Research

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Switzerland: SNB to hike by 25bp

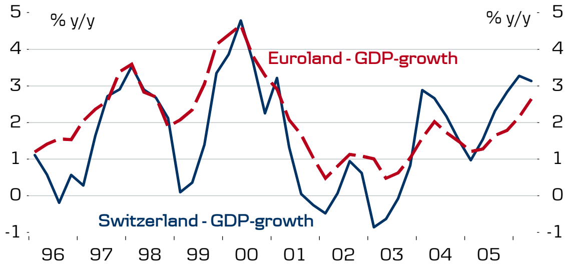
- **We expect the Swiss central bank (SNB) to hike interest rates by 25bp to 1.75% at its monetary policy meeting on September 14.**
- **Looking further ahead, we believe the SNB will continue its gradual tightening of monetary policy, and we see the key rate at 2.75% in 12 months – this is somewhat higher than the market expects.**
- **The Swiss franc (CHF) will likely be unaffected by this week's meeting – unless the SNB tightens its rhetoric considerably. Longer term, further rate hikes mean the CHF will finally begin to strengthen.**

Monetary policy is very loose ...

Switzerland is in the middle of an economic upswing. Recently released GDP figures for the second quarter showed robust growth of 3.2% over the past year. The economic expansion has been broadly based – private consumption, investments and exports are all growing nicely. Private consumption is being supported by rising employment and an expansive monetary policy, while exports are reaping the benefits of the upswing in Euroland – a hefty 60% of Swiss exports find their way to the EU 25. In a small, open economy like the Swiss there is a relatively high degree of co-variance in the economic cycle with that of Euroland – the correlation between growth in Switzerland and Euroland has been more than 80% over the past five years. Unusually, the Swiss economy has actually outperformed the European during the past year – something not seen since the 1980s.

There is, in fact, much to suggest that Switzerland will again outperform Euroland in the coming few years. Our forecast is growth of around 3% in 2006, which is considerably above the estimated trend growth of 1.5%. Growth may fall back somewhat in 2007 as a result of a global slowdown and tighter monetary policy, though the Swiss economy is expected to keep growing above trend. We are looking for growth of 1.8% in 2007.

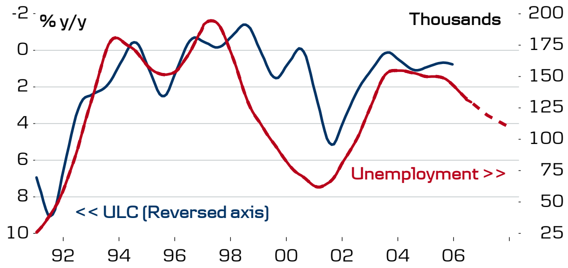
Close co-variance between Switzerland and Euroland



The buoyant economy is having a clear impact on the labour market. Unemployment has fallen by around 20,000 in the past year, and we believe the jobless numbers could be cut from the current 130,000 to as low as 110,000 towards the end of 2007, equating to an unemployment rate of about 2.8%. The SNB is also looking for unemployment to dip below 3.0% in 2007 – a level central bank chief Roth describes as “full employment”.

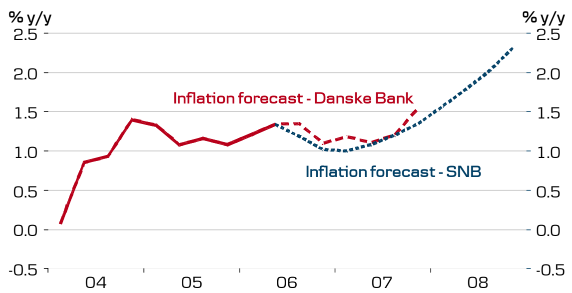
A tighter labour market will undoubtedly mean increasing wage pressures that will in turn have an impact on inflation. Labour unions have already been sabre-rattling ahead of the 2007 wage rounds. There is normally quite a close correlation between labour market pressures and subsequent increases in unit labour costs, and we expect the same phenomenon this time around too.

