Interest rates remain negative for the time being

Monitor Switzerland | Fourth quarter 2019
Dear Reader

On January 15, 2015 – or almost exactly five years ago – the Swiss National Bank (SNB) announced that it would be cutting its key interest rate to well below zero. If someone had been bold enough to predict five years earlier that interest rates in Switzerland would ever reach such a low level, he or she would probably have been dismissed as being rather light in the head. Yet today the yields on Swiss government bonds are in negative territory up to terms of well beyond 30 years, while interest rates are also negative in numerous other European countries.

The focus article of this edition of Monitor Switzerland takes a detailed look at the causes and repercussions of negative interest rates, not least because this issue continues to be hotly debated in the press and public domain generally. The SNB’s influence – i.e. its room for maneuver when determining the level of interest rates – is much more limited than is often assumed. First, the trend of declining interest rates is a global phenomenon that has persisted for decades and also encompasses the Swiss market. This trend is attributable on the one hand to the decline in inflation – and in this sense to a restrictive central bank policy that focuses on monetary stability – and on the other to the decline in real interest rates. The latter are a consequence of (among other things) demographic aging, lower productivity growth, a high savings rate (partly for cyclical reasons), and a fairly low level of investment demand. Even the "big" central banks such as the Federal Reserve and the European Central Bank can only influence this real component of interest rates in a temporary way.

Second, the SNB is confronted with the so-called monetary policy “trilemma”: It essentially has a choice between managing key interest rates and managing the exchange rate – unless it chooses the third option of interfering with capital flows between Switzerland and the outside world. However, this latter measure would do enormous damage to the Swiss economy and financial center. As things stand, it seems premature to assume that the SNB will simply let the exchange rate “do its thing.”. Given the still fragile global and European economy, the risk of such a laissez-faire approach to a significant proportion of our export sector would be too great. Furthermore, even in such a scenario it is unlikely that long-term interest rates would rise and thus (for example) improve the investment income outlook for Swiss pension funds.

This makes it all the more important to tackle, swiftly and consistently, the structural problems – particularly in the Swiss pension system – that have been exacerbated by low interest rates. This is an area in which the SNB is powerless to help.

We thank you for your interest, look forward to your feedback, and wish you all the best for the New Year.

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Swiss Economy

GDP growth only moderate in 2020 too

Although economic output is likely to be higher in 2020 (1.4%) than in 2019 (0.9%), this acceleration will be exaggerated by various major sporting events. Nonetheless, the manufacturing sector should stabilize.

Focus – negative interest rates

Interest rates remain negative for the time being

Negative interest rates in Switzerland are a consequence of global developments. There are no clear signs to suggest that the monetary policy of the Swiss National Bank (SNB) is too expansionary. The SNB is very likely to continue to seek to prevent a stronger appreciation of the Swiss franc with negative interest rates and sporadic currency market interventions as long as the economy of Switzerland’s most important trading partners does not improve materially.

Monetary policy

Larger profit distribution?

We estimate that the foreign currency reserves of the Swiss National Bank (SNB) will yield CHF 18–20 bn per annum (p.a.) over the next 5 years, while the expected loss in a worst-case scenario would reach CHF 75 bn. Nevertheless, an increase of the annual distribution to the cantons and the Confederation could be considered, in our view.

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Global environment

Europe

Europe has suffered disproportionately from the recent weakness in global manufacturing, with home-made crises – such as the problems of the automotive industry and the repercussions of Brexit – weighing additionally on economic growth. The improvement that we expect to see should therefore have a clear positive effect. Furthermore, the outlook for consumer spending remains good, as European households are in a buying mood thanks to low unemployment and rising real incomes. Furthermore, the expansionary monetary policy of the European Central Bank (ECB) is having a supportive effect, and even countries like Germany are considering an increase in government spending.

USA

It is clear that the Sino-US trade dispute is weighing on global trade, as the sharpest declines in global industrial production have been recorded in the direct aftermath of tariff increases being implemented. However, this conflict does not appear to be having any real negative impact on the sentiment of US companies, as the US small business optimism index remains well above its long-term average. The US economy’s relatively strong resilience is buoyed by the more expansionary monetary policy being pursued by the Federal Reserve. That said, the Fed is now likely to pause for a while after having cut key interest rates three times in 2019.

China

China’s economic growth is likely to weaken slightly again in 2020. However, the slowdown is likely to be attributable to more than just the trade dispute with the US – consumer spending in China itself is also weakening. For example, car sales in China have been declining for the last 12 months or so. To prevent the economy from weakening too severely, the central bank and the government are likely to adopt counteractive measures in the form of credit stimuli and quantitative easing.

Source: Datastream, Credit Suisse
GDP growth only moderate in 2020 too

Although economic output is likely to be higher in 2020 (1.4%) than in 2019 (0.9%), this acceleration will be exaggerated by various major sporting events. Nonetheless, the manufacturing sector should stabilize.

Growth in the third quarter thanks to two sectors

Swiss economic growth recorded a quarter-on-quarter rise of 0.4% in the third quarter of 2019, a surprisingly strong increase. However, this growth relates almost exclusively to the booming pharma industry and record-high electricity exports, the latter being attributable to full reservoirs following a winter characterized by heavy snowfall. Excluding these two areas, the Swiss economy recorded only weak growth, while the capital goods industry actually recorded a decline. Against this backdrop, we are reducing our forecast for growth in gross domestic product (GDP) in 2019 to 0.9% (from 1.1%).

