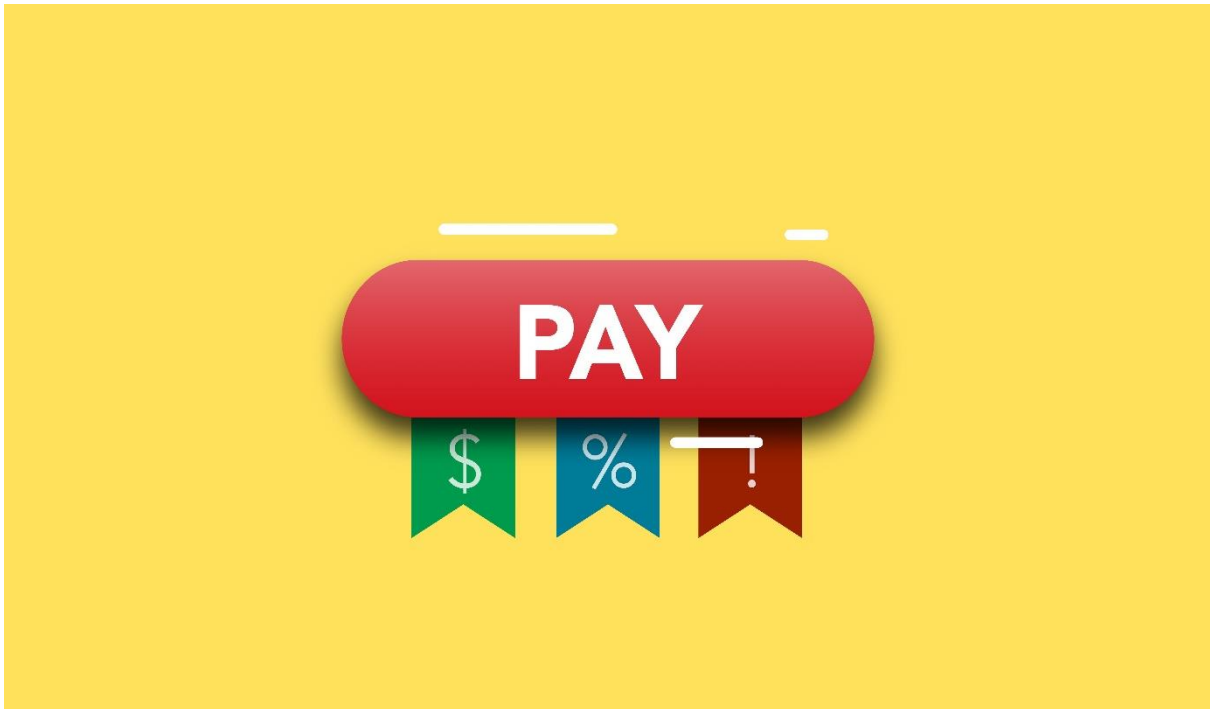


## What are the consequences of Swiss inflation on interest rates?



*Usefulness of the article: In addition to commodities' prices, inflation is influenced by many determinants, which are useful to identify in order to follow their developments. In Switzerland, there exists a strong positive correlation between, on the one hand, the policy rate of the central bank and sovereign bond yields and, on the other hand, between these lasts and the fixed interest rates on mortgages. An accurate anticipation of the monetary policy is therefore essential to the anticipation of these key interest rates for investors and households.*

### **Summary:**

- In Switzerland, inflation varies at a pace close to that of unit labor costs over the long term; a survey from UBS, according to which wage increases obtained for 2023 would stand at 2.2% while inflation stood at 2.8% in 2022, could be the sign of potentially slowing wage and inflation dynamics;
- At least two factors will very likely exert a downward pressure on inflation over the medium term: international competition and, especially, the nominal appreciation of the Swiss franc which stood, over the last 30 years, at 2% per year on average;
- Inflation should drop below the 2% threshold in 2024; therefore, the SNB's policy rate could decrease by 2025 from its end of 2023 peak;
- An inflation that would finally be lower than expected would be associated with lower policy rates and thus with lower bond returns.

