What a return to negative territory for Swiss inflation means for the SNB

Inflation in Switzerland has dipped back into negative territory, coming in at -0.1% year-on-year. This development presents a significant challenge for the Swiss National Bank, which is now expected to respond – likely by cutting interest rates, and possibly even pushing them into negative territory

Schaffhausen, Switzerland

Inflation slips below zero

Here we go again... Swiss inflation figures for May show a return to deflation, with the Consumer Price Index (CPI) falling by 0.1% year-on-year. Since peaking at 3.5% in August 2022, inflation has steadily declined, reaching 0% in April and now slipping into negative territory. This isn't unprecedented; Switzerland has experienced several deflationary periods in recent years, including during the pandemic (March 2020 to March 2021), and earlier from September 2014 to November 2016, and October 2011 to October 2013. In fact, we've seen Swiss inflation in negative territory for roughly one-third of the time since 2009 until now (75 out of 197 months).

The latest decline is largely driven by external factors. A strong Swiss franc has significantly reduced the cost of imported goods, which fell by 2.4% year-on-year in May. Given that imports make up 23% of the CPI basket, this has a notable impact on overall inflation in Switzerland.

Additionally, global energy prices have dropped, leading to an 8.3% decline in energy inflation. Administered prices, which account for 27% of the CPI basket, also fell by 0.7%.

On a more stable note, service inflation remains at 1.1%, and core inflation is holding at 0.5%, both still within the SNB's comfort zone.

A persistent headache for the SNB

Despite the external nature of these deflationary pressures, the Swiss National Bank (SNB) finds itself in a difficult position. Its medium-term inflation target is between 0% and 2%, and current figures fall outside this range. If energy prices remain low and the franc stays strong, inflation could remain too subdued for months to come.

To prevent inflation expectations from becoming unanchored, the SNB is likely to act. To do this, it will seek to combat the appreciation of the Swiss franc with the weapons at its disposal. First and foremost, key interest rates. We expect the SNB to cut its policy rate by 25 basis points at its next meeting on 19 June, with further cuts likely. Based on current data, a return to negative interest rates before year-end appears increasingly probable. Our base case includes a second 25bp cut in September, bringing the policy rate to -0.25%. While the SNB would prefer to avoid deeper cuts, a 50bp reduction in June cannot be ruled out.

We anticipate the SNB will aim to stop at -0.25%, but further deterioration (such as a stronger franc or continued declines in oil prices) could force its hand. A more aggressive move to -0.5% would likely require the SNB's conditional inflation forecasts to turn negative over the medium term.

It is also likely that the SNB will want to rely more on intervention in the foreign exchange market in the coming months, to accompany rate cuts and push for a depreciation of the Swiss franc. However, this is not easy in the current conditions, and there is always the risk of provoking the ire of the US administration. Remember that during US President Donald Trump's first term in office, Switzerland was labelled a currency manipulator by the United States...

The SNB is likely to intervene a little more in the coming months, and also to insist more on the fact that it can do so. But these interventions will not be a panacea, and the SNB is likely to be left with a persistent headache from a situation that will be difficult to resolve in the coming months.

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