Rising cost pressures ahead



Despite the rising cost pressures, inflation is expected to remain relatively subdued for most of 2007, as energy prices, which are assumed to remain stable in the year ahead, will act as a drag on inflation. We expect inflation to average around 1.3% in 2007. As the year comes to a close, however, inflation will begin to tick up. The SNB presents a similar inflation profile and in fact sees the inflation target in 2008 as unachievable without further monetary tightening.

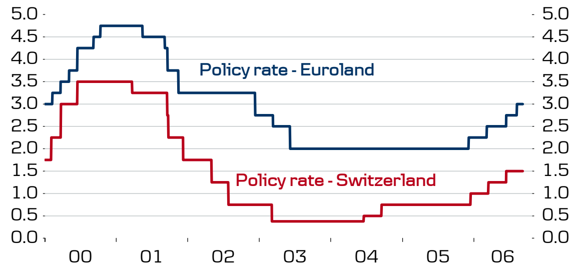
Inflation begins to tick up during 2007



Monetary policy was put on a course of normalisation by the SNB back in 2004, but this strategy was temporarily suspended because of a minor setback in economic growth. Gradual normalisation was resumed in December 2005 and the SNB has since then raised interest rates by 25bp per quarter from 0.75% to the current 1.5%.

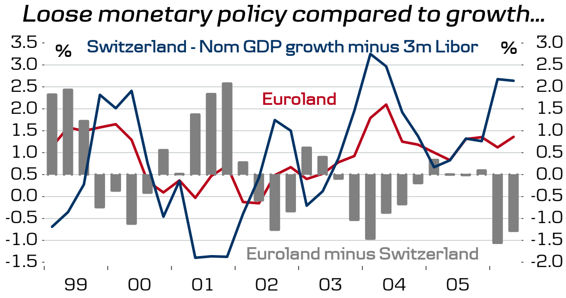
The European Central bank (ECB) has, however, outpaced the SNB over the past year, hiking four times by 25bp and hence widening the interest rate spread between the two.

Normalisation of monetary policy is underway



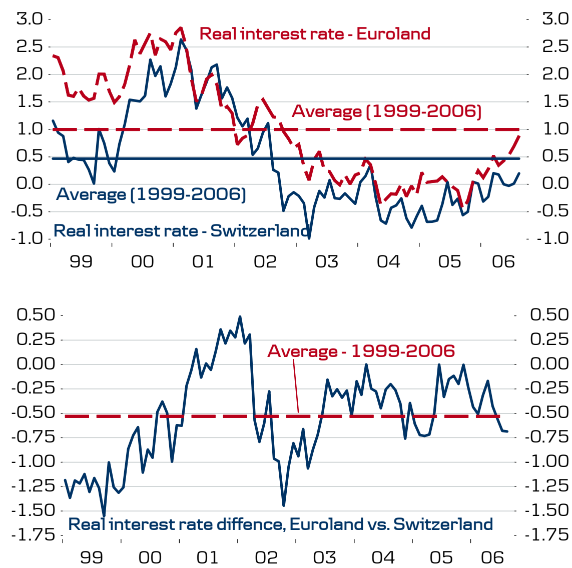
And Swiss monetary policy does look particularly accommodative when compared to nominal growth, both in absolute terms and compared to Euroland. The relative difference to Euroland has, in fact, almost never been greater since the euro was first introduced in 1999.

Loose monetary policy compared to growth...



The reason the SNB can be relaxed despite a strongish upswing is the inflation picture. Whereas the ECB is struggling to squeeze inflation below the official target, the SNB is some way from breaching its target of inflation below 2%. Inflation was 1.5% in August, and even has some prospects of declining in the coming months as a result of lower energy prices.

