

Switzerland Cuts Rates Ahead of the Pack

By John Greenwood

Overview

- On March 21st, to the surprise of most market participants, the Swiss National Bank (SNB, Switzerland's central bank) announced that it was lowering the SNB policy rate by 0.25 percentage points to 1.5%, effective March 22nd.
- How was it that the SNB was able to do this well ahead of other major central banks such as the Fed, the ECB, or the Bank of England?
- The immediate reason was that Swiss inflation had already been below 2% for six months and was predicted by the SNB to stay low. But what in turn was the reason for this achievement?
- Many commentators explained that the low inflation was a result of the recent strength of the CHF (Swiss franc), which eased the risks that any currency setback – after cutting rates – would result in a resurgence of inflation.
- However, this is a superficial view. As I show in this Newsletter, the underlying reason is that the SNB has kept monetary policy – i.e., broad money growth – tighter than any of those other central banks.
- An analysis of the SNB's balance sheet shows that it has not undertaken any significant monetary expansion by means of domestic credit creation.
- Low M3 growth in Switzerland has been the key to low inflation and low interest rates.
- It follows that inflation, “always and everywhere a monetary phenomenon” in Friedman's famous dictum, is also a local phenomenon, not a global one.
- This analysis has implications for the CHF and for the Swiss bond market.

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Introduction

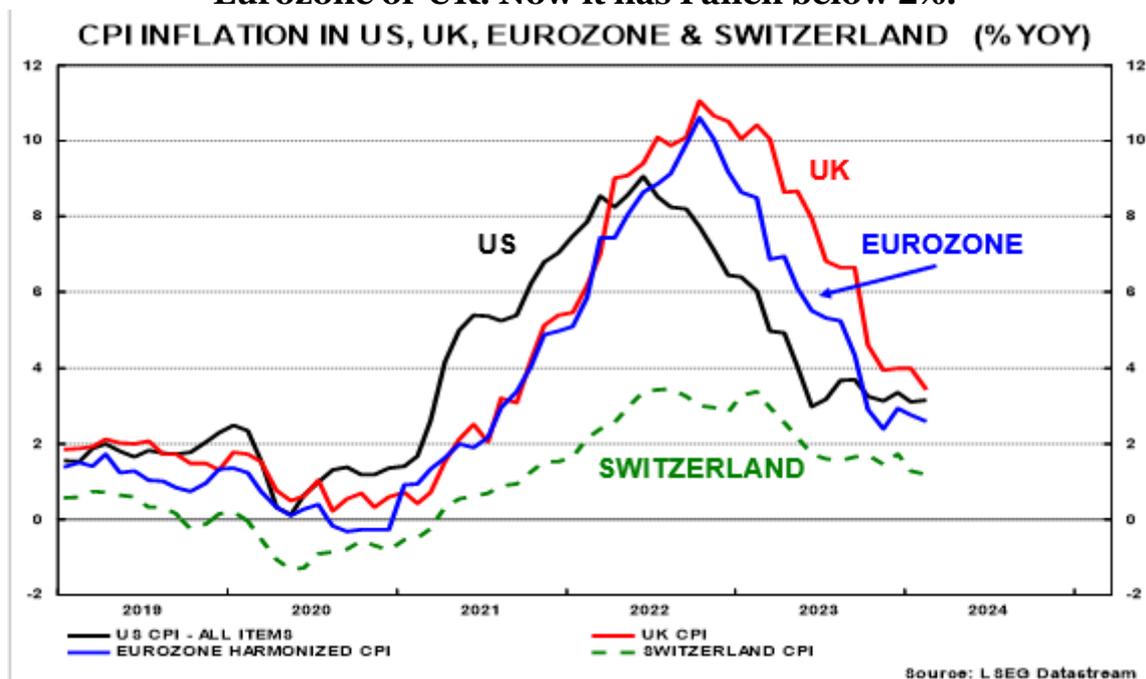
As result of spending last week in Switzerland I was able to give some time to studying and thinking about Swiss monetary policy.

