Swiss Economics

Swiss interest rate bonus is back to stay

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Editorial

Dear Reader

As 2022 draws to a close, we can look back on a year that looks certain to be prominent in the economic history books. Inflation was already a cause for concern at the start of the year, but the outbreak of war in Ukraine drove prices up even further. Inflation rates of 9% in the US and double-digit figures in the EU and the UK could indeed be described as historic following decades of relatively subdued inflationary development. Inflation levels of this magnitude are bad for economic growth, while at the same time having incendiary repercussions at a social level. To emphasize the point: Given a consistent inflation rate of 10%, the purchasing power of cash would halve in the timespan of just seven years. In response to rising inflation, the world's central banks – most notably the Fed in the US – ratcheted up interest rates with a vehemence and suddenness that had not been seen for 40 years. Furthermore, they signaled their resolve to keep interest rates high for as long as it takes to bring inflation under control. Accordingly, the "interest rate turnaround" became the new reality within a short span of time. The combination of high inflation, high interest rates and high geopolitical uncertainty is toxic for economic growth. Accordingly, the US economy is on the verge of a recession, while the UK and the Eurozone have in all likelihood already slid into one.

The Swiss economy has likewise lost considerable momentum. As our focus article on page 6 explains, however, Switzerland is likely to avoid sliding into recession. Switzerland enjoys a "growth advantage" thanks to robust consumer spending, which will support growth in 2023 too. In addition to immigration and a liberal labor market, another advantageous aspect is the Swiss "inflation bonus": Inflation in Switzerland is more than a third lower than in its neighboring countries, and should – thanks to prompt action by the Swiss National Bank among other things – soon come back down to a level compatible with price stability. However, the outlook for large parts of the Swiss export industry is much less rosy. Due to the recession in the Eurozone, both the mechanical engineering, electrical and metalworking (MEM) industry and the chemicals sector will have to brace themselves for a fall in foreign demand, whereas pharma exports tend to be inelastic in their short-term response to changes in the EU economy. At the same time, higher energy prices and the uncertain supply situation also present a challenge in Switzerland. But preparations by companies for a potential energy shortage are fairly advanced, as our survey among purchasing managers shows. Moreover, the Swiss manufacturing sector only uses around half as much energy as its foreign counterparts to generate its value added.

Our focus article looks at the traditional Swiss "interest rate bonus". Switzerland is currently once again benefiting from much lower interest rates than other countries. This was a familiar constellation for decades, but was eroded at the start of the 2000s and then disappeared altogether during the COVID-19 pandemic. With the interest rate turnaround this "interest rate bonus" has now returned, and there are good reasons to suggest that interest rates in Switzerland will remain lower than in other countries for some time. Switzerland therefore has a number of trump cards to play as it grapples with current difficulties.

We wish you an enjoyable read.

André Helfenstein	Claude Maurer
CEO Credit Suisse (Switzerland) Ltd	Chief Economist Switzerland

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Switzerland's growth advantage

Thanks to robust consumer spending, Switzerland should be able to avoid sliding into recession, but economic momentum is waning. We are forecasting GDP growth of 1.0% for 2023, following growth of 2.0% in 2022

Consumer spending supports growth

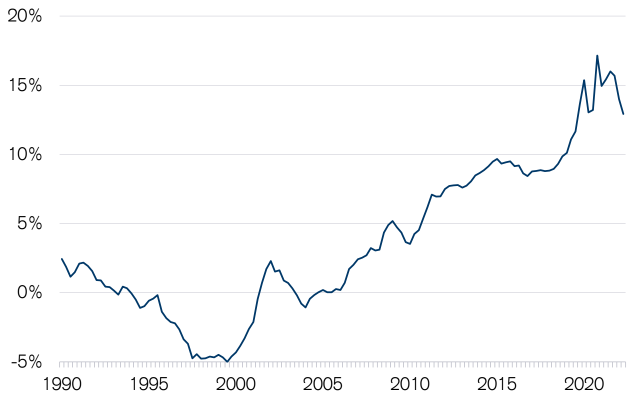
In the third quarter of 2022, consumer spending once again proved a solid pillar of Swiss economic growth. It should remain a source of support in 2023 too, given that the unemployment rate is at its lowest level in two decades and employment is rising. Although momentum will slow, the labor market situation should remain positive in the coming year too (see labor market box, page 8). Despite economic fears, the income situation of Swiss households remains healthy, and this is typically the crucial driver of consumer spending. In addition, a significant number of workers are switching to better-paid jobs, with the result that salaries tend to rise. Even workers who are staying in their existing jobs can expect to see wage increases of 2.3% next year, following on from an increase of 1.5% in the current year. Overall, the total figure paid out in wages is rising more strongly than purchasing power is being eroded by inflation. Indeed, the increase in Switzerland's wage bill in the first nine months of this year amounted to 5.0% – well above inflation (2.8%).

Inflation has passed its peak

Inflation has now passed its peak (see inflation box, page 8), and is likely to return to a level that is compatible with price stability in the foreseeable future (forecast for 2023: 1.5%). In addition, the average Swiss household still has a financial cushion dating back to the era of COVID-19 lockdowns. The savings rate – or the proportion of income not spent for consumption – rose dramatically in the first quarter of 2020 due to the considerable uncertainty and limited spending opportunities available, and persisted at an unusually high level until the first quarter of 2022 (Fig. 1). While the savings rate has been declining since the second quarter of the year, probably in part due to the repeal of the remaining coronavirus measures in April, it remains above its pre-pandemic level. In other words, no process of "de-saving" – i.e. the shrinking of the financial cushion – has taken place so far. Furthermore, immigration has recently accelerated (cf. box, page 8). Immigration is an important driver of consumer spending. Indeed, on average it has accounted for significantly more than a quarter of all consumer spending growth in recent years. In addition to household spending, government spending can also be expected to further support economic growth, particularly given the extraordinary increases in expenditure due to the measures to prevent an electricity shortage.

Fig 1: Savings rate remains high

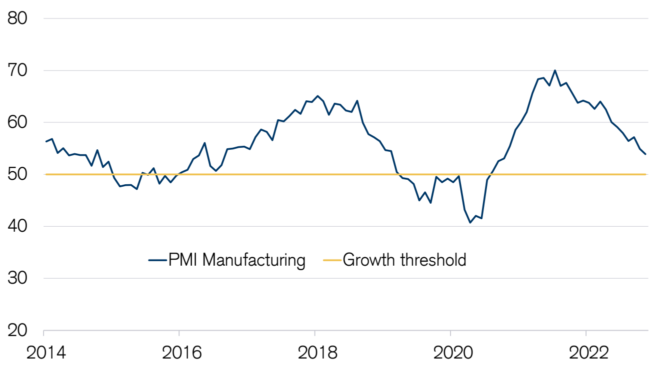
Relationship between household spending and employee compensation



Source: SECO, Credit Suisse. Last data point: Q3 2022

Fig 2: Manufacturing PMI above growth threshold

Purchasing Managers Index (PMI)



Source: procure.ch, Credit Suisse. Last data point: November 2022

Traditional manufacturing loses momentum

The manufacturing outlook is less good. Although the Purchasing Managers Index (PMI) for Swiss manufacturing (Fig. 2) is still not indicating a contraction – in contrast to its Eurozone counterpart – the loss of momentum is plain to see. Due to the recession in the Eurozone, the mechanical engineering, electrical and metalworking (MEM) industry and the chemicals sector are particularly exposed to a fall in foreign demand, whereas pharma exports tend to be inelastic in their short-term response to changes in economic dynamism. According to our forecasts, the EUR/CHF currency pair will remain below parity for the time being. Thanks to the much lower inflation rate in Switzerland, however, the export industry is coping with the current EUR/CHF exchange rate relatively well, as the lower cost increases alleviate the competitive pricing disadvantage. In addition, signs of normalization are becoming increasingly apparent on the purchasing side: In November, two-thirds of companies reported unchanged delivery times, whereas the number of companies reporting longer or shorter delivery times was broadly balanced.

Energy prices a major challenge

Higher energy prices and an uncertain supply situation are a challenge in Switzerland too, even though Swiss manufacturers use less than half the energy of their EU or UK counterparts to generate value added (Fig. 3). Nonetheless, around 4.0% of manufacturers in the October PMI survey stated that they had scaled back production due to the gas market situation, with almost 10% of respondent manufacturers having reduced production due to high electricity prices.

