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MACRO MORNING BRIEFING

December 11, 2024

ECB Needs to Keep Pace with SNB

ECB and SNB to cut, latter may move 50bp

- 50bp cut possible for both ECB and SNB
- SNB far ahead in race towards neutral; negative rates an option
- ECB to keep meetings live as export pressures move up agenda

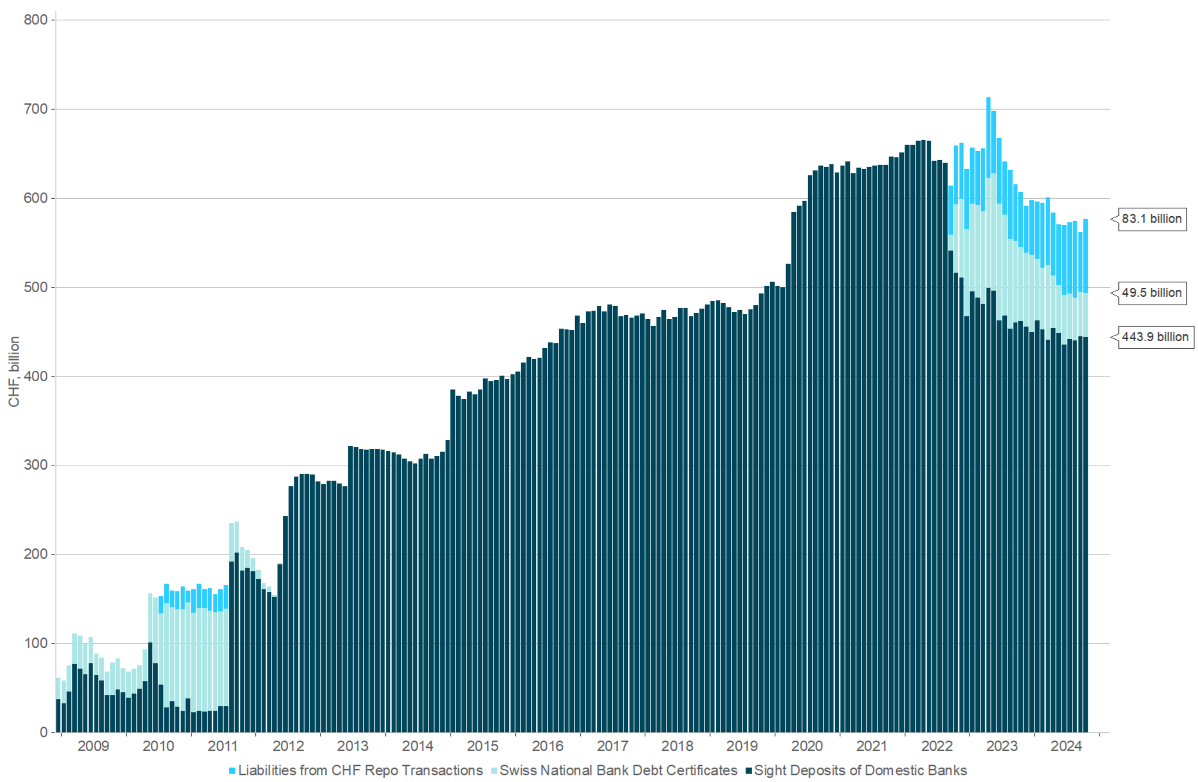
European easing continues apace but ECB risks being left behind

Considering the economic relationship between Switzerland and the Eurozone, conventional wisdom dictates that the Swiss National Bank (SNB) aligns its monetary policy with the European Central Bank (ECB) as closely as possible. Normally, this is manifested in the form of a requisite interest rate gap to limit franc appreciation and the subsequent price risks, both to the upside and the downside. Over the past decade, however, the SNB has become far more proactive in managing monetary policy: in 2022, amid escalating inflation risks, the SNB moved back to positive rates ahead of the ECB and, for a brief period, looked set to lead the way amongst traditional funding currencies offering positive rates. Symmetrically, as cuts were deemed necessary in the current cycle, the SNB has been easing equally aggressively, albeit from a lower base, and we expect a swift return to the nominal zero lower bound soon. Their actions have been largely independent of the ECB, as arguably there has been less of a need to cut aggressively, especially earlier this year, as the ECB favoured “higher for longer” due to stubborn services inflation.