For 2020 we are forecasting GDP growth of 1.4%. The situation in the capital goods industry should stabilize. The purchasing managers index (PMI) that we produce for the Swiss manufacturing sector together with procure.ch is only just below the growth threshold, and there are signs of a stabilization of foreign demand (cf. page 5). At the same time, Swiss economic growth will continue to be buoyed by consumer spending. Households remain in a spending mood, particularly as fears over job security have barely increased – and rightly so, as the labor market situation remains comparatively robust (see Fig.). Construction investment is likely to enjoy an acceleration in growth in 2020 following a brief phase of weakness in the construction economy this year.

However, the rise in underlying economic growth is likely to be weaker than our higher forecast would suggest. This is because the (summer) Olympic Games and the European Football Championship are set to boost Swiss GDP by a good 0.3 percentage points in 2020 compared to 2019, a year in which there were no comparable major sporting events. This growth effect is due to the fact that the corresponding international sporting associations (IOC and UEFA) are headquartered in Switzerland and their income is assigned to Swiss GDP, even though the relevant activities actually take place outside of Switzerland.

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Inflation

For structural reasons, we are anticipating declining prices in both healthcare and communication for the foreseeable future. In view of the increase in the rental apartment vacancy rate, rents can also hardly be expected to rise further. However, there is evidence of (moderate) upward price pressure in the areas of household management, transport, leisure and culture, and education/teaching. Overall we are revising our forecast for 2020 downward slightly, and are now expecting an average inflation rate of 0.3% (previously: 0.5%). For 2019 inflation should amount to 0.4% (original estimate: 0.5%).

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Labor market

The Swiss labor market remains in rude health. In the third quarter of 2019, employment was 1.1% above the prior-year level, which is higher than it has ever been. At the same time, more than 79,000 vacant positions were registered, just under 10% more than a year before. However, this increase is almost exclusively attributable to the services sector. Although employment in manufacturing has developed robustly so far this year despite weak demand in the export sector (Q3 2019: +1.2% compared to previous year), the outlook is more modest, with the various surveys giving off mixed signals.

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Immigration

Immigration into Switzerland is not evenly distributed between the various regions. Almost a half of net immigration relates to the cantons of Zurich, Geneva, and Vaud. Canton Zurich alone is the region of choice for around a quarter of all net immigration. Some way behind come the cantons of Aargau (8%), Bern (8%), and Basel-City (6%). This spread is hardly surprising given that the lion’s share of immigrants move to Switzerland for employment reasons. Immigrants therefore make the larger labor markets of Switzerland’s major cities their point of focus.

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Source: Swiss Federal Statistical Office, Credit Suisse

A quarter of all immigrants opt for Zurich

Net immigration into Switzerland, number of persons, permanent residential population (Swiss and foreigners), 2018

Source: Swiss Federal Statistical Office, Credit Suisse
Pharmaceutical industry

In the summer of 2019, the pharma industry managed to increase its exports by more than 22% compared to the prior-year quarter. This positive result is above all attributable to increased exports to the markets of Germany and the US. Overall, the pharma industry was responsible for some 40% of all Swiss exports in the third quarter. The various effected and planned acquisitions in the area of pioneering gene therapy, in addition to highly promising new medications set to come onto the market over the next two years, should keep the Swiss pharma industry on its upward trajectory.

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Engineering, electrical and metal industry (MEM)

MEM exports have been showing signs of weakness ever since the start of the year, and the situation intensified further in the third quarter of 2019. Sentiment in the German manufacturing sector, which is so important to the Swiss MEM industry, fell to recessionary levels. At the same time, exports to China, Italy, and the UK also declined. We are anticipating only a gradual recovery in global and German industrial production. The situation for the MEM industry is therefore set to remain challenging.

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Watch industry

Swiss watch exports to Hong Kong have collapsed as a result of local unrest. However, the industry has managed to offset this decline by increasing its exports to mainland China and Singapore. This would suggest that the Chinese are managing to procure their Swiss watches either on the mainland or on trips to Singapore. Nonetheless, the Swiss watch industry has been unable to repeat the strong growth rates recorded in 2018, particularly as it has been confronted by a decline in exports to key European markets such as Germany, France and Italy.

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Source: Swiss Federal Customs Administration, Credit Suisse

*January to September 2019
Retail

In the third quarter of 2019, the non-food retail sector recorded a nominal sales increase (+0.7%) for the first time since the beginning of 2017. However, this was also attributable to favorable weather conditions. Developments on the currency front and as a result of shopping tourism and online trading will pose challenges to retailers once again in 2020. On the other hand, positive population growth in Switzerland as well as an increase in purchasing power – assisted by the modest rise in health insurance premiums (0.2% on average) – are likely to give the retail sector a boost.

Tourism

Following a sharp rise in overnight stays over the summer months, particularly thanks to foreign guests, growth then weakened again in the fall. The development of overnight stays on the part of Swiss guests remained positive. In our view, this positive domestic trend in overnight stays can be expected to continue given the ongoing optimism of consumer sentiment in Switzerland (particularly in respect of workplace security and household budgets). We consider the risk of the weakness in manufacturing spreading to the services sector to be low.

