Swiss Economics

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How justified are inflationary fears?

Monitor Switzerland | Q3 2021

Editorial

Dear readers

Swiss economic output has now returned to pre-crisis levels, and the recovery is ongoing. However, coronavirus and its health consequences will likely preoccupy Switzerland for quite some time yet. Although the vaccination progress made so far and the agility of the economy should suffice to keep the risk of another recession very low, there is no place for wild optimism. A number of sectors – such as catering and various branches of the leisure sector – are still subject to selective restrictions, while for other sectors such as international tourism and large events, a return to "normality" will not come until well into 2022.

In manufacturing, by contrast, global demand is now so strong that existing capacity is barely sufficient, which is in turn leading to rises in the prices of goods. Price surges, combined with massive government spending and extremely expansionary policy on the part of central banks, have sparked inflationary fears, leading some observers to recall the damage done by inflation back in the 1970s. Back then, persistently high inflation distorted the relative price structure: It allowed companies to believe they were making profits even though they were actually posting losses, with the result being misinvestment on a huge scale. At the same time, households were continually striving to stave off losses on the purchasing power of their income and savings. It was only the decisive action of central banks – and above all the resoluteness shown by the then Chairman of the US central bank (Fed), Paul Volcker, that finally tamed the "inflation dragon".

History shows that what followed was a long phase of low and comparatively stable inflation worldwide. At times of crisis, most recently in the pandemic year of 2020, inflation at times even turned negative, particularly in Switzerland. However, declining prices on a broad front can prove at least as damaging as excessive rises and inflation. For example, the economic crisis of the 1930s was characterized by a deflationary spiral, i.e. a vicious circle of declining prices, spending reticence on the part of consumers, and rising unemployment. Particularly in the US, the fear of deflation has cemented itself firmly in the economic memory. In Switzerland, by contrast, the fall in the level of prices was in some cases even viewed as a positive thing. Specifically imported goods became cheaper, which is why there was no negative feedback effect on the labor market. From an economic perspective, however, it should nonetheless be seen as a good thing that inflation has recently pushed back into positive territory in Switzerland too.

In our main scenario, we remain optimistic that the benign inflation climate in Switzerland and Europe will persist for the time being. Moreover, we are expecting inflationary risk to remain at a manageable level even in the US (cf. Focus article, page 12). However, the higher-risk alternative scenarios cannot be wholly ruled out, and therefore need to be watched carefully.

We wish you an enjoyable and interesting read.

André Helfenstein
CEO Credit Suisse (Switzerland) Ltd

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Monkey wrench in the recovery

The COVID-19 pandemic will preoccupy Switzerland for some time yet, but the economic recovery is persisting. We are anticipating economic growth of 3.5% this year, and 2.5% in 2022. Certain industry sectors are lagging behind, however.

Strong GDP growth thanks to easing of COVID measures

Swiss gross product (GDP) recorded a 1.8% quarter-on-quarter rise in the second quarter. This expansion was attributable to the widespread easing of the COVID containment measures imposed during the lockdown in the first quarter, and strong global demand for goods. It is clear that Switzerland has coped relatively well with the crisis from an economic standpoint so far (cf. Fig. 1): Only in the US, where the government has massively stimulated economic growth through government spending, and in Sweden, where the virus containment measures imposed were for the most part less strict, has economic output in the second quarter of 2021 proved higher than in Switzerland when compared to pre-crisis levels.

GDP climbs back above pre-crisis levels in recent weeks

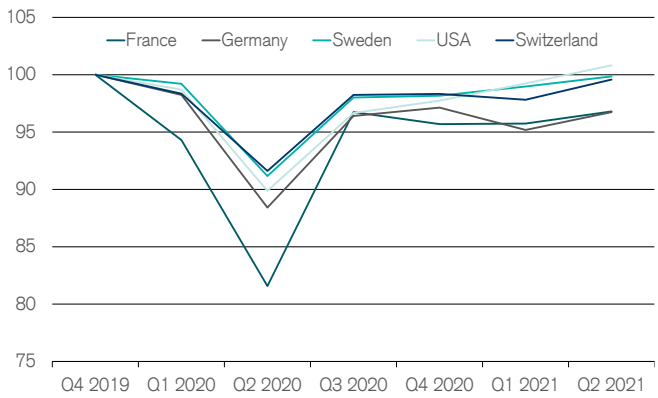
According to the weekly economic indicator published by the State Secretariat for Economic Affairs (SECO), Swiss GDP has actually surged past pre-crisis levels in recent weeks (cf. Fig. 2). That said, the loss in national prosperity as a result of the pandemic is likely to have been significant: When taking into account the lost growth, we estimate that pandemic-related GDP losses in Switzerland amount to some CHF 57 bn. (approx. 8% of 2019 GDP). Furthermore, the recovery has been extremely uneven: While some sectors such as manufacturing (including the pharma industry in particular), automotive sales, and insurance and financial services have actually surged past pre-crisis levels, others – such as tourism and transportation (including public transport) – still languish some way below those levels (cf. Fig. 3).

Positive leading indicators

The economic recovery can be expected to persist over the coming months. The Purchasing Managers Index (PMI) for manufacturing – produced by us in collaboration with procure.ch – remains close to its record high, while its counterpart for the services sector is likewise comfortably in the growth zone. In addition, the labor market is improving, which is in turn having a positive impact on consumer sentiment. The unemployment rate should gradually fall further to 2.5% by the end of 2022, while the level of short-time working is also declining further.

Fig. 1: Switzerland copes with economic crisis relatively well

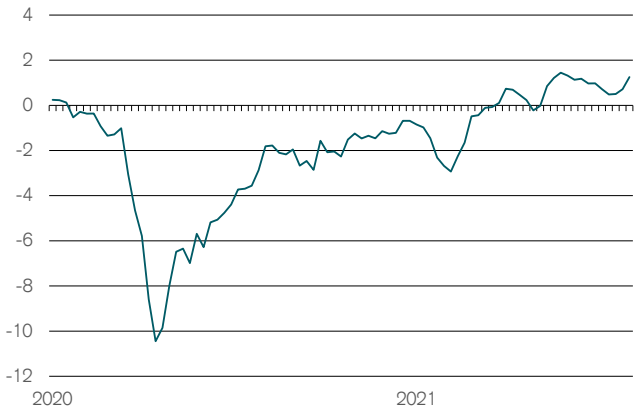
Real GDP, seasonally adjusted. Q4 2019 = 100



Source: Datastream, Credit Suisse. Last data point: Q2 2021

Fig. 2: Weekly economic activity exceeds pre-crisis levels

Economic activity relative to pre-crisis level, change in %



Source: State Secretariat for Economic Affairs (SECO), Credit Suisse. Last data point: Week 32 2021

Pandemic persists, but risk of recession is low

Any excessive optimism would be misplaced, however, as the recovery will repeatedly be held back, particularly as it is likely to be quite some while before the pandemic is fully under control. In certain areas, most notably intercontinental tourism, it would be unrealistic to expect any normalization of demand before mid-2022, while other sectors such as catering and various branches of the leisure industry are repeatedly subject to selective restrictions. However, the progress of the vaccination program so far and the agility of the Swiss economy should suffice to keep the risk of any recession low, even in the event of a severe deterioration of the epidemiological situation and the renewed imposition of certain containment measures.

Supply problems lead to consistently high demand for goods, ...

In addition, the recovery will continue to be impeded for the time being by widespread supply shortages in manufacturing: Around 70% of the purchasing managers who took part in our monthly survey are currently reporting extended supply times and rising purchase prices. Accordingly, some of the high demand for goods will remain unsatisfied for quite a while. Moreover, the times of declining prices that gave consumers additional incentives to spend look to be over for now (cf. Focus on inflation on page 12). On the other hand, while supply problems will act as a brake on what has become a booming recovery for manufacturers, they will not derail that recovery. Furthermore, the increased demand for goods should now persist for longer than we had previously forecast as a result of various supply delays. As such, we are not anticipating demand for goods to flatten off meaningfully until mid-2022. However, there could then be quite a steep slump due to the future threat of saturation and the possible destocking on the part of companies.

... but this can be expected to weaken going forward

Indeed, a certain saturation in demand for durable consumer goods is already evident in the monthly figures for retail sales (cf. Fig. 4). The leap in the sales of durable consumer goods was much less pronounced after the second lockdown than after the first. In part, this is obviously due to the fact that the second lockdown was shorter and less draconian than the first, while at the same time more alternative spending opportunities were available. But it is also in the nature of durable consumer goods that – once they have actually been bought – a certain need is satisfied for a prolonged period of time.

Recovery persists – but so does disparity between sectors

As a consequence, by mid-2022 we are expecting a sharp weakening in manufacturing momentum against a backdrop of higher supply, which should in turn resolve supply delays and take some of the heat out of prices. Furthermore, the recovery is then likely to have spread to other sectors that are currently still suffering from restrictions and therefore lagging behind. So while we should see an overall Swiss GDP rise of 3.5% this year, the growth tempo next year can be expected to slow to 2.5%.