With greater policy independence in mind, the latest inflation figures in Switzerland suggest that outright deflation cannot be ruled out. The three conditional inflation forecasts contained in the SNB’s quarterly monetary policy updates already echo problems in the past where inflation expectations were firmly anchored close to zero, even with negative rates in place.

While the external risks are not as acute due to expectations of higher terminal rates, geopolitical and other non-market factors could continue to strengthen the franc's status as a haven. While we acknowledge that the SNB is probably more comfortable with inflation well below 2%, avoiding further declines in inflation expectations is a policy prerogative, and there could be additional risks arising from US-European trade tensions in the coming quarters as well. Consequently, new SNB President Schlegel has explicitly retained negative rates in the SNB's toolkit. We do not doubt the SNB's resolve on this front but continue to highlight that several steps are needed on the policy front to clear the path for negative rates. Outright intervention remains a long shot given current rate differentials and manageable valuations for the franc.

Exhibit #1: SNB Balance Sheet – Liabilities



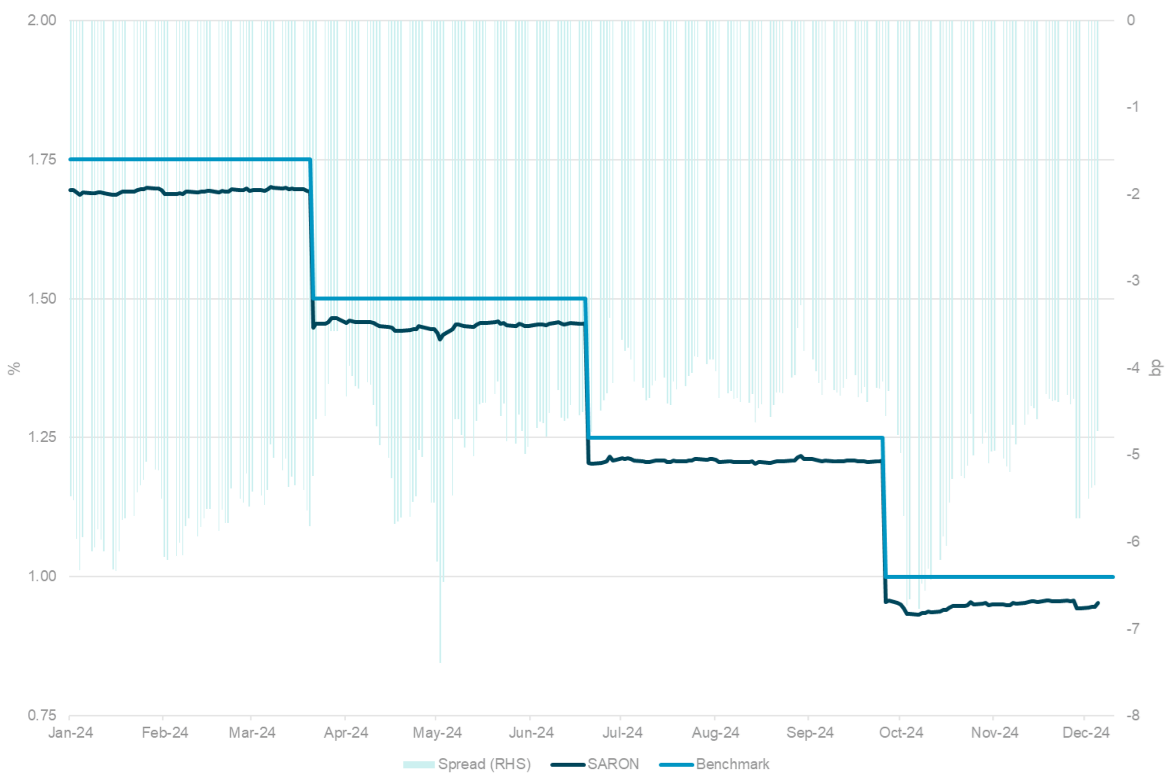
Source: Macrobond, BNY

Considering the Q4 monetary policy report will likely lower the conditional inflation forecast further, we see a very strong case for a 50bp cut. Moving to the nominal zero lower bound as quickly as possible can serve as a policy deterrent against further franc purchases, and the SNB can take advantage of expectations of the ECB moving by only 25bp later today, while the Fed may also not be in a position to cut more aggressively. Meanwhile, we note that there is also significant room for manoeuvre through balance sheet operations.