Risk of energy shortage currently low thanks to measures taken

At any rate, the high inventory levels of gas in the Eurozone, mild weather conditions and the scaling-back of production until now have reduced the risk of repeated disruptions in the European gas market recently, which will also be of benefit to Europe's electricity supply. In addition, preparations are underway in Switzerland for a possible energy shortage, with measures being taken at various levels to prevent this from occurring. For example, the federal government has set up a hydropower reserve and is procuring reserve plants for gas and oil. Accordingly, the risk of an energy shortage with production disruptions in Switzerland has receded, for all that the situation remains tense. Much depends on winter temperatures, which cannot be predicted. The answers given in the PMI survey provide some information on preparations in the private sector for a possible escalation of the energy crisis: More than a half of companies have already taken such measures, and around a quarter have approved contingency measures. The most common measure to counteract an electricity shortage is a general reduction of electricity consumption (Fig. 4). Some 18% of companies have purchased emergency electricity generators or batteries, and some are installing photovoltaic facilities. By way of preparing for a gas shortage, 35% of industrial businesses have converted their facilities to work with oil.

Growth drivers lacking

Overall, Swiss economic growth will slow in 2023, in line with the wider global economy. Thanks to robust consumer spending the risk of a recession remains comparatively low. However, given the difficult situation of the global economy, which is battling inflation, monetary policy tightening, geopolitical uncertainties, and war in Ukraine, there are no growth drivers in sight.

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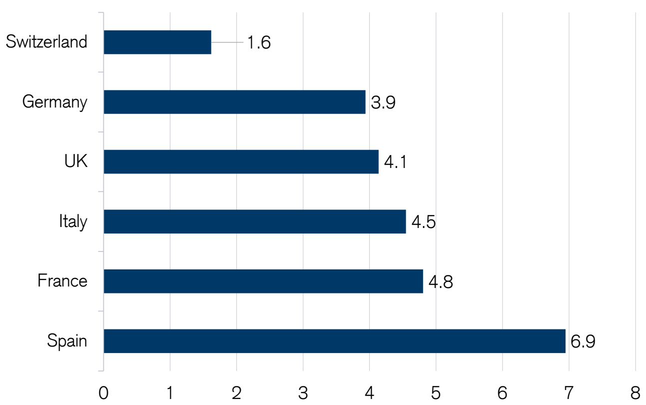
Fig 3: Swiss manufacturing less energy-intensive

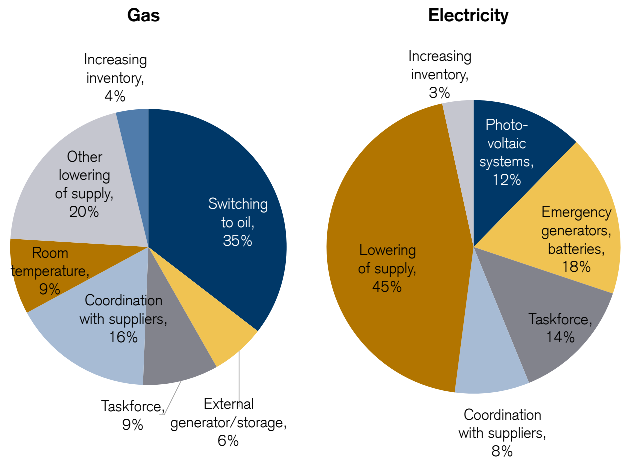
Energy intensity: energy per value added in terajoules/EUR mn.



Source: IEA World Energy Balances 2022, Credit Suisse

Fig 4: Companies already preparing for energy shortage

What preparations have you made for a possible energy shortage in the coming winter? Proportion of responses



Source: procure.ch, Credit Suisse. Last data point: October 2022

Inflation

We are sticking with our forecast that inflation will fall in 2023. First, the contribution of the oil price rise from the start of 2022 to the inflation rate will wane. Second, supply bottlenecks are increasingly easing in the manufacturing sector, which should help to reduce inflation of consumer goods prices. One risk does remain, however: An increase in the reference interest rate appears ever more likely. That would allow for a stronger rise in rents, although this would not kick in until the end of next year. We are therefore still expecting an average inflation rate of 1.5% for 2023 (2022: 2.9%).

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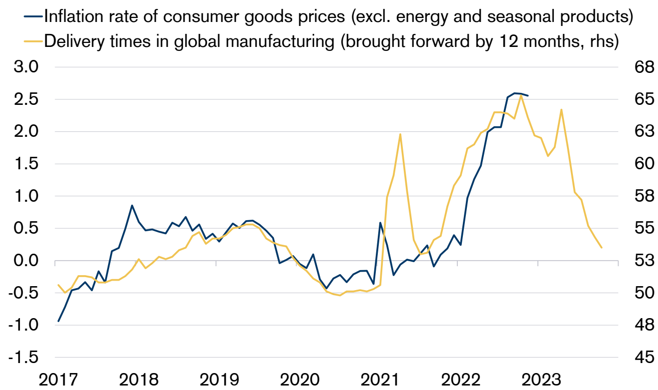
Normalization of delivery times

Year-on-year inflation comparison in %; delivery times as per global PMI (rhs)



Source: SFSO, Bloomberg, Credit Suisse. Last data point: October 2022

Labor market

With a rise of 2.4% compared to the prior year, full-time equivalent employment may have grown less strongly in the third quarter of 2022 than in the first semester, but the growth rate remains above average. The latest economic surveys point to companies planning a further increase in headcount in net terms over the coming months. In view of the muted economic outlook, however, we can expect to see slowing momentum in employment development over the coming year. On average we are anticipating job growth of 0.7% in 2023, down from 2.6% this year.

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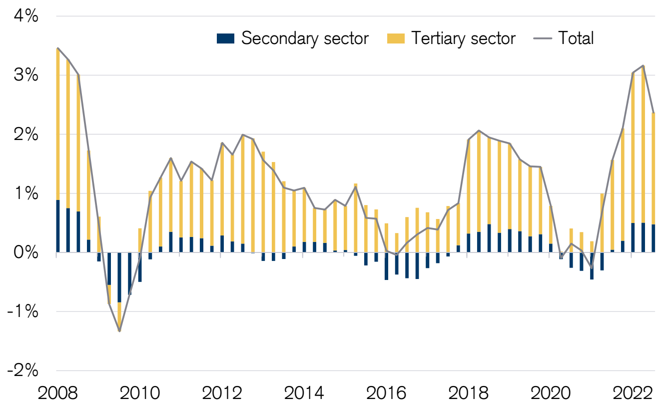
Employment growth remains strong but has passed its peak

Full-time equivalent employment: change year-on-year in %, growth contributions in percentage points



Source: SFSO, Credit Suisse. Last data point: Q3 2022

Immigration

A shortage of labor has boosted the numbers of people moving to Switzerland, with net immigration likely to amount to some 75,000 persons this year. We are anticipating a slight weakening of net migration in 2023. Although the Swiss economy can be expected to weaken too, we are not expecting a recession here – unlike in the Eurozone. As a result, the gap between Switzerland and its neighbors is likely to widen further, which is likely to be conducive to the migration of labor to Switzerland on the one hand, and Swiss citizens and foreigners choosing to stay here on the other. The combined effect should result in net migration of around 70,000 persons in 2023.

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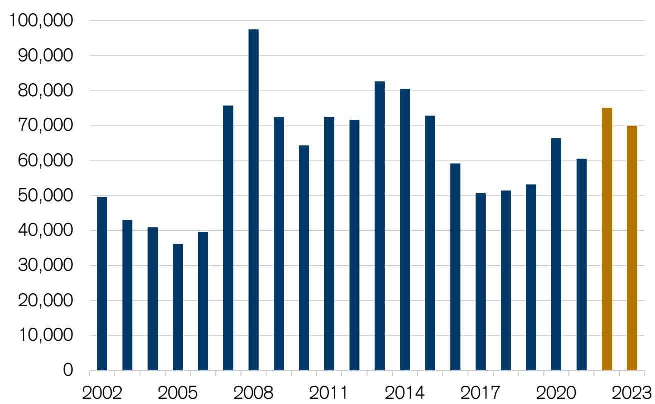
Immigration to slow only slightly in 2023

Net migration of permanent residential population (excluding register corrections, incl. Swiss citizens); 2022: estimate; 2023: forecast



Source: State Secretariat for Migration, Credit Suisse

Pharmaceutical industry

In the third quarter of 2022, the pharmaceutical industry recorded a year-on-year decline in exports of 4.2%. While exports to Germany and the US declined, there was a significant rise in exports to China. Broadly speaking, however, pharma exports appear to have stabilized, as indicated by a comparison with the previous quarter (+1.3%). As a consequence, we are expecting solid development for the next few months too, particularly as pharma exports typically have relatively little correlation with the development of the global economy.