In Switzerland, the 2022 imported inflation shocks were subdued by the appreciation of the currency, which sometimes plays the role of a safe haven (/refuge currency). In this country, inflation is lower than in the euro area and in the United States, both in 2022 (+2.8%) and in the long run: since 2002, it stands at an average of 0.5% in Switzerland, but at 2% in the euro area and at 2.4% in the United States. Within the current inflationary environment, the SNB rose its policy rate along with the European central bank (ECB), but to a lesser extent, the policy rate having been set at 1.5% in Switzerland and at 3.5% in the euro area in March.

The case of Credit Suisse, acquired by UBS, is related to governance difficulties that are specific to this bank and which should not induce by themselves an inflection in the SNB's monetary policy.

Which pressures will apply on prices in Switzerland over the medium term? Which implications will the monetary policy have on sovereign returns and mortgage rates? To which macroeconomic scenario investors' anticipations on sovereign returns and monetary policy correspond?

## 1) The specificities of the Swiss economy in favor of a low inflation

Having the 5<sup>th</sup> GDP per capita in the world and the 7<sup>th</sup> in purchasing power parity, the Swiss economy is firstly characterized by its high standard of living, backed by an intensive use of labor as a production factor (employment rate at 80%, more hours worked per employee per year than in France owing to a lower amount of days off). Labor productivity is high in the industry, which represents around 20% of the value added of the country.

Switzerland therefore registers a strong current account surplus (of 6.5% of its GDP on average over the last ten years), driven by pharmaceutical, chemical and watchmaking sectors, as well as commodities trading. Furthermore, the Swiss economy benefits from an effective labor market (unemployment rate structurally below 5% by ILO standards), a vocational training system that is useful to labor market inclusion and an ecosystem conducive to innovation, in addition to R&D spending amounting to 3.2% of the GDP in 2019.

The strong current account surplus of Switzerland, as well as its low inflation rate, structurally contribute to the appreciation of its currency, by 2% per year on average against all other currencies. The Swiss franc appreciation exerts a downward pressure on internal prices. In 2015, the deletion of the minimal value of euros in Swiss francs (1.20) led to a sharp appreciation of the Swiss franc and to a slight deflation within the Swiss economy. The Swiss central bank (SNB) then endeavored to intervene on exchange rate market and to maintain short term interest rates below those of the Euro area in order to avoid too quick an appreciation of its currency.

Being, like Japan, part of the countries which struggled against deflation between 2015 and 2019, Switzerland was in a good position to absorb the inflationary shocks of 2021-2022 relating to hydrocarbons and food commodities, bottlenecks in supply chains and the covid-19 fiscal policy. In Switzerland, the steps sustaining the economy - essentially in the short run except an increased funding for applied research – represented 2.2% of the GDP, but were not followed by a distinct recovery plan strictly speaking, conversely to what was observed in the euro area and in the US.

