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Flash Note

Switzerland: Monetary policy

No hint of a rate hike in 2017

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At its latest policy meeting, SNB left its accommodative monetary policy unchanged. The interest rate on sight deposits was maintained at a record low of -0.75% and the SNB reiterated its willingness to intervene in the foreign exchange market if needed, "taking the overall currency situation into consideration", as it had mentioned in its previous press release.

FX interventions are likely to remain the policy tool of choice to counter any appreciation of the Swiss franc.

Our baseline scenario is for the interest rate on sight deposits with the SNB to stay at -0.75% in 2017, with a first rate hike coming in March 2018. Our main argument for this forecast is that the SNB is unlikely to pre-empt the ECB in normalising monetary policy.

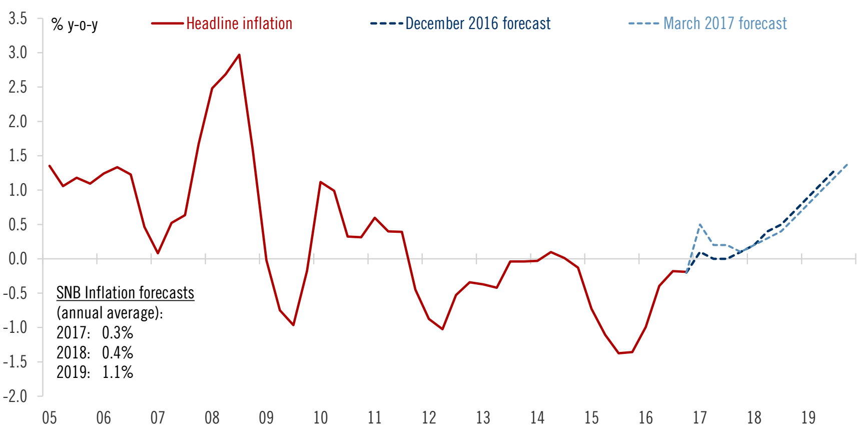
At its quarterly assessment (not followed by a press conference), the Swiss National Bank (SNB) **left its accommodative monetary policy unchanged**. The SNB kept unchanged the target range for the three-month Libor at between -1.25% and -0.25% and the interest rate on sight deposits at a record low of -0.75%. The SNB highlighted once again that the Swiss franc remains "significantly overvalued" and **reiterated its readiness to intervene on the foreign exchange market if needed, taking in account the "overall currency situation"** as it had mentioned in its previous press release.

Upward revision in 2017 inflation forecast

The SNB published an update of its forecasts for inflation (see Chart 1) and GDP growth. The central bank revised slightly up its conditional inflation forecast for 2017 from 0.1% to 0.3%, owing to the increase in oil prices. For 2018, the SNB anticipates inflation of 0.4%, compared to 0.5% in December. For 2019, the SNB foresees an inflation of 1.1%. (Pictet PWM's own forecast is for +0.4% headline inflation in 2017, +1.0% in 2018).

Regarding the growth outlook, the SNB remains "cautiously optimistic" for 2017. The central bank maintained its forecast for the Swiss economy to grow by 1.5% in 2017, mentioning that "the forecast is marked with considerable uncertainty emanating from international risks". (Pictet PWM's forecast is for 1.4% GDP growth in 2017).

Chart 1: Swiss headline inflation and SNB's forecasts



Source: *Pictet WM – AA&MR, SNB*

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Libor rate to stay at -0.75% in 2017

As a small open economy, Switzerland is highly dependent on external developments. The ECB's accommodative monetary policy and the Swiss franc's status as a safe-haven currency have pushed the SNB to become the most accommodative central bank among any in the developed world in recent years. **Interest rate remains at a record low (-0.75%) and the central bank's balance sheet has risen more than sevenfold since 2007**.

Since January 2015, the SNB has maintained its monetary policy strategy unchanged, focusing on two key elements: negative interest rate and foreign exchange (FX) interventions. Now, at a time when the economy is recovering, the headline inflation rate is gradually rising, the ECB is adopting a more neutral stance than before and the Fed is raising rates, **the crucial question is when the SNB will start tightening its own monetary policy.**

Our baseline scenario is for the interest rate on sight deposits with the SNB to stay at -0.75% in 2017, with a first rate hike coming in March 2018. **Our main argument for this forecast is that the SNB is unlikely to pre-empt the ECB in normalising monetary policy**. In our view, the ECB is likely to wait until September before deciding about QE extension into 2018 and will **most likely announce a tapering of asset purchases starting in Q1 2018.**

Moreover, **the SNB might be keen to keep the current interest rate differential or even let the differential widen more**. Recently, the SNB's policy stance has come under pressure as the differential between short Swiss and euro area rates has narrowed, squeezing the buffer which prevents further Swiss franc appreciation.