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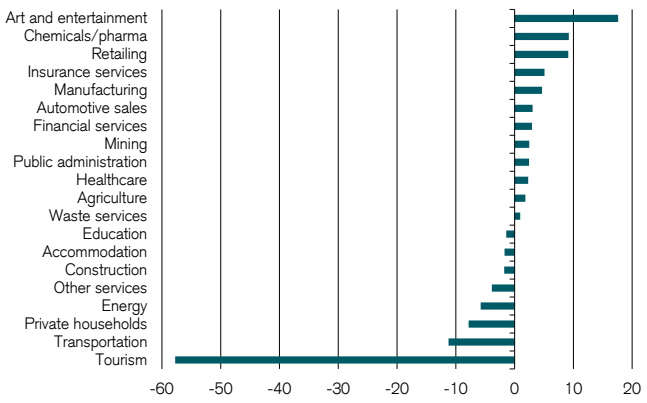
Fig. 3: Significant differences between sectors

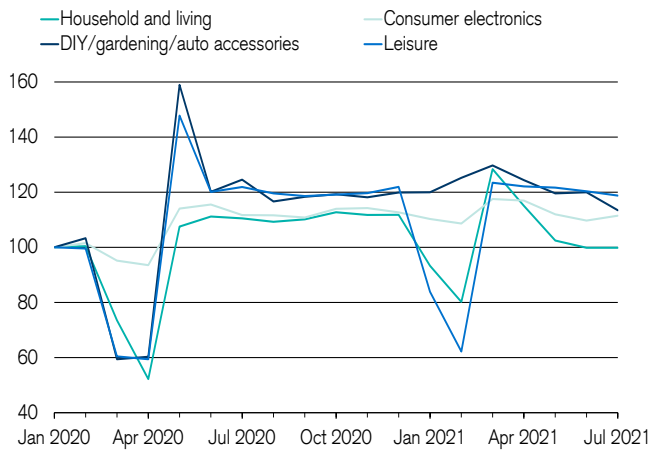
Deviation of value creation from level recorded in Q4 2019, in %



Source: State Secretariat for Economic Affairs (SECO), Credit Suisse. Last data point: Q2 2021

Fig. 4: Sales of durable consumer goods flatten off

Index January 2020 = 100



Source: GfK, Credit Suisse. Last data point: July, 2021

Inflation

Inflation is set to rise to 1% next month, before then reverting to a level below this figure in 2022. On average, the rate of inflation is likely to amount to 0.5% in both 2021 and 2022. The main drivers of the current acceleration in price momentum include the "Living", "Transport", "Household goods", and "Restaurants and hotels" components. Higher oil prices (which impact the "Living" and "Transport" categories) have contributed some 0.5 percentage points to the rate of inflation since May 2021. Under the assumption that oil prices remain constant in the future, their contribution to Swiss inflation is likely to remain similarly high until December 2021, before then gradually falling back.

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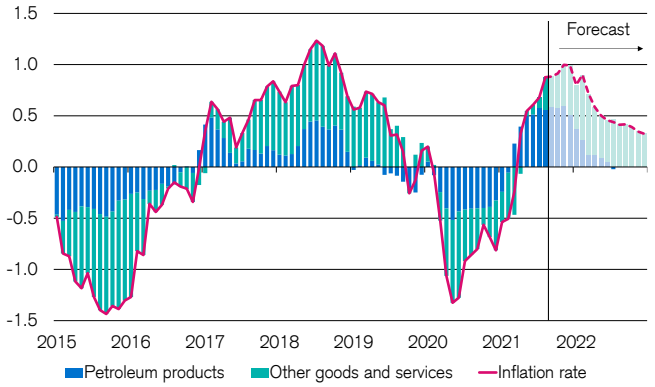
Temporary rise in inflation

Change in %



Source: Refinitiv Datastream, Credit Suisse. Last data point: August 2021

Labor market

After employment continued to decline in the first quarter of 2021, it then recovered in the second quarter against the backdrop of the easing of coronavirus measures (+0.3% compared to previous year). The lion's share of this growth is attributable to the temporary labor segment, which – just like in previous crises – reacted sharply to the economic downturn and subsequent upturn. Following a hefty slump in the second quarter of 2020 (-18% compared to the previous quarter), the number of temporary employees then picked up relatively briskly; by mid-2021 it was actually 9% above its end-2019 level after seasonal adjustments. For employment overall, we are expecting average annual growth of 0.3% in 2021, and 1.2% in 2022.

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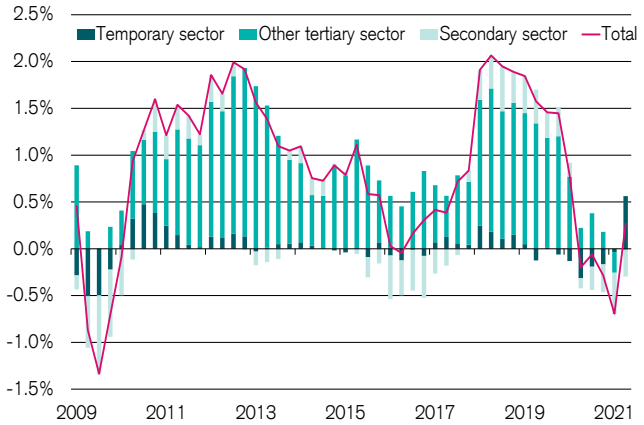
Temporary labor segment makes good the ground lost during coronavirus

Employment (full-time equivalents): Year-on-year change in % (total) and growth contributions in percentage points (sectors)



Source: Federal Statistical Office, Credit Suisse; Last data point: Q2 2021

Immigration

In the first six months of the current year, there was a net influx of 109,103 persons into Switzerland. Based on this half-year figure, net immigration is 9.2% lower than for the equivalent prior-year period. This is in line with our forecast of a slight weakening of net immigration this year. On the one hand, demand for foreign labor is likely to be lower against a backdrop of muted employment momentum; on the other, following a sharp decline in the number of short-term residents in 2020, we can expect to see fewer changes of status from the non-permanent to the permanent residential population.

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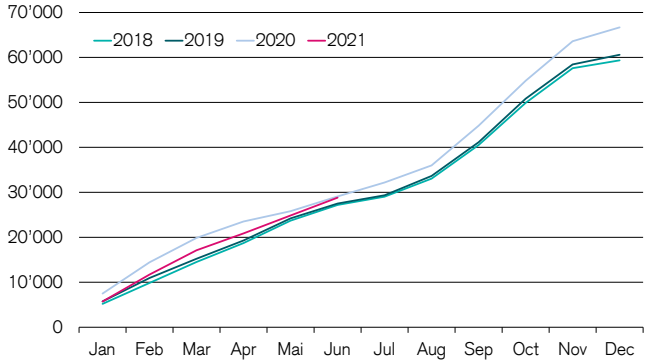
Net immigration records slight year-on-year decline in H1 2021

Net immigration of permanent foreign residential population (excluding registry corrections), cumulative values



Source: State Secretariat for Migration, Credit Suisse. Last data point: June 2021

Pharmaceutical industry

The pharma industry made a significant contribution to the recovery of Swiss exports overall in the second quarter of 2021. The most impressive increase was recorded by pharma exports to Spain, which were up 106% compared to the prior-year quarter. This is probably attributable to deliveries of active agents for COVID-19 vaccines, as Spain is a key center for the production, bottling, and delivery of such products. Demand for vaccines is likely to remain high – as is international demand for other pharmaceutical products made in Switzerland.

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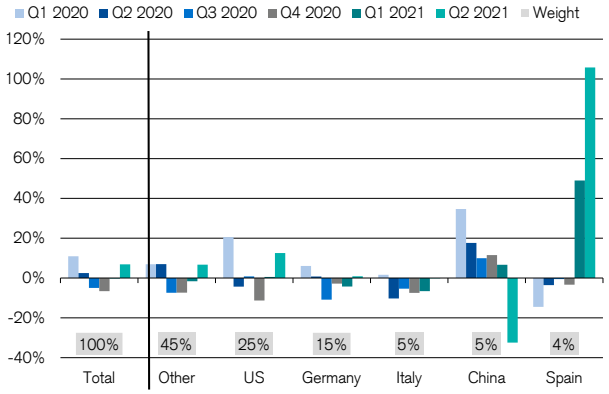
Surge in pharma exports to Spain

Development of pharma exports compared to prior-year quarter, by country, seasonally adjusted, and proportion of total pharma exports (2019)



Source: Swiss Federal Customs Administration, Credit Suisse

Engineering, electrical and metal industry (MEM)

MEM exports climbed back to their pre-crisis levels in the second quarter of 2021. A key driver of this development was the strong growth rates recorded by key European customers. Exports to the US and China also rose further. Despite certain supply bottlenecks, global manufacturing sentiment remains optimistic, and production has been ramped up. As a consequence, international demand for Swiss MEM exports should remain strong.

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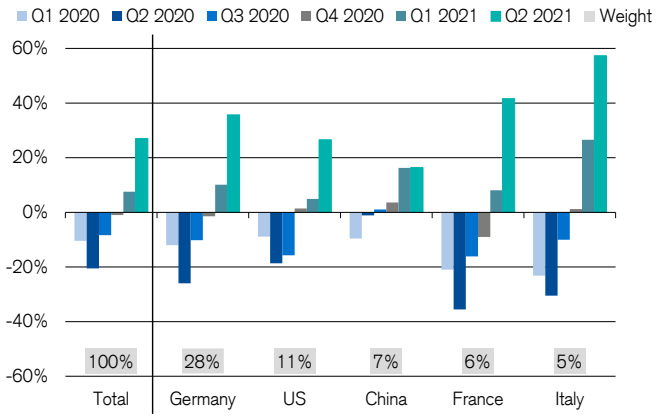
MEM exports get back to pre-crisis levels in Q2 2021

MEM exports by country, seasonally adjusted, change compared to prior-year quarter, and proportion of total MEM exports (2019)



Source: Swiss Federal Customs Administration, Credit Suisse

Watch industry

The second quarter of 2021 witnessed a complete recovery in watch exports too. Exports surged back to the level recorded in the pre-crisis year of 2019, with China in particular exhibiting strong demand for Swiss watches. Whereas the principal source of Chinese demand for Swiss watches used to be Chinese tourists traveling abroad, demand has now picked up in China itself as a result of the coronavirus pandemic. While the Delta variant poses a degree of risk that could yet dampen demand for Swiss watch exports once again, this is not our base scenario.