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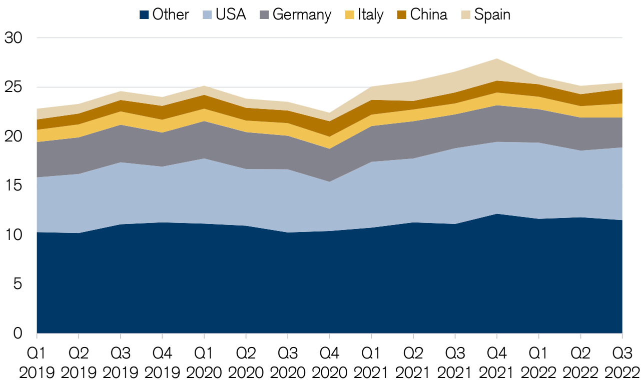
Pharma exports remain stable
Pharma exports in CHF mn, by country, seasonally adjusted



Source: Federal Customs Administration, Credit Suisse

Mechanical engineering, electrical and metal industry

The exports of the MEM industry lost considerable momentum in the third quarter of 2022, with the global deterioration in manufacturing sentiment already becoming apparent. MEM exports to Germany stagnated, while those to France and Italy recorded declines. Exports to China likewise declined in the third quarter. Only in the case of the US an acceleration in export growth was apparent. According to purchasing managers indices, demand can be expected to weaken further over the coming months. In China, the risk regarding COVID-19 continues to be a factor of uncertainty for demand. The recently announced easing measures are unlikely to bring rapid relief.

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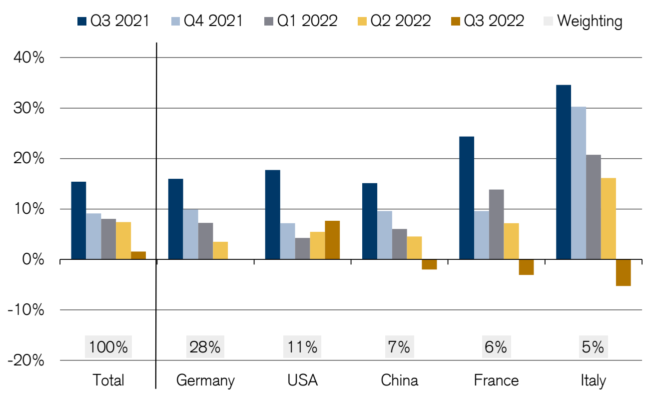
MEM industry feels deterioration in manufacturing sentiment
MEM exports compared to prior-year quarter by country, seasonally adjusted



Source: Federal Customs Administration, Credit Suisse

Watch industry

Watch exports climbed to a new peak in the third quarter of 2022. This was above all attributable to the pronounced recovery of Chinese demand (+16% compared to the prior-year quarter). Exports to the US rose once again, albeit less strongly than in previous quarters. However, this industry is unlikely to enjoy any further significant growth support from China over the coming months. Recovery in demand from Hong Kong also remains some way off. Due to subdued consumer sentiment, we are expecting demand to stagnate.

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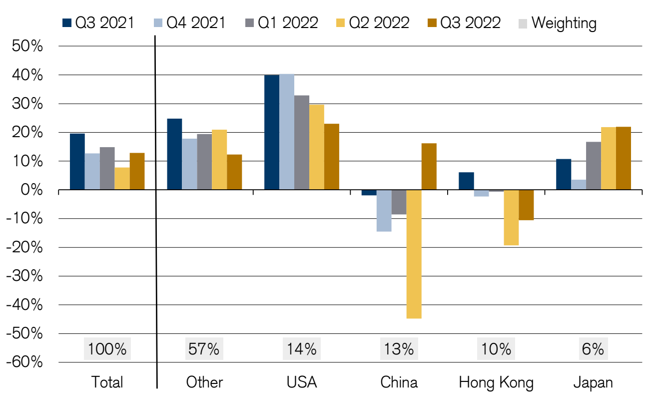
Watch exports boosted by growth stimulus from China
Watch exports compared to prior-year quarter by country, seasonally adjusted



Source: Federal Customs Administration, Credit Suisse

Retail trade

In the third quarter of 2022, the retail industry recorded nominal sales growth (+0.6%) for the first time in more than a year. Due to inflation (+2.3%), however, real sales growth ended up in negative territory (–1.7%). In nominal terms, the non-food area recorded particularly striking growth, whereas the food/near-food segment stagnated. The positive overall development was supported by the robust Swiss labor market situation, which is likely to continue to prop up consumer spending over the coming months. As a result, we are not expecting any slump in retail sales over the coming three months, despite the deterioration in consumer sentiment.

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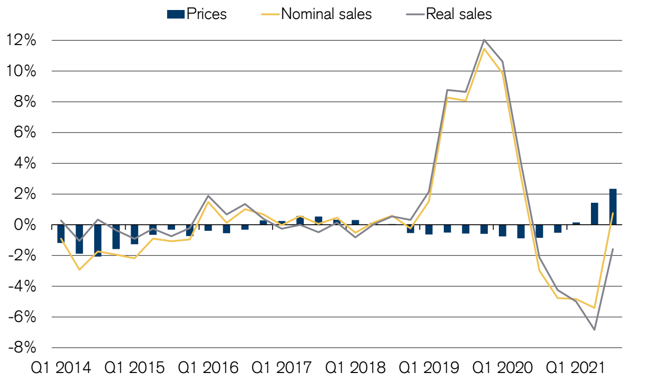
Nominal rise in retail sales
Retail sales, seasonally adjusted, and prices compared to prior-year quarter



Source: GfK, Credit Suisse

Tourism

The number of overnight stays in Switzerland increased further over the summer months. Although Swiss guests continue to account for the majority of overnight stays, the year-on-year growth in overnight stays was generated by visitors from the Americas, Asia, and Europe. Tourist municipalities and urban centers benefited equally from this development. Looking ahead to the coming winter months, the deterioration in the economic outlook and inflationary developments are likely to weigh on the consumer sentiment of European guests in particular. That said, as this is expected to be the first winter season without COVID-19 restrictions, the catch-up factor is likely to predominate.

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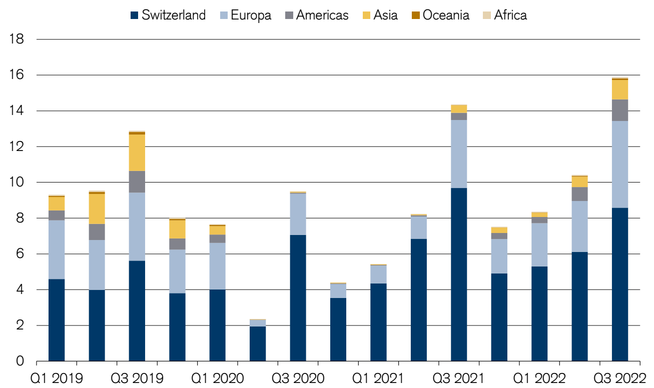
Resurgence in visitors from Asia and the Americas
Overnight stays in mn, by continent of origin



Source: Federal Statistical Office, Credit Suisse

Information technology (IT)

Although sentiment in the IT sector recorded a slight quarter-on-quarter improvement in the third quarter of 2022, it remains below the long-term average. The balance between companies that view their business situation as positive and those that view it as negative most recently stood at 37%, following a nadir in the second quarter. This cautiously positive development reflects the robust growth of the Swiss services sector so far. However, the deterioration of global manufacturing sentiment can be expected to weigh on IT companies over the coming months.

