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MONETARY POLICY OUTLOOK

June 2024

Switzerland

The SNB once again caused tension and surprised some with its decision to lower the key interest rate by 0.25% to 1.25%, as the reactions on the foreign exchange market show. In view of the continuing positive inflation trend, we saw scope for a further easing of monetary policy. It is now important to categorise the decision correctly.

The SNB has adjusted its inflation forecast to the new key interest rate level of 1.25% (Figure 1). This time, the forecast has not been revised downwards, but the forecast inflation path is practically identical to that of the last forecast. This is to be understood as meaning that, due to weaker inflation dynamics, the same inflation path can now be achieved with a looser monetary policy, especially as the forecast would be lower without the latest interest rate cut.

The following can therefore be deduced from the assessment of the situation: The SNB currently rates the economic benefits of easing monetary policy higher than the benefits of greater disinflation. This means that there is still room for further interest rate cuts if inflationary pressure eases more than the SNB forecasts.

The current inflation is due to domestic inflation, in particular the rise in service prices. These are particularly sensitive to wage developments. In view of the positive real wage trend, the high level of employment and the easing of monetary policy, it remains questionable how likely it is that domestic inflation will cool significantly in the coming months. The positive economic impetus on the demand side could even boost inflation again in the short term, which could lead to the forecast rise in inflation in the coming quarters.

On the other hand, the question arises as to how accurately the SNB is assessing the situation. At the beginning of the macroeconomic change, the SNB underestimated inflationary pressure, whereas since the start of the disinflationary phase it has tended to act more cautiously and overestimate it (Figure 2).

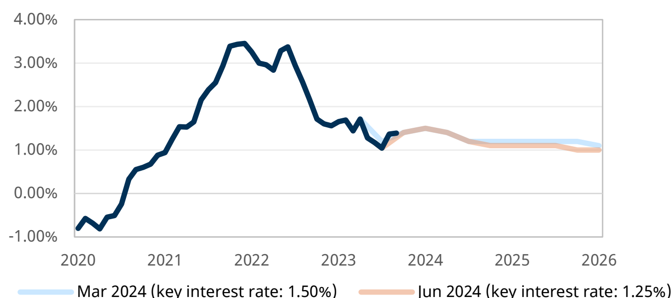
Irrespective of the further course of monetary policy, players from the construction sector in particular who are postponing investments due to the economic situation and financing conditions should gradually come to terms with the new environment. Those who continue to wait for better conditions could be disappointed and miss out on attractive investment opportunities.

The economy should normalise over the course of the year and support demand, even if growth is likely to be moderate in the coming years due to weaker global development (Figure 3). Further monetary easing is more likely to lead to a normalisation of the yield curve without significantly lowering interest rates and further easing financing conditions. The two key interest rate cuts had only a limited effect on the entire yield curve, as cuts are priced in for the medium and long term (Figure 4).

Our expectation

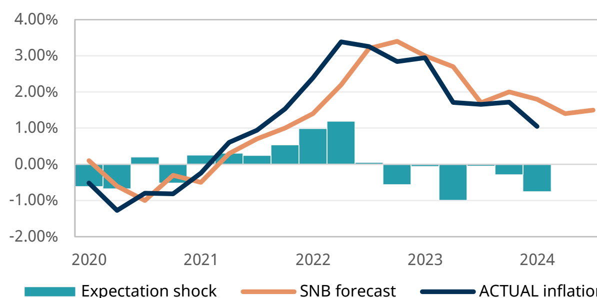
The data basis for inflation will point the way in the coming months. We will regard a lower inflation trend, as expected by the SNB, as a strong indication for a further reduction. We continue to believe that a key interest rate of 1.00% by the end of the year is realistic.