Domestic developments also suggest that the SNB might be cautious before hiking. Remember, the SNB's mandate is "to ensure price stability and, in so doing, to take due account of economic developments". The SNB equates price stability with a rise in the national consumer price index (CPI) of less than 2% per annum. Headline inflation is gradually rising, but according to the SNB's forecasts (which serve as the main point of reference for monetary policy decisions), it is likely to remain subdued in 2017 (see Chart 1). Moreover, core inflation remains negative, revealing the underlying inertia in Swiss price dynamics. Regarding growth, the economic recovery continues to be modest and patchy across sectors. Thus, **the SNB may wait for more sustained inflation and a stronger and more broad-based economic recovery before acting**.

What are the main risks for our baseline scenario?

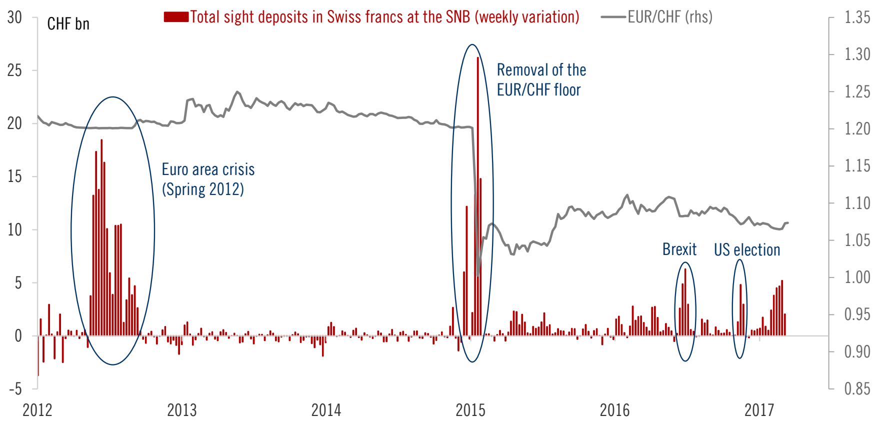
We see three main external risks to our baseline scenario for SNB policy:

- **A hawkish communication or/and a rate hike from the ECB in the coming months might open the door for the SNB to hike once already in 2017**. The effects of sustained negative interest rates remain a cause of anxiety and **the SNB might be tempted to take the first occasion to start normalising its monetary policy**. Negative rates reduce bank profitability and present a risk for the Swiss housing market—although certain exemptions from negative interest rate and macro prudential policies have helped to mitigate somewhat this risk. However, as we noted after the ECB press conference on 9 March, we expect the reference to "lower rates" in the ECB statement to be removed soon, but we believe that the Governing Council will wait until next year before hiking the deposit rate for the first time.

- **Global growth that surprises to the upside** might take pressure off the Swiss franc, also opening the door for a Swiss hike in 2017.
- **A significant deterioration in the European political landscape** might have investors urgently seeking safe-haven assets, triggering a significant appreciation of the Swiss franc in the process. This might push the SNB to cut rates if FX interventions become too massive**.** Since the beginning of the year, the Swiss franc has remained under substantial appreciation pressure, reflecting concerns about European political risk. This comes despite better euro area economic data, which under normal circumstances would have taken some pressure off the franc. Using weekly variation in SNB sight deposits as a proxy (see Chart 2), we estimate that SNB FX interventions has amounted to more than CHF20 bn.

Overall, **we expect the SNB to maintain its policy rate unchanged at -0.75% in 2017**. FX market intervention will remain the policy tool of choice in 2017 to counter any unwarranted appreciation of the Swiss franc. In our view, the recent inclusion of Switzerland among countries the US Treasury department is monitoring for possible currency manipulation is unlikely to affect the SNB's monetary policy stance.

Chart 2: total sight deposits in Swiss francs held at the SNB



Source: *Pictet WM – AA&MR, SNB*