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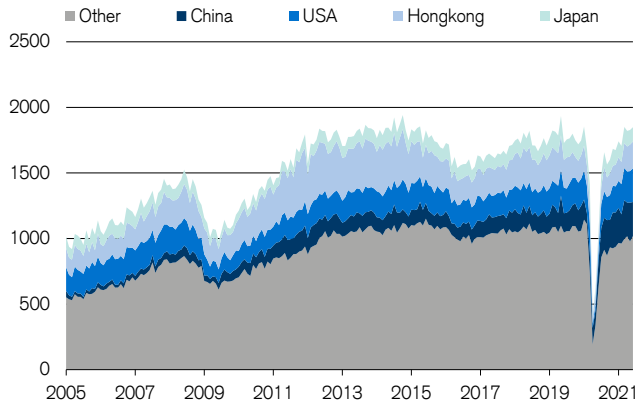
Chinese demand picks up

Watch exports in CHF mn, by country, seasonally adjusted



Source: Swiss Federal Customs Administration, Credit Suisse

Retail trade

The boom in the DIY/garden/automotive accessories and leisure categories as a result of the COVID-19 pandemic has so far continued this year. In the first semester, the clothing and shoes segment clawed back some of the ground lost as a result of last year's sales slump. However, sales were still down around 16% on pre-crisis levels at the end of June. This gap can be expected to close further as things gradually return to normal. That said, structural change and the migration of business to foreign providers are likely to continue to prevent a full sales recovery.

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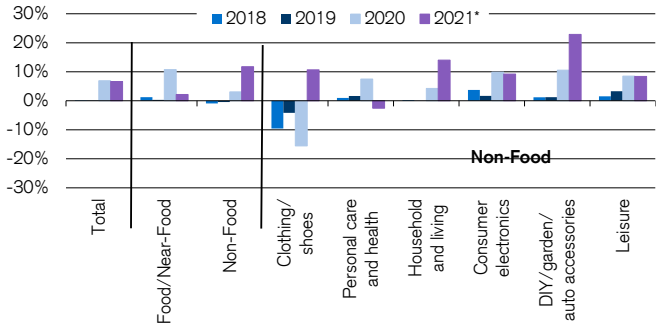
Clothing segment reverses some of pandemic-driven slump in sales

Development of seasonally-adjusted nominal retail sales compared to prior year



Source: GfK, Credit Suisse. * For 2021, sales data runs up to June

Tourism

In the second quarter of 2021 too, the dearth of foreign guests remained a feature of the Swiss tourist industry. At the same time, however, domestic tourism once again proved a key prop. In the second quarter of 2021, overnight stays of Swiss guests were up 55% compared to the pre-crisis year of 2019. Although international travel will pick up thanks to COVID-19 vaccine certificates and the easing of protective measures, ongoing hurdles and uncertainties are likely to make at least a proportion of Swiss holidaymakers reluctant to travel abroad. This will continue to support domestic tourism.

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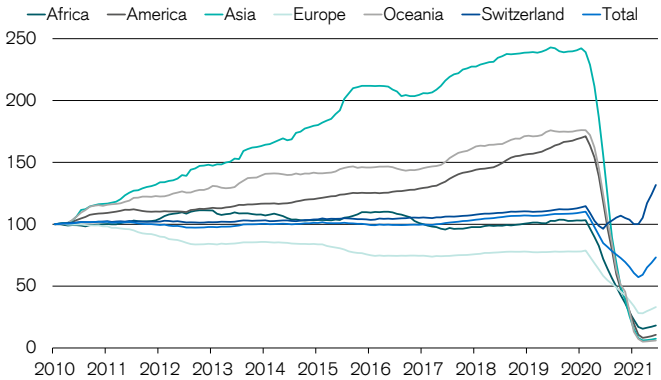
Domestic guests prop up Swiss tourism

Overnight stays, indexed, 12-month averages, by guest origin



Source: Swiss Federal Statistical Office, Credit Suisse

Information technology (IT)

Despite the difficult economic situation during the coronavirus crisis, the IT sector has not suffered a wave of bankruptcies. Indeed, thanks to government support measures, the bankruptcy rate even fell below the long-term average at times. By contrast, a wave of new company registrations since the middle of 2020 has become apparent. The number of newly founded companies reached a record level in the first half of 2021. This is partly attributable to the fact that the COVID-19 pandemic has accelerated structural change in many areas. IT service providers will benefit from this development over the coming months too.

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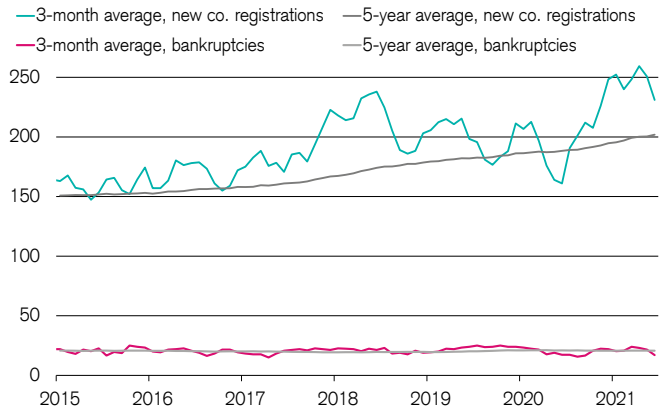
Record number of new company registrations in 2021

Number of new company registrations and bankruptcies among IT service providers



Source: Economic research unit of the ETH Zurich (KOF), Credit Suisse

Temporary acceleration

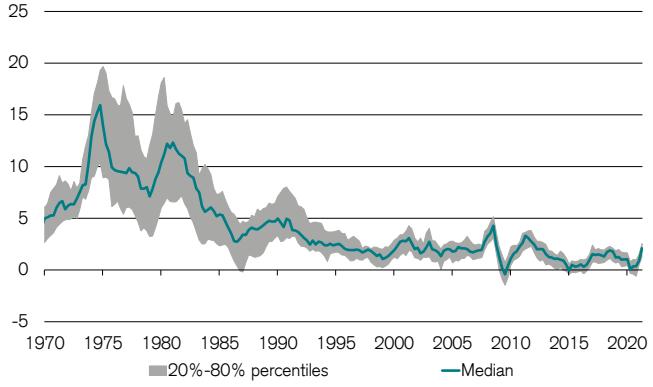
Consumer price inflation has heated up globally, fueling concerns of an overheated economy boosted by an exceptionally expansionary monetary and fiscal policy mix. The inflationary risk has indeed risen, particularly in the USA. However, in the Eurozone, Switzerland and Japan, inflation is unlikely to become a constraint for loose monetary policy any time soon, in our view.

The recent increase in inflation rates globally is largely due to higher oil prices

Inflation rates globally have largely converged since the late 1990s and have been particularly low in the aftermath of the global financial crisis (Fig. 1 and 2). In that context, the recent acceleration in inflation has caught the attention of markets, despite not being particularly elevated in a longer-term historical perspective. Much of this acceleration is due to the rise in commodity prices, oil prices in particular (see box on inflation page 8), which gives the impression that inflation rates are largely correlated among countries. However, the core inflation rates, i.e. the inflation rates that exclude energy and food prices, have not been much correlated lately among the largest advanced economies (the USA, the Eurozone and Japan) and Switzerland (Fig. 3 and 4). This suggests that beyond the surface consumer price dynamic largely depends on domestic factors.

Figure 1: Pick-up in inflation in advanced…

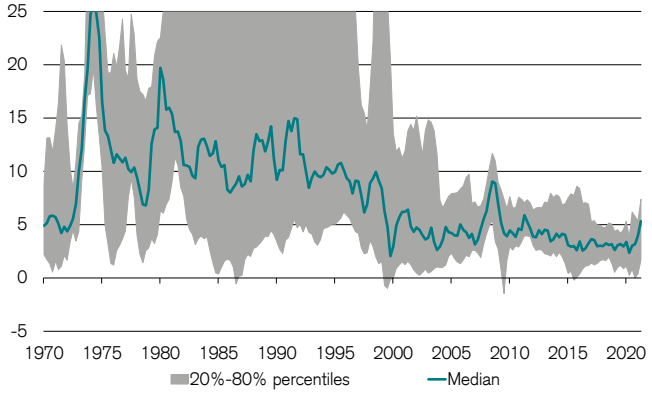
Consumer price inflation, in % YoY



Sample includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Korea, Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom and the United States. Source: Refinitiv Datastream, International Monetary Fund, Credit Suisse. Last data point: Q2 2021

Figure 2: …and emerging economies

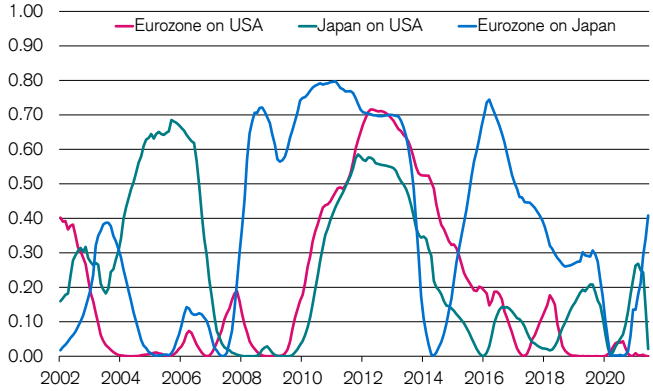
Consumer price inflation, in % YoY



Sample includes Brazil, China, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Russia, Saudi Arabia, South Africa, Thailand and Turkey. Data only partially available before 1993. Vertical scale is intentionally truncated. Source: Refinitiv Datastream, International Monetary Fund, Credit Suisse. Last data point: Q2 2021

Figure 3: No synchronization of core inflation rate moves

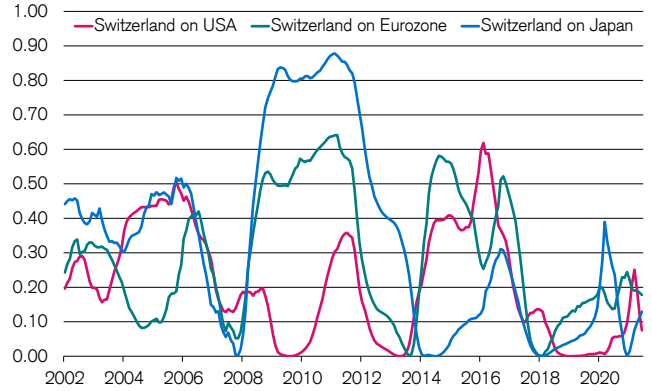
R-squared of a 5-year rolling linear regression of core inflation rates. An R-squared value close to 1 indicates highly correlated series.



