Executive Summary KOF Economic Forecast, Autumn 2019

2 October 2019

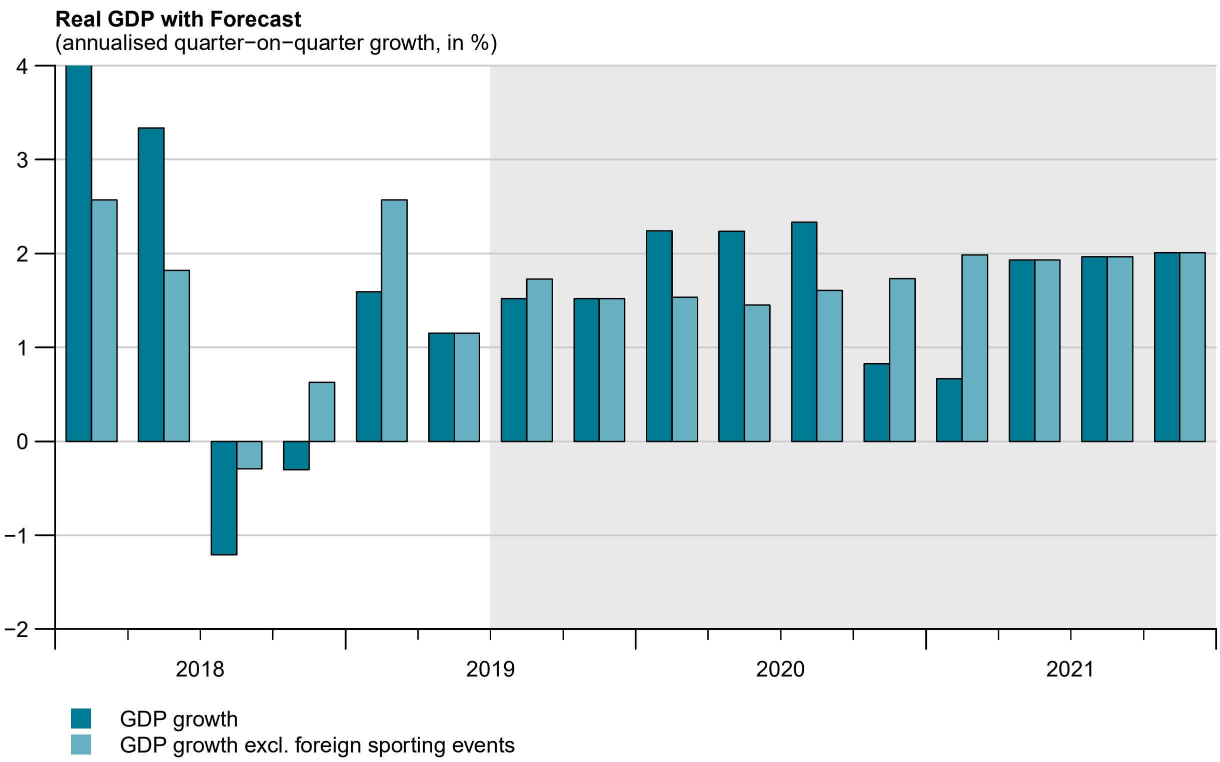
This is a summary of the 2019 autumn forecast for Switzerland, released by the KOF Swiss Economic Institute at ETH Zurich on 2 October 2019, with a forecast horizon up to the end of 2021.

The international environment for the Swiss economy has deteriorated further in recent months. The economy in the euro area weakened in the second quarter of 2019, while total economic output in Germany actually fell. In addition, global trade contracted significantly in the second quarter following what had already been two negative quarters. For the coming quarters KOF expects relatively subdued economic activity in Switzerland's international environment.

Monetary expansion continues

The worsening of the global economic outlook as well as muted inflationary pressures led to further expansionist monetary policies in the major currency areas. At its last two meetings the Federal Open Market Committee (FOMC) lowered its target rate by a total of 50 basis points (bp), although unemployment rates are at historic lows and wages continue to grow. In light of the ongoing trade dispute the actions of the FOMC can be interpreted as a precautionary measure to shield the US economy from a possible downturn.

We expect the Federal Reserve (Fed) to gradually reduce rates to 1.25-1.5 per cent by mid-2020. At its September meeting the European Central Bank (ECB) cut its deposit facility rate by 10bp and announced the resumption of its asset purchase programme (APP) of 20 billion net purchases per month. This is the first time that the ECB's forward guidance has left future changes to its APP unspecified. The ECB is expected to lower its deposit rate by a further 10bp in December.



