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MONETARY POLICY OUTLOOK 2025

January 2025

Executive Summary

Falling inflation gave most central banks room to cut interest rates in 2024. However, monetary policy paths are likely to diverge more strongly in 2025. The risk of another wave of inflation, high government debt and political and economic uncertainties characterise the outlook.

Switzerland: The interest rate market remains stable in an international comparison with moderate volatility. Falling electricity prices and a strong franc are limiting inflation risks, making a renewed rise unlikely. The Swiss franc is likely to appreciate further in the medium term, while the SNB is only likely to intervene if it becomes excessively strong. Short and medium-term interest rates could fall further, while the long end remains stable. We expect two further rate cuts to 0%.

EU: The eurozone remains economically weak, burdened by political fragmentation and structural deficits. A growth-promoting fiscal policy would be necessary, but is hardly realisable due to high levels of debt. The Trump administration is also increasing the risk of trade tensions. While monetary easing is necessary, there is a threat of stubborn inflation. We expect at least two more interest rate cuts, but assume that the ECB will pause in the summer due to persistent inflation risks.

USA: The US economy remains robust, while inflation risks are rising - a "no landing" scenario is becoming more likely. Parallels to the 1980s are recognisable and the Fed must avoid repeating old mistakes by cutting interest rates too early. The Trump administration brings additional uncertainties that could increase inflationary pressure. Without clear signals of declining inflation or a weakening labour market, the scope for rate cuts remains limited. We expect a pause in interest rates until the summer.

2025 - Monetary policy between divergence and inflationary pressure

2024 was the synchronised swimming of many central banks

The synchronised interest rate hikes in 2022 and 2023 were followed by an equally coordinated phase of easing in 2024. Most economies responded to the slowdown in inflation by cutting interest rates, which led to a global turnaround in monetary policy (Figure 1).

2025, on the other hand, is likely to be somewhat chaotic

This lockstep pattern will not last. In 2025, monetary policy paths are likely to diverge more strongly again as economic and inflationary developments increasingly diverge. While some central banks have already reached the end of their interest rate cuts, others are only at the beginning - or, as in the case of Japan, are about to tighten further.

Global economy so far without recession

Despite many warnings, a global recession has been avoided so far, even though economic momentum has slowed noticeably. A recession has also failed to materialise in the largest economies, but economic development has varied. While the USA is performing well economically despite the sharpest rise in interest rates since the turn of the millennium, Europe is lagging behind.

Inverted yield curve remains a relevant signal

One of the most reliable technical signals of an impending recession is the inverted yield curve, which has normalised again in recent months (Figure 2). However, the assumption that this is a false alarm falls short of the mark. The normalisation was not caused by falling short-term interest rates, but by rising long-term interest rates - driven by higher growth and inflation expectations. This does not mean that the risk of a recession is off the table, but remains a possible scenario.

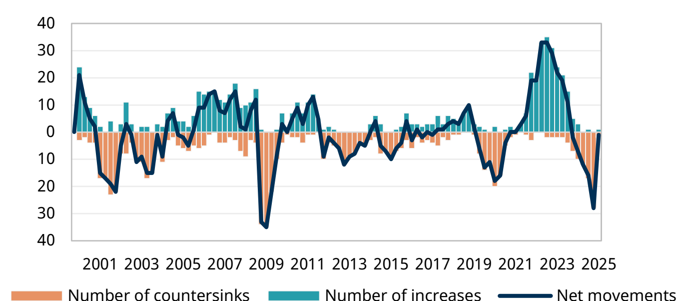
Macroeconomic risks remain high

The current global macroeconomic environment, particularly in the USA, is characterised by a "higher-for-longer" regime. In view of high private and government debt, a possible return of inflation and economic and geopolitical uncertainties, there are considerable risks - not only of a slowdown in growth, but also of unexpected tensions in the financial system.