Figure 1: New SNB inflation forecast



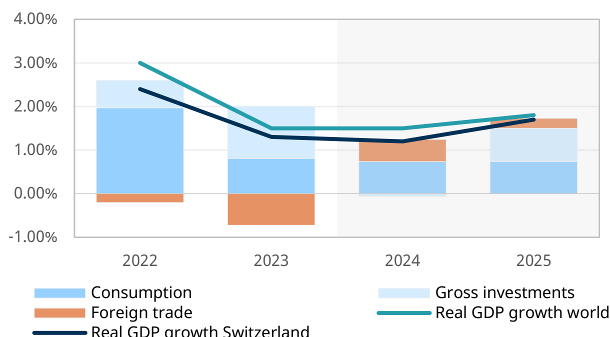
Note: The chart shows the current development of inflation and at the same time depicts the SNB's inflation forecasts as they were made at the time of the last monetary policy assessment. These forecasts are based, among other things, on the assumption that the key interest rate will remain unchanged over the entire forecast period of three years.
Source: Data from SNB, BfS, 20.06.2024

Figure 2: SNB inflation forecasts vs. actual inflation



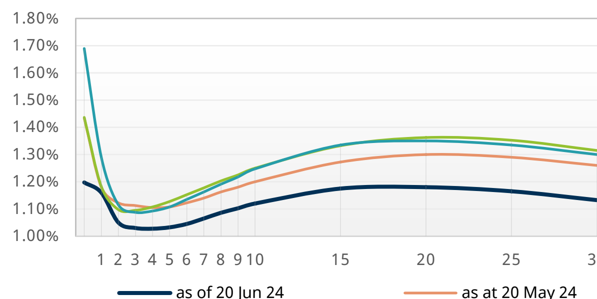
Note: With each monetary policy assessment, the SNB publishes its conditional inflation forecast, which is based on various assumptions and certain input parameters. This forecast is only valid until the next quarter. The deviation from actual inflation makes it possible to judge how accurate the forecasts were and whether they were cautious or optimistic.
Source: Data from Federal Statistical Office, SNB, 20.06.2024

Figure 3: Economic growth



Note: The chart shows the historical development and forecast of real GDP growth in Switzerland as well as the contributions of consumer demand, foreign trade and gross investment. The forecast growth rates for the global economy are also shown.
Source: Data from SECO, BfS, 20.06.2024

Figure 4: Interest rate swap curve



Note: The swap curves serve as a graphical representation of the underlying interest rate structure on the Swiss swap market. The respective swap rates as at the reporting date for the different maturities (in years) together form the swap curve.
Source: Data from Refinitiv Eikon, 20/06/2024

International

The ECB lowered its key interest rate before the Fed and the Bank of England (BoE) and thus began easing monetary policy. However, the next cut is unlikely to follow so quickly. The BoE is expected to follow the ECB's example in August, while the Fed is not expected to ease until September at the earliest.

Inflation is currently stagnating in many economic areas and the process of disinflation is proving to be increasingly protracted (Figure 5). Meanwhile, the inflation rate in the UK has fallen to 2.0% for the first time, which is exactly in line with the BoE's upper target. Despite the fall in headline inflation, continued pressure from rising real wages and high inflation in the services sector require cautious monetary policy management by the BoE, which has so far decided against cutting interest rates. It is now expected that the BoE will be in a position to loosen the interest rate screw at its meeting in August. The BoE's key interest rate, which is more than 3.00% above the inflation rate in May, represents a high real key interest rate compared to other central banks.

The high wage growth rates make it difficult for the ECB to cut interest rates further quickly. Inflation, which was initially driven mainly by corporate profits after the pandemic, is now increasingly being caused by rising labour costs (Figure 6). This development is expected to remain the main driver of inflation in the coming years. This type of inflation is considered to be extremely stubborn and as long as there is no economic slump and the labour market remains stable, the scope for further interest rate cuts will be limited.

In the US, inflation remains stubborn and progress towards the inflation target is moderate. As long as inflation risks persist and disinflation does not continue, a continued restrictive monetary policy is appropriate.

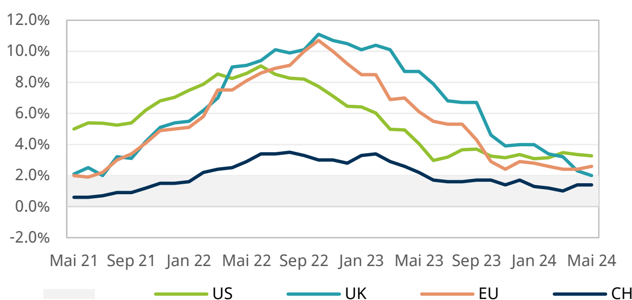
However, the Fed has repeatedly signalled that it is prepared to cut interest rates in the event of a significant weakening of the US labour market, regardless of inflation dynamics. The labour market has already cooled significantly and some indicators suggest that it has returned to pre-pandemic levels (Figure 7). Despite this slowdown, the labour market is considered healthy and is showing high employment growth. As long as there is no abrupt deterioration in the labour market situation, the Fed will not feel compelled to cut interest rates early.