Source: Credit Suisse. Last data point: June 2021

Figure 4: Core inflation rate in Switzerland not much dependent on foreign development

R-squared of a 5-year rolling linear regression of core inflation rates. An R-squared value close to 1 indicates highly correlated series.



Source: Credit Suisse. Last data point: June 2021

A surge in money supply and an economy running "hot" are common explanations of inflation

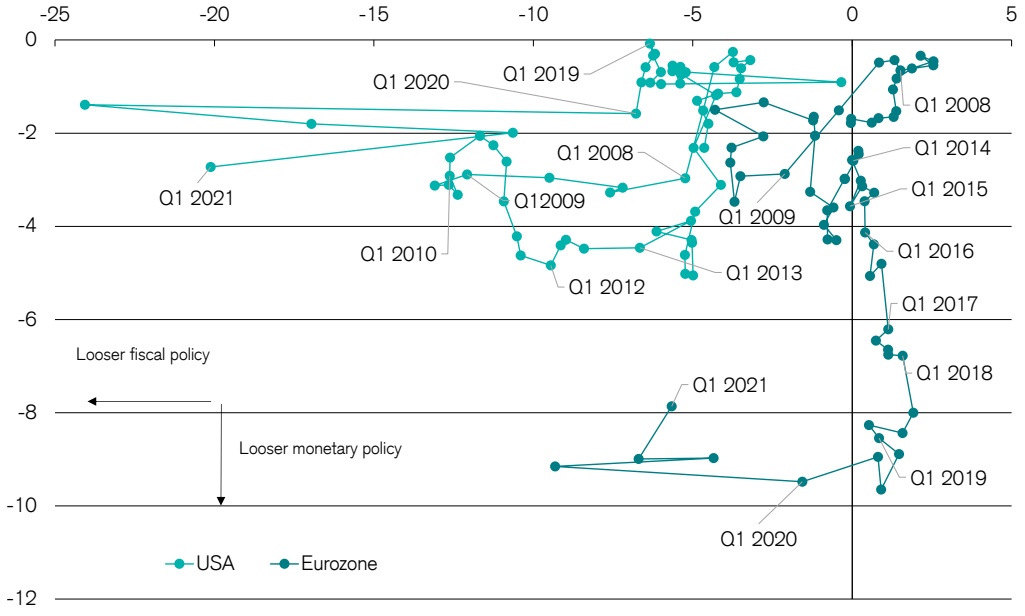
While there is a consensus among economists that high inflation rates are not desirable, there are different views on the drivers of inflation and their importance in the current context. We will mainly focus on two common explanations. The first states that inflation is always a monetary phenomenon. The idea is that when the quantity of money increases faster than the quantity of goods and services produced by an economy, prices will rise. The second explanation is a more cyclical view of inflation and associates inflation with the current state of the economy – an economy that is running "hot" and is characterized by low unemployment. A high utilization of capacity will lead to higher prices as wages rise, production lags demand and consumers bring forward spending in anticipation of higher prices. In addition, we focus on developed economies, in light of the diverging economic and inflation trends in emerging economies.

The link between money supply and inflation has considerably weakened over time

As shown in Fig. 5 for the USA and the Eurozone, the current monetary and fiscal policy mix is particularly expansionary in historical comparison, which has led to a surge in money supply. This surge in money supply has fueled concerns of a rapid increase in inflation. We do not share these concerns. Indeed, the relationship between money growth and inflation has weakened considerably in both advanced and emerging economies (Fig. 6). One possible explanation is the drop in the so-called velocity of circulation of money (money velocity) or, in other words, the rate at which money is spent. Unfortunately, money velocity cannot be observed and must be derived from the ratio between nominal gross domestic product (GDP) and the supply of money. Fig. 7 shows the drop in money velocity for selected advanced economies. One explanation for this decline is the fall in interest rates. With interest rates very low or negative, the opportunity costs of money are very low. In other words, the return on physical cash or on bank deposits has become much more attractive, making firms and households more willing to hold cash. Moreover, there is evidence that the so-called equilibrium interest rate has fallen to very low levels in many advanced economies. As the equilibrium interest rate can be understood as the "normal" interest rate level, a lower equilibrium level implies a permanently lower money velocity. Simply put, far more money is needed to generate inflation in a low rate environment. Accordingly, inflation would become a more pressing concern in the event of a sustainable rise in the equilibrium interest rate level, as it would lead to a higher money velocity. However, the decline in the equilibrium interest rate is the result of a multi-decade trend driven by demographics and productivity developments. These trends are unlikely to reverse suddenly and rapidly, and thus a substantial rise in the equilibrium interest rate in the short to medium term is highly unlikely.

Figure 5: Expansionary monetary and fiscal policy mix in the USA and the Eurozone

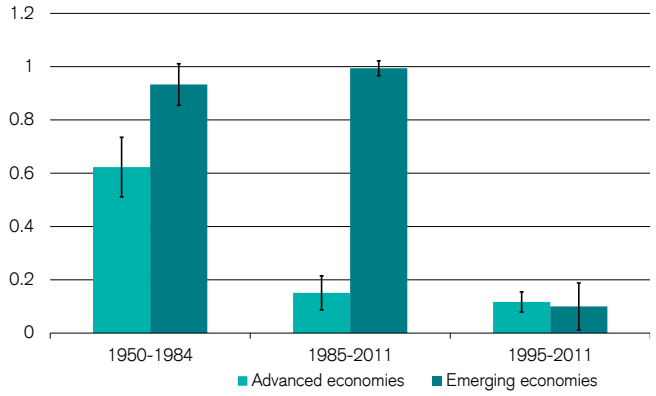
A shift to the left indicates a looser fiscal policy and a shift lower, a looser monetary policy. The vertical axis represents the difference between the shadow policy rate that takes also unconventional policy interventions into account (Wu-Xia) and a nominal estimate of the equilibrium rate (Holston-Laubach-Williams). The horizontal axis represents the budget balance in % of potential nominal GDP (in the case of the Eurozone: primary budget balance).



Source: Refinitiv Datastream, European Central Bank, Federal Reserve Bank of St. Louis, Credit Suisse. Last data point: Q1 2021

Figure 6: The link between money and inflation has weakened

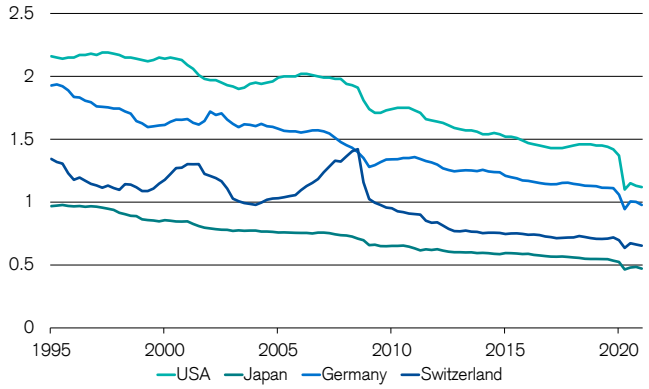
Relationship between money growth and inflation (long-run coefficients) and confidence interval (+/- 2 standard deviations)



Source: Gertler, P. et B. Hofmann (2016), Credit Suisse

Figure 7: Money velocity has declined in major advanced economies

Money velocity defined as the ratio of the annualized nominal GDP to the stock of money M2



Source: Refinitiv Datastream, Credit Suisse. Last data point: Q1 2021

For prices to rise, consumers need to step up spending

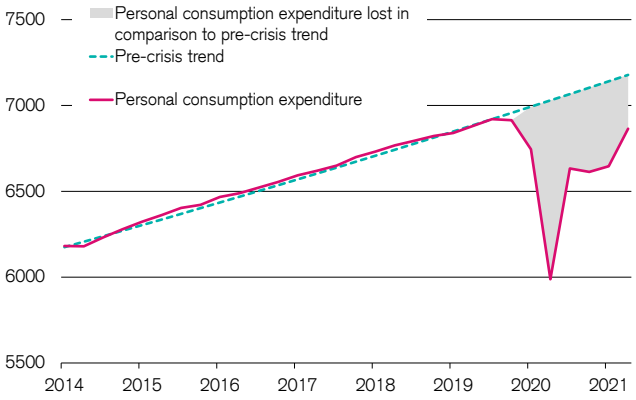
History has shown that periods of hyperinflation often have coincided with large fiscal deficits financed by central bank money. However, for consumer prices to rise (and hence inflation to accelerate), this money needs to be spent on private consumption. So far, it has only partially been the case. Looking at the four largest advanced economies (the USA, the Eurozone, Japan and the UK), consumer spending is still significantly below its pre-crisis trend (Fig. 8). This is essentially due to social distancing measures and lockdowns that governments have implemented to fight the COVID-19 pandemic. As a result, consumption has been significantly restricted or impossible in many areas, hence limiting spending. However, not all consumption categories have been restricted and demand for some categories, in particular for goods, has been exceptionally strong and substantially above the pre-crisis trend (Fig. 9). It is therefore not surprising that goods prices have visibly accelerated and have become the main driver of inflation (Fig. 10 and 11).