Information technology (IT)

Although the business situation in the IT sector continues to be viewed as “good” or at least “satisfactory” by a majority of the IT service providers surveyed by the Economic research unit of the ETH Zurich (KOF), the proportion of optimistic survey respondents has fallen to a multi-year low. The weakness in the manufacturing sector has no doubt played a key part in this deterioration in sentiment. In the absence of any recovery in this key end market, IT service providers are likely to continue to express a certain amount of skepticism over the future development of business.
Focus – negative interest rates

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Negative interest rates in Switzerland are a consequence of global developments. There are no clear signs to suggest that the monetary policy of the Swiss National Bank (SNB) is too expansionary. The SNB is very likely to continue to seek to prevent a stronger appreciation of the Swiss franc with negative interest rates and sporadic currency market interventions as long as the economy of Switzerland’s most important trading partners does not improve materially.

Both long-term and short-term interest rates have been on a downward trajectory worldwide since the early 1990s. Swiss interest rates have replicated this development almost exactly (Fig. 1). The decline of long-term interest rates was on the one hand the consequence of the successful fight against inflation, which had risen strongly between the mid-1960s and the late 1970s. Another contributory factor was the intense global competition in the markets for goods, services, and labor. The inflationary expectations of market participants now appear to be “anchored” at a low level, thereby reducing the inflation premium inherent in prevailing interest rates.

However, the real interest component has also declined sharply, particularly since the financial crisis. The key reasons cited for this development are the waning of global growth momentum – which is itself partially a consequence of demographic aging and lower productivity growth ¹ – along with a (partly for cyclical reasons) high savings rate (“savings glut”) and fairly low investment demand. In addition, the strong demand for secure investments, particularly government bonds, is also likely to have put downward pressure on real interest rates, even though the supply of such securities has risen dramatically as a result of high government deficits.

Short-term interest rates, which are determined by central banks, typically behave in the same way as capital market rates, albeit with significant deviations over the course of the economic cycle (Fig. 2). In addition, the massive quantitative easing measures taken by the US central bank (Fed) and the European Central Bank (ECB) as a response to the global financial and euro crises appear to have furthered the decline of interest rates at the long end. By contrast, the interest rate hikes pushed through by the Fed since 2017 have contributed to at least a temporary rise in long-term US rates.

¹ See Monitor Switzerland of December 2015
Recent surge in criticism of monetary policy

It is almost unanimously agreed that the enormous quantitative easing measures taken by central banks in the aftermath of the financial and euro crises were both necessary and successful. More recently, however, there has been an increase in criticism of central bank policy, above all in northern Europe, whereas a similar level of criticism in the US is difficult to discern. By contrast, fears have been expressed in both continents that monetary policy has lost some of its impact on the economy and inflation. And indeed, the major central banks have failed to meet their inflation targets, in some cases for years. In Japan first and foremost, but in the Eurozone too, inflation is below (or in the case of the ECB, “below, but close to”) the target rate of 2%. Although inflation is more or less in the desired target range over in the US, the Fed is currently leaning toward an increase in its inflation target. It appears to be striving for a “symmetrical” inflation target by not just tolerating inflation overshooting the 2% target but actually welcoming it. The idea behind this strategy is to make the economy overheat temporarily. This in turn would allow the Fed to raise key rates more sharply (albeit progressively), which would then give it more freedom of maneuver to cut rates in the event of a downturn.

Rate cuts more likely than rate hikes

Given this background, we believe it is unlikely that interest rates will be raised in the world’s key currency areas for the foreseeable future. As we are expecting a slight improvement in global economic momentum, however, our forecast for 2020 at least envisages no further rate cuts on the part of the Fed and the ECB. However, the downside risks are the most prevalent in this forecast.

Is the SNB’s monetary policy too expansionary?

In Switzerland too, a heated debate is taking place over whether monetary policy is currently too loose. Although the restrictiveness of monetary policy cannot be precisely determined, a number of indicators can be drawn on in this regard (see table on next page). The SNB does not pursue an inflation target of precisely 2%, but seeks to keep inflation within a bandwidth of 0% to 2% in the medium term. Although the official rate of inflation stood at –0.1% in November, somewhat below this bandwidth, consensus forecasts point to a slight rise over the coming months.

CHF overvalued against EUR

Another measure of the restrictiveness of monetary policy is the valuation of the exchange rate compared to a theoretically balanced or “fair” value. In fact, the SNB no longer describes the franc as “overvalued”, but does consider it “highly valued”. According to our own estimates, however, CHF remains around 10% overvalued against EUR, with the Credit Suisse fair value for the EUR/CHF currency pair currently standing at 1.22. Relative to the US dollar we perceive no overvaluation. Obviously, any estimate of fair value involves some degree of uncertainty. In addition, the fair value of currencies changes over time, as we illustrated in one of our recent editions of Monitor Switzerland2. However, our analyses at that point also showed that the fair value of CHF differs greatly from sector to sector. Sectors such as the pharma industry can live with the exchange rate at its current level, whereas the “fair” EUR/CHF exchange rate for many other export sectors is significantly higher.

Estimate of interest rate equilibrium points to neutral monetary policy, ...

