# EUROPEAN ECONOMICS UPDATE

CAPITAL ECONOMICS

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## SNB determined to head off deflation threat

- **The latest comments from the Swiss National Bank (SNB) confirm that it will maintain its strong policy stimulus for the foreseeable future, helping to reduce the significant risk of a sustained period of deflation. But we still expect the Swiss economy to take longer to recover than others, a view that the SNB also expressed today but which consensus forecasts have yet to reflect.**
- In an interview in today's Swiss *Handelszeitung* newspaper, SNB Governing Board member Thomas Jordan stated that the Swiss economy was unlikely to expand again before mid-2010, after the US and the euro-zone, and that a long period of deflation could not be ruled out. **Accordingly, he said that the Bank had no plans to alter its policy of intervening to prevent any appreciation of the Swiss franc, providing generous liquidity to the banking sector and purchasing corporate and covered bonds.**
- Its bold actions have already left the SNB among the central banks acting most aggressively to stimulate their economies. The Swiss monetary base has soared to 23% of GDP, nearly double the equivalent shares in the US and euro-zone. This has partly reflected the surge in currency purchases necessary to keep the franc at around 1.50-1.53 per euro, which has not been fully sterilised. (See Chart 1.)
- But, like Mr. Jordan, we think that fears of the inflationary consequences of these policies are overdone. Consumer price inflation has already dropped to -0.9% and, while this largely reflects temporary base effects in the energy component, there is plenty of evidence of sustained downward pressure to come.
- **Despite currency intervention since March, import prices dropped by a huge 10.4% in the year to July and producer price inflation stood at a record low of -3.8%, albeit mainly due to falling energy prices.** (See Chart 2.) Admittedly, consumers' inflation expectations have nudged up, but only from a very low level, and the recent increase in unemployment suggests that wage growth will soon fall.
- Given a relatively moderate downturn so far, less economic slack has opened up than in the euro-zone. But a necessary correction in inventory levels probably prompted a very steep contraction in Q2 (data to be released on 1st Sep.) and the business surveys so far point to a further decline after that.
- The fact that the euro-zone contracted only marginally in Q2 might look encouraging as the region accounts for around half of Switzerland's exports. **But note that euro-zone *imports* are still falling sharply.** What's more, given Switzerland's specialism in the export of machinery, metals, electronics, and chemicals, it will not benefit directly from the region's car purchase incentives. With the financial sector still struggling too, we see sustained weakness in total activity prompting spare capacity to surge.
- In all, then, while the SNB's pledge of continued strong policy support should help to avoid a worst case deflationary scenario, we still see the Swiss economy lagging behind others next year with around a 1.5% contraction to follow this year's 4.0% fall. **Resulting downward pressure on the franc might eventually allow the SNB to ease off its currency intervention, but other forms of policy support will remain in place for a long time to come.**

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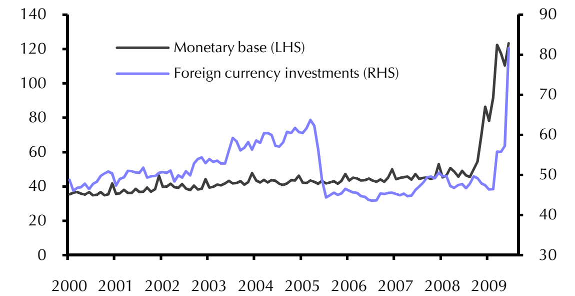
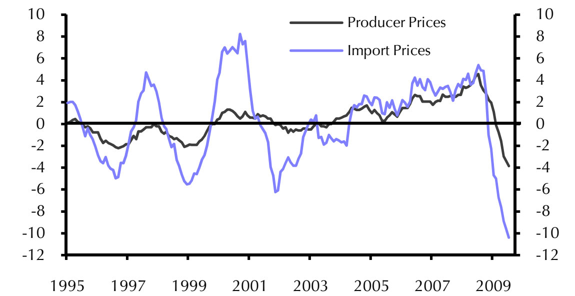
**Chart 1: SNB Currency Holdings & Monetary Base (CHF bn)**




Source – Swiss National Bank

**Chart 2: Swiss Producer & Import Prices (% y/y)**




Source – Thomson Datastream