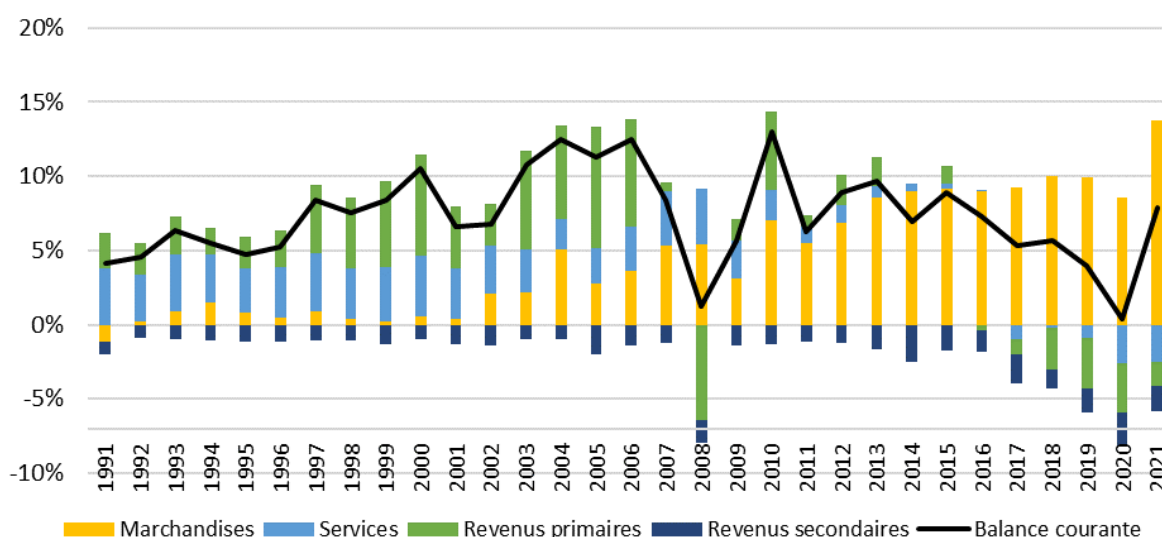
## 2) Inflation should quickly fall below the 2% threshold in Switzerland, as a result of the trend of nominal appreciation of the currency and international competition

In Switzerland, the increase in the general price level measured by the consumer price index (CPI) stood at +2.8% in 2022.

However, many factors will structurally exert downward pressures on inflation in the next ten years. **Between 1994 and 2022, the Swiss franc appreciated by 81% in nominal terms, i.e. 2% per year on average**, knowing that this yearly pace was maintained in the last ten years. If the Swiss franc appreciation peaks, observed for instance versus the euro, were caused by financial determinants or the safe haven role of this currency, it must be noted that the corrections that followed were only partial.

Indeed, a key factor exerts upward pressures on the Swiss franc over the medium term: the surplus of the Swiss current account, which implies a structural excess demand for the Swiss franc for current payment purposes (purchases of goods and services in Switzerland and income flows). **The Swiss current account surplus was at 6.5% of the GDP on average over the last ten years.**

**Chart: current account and its components according to the SNB, as % of the GDP**



After an exceptional deterioration at the peak of the covid-19 pandemic in 2020, the Swiss current account rebounded at 8% of the GDP in 2021 and is not on the verge of decreasing in 2022, according to the data of the first three quarters. **For the years to come, it is reasonable to count on a substantial current account surplus in Switzerland**, the massive balance of goods surplus being backed by two sectors whose demand is little sensitive to prices: the pharmaceutical industry and commodities trading. The current account surplus should contribute to the nominal appreciation of the Swiss franc, which should keep on trending and exert a downward pressure on import prices, as long as a major real appreciation of the currency has not been observed.

Furthermore, **international competition** should remain intense and contribute to put pressure on production prices in sectors that are exposed to it. Besides, in the short run, the deletion of supply chain **bottlenecks** linked to sanitary restrictions should increase the supply of goods and thus contribute to a decrease in prices, notably on the import side according to UBS, which also expects a stabilization of energy prices.

Finally, **wages** represent a large share, ranging from 54% to 60% over the period 1995-2021, of the

Swiss GDP. Hence, they have a high weight in the cost of the goods and services produced on the Swiss territory. On average, unit labor costs grew by 0.4% per year over the period 1991-2021 according to the OECD, a slow pace in international comparison and slightly lower than inflation.

The 2022 inflation peak (2.8%) would, according to a survey from UBS, only have given birth to an average increase in wages of 2.2% for 2023. If this figure remains to be confirmed by official data, it does not suggest an acceleration of the wage-price dynamic. Let us note as well that the share of wages in the GDP was already close to a peak in 2021 (59.2%), so that it appears unlikely that this share significantly increases in the years to come.

Taking into account the trajectory of the main inflation drivers in Switzerland, it is likely that this last quickly falls (in 2024) below the 2% threshold, before staying there lastingly, except in case of a new inflationary shock (cf. part 3).