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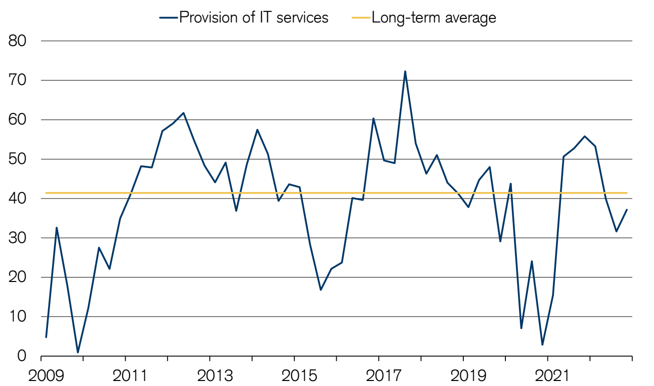
Sentiment remains below average in IT sector
Balance between companies that view their business situation as positive and those that view it as negative, in %, and long-term average



Source: KOF Swiss Economic Institute of ETH Zurich, Credit Suisse

The comeback of the Swiss interest rate bonus

The difference between German and Swiss nominal interest rates is larger than it has been in the past 10 years. This situation seems largely due to inflation expectations having increased less in Switzerland than elsewhere. As maintaining price stability will likely become more challenging for central banks globally, and given Switzerland's more favorable initial position, there are reasons to believe that the Swiss interest rate bonus will persist for some time.

The Swiss interest rate bonus vanished during the pandemic…

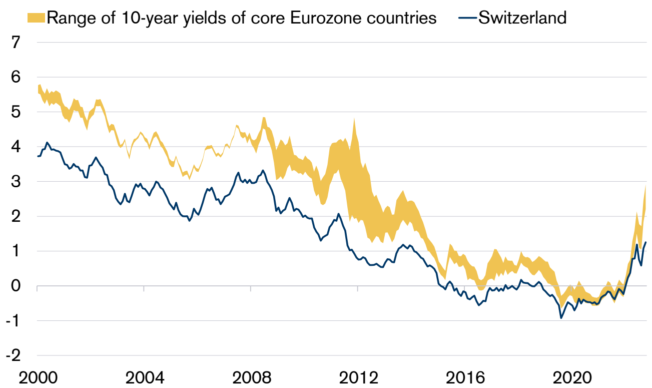
For decades, nominal interest rates on government bonds have been lower in Switzerland than in most countries of the world. As sovereign bond yields are used as benchmark rates for most interest rates in an economy, the Swiss economy has thus generally benefited from lower inter-est rates more than other countries. This difference was particularly relevant with European countries, due to the close economic ties of these countries with Switzerland and was labelled as the "Swiss interest rate bonus." However, between the beginning of the 2000s and the COVID-19 pandemic, interest rates have converged, in particular between Switzerland and Euro-pean countries with similarly low default risks, including, among others, Germany, the Nether-lands and France. During the COVID-19 pandemic, yields on 10-year German and Dutch gov-ernment bonds even fell below the Swiss ones. Not only did nominal interest rates converge, but they also declined to reach unprecedented negative levels (Figure 1).

…or even before, once adjusted for inflation

Real interest rates, i.e. interest rates adjusted for inflation, have followed a similar trend until the pandemic, although uncertainty is higher, as real rates cannot be observed and need to be es-timated. Our simple measure of real rates, i.e. the difference between nominal interest rates and the inflation trend obtained from a statical filter (Hodrick-Prescott filter), suggests that Swiss and German 10-year real yields have continuously declined since at least the 2000s. Moreover, it appears that German 10-year real yields have fallen below Swiss 10-year real yields already since the beginning of the 2010s (Figure 2). More sophisticated estimates point to a similar trend.[1]

Figure 1: European and Swiss interest rates converged until the pandemic

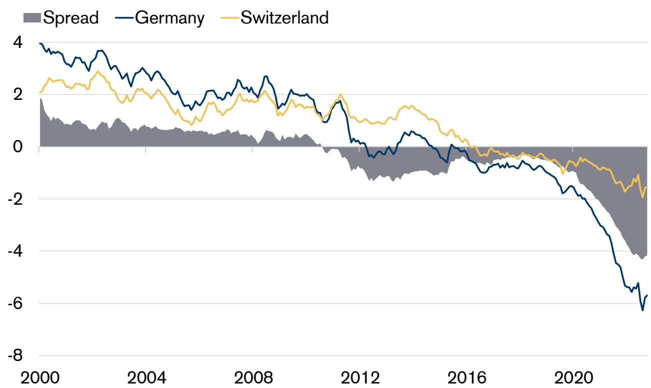
10-year sovereign bond yields, in % p.a.; core Eurozone countries include Austria, Belgium, Finland, France, Germany, and the Netherlands.



Last data point: 10/2022. Source: Refinitiv Datastream, Credit Suisse

Figure 2: German 10-year real interest rates have been lower than their Swiss counterparts for at least 10 years

Estimated 10-year real sovereign bond yields, in % p.a.



Last data point: 10/2022. Source: Refinitiv Datastream, Credit Suisse

[1] P. Bacchetta, K. Benhima and J.-P. Renne (2021): «Understanding Swiss Real Interest Rates in a Financially Globalized World». Grundlagen für die Wirtschaftspolitik Nr. 25. State Secretariat for Economic Affairs, SECO, Bern, Switzerland.

After rising in tandem, German and Swiss yields decoupled in May 2022

In that context, how should we assess this year's rebound of nominal rates from negative levels and what should we make of the rising difference between German (and European, more generally) and Swiss rates since early 2022? The latter is particularly interesting, as German and Swiss 10-year nominal yields first rose in tandem until early May 2022, before decoupling. Since then, the rate difference has continuously widened and currently stands at around 1.0 percentage point (Figure 3). Should we assume that this difference will last?

The rise in German yields is partly due to rising inflation expectations

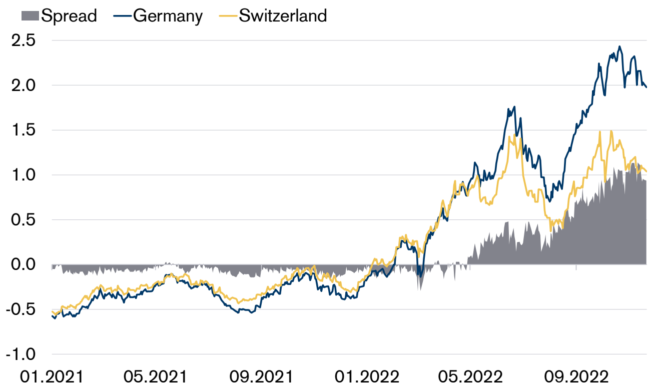
One driver of nominal interest rate is inflation expectations, or the premium that investors ask to compensate for the risk of inflation eroding the expected return on their investments. As some governments issue inflation-linked bonds, we have a measure of financial markets' inflation expectations for some economies. In particular, it appears that the rise in the 10-year German government bond yield from –0.9% on 9 March 2020 (record low) to 2.9% on 31 October 2022 (+3.8 percentage points) was partly due to an increase in inflation expectations of 1.8 percentage points, i.e. financial markets have revised their inflation expectations from 0.6% p.a. for the next 10 years on 9 March 2020 to 2.4% p.a. on 31 October 2022 (Figure 4).

Relying on economic theory to derive market-based inflation expectations for Switzerland

One explanation for the widening interest rate spread between German and Swiss sovereign bonds could therefore be diverging inflation expectations for Germany and Switzerland since May 2022. Unfortunately, we do not have a market-derived measure of inflation expectations for Switzerland. To fill the gap, we computed our own measure of market-derived inflation expectations, relying on economic theory. To do so, first, we need to assume that the purchasing power parity (PPP) holds. The purchasing power parity implies that the expected change in the exchange rate of a currency pair should correspond to the expected change in relative prices of the two currency areas, or in other words, the expected inflation differential. Second, we also need to assume that the uncovered interest rate parity (UIP) holds. Accordingly, the expected change in the exchange rate should correspond to the interest rate differential of the two currency areas. If both PPP and UIP hold, it implies that the interest rate differential between two economies should correspond to the expected inflation differential between the two economies. We can therefore compute inflation expectations for Switzerland by adding inflation expectations for Germany to the interest rate spread between Switzerland and Germany. We can also derive these expectations via US interest rates and US inflation expectations. However, if both PPP and UIP hold, it also implies that the real interest rate is the same for both economies. This is a very strong assumption and seems quite unrealistic to hold for Switzerland and the USA. On the other hand, it seems more realistic to hold for Switzerland and Germany. In any case, we would not focus too much on the level of our measures of inflation expectations for Switzerland, but we believe that changes in these measures over a relatively short period of time still provide useful information.