In contrast to the ECB and the Fed, the Swiss National Bank (SNB) has not yet changed its target rate. To prevent the Swiss franc from appreciating and to keep deflation at a safe distance, however, the SNB is likely to follow the ECB's move within the next few months. This is supported by the decision to increase banks' exemption thresholds for sight deposits held at the SNB, thereby reducing negative interest payments for the banking sector. Mirroring the expansionist stance of global monetary policy, long-term yields have even dropped below the previous all-time lows. Although they have already recovered somewhat, they are likely to stay very low throughout the forecast horizon. The exchange rate against the euro is expected to remain stable at around 1.09 EUR/CHF, which is 4 cents lower than our last forecast.

Switzerland's public finances in surplus again

In recent years the Swiss authorities have regularly underestimated budget surpluses at the federal and cantonal levels as well as in the social security system. This year the federal government will have an unexpectedly high budget surplus of over 2 billion Swiss francs. Although tax revenues will decrease in 2020 owing to the implementation of corporate tax reforms, the federal and cantonal governments still expect to have yet another budget surplus in 2020, partly caused by the encouraging situation on the labour market. At the municipal level we are forecasting balanced budgets or even small budget deficits rather than any budget surpluses.

The surpluses at both the federal and cantonal levels would in principle permit a strong increase in public consumption. However, the implementation of corporate tax reforms in 2020 and 2021 does create uncertainty about tax revenues. We therefore expect public consumption to increase only modestly in 2020.

Weak exports

The slowdown of the world economy in the course of 2019 has weighed on the export sector in Switzerland. Total exports (excluding valuables) declined by an annualised 2.3 per cent in the second quarter of 2019 owing to lower net earnings from merchanting and subdued exports of manufactured goods and services. Imports were 2.6 per cent lower compared with the previous quarter.

In the manufacturing sector, exports of machinery and electronics continued to weaken and the outlook remains gloomy. Exporters of watches suffered from lower demand from Hong Kong and Europe. Export growth in the pharmaceutical industry remained stable. The ongoing recovery in the domestic tourism sector was reflected in increased tourism exports, while exports of other services remained sluggish.

The performance of the export sector is likely to remain subdued in the coming quarters. The continued slowdown of the world economy, sluggish international trade, the recent appreciation of the Swiss franc and uncertainties relating to the trade dispute between the US and China are important factors weighing on Swiss exports.

Overcapacities and uncertainty curbing investment

Construction investment is losing momentum. Growth has slowed to 0.4 per cent in 2019. KOF expects construction investment to decline in 2020 (by 0.5 per cent) and to stagnate in 2021 (0.0 per cent) because of overcapacities and rising vacancies in the residential construction sector. Institutional investors searching for yield have invested heavily in multi-family dwellings in recent years, causing imbalances in the Swiss housing market. New self-regulatory guidelines in the financial industry focusing on investors in the rental housing sector will be introduced from 2020 onwards.

However, the implementation of the two infrastructure funds (roads and railways) is supporting civil-engineering investment, thereby compensating for the decline in residential construction.

The international economic environment is characterised by major political and economic uncertainty, sluggish world trade and weak economic activity in the euro area. This is having a negative impact on the Swiss economy in general and on investment in machinery and equipment in particular.

The recent investment cycle of only moderate growth rates ended in spring 2018. Investment growth in machinery and equipment slowed to roughly 1 per cent in 2018, down from 4.6 per cent in 2017. This slowdown is common across all investment categories.

Many indicators support the view that the necessity and willingness for firms to invest has decreased. According to the latest KOF Investment Survey, Swiss firms have already scaled back their investment activities in 2019 and intend to reduce them even further in 2020. New order intake is sluggish and leading indicators are generally at low levels. Capacity utilisation in the manufacturing sector fell below its long-term average to its lowest level since the end of the financial crisis. Furthermore, recent profits are not expected to provide any impetus for pronounced investment activity. For the near future we therefore expect investment to continue to be low by historical standards despite uniquely favourable financing conditions. We project investment growth to slow down further to 0.6 per cent in 2019 and to only gradually pick up over the course of the next few years. In 2020, dynamics in machinery investment will mostly be driven by deliveries of new air and rail vehicles in the transport segment.

Labour market

Although the economic situation has deteriorated owing to the gloomier international economic situation and outlook, the Swiss labour market is not yet showing any pronounced signs of a slowdown. In fact, various leading indicators for the labour market remain at high levels. Nevertheless, there have been signs of a trend reversal in recent weeks. For the first time since the beginning of 2016, for instance, the rate of job seekers in manufacturing has risen slightly and the number of short-time workers has increased. Overall, our short-run outlook for the Swiss labour market is thus neither positive nor particularly negative. KOF’s nowcasting and short-term forecasting models predict modest employment growth for the third and fourth quarters of 2019. Employment may decline in cyclically sensitive, export-driven sectors. For 2019 we predict that full-time-equivalent employment will grow by 1.2 per cent. KOF expects this growth rate to fall to 0.8 per cent in 2020 and 2021.