Monetary policy outlook

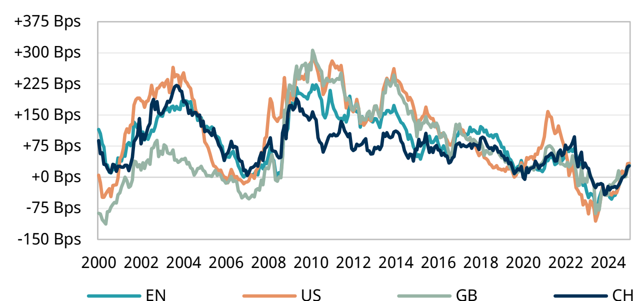
From a monetary policy perspective, there are a number of factors that need to be observed and categorised. In this year's Outlook, we address these in the form of key questions, provide answers and formulate our assessment of monetary policy in the current year.

Figure 1: Global interest rate policy: interest rate cuts dominated in 2024



Note: The chart shows the number of key interest rate changes - both increases and decreases - by the central banks of the OECD member states on a quarterly basis
Source: Refinitiv Eikon

Figure 2: Term spreads return to positive territory



Note: The chart shows the term spreads of various countries, calculated as the difference between the yield on a ten-year and a two-year government bond.
Source: Refinitiv Eikon

Switzerland

Is volatility also returning to the Swiss interest rate market?

The year starts with conspicuous movement on the interest rate markets: Government bonds in many countries reach record highs, while British bonds even exceed these levels (Figure 3). Swiss government bonds also show price declines, leading to slightly higher yields - although volatility is moderate by international standards.

The drivers are inflation concerns, high debt levels, persistent budget deficits and political uncertainties. Switzerland stands out due to its solid financial policy, but there are concerns that long-term interest rates could be affected by global uncertainties. Without clear inflationary impulses, however, major jumps in yields or a trend reversal are unlikely to materialise.

How high is the risk of a return of inflation in Switzerland?

While global inflation - especially in the services sector - remains stubbornly high, the trend in Switzerland is different (Figure 4). As services inflation is primarily influenced by domestic factors such as labour costs and local demand, it is unlikely that global inflationary momentum will spill over into Switzerland.

Structural price reductions will also have an impact in the coming months: In January, falling electricity prices are likely to push inflation down by 20 bps, and an expected reduction in the mortgage reference interest rate in March could result in an additional reduction of 15 bps over the rest of the year. Inflation is likely to be close to 0% or even negative by the second quarter at the latest. A stable or stronger franc could even intensify this effect. A further significant rise in inflation is therefore unlikely.

Will the franc continue to appreciate and when will the SNB intervene?

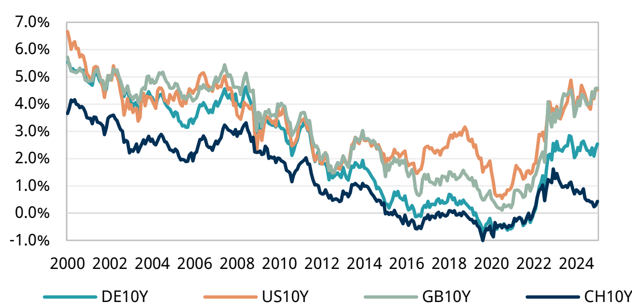
While some economists expected the Swiss franc to depreciate last year, not least due to the interest rate differential and early interest rate cuts, the opposite has happened. The Swiss franc remains in demand as a safe haven in the current macroeconomic environment and is proving resilient to the four interest rate cuts (see Figure 5).

The Swiss franc is likely to appreciate further in the medium term, supported by Switzerland's economic strength, low inflation and other fundamental factors. The SNB's monetary policy measures can hardly slow this trend in the long term, but are aimed at preventing abrupt jumps in appreciation. The SNB has clearly signalled that it will intervene if the Swiss franc becomes excessively strong. Its willingness to reintroduce negative interest rates if necessary and the latest interest rate cut of 50 bps emphasise this stance. The Swiss franc has not appreciated further since the last meeting and the SNB appears to be satisfied with the current exchange rate level. Further interventions remain possible, but are not necessarily to be expected.

