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SNB to Continue Forceful Easing

Last push against franc strength in Jordan's valedictory meeting

- Disinflation remains driven by foreign prices, but domestic transmission limited
- Markets reluctant to revisit ZLB but SNB can temporarily move below neutral
- Franc valuations in real terms far more manageable than 2010-2012 surge

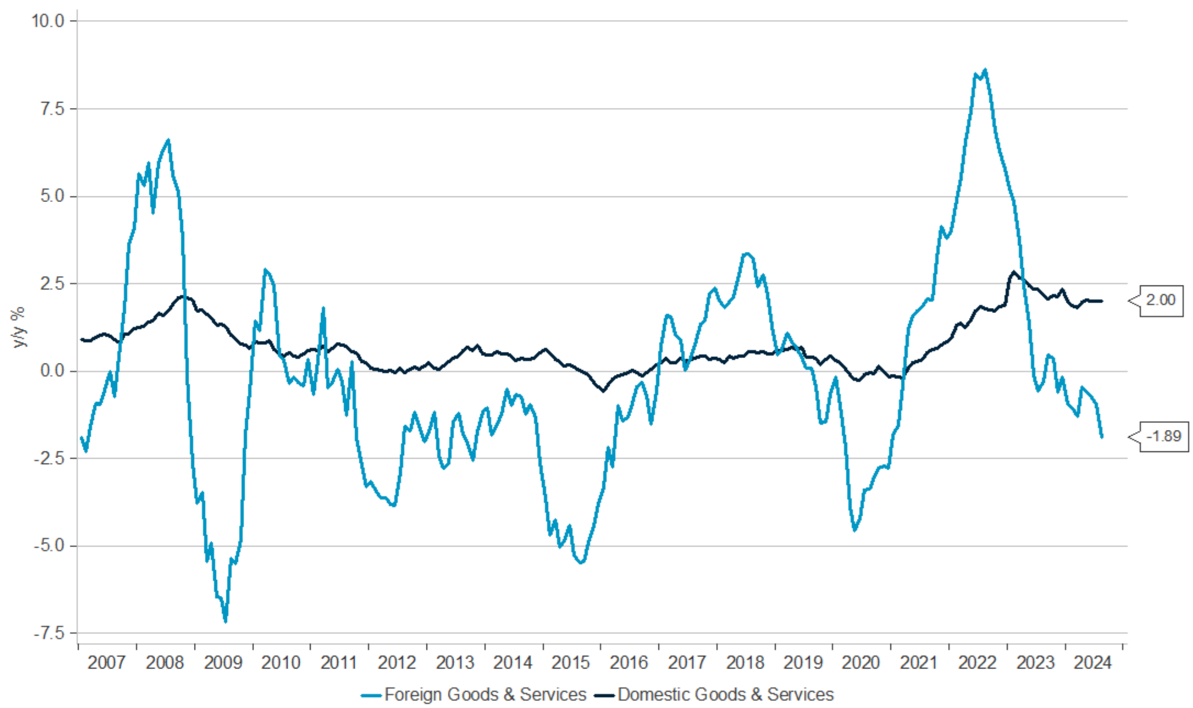
Conventional policy measures far from exhausted for SNB

This week's SNB decision marks the end of an era. Swiss National Bank (SNB) President Thomas Jordan is the longest-serving G10 central bank governor, but he will step down at the end of the month. Among his peers at major central banks, only Klaas Knot of De Nederlandsche Bank has been in office longer. Both Jordan and Knot, however, are unlikely to match the tenure of Mugur Isărescu, who has led the National Bank of Romania for 33 out of the last 34 years.

Given the policy challenges currently faced by the SNB, we doubt Jordan will be in a valedictory mood. The SNB's success in bring inflation down to target has now reverted to the age-old challenge of combating disinflation, especially downside price pressures driven by a strengthening Swiss franc. Considering the SNB's conditional inflation forecast from June has inflation falling to 1.0% in 2026 based on a conditional SNB policy rate of 1.25%, much more aggressive easing is needed to even get the inflation trajectory back on track, let alone the level of inflation. As such, a 50bp "parting gift" cut is absolutely in play. With the market already shifting toward a similar move by the ECB next month, the SNB needs to at least match Frankfurt's path, if not move more aggressively.

