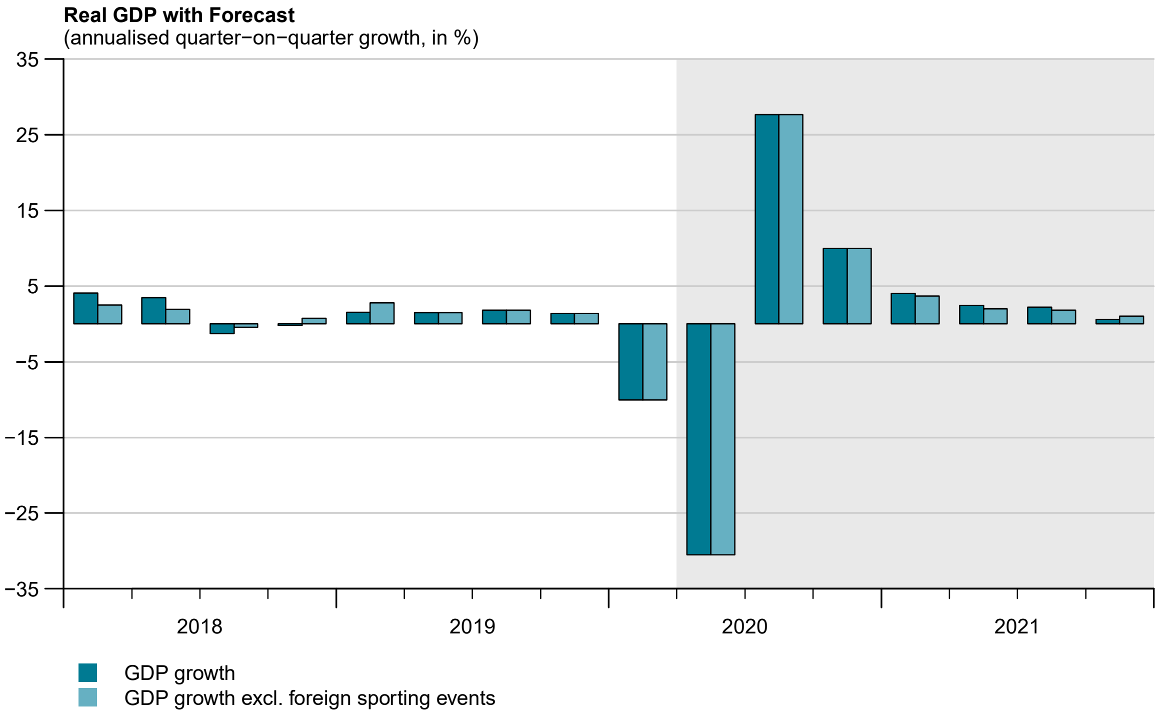
Executive Summary of KOF's Economic Forecast for Summer 2020

16 June 2020

This is a summary of the 2020 summer forecast for Switzerland, released by the KOF Swiss Economic Institute at ETH Zurich on 16 June 2020, with a forecast horizon up to the end of 2021.