How will the yield curve develop?

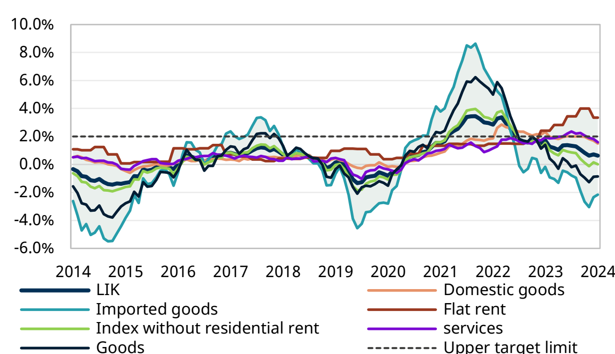
Historical trends indicate that there is further downside potential in the short and middle segments of the yield curve, particularly in the event of further interest rate cuts (Figure 6). The long end of the curve, on the other hand, is likely to remain largely stable. A significant decline in swap rates would require scenarios that are accompanied by sharp economic downturns - similar to those at the beginning of the pandemic. As long as these do not materialise, we expect the yield curve to remain stable in the long end, while the short and medium segments will be able to react more flexibly to monetary policy measures.

Figure 3: Rise in yields



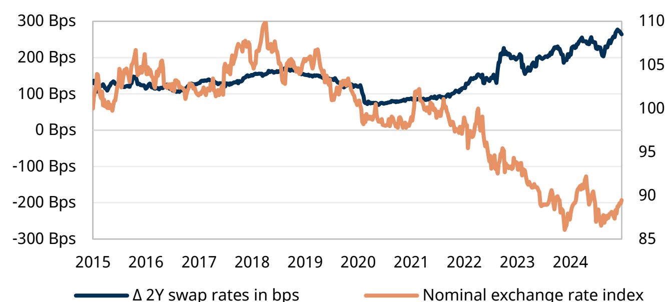
Note: Development of the ten-year bond yields of various countries.
Source: Refinitiv Eikon

Figure 4: National consumer price index (CPI)



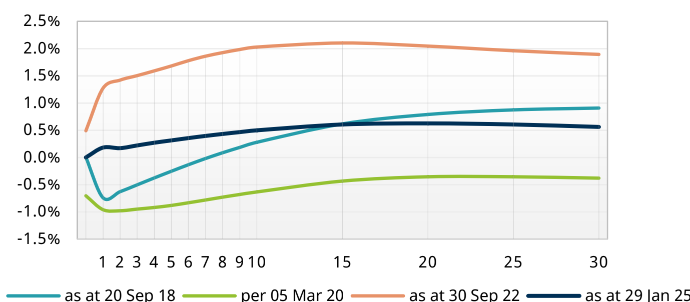
Note: The chart shows the changes in the previous year for the national consumer price index (CPI) and the most important sub-indices.
Source: Federal Statistical Office

Figure 5: Decoupling of interest rate differential and exchange rate development



Note: The chart shows the trade-weighted nominal CHF exchange rate and the difference in 2-year swap rates against the most important trading currencies. A falling exchange rate index means a stronger franc, a higher interest rate differential means lower Swiss swap rates.
Source: Refinitiv Eikon

Figure 6: Interest rate swap curves



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: Refinitiv Eikon

European Union

When will the European economy recover?

In September last year, former ECB President Mario Draghi summarised the structural problems of the European Union in a comprehensive report - and at the same time provided concrete proposals for solutions. The need for action is urgent.

The ailing state of the European economy is particularly evident in the German economy (Figure 7). The problems range from inefficient regulatory hurdles, low investment and a lack of cooperation between member states to a shrinking labour force and stagnating productivity. As a result, the European economy behind the US in many metrics (Figure 8). European countries need a clear guideline to create productive framework conditions. Further easing of monetary policy is therefore unlikely to help much here.