...and inflation



However, even taking the low inflation into account, Swiss monetary policy still looks very accommodative. The real interest rate – defined as the difference between the 3-month rate and inflation – is currently not much above zero and, moreover, is still some way below the average for the period 1999-2006. The real interest rate spread to Euroland is also rather large at the moment – 0.75 percentage points, while the average for the period 1999-2006 has been Euroland rates around 0.5 points higher than in Switzerland.

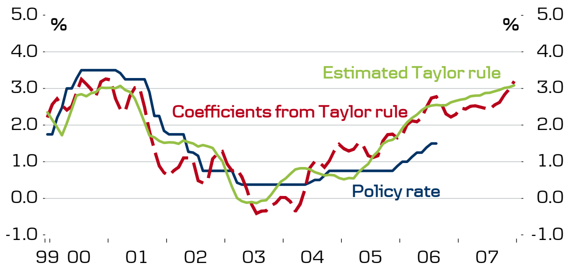
All in all, there is thus no question – either from us or the SNB – that monetary policy should be tightened going forward, irrespective of which parameter one may look at. Otherwise the Swiss central bank is very much in danger of slipping behind the curve. The big issue is, of course, how much and how fast monetary policy should be tightened.

...but by how much should monetary policy be tightened?

Assuming our current growth forecast holds, which requires among other things that the global economy remains on track in 2007, we believe that the SNB will take the key policy rate to around 2.75% by the end of 2007.

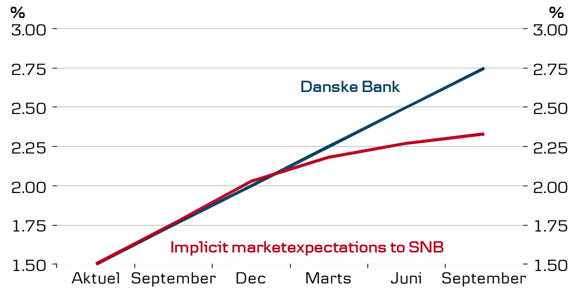
The so-called Taylor rule (based on e.g. the output gap and the inflation forecast) indicates that the policy rate should be all the way up around 3% by the end of 2007. However, the SNB is also keeping a careful eye on the exchange rate. If one adds the nominal trade-weighted exchange rate and assumes unchanged exchange rates, this suggests that the SNB should only raise rates to around 2.25% by the end of 2007.

Some way to go before the SNB can take a break



Of course, the Taylor rule is merely a rule of thumb, and as always there is much uncertainty surrounding the economic forecasts. As things stand at the moment we do not expect the SNB will be in any great hurry to lift interest rates to a more normal level. Low inflation means the SNB can await greater clarification on the state of health of the global economy and how much the tight labour market will affect wages. Hence we expect that the SNB will stick to tightening gradually by 25bp per quarter in the coming quarters. This means our expectation for the coming 12 months is a rate hike of 25bp at the September 14 rate meeting, followed by 25bp hikes at the meetings in December, March, June and September 2007. This means the key policy rate rising from today's 1.5% to 2.75%, equating to a real interest rate of 1.25% by the end of 2007 – still not tight for an economy that by then is expected to be growing at around trend. Our forecast is a little higher, though, than market expectations.

DB rate forecast vs market expectations



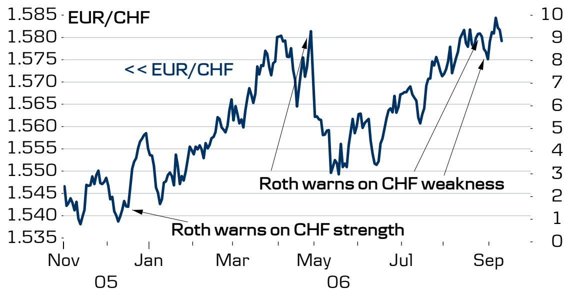
+25bp at September meeting – and Swiss franc to remain weak

A rate hike of 25bp at the September meeting appears to be a done deal. Partly because the low inflation means that SNB is in no hurry, and partly because SNB has not seriously warned about an upcoming change in the monetary policy strategy – despite SNB chief Roth's repeated warnings about the weak Swiss franc (see below). Looking further ahead, it cannot be ruled out that the SNB might prefer to be one step ahead of developments and deliver a 50bp hike at the meeting in December. This would very much depend on exchange rate developments in the meantime, but we would roughly estimate the probability of a 50bp hike in December to be around 20%. Even if the SNB does choose a more aggressive path in the near term, however, we still believe the key policy rate will be around 2.75% at the end of 2007.