Non-sight liabilities of the SNB have stabilised at around CHF130bn over the past six months

(Exhibit #1). This is a level which has also managed to maintain a comfortable gap of around 5bp between the effective Swiss Average Rate Overnight (SARON) and the SNB's own deposit rate. The strongest periods of liquefication of such items – through maturities in SNB certificates and repo transactions – through the end of last year and early this year (Exhibit #2), have generated an even wider gap versus deposit rates, which increases the compensatory incentives for money-market participants to continue using the CHF as a funding currency. For now, there is no compelling pressure to act more aggressively but we stress that because of the non-sight liability buffer in place, the SNB has room to move on the policy rates without being concerned about running out of additional policy space, even without resorting to negative rates or outright large-scale intervention. The fact that this buffer hasn't been utilised at all suggests marginal interest in liquidity is not in place yet. Consequently, policy is still orthodox and the SNB can act accordingly until inflation expectations are under control.

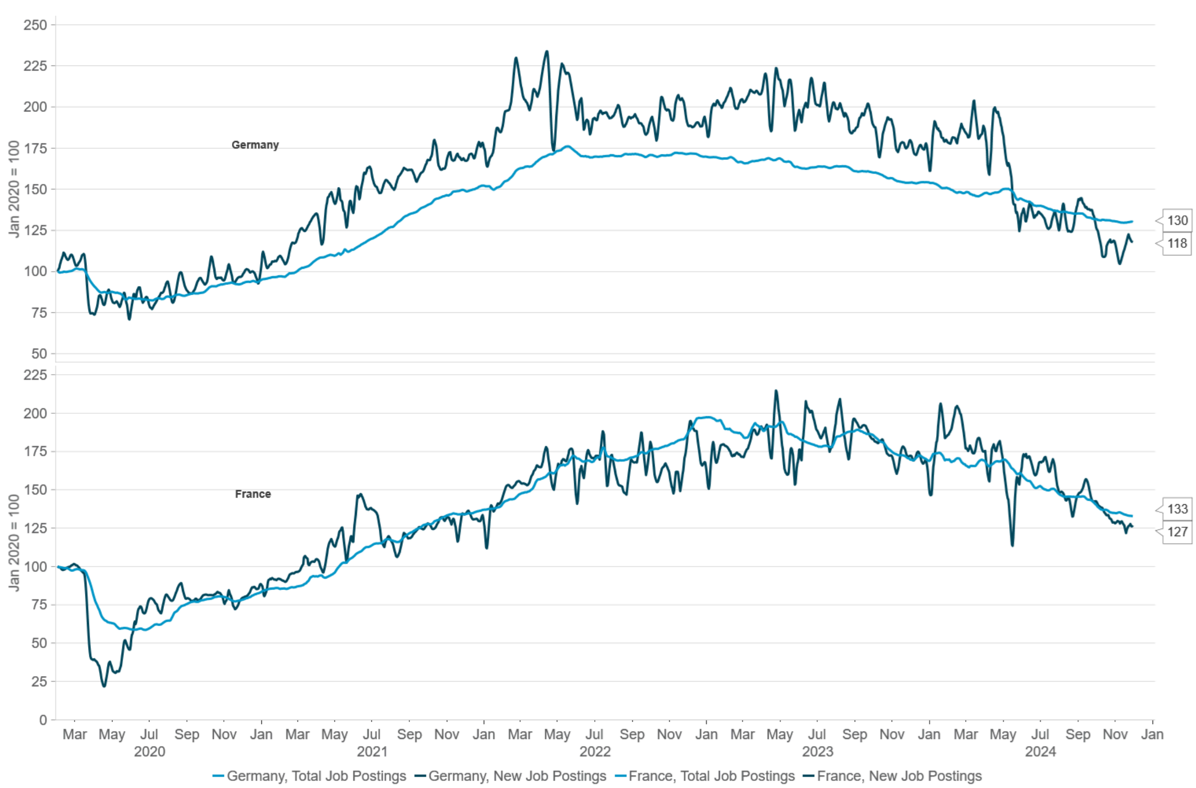
Exhibit #2: SARON vs. Benchmark Spread



Source: Bloomberg, BNY

The ECB, on the other hand, seems reluctant to move as aggressively even though inflation figures are now clearly beginning to surprise to the downside. After keeping HICP projections largely unchanged during the September release, any downward revision of 0.2pp or larger will push headline 2025 inflation on the 1-handle, which would open the way for more assertive easing. Even for more hawkish members who would prefer to focus on core inflation, it will only require two more forecast cycles for the same figure to fall below the target threshold. Governing Council members are concerned about ongoing stubbornness in inputs and also wages, but the labour market outlook is struggling materially: the latest Purchasing Manager Indices (PMI) for the region have highlighted the risk of services contraction due to a collapse in manufacturing demand, while real-time “hard data” show that new and total job postings are falling towards 2021 levels (Exhibit #3), with no turnaround in sight. The labour market risks from the export sector will