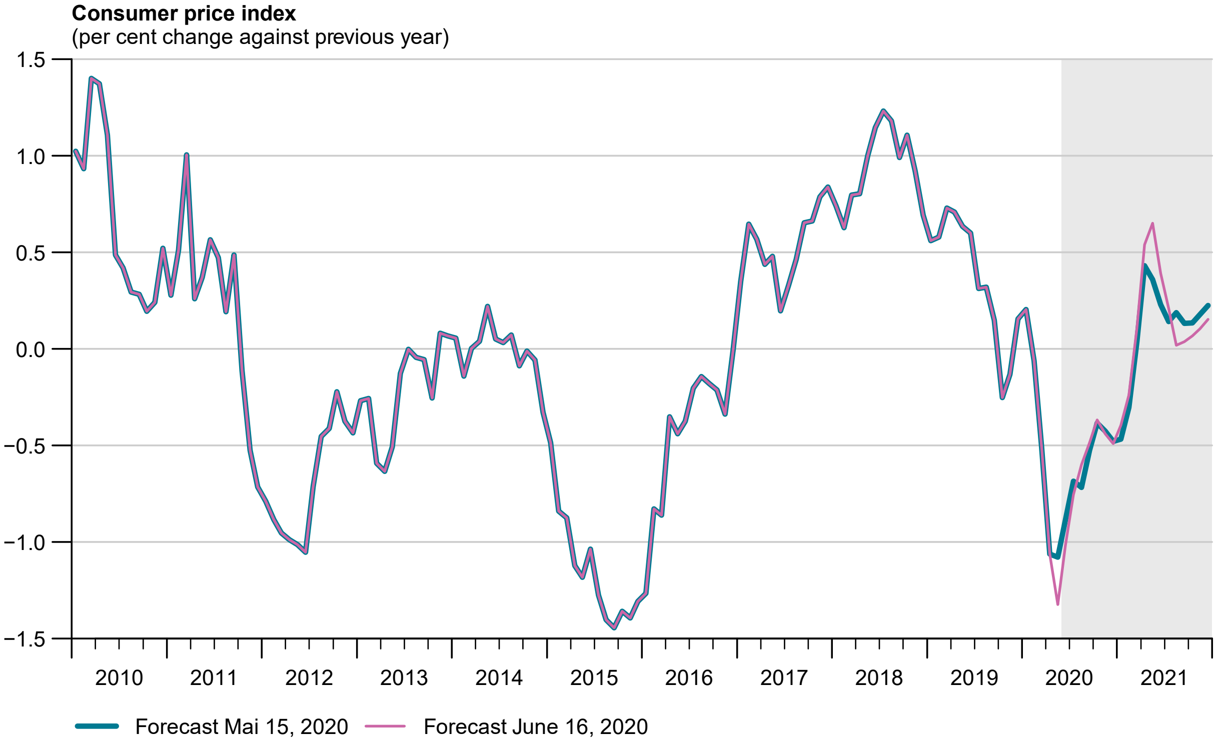
Swiss economy is weathering the crisis well by international standards
The Swiss economy experienced a sharp downturn as a result of the coronavirus crisis. This began in March and reached its lowest point in the first half of April, when gross domestic product (GDP) was estimated to be 16 per cent below its level at the end of 2019. A recovery began in the second half of April and is still continuing. Nevertheless, aggregate economic output is likely to fall sharply for 2020 as a whole, with KOF forecasting a decline of 5.1 per cent in annual GDP. This would be the lowest figure since the crisis year of 1975.



On an international comparison the Swiss economy is weathering this severe global crisis relatively well, according to our forecast. Switzerland's GDP growth rate for 2020 is less negative than in most neighbouring economies. At around 97 per cent of pre-crisis levels its GDP at the end of 2020 will be higher than in other countries.

KOF is forecasting weak economic activity for 2021, with indirect effects of the coronavirus crisis having a dampening effect. However, the considerable backlog from 2020 will result in a very high GDP growth rate of 4.3 per cent for 2021 as a whole. We expect GDP at the end of 2021 to have returned to roughly the same level as at the end of 2019.

The slump in oil prices since February of this year has reduced inflation sharply. The core rate is also likely to fall considerably in the coming months owing to the lack of aggregate economic demand and may even temporarily drop below zero. KOF is forecasting that the national consumer price index will decline by 0.6 per cent for 2020 as a whole and that it will increase by 0.2 per cent for 2021.



COVID-19 pandemic hitting not just retail and hospitality but also industry
The coronavirus crisis is affecting the individual sectors of the Swiss economy to varying degrees. At the bottom end of the scale comes the hospitality sector, whose output in the second quarter of 2020 is estimated to be 56 per cent lower than in the final quarter of 2019, followed by the arts and entertainment sector, which is down by 26 per cent. At the other end of the spectrum is the public sector, which has come through the crisis without any losses. This is due to the fact that output here is primarily measured in terms of wages. Output in the industrial sector (including agriculture) is likely to be 13 per cent lower in the second quarter than at the end of 2019. This slump is much more pronounced than in construction (down by 9 per cent) and almost as drastic as in the combined retail, transport and hospitality sectors (15 per cent lower).