... but the steepness of the yield curve suggests a rather more restrictive stance

A third measure of the restrictiveness of monetary policy is the level of short-term real interest rates compared to an equilibrium value, which must also be determined via a model. These estimates too are inevitably subject to uncertainties. Our model puts the current equilibrium value for the short-term real interest rate in Switzerland at –0.6%. The real 3-month CHF LIBOR rate is currently around –0.5%. In other words, this indicator suggests that the SNB has adopted an essentially neutral monetary policy stance. By contrast, the Monetary Conditions Index (Fig. 3), which summarizes exchange rate and interest rate deviations from their fair and equilibrium values respectively in a single ratio, currently suggests that SNB monetary policy is restrictive.

A fourth measure of restrictiveness, likewise derived from the financial markets, is the steepness of the yield curve, i.e. the difference between long-term and short-term interest rates. An inverted yield curve indicates restrictive monetary policy, as the interest rate markets imply an impending reduction in key rates in such a scenario. (Inversion also points to the likelihood of economic weakening, which would likewise strengthen the case for a cut in interest rates). By contrast, a steep yield curve indicates expansionary monetary policy. The phenomenon of an inverted yield

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2 See Monitor Switzerland of June 2019.
The yield curve was seen in many markets in the first semester of 2019, including Switzerland, thereby suggesting fairly restrictive monetary policy. However, yield curves have now "righted" themselves to some extent. But in a historical comparison they remain rather flat, and therefore hardly suggest expansionary monetary policy.3

Finally, the growth of bank credit lending and the health of the economy can also be used as a yardstick for the degree of monetary policy restrictiveness. Lending growth in Switzerland has exceeded economic growth by a considerable margin for several years. According to the Bank for International Settlements (BIS), the so-called credit-to-GDP gap – i.e. the deviation of credit lending from the long-term economic trend, currently amounts to some 10% of gross domestic product (GDP). According to this measure, therefore, Swiss monetary policy has tended to be overly expansionary in recent years. By contrast, the development of the Swiss economy itself does not suggest any overheating. The current purchasing managers index for the manufacturing industry (November: 48.8) is pointing more toward economic slowdown, whereas its counterpart for the services sector (51.7) suggests moderate expansion. At any rate, when all indicators are viewed on an aggregated basis, the SNB’s policy currently appears to be neutral.

### Is the current SNB policy having an impact?

Both in Switzerland and elsewhere, the question is not just whether monetary policy is too loose, but whether it is actually having any effect. Indeed, there is a debate about whether negative interest rates could be damaging the economy. (The possible repercussions of negative interest rates are discussed in Part 2 of this Focus on page 15 onward.)

### Focus of SNB on exchange rate since financial crisis

Although price stability is the overarching central bank objective in Switzerland, the SNB must additionally take into account economic developments. Particularly in the years since the financial crisis, geopolitical and economic flashpoints have posed a threat to the stability of the Swiss economy. These global factors have impacted on the Swiss economy and the level of prices through significant exchange-rate fluctuations, among other things. For this reason, the SNB has focused primarily on the stabilization of the exchange rate since the financial crisis, employing a number of very different measures to achieve this end. These range from interest rate cuts and "verbal interventions" to the expansion of the money supply, currency market interventions, and – in September 2011 – the introduction of a minimum EUR/CHF exchange rate.

However, when the ECB loosened its own monetary policy further and cut interest rates, the upward pressure on the franc strengthened. As a result of the ECB measures, the difference between interest rates in the EUR and CHF money markets fell to new lows, and the SNB had increasingly been forced to intervene in the foreign exchange market to stabilize the euro against the franc. In a major development, the SNB abandoned its floor for the EUR/CHF currency pair in January 2015, while at the same time cutting money market interest rates into negative territory. And although it has permitted certain fluctuations in EUR/CHF ever since, the SNB has continued to intervene as required to prevent major franc surges. At the same time, the SNB has continued to stress that it will cut interest rates further if need be.

3 The comprehensive purchases of longer-term bonds by central banks (quantitative easing), which has had the general effect of reducing long-term interest rates, could have distorted the steepness of yield curves as a measure of the restrictiveness of monetary policy.
A key question is therefore whether the interest rate instrument – respectively the “defense” of the interest rate differential between CHF and EUR money markets – actually stabilizes the exchange rate. According to (covered) interest rate parity theory, this appears dubious, as lower CHF interest rates in the futures market imply franc appreciation. In fact, the available data reveals no clear relationship (Fig. 4). In certain periods a high interest rate differential between EUR and CHF correlates with the depreciation of CHF, whereas at other times no relationship is identifiable, or a higher interest rate differential has even coincided with an appreciation of the franc. For this reason, doubts are often expressed over whether the SNB's current monetary policy, which focuses on the interest rate differential, is effective.

However, this argument/viewpoint fails to convince for two reasons: First, the (uncovered) interest parity theory states that only an unexpected widening of the interest rate differential (e.g. an unexpected rate cut on the part of the SNB) weakens the franc. And second, there are other factors that impact on the value of the franc. In particular, due to its “safe haven” status the franc typically appreciates against a backdrop of increasing international uncertainty – without this having any impact on the interest rate differential. It is even possible that capital flows into the franc at times like this have the effect of reducing interest rates in Switzerland, i.e. widening the interest rate differential. Our econometric tests confirm this theory: When variables for uncertainty in the global and European financial markets are taken into account (as well as variations in the interest rate gap), changes to the interest rate differential have the expected effect. Overall, therefore, the SNB appears to be able to continue to weaken the franc by widening the difference between Swiss and Eurozone interest rates.

