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Western European Indicators and Insights

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Switzerland: Deflation envisaged?

Surprising few once again, and underlining the policy shifts it made in a series of statements over the last month, the SNB reiterated that it will enforce the minimum exchange rate of SFr 1.20 per euro set on September 6 with the utmost determination, once again underscoring that it is prepared to buy foreign currency in unlimited quantities. It continues to aim for a three-month Libor at zero and will maintain total sight deposits at the SNB at significantly above SFr 200 billion.

Very clearly, the SNB is taking a stand against the acute threat (mainly from the risk of deflationary development) it regards is facing the Swiss economy from what it sees as the massive overvaluation of the Swiss franc. The SNB very much noted that even at a rate of SFr 1.20, the Swiss franc is still high and should continue to weaken over time. If the economic outlook and deflation risks so require, the SNB will take further measures.

As far as growth is concerned, the SNB very clearly acknowledges that the global economy has slowed substantially in the course of the last quarter and that risks for the global financial system have increased substantially, all worsening the outlook for the advanced economies such as Switzerland. The SNB expects Swiss GDP growth to come to a halt in the second half of the year, meaning that for 2011 as a whole, the economy will average growth between 1.5-2.0%, an apparently acceptable performance albeit only resulting from the favorable economic development in the first half of the year. The SNB alleges that without the stabilizing effect of the minimum exchange rate, there would be a substantial threat of recession.

Regardless, from the SNB perspective, the inflation outlook has shifted substantially downwards as a result of the massive appreciation in the Swiss franc and the deterioration in the outlook for the global economy. For 2011, the forecast shows an inflation rate of 0.4%, for 2012 a rate of -0.3% and for 2013 a rate of 0.5%.

There is little of note in the latest SNB update. Very clearly, the SNB is emphasizing downside risks to activity and prices that actually materialize in the next year to the extent that it envisages a year of falling consumer prices, with little recovery in 2013. To some extent this caution is justified, although given the clear economic resilience seen in Switzerland to date, something that can be put down to its resistant banking system and inter-related monetary dynamics, the SNB may be being too wary. Indeed, there are clear warnings from some that the massive monetary stimulus the SNB is entertaining via the prospect of unlimited intervention (albeit with it unclear how much will be sterilized) carries with it the threat of much higher inflation down the road. Indeed, some remind of the pegging of the franc against he Deutschemark in the late 1970s, something that was followed by a decade of higher inflation. This omits the fact that all countries experienced high inflation in the 1980s, implying that SNB actions alone were not to blame.