Figure 3: After rising in sync, German and Swiss yields have decoupled since May 2022

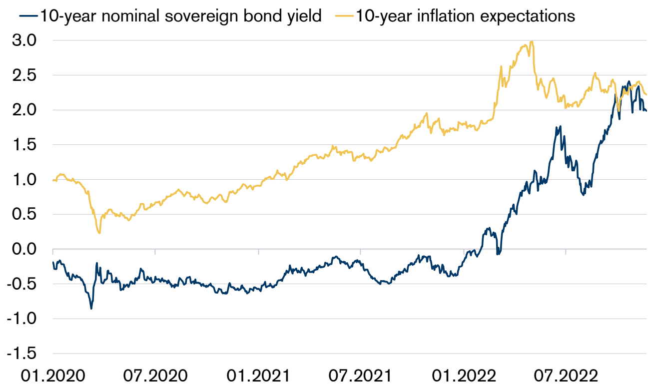
10-year nominal sovereign bond yields, in % p.a.



Last data point: 21/11/2022. Source: Refinitiv Datastream, Credit Suisse

Figure 4: The increase in German bond yields is partly due to rising inflation expectations

German interest rates and inflation expectations, in % p.a.



Last data point: 21/11/2022. Source: Bloomberg, Credit Suisse

Declining inflation expectations in Switzerland…

Our market-derived measure of 10-year inflation expectations for Switzerland (obtained via German 10-year bond yields and German 10-year inflation expectations) suggests indeed that since May 2022, Swiss and German inflation expectations have started to diverge, as Swiss inflation expectations have gradually declined, while German inflation expectations have remained broadly constant. Computing 10-year inflation expectations for Switzerland via US interest rates and US inflation expectations shows a similar picture: market-based long-term inflation expectations for Switzerland have peaked at the beginning of Q2 2022 and have since then declined by around 1.25 to 1.50 percentage points (Figure 5).

…explain the recent widening spread between German and Swiss yields

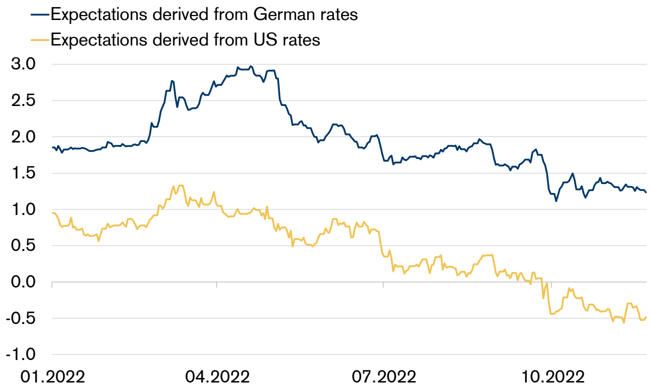
Our findings imply that the widening of the interest rate spread between the 10-year German government bond yields and its Swiss counterpart since May 2022 is essentially due to a higher inflation premium for German yields than the Swiss one. Two factors have likely contributed to this development. First, inflation has reached multi-decade high in Germany (and in the Eurozone), and we forecast it to average 6.4% next year. On the other hand, Swiss inflation has remained more moderate, and we forecast it to average 1.5% next year. This significant difference in the short-term inflation expectations partly explains the difference in the long-term inflation expectations (the 10-year inflation expectation is the average annual inflation rate expected over the next 10 years).

Long-term inflation expectation measures indicate a high degree of confidence in the SNB's ability to maintain price stability

Second, the Swiss National Bank (SNB) has adjusted its monetary policy more quickly to rising inflationary pressures than the European Central Bank (ECB) did, in raising its policy rate by 0.50 percentage point on 16 June 2022, while the ECB waited until July for its first interest rate hike. In doing so, the SNB has strengthened its credibility to maintain price stability, while the ECB's credibility has likely suffered from its slow response. A higher central bank credibility should translate into lower long-term inflation expectations. The problem with the 10-year inflation expectations as a measure of long-term inflation expectations is the impact of the short-term expectations, especially in the current environment, where short-term inflation expectations are particularly high for Germany (and the Eurozone in general). To avoid this problem, we turn on so-called 5-year/5-year inflation swaps, which measure the expected average annual inflation in five years from now, for the following five years. These inflation expectation measures are constructed by using 5-year and 10-year inflation expectations, allowing us to derive a 5-year/5-year inflation swap for Switzerland, based on the 5-year and 10-year expectations computed according to the methodology described above. Again, we would not focus too much on the level of the 5-year/5-year expectations, given the strong assumptions needed to compute them. Nevertheless, these measures of long-term inflation expectations have declined after an initial increase at the beginning of the year, a change that is consistent with a solid credibility of the SNB in maintaining price stability in the long term. On the other hand, long-term inflation expectations have remained elevated in the Eurozone in a sign that the ECB may not be as credible as the SNB in reining inflation (Figure 6).

Figure 5: Financial market-derived inflation expectations for Switzerland have declined since Q2 2022

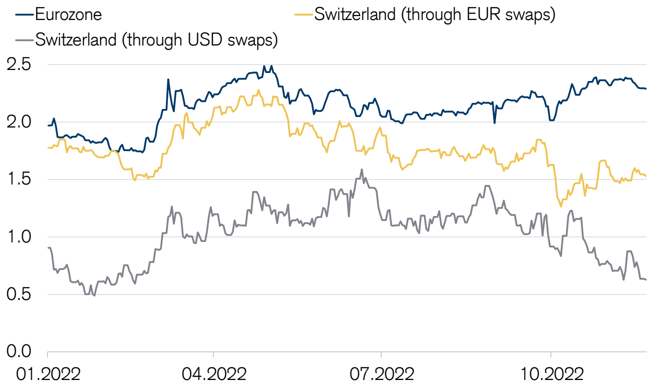
Measures of 10-year inflation expectations for Switzerland, in % p.a.



Last data point: 21/11/2022. Source: Credit Suisse

Figure 6: Diverging trend between long-term inflation expectations for the Eurozone and Switzerland

5-year/5-year inflation swaps, in % p.a.



Last data point: 21/11/2022. Source: Bloomberg, Credit Suisse

Challenges for global monetary policy speak for the persistence of the Swiss interest rate bonus

Whether the nominal interest rate spread (the Swiss interest rate bonus) will persist or not will depend on the ability of central banks to bring back inflation within their definition of price stability. In that respect, the task of the SNB seems easier, as inflation is already lower in Switzerland and the SNB's credibility in maintaining price stability seems higher than other central banks. Nevertheless, monetary policy globally will likely be confronted with new challenges. Indeed, not only is the inflation outlook particularly uncertain, but there are reasons to believe that inflation will remain above its pre-pandemic level. Working-age population is shrinking in China and this trend is soon expected to be more pronounced in high-income countries, putting upward pressure on wages. There is a risk of widening fiscal deficits too, as population aging will raise spending needs in healthcare and pensions, while the war in Ukraine will lead to higher military spending. Higher fiscal deficits are generally inflationary. Furthermore, while the focus of central banks is currently firmly on lowering inflation, their commitment may diminish before inflation reaches current central bank targets, as the costs of lowering inflation will become more apparent. The risks are therefore for inflation expectations to remain higher in the longer term than they were before the pandemic. This trend would contribute to generally higher inflation expectations and also speak for the Swiss interest rate bonus to persist, unless the SNB were to raise its inflation target or relax its efforts to lower inflation.

