SWITZERLAND: MONETARY POLICY AND CURRENCY

SNB'S HAWKISH SHIFT SUPPORTS THE FRANC

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SUMMARY

- The Swiss National Bank (SNB) joined the tightening party by hiking its policy rate by 50bp to -0.25% at its 16 June meeting. We see the SNB raising the policy rate by a further 50bp in September and by 25bp at each subsequent quarterly meeting until at least March 2023, bringing it up to at least +0.75%. Bolder moves remain a possibility.
- We remain constructive on the Swiss franc, given supportive inflation differentials, a narrowing rate gap and a Swiss current account surplus that looks resilient to external shocks. We now see the Swiss franc (CHF) reaching parity against the euro over the next three months, before rising further to CHF0.98 in six months and CHF0.96 in 12 months.

SNB knows how to surprise

At its 16 June meeting, the Swiss National Bank (SNB) joined in the recent round of hawkish central bank policy surprises by raising its policy rate by 50bps to -0.25%. This was the first interest rate hike from the SNB since 2007. Three factors probably pushed it to act so boldly: first, the increasing hawkishness of the US Federal Reserve (Fed), which also raised its main policy rate last week (by 75bp); second, the likelihood the European Central Bank (ECB) introduces a new backstop instrument in July at the same time as it raises rates so as to prevent financial fragmentation (something that could enable the ECB to accelerate its rate hikes); and third, the recent depreciation of the trade-weighted Swiss franc (CHF), especially in real terms.

It seems that the SNB has become a lot more concerned about inflation. Indeed, the SNB explained the rate hike as aimed at "preventing inflation from spreading more broadly to goods and services".

The SNB has revised its conditional inflation forecasts up sharply to 2.8% (from 2.1%) for 2022, 1.9% (from 0.9%) for 2023, and 1.6% (from 0.9%) for 2024 (*see chart 1*). Importantly, the new end point of the forecast is Q1 2025, when it expects inflation will be 2.1%, slightly above the central bank's definition of price stability (i.e. a rise in the consumer price index of less than 2% per annum). In light of these revised inflation forecasts, further rises in the SNB policy rate are very likely.

We see the SNB hiking its policy rate by 50bp in September and then by 25bp at each subsequent quarterly meeting until at least March 2023, bringing it up to at least +0.75%. Bolder moves remain a possibility since the SNB seems intent on keeping the CHF strong to reduce imported inflationary pressures. A lot will depend on moves by other central banks. The next SNB meeting is scheduled for 22 September. Before then, the Fed has two policy meetings scheduled (on 27 July and 21 September) as has the ECB (on 21 July and 8 September).

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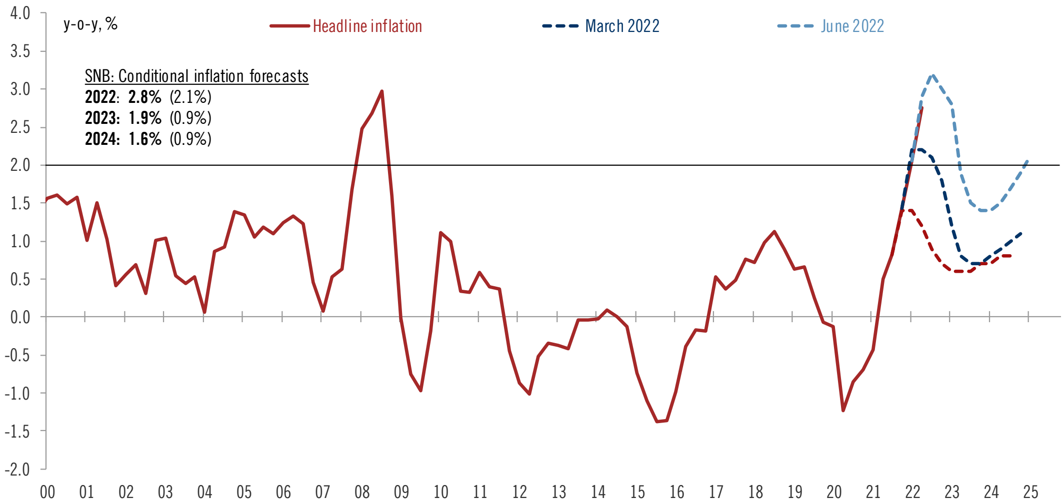
CHART 1: SNB CONDITIONAL INFLATION FORECASTS