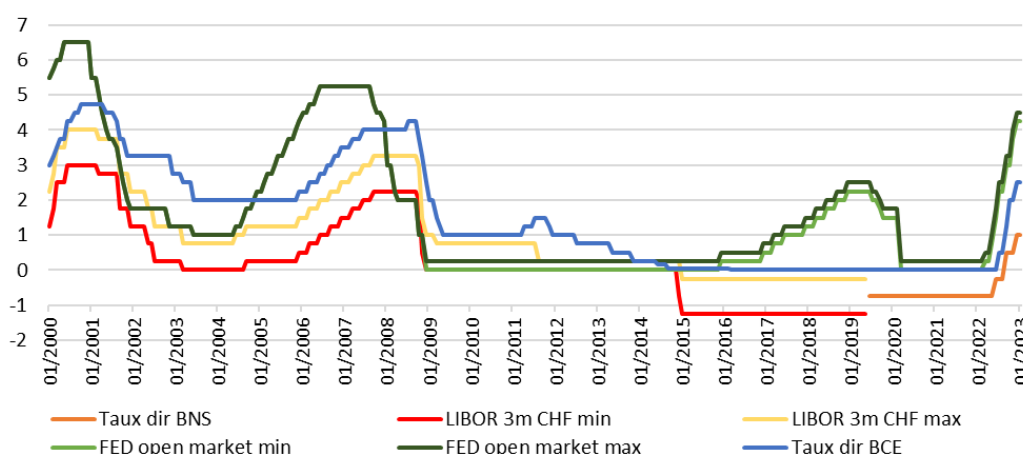
### 3) Inflation could be lower than expected, which would induce a potential decrease in ten-year yields

In the short run, even if inflation falls below the 2% threshold in the end of 2023 or in 2024, it will remain subject to a potential rebound linked to imports from Switzerland's large trading partners (the euro area and the US). In particular, if a one-time depreciation of the Swiss franc occurred compared to its December 2022 peak, for instance in connection with worries on financial stability – which seem to have been tamed at this stage – import prices would increase. Thus, in order to avoid a depreciation of the Swiss franc, it is likely that the SNB does not set, in 2023, its policy rate at a much lower level than that of the ECB.

However, once inflation would have fallen in Switzerland and decreased in the euro area and in the US (in 2024/2025), the SNB will have no reason not to increase the difference between its policy rate and that of the ECB. In particular, it could set its policy rates at more clearly lower levels than those of the ECB than at the moment, without worrying about an imported inflation shock. In addition, GDP growth in the euro area and in the US should be below its potential at least until 2024, which should refrain the Swiss growth, which is essentially determined by foreign trade.

Thus, taking into account its objective of supporting the activity, the SNB could, from the end of 2024, reduce its policy rates, except in case of a new inflationary shock.

