ETH zürich KOF

Executive Summary KOF Economic Forecast, Winter 2018/2019

13 December 2018

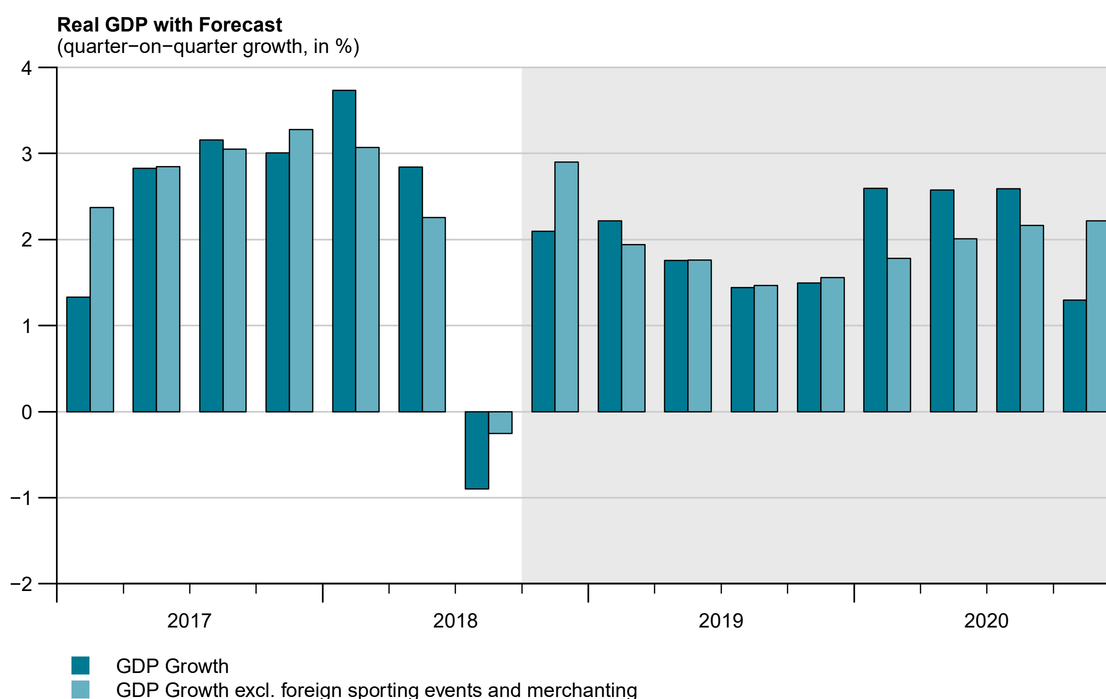
This is a summary of the 2018 winter forecast for Switzerland, released by the KOF Swiss Economic Institute at ETH Zurich on 13 December 2018, with a forecast horizon until the end of 2020. It first focuses on recent economic developments abroad, which constitute the most important conditioning factors for the Swiss economy, and then presents the main forecast results for Switzerland.

The global environment

During this year, the state of the world economy has become somewhat less favourable for Switzerland. While the US economy still benefits from strong fiscal stimulus, the euro area and major Asian economies have been slowing down. The risk of a rapid downturn in 2019 has increased lately. However, the signs of a soft landing for the global economy still prevail, even though down side risks stemming from, e.g., the unclear Brexit situation, the recent political turmoil in France, the dispute on the Italian budget plans and the trade dispute between the United States and China weigh on the economy.

The Swiss economy

Our forecast for Swiss GDP growth is 2.6 per cent this year, 1.6 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 reveal that the Swiss economy has passed its peak in the growth cycle which, according to the provisional Swiss GDP data, was during the first quarter of 2018. The same statistics recently delivered a surprise, showing that third-quarter GDP growth was negative. Whilst this does not stand in complete contrast to the broader picture from the international economy or the current indicators for Switzerland, we consider this sharp decline in growth to be an outlier. Our forecast suggests that we will see a rebound in the fourth quarter; after that, growth rates will weaken somewhat, before returning to around potential. 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. Apart from this, 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 1.9 per cent for 2017, 2.5 per cent for this year, 1.7 per cent for 2019 and 1.8 per cent for 2020.

