Executive Summary KOF Economic Forecast, Autumn 2018

3 October 2018

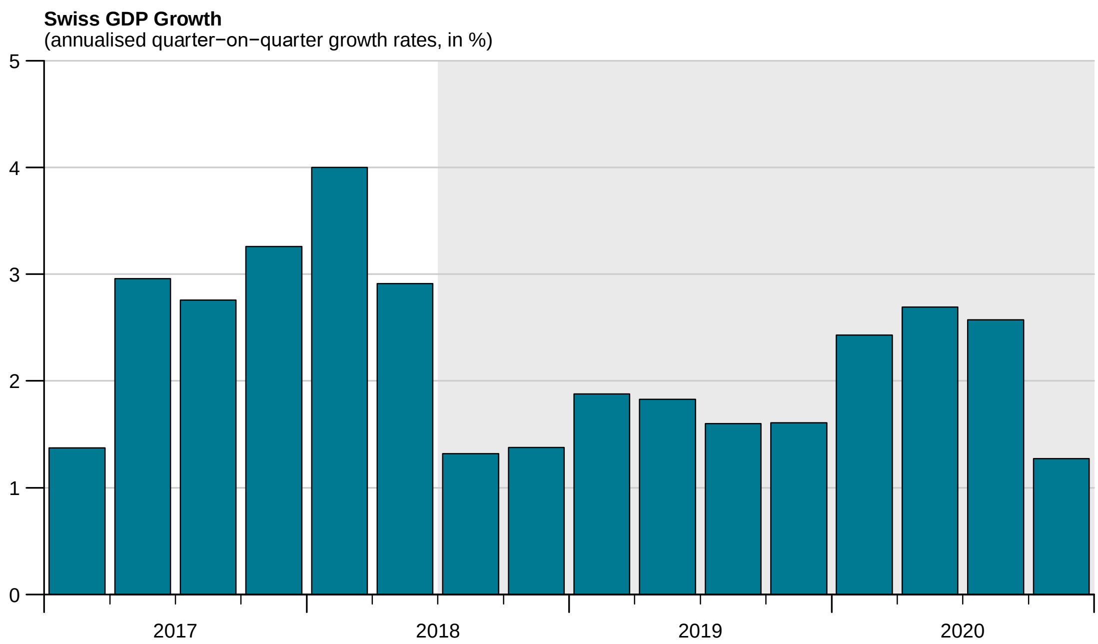
This is a summary of the 2018 autumn forecast for Switzerland, released by the KOF Swiss Economic Institute at ETH Zurich on 3 October 2018, with a forecast horizon now extended to the end of 2020. It first focuses on recent economic developments abroad, which constitute the most important conditioning factors for the Swiss economy, and then presents the main forecast results for Switzerland.

The global environment

The international economy is currently favourable for Switzerland. By the end of the forecasting horizon in 2020, however, the outlook is likely to weaken. In particular, whereas in the second half of 2018 the current global expansion is predicted to accelerate slightly, we expect this to slow starting in 2019. The economic momentum in the developed economies will gradually decline up to the end of the forecast horizon, the main reason for this being increasing capacity constraints. In some globally important emerging markets, liquidity outflows and currency depreciations may dampen or even depress economic activity.

The Swiss economy

Our forecast for Swiss GDP growth is 2.9 per cent this year, 1.7 per cent for 2019 and 2.1 per cent for 2020 − after moderate headline GDP growth of 1.6 per cent in 2017. The quarter-on-quarter figures suggest that the Swiss economy has passed its peak in the growth cycle, which, according to the provisional Swiss GDP statistics, was in the first quarter of 2018. Whilst our forecast suggests that growth rates will weaken somewhat, apart from a mild dip at the end of 2019, the Swiss economy will continue to expand dynamically. The underlying annualised quarter-on-quarter GDP growth rates are shown in the figure below.



The pattern of Swiss GDP growth over time is only of limited help in determining the Swiss business cycle, as the former is distorted by sizeable international spectator sporting events, which are only remotely related to the performance of the domestic economy. Moreover, international commodity trading, for which the business and tax environment has made Switzerland a preferred headquarters location, is long known to contribute significantly, but erratically, to Swiss value added. With the information available to complement the official 'headline' GDP data, we are able to compute an estimate of 'core GDP', which excludes these dimensions. At this stage, the annual core GDP growth estimate amounts to 2.2 per cent in 2017, 2.8 per cent this year, and 1.8 per cent for both 2019 and 2020. Its quarterly breakdown confirms that the growth rate peaked last winter.