By contrast, a narrowing of the interest rate differential through an autonomous rate hike on the part of the SNB would trigger a rise in the value of the franc – particularly in a global environment still characterized by uncertainty. Paradoxically, such a step could even reduce inflationary expectations in Switzerland, which could in turn feed through into lower long-term interest rates. Exiting the current monetary policy regime is therefore only likely to happen once interest rates in the international capital markets rise and the Fed or the ECB increases its own key rates. This would probably only occur against the backdrop of a significant pickup in either global growth or inflation – both scenarios looking improbable to us as things stand. A go-it-alone rate hike on the part of the SNB would only be possible if the franc were to depreciate strongly “under its own steam.” However, such a scenario is only to be expected against a backdrop of a much more stable global environment.

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4 As stated above, according to interest rate parity theory only an unexpected widening of the interest rate gap leads to a depreciation of CHF. However, distinguishing between expected and unexpected interest rate changes is empirically difficult.

5 As a measure for uncertainty in the financial markets we use the VIX index for volatility in the S&P 500 and the spread between Italian and German government bond yields.
However, the SNB could tolerate a further appreciation of the franc as soon as monetary policy conditions in Switzerland allow, particularly as there is evidence that the overvaluation of the franc is currently subsiding. The challenge here would be to avoid a speculative upward surge. However, the SNB’s current flexible exchange-rate regime is less vulnerable than its fixed EUR/CHF minimum exchange rate policy of a few years back. In our view, there are no real alternatives right now to the existing policy of negative exchange rates. Although there is a debate going on in the Eurozone about more expansionary fiscal policy replacing (or supplementing) loose monetary policy, such a strategy does not appear to make much sense in Switzerland’s case. Although the federal government does have some freedom of maneuver in the area of fiscal policy, a political decision of this kind appears improbable. Furthermore, due to the dominance of foreign capital market interest rates in Switzerland, more expansionary fiscal policy would only have a very limited impact on Swiss interest rates, and would ultimately probably have the effect of strengthening the franc.

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Focus – negative interest rates

Public finances

The state – and by extension the Swiss taxpayer – is the undisputed beneficiary of lower interest rates. We estimate that the Confederation and the cantons saved a total of some CHF 23 billion in interest between 2008 and 2017, with the Confederation alone saving CHF 13 billion. The annual saving amounts to between 0.3% (Canton Basel-Country and its municipalities) and 2.8% (Confederation) of overall expenditure. It is actually likely that these figures underestimate the total saving, as the negative interest rates at which the Confederation and a number of cantons can borrow money are difficult to capture.

Households

The repercussions of declining interest rates for private households are not clear. On the one hand, lower interest rates mean lower debt interest payments (particularly for mortgages). According to our estimate, households saved more than CHF 10 billion in 2017 (compared to 2007) in this manner. On the other hand, Swiss households also receive less income on their savings accounts and bond holdings. We estimate that these two factors more or less neutralize each other at the moment. Households with higher incomes capable of taking on more debt are the greater beneficiaries of low interest rates. In addition, they also have higher risk capacity when it comes to investing.

Savings deposits

As mentioned above, households have had to take a hit on the amount of income they receive. Although many households could invest at least a proportion of their savings in investments that generate somewhat higher returns, the fact of the matter is that more than a half of all financial assets of Swiss households are held in the form of bank deposits. On an inflation-adjusted basis, however, the interest earned on savings accounts has been virtually zero over the long term, irrespective of the SNB’s interest rate policy.

Estimated annual saving in interest rate payments, in % of total expenditure for 2017

Source: Credit Suisse, *For 2018

Neutral impact on the “average” household

Source: Credit Suisse

Long-term return on bank deposits just in positive territory

Source: SNB, Credit Suisse
Focus – negative interest rates

Pension funds

The very low yields available on bonds are becoming a major headache for pension funds. As mentioned in the main article, however, the SNB has little influence on these interest rates. The direct repercussions of the negative interest rate policy are restricted to the cash held by pension funds, which currently amounts to some 5% of all pension fund assets. As the graph to the right shows, the returns of pension funds therefore also do not correlate with the SNB’s key interest rate. The main problem facing pension funds (excessively high conversion rates and an overly generous (i.e. low) retirement age) is exacerbated by the negative interest rate policy.

Source: SNB, pension fund index of Credit Suisse

Construction investment

If interest rates remain below their equilibrium level for too long, the risk of a misallocation of capital theoretically rises, i.e. investments could be channeled into less productive rather than more productive projects. One argument being put forward in Switzerland at the moment is that the negative interest rate policy has triggered an excessive amount of investment in residential construction. However, the data shows that such investment has not risen much more than gross domestic product (GDP) since the recession of 2008. Indeed, since 2013 the volume of residential construction investment has actually grown in line with GDP. Yet above all institutional investors are building large numbers of rental apartments, as a result of which vacancies in this segment are on the rise.