The recovery in the above-mentioned service sectors should be relatively strong in the second half of the year, as the gradual removal of the restrictions imposed by the social-distancing and hygiene measures will allow robust growth. We forecast that output levels in the retail, transport and hospitality sectors at the end of 2020 will be similar to those in industry (around 95 per cent of pre-crisis levels). Output in all of these sectors should have returned to its pre-crisis levels by the end of 2021.

Fiscal policy is counteracting the crisis
Switzerland's degree of fiscal expansion has increased sharply in response to the abrupt economic slump, thereby significantly mitigating the crisis. Additional coronavirus-related government spending, including social security contributions, is expected to generate a fiscal stimulus of 3.6 per cent of potential GDP this year. Around two-thirds of this is additional spending on short-time working compensation and unemployment insurance. These automatic stabilisers will be supplemented by additional spending on public consumption and transfers. This includes income support for the self-employed. For the coming year we expect a negative fiscal stimulus of 1.4 per cent. On an international comparison Switzerland is in the middle to lower range in terms of fiscal stimuli to cushion the economic impact of the pandemic.

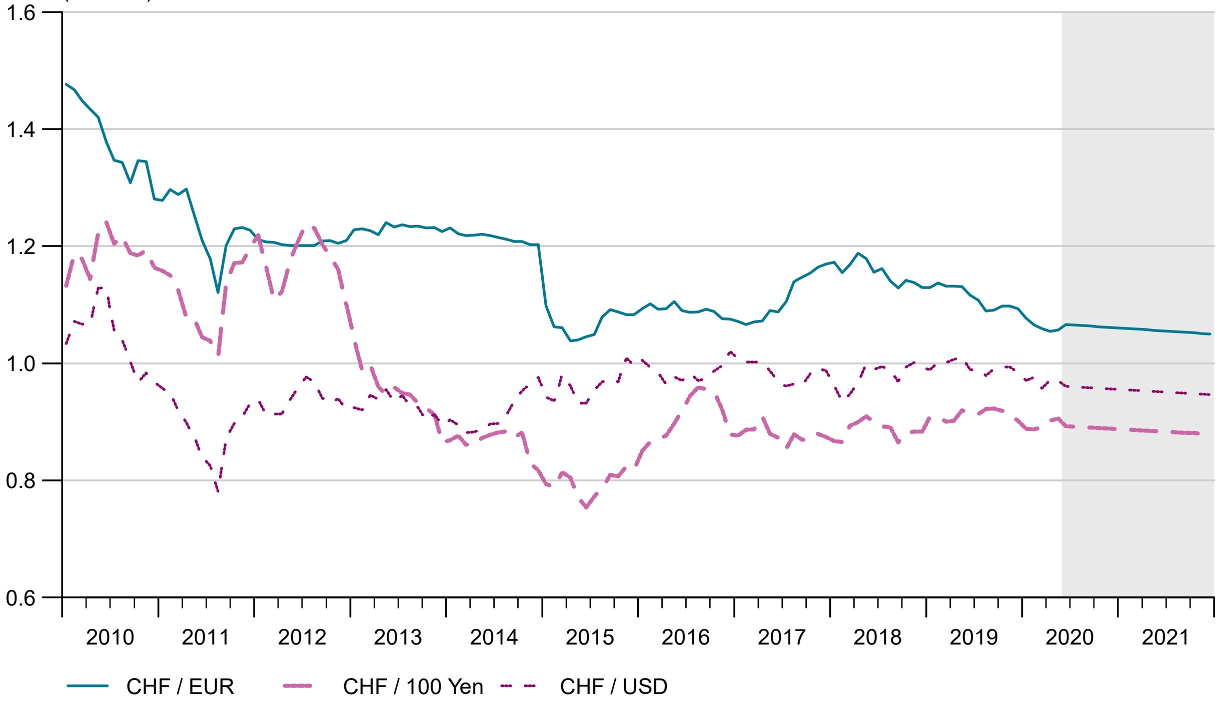
High government deficits are expected in the wake of the crisis because, in addition to rising public spending, tax revenues will plummet. For this year and next we are forecasting overall government deficits of 3.6 per cent and 3.0 per cent of GDP respectively. If all taxes were accounted for on an accrual basis, this year's deficit would be 6.7 per cent of GDP. The federal debt ratio is likely to rise from around 27 per cent of GDP last year to around 33.5 per cent in 2021.

