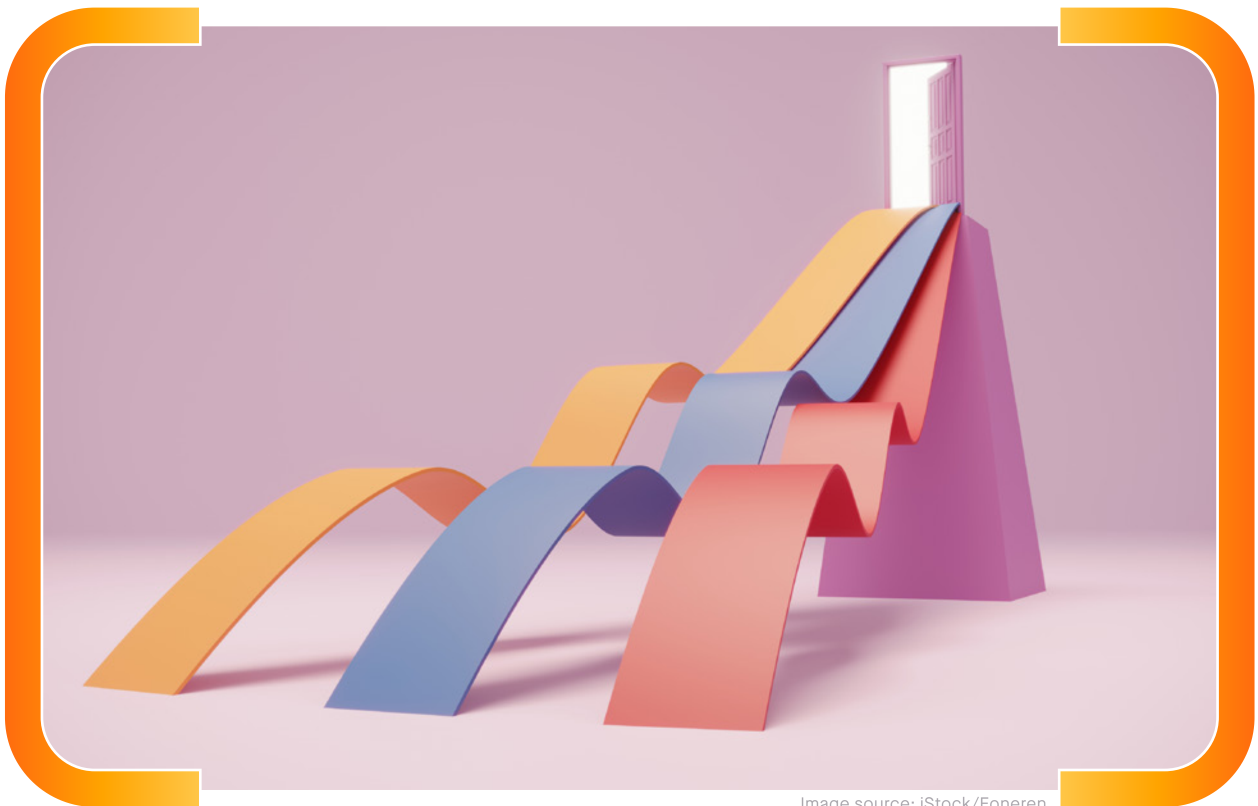
SNB and ECB cut rates

A tale of two central banks: the ECB navigates stagflation and the SNB fights deflation pressures coming from CHF strength.



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The European Central Bank and the Swiss National Bank both held their monetary policy meetings yesterday. They both lowered their key policy rate, but the size of the respective rate cuts and the communication differed significantly between the two. Indeed, the Eurozone and Switzerland face opposite challenges, with significant implications for their monetary policy.