Does the poor budget balance permit an expansionary fiscal policy?

The high national debt and budget deficits that have arisen as a result of the pandemic have not yet recovered and have even worsened in some countries (Figure 9). The majority of countries continue to exceed the EU's 3% limit for budget deficits.

The weak economy combined with high interest rates is putting additional pressure on public finances. Although some countries are forecasting an improvement in their budgetary situation in the coming years, considerable doubts remain. This is because extensive investment is urgently needed to ensure long-term stability and competitiveness - including from the public sector. Hesitating too long could jeopardise Europe's global competitiveness, while an immediate expansionary course would put financial sustainability under pressure. In addition, there is a lack of unity in politics, which makes critical decisions more difficult and often leads to political gridlock.

How well prepared is Europe for Trump 2.0?

In the wake of the war in Ukraine, European economies have had to reorganise their supply chains and sales markets. China, once an important sales market, particularly for green technologies, is increasingly becoming a global competitor and is gaining considerable independence in high-tech sectors.

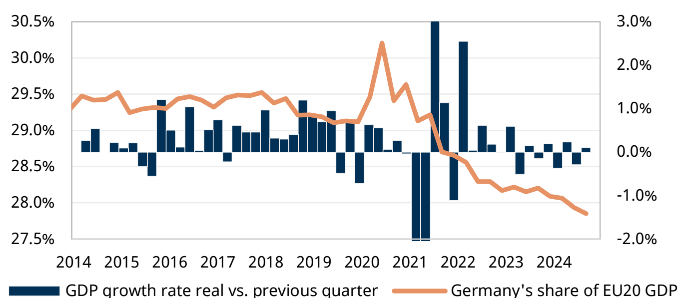
To fill this gap, Europe has intensified its trade relations with the USA. However, a Trump 2.0 with his unpredictable "America First" policy could quickly jeopardise this strategy. Protectionist measures would push Europe into an economically disadvantageous position. Europe's strong dependence on stable transatlantic relations thus becomes a potential weak point.

How high is the risk of a return of inflation in Europe?

The ECB has made it clear that it will continue to gradually lower its key interest rates. However, similar to the USA, albeit to a lesser extent, there is also a risk of a renewed surge in inflation. A key indicator of this is the high wage growth rates, which are above both the inflation target and current inflation and contribute significantly to service inflation (Figure 10).

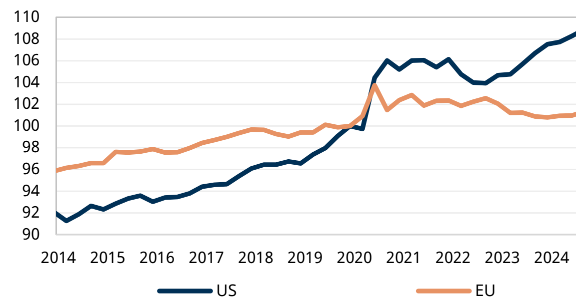
In principle, rising disposable income strengthens the domestic economy. However, the combination of higher wages and stagnating productivity harbours considerable inflation risks, which could gain momentum, particularly in the event of an economic upturn - risks that currently have to be accepted.

Figure 7: Germany, the sick man of Europe



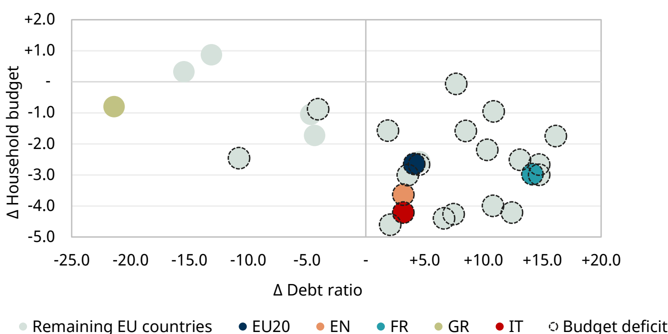
Note: The chart shows the share of Germany's nominal GDP in the total GDP of the EU20 countries (left axis) and the quarterly real growth rate of the German economy (right axis).
Source: Eurostat