Stable franc as top priority
In addition to fiscal policy, monetary policy also plays an important role in supporting the economy. The gradual appreciation of the Swiss franc against the euro, which began in 2018, has hardly intensified at all in the wake of the coronavirus crisis. The absence of any safe-haven appreciation is likely to be due to the strong

interventions by the Swiss National Bank (SNB) in recent months. This is suggested by the massive increase in sight deposits at the SNB since January. However, other factors such as the federal government's COVID-19 lending programme probably also play a role in the movements of sight deposits. Any appreciation in the franc would hit the Swiss real economy hard. The SNB's currency market interventions are therefore providing strong monetary policy stimulus for Switzerland.

In making this forecast, KOF is assuming that short-term and long-term interest rates will remain unchanged and that the Swiss franc's real exchange rate against the euro will remain stable.

Exchange rates, with forecasts
(nominal)



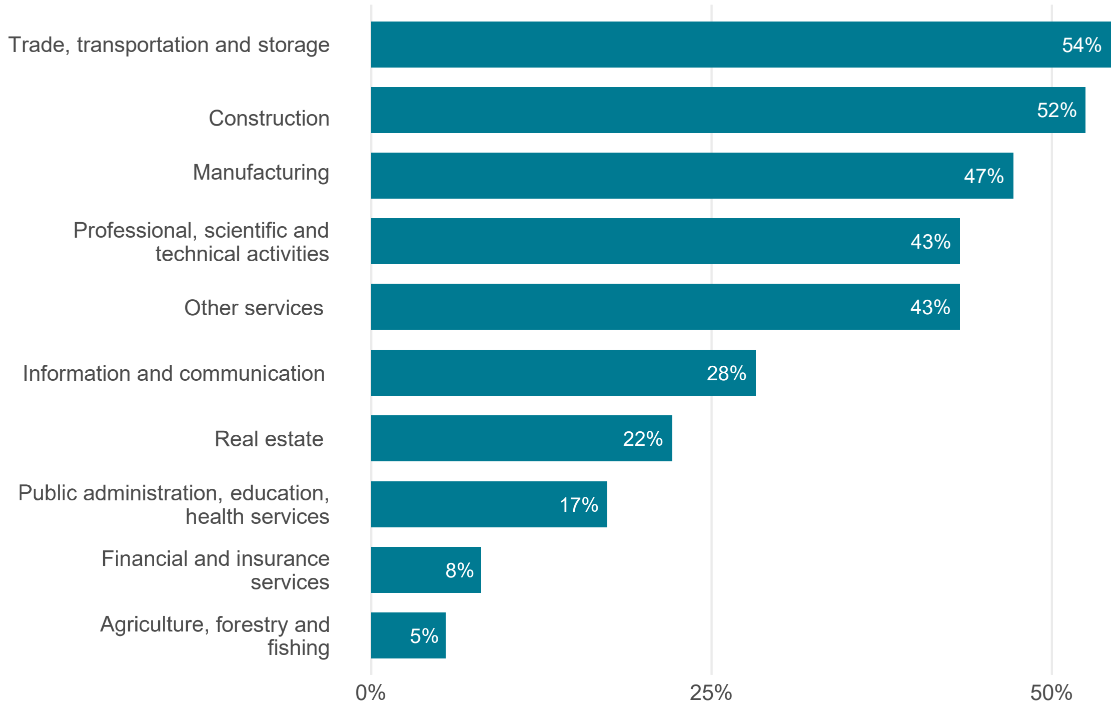
Surge in short-time working will be followed by rise in unemployment
The consequences of the COVID-19 pandemic were already noticeable on the labour market in March, which saw an unprecedented increase in applications for short-time working. However, this increase finally levelled off last month. In May, applications for short-time working had been filed for around 37 per cent of all employees in Switzerland. The sectors with the highest proportions of applications are textiles and clothing (80 per cent) and hospitality (77 per cent). A large number of applications was also received for industry (47 per cent) and construction (52 per cent), although the lockdown in these sectors was either only partial or non-existent.