However, on the domestic front, SNB and incoming President Martin Schlegel have a lot more room to work with and prevent them from acting more aggressively. Compared to a dozen years ago when the Swiss economy faced similar pressures, there is a similarly large split between positive domestic goods and services inflation versus the foreign equivalent. Franc strength swiftly generates negative pass-through to this effect, depending on the stage of the cycle (Exhibit #1). However, we can see that between 2009 and 2021, domestic goods and services were also in a relatively weak range and fell into negative at various points. In contrast, current domestic inflation dynamics are better and managing to hold at around 2%, though we would not categorize it as strong. Given that wages are the key input into domestic inflation for key developed market economies, we can surmise that the labor market is also relatively robust, but the SNB will be attentive to downside risks.

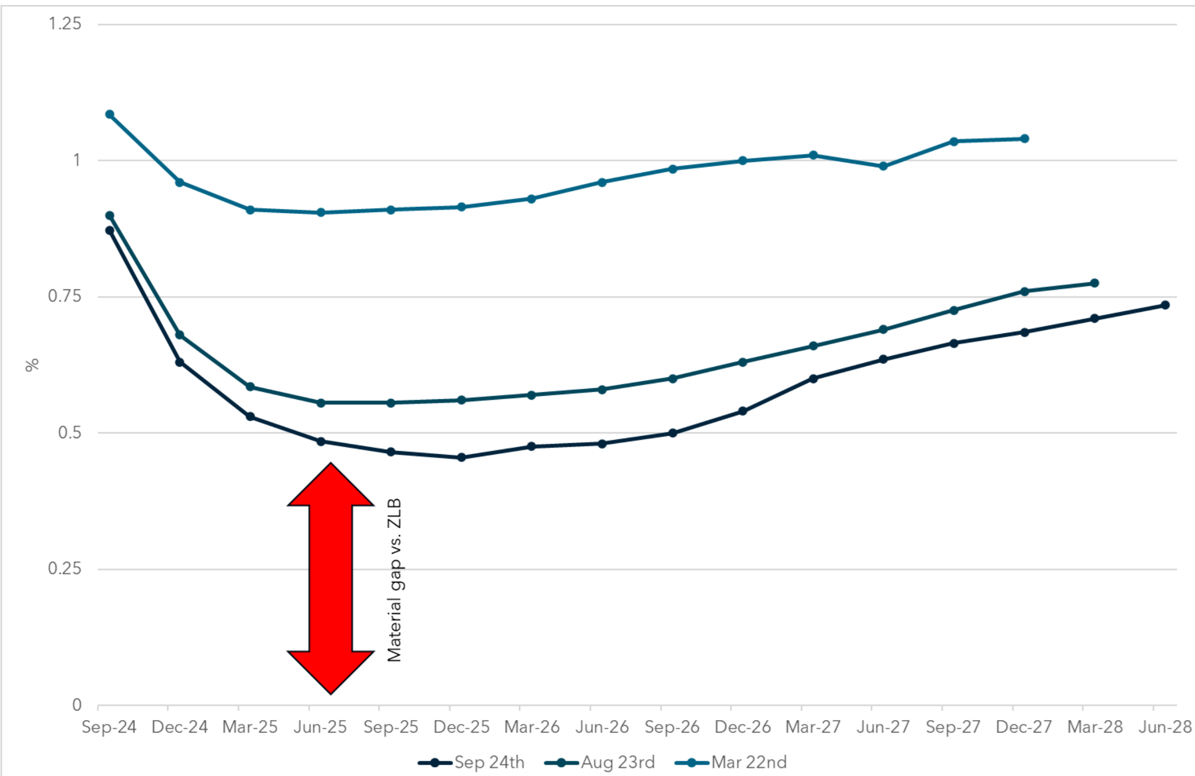
Exhibit #1: Domestic Inflation at Target



Source: Macrobond, BNY

One of the features of the current global monetary setup is that the rest of the world is not in a rush to follow the ECB and the Fed. For example, last week the Brazilian Central Bank hiked rates and the Bank of England is clearly erring on the side of stronger wage growth in calibrating policy. We see the SNB as far more rule-based in its approach to policy-setting, and the need to bring the conditional inflation forecast back toward the 2% target through their forecast horizon warrants continued easing, irrespective of whether price declines are domestic- or foreign-based. Market pricing of the SNB's path (Exhibit #2) has shifted significantly over the last six months, but there seems to be a hard floor at around 50%, which is well above the nominal zero lower bound (ZLB), let alone negative rates which anchored SNB policy in the past. We agree with the view that the SNB will try to avoid moving back into negative but there is no reason to discount the nominal ZLB so early, especially with inflation likely to remain well off target. There is every risk that at tomorrow's assessment, the outlook through to 2026 remains at 1% or even lower with the policy rate at 1%. In such a scenario there will be 25bp cuts per quarter and given where the ECB and Fed are headed, it is very hard to see the SNB ending rate cuts at 50bp, which could come as early as December if there is a 50bp move for the upcoming meeting. President Jordan may have stated that the neutral rate is higher than in the past, but this doesn't preclude the SNB moving below said level out of policy necessity.