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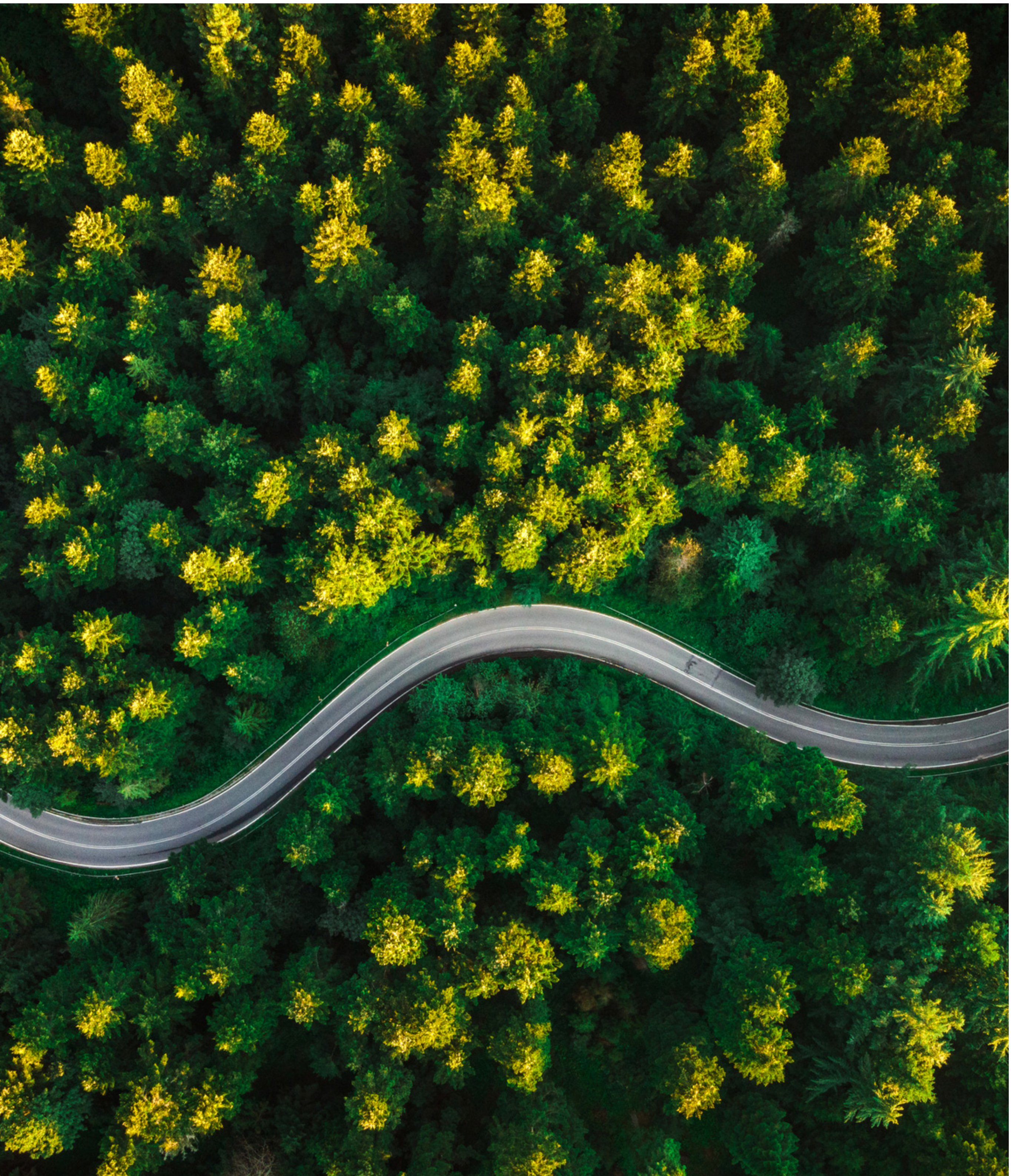

Higher rates to come

Inflation is still too high in Switzerland and therefore warrants a tighter monetary policy, in our view. We expect the Swiss National Bank (SNB) to continue to raise its policy rate and to sell foreign currency reserves.

SNB to raise its policy rate up to 1.00%

As inflation remains above what the SNB defines as price stability (a positive inflation rate below 2%), we expect a further tightening of monetary policy in Switzerland. However, as we expect inflation to gradually slow down, only a moderate tightening is warranted, in our view. We expect the SNB to do this through two instruments. Firstly, we forecast further increases in the SNB's policy rate following those of last June and September. However, the rate hikes we expect will likely be smaller than those of last summer. We expect the policy rate to rise from the current 0.50% to 0.75% in December and to 1.00% in March of next year (Figure 1). On one hand, these rate hikes should help limit the increase in domestic price inflation by preventing economic growth to accelerate in Switzerland. On the other, these rate hikes should prevent the franc from depreciating against other currencies. Indeed, after years of fighting against an overly strong franc, the SNB is now limiting any depreciation of the franc. A weaker franc – in particular against the euro – would indeed contribute to higher inflation by increasing prices of imported goods.

Foreign currency sales likely to prevent the CHF from weakening

Secondly, and also to avoid a depreciation of the franc, we expect the SNB to sell foreign currency reserves (and thus buy francs). In fact, there is already evidence that the SNB has sold foreign currency reserves, as we estimate these sales at CHF 3.4 bn for September and CHF 13.3 bn for October (Figure 2). As foreign currency reserves sales contribute to the tightening of monetary policy, fewer rate hikes are needed, in our view. The costs of monetary policy tightening should therefore be more modest for the Swiss economy, in particular in comparison to other economies where central banks are rapidly raising their policy rates. In addition, and while the SNB would likely welcome a slowdown, rapid interest rate hikes could excessively weaken the real estate market. Finally, the faster the SNB raises its policy rate, the greater the risk of a rapid increase in the reference interest rate used to set housing rents, which would allow landlords to raise rents, thus fueling inflation and running counter to the SNB's objective of reducing inflation.

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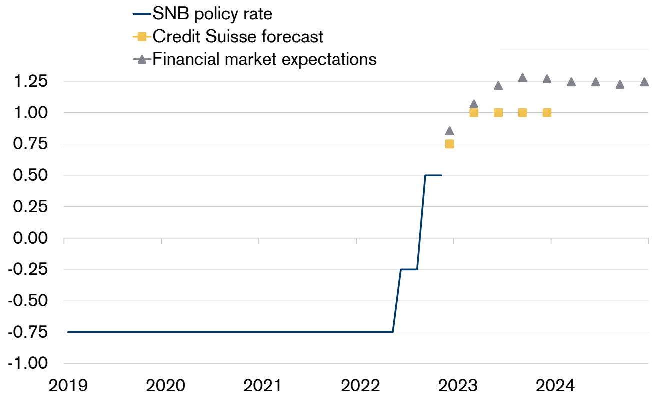
Figure 1: SNB likely to raise its policy rate up to 1.00%

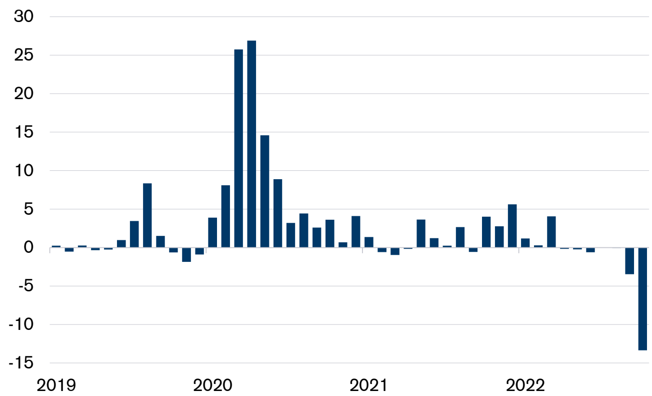
In %, market expectations from 6 December 2022



Source: Bloomberg, Credit Suisse

Figure 2: More foreign currency sales likely

Estimated foreign exchange interventions by the SNB (positive values indicate purchases of foreign currencies), in CHF bn



Source: Credit Suisse

Liquidity

In parallel to raising its policy rate, the SNB has withdrawn liquidity to make sure that its monetary policy is transmitted to financial markets. The SNB essentially uses two instruments to absorb liquidity: repos and the issuance of debt certificates (SNB Bills). In both cases, these operations can be understood as the SNB temporarily borrowing liquidity from its counterparties (essentially banks). Separately, foreign currency sales also reduce liquidity, as the SNB buys Swiss francs back. Overall, the SNB has reduced liquidity by CHF 174 bn since August.

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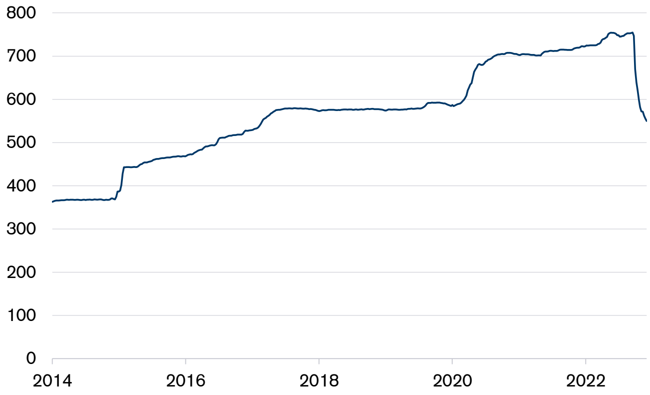
Liquidity is falling rapidly

Total sight deposits at the SNB, in CHF bn



Source: SNB, Credit Suisse

Banknotes

Since the first policy rate hike by the SNB in June 2022, demand for banknotes has declined rapidly. While banknotes in circulation are usually down by around CHF 1.2-1.3 bn in September in comparison to their year-end level, they were CHF 8 bn below their December 2021 level this time. As interest rates have risen, the opportunity costs of holding physical cash have also increased. Given that the drop in banknotes in circulation is essentially due to a decline in CHF 1000 bills, it suggests that physical cash has been hoarded to avoid negative interest rates.