Source: Swiss Federal Statistical Office, Credit Suisse

Household debt and real estate prices

Whereas the volume of construction compared to GDP has not increased excessively (see above), the price of real estate – particularly owner-occupied apartments – has risen much more strongly than the consumer price index since 2008. While the acceleration of population growth has clearly played an important role here, this trend is primarily a consequence of the decline in interest rates. The resulting level of indebtedness of Swiss households, which is very high in an international comparison, poses a risk in the event of interest rates rising unexpectedly sharply and/or property prices declining unexpectedly sharply.

Source: Datastream, SNB, Wüest Partner, Credit Suisse
Focus – negative interest rates

Exemption threshold

Ever since November 1, 2019, a smaller proportion of the sight deposit balances of the commercial banks with the SNB has been subject to a negative rate of interest. The SNB has increased its so-called “exemption threshold”, with the result that an additional CHF 119 billion or so of the deposits of domestic banks held with the SNB is now exempt from negative interest. This should have the effect of reducing the negative interest expenditure of domestic banks by around CHF 890 million compared to the expenditure incurred under the previous exemption threshold. Moreover, by raising the exemption threshold, the SNB has created freedom of maneuver to cut interest rates further if necessary.

Passing on negative interest rates

The precise level of costs incurred by the banks as a result of the SNB’s negative interest policy is difficult to determine. Up until now, the banks have been reticent about passing on negative interest to client deposits and have suffered an erosion of their deposit margin accordingly. We have estimated the impact of a key interest rate reduction of 25 basis points on the key balance sheet positions of domestically focused banks. According to our estimate, such a step would reduce the interest margins of the banks by between 1 and 4.5 basis points. The impact on the profitability of the banks of a decline in capital market interest rates (flattening of the yield curve) can be expected to be stronger generally.

Overall impact on domestic banks

For regulatory reasons, the banks must publish estimates of the repercussions of a rise (or a decline) of the level of interest rates by 1.5 percentage points for their net interest income. This data (see Fig. right for the ten largest domestically focused banks) supplies three interesting findings. The results differ considerably from bank to bank. For some, net interest income would paradoxically rise if interest rates declined generally. Moreover, a general rise in interest rates would probably have only limited positive repercussions for the selection of banks illustrated here.

Source: Disclosure reports of banks, Credit Suisse

Change in net interest income, in % of balance sheet

Source: Disclosure reports of banks, Credit Suisse
Monetary policy

Larger profit distribution?

We estimate that the foreign currency reserves of the Swiss National Bank (SNB) will yield CHF 18–20 bn per annum (p.a.) over the next 5 years, while the expected loss in a worst-case scenario would reach CHF 75 bn. Nevertheless, an increase of the annual distribution to the cantons and the Confederation could be considered, in our view.

Once a year, our investment strategy team updates their 5-year forecasts (so-called Capital Market Assumptions, CMA) for a large range of financial assets. In the past, we already used these forecasts to simulate how the foreign currency reserves of the SNB would likely perform. In an article we published in June 2018 (based on the 2017 CMA), we estimated the expected return of the SNB foreign currency reserves at 3.9% p.a. As shown in the figure on the left-hand side, this forecasted return has been quite accurate, even when taking into account the purchases of foreign currencies by the SNB in 2018 and 2019.

The 2019 update of the CMA has two implications in terms of the projected performance of the SNB foreign currency reserves. First, the expected return is lower at 2.5% p.a. over the next 5 years. Second, the expected risk is also lower, as shown in the narrower confidence interval of the projected development of foreign currency reserves in comparison to the 2017 estimates. Based on the current level of foreign currency reserves, the expected return of 2.5% would yield around CHF 18–20 bn p.a. Our estimated risk metrics indicate that a worst-case scenario would, on average, lead to a loss of 9.6% (conditional value-at-risk, 95% confidence level) or CHF 75 bn.

The SNB’s equity capital had reached CHF 169.7 bn at the end of Q3 2019, of which CHF 90.6 bn should be available for distribution to the cantons and the Confederation, according to our estimates. Currently, the maximal payout to the cantons and the Confederation is limited to CHF 2 bn p.a., according to an agreement between the SNB and the Federal Department of Finance (FDF) for the period 2016–2020. By the end of next year, the SNB and the FDF will renegotiate the current agreement. Our projection of future income from the foreign currency reserves suggests, even considering the risk of a loss, that there could be an opportunity to raise the annual distribution to the cantons and the Confederation.

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We would like to thank Vojo Gunevski from the Credit Suisse Investment Management team for providing the simulated returns and risk estimates.
Monetary policy Monitor

Money market

The decision of the SNB to raise the exemption threshold above which commercial banks’ deposits at the SNB are subject to the negative deposit rate of –0.75% has led to an increase in the daily volume of repurchase agreements (so-called repos). Repos are short-term (up to 12 months) secured lending operations among banks. With the implementation of the new threshold at the SNB on 1 November, some banks became fully exempted from the negative interest rate and can therefore borrow at a negative rate from other banks and deposit the proceeds at the SNB at 0%. This rebalancing process explains the rise in repo market volume.