Inflation has remained low in the second half of 2018 at close to 1 per cent. Core inflation is only about half of the total. Inflation of domestic goods and services remains close to half a per cent, and that on imported goods and services passed its peak in the summer, as expected. The increase in rents reported in November and the estimated growth in wages were low. The prices of aviation and package travel have also been significantly lower in recent months than in previous months. Compared with autumn, the forecasts for this year and next are slightly down. This mainly reflects the significant decline in oil prices as well as slightly lower expected services price inflation. The outlook for 2020 remains unchanged. Overall, the risk of inflation remains low, even if the core rate is likely to rise.

Employment has grown strongly and unemployment has fallen in 2018. Employment has grown even in industries such as the accommodation and food service sector and others that have created hardly any jobs for years. Seasonally adjusted unemployment, according to the figures from the State Secretariat for Economic Affairs (SECO), recently decreased to a low 2.4 per cent (with part of the decline compared with the previous year due to technical changes in the recording of the unemployed). Even the unemployment rate according to the International Labour Organization, which had previously been just under 5 per cent for years, suddenly fell to a seasonally adjusted 4.3 per cent in the third quarter of 2018. Although overall employment growth slowed somewhat in the third quarter compared with the beginning of the year, the outlook for the labour market remains positive, as numerous labour market indicators are pointing to high levels. Accordingly, we expect the Swiss labour market to continue to perform well in the fourth quarter of 2018 and at the beginning of 2019. We are forecasting that full-time-equivalent employment will grow by 1.1 per cent in 2019 after 1.8 per cent in the current year. The number of people employed is expected to increase by 1.5 per cent in 2019. The SECO unemployment rate will remain at its current level, averaging 2.4 per cent next year (after an average of 2.6 per cent in the current year). The unemployment rate according to the ILO will evolve similarly; we are forecasting that it will continue to decline slightly and then stabilise at just over 4 per cent.
After three good years, wage earners in Switzerland are currently facing less rewarding times. Although nominal wages rose comparatively little in the years 2014 to 2016, the purchasing power of wages increased as consumer prices declined. This led to considerable annual growth in real wages. Since 2017, this trend has been reversing. Real wages stagnated in 2017 and are likely to have fallen in 2018 owing to slightly higher inflation. 2019should should turn out a little better. After an estimated 0.6 per cent this year, we expect growth of the Swiss wage index of about 1 per cent next year according to the Swiss wage index. Average wages according to national accounts which, in contrast to the Swiss wage index, also factor in bonuses and wage variations due to changes in the sector structure, are likely to grow at a similar rate. With consumer price inflation forecasted at 0.6 per cent for next year, this will allow for a small increase in the purchasing power of wages.

Private consumption is by far the largest Swiss demand component, and in the near future it will become an important growth driver for the Swiss economy. In the third quarter of this year, the emerging positive trend in private consumption was still masked by various one-off factors. The hot and dry summer as well as the delivery difficulties experienced by some foreign car manufacturers almost caused consumer spending to

stagnate. The numbers of passenger cars registered in the third quarter of 2018 were low compared with last year. In the retail sector, price-adjusted clothing sales were weak, especially in September. However, employment will increase and nominal earnings and households' real disposable incomes rise more than previously, this will pave the way for an expansion in consumer spending. Private consumption should thus grow by around 1.2 per cent next year after a price-adjusted 1 per cent this year. In 2020, private consumption could increase by about 1.6 per cent.

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, 1.5 per cent in 2019, and falling back to 0.8 per cent in 2020.

In the third quarter there was a surprisingly sharp fall in equipment investment. Although we had already anticipated a decline in this spending in our autumn forecast in the third quarter, the severity of this decrease was clearly underestimated. Except for industrial machinery, all sub-components of equipment investment declined, and one-time factors additionally exacerbated this slump. In the current quarter we expect to see investment rebound. Neglecting one-off factors (acquisitions of aircraft and trains), the investment cycle that has been ongoing since 2015 will come to an end and will then reach its trough in the winter of 2019/20. Notably, this marks the end of an unusually flat and protracted investment cycle, which differs significantly from the typically shorter and more accentuated cycles observed since the 1980s.