Switzerland’s inflation during and after Covid never reached the peaks that neighbouring economies such as Germany, France and Italy experienced. While the latter three saw peak year-on-year rates of CPI inflation of 8.8%, 6.3%, and 11.8% respectively, the peak of Swiss CPI inflation was just 3.4%.

In Figure 1, Swiss CPI inflation is compared with inflation rates in the US, the UK, and the eurozone. Again, the 3.4% peak CPI inflation rate in Switzerland is strikingly different from the peak rates in the US (9.1%), the eurozone (10.6%), or the UK (11.1%).

Swiss inflation fell below 2% year-on-year in June 2023, and has remained on a broadly downward track ever since. In February 2024 the CPI inflation rate was 1.2% year-on-year. In its “Monetary Policy Assessment” which accompanied the decision of the Swiss National Bank (SNB) to cut rates on March 21, the central bank said, “For some months now, inflation has been back below 2% and thus in the range the SNB equates with price stability. According to [our] new forecast, inflation is also likely to remain in this range over the next few years.”

Figure 1. Swiss Inflation Never Reached the Peaks Seen in the US, the Eurozone or UK. Now it has Fallen below 2%.



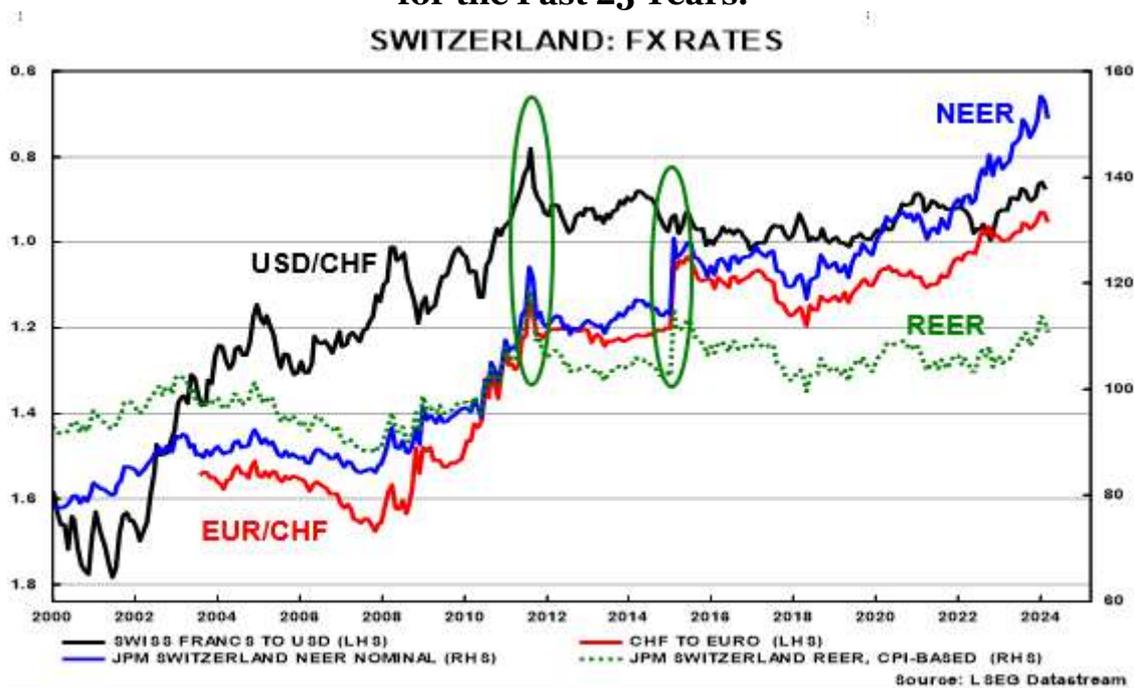
This paper analyses the real reasons why the Swiss National Bank has been able to reduce its inflation rate and hence its interest rates ahead of the pack of central banks.