Goods demand should normalize, thus reducing somewhat the upward pressure on prices

It is, however, unlikely that goods demand will remain as high as it has been since June 2020. Indeed, some of the additional goods demand has come from the substitution of services with goods consumption. With the money saved on restaurants, hotels, concerts and travel, households have spent on furniture, electronic appliance and sport equipment. With less and less restrictions in place, services consumption is set to pick up and the substitution effect to fade. This rebalancing process is likely to put upward pressure on services prices, while goods price inflation should gradually ease. Should we be worried about services prices accelerating significantly?

Figure 8: Personal consumption expenditure still significantly below its pre-crisis level in major advanced economies

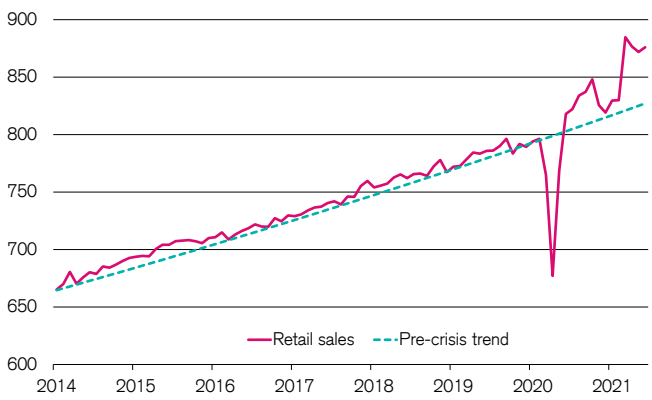
In USD (bn) non-annualized at constant prices and fixed exchange rates. Sample includes the USA, the Eurozone, Japan and the UK



Source: Refinitiv Datastream, Credit Suisse. Last data point: Q2 2021

Figure 9: Goods consumption has surged after collapsing at the beginning of the pandemic

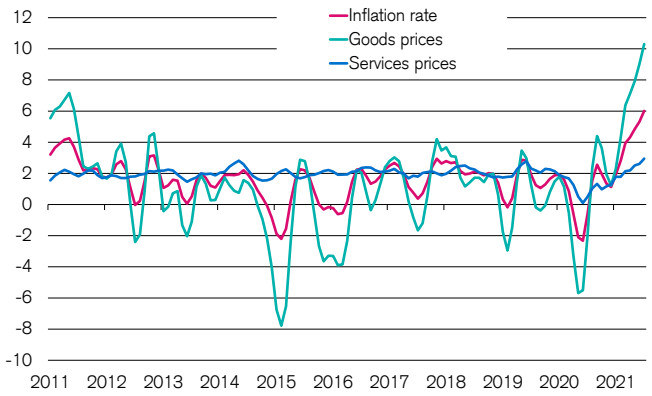
In USD (bn) non-annualized at constant prices and fixed exchange rates. Sample includes USA, Eurozone, Japan and UK



Source: Refinitiv Datastream, Credit Suisse. Last data point: 06/2021

Figure 10: Goods prices have increased much faster globally…

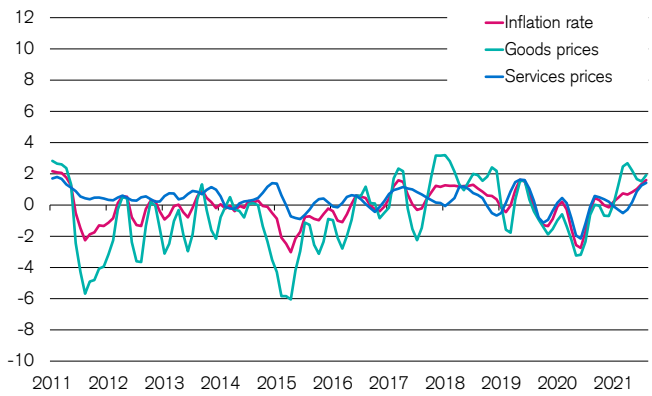
3-month/3-month annualized change in % for the USA, the Eurozone, Japan and the UK. Weighted by nominal personal expenditure.



Source: Refinitiv Datastream, Credit Suisse. Last data point: 07/2021

Figure 11: …and to a lesser extent in Switzerland

3-month/3-month annualized change in %



Source: Refinitiv Datastream, Credit Suisse. Last data point: 08/2021

While recovering, services demand is unlikely to overshoot as much as goods demand did

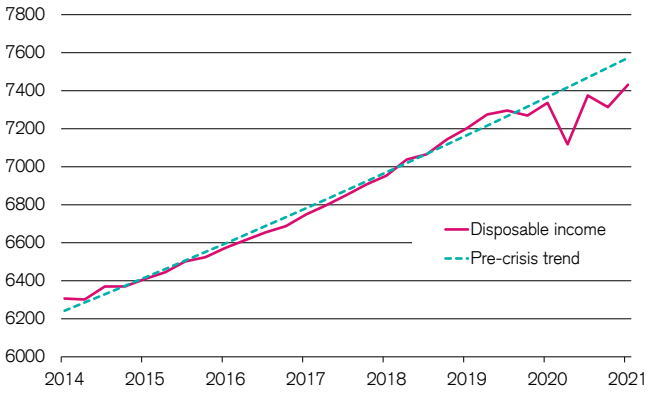
There are a few reasons to believe that services consumption should not overshoot the pre-pandemic trend as much as goods consumption did. First, some of the consumption spending on services has been definitely lost during lockdowns, as households are unlikely to catch up all meals at restaurants and haircuts that they missed. Second, and this is particularly true for regions including the Eurozone and Switzerland, households' disposable income has dropped below its pre-crisis trend during the pandemic and has not yet recovered (Fig. 12). While households in these economies have accumulated more savings due to the restrictions put on consumption, they are unlikely to spend all these savings immediately after the reopening of the economy, given the income erosion. The situation is different in the USA, where household disposable income has significantly exceeded its pre-crisis trend due to the substantial fiscal transfers (Fig. 13). Personal spending is therefore likely to exceed its pre-crisis trend for some time in the USA, which explains why the inflationary risk is higher there than in the Eurozone and Switzerland. Nevertheless, disposable income is about to normalize in the USA and return to its pre-crisis trend. In addition, households are anyway unlikely to spend all the additional income immediately and will likely smooth personal spending over time.

Employment is recovering, but wages are not rising at a faster pace

The risk, particularly in the USA, is that rising demand for services will require firms to hire more employees, which in turn will put upward pressure on wages. As labor costs rise, service providers will need to raise prices potentially fueling a wage-price inflation spiral. While some sectors indeed report recruiting difficulties and the labor participation rate has declined presumably due to the pandemic setting, labor markets in most advanced economies have not yet recovered their pre-crisis level (Fig. 14). Even if employment has expanded rapidly in the USA, full employment has not yet been reached. There have been reports of rising wages in the country, but the aggregate

Figure 12: Household disposable income has dropped below its pre-crisis trend in the Eurozone…

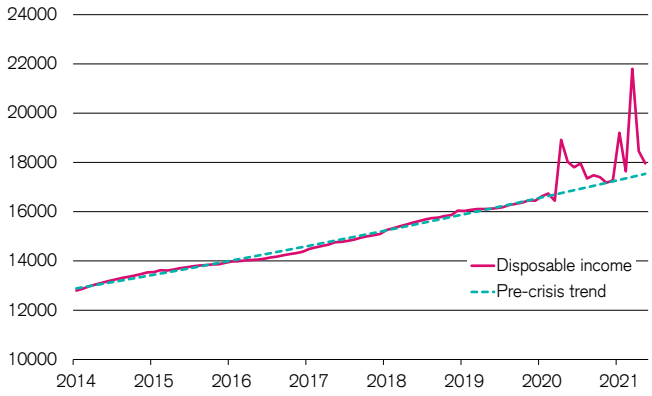
In EUR (bn), annualized and seasonally adjusted, quarterly data



Source: European Central Bank, Credit Suisse. Last data point: Q1 2021

Figure 13: …while fiscal support has led to a surge in the USA

In USD (bn), annualized and seasonally adjusted, monthly data



Source: Refinitiv Datastream, Credit Suisse. Last data point: 06/2021

wage growth has not been faster than before the COVID-19 crisis. In Europe, including in Switzerland, furlough and short time work schemes are still broadly used, which means that service providers can rapidly raise their activity in calling back employees that are on furlough. Since there is no need to re-hire them (furloughed employees have not been formally fired), employees will come back to work at the same wage than before the crisis without re-negotiations as wage bargaining tends to be concentrated to the year-end or job changes. In these economies, a wage-price inflation spiral is, therefore, highly unlikely.