The Swiss construction sector is currently performing well, albeit not as dynamically as during the construction boom of 2008-14. Investment in infrastructure is driving the construction industry. Rising interest rates from 2019 onwards and subdued demand (weaker immigration, macro-prudential measures) are slowing down housing construction. Excess capacity is beginning to appear, which is reflected in higher vacancy rates. Institutional investors are still investing heavily, but they are becoming more cautious about property selection. As companies currently have more scope for expansion and replacement investment in buildings, however, industrial and commercial construction should perform strongly from 2019 onwards. Numerous large-scale projects are supporting this sector. Construction of educational and healthcare buildings is performing solidly but is losing momentum compared with recent years. Civil-engineering investment in Swiss infrastructure is supporting the construction sector. The Railway Infrastructure Fund was introduced in 2016, followed by the National Road and Agglomeration Transport Fund in 2018. Civil engineering could thus replace the housing sector as a driver of the Swiss construction industry.

Foreign trade performed poorly in the third quarter of 2018. Exports of goods fell sharply and service exports, with the exception of tourism, also declined. Foreign demand has weakened across the board in comparison with the first half of 2018. The appreciation of the Swiss franc against the euro also weighed on exporters. Weaker momentum was recorded in virtually all export categories and markets. In addition, one-off effects pushed exports further into negative territory. For example, the interruptions in German car production are likely to have had a negative impact on Swiss suppliers. The sharp decline in exports from the chemical and pharmaceutical industries is even more significant. Exports are likely to pick up again in the fourth quarter, driven by catch-up effects. Against the backdrop of a cooling economy in Europe, we expect to see weaker export momentum, especially for goods, in the coming year. By contrast, trade in services should continue to boost Swiss GDP.

The surprisingly negative GDP growth in the third quarter of 2018 was for the most part due to one-off factors. The diesel emissions scandal left its mark on the gross value added by suppliers to the auto industry. In addition, sales of cars in Switzerland were affected significantly. Moreover, the retail sector suffered from the extreme weather conditions during the summer. The exceptionally warm and long summer caused a decline in demand for autumn outfits, which hit clothing sales. The extraordinary weather conditions also had a

negative impact on electric power generation, where the exceptionally low levels of precipitation resulted in lower electricity generation by river and storage power stations. The drop in sales in the pharmaceutical industry during the third quarter of 2018 constitutes another one-off factor. We expect sales in the pharmaceutical industry to rebound in the fourth quarter of 2018, compensating for their weak level during the third quarter. Given the worse international economic outlook, however, the growth rate for the gross value added by the manufacturing sector has been revised downwards slightly for 2019 and 2020. This will see a somewhat weaker, albeit solid expansion in Swiss economic activity in 2019 and 2020.

Switzerland's 'unconventional' central bank policy stance, with its interbank target rate of −0.75 per cent, is likely to continue for another year, although we expect to see initial changes before the end of our forecasting horizon. We continue to forecast a gradual tightening by the US Federal Reserve over the next two years, albeit at a slower pace, also owing to recent increases in international risks. As expected, the European Central Bank is taking its time with its first hike in key interest rates. Crucial factors here are persistently low core inflation as well as risks and uncertainties associated with – among other things – Brexit and upheavals in financial markets. Nonetheless, we still expect the ECB to follow the US's interest-rate hikes next summer, even though the likelihood of this scenario has decreased. The Swiss National Bank confirmed its negative rate at its September meeting. At present, interest rates seem to be an adequate tool to protect Swiss exporters from excessive appreciations of the Swiss franc, since the central bank's current accounts provide no evidence of any foreign-currency interventions by the SNB. As its board of directors is unlikely to risk any significant appreciation in future, and inflation will remain low for the time being, interest-rate policy will continue to be geared towards the ECB for now.

Asymmetric forecast risk profile

Considerable downside risks to our forecast should be mentioned. A slump in international trade due to intensifying trade wars could hit Switzerland badly. Moreover, with a hard Brexit looming, social protests in France, an unresolved quarrel in the EU on the Italian budget plans and an increased likelihood of seeing the asset-price bubble burst rather than, the Swiss franc as a traditional safe-haven currency could appreciate sharply and consequently impair or even eliminate the price competitiveness of Swiss exports. At present, we do not see upward risks of comparable magnitude, so the current risk profile is more asymmetric than usual.

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 →