The FOMC meeting shows that the median forecast envisages one interest rate hike by the end of the year. By contrast, the interest rate market is pricing in almost two rate hikes of 25 bps each (Figure 8). Around two rate hikes are also being priced in for the ECB.

Our expectations

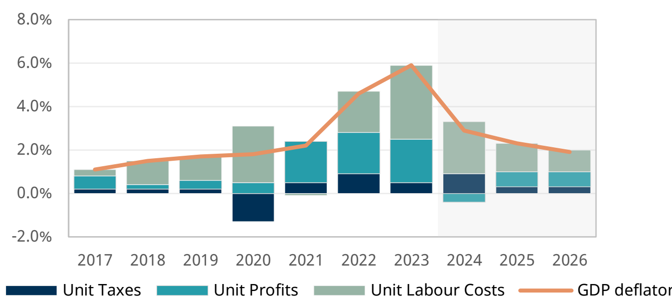
We assume that the ECB and the Fed will cut interest rates in September at the earliest, although we consider a cut by the ECB to be more likely.

Figure 5: Consumer price indices



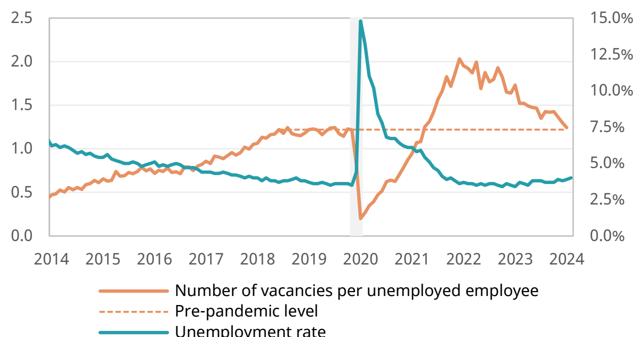
Note: The chart includes the historical development of the most representative consumer price indices of the respective countries / regions. Currently, all national banks shown define their inflation target at 2.00%.
Source: Data from Refinitiv Eikon, as at 20/06/2024

Figure 6: Breakdown of inflation in the eurozone



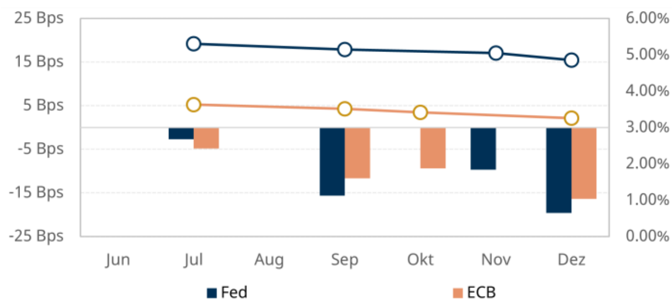
Note: The GDP deflator is a key figure for measuring inflation in an economic area. In contrast to the consumer price indices, which only refer to the prices of consumer goods, the GDP deflator measures the inflation of the entire economy. This can be broken down into the components shown (unit taxes, unit profits, unit labour costs) in order to better understand the origin of inflation.
Source: Data from ECB Data Portal, as at 20/06/2024

Figure 7: Cooling US labour market



Note: The chart illustrates the development of the US labour market. The shaded area marks the recession phase during the pandemic.
Source: Data from Fred, as at 20/06/2024

Figure 8: Market-implied key interest rate developments



Note: The chart shows the market-implied development for the key interest rates of the Fed and the ECB (right axis). These are derived from Fed funds futures and overnight index swaps. The left axis shows the implied interest rate adjustments (in basis points) in the respective month in which a monetary policy meeting is scheduled.
Source: Data from Refinitiv Eikon, as at 20/06/2024

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