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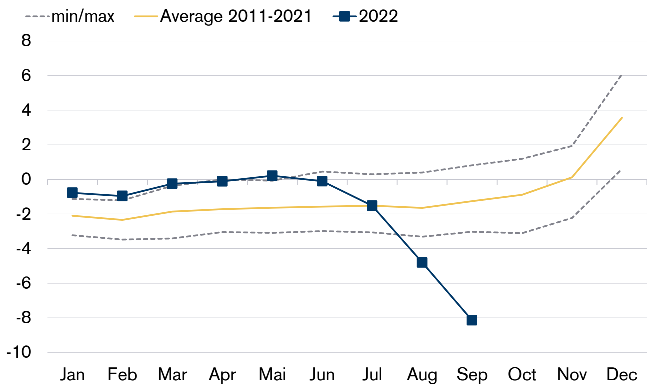
Banknotes in circulation are falling rapidly

Cumulative change in banknotes in circulation since year-end, in CHF bn



Source: SNB, Credit Suisse

COVID-19 credits

Reimbursements of COVID-19 credits have picked up since our last update. Since 31 August, CHF 622 m of COVID-19 credits have been paid back, while only CHF 146 m were reimbursed in the previous period (8 June – 31 August). Defaults have climbed to CHF 658 m from CHF 513 m, while CHF 20.7 m (+ CHF 4.1 m) could be recovered from previously defaulted loans. As the interest rate level has risen, it seems likely to us that the government will adjust the interest rate on COVID-19 credits higher (currently at 0.0% for most of them) on 31 March, the next possible adjustment date.

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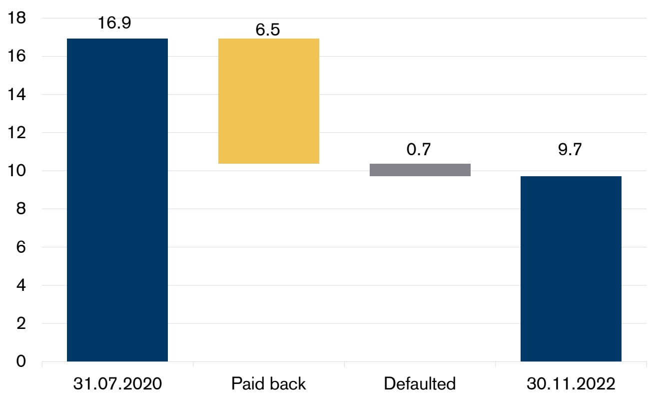
Companies continue to pay back COVID-19 credits

Outstanding COVID-19 credits, in CHF bn



Source: SECO, Credit Suisse

Owner-occupied housing

Despite significantly higher interest rates, the price of owner-occupied housing continues to rise strongly. Compared to the prior year, the average condominium increased in price by a further 6.6% in the third quarter of 2022, with the average single-family home up 7.2%. Although these increases remain well above the long-term average in both cases, a weakening is apparent compared to the previous quarter. We are expecting a clear decline in price momentum over the next few quarters. However, we still do not expect any price declines for the time being, as the scarcity of supply will support prices. However, in the event of further rises in interest rates or Switzerland sliding into a prolonged recession, even price falls are conceivable in the medium term.

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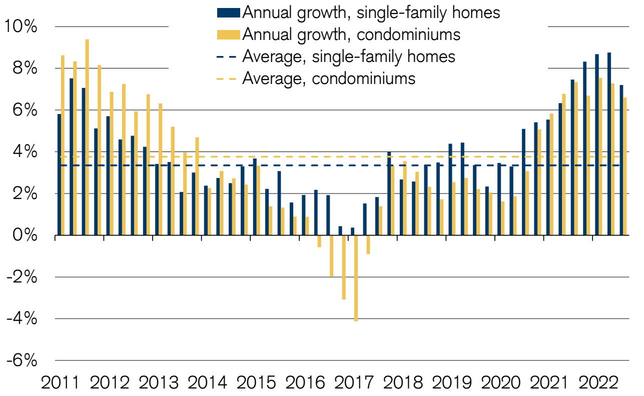
Price growth has passed its peak

Price development of medium segment; dotted lines: average 2000–2021



Source: Wüest Partner. Last data point: Q3 2022

Rental apartments

The apartment vacancy rate has recorded another sharp fall so far in 2022. The decline in the total number of apartments (9,869) extends to all segments, all apartment sizes, and the majority of regions. As of the most recent observation date, 2.13% of rental apartments stood empty. In the case of owner-occupied housing, the vacancy rate amounted to a low 0.4%. This sharp decline has been driven on the one hand by strong demand following the recovery from the COVID-19 pandemic and the associated rise in net immigration, and on the other by construction activity, which has been declining for three years or so even in the area of rental apartments.

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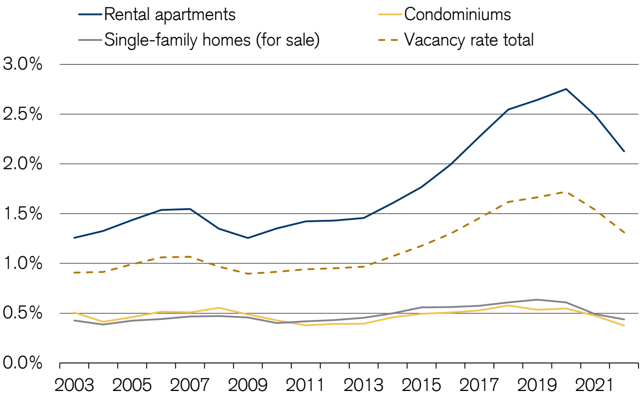
Accelerated decline in proportion of vacant apartments

Vacancy rate by segment, as % of existing stock in each case



Source: Federal Statistical Office, Credit Suisse. Last data point: June 1, 2022

Office property

Over the last 12 months, an investment volume of CHF 1,717 million was approved for construction in the area of office property. Although this figure indicates a clear year-on-year recovery, it is still a hefty 11% below the long-term average since 1995. Similarly, planning applications were almost 10% below their long-term average. It therefore seems that the uncertainty over companies' future need for space as a result of hybrid working models has not been fully eliminated. Moreover, the great volatility of both construction prices and delivery times is complicating the planning of construction projects. Last but not least, higher financing costs are squeezing returns and thus reducing the appeal of real estate investments.

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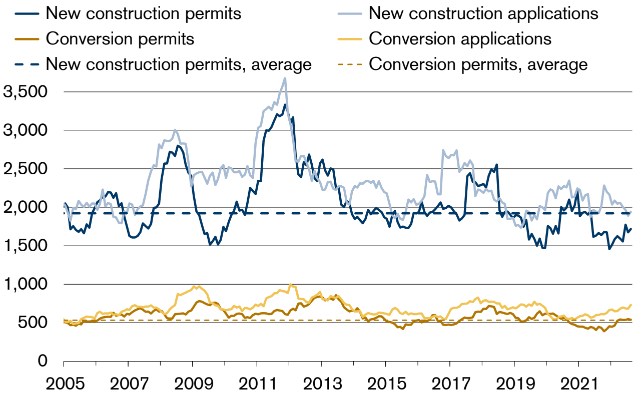
Office newbuild activity loses momentum

Planning applications and construction approvals, moving 12-month total, in CHF mn



Source: Baublatt, Credit Suisse; last data point: August 2022

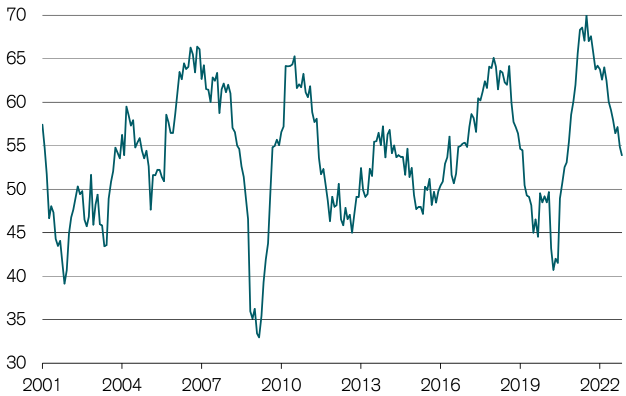
Credit Suisse Leading Indicators

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.