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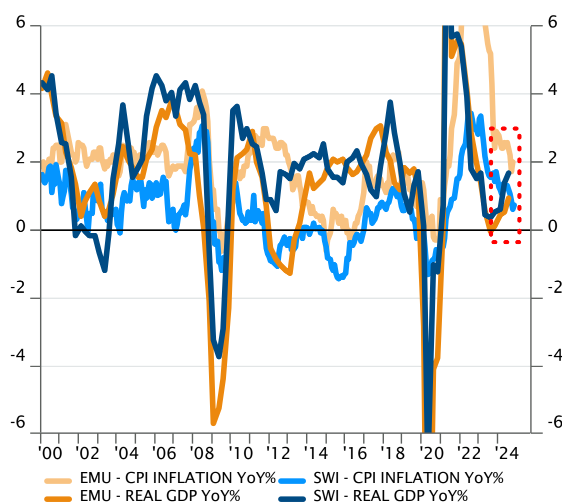
The European Central Bank delivered a 25bp rate cut that was anticipated by financial markets, but ECB President Lagarde made a less dovish call than possibly expected given recent economic growth developments in the Eurozone. The clear deterioration in growth dynamics since last spring, with no signs of an imminent recovery, seemed to call for either an acceleration in the pace of monetary easing or, at the very least, a clear signal that the ECB was committed to decisive policy action. Unfortunately, inflationary pressures linger in the monetary union, with "core" inflation still above the ECB's 2% target and wages' growth unexpectedly accelerated over Q3. As a result, the ECB, whose first mandate is price stability, must maintain a balance between downside risks on growth and upside risks on inflation in its monetary policy assessment. The result was yesterday's "cautious" 25bp rate cut, that leaves monetary conditions in restrictive territory, despite the weakness of economic activity in the Eurozone.

Higher growth and lower inflation in Switzerland than in the Eurozone



Source: Bank Syz, FactSet Research

Just hours before, the Swiss National Bank announced a 50bp rate cut of its key rate, a movement not completely expected by the consensus in its size. The situation in Switzerland is indeed quite different from its large neighbouring economy, as inflation has been slowing down faster than expected this year. In fact, while domestic activity has proved quite resilient, external factors have been impacting the Swiss economy in 2024. In particular, the strength of the currency has weighed on inflation, pushing import prices lower at a faster pace than expected and overall inflation increasingly close to 0%. In parallel, the strength of the currency has also weighed on export-oriented Swiss companies, amplifying the negative impact of weaker demand coming from the struggling economies of the Eurozone who are the main export market for Switzerland. In this context, an acceleration in the pace of monetary policy easing was warranted, mostly to stem upward pressures on the currency, while providing some support to domestic demand to balance the impact of the negative external factors. SNB Chairman Schlegel hinted clearly at more rate cuts ahead given the SNB's projection of inflation slowing down even further in 2025.

The difference in situations between these two economies on the same continent and closely linked by trade is telling: one faces an unpleasant mix of unwarranted inflationary pressures and weaker activity, while the other is fighting the impact of a strong currency. From a central banker's point of view, the situation in Switzerland is likely less complicated to address than the one of the Eurozone, as the playbook for deflation risks has been extensively used in the 2010's. Addressing stagflation risks as the ECB currently faces is much more complicated.

ECB

The European Central Bank has lowered its key interest rates by 25bp today, as widely expected. This fourth rate cut in six months now puts the deposit facility rate at 3.00%, and the main refinancing rate at 3.15%, their lowest levels since the first half of 2023.

These rate cuts aim at easing financing conditions in the Eurozone, as inflation is on track to stabilise around the ECB's 2% target. However, as wages and prices in certain sectors continue to adjust to the inflation shock of 2022 and 2023, the ECB sticks to its gradual approach and leaves its monetary policy stance in restrictive territory for the time being, even if progressively less so.