**Chart: policy rates in Switzerland, in the euro area and in the US, according to the SNB, %**



Source: SNB

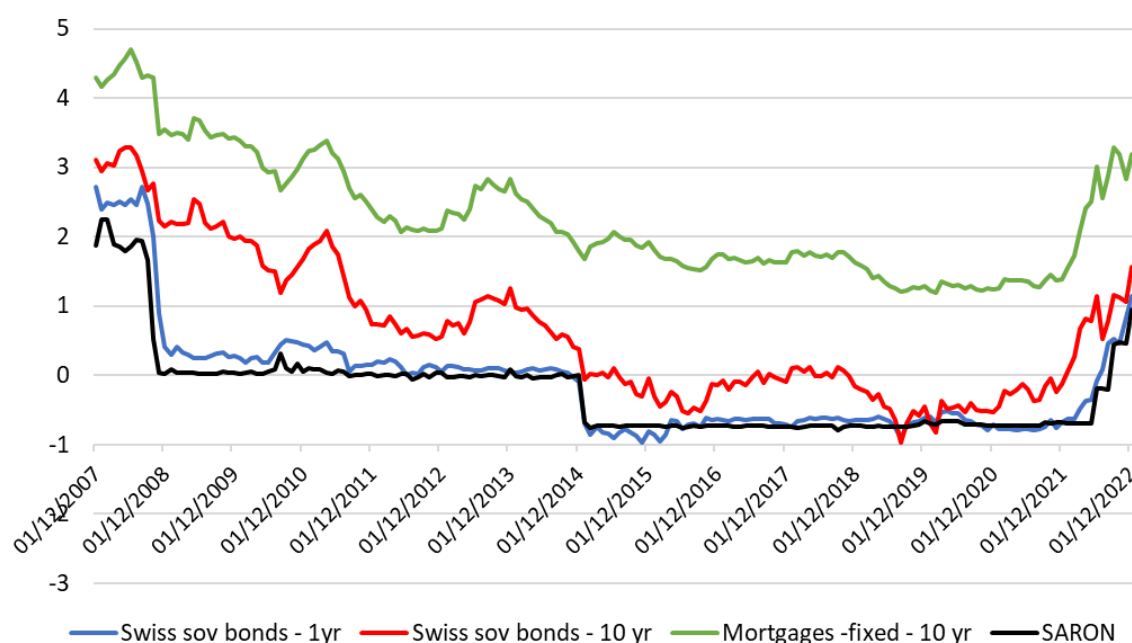
**Sovereign bond yields** are precisely linked to the policy rates of the national central bank, which partly determine short term interest rates. Sovereign bond yields therefore stand – except in case of a sharp increase in foreign fundings – with risk premiums (notably offsetting the risks of illiquidity and default at maturity) with respect to expected policy rates. In the case of Switzerland, where public finances are especially sound thanks to effective debt brake mechanisms (the public debt fell to 40% of the GDP at the end of 2022), the difference between sovereign bond returns and the expected SNB's policy rate is particularly small.

When policy rates were expected to stay in slightly negative territory (2019), ten-year sovereign bond yields stood at -0.49%, 26 basis points above the SNB's main policy rate (-0,75%).

In February, the yields of ten-year sovereign bonds stood at 1.45%. They encompassed monetary policy anticipations and a risk premium. These bond yields could correspond to (a) a risk premium at the level observed in 2019 (26 basis points) and an average anticipated policy rate of 1.2% for the next ten years; or (b) a higher risk premium associated with a lower anticipated policy rate than in the previous scenario (a). However, a significant increase in this risk premium ought not to be considered a central scenario given the soundness of the Swiss public finances. Furthermore, if the average policy rate stood at 1.2% over the next ten years, it would correspond to the high range of macroeconomic scenarios that can be anticipated (with a higher inflation than in a central scenario). If policy rates turned out to be lower than anticipated, the ten-year sovereign yields could decrease.

If sovereign bond yields were finally excessively high, average interest rates on new mortgages, which are strongly linked to bond yields (see green curve on the chart below), would also be this way. **Fixed ten-year mortgages granted in January 2023 stood**, with a premium with respect to sovereign yields of the same maturity, **at 2.9% on average**. They could nevertheless decrease, within a scenario of a more accommodative SNB, in an environment of restrained inflation.

**Chart: average overnight rate (SARON), sovereign yields and mortgage interest rate, %**



Source: SNB

Let us however note that, whatever the scenario that will occur, interest rates on new mortgages will remain, in the short run, much higher than the average interest rate on the stock of mortgages (1.3%), which will gradually, but slowly, increase.

## Conclusion

Many factors (trending nominal appreciation of the Swiss franc, international competition, slow increase in wages) should keep on weighing structurally, and probably increasingly, on the developments of consumer prices in Switzerland. These structural disinflationary forces should contribute to the preservation of savers' purchasing power and to make acceptable more moderate wage increases than abroad.

Inflation should fall below 2% in 2024, giving the SNB the option of reducing its policy rate compared to the end of 2023 peak. If the SNB did it, sovereign bond yields could join this decreasing trend at a 2024/2025 horizon.

**Alain CARBONNE**