There is no evidence of consumers expecting persistently higher inflation rates

In the USA, Europe and Switzerland, consumers expect prices to rise at a faster pace over the next 12 months than on average over the last 20 years. Were such expectations to persist, they could indeed fuel inflation, as consumers would bring forward spending, as waiting longer would inflate the bill. Bringing forward spending would add to household demand and push prices higher. However, in the USA where consumers are also surveyed on their longer-term inflation expectations, it appears that consumers largely anticipate inflation to rise only temporarily (Fig. 15). In central banking languge, it appears that long-term inflation expectations remain well anchored. While similar surveys are not available for the Eurozone and Switzerland, it is hard to imagine that consumers there expect much higher inflation rates in the longer term, as inflation has been persistently low in these two economies for many years and the increase has been much more benign in the recent months too.

Inflation risk is the highest in the USA, while inflation is likely to remain low in the Eurozone, Switzerland and Japan, making any rate hikes unlikely there

After years of lethargy, consumer price inflation has accelerated globally. In the USA, we believe that the risk of inflation sustainably overshooting the 2% target of the US central bank – the Federal Reserve (Fed) – is the highest it has been in at least 10 years. Moreover, the probability of such outcome is sufficiently high to warrant a close monitoring of the inflation dynamic over the coming quarters. Yet, the risks are not high enough to warrant an immediate monetary and fiscal policy tightening, in our view. On the other hand, we believe that the inflation outlook in the Eurozone, Japan and Switzerland is much more benign and that the increase in the consumer price inflation rates that we have witnessed in the Eurozone in particular and to some extent in Switzerland will prove largely temporary, even if the inflation risks in the USA were to materialize. In any case, a higher probability of persistently higher inflation is a desirable outcome in a context of an exceptionally loose monetary and fiscal policy mix. If this risk had not increased, any hope for central banks to ever raise their policy rates would have been disappointed. Unfortunately, for central banks in the Eurozone, Switzerland and Japan, this risk has not increased sufficiently to warrant policy rate hikes before long and extricate themselves from their negative interest rate policy.

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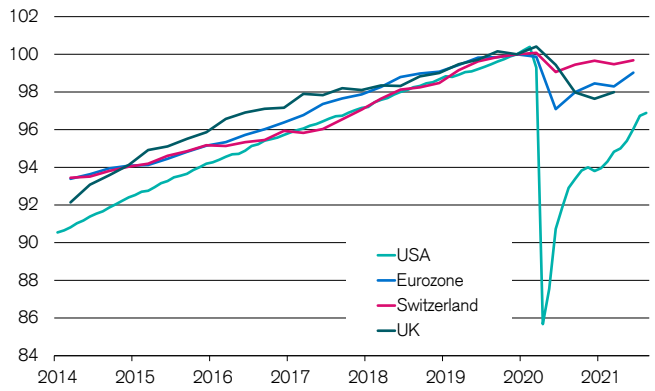
Figure 14: Employment has not yet fully recovered in most countries

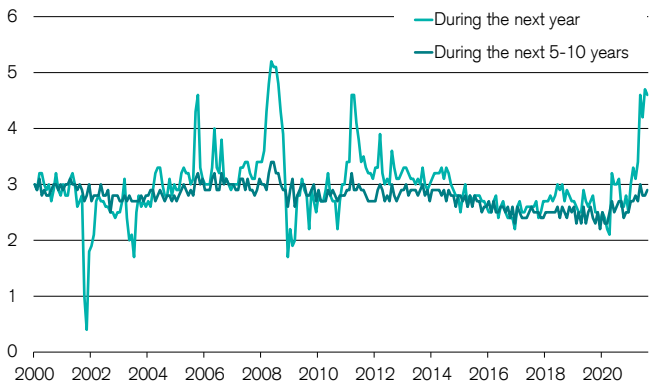
Employment, index (100 = December 2019 or Q4 2019), seasonally adjusted



Source: Refinitiv Datastream, Credit Suisse. Last data point: 08/2021 (USA)

Figure 15: US consumers expect prices to rise much faster in the short term than in the longer term

Expected change in prices per year, in %



Source: Bloomberg, Credit Suisse. Last data point: 08/2021

Targeting higher inflation

Several central banks have raised their inflation targets over the recent past, suggesting that they will pursue an expansionary monetary policy for longer than previously anticipated. The SNB, on the other hand, has kept its objective unchanged but has repeatedly reaffirmed its commitment to maintaining a loose monetary policy.

Fed and ECB have revised their inflation target

The US Federal Reserve (Fed) and the European Central Bank (ECB) reviewed their monetary policy strategy, which led in both cases to an upward revision of their inflation target. Both central banks now aim at achieving an inflation rate of 2%, while allowing for some overshoot if the inflation target has been missed for a prolonged period of time. The Bank of Japan (BoJ) already raised its inflation target to 2% from 1% in 2013, while the Bank of England (BoE) has a target of 2% and is required to justify any deviation of the inflation rate of 1 percentage point in either direction.

SNB maintains target inflation band…

In that context, the Swiss National Bank (SNB) has a conservative inflation target, as it aims to achieve a positive inflation rate of less than 2%. With inflation at 0.7% in July, it implies that the SNB is currently achieving its objective of price stability (Fig. 1), despite Switzerland displaying one of the lowest inflation rates globally. The risk is that this situation could fuel expectations of a normalization in monetary policy, which would lead to an appreciation of the Swiss franc, precisely something that the SNB wants to avoid. Moreover, the SNB has not expanded its balance sheet through financial asset purchases as much as other central banks did in the first half of the year, and is unlikely to match their purchase pace over the next 18 months (Fig. 2).

…while committing to an accommodative monetary policy

To compensate for what seems to be a preference for lower inflation than in other economies and to alleviate the appreciation pressure on the Swiss franc, the SNB has repeatedly said that an expansionary monetary policy is warranted in Switzerland, even when it appears that its objective of price stability is achieved. Moreover, the SNB has demonstrated on many occasions that when necessary it is ready to buy financial assets denominated in foreign currencies in volumes that are significantly larger than what other central banks do in relation to gross domestic product. Together, that should help prevent the Swiss franc from appreciating too much.

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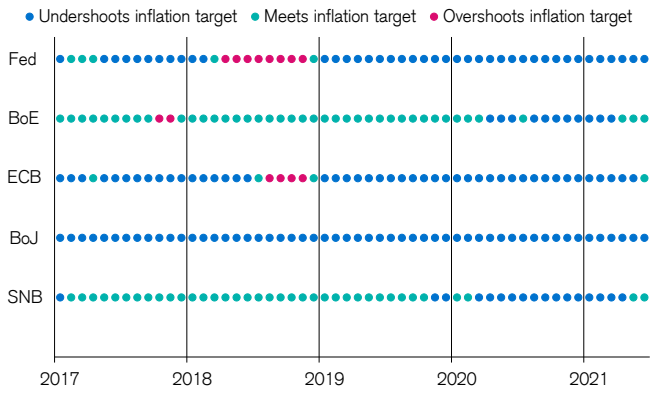
Figure 1: How central banks have met their inflation target

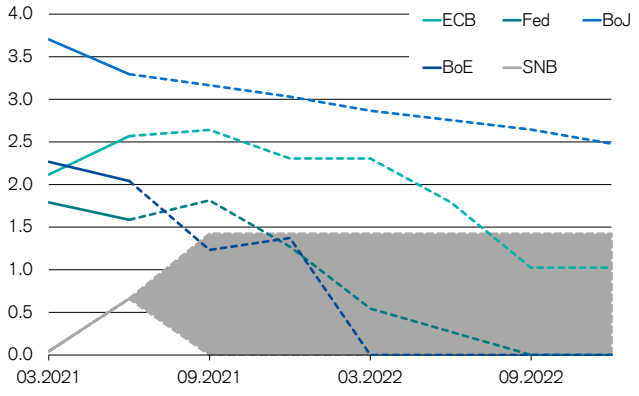
Observed inflation rate (3-month average except for BoE) compared with the central bank target



Source: Credit Suisse. Last data point: 06/2021

Figure 2: Asset purchases by central banks

In % of annualized Q1 2021 nominal GDP



Forecasts from Q3 2021. Assumption for the SNB: Foreign currency purchases between 0 and the average of the purchases estimated for the period between February 2015 and May 2016. Source: Credit Suisse. Last data point: Q2 2021

COVID-19 loans

Since our last update (on 12 May 2021), companies in Switzerland have paid back an additional CHF 1032 m of COVID-19 loans. So far, corporates have paid back around CHF 3.1 bn or 18% of COVID-19 loans. Defaults have also increased since our last update, from CHF 171 m to CHF 239 m, but have remained low in comparison to the total loans granted (default rate of 1.4%). Outstanding COVID-19 loans (CHF 13.6 bn) make around 2.7% of all bank credit limits (including mortgage loans) to companies in Switzerland.

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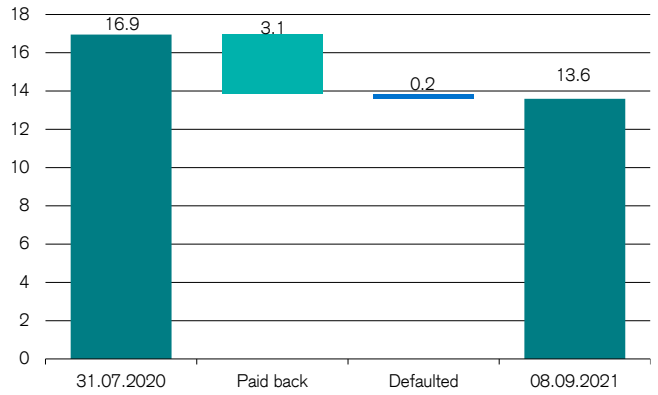
Companies continue to pay back COVID-19 loans

COVID-19 loans, in CHF bn



Source: SECO, Credit Suisse

Mortgage loans

Mortgage loan growth has remained very resilient during the COVID-19 pandemic. This resilience is essentially due to mortgage loans to households, which have expanded at a steady rate. On the other hand, mortgage loans to corporates have been more volatile, with slower growth during the third quarter of 2020, followed by a sharp acceleration. Despite the volatility, mortgage loans to corporates have increased more rapidly than mortgage loans to households for the last 4.5 years. In terms of volume outstanding, mortgage loans to households account for 74% of all domestic mortgage loans (CHF 1089 bn).