We expect that the relatively low rate of job growth will push up unemployment slightly. The unemployment rate as defined by the International Labour Organization (ILO), which was 4.4 per cent in the second quarter of 2019, will remain constant and then slightly increase to an average of 4.5 per cent in 2021. The registered unemployment rate, as published monthly by the State Secretariat of Economic Affairs (SECO), is forecast to rise from its current 2.3 per cent to 2.5 per cent in 2020. The levels of unemployment in the near future will partly depend on the effects of the ‘job registration requirement’ introduced on 1 July 2018.

The data suggest that wage earners have not benefited from the strong performance of the labour market over the last two years. Real wages – as measured by the Swiss wage index – declined slightly in 2017 and 2018. Moreover, it looks as if there will be no major real wage growth in 2019 either. Based on the data for the first half of this year, KOF expects nominal wage growth of only 0.6 per cent according to the Swiss wage index. After allowing for projected inflation, this will result in only a very small increase in real wages. For 2020, KOF is forecasting nominal wage growth of 0.8 per cent according to the wage index. Given expected consumer price inflation of 0.3 per cent, this would result in real wage growth of a moderate 0.5 per cent.

Modest increase in private consumption

The growth rate in consumer spending was relatively low in 2017 and 2018. Only a modest increase of 1.1 per cent is expected in 2019. Although real disposable incomes are rising significantly – in particular owing to low inflation and growing employment – individuals are saving a large proportion of their surplus income rather than spending more on consumption. According to the latest consumer sentiment index and retail trade sales, however, households have recently become more willing to consume. We expect consumer spending to rise faster in 2020 and 2021, which will make a major contribution to GDP growth. If we look at the various consumption components, projected expenditure on healthcare services and telecommunications will rise the most sharply.

Prices: consumer price inflation expected to slow

According to the Swiss Federal Statistical Office (FSO), consumer price inflation was 0.3 per cent in July and August, which was down on preceding months. This downward trend mainly reflected lower service price inflation as the strong increase in prices of dental services in July of last year dropped out of this year-on-year growth rate. Rents rose only modestly from July to August, reflecting higher vacancy rates. Underlying inflationary pressures remain low as wage inflation stays low. Looking ahead, we expect inflation to slow in the coming months before picking up later on in 2020. Compared with our June projections we have revised the inflation outlook downwards for both years, reflecting the deterioration in the overall economic outlook and the appreciation of the Swiss franc. KOF is now forecasting annual inflation of 0.4 per cent for 2019 and 0.3 per cent for 2020. We expect inflation to rise slightly to 0.5 per cent in 2021.

Decline in the construction sector; output gap remains negative

The construction industry has been an important stabiliser in recent years. It will continue to play this role, albeit to a lesser extent. Although civil engineering and commercial construction continue to perform well, our forecast for residential construction is somewhat more pessimistic. For some years now the number of newly built apartments has been higher than the increase in the number of households. Despite record-low mortgage interest rates we therefore expect to see a slow decline in production in this construction segment.

On the other hand, the situation in the retail sector has improved somewhat. Although the stronger Swiss franc may cause an increase in cross-border shopping, we do not expect to see a significant effect. Uncertainty about oil production in the Middle East going forward and ongoing international trade conflicts is fuelling greater volatility in commodity prices. Although this is not good news for the manufacturing industry, it is beneficial to merchanting, which now generates 5 per cent of Switzerland's value added. In such an environment it is possible for this sector to increase the number of transactions as well as its margins.

We are cautiously optimistic about the financial sector. Although traditional interest-spread business is suffering in an environment of negative interest rates, asset management and the demand for currency hedges and insurance products are hardly slowing. However, the worsening of the situation in many emerging markets is curbing the rapid growth in demand for insurance products from those markets.

The implementation of corporate tax reforms at the federal and cantonal level will probably lead to cautious spending policies and therefore generate little economic stimulus. It is also unlikely that these reforms will trigger large-scale foreign direct investment, but the probability of existing foreign firms migrating has diminished. However, sectors such as education and healthcare should continue to grow at above-average rates. Although growth in the healthcare sector has recently been somewhat weaker, an ageing and growing population will continue to have a positive impact on both sectors.

According to KOF estimates the output gap was slightly negative last year. This means that overall economic capacity utilisation was below average. Compared with 2017, however, this gap was reduced. This process will stall and the output gap will increase slightly in 2019 and 2020 before decreasing slightly in 2021.

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 →