Market expectations are also for a 25bp hike at Thursday's meeting. Fixed income markets have for some time been pricing in 25bp, and neither yields nor the exchange rate have reacted to the economic data of late – irrespective of how much they have surprised (typically on the upside)

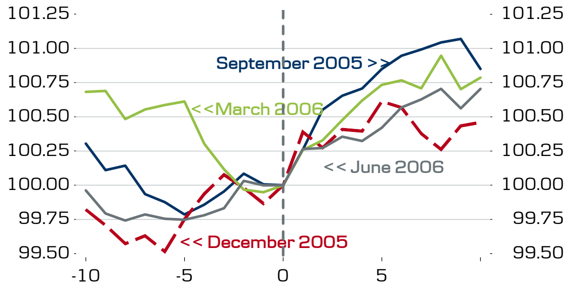
Market reaction to statements from Central Bank Governor Roth also point to very stable expectations on the SNB. In December 2005 Roth warned that the strong CHF could mean monetary policy not being tightened at the expected pace, which led to a substantial weakening of the CHF. On the next two occasions Roth spoke he warned that the pace of rate hikes could be accelerated if the CHF remained weak – and both times the CHF strengthened immediately afterwards. However, Roth's latest comments, at the end of August, had no effect on the market, and EUR/CHF is now somewhat higher than when Roth spoke.

Central bank chief Roth and EUR/CHF



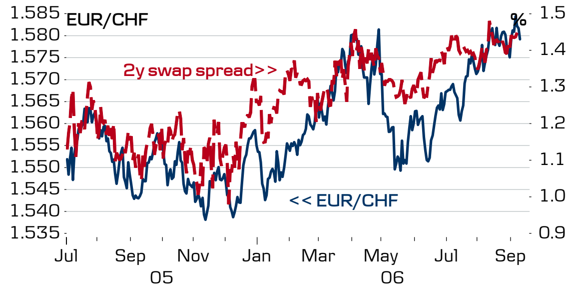
The CHF weakened after the latest four SNB meetings, suggesting that either the market had expected the SNB to deliver more than it did, or that there were expectations of the SNB signalling a faster pace of hiking ahead.

EUR/CHF around SNB meetings (indexed, meeting date = 100)



Given the very stable market expectations, this time around we do not foresee the CHF strengthening sharply in the run-up to the meeting, or weakening immediately afterwards. It is possible that some will close their short CHF positions in the run-up to the meeting, but the latest IMM data do not suggest the market is extremely short CHF. Should the SNB signal that the pace of hiking will be picked up, this could of course have an effect. But we both doubt this will happen, and that it would be enough to send the CHF significantly stronger if it did.

EUR/CHF and 2-year swap spread



Looking further ahead, we are making no changes to our fundamental view on the CHF. The weakness of the currency can largely be explained by developments in relative rates, and irrespective of the strength of the Swiss economy and the continued tightening of monetary policy, the SNB can only match the pace of the ECB in 2006. Meanwhile, there are (as yet) no signs of the global liquidity situation having become so tight that low-yielding currencies such as the CHF are about to strengthen sharply.

However, looking into 2007, there are prospects of the SNB being able to close some of the gap to the ECB and the CHF finally strengthening. Hence we foresee a rather stronger CHF in 6-12 months. Our current forecast for EUR/CHF is 1.58, 1.57 and 1.54 in 3, 6, and 12 months' time, respectively.

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