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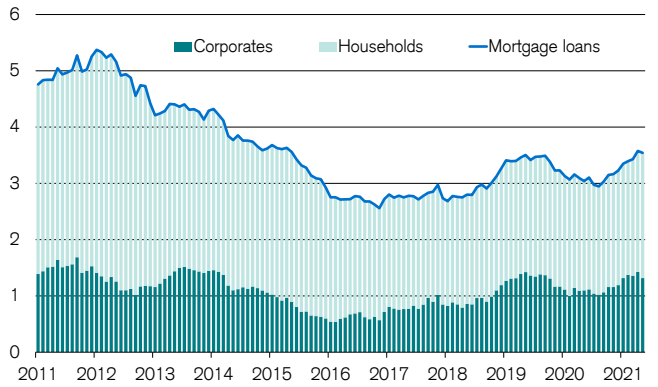
Mortgage loan growth has accelerated

In % YoY



Source: Refinitiv Datastream, Credit Suisse. Last data point: 05/2021

SNB profits

The SNB reported a net profit of CHF 43.5 bn for the first half of the year. Taking into account this profit and the portion of this profit that will be provisioned at the end of the year, around CHF 126 bn will be available for future distribution to the Confederation and the cantons. Unless the SNB reports a loss of more than CHF 86 bn for the second half of the year, the Confederation and the cantons will receive the maximal amount allowed by the current profit distribution agreement of CHF 6 bn next year. While the SNB has a large buffer, any appreciation of the CHF by 1% leads to a loss of almost CHF 10 bn for the SNB.

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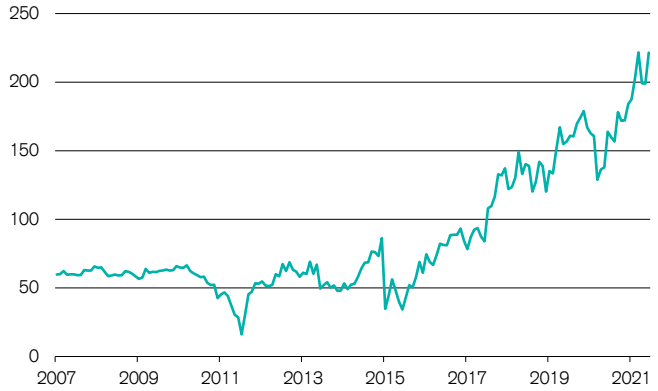
Retained earnings have boosted SNB's provisions

Provisions and equity capital of the SNB, in CHF bn



Source: Refinitiv Datastream, Credit Suisse. Last data point: 06/2021

Construction activity

The rental apartment construction market has passed its peak. Over the last year, the number of approved apartments declined by 11.5%. Over the same period, the number of submitted planning applications declined by 11.6%. That said, rental apartment construction activity still remains over-brisk in many places. The picture on the owner-occupied housing front is bifurcated: Building permits for condominiums recorded a decline of 2.3%, and planning applications a hefty fall of 8.9%. By contrast, there was another slight rise in the number of both building permits (+3.0%) and planning applications (+5.4%) for single-family homes.

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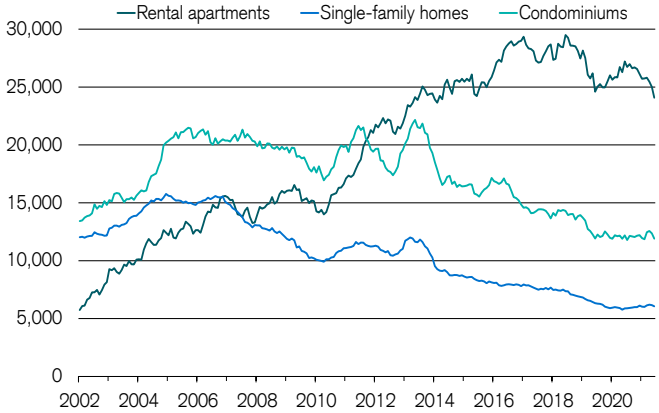
Newbuild activity declines

Number of approved housing units, moving 12-month total



Source: Baublatt, Credit Suisse. Last data point: June 2021

Owner-occupied housing

Residential property is currently experiencing huge interest from potential buyers. As supply remains scarce, price momentum has gradually gathered steam over the last few quarters. The prices of single-family homes are up 6.3% over the last year. The price increase for condominiums is even higher, namely 6.8%. These are the highest growth rates recorded since 2011/2012. That price growth has not been even higher is likely to be primarily due to Switzerland's rigorous regulatory financing requirements. These will limit upside price potential in the future too.

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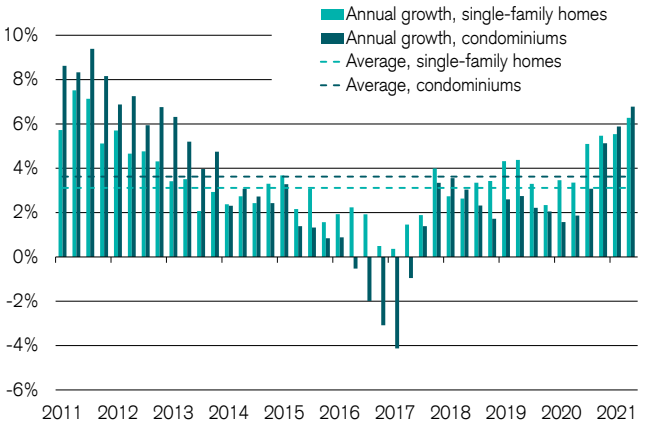
Residential property prices accelerate further

Price development in mid-range segment; dotted lines: average 2000 – 2020



Source: Wüest Partner. Last data point: Q2 2021

Real estate investments

The yield premium enjoyed by real estate investments compared to government bonds has declined slightly over the last few quarters. On the one hand, the yields on Confederation bonds have recovered slightly – even if they do remain deep in negative territory. On the other, the downward pressure on real estate yields has persisted. This is particularly the case for real estate funds, which have recently recorded strong price growth. However, in addition to distribution and cashflow yields, we now see value increases. For the time being, the upward potential of direct real investments such as apartment blocks is unlikely to have run its course.

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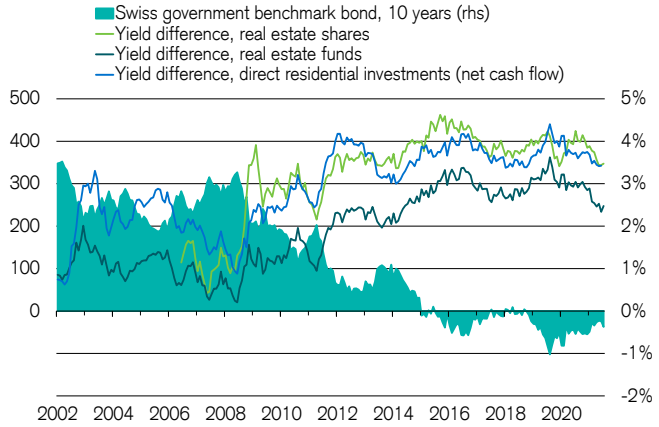
Real estate yields decline slightly

Yield differences between real estate investments (distribution) and 10-year Swiss government bonds, in basis points (lhs)



HISTORICAL PERFORMANCE DATA AND FINANCIAL MARKET SCENARIOS ARE NOT A RELIABLE INDICATOR OF FUTURE RESULTS. Source: Datastream, IAZI, Credit Suisse. Last data point: July, 2021

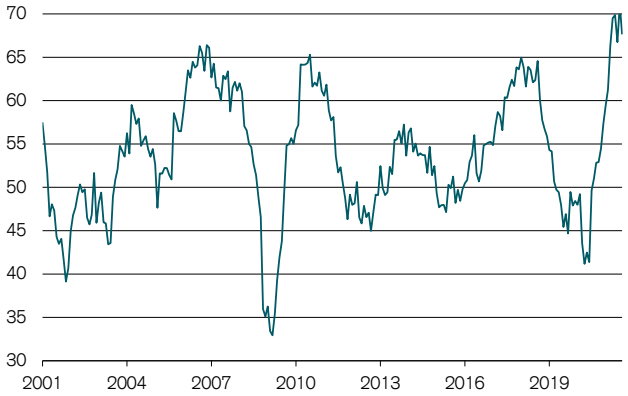
Credit Suisse Leading Indicators

Purchasing Managers' Index (PMI)

Purchasing managers stand at the beginning of the production process. The PMI uses this forward-looking feature to forecast the level of economic activity. The index is based on a monthly survey conducted by procure.ch, the industry body for purchasing and supply management. Purchasing managers respond to eight questions on output, backlog of orders, purchasing volumes, purchase price, delivery times, stocks of purchases, stocks of finished goods, and employment. They indicate whether activity levels are higher, the same, or lower than in the preceding month. The percentage share of responses stating "higher" and "no change" are used to calculate the sub-indices, though only half of the "no change" share of responses is included. The PMI lies between 0 and 100, with a figure of more than 50 indicating an expansion of activity compared with the previous month.