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Banknotes

Demand for banknotes has remained particularly weak despite very low interest rates. In particular, the demand for the CHF 1000 bills has declined for almost a year, in what is the sharpest drop since 1990. The demand for banknotes seems more sensitive to changes in the interest rate rather than to the level of interest rate. The weak demand may be explained by the stability of the policy rate. Indeed, since the SNB began to conduct its monetary policy via a target interest rate, it has never held it unchanged for such a long period - the last change occurred in January 2015.

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Foreign exchange interventions

After renewed purchases of foreign currencies over the summer, the SNB has halted its interventions in the foreign exchange market since October, according to our analysis. The CHF has appreciated since June against the EUR, as expectations of further monetary policy easing by the European Central Bank (ECB) began to build. The ECB indeed cut its policy rate in September and re-activated its asset purchase program. However, as the ECB did not cut rates as much as financial markets had expected, the appreciation pressure on the CHF diminished somewhat, reducing the need for foreign currency purchases.

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Source: SIX Swiss Exchange, Credit Suisse

Drop in CHF 1000 banknotes

Growth rate of banknotes in circulation, in % YoY

Source: Swiss National Bank, Credit Suisse

SNB halts its foreign exchange interventions in October

In CHF, billion and EUR/CHF (r.h.s.)

Source: Datastream, Swiss National Bank, Credit Suisse
Real Estate Monitor

Owner-occupied housing

The rise in the price of owner-occupied residential property has slowed somewhat recently. In the third quarter of 2019, the prices of owner-occupied apartments increased by 2.2%. This rate of growth is significantly below the long-term average of 3.8%. The rise in the prices of single-family homes has likewise slowed, but at 3.3% remains slightly above the long-term average of 3.2%. Thanks to intact demand and a decline in newbuild activity, we are expecting prices to rise over the next few quarters too. However, these are likely to continue to be kept in check by the regulatory guidelines that apply to credit lending.

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Rental apartments

As per June 1, 2019, more than 60,000 rental apartments (2.64% of the total stock) were vacant in Switzerland for the first time ever. However, the latest rise was much less pronounced than in the previous five years, and has predominantly affected regions outside of the major conurbations. The demand side of the Swiss rental market benefited from a stabilization in net immigration and a robust labor market. At the same time, the trend of persistent recovery in construction activity has paused for the time being. That said, a combination of the economic slowdown and the unbroken demand for real estate as an asset class could see a renewed rise in vacancies as early as 2020.

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Office property

The strong surge in office employment has led to a temporary situation of high demand for office space. However, this is now receding in keeping with the decline in employment growth. We are forecasting surplus demand of 486,000 m² for 2019 and 253,000 m² for 2020. In a number of cantons, positive economic developments have led to an improvement in the vacancy situation for office property. The current slowdown on the demand side is unlikely to alter this situation, as any imbalances are likely to be warded off by the very modest expansion expected on the supply side.

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Price growth has recently slowed

![Price growth has recently slowed](chart)

Source: Wüest Partner, Credit Suisse; last data point: Q3 2019

Slowdown in increase in rental apartment vacancies

![Slowdown in increase in rental apartment vacancies](chart)

Source: Swiss Federal Statistical Office, Credit Suisse; last data point: 1.6.2019

Decline in surplus demand for office space

![Decline in surplus demand for office space](chart)

Source: Credit Suisse, Swiss Federal Statistical Office; last data point: Q2 2019
Credit Suisse Leading Indicators

Purchasing Managers’ Index (PMI)

Purchasing managers stand at the beginning of the production process. The PMI uses this forward-looking feature to forecast the level of economic activity. The index is based on a monthly survey conducted by procure.ch, the industry body for purchasing and supply management. Purchasing managers respond to eight questions on output, backlog of orders, purchasing volumes, purchase price, delivery times, stocks of purchases, stocks of finished goods, and employment. They indicate whether activity levels are higher, the same, or lower than in the preceding month. The percentage share of responses stating “higher” and “no change” are used to calculate the sub-indices, though only half of the “no change” share of responses is included. The PMI lies between 0 and 100, with a figure of more than 50 indicating an expansion of activity compared with the previous month.

Credit Suisse Export Barometer

The Credit Suisse Export Barometer takes as its basis the dependence of Swiss exports on foreign export markets. In constructing the export barometer, we have drawn together important leading industry indicators in Switzerland’s 28 most important export markets. The values of these leading indicators are weighted on the basis of the share of exports that goes to each country. The export barometer consolidates this information to produce a single indicator. Since the values in question are standardized, the export barometer is calibrated in standard deviations. The zero line corresponds to the growth threshold. The long-term average growth of Swiss exports of approximately 5% is at 1.

CS CFA Society Switzerland Index

Financial analysts have their finger on the pulse of the economy. Since 2017, we have been conducting a monthly survey of financial analysts jointly with CFA Society Switzerland under the heading Financial Market Test Switzerland\(^1\). Analysts are questioned not only about their assessment of the current and future economic situation as well as the rate of inflation but also about financial market issues such as equity market performance and interest rate forecasts. The CS CFA Society Switzerland Index represents the balance of expectations regarding the development of Swiss economic activity over the coming six months.