Section 1. Background of Swiss Monetary Policy: The Currency

The immediate response of most observers when asked about the Swiss inflation rate is to link it to the exchange rate vis-a-vis the euro. After all, although Switzerland is not a member of the single currency area, the country is surrounded by eurozone economies. Its trade with these economies amounts to a substantial share of GDP so that imported goods prices play a significant role in setting domestic prices in Swiss francs.

Moreover, there have been several episodes in the past when the SNB has reacted to strong movements in the currency by intervening in the foreign exchange market on a large scale with the idea of ensuring that the CHF remains broadly aligned with the euro. Two such incidents (both circled in the chart) were in 2011 during the euro-area debt crisis and in 2015 immediately ahead of the ECB's adoption of QE in March of that year. On each occasion the SNB intervened to limit or reverse what it deemed to be unwarranted appreciation and therefore potentially undesirable damage to Swiss manufacturing and service industries.

Figure 2. Despite Occasional Reversals, the CHF has been Appreciating for the Past 25 Years.



Since March 2021, the CHF has appreciated from 1.10 per EUR to 0.95, so it is natural for commentators to refer to the apparently adverse effects of a rising currency on domestic industries, and to expect the authorities at the SNB to take steps to limit the appreciation of the currency. The SNB itself mentioned currency strength as a factor in its rate decision, although it made sure to include other factors: “With its decision, the SNB is taking into account the reduced inflationary pressure *as well as the appreciation of the Swiss franc in real terms over*

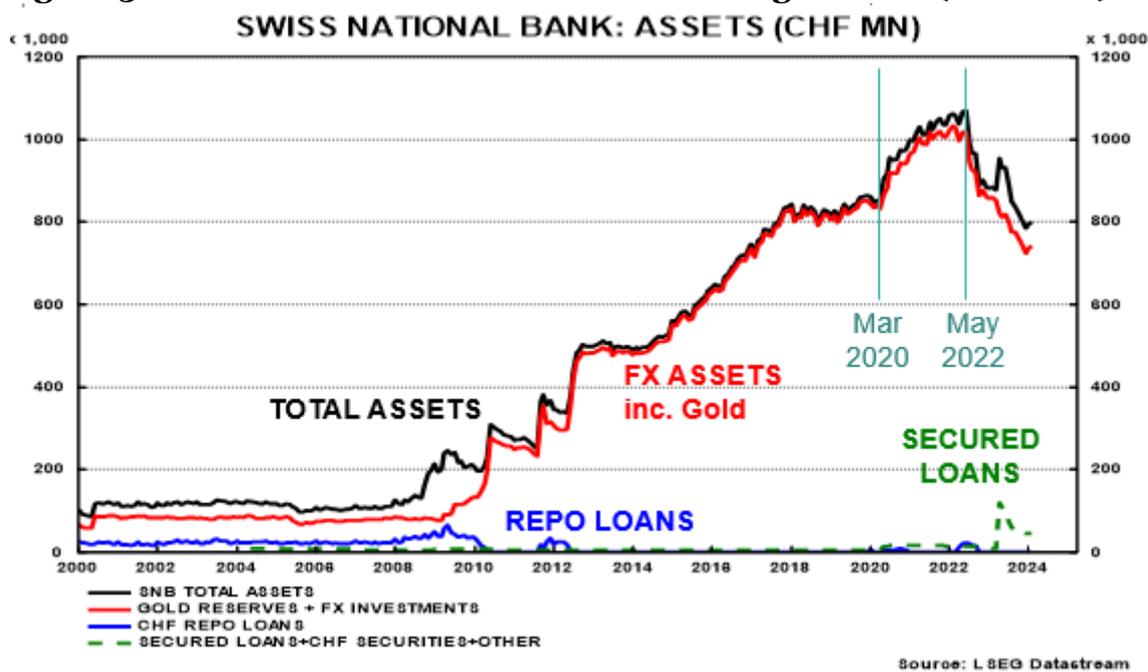
the past year. The policy rate cut also supports economic activity. Today’s easing thus ensures that monetary conditions remain appropriate.” (Emphasis added.)