Industrial Activity

PMI index > 50 = growth



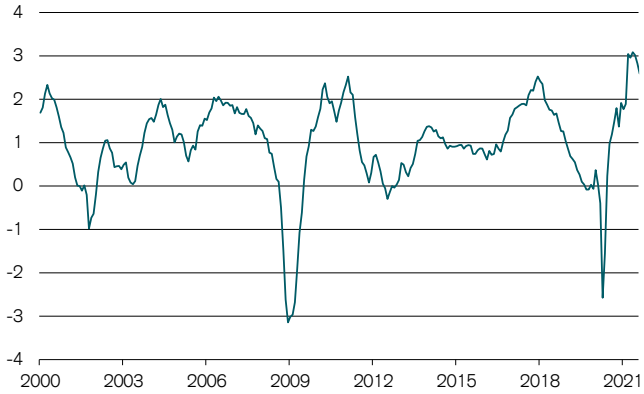
Source: procure.ch, Credit Suisse. Last data point: 08/2021

Credit Suisse Export Barometer

The Credit Suisse Export Barometer takes as its basis the dependence of Swiss exports on foreign export markets. In constructing the export barometer, we have drawn together important leading industry indicators in Switzerland's 28 most important export markets. The values of these leading indicators are weighted on the basis of the share of exports that goes to each country. The export barometer consolidates this information to produce a single indicator. Since the values in question are standardized, the export barometer is calibrated in standard deviations. The zero line corresponds to the growth threshold. The long-term average growth of Swiss exports of approximately 5% is at 1.

Exports

In standard deviation, values > 0 = growth



Source: PMIPremium, Credit Suisse. Last data point: 08/2021

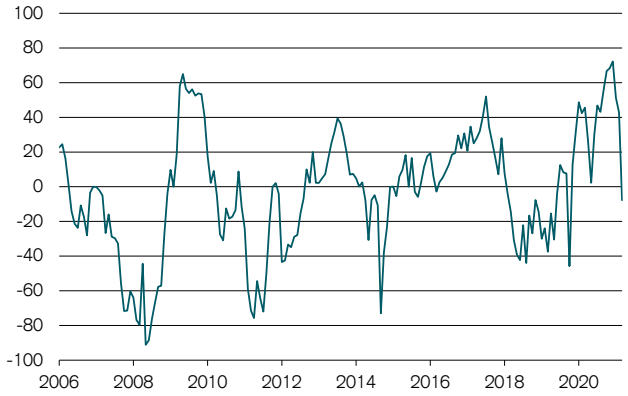
CS CFA Society Switzerland Index

Financial analysts have their finger on the pulse of the economy. Since 2017, we have been conducting a monthly survey of financial analysts jointly with CFA Society Switzerland under the heading Financial Market Test Switzerland[1]. Analysts are questioned not only about their assessment of the current and future economic situation as well as the rate of inflation but also about financial market issues such as equity market performance and interest rate forecasts. The CS CFA Society Switzerland Index represents the balance of expectations regarding the development of Swiss economic activity over the coming six months.

[1] Published as the Credit Suisse ZEW Index from 2006 until 2016

Economic Activity

Balance of expectations, values > 0 = growth



Source: CFA Society Switzerland, Credit Suisse. Last data point: 08/2021

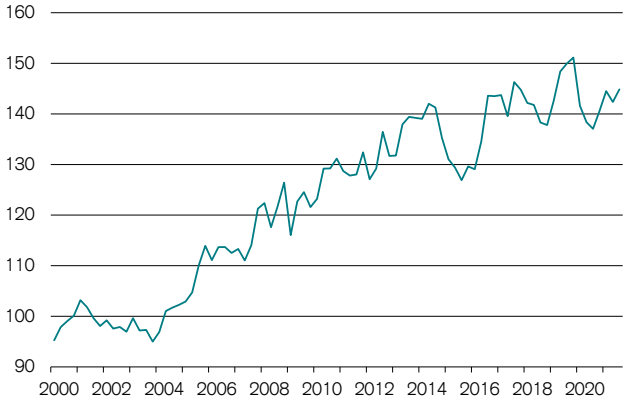
Credit Suisse Leading Indicators

Swiss Construction Index

The Swiss Construction Index is published once a quarter jointly by Credit Suisse and the Swiss Contractors' Association (SCA). It serves as a leading indicator for the state of Switzerland's construction sector by forecasting the volume of work in the core construction business in the coming quarter. The indicator is calculated by Credit Suisse and is based mainly on a quarterly survey conducted by the SCA among its members. Additional data is provided by the Swiss Federal Statistical Office and Baublatt. The Construction Index was launched in the first quarter of 1996.

Construction Industry Climate

1st quarter 1996 = 100



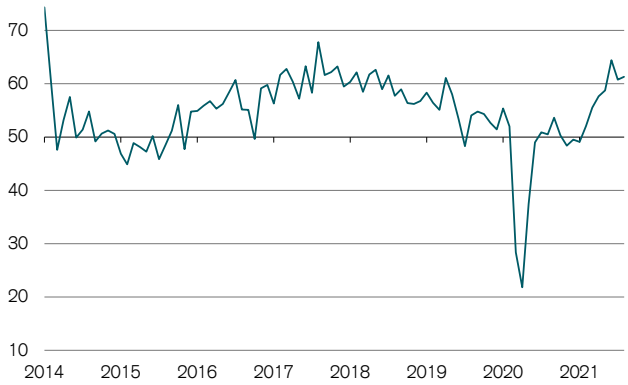
Source: Swiss Contractor's Association, Credit Suisse. Last data point: Q3 2021

PMI Services

Procure.ch, the professional association for purchasing and supply management and Credit Suisse launched a PMI for the services sector in 2014. The Services PMI is structured in exactly the same way as its industry counterpart. Values over 50.0 points mean expansion. It is based on a survey of purchasing managers from Swiss service providers. There are six subcomponents: type of business, new orders, order book, purchasing prices, sales prices and number of employees.

Activity in the services sector

PMI Services index > 50 = growth



Source: procure.ch, Credit Suisse. Last data point: 08/2021

Forecasts and Indicators

Forecasts for the Swiss Economy

	2021	2021	2021P	2021P	2022P	2022P	2022P	2022P	2021P	2022P
	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2	Quarter 3	Quarter 4		
GDP (YoY, in %)	-0.7	7.7	3.3	3.6	4.4	3.2	1.4	1.2	3.5	2.5
Consumer spending	-2.7	9.0	3.4	5.0	1.6	1.6	1.6	1.6	3.5	2.5
Government expenditure	-3.3	8.2	3.4	6.0	9.0	4.2	-0.7	-2.0	7.0	-1.5
Gross capital investment	0.9	10.1	0.5	-1.4	0.7	0.7	1.9	3.2	2.4	1.7
Construction investment	0.6	5.7	-0.3	-0.8	0.2	0.2	0.2	0.2	1.2	0.2
Investment in plant and equipment	1.1	12.8	1.0	-1.7	1.0	1.0	2.9	5.0	3.0	2.5
Exports (goods and services)	-0.7	20.0	12.0	3.0	5.0	5.0	5.0	5.0	8.0	5.0
Imports (goods and services)	-5.9	13.4	10.5	15.0	4.0	4.0	4.0	4.0	8.0	4.0
Inflation (in %)	-0.5	0.5	0.9	1.0	0.8	0.5	0.4	0.4	0.5	0.5
Unemployment (in %)	3.3	3.2	2.9	2.8	2.7	2.6	2.5	2.5	3.0	2.6
Employment growth FTEs (YoY, in %)	-0.7	0.3	0.6	0.8	1.3	1.4	1.0	1.0	0.3	1.2
Net immigration (in thousands)									55,000	55,000
Nominal wage growth (YoY, in %)									0.3	0.6

Source: Federal Statistics Office, State Secretariat for Economic Affairs SECO, Credit Suisse

Forecasts for the World Economy

	Forecasts				Structure		Significance for Switzerland	
Forecasts	GDP YoY, in %		Inflation YoY, in %		Population In million	GDP In USD billion	Share of exports In %	Share of imports In %
	2021	2022	2021	2022	2020	2020	2020	2020
World	5.8	4.5	3.3	2.9	7,674	83,845	100	100
US	5.9	4.3	4.3	3.1	330	20,807	17.5	6.3
Euro zone	5.0	4.6	2.1	1.5	343	12,712	48.3	66.3
Germany	3.4	4.5	2.7	1.8	83	3,781	17.9	27.1
France	6.5	4.7	1.6	1.2	65	2,551	5.2	7.0
Italy	5.4	4.6	1.3	1.3	60	1,848	5.8	9.2
UK	7.5	6.0	2.1	2.4	67	2,638	3.5	2.8
Japan	2.0	1.7	-0.3	0.1	126	4,911	3.1	2.0
China	8.2	6.1	1.2	2.2	1,404	14,861	6.5	8.8

Source: Datastream, International Monetary Fund, Credit Suisse

Interest Rates and Monetary Policy Data

	Current	3-month	12-month		07/2021	06/2021	07/2020
SNB target range (in %)	-0.75	-0.75	-0.75	M0 money supply (CHF bn)	724.5	719.5	703.7
10-year government bond yields (in %)	-0.26	-0.3	-0.2	M1 money supply (%. YoY)	6.7	5.9	4.7
				M2 money supply (%. YoY)	3.6	3.8	2.4
				M3 money supply (%. YoY)	3.4	3.7	3.8
				Foreign currency reserves (CHF bn)	945.9	963.8	859.1

Source: Datastream, Bloomberg, Credit Suisse

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