Inflation and growth forecasts have only been marginally lowered compared to September's forecasts:

- headline inflation is expected to slow down from 2.4% in 2024 to 2.1% in 2025 (2.2% previously expected) and to 1.9% in 2026 (no change compared to September's projections)
- "core" inflation (excluding food & energy prices) is expected to slow from 2.9% in 2024 to 2.3% in 2025 (same as in September) and to 1.9% in 2026 (2.0% expected in September)
- GDP growth projections for the Eurozone have been slightly revised lower for the coming two years: after +0.7% in 2024, GDP growth is projected to pick up to +1.1% in 2025 (+1.3% expected in September) and to +1.4% in 2026 (vs +1.5% in September)

December 2024 ECB staff macroeconomic projections				
	2023	2024	2025	2026
HICP	**5.4**	**2.4**	**2.1**	**1.9**
Change compared to September projections	0.0	-0.1	-0.1	0.0
HICP "core"	**4.9**	**2.9**	**2.3**	**1.9**
Change compared to September projections	0.0	0.0	0.0	-0.1
Real GDP	**0.6**	**0.7**	**1.1**	**1.4**
Change compared to September projections	0.0	-0.1	-0.2	-0.1

Source: Bank Syz, FactSet Research

The ECB finds itself in an uncomfortable position as it faces a combination of stagflation and fragmentation pressures in the monetary union.

- The weakness of economic growth at the Eurozone level, below potential for a second year in a row in 2024 alongside an inflation rate still above the ECB's 2% target. Given the ECB's primary mandate of ensuring price stability, the central bank cannot afford to ease its monetary policy in response to weak economic growth if inflation remains above its target.
- On top of that, significant divergences are visible within the monetary union. The "core" of the Eurozone, Germany and France in particular, is experiencing multiple headwinds to activity and is on the brink of recession. In the meantime, peripheral economies such as Spain, Italy, and Greece, enjoy stronger growth dynamics, supported by their service sector.

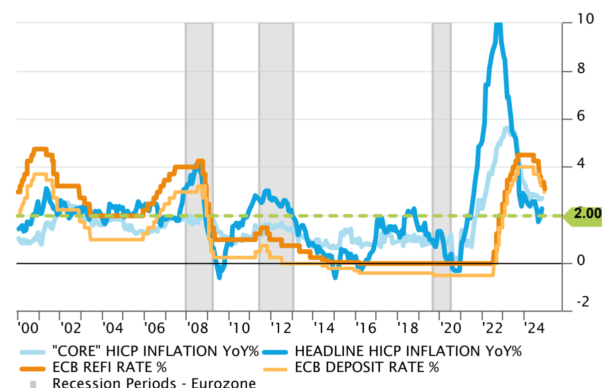
This context prevents the ECB to ease more rapidly its monetary policy stance, which remains significantly restrictive: the policy rate is still above the estimated neutral rate level (1.5%) and the real short-term rate (ECB rate minus inflation) is still clearly positive.

In her press conference, President Lagarde outlined that risks to growth prospects are tilted downwards, as demand for labour continues to weaken and economy is losing momentum. While refraining from country-specific comments, one can easily guess that this statement particularly applies to the German economy, as well as the French.

However, as long as this weakness of the "core" is somehow balanced by resilience in the "periphery" (in a reversal of fortune from the 2010-13 period), the ECB has limited room for manoeuvre in relaxing its monetary policy stance, especially as inflation is still above its target and wages continue to grow at an elevated pace.

This is likely the explanation for the gradual approach followed by the ECB since the first rate cut of this cycle in June 2024. President Lagarde revealed that some discussions around a 50bp cut were held today, but that there had been an overall agreement that a 25bp cut was the right move.

Given the ongoing growth dynamics in the Eurozone, we believe that economic growth will likely continue to disappoint in the first part of 2025, especially if Europe must face an additional headwind in the name of US tariffs. This would be an additional blow to export-sensitive economies such as Germany. Prolonged weakness in activity will likely rapidly ease upward pressures on wages if the labour market deteriorates. Inflationary pressures will likely significantly ease as a result, paving the way for more ECB rate cuts, and possibly at a faster pace. The lack of support from fiscal policy in 2025, due to Germany's debt brake and France's already concerning public deficit levels, could rapidly put the shift the responsibility of supporting Europe's economic growth back on the ECB shoulders, much like in the decade preceding the COVID pandemic. We see here a major difference when looking at the US economy, where stimulative fiscal policy is supporting growth dynamics and inflationary pressures and increasingly pushes the Fed to be cautious when considering rate cuts.