Figure 8: Labour productivity: USA overtakes Europe



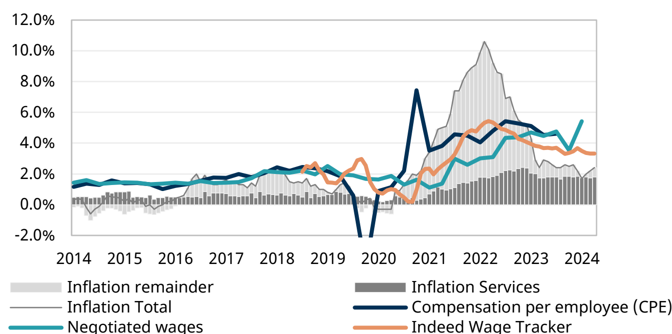
Note: The chart shows labour productivity per hour worked in the USA and Europe. Both indices are indexed to 100 on 31 December 2019.
Source: ECB Data Portal, Fred

Figure 9: Change in government budget in relation to GDP vs. debt ratio, Q2 2024 vs. Q4 2019 in %P



Note: The chart shows the change in the debt ratio on the horizontal axis and the change in the budget on the vertical axis, both in percentage points (%P). Dotted circles indicate countries with a budget deficit in the second quarter of 2024.
Source: ECB Data Portal

Figure 10: High wage growth rates jeopardise the inflation trend



Note: The chart shows the inflation rate, broken down into services and the rest, and the development of various indicators for monitoring wage trends in the eurozone.
Source: ECB Data Portal, GitHub

USA

"Soft landing" or rather a "no landing"?

The US economy remains robust. The labour market, which still showed significant weaknesses in the second quarter of last year and prompted the Fed to take a jumbo step of 50 bps, has now stabilised (Figure 11).

A full-scale recession has so far failed to materialise, but the soft landing sought by the Fed has not been achieved either. Stubborn inflation, which has recently started to rise again, combined with an economy that remains strong, rather points to a "no landing" scenario - a situation in which inflation remains high despite a restrictive monetary policy and the economy barely slows down.

Is the USA facing an inflationary surge like in the 1970s?

History does not repeat itself, but it rhymes - an idea that applies to the current inflation trend. This shows clear parallels with the 1970s (Figure 12). At the beginning of the rate hike cycle, Jerome Powell emphasised several times that the Fed wanted to learn from past mistakes and not cut interest rates too early. However, if inflation picks up again, the Fed could once again find itself in a difficult situation and run the risk of repeating the experience of the .

Did the Fed start cutting interest rates too early?

Looking back, it can certainly be argued that the Fed started cutting interest rates too early (Figure 14). Since September, long-term interest rates have risen, while expectations for further cuts have declined significantly. Inflation remains stubbornly high, driven by rising housing costs and services, which are likely to remain high given the current macroeconomic environment. With Trump 2.0, there is also growing concern that inflation will flare up again, which will not only weigh on monetary policy stability but also limit the Fed's ability to act. Some market participants are already speculating that the Fed will not only refrain from further interest rate cuts this year, but could even raise interest rates again.

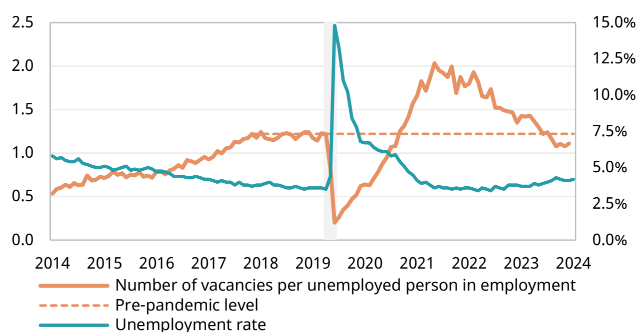
What does Trump 2.0 mean for inflation, the labour market and monetary policy?