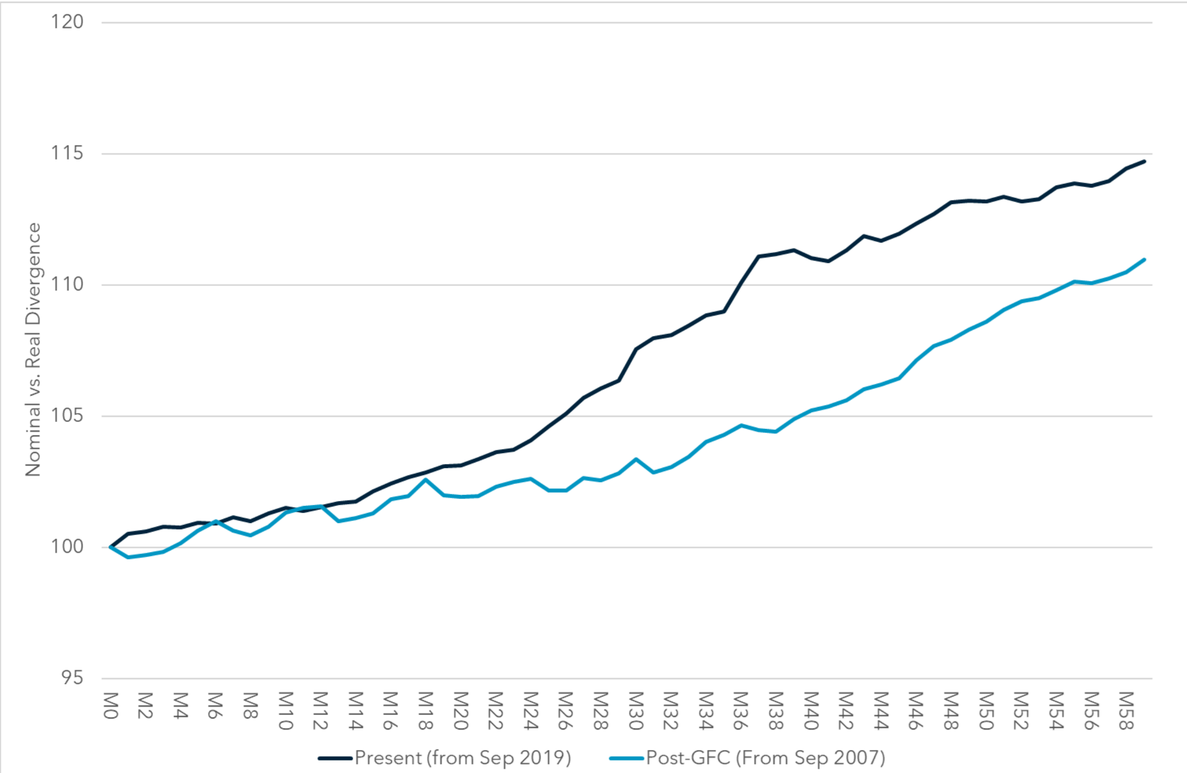
Exhibit #2: Market Doesn't See 0% as the Lower Bound



Source: Bloomberg, BNY

If the SNB does finish its easing cycle well above zero, then the immediate risk to the CHF is to the upside given its safety and quality features. Like the BOJ, it is less about global investors buying the franc and more about domestic investors limiting their overseas investments or FX exposures due to lower external yields. Furthermore, irrespective of the SNB's rate view, we believe there is still plenty of room for the franc to strengthen against the dollar and euro. Even after the rally this year, the franc's real effective exchange rate (REER) has only rebounded by around 2% since the aftermath of the March meeting. The strength in external inflation has meant that the nominal effective exchange rate (NEER) has been outperforming the REER far more aggressively during this cycle (Exhibit #3). Furthermore, as wage growth is driving external inflation, the impact on Swiss competitiveness in goods and services is weaker, which explains why domestic inflation in Switzerland has grown at a faster pace relative to historical levels. This is not to say that the SNB will tolerate speedy appreciation in the franc, but for now any policy response will be more measured.