\(^1\) Published as the Credit Suisse ZEW Index from 2006 until 2016

Source: procure.ch, Credit Suisse

Source: PMIPremium, Credit Suisse

Source: CFA Society Switzerland, Credit Suisse
Swiss Construction Index

The Swiss Construction Index is published once a quarter jointly by Credit Suisse and the Swiss Contractors’ Association (SCA). It serves as a leading indicator for the state of Switzerland’s construction sector by forecasting the volume of work in the core construction business in the coming quarter. The indicator is calculated by Credit Suisse and is based mainly on a quarterly survey conducted by the SCA among its members. Additional data is provided by the Swiss Federal Statistical Office and Baublatt. The Construction Index was launched in the first quarter of 1996.

PMI Services

Procure.ch, the professional association for purchasing and supply management and Credit Suisse launched a PMI for the services sector in 2014. The Services PMI is structured in exactly the same way as its industry counterpart. Values over 50.0 points mean expansion. It is based on a survey of purchasing managers from Swiss service providers. There are six subcomponents: type of business, new orders, order book, purchasing prices, sales prices and number of employees.

Macro Momentum Indicator

The Credit Suisse Macro Momentum Indicator (MMI) condenses the current performance of key Swiss economic data to a single figure. Data from economic surveys, consumption, the labor market, lending and the export economy are used to calculate a standardized momentum that is then weighted with the applicable correlation to GDP development. Values above (below) zero point toward an acceleration (slowdown) of the Swiss economy in the last three months compared with the past six months.
Forecasts and Indicators

Forecasts for the Swiss Economy

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<td>Quarter 4</td>
<td>Quarter 1</td>
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<td>Quarter 3</td>
<td>Quarter 4</td>
<td>Quarter 1</td>
<td>Quarter 2</td>
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<td>GDP (YoY, in %)</td>
<td>0.9</td>
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<td>1.1</td>
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<td>Consumer spending</td>
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<td>Government expenditure</td>
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<td>0.9</td>
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<td>1.0</td>
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<td>Gross capital investment</td>
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<td>-1.0</td>
<td>1.2</td>
<td>2.1</td>
<td>1.2</td>
<td>1.1</td>
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<td>1.0</td>
<td>0.5</td>
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<td>Construction investment</td>
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<td>0.3</td>
<td>0.8</td>
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<td>1.0</td>
<td>1.0</td>
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<tr>
<td>Investment in plant and equipment</td>
<td>-1.3</td>
<td>-1.2</td>
<td>1.8</td>
<td>2.8</td>
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<td>Exports (goods and services)</td>
<td>2.8</td>
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<td>Imports (goods and services)</td>
<td>-0.5</td>
<td>-0.9</td>
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<td>Inflation (in %)</td>
<td>0.6</td>
<td>0.6</td>
<td>0.3</td>
<td>-0.1</td>
<td>0.3</td>
<td>0.1</td>
<td>0.2</td>
<td>0.6</td>
<td>0.4</td>
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<td>Unemployment (in %)</td>
<td>2.3</td>
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<td>2.4</td>
<td>2.5</td>
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<td>Employment growth FTEs (YoY, in %)</td>
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<td>1.2</td>
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<td>0.7</td>
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<td>0.9</td>
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<td>Net migration (in thousands)</td>
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<td>Nominal wage growth (YoY, in %)</td>
<td>0.5</td>
<td>0.7</td>
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<tr>
<td>Public debt (in % of GDP)</td>
<td>7.2</td>
<td>7.4</td>
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Source: Federal Statistics Office, State Secretariat for Economic Affairs SECO, Credit Suisse

Forecasts for the World Economy

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<tr>
<th>Forecasts</th>
<th>GDP YoY, in %</th>
<th>Inflation YoY, in %</th>
<th>Population In million</th>
<th>GDP In USD billion</th>
<th>Share of exports In %</th>
<th>Share of imports In %</th>
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<td>World</td>
<td>2.6 2.5 2.7 2.8</td>
<td>7'530 8'470</td>
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<td>US</td>
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<td>16.3 6.2</td>
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<td>Euro zone</td>
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<td>44.3 61.7</td>
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<td>83 4'000</td>
<td>18.8 27.1</td>
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<td>France</td>
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<td>6.5 8.0</td>
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<td>Italy</td>
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<td>6.2 9.3</td>
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<td>UK</td>
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<td>Japan</td>
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<td>China</td>
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<td>1'395 13'407</td>
<td>5.2 7.1</td>
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Source: Datastream, International Monetary Fund, Credit Suisse

Interest Rates and Monetary Policy Data

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<tbody>
<tr>
<td>SNB target range (in %)</td>
<td>-0.75</td>
<td>-0.75</td>
<td>-0.75</td>
<td>589.7</td>
<td>568.4</td>
<td>548.0</td>
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<td>10-year government bond yields (in %)</td>
<td>-0.40</td>
<td>-0.4</td>
<td>-0.3</td>
<td>6.1</td>
<td>5.2</td>
<td>6.9</td>
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<td>M1 money supply (%, YoY)</td>
<td>3.6</td>
<td>3.5</td>
<td>3.7</td>
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<tr>
<td>M3 money supply (%, YoY)</td>
<td>3.5</td>
<td>3.6</td>
<td>3.3</td>
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<tr>
<td>Foreign currency reserves (CHF bn)</td>
<td>787.0</td>
<td>787.7</td>
<td>787.4</td>
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Source: Datastream, Bloomberg, Credit Suisse
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Swiss Economics I Fourth quarter 2019 25
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