Section 2. Background to Swiss Monetary Policy: the SNB’s Balance Sheet

A useful way to think about the role of the exchange rate in any central bank’s policy is to examine the asset counterparts on the central bank’s balance sheet. As Figure 3 makes clear, the total assets of the SNB are dominated by its accumulation of foreign exchange reserves. Basically, this means that whether the central bank is expanding or contracting its balance sheet, the assets it is using to do so are foreign currency, not domestic currency loans or securities. In essence, every time the SNB intervenes it is purchasing or selling euros, thereby adding to or subtracting from commercial banks’ reserves at the SNB, and hence indirectly and potentially affecting the broad money stock in the economy. (Note, however, that the multiplier between the SNB’s balance sheet or monetary base and M3 has been highly variable in recent years.)

As a corollary, the SNB’s domestic activities (lending, purchase of securities etc) were minimal. In this respect, the SNB is the polar opposite of the Fed whose activities are virtually always in domestic assets. Historically the reason for the SNB’s focus on foreign assets was in part related to the fact that the Swiss federal government (and its cantons) did not have significant outstanding debt that the central bank could purchase to conduct domestic open market operations. In Figure 3, the very low figure for repo lending (in blue) is evidence of this, while the March 2023 spike (in green) was secured lending of up to CHF 168 billion associated with the attempt to keep Credit Suisse afloat prior to its eventual absorption by UBS.

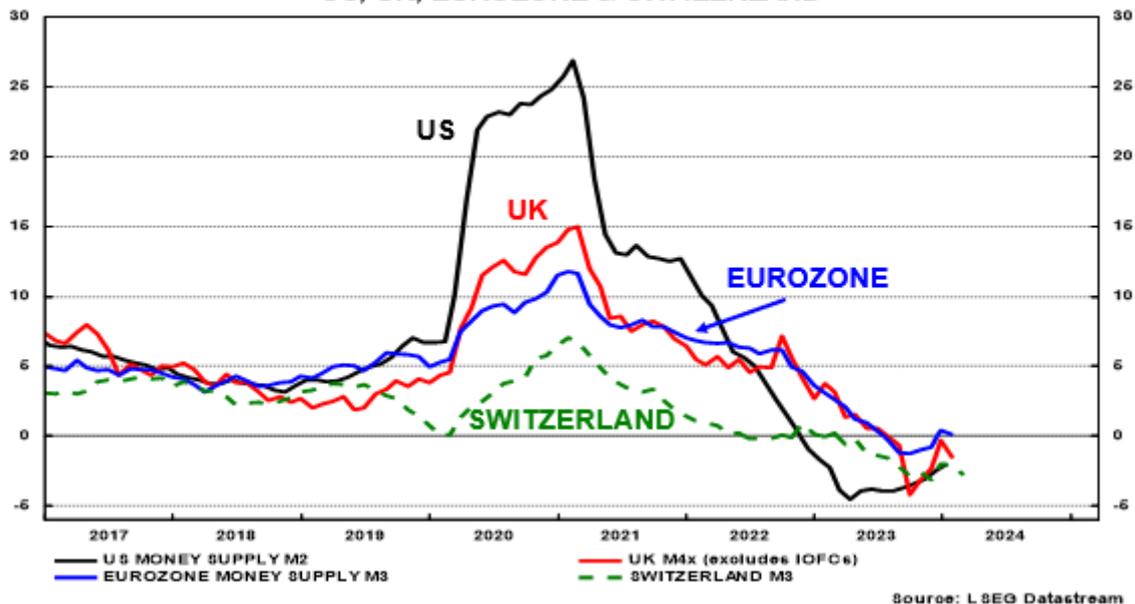
Figure 3. The SNB’s Assets are Almost all Foreign Assets (inc. Gold).



Returning to the central bank's FX activity during the Covid crisis, on the basis of the data in the chart, the SNB was persistently **purchasing** euros (and selling or creating CHF in exchange) from March 2020 until May 2022 -- at which point other major central banks switched from QE and low rates to ending QE and hiking rates. Since then, the SNB has been a persistent **seller** of euros, buying back (or cancelling) CHF and reducing the reserve balances of Swiss banks at the central bank.

