Executive summary of KOF's economic forecast for spring 2022

23 March 2022

This is a summary of the 2022 spring forecast for Switzerland, released by the KOF Swiss Economic Institute at ETH Zurich on 23 March 2022, with a forecast horizon up to the end of 2023.

24 February 2022: war in Ukraine causes new shock to the world economy

The global economy has been plunged back into crisis by Russian troops' invasion of Ukraine on 24 February and by the sanctions triggered in response to this attack, the intensifying geopolitical tensions and the considerable uncertainty about further developments in Ukraine and elsewhere. The economic recovery accompanying the easing or lifting of the restrictions imposed in many countries to contain the spread of the COVID-19 virus is therefore being hampered by new negative shocks. The war's short-term impacts on the economy are dominated by the sharp rise in energy and commodity prices, which is exacerbating the surging prices already seen in many places. Trade with Russia has virtually ground to a halt in all sectors except energy. An additional factor for the Swiss economy is that it hosts several companies engaged in the international commodities trade and could therefore be seriously adversely affected by any further, more far-reaching and effective embargos. And, last but not least, the uncertainty arising from the threat of any further escalation – including the possibility of military action against other countries in the region – could have a negative impact on consumption and investment.

It is unclear when and how a comprehensive ceasefire might come about in Ukraine. But even if this were to happen fairly soon, the global economy will operate differently than before for many years to come. The first change is likely to be that countries will rethink where they obtain their energy supplies from and will increase their military and defence spending. Because the pandemic-related supply shortages are now being followed by war-related shortages that are further undermining confidence in the existing international supply networks, countries engaging in international trade will be looking to rethink and reconfigure their strategies while becoming increasingly self-reliant. It is unlikely that Switzerland would experience lasting energy shortages, however, because the relatively small amounts of gas that it imports from Russia could be replaced by other suppliers. Moreover, if the price of fossil fuels were to remain elevated over the long term, alternative sources of energy would become more competitive, which would accelerate the transition to less environmentally harmful forms of production and consumption.

Favourable scenario versus negative scenario

KOF is presenting two scenarios in this forecasting round to reflect the current situation in Ukraine. KOF sees the favourable scenario, which is outlined first, as being favourable because it assumes that the military action in Ukraine will end soon and that the adverse impact on economic activity will be fairly short term in nature. This is contrasted with a negative scenario, which assumes that the war will escalate further and the fighting will continue for longer, with the West imposing even tougher sanctions on Russia and Russia responding by imposing sanctions on the West. This negative scenario would see all Russian exports of energy and commodities to the European Union (EU) being discontinued, which would cause serious shortages of energy and intermediate products, thereby disrupting production and necessitating rationing. Europe's economy would then slide into recession and the Swiss economy would suffer a sharp decline in output in the second quarter of this year.

Endemic scenario for Switzerland

A new wave of COVID-19 infections began to emerge at the beginning of the final quarter of last year. It hit new highs at the end of January this year and again in mid-March – with around 40,000 reported cases each time – and, in terms of daily infections, exceeded all previous waves, although, given the high positive test rates, there is expected to be a large number of unreported cases. The fact that fears of an emergency arising in hospitals failed to materialise is partly because people were better protected and less vulnerable than previously, as they had already been vaccinated and, in some cases, had already acquired immunity after having been infected with COVID-19. However, this can also be attributed to something that we described as an optimistic scenario in our autumn forecast, namely the fact that the omicron variant is much more infectious than previous mutations but causes less serious illness. Almost all restrictions previously imposed in Switzerland were therefore lifted on 17 February, which means that all sectors of the economy are now able to operate freely, just as they did prior to the pandemic, with the only remaining constraints being the caution that individuals continue to exercise.