Consumer price inflation, disregarding energy prices and seasonal products, was close to 0.5 per cent in the first eight months of the current year – roughly half of the headline figure. Domestic goods prices increased less than the prices of imported goods, reflecting a weaker Swiss franc and higher energy costs. In June, domestic service prices rose more than expected, mainly because of changes in the remuneration schedule for dental services. We see inflation at 1.0 per cent in 2018 and 0.8 per cent in 2019. The decrease next year is due to the lower contribution from imported goods. At the same time, though, domestic price pressures will increase in the coming years owing to higher capacity utilisation and a tighter labour market. The estimate for consumer price inflation in 2020 is 0.7 per cent, reflecting a continuation of these trends.

The Swiss labour market has displayed a strong performance in recent quarters, gaining momentum after a period of relatively mediocre growth. According to the latest figures from the seasonally adjusted job statistics, Swiss firms have created close to 50,000 new full-time equivalent (FTE) jobs since the end of 2017. Many different economic sectors have contributed to this impressive performance, although particularly strong employment growth in the manufacturing sector and in the 'employment activities' sector, which mainly comprises workers at temporary employment agency firms, has been observed. The latter suggests that many firms have experienced high demand, which they have met by hiring workers on a temporary basis. At the same time, an increasing number of firms participating in the KOF Business Tendency Surveys have reported that the problem of finding qualified workers is an impediment to their growth. Consistently, various short-term indicators of the Swiss labour market, such as the KOF Employment Indicator and the number of job vacancies according to the job statistics, have reached levels not seen for several years. The short-run outlook for the Swiss labour market is therefore very positive. We expect the number of FTE jobs to grow by 1.9 per cent year on year in 2018. Although the growth rate will be slightly lower in 2019 owing to the predicted moderation in GDP growth, it will remain elevated at 1.3 per cent. We expect that this will reduce the unemployment rate; accordingly, we are forecasting that the unemployment rate according to the standards of the International Labour Organization (ILO) will decline from 4.7 per cent this year to 4.4 per cent next year. The rate of registered unemployed, published monthly by Switzerland's State Secretariat for Economic Affairs (SECO), is forecast to decline to 2.5 per cent in 2019 (after 2.7 per cent in 2018).

One open question regarding changes in the level of unemployment in the near future pertains to the effects of the 'registration requirement' introduced on 1 July 2018. Since then, employers in Switzerland have been legally required to register at the country's regional employment centres (RAVs) all vacancies in occupations in which the national unemployment rate is at least 8 per cent. This has substantially increased the number of vacancies in those occupations registered on the internet platform of the public employment service. Following the introduction of this law, the total number of vacancies registered at the RAVs has risen from roughly 30,000 in the spring of this year to 82,000 in August, suggesting that employers have complied with the new regulation.

Wage earners will benefit from the strong labour market, albeit with a one-year time lag. According to the Swiss wage index, real wages will most likely stagnate in 2018 following forecasts of paltry nominal annual wage growth of 0.8 per cent combined with the return of inflation to Switzerland. We anticipate that the growth in consumer prices will fully offset the growth in nominal wages. This is expected to change in 2019 when nominal wage growth will slightly outpace inflation.

Private consumption is by far the largest Swiss demand component. The first two quarters of 2018 produced rather moderate increases in consumption expenditure. One reason was unusually low spending on housing and energy. In line with our labour market and inflation forecasts, real disposable nominal income is expected to grow by 3.2 per cent although, given the slow start, real growth in private consumption will reach only 1.4 per cent in 2018. The sharp increases in disposable income – partly on the back of higher employment – this year and next should sustain consumer spending, resulting in growth rates of around 1.7 per cent in 2019 and 1.5 per cent in 2020.

Given Switzerland’s debt brake and its established culture of conservative budgeting, real government consumption is expected to grow sluggishly by 1.1 per cent this year and 1.3 per cent in 2019, falling back to 0.7 per cent in 2020.