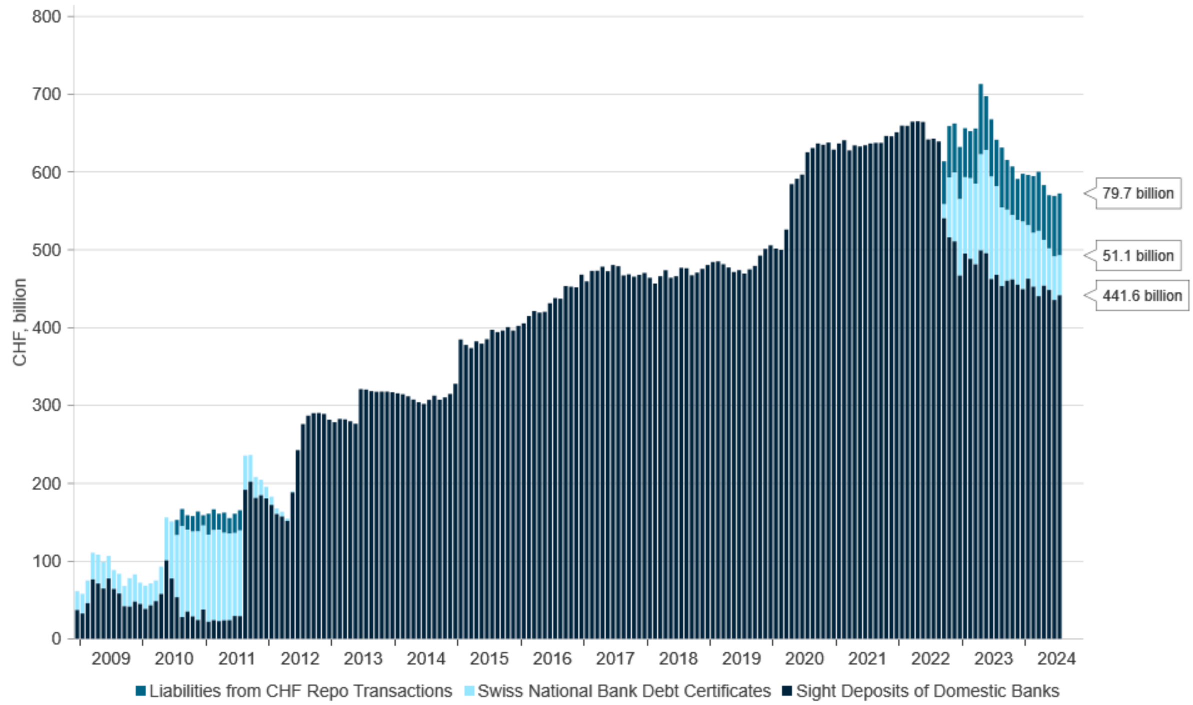
Exhibit #3: Nominal Surge More Apparent This Time



Source: Bloomberg, BNY

Finally, we believe that the relatively contained REER also means the SNB is very far from active intervention in currency markets. As we have highlighted in our previous rundown of the bank's playbook in 2011, there are several hurdles to clear before large-scale purchases of foreign currency are even on the table. Rates would need to move to zero first, though this can happen very quickly. The next phase would be to fully adjust the liabilities on their balance sheet into sight deposits, i.e., unwind sterilization operations adopted since 2022. At present, the combined level of SNB debt certificates and repo transactions still stands at CHF 130bn (Exhibit #4), which is over 20% of core liabilities. The process will exert further downside pressure on money market rates and offer a carry buffer, which the SNB hopes will be sufficient to counter franc strength, under the assumption that other central banks will not move to zero this time.

Exhibit #4: SNB Bills and Repo Transactions the First Line of Defense



Source: Macrobond, BNY

As the rest of the world – especially Switzerland's immediate neighbors – struggles with political uncertainty, high debt levels, weak growth and the start of easing cycles, the franc is once again a sought-after haven against which even lower rates is hardly a deterrent. Switzerland itself also had to deal with financial stability challenges in its domestic banking sector. President Jordan could be forgiven for wondering whether anything has changed since the day he assumed the SNB leadership in 2012 when he faced identical issues. However, he can take comfort in the fact that he leaves the SNB with ample resources and a tried-and-tested toolkit to meet the challenges ahead.

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNY.com

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