become even more acute next year as a potential escalation of disputes with China and the US looms. We find it surprising that ECB President Lagarde has chosen to take a view on the issue and called upon the European Union to adopt a “chequebook strategy” and “to buy certain things from the United States.” If this is in the context of a much-needed investment boost in Europe which generates greater domestic demand, then such calls are understandable. On the other hand, some of her peers on the Governing Council are already concerned about job losses and have called for rate cuts in reaction to tariffs as an offset. This suggests that a severe fall in Eurozone exports and associated demand losses will be more than enough to offset any upside to prices from a weaker exchange rate.

Exhibit #3: German, French Labour Markets



Source: Macrobond, BNY

Either way, the ECB has more policy space to run with and we have questioned in the past why the Governing Council is not recognising the scarring risk to manufacturing and moving faster on easing, given services and wage inflation will likely subside in any case. Much room has already been lost this year – especially in the first two quarters, during which the market was pulling back on its terminal rate expectations for 2025 (Exhibit #4). This means that even though the market is supposedly pricing in a dovish ECB, as of the final decision this year there has been no change in terminal rate pricing, even though over the past year the deterioration in the Eurozone's current and future economic performance has been material. In contrast, SNB expectations have not adjusted as much and the path has been far more consistent, recognising weakness in the global economy and incremental demand for the franc, which also affects domestic inflation. "Stance convergence" between the SNB, the Riksbank and the ECB is the natural state, but increasingly it is the ECB which is lagging. Every meeting up ahead for the ECB should be marked as live, and a 50bp move remaining on the table throughout.

Exhibit #4: Change in Z5 Futures, SARON and ESTR

Source: Bloomberg, BNY

Please direct questions or comments to: iflow@bny.com

Disclaimer & Disclosures

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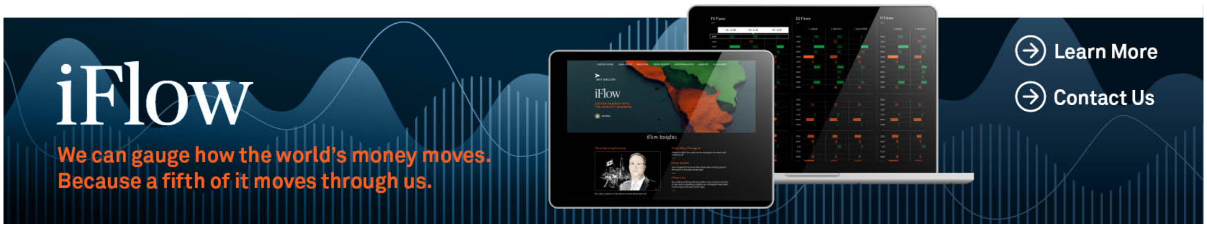

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