Unlike the short and pronounced investment cycles observed in the past, the Swiss economy is currently experiencing a relatively protracted investment cycle with comparatively moderate growth rates. The peak of this unusual cycle occurred in 2017. After yet another quarter of high capital spending in the first quarter of 2018, investment activity moderated during the second quarter, mostly as a result of weaker research and development expenditure and lower investment in aircrafts. We consider the sluggish second quarter to be a temporary pause and expect investment activity to return to higher growth rates by the end of 2018. For 2019 and 2020 we are forecasting that the present investment cycle will continue, albeit with declining growth rates. Lower anticipated growth in the world economy, the recent decrease in capacity utilisation in Switzerland and the rise in the relative price of capital will be the factors driving this reduction in investment growth rates.

The Swiss construction sector got off to a positive start in 2018. Given the strong domestic economy, we expect construction investment to expand by 1.9 per cent in 2018. Over the following two years, rising interest rates and sluggish demand will dampen residential construction, and institutional investors’ sentiment about residential building will remain a downside risk. Non-residential construction investment has comparatively better prospects, supported by a number of huge projects, and two infrastructure funds will provide additional momentum. We thus expect the civil engineering sector to replace residential construction as the building sector’s growth engine. In total, we are forecasting real construction investment growth of 0.6 per cent in 2019 and 0.3 per cent in 2020.

Swiss exports provided a substantial boost to GDP growth in the first half of 2018, buoyed by increasing international demand and the (hitherto) favourable exchange rate. Manufactured goods contributed most to this growth. We observed higher tourism exports in line with the recovery in the domestic tourism sector after the 2015 currency shock. Exports of other services, however, continued to be sluggish. The export sector is expected to remain supportive to GDP growth, although some loss of momentum is anticipated in the third quarter of 2018 owing to the recent appreciation of the Swiss franc and rising uncertainties related to international trade disputes. Nevertheless, our baseline scenario predicts that global economic growth will remain supportive to Swiss exports of goods and services.

The current economic expansion in Switzerland is broad based. The Swiss manufacturing sector has experienced a surge in gross value added during the last six quarters, contributing significantly to the present economic upswing. Until recently, the main driver in manufacturing was the pharmaceutical sector and, to a lesser extent, the watch industry. Currently, however, the upswing is quite broad based and encompasses sectors previously suffering heavily from the appreciation of the Swiss franc, such as the engineering and metalworking industries. In addition, the service sectors have also experienced solid growth of late. Although manufacturing will not be able to sustain the recent pace of expansion, it will be the main driver of growth. Service sectors should contribute equally. The outlook for construction is fairly stagnant, albeit at a high level.

Although the Swiss central bank's 'unconventional' policy – with an interbank target rate of minus 0.75 per cent – is likely to continue for another year, we expect the first adjustments to be made before the end of our forecasting horizon. In the US, a strong economy, low unemployment and signs of increasing wage pressures have led the Fed to raise its federal funds target range to 2.0−2.25 per cent. The European Central Bank (ECB) now finds that the economy is strong enough for inflation to converge to the ECB's target even after the gradual winding-down of net asset purchases. The ECB currently expects its purchase programme to end in December 2018, while short-term interest rates are likely to remain at their present levels for at least another year. In Switzerland, inflation risks are for the time being contained thanks to subdued domestic price pressures and the recent appreciation of the Swiss franc. Accordingly, we currently expect to see the Swiss National Bank's first rate hike towards the end of 2019.

Asymmetric forecast risk profile

Considerable downside risks to our forecast are worth mentioning. Above all, a slump in international trade due to further intensifying trade wars could hit Switzerland badly. Moreover, with a hard Brexit looming and the potential revival of concerns about the stability of the euro, the Swiss franc – a traditional safe-haven currency – could appreciate sharply and consequently choke Swiss exporters' recovery from the 2015 appreciation shock. At present, we do not see any upside risks of a similar magnitude, so the current risk profile is markedly asymmetric.

Further information about the KOF Economic Forecast can be found via:
https://www.kof.ethz.ch/en/forecasts-and-indicators/forecasts/kof-economic-forecast.html →