EUR/CHF: Sea change in Swiss National Bank’s FX attitude

For a central bank that acquired close to half a trillion Swiss francs worth of FX reserves in fighting a strong Swiss franc, the Swiss National Bank (SNB) seemingly now welcoming Swiss franc strength has come as quite a shock. Given the SNB's focus on a stable real exchange rate, low inflation in Switzerland points to EUR/CHF trading 4% cheaper next year

Inflation in Switzerland is running around 4% lower than its main trading partner, the eurozone

Keeping it real

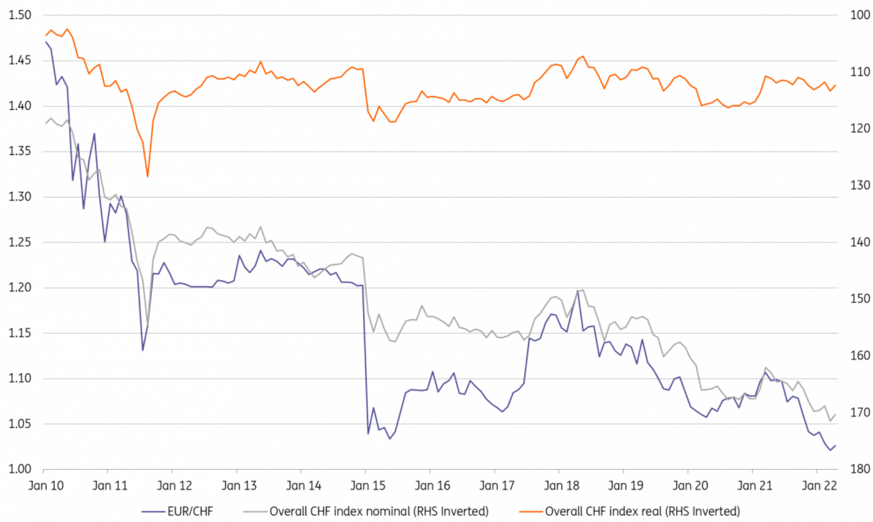
The Swiss franc (CHF) has been the strongest G10 currency over the last five days. Its low and negative correlation with global equity markets has certainly helped in the current risk-averse global environment.

But CHF's strength over the last 24 hours has been helped by comments from SNB president Thomas Jordan. Yesterday he was quoted saying: "The SNB is ready to act if inflation risks materialise". These comments un-nerved a market thinking that the SNB would prefer to delay rate hikes and allow an ECB tightening cycle to lift EUR/CHF off the floor. After all, the SNB has accumulated CHF500bn of FX reserves in fighting CHF strength over the last decade, so surely it would prefer a stronger EUR/CHF?

Apparently not. In an important speech made on 29 April, entitled '*What are the consequences of the war in Ukraine for the SNB's monetary policy?* Jordan made the revelatory point that a weaker real Swiss franc exchange rate would be inappropriate given the inflation threat in Switzerland.

The implication here is that the SNB wants at least a stable real exchange rate. Given that inflation in Switzerland is running around 4% lower than its main trading partner, the eurozone, one could roughly argue that EUR/CHF needs to be 4% lower in nominal terms over the next year to keep the real CHF stable. That would point to EUR/CHF trading under parity this time next year. Or at least the point we have been making over recent weeks is that parity should not be seen as any kind of floor.

Stable real CHF + inflation differential = lower EUR/CHF



Source: SNB, ING

What about SNB rate hikes?

Inflation in Switzerland has risen significantly in recent months, in line with other countries, reaching 2.5% in April. This is above the SNB's target, but still well below what is observed elsewhere, thanks to a favourable energy mix and the relative strength of the Swiss franc, which lowers imported inflation. We expect inflation to remain above 2% for the remainder of the year, averaging 2.3% in 2022, before falling sharply back to 1% in 2023.

Against this background, and also taking into account the fact that the SNB is willing to accept a stronger Swiss franc in nominal terms to avoid a real depreciation, the SNB is likely to seize the opportunity of the ECB rate hike to also embark on a series of rate hikes to normalise its monetary policy. If the ECB starts raising rates in July, then in September and again around the turn of the year as we expect, the SNB should follow suit.

We expect a first SNB rate hike of 25 basis points at the September meeting, a second in December and a final one in March 2023. At the same time, the SNB is likely to continue to express its readiness to intervene in the foreign exchange markets when it deems it necessary, although it will effectively accept a more expensive Swiss franc in nominal terms as the inflation differential is expected to remain high, at just over 4% for the whole of 2022.

Where the CNB goes, will the SNB follow?

Over the last decade, there have been some similarities between the Czech National Bank (CNB) and the SNB when it comes to foreign exchange policy. Both employed FX floors when the zero bound constraint was hit. And both seemingly now want stable or firmer currencies in the support of monetary policy goals. In fact, the CNB intervened to sell EUR/CZK last week after the koruna sold off on the announcement that the next CNB governor would be the more dovish Alex Michl.

Clearly with policy rates at 5.75% in the Czech Republic and -0.75% in Switzerland there are substantial differences in monetary policy. But just as there had been discussions in the Czech Republic over whether massive FX reserves would be formally used to drive EUR/CZK lower, could the same story come to the SNB and EUR/CHF?

The prospect of the SNB outright selling EUR/CHF does seem fanciful right now. But the policy choice of a stronger nominal CHF from the SNB is starting to make the case that EUR/CHF will struggle to sustain any moves above 1.05 over the next 12 months and that our baseline EUR/CHF forecast profile must now be revised lower.

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