Industrial Activity

PMI index > 50 = growth



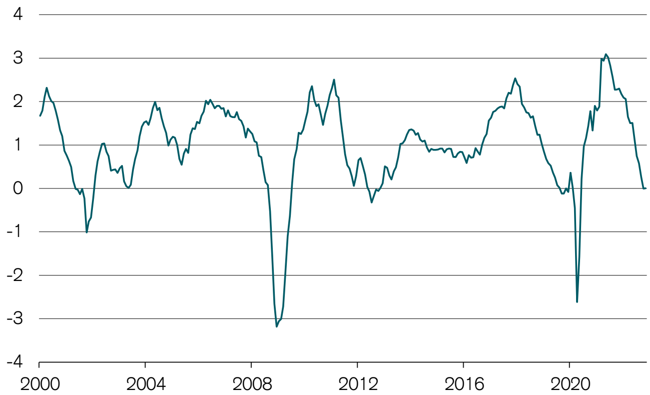
Source: procure.ch, Credit Suisse

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.

Exports

In standard deviation, values > 0 = growth



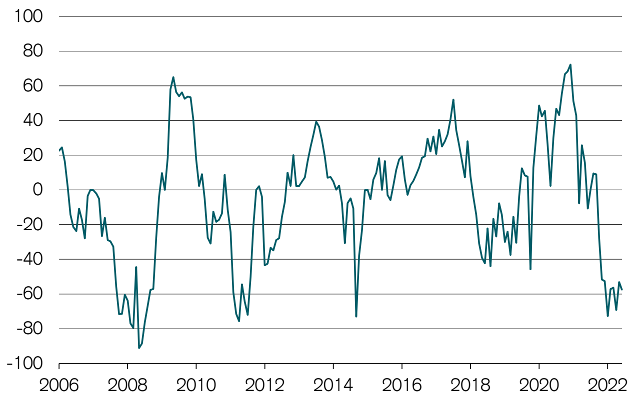
Source: PMIPremium, Credit Suisse

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.

Economic Activity

Balance of expectations, values > 0 = growth



Source: CFA Society Switzerland, Credit Suisse

[1] Published as the Credit Suisse ZEW Index from 2006 until 2016

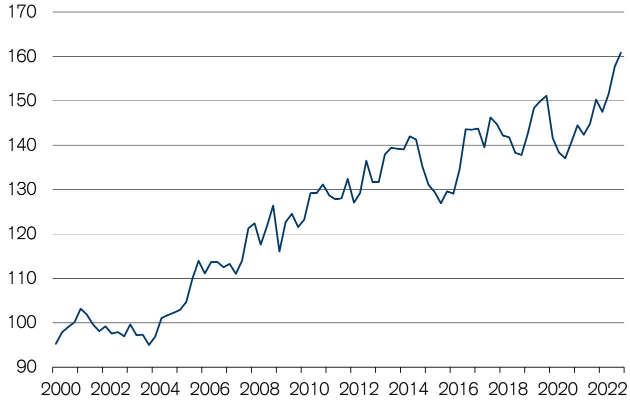
Credit Suisse Leading Indicators

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.

Construction Industry Climate

1st quarter 1996 = 100



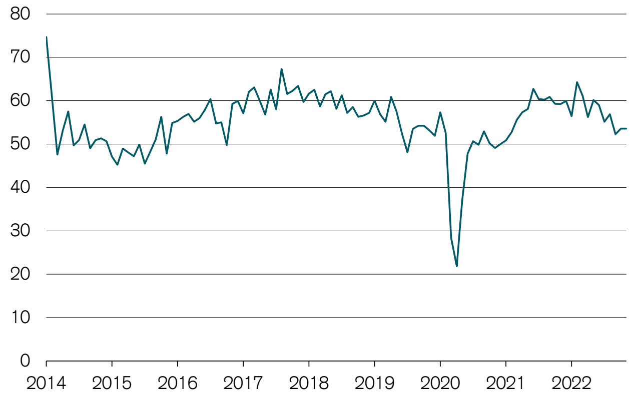
Source: Swiss Contractor's Association, Credit Suisse

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.

Activity in the services sector

PMI Services index > 50 = growth



Source: procure.ch, Credit Suisse

Forecasts and Indicators

Forecasts for the Swiss Economy

	2022 Quarter 1	2022 Quarter 2	2022 Quarter 3	2022P Quarter 4	2023P Quarter 1	2023P Quarter 2	2023P Quarter 3	2023P Quarter 4	2022P	2023P
GDP (YoY, in %)	4.4	2.2	0.5	0.9	0.7	0.7	1.0	1.4	2.0	1.0
Consumer spending	7.0	4.3	2.5	2.5	2.0	1.2	1.3	1.2	4.0	1.4
Government expenditure	2.0	1.5	0.9	1.3	2.0	1.1	1.1	0.2	1.4	1.1
Gross capital investment	1.4	0.2	0.6	0.4	2.0	0.9	-0.1	-0.2	0.6	0.6
Construction investment	-3.4	-2.7	-6.2	-1.8	-0.5	-0.5	-0.5	-0.5	-3.5	-0.5
Investment in plant and equipment	3.7	1.7	4.1	1.5	3.0	1.5	0.0	0.0	2.7	1.1
Exports (goods and services)	12.0	8.6	6.2	-1.0	3.0	3.0	3.0	3.0	6.2	3.0
Imports (goods and services)	9.0	6.2	7.3	3.0	2.5	2.5	2.5	2.5	6.3	2.5
Inflation (in %)	2.1	3.0	3.4	3.0	2.7	1.6	1.0	0.9	2.9	1.5
Unemployment (in %)	2.3	2.2	2.1	2.0	2.1	2.2	2.2	2.3	2.2	2.2
Employment growth FTEs (YoY, in %)	3.0	3.2	2.4	1.7	1.1	0.6	0.5	0.6	2.6	0.7
Net immigration									75'000	70'000
Nominal wage growth (YoY, in %)									1.5	2.3

Source: Federal Statistics Office, State Secretariat for Economic Affairs SECO, Credit Suisse

Forecasts for the World Economy

	Forecasts				**Structure**		**Significance for Switzerland**	
Forecasts	**GDP** YoY, in %		**Inflation** YoY, in %		**Population** In million	**GDP** In USD billion	**Share of exports** In %	**Share of imports** In %
	2022	**2023**	**2022**	**2023**	**2021**	**2021**	**2021**	**2021**
World	2.7	1.6	7.6	5.1	7,764	97,076	100	100
US	1.8	0.9	8.1	4.2	332	22,996	18.1	6.0
Euro zone	3.2	-0.2	8.6	6.0	343	14,559	51.5	66.8
Germany	1.7	-0.8	8.5	6.4	83	4,263	17.0	27.4
France	2.5	0.2	6.0	4.8	65	2,957	5.7	7.6
Italy	3.7	-0.2	8.2	6.0	59	2,101	6.0	9.4
UK	4.3	-1.3	9.1	7.6	67	3,188	3.0	2.2
Japan	1.2	0.4	2.2	1.7	126	4,933	2.9	2.0
China	3.3	4.5	2.2	2.0	1,413	17,745	6.0	8.9

Source: Datastream, International Monetary Fund, Credit Suisse

Interest Rates and Monetary Policy Data

	Current	**3-month**	**12-month**		**12/2022**	**11/2022**	**12/2021**
SNB target range (in %)	0.50	0.75	1.00	M0 money supply (CHF bn)	626.1	700.4	729.8
10-year government bond yields (in %)	1.0	1.3	1.4	M1 money supply (%, YoY)	0.0	1.6	5.4
				M2 money supply (%, YoY)	-1.7	-0.6	2.6
				M3 money supply (%, YoY)	-0.2	0.0	2.5
				Foreign currency reserves (CHF bn)	821.9	808.4	951.2

Source: Datastream, Bloomberg, Credit Suisse

Impressum

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