Tariffs, tax cuts, deregulation, a hiring freeze in the public sector, restrictions on immigration and new sanctions are already in force or imminent. Some of these measures are increasingly serving as leverage for international negotiations, but are creating considerable uncertainty in the short term.

Other measures such as deregulation and tax incentives could promote economic growth, but at the same time further fuel inflation. Restricting immigration is likely to further reduce the supply of labour, which could drive wage inflation. The US labour market is heavily reliant on immigration. The hiring freeze and planned job cuts in the public sector, on the other hand, are likely to weaken labour market momentum (Figure 13).

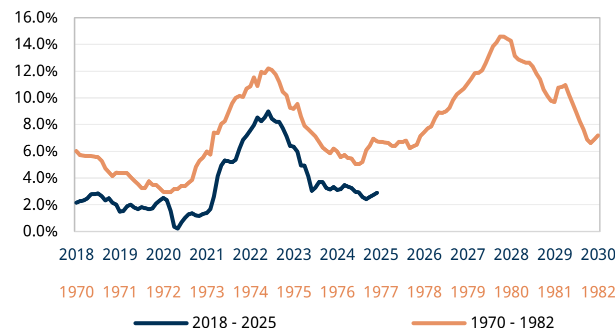
Trump also wants to influence monetary policy and introduce lower interest rates more quickly. This could significantly impair the Fed's ability to control inflation. Political pressure jeopardises confidence in its independence and its role in anchoring inflation expectations. Studies show that political interference in central bank operations often leads to higher and sustained inflation. Maintaining its credibility under Trump 2.0 will be a particularly complex challenge for the Fed.

Figure 11: Robust momentum on the US labour market



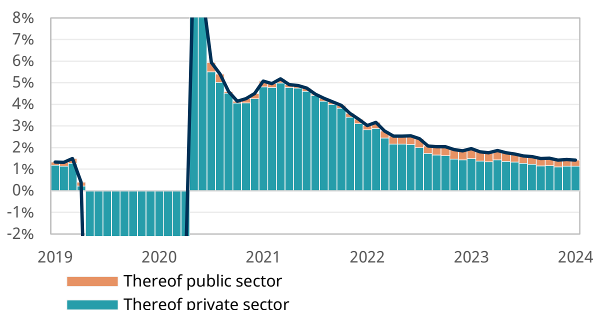
Note: The chart illustrates the development of the US labour market. The shaded area marks the recession phase during the pandemic.
Source: Fred

Figure 12: The current inflation trend shows strong parallels to the high inflation phase of the 1970s



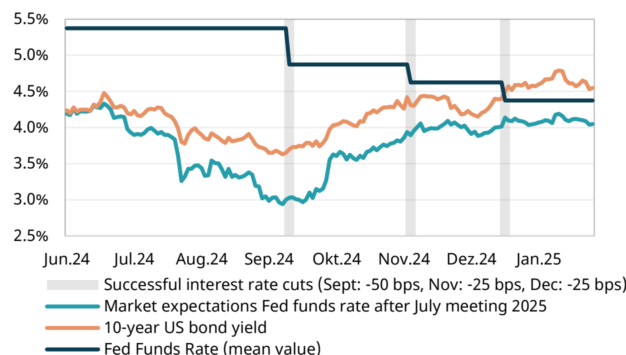
Note: The chart shows the current inflation trend in comparison to the inflationary environment in the 1970s and 1980s in the USA.
Source: Fred

Figure 13: Employment growth, broken down into the private and public sectors



Note: The chart shows employment growth in the USA, broken down into the private and public sectors.
Source: Fred

Figure 14: Did the Fed cut too early? - Rise in interest rates and expectations since the first rate cut



Note: The chart shows the development of the Fed Fund Rate, the 10-year bond yield and the market-implied Fed Fund Rate after the July 2025 meeting.
Source: Fred, CME Group

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Our outlook for monetary policy in 2025

Switzerland

In December, interest rate swaps priced in a negative key interest rate for the second half of 2025 for the first time. However, these expectations have fallen significantly in recent weeks. The swap market currently expects a reduction of around 30 basis points for 2025, although an interest rate cut in March is not being priced in as a complete certainty (Figure 19).