Section 3. The Reason for Switzerland's Early Escape from Inflation: Tighter Money Growth

Figure 4. Swiss Broad Money Growth Stayed Low through Covid.
COMPARISON OF BROAD MONEY GROWTH RATES (% YOY)
US, UK, EUROZONE & SWITZERLAND



Having discussed Swiss inflation, the performance of the exchange rate, and the modus operandi of the SNB, we are now in a position to see that the underlying reason for Switzerland's low inflation rate and its strong currency performance was the relatively tighter monetary policy pursued by the SNB – specifically the slower growth rate of Swiss M3 than the growth rates of broad monetary aggregates in other major economies.

Figure 4 shows that compared to a peak growth rate of 26.9% for M2 in the US, or 15.0% for M4x in the UK, and 11.8% for M3 in the euro area, Swiss M3 peaked at only 7.0% in January 2021. Inevitably this has resulted in slower nominal GDP growth and a lower inflation rate than experienced in the three other major economies. Switzerland, in short, though subject to the same supply chain problems and the same external energy and food price shocks, did not experience the same high inflation rates as those seen in the US, the euro area, or the UK.



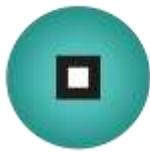
It also follows that Switzerland's inflation has returned to normal more rapidly than inflation rates elsewhere, and this is the fundamental reason why the SNB has been able to cut interest rates ahead of either the Fed, the ECB, or the Bank of England.

More broadly, Switzerland's divergence from inflation trends elsewhere shows that inflation, besides being "always and everywhere a monetary phenomenon" in Milton Friedman's famous dictum, is always and everywhere a local phenomenon, not a global phenomenon.

Finally, at a fundamental level, the SNB has shown why it was unnecessary for the major central banks to adopt policies of rapid monetary expansion when Covid struck their economies in March 2020. If the other central banks had restricted monetary growth in the way that the SNB did, then the whole dismal saga of inflation – including blaming it on the breakdown of supply chains or the war in Ukraine and its impact on energy and food prices – could have been avoided.

Summary and Investment Conclusions

- On March 21st, the Swiss National Bank (SNB, Switzerland's central bank) announced that it was lowering the SNB policy rate by 0.25 percentage points to 1.5%, effective March 22nd.
- How was it that the SNB was able to do this well ahead of other major central banks such as the Fed, the ECB, or the Bank of England?
- The SNB said the immediate reason was that Swiss inflation had already been below 2% for six months and was predicted by the SNB to remain low. But what in turn was the reason for this achievement?
- Many commentators explained that the low inflation was a result of the strength of the CHF (Swiss franc), which was mentioned by the SNB itself. But many commentators went on to say that recent currency appreciation would limit the risks that any currency setback – after cutting rates – would result in a resurgence of inflation.
- However, this is a superficial view. As I showed in this Newsletter, the underlying reason for the currency strength and the low inflation was that the SNB had kept monetary policy – i.e., broad money growth – tighter (lower) than the growth rates allowed by other major central banks.
- An analysis of the SNB's balance sheet showed that it has not undertaken any significant monetary expansion by means of domestic credit creation. The main counterpart of monetary base expansion has always been the acquisition of foreign currency.
- In other words, the SNB has not indulged in domestic credit creation.



- Low M3 growth in Switzerland has been the key to low inflation and low interest rates.
- It follows that inflation, “always and everywhere a monetary phenomenon” in Milton Friedman’s famous dictum, is also a local phenomenon, not a global phenomenon.
- This analysis has implications for the CHF and for the Swiss bond market. It means that the CHF is likely to strengthen further, especially when, later in 2024, other central banks start cutting rates, giving rise perhaps to the need for the SNB to intervene again by buying foreign exchange. In the meantime, there is clearly scope for CHF-denominated bonds to appreciate as yields fall.

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