Source: Pictet WM –CIO office and Macro Research, Swiss National Bank, 21 June 2022

Balance sheet could play a role in SNB policy normalisation

Along with the big rate rise, the change in the SNB's currency policy was the most noticeable outcome of the SNB's June meeting. **The SNB dropped previous references to the Swiss franc as being "highly valued" in the statement that followed the meeting**. In addition, SNB chairman Thomas Jordan mentioned in remarks that the SNB would consider selling foreign currency if the CHF were to weaken.

This is a major U-turn if one considers that SNB currency interventions in recent years market have all been designed to weaken the CHF. At this stage, we feel the conditions are still not right for the SNB to sell its currency reserves. This will be more a story for 2023, but we will need to monitor developments in this area given the size and composition of the SNB's balance sheet.

Looking at some franc appreciation

As the SNB moves to tighten monetary policy, the CHF should be less penalised by the interest-rate gap. Moreover, comparatively low inflation should continue to support the Swiss franc in the coming quarters. Indeed, the value of the franc has been eroded less by rising prices than other currencies such as the euro over the past year already. This highlights the large gap between the value of the franc in nominal terms and in real terms.

From Jordan's comments, it is clear the SNB is now happy to have a strong franc as the first line of defence against imported inflation. And the weakness of the franc in real terms in recent months *(see chart 2)* suggests that Swiss exporters may not be too penalised in the short term if the nominal rate remains strong.

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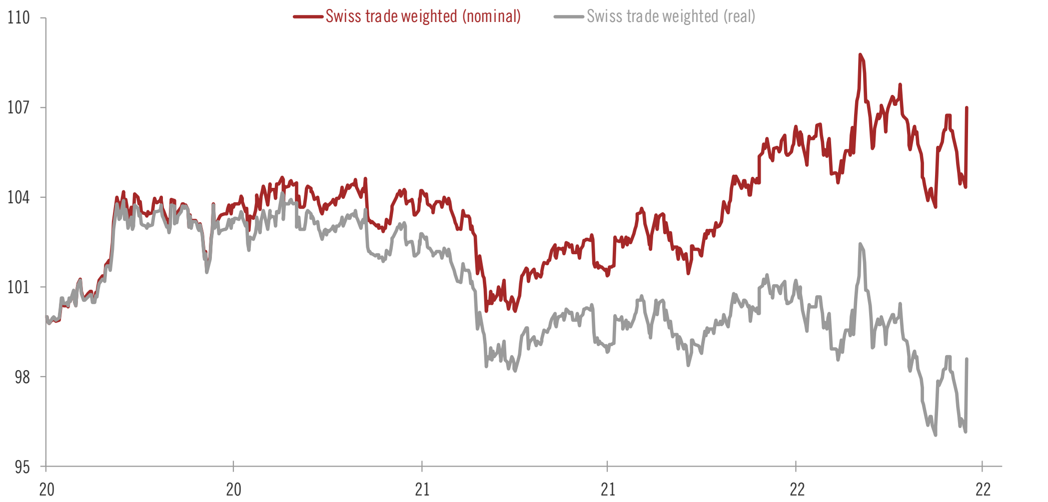
CHART 2: SWISS TRADE WEIGHTED INDEX VS. REAL TRADE WEIGHTED INDEX



Source: Pictet WM –CIO office and Macro Research, Refinitiv, 21 June 2022

Along with supportive inflationary differentials, the Swiss current-account surplus provides a structural tailwind for the CHF. In particular, trade flows, the main component of the Swiss current account, have been looking resilient to external shocks (notably high energy prices) thanks to Switzerland's favourable energy mix and the high added value of its exports.

In view of all these favourable factors (narrowing rate gap, lower inflation, a structurally strong current account), our view of the CHF remains constructive. **Our revised projections are for the CHF to attain parity against the euro over the next three months**, before rising further to CHF0.98 over six months and to CHF0.96 on a 12-month horizon. The main risk to our positive outlook for the CHF would be a sustained upturn in global risk appetite, which could weigh on the safe-haven Swiss currency.

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