The strength of the Swiss franc has eased recently and there have been no abrupt revaluations - a development that should be satisfactory from the SNB's point of view. Whether further interest rate cuts will follow depends crucially on the development of inflation in the coming months. If inflation is above the forecast, additional cuts would not be necessary. If, on the other hand, inflation is below the SNB's conditional forecast, we believe a rate cut in March is more likely. A persistently negative inflation rate could also necessitate a further reduction in the key interest rate to 0% by June. Further monetary policy measures could become necessary due to global economic risks or an unexpected appreciation of the Swiss franc. Under these circumstances, we expect a key interest rate of 0% by the end of the year.

EU

Following its latest interest rate hike, the ECB still has room for further easing, which is also reflected in the interest rate market, which is currently pricing in almost three further cuts for this year. However, in view of the ongoing inflation risks, the ECB is likely to maintain a cautious pace and implement the adjustments gradually in 25 bps increments. However, a renewed acceleration in the pace of inflation - a realistic scenario in our view - could limit this room for manoeuvre. We therefore expect the ECB to make two further interest rate cuts by the summer before taking a break due to inflationary pressure. If the monetary policy measures take effect as hoped, cyclically-driven cuts could follow later in the year.

USA

We welcome the Fed's decision to leave interest rates unchanged for the time being and to wait and see how the economy develops. It is crucial that it neither repeats the mistakes of the nor gives in to political pressure, such as from Donald Trump. Instead, it should consistently pursue its dual mandate and maintain a restrictive monetary policy as long as the labour market remains strong and there is no clear progress in the fight against inflation - a line that Jerome Powell has also emphasised. We therefore believe that major interest rate cuts are unlikely this year and expect a pause in interest rates until the summer. If the economy remains stable, we then expect a maximum of three interest rate cuts over the course of the year.

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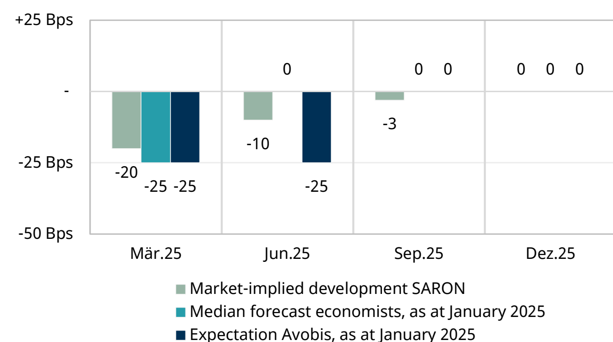
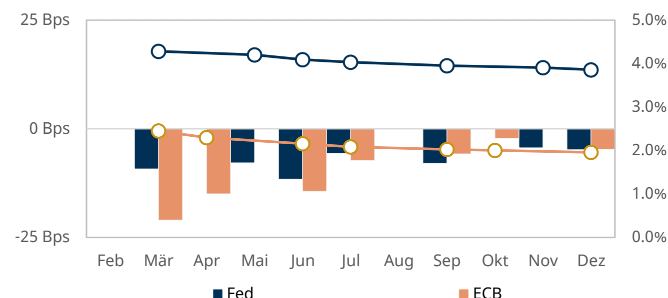
Figure 19: Market expectations & forecasts for the SARON rate and SNB key interest rate



Note: The market-implied forecast for the SARON rate is derived from the interest rate swaps. The economists' forecast is based on regular surveys by Bloomberg.
Source: Bloomberg, Refinitiv Eikon, Avobis

Figure 20: Market-implied key interest rate developments Fed & ECB



Note: The chart shows the market-implied development for the key interest rates of the Fed and 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: Refinitv Eikon

Status: 30 January 2025

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