The actual extent of the loss of working hours covered by short-time working is not yet known because companies have several months in which to settle their accounts for short-time working. Such accounts have so far been settled for about half of all applications for March. The resulting number of lost working hours covered by short-time working is about 5.5 per cent of the average monthly working hours in Switzerland last year.

The short-time working regime and the COVID-19 lending programme have so far prevented the sort of abrupt rise in unemployment seen in the United States, for example. Nevertheless, the unemployment rate in Switzerland has increased in recent months and is likely to continue to rise until the beginning of next year. The number of company bankruptcies and restructurings is expected to grow over the coming months and result in redundancies. In addition, the expansion of employment and consequently – as is already evident – the process of transitioning from unemployment to employment is likely to falter. This is because during the economic recovery phase in the second half of 2020 companies will initially increase the workload on their currently under-employed staff and will therefore be reluctant to hire new workers. The coronavirus crisis will therefore particularly affect those entering the labour market for the first time. Long-term unemployment will also increase because those who are currently without a job will find it harder in the medium term to find employment than before the crisis.

Compensation for short time work

Employees with granted compensation (reservations)
in % of total employees per sector (Eurostat), status May 2020



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Crisis will affect investment for longer than private consumption

On the demand side, the economic effects of the pandemic caused private consumption to fall as early as the first quarter of 2020. The slump during the first half of March, at least, is likely to have been largely attributable to voluntary restraint in demand, as general business closures did not start until 17 March. This slump is likely to become massively more pronounced in the second quarter. According to KOF's indicators, however, private consumption has already been recovering since May, and this trend will continue in the summer and generate high growth rates for the third quarter. By the end of 2020, private consumption should be closer to its pre-crisis levels than in other countries. The reasons for this are the substantial financial reserves held by Swiss households, the expanded short-time working regime and the country's smoothly functioning social security systems. In 2021 we expect to see weak consumption activity as higher unemployment, modest wage growth and lower immigration act as a drag on the economy.

Gross fixed capital formation also fell as early as the first quarter of 2020. The latest KOF Investment Survey reveals that companies have massively revised downwards their planned investment in equipment for this year as a result of the COVID-19 pandemic. Industry is much more severely affected here than the service sector. We do not expect equipment investment to increase until the end of this year. The recovery should continue next year and generate above-average quarterly growth rates. The Investment Survey reveals no evidence of any statistically significant downward revision of construction investment. Even before the coronavirus hit, however, company data suggested that construction investment would decline this year and next.

International slump in demand has made a substantial contribution to coronavirus-related losses

The COVID-19 pandemic is often perceived primarily as a shock to domestic demand. However, KOF estimates that the international share of coronavirus-related losses for the Swiss economy up to June of this year is between 45 per cent and 75 per cent. Exports fell across almost all sectors in March. Only thanks to a significant increase in chemical and pharmaceutical exports was the growth rate for total exports positive in the first quarter. The slump worsened significantly in April. Watch exports were affected in an unprecedented way in April, achieving just 15 per cent of their December 2019 level. As international demand picks up again, exports will recover in the second half of the year, but without reaching pre-crisis levels. Thereafter, the trend is likely to remain below average owing to the sluggish global recovery, with only chemical and pharmaceutical exports providing some momentum.

Forecasting uncertainty high as downside risks predominate
Forecasting uncertainty is currently very high. It is difficult to estimate how strong the economic recovery will actually be in the second half of 2020 and to what extent the after-effects of the coronavirus crisis will act as a drag on economic activity in the coming year.

The emergence of a second wave of COVID-19 represents a downside risk that is not included in the forecast. On the other hand, the rapid development and spread of a vaccine is an upside risk. Also not included in the forecast is the risk of a resurgence of the European banking and sovereign debt crisis triggered by a wave of bankruptcies in Italy. The Swiss economy could not escape such a crisis.

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