imposed by exchange rate considerations. And following a particularly strong appreciation of the franc, the target was abandoned altogether in mid-1978 in favour of an exchange rate ceiling of DM100 = S Fr80. As a result of heavy central bank intervention, M1 rose by over 16% during that year, the effects of which were claimed to have been felt until well into last year. No target for M1 was set for 1979, but with pressure on the exchange rate having subsided, the SNB set a limit in mid-year to the absolute growth of the monetary base. The SNB adopted the base [1] as a target in preference to M1, largely because the earlier short-term relationship between the two appeared to have broken down under the influence of exchange rate expectations.

In both 1980 and 1981 the target was an average rise of 4% in the monetary base, but in each year the outturn was an actual decline of ½%. In 1981 the target was in fact abandoned (without publicity) before mid-year, when policy had to be tightened appreciably to combat rising inflation. This year's target - a rise of 3% - is

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[1] Essentially, bank notes in circulation plus banks' balances at the SNB.

much more expansionary than would appear at first sight, because notes in circulation (which comprise 75% of the base) are not expected to rise, and banks' balances at the SNB will therefore need to increase by around 12% if the target is to be met. This markedly relaxed stance has been justified by the recession and the associated weak M1 multiplier. During the first three months of the year, the base was still 1¼% below the corresponding period of 1981. Since then, a much easier monetary policy, essentially reflected in 'cheap' dollar swaps, has led to lower interest rates and rapid growth in CBM (which by May was 2½% higher than a year earlier). The average for the first five months was broadly the same as in the corresponding period of 1981; but if policy had not been tightened somewhat and the rate of increase during the three months to May had continued, the target would have been overshot by a large margin. The SNB now feels that it is broadly on course.

The exchange rate ceiling against the deutschemark, mentioned earlier, in practice became irrelevant before the end of 1978, but was not formally abandoned until late 1981. The present status of exchange rate policy is difficult to determine: Leutwiler has indicated that the SNB will not abandon this year's monetary target in order to hold down the franc, while Languetin stated last month that 'monetary policy can no longer be geared simply to a steady increase in the money supply independent of the exchange rate'.