Source: Bank Syz, FactSet Research

SNB

The Swiss National Bank has decided to act decisively yesterday in the current context of weak inflation, upward pressures on the Swiss franc, and worrying dynamics in neighbouring European countries. The 50bp rate cut is a larger move than what most had been expecting for this meeting.

Given the slowdown in inflation dynamics since the September meeting and the additional downward revision of SNB's inflation projections for 2025, this 50bp rate cut however appears fully warranted. Swiss CPI inflation has slipped below 1% in the fourth quarter of 2024 (+0.7% in November) and is expected to slow further in 2025. The SNB expects inflation to hover just above zero (+0.2%/+0.3%) for most of next year before picking up slightly as 2026 draws near. By averaging +0.3% in 2025, the inflation rate would be at the very bottom of the 0-to-2% range that the SNB targets.

As the Swiss economy faces headwinds from the strength of the Swiss franc and the weakness of economic activity in Germany and most other European economies, monetary policy has no reason to be restrictive and had to be adjusted. After yesterday's rate cut, the monetary policy stance is about neutral (with a real short-term rate close to 0%).

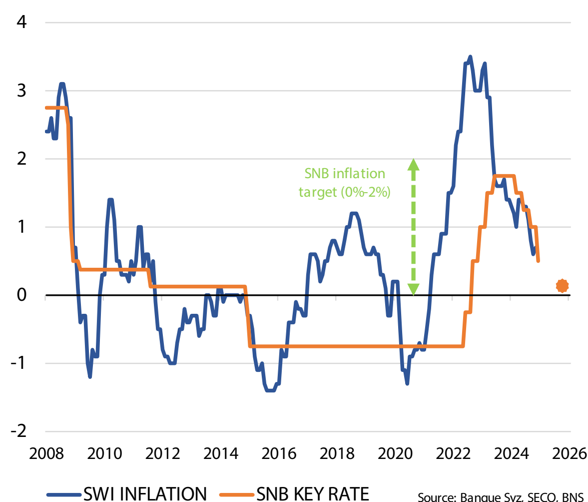
Looking ahead, more rate cuts are to be expected in 2025. We expect the CHF short-term rate to be lowered to 0.0% by June next year, with 25bp rate cuts at the March and June meetings.

Indeed, as inflationary dynamics remain subdued in the Confederation, due to moderate economic growth and the level of the Swiss franc, short-term rates will have to be lowered to 0% for maintaining the monetary policy stance around the neutral level.

With a 0% cash rate and inflation at 0.2% or 0.3%, monetary policy would be slightly tilted to an accommodative stance with a marginally negative real rate that would appear appropriate in a context of moderate and below-trend economic growth.

Yesterday's decision also must be analysed in the context of ongoing developments in Europe. Political uncertainty and instability in France and Germany, worrying growth dynamics in Germany, that continues to err on the brink of recession, and easing inflationary pressures in the Eurozone will lead the ECB to ease significantly its monetary policy soon. A 25bp rate cut in EUR cash rate is expected later today, and more rate cuts will follow in 2025. To prevent an undue appreciation of the Swiss franc, the SNB needs to act boldly to maintain the EUR/CHF interest rate differential.

A return to negative interest rates in Switzerland is unlikely at this point, even if it hasn't been ruled out by SNB Chairman Schlegel yet. Potential undue upward pressures on the CHF will then likely be addressed with interventions on the FX market and a possible expansion of the SNB's balance sheet size. It would require a significant deterioration in global growth and inflation dynamics next year for the SNB to be pushed back into negative interest rate policies, which we believe is unlikely.



Source: Bank Syz, FactSet Research

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