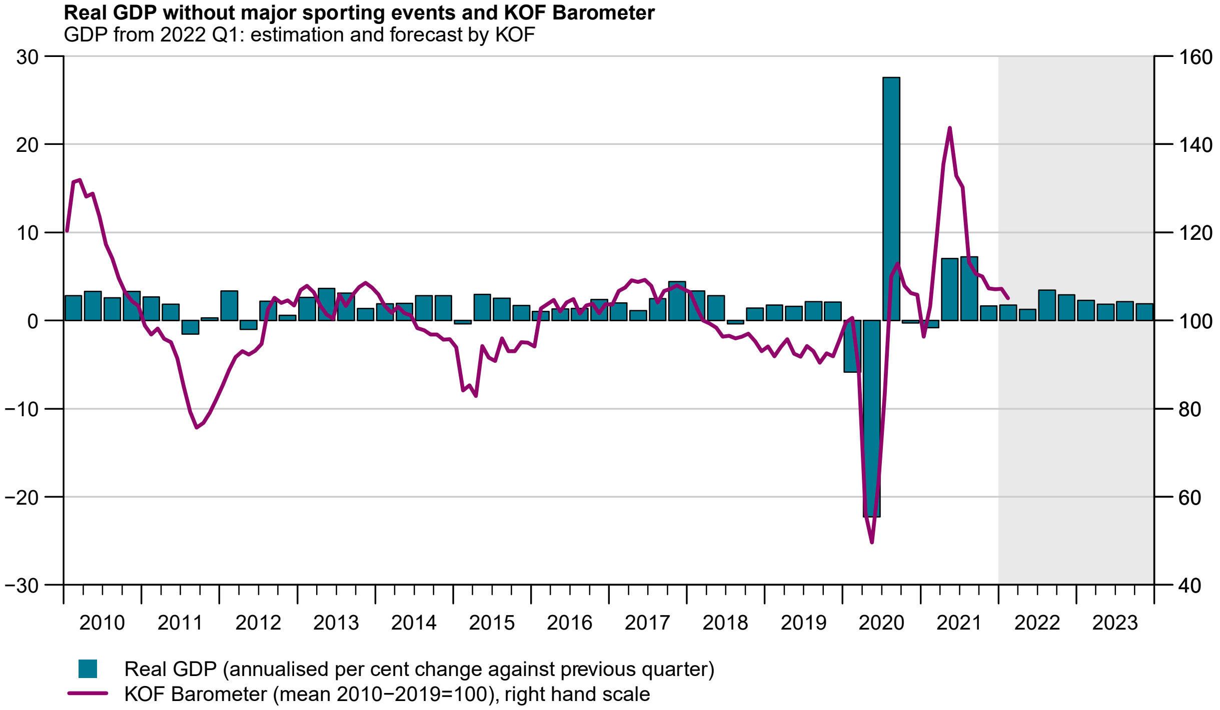
Now that the restrictions have been lifted, the number of infections has started to rise again, and we are beginning to see a slightly worrying trend in terms of hospitalisations. Despite this, it appears that the political decision-makers in Switzerland now regard the epidemic as being over. KOF has therefore assumed for the purposes of this forecast that no mandatory certification or contact restrictions will be reintroduced. The endemic scenario implicitly assumed for Switzerland predicts that COVID-19 infections will form a normal part of everyday life without imposing serious constraints on healthy individuals' activities. KOF has based both of its economic scenarios on these assumptions. However, this endemic scenario could prove to be over-optimistic given that the global pandemic is likely to be far from over, which poses the risk that new and dangerous variants of the virus could emerge and, moreover, it is not yet clear how long the Swiss population's current immunity to the variants now circulating will last.

Current economic situation in winter 2021/22

The fourth quarter of last year saw the Swiss economy continue to recover from the effects of the pandemic, albeit at a slower pace than before. Provisional data released by Switzerland's State Secretariat for Economic Affairs (SECO) shows that gross domestic product (GDP) adjusted for sporting events rose by 0.5 per cent after having increased by 1.7 per cent in the third quarter. Only in the hospitality sector did value added continue to decline. The chemical and pharmaceutical industries remained the engines of growth. This enabled Swiss industry's exports to achieve a significant increase. Total exports contracted on balance, which can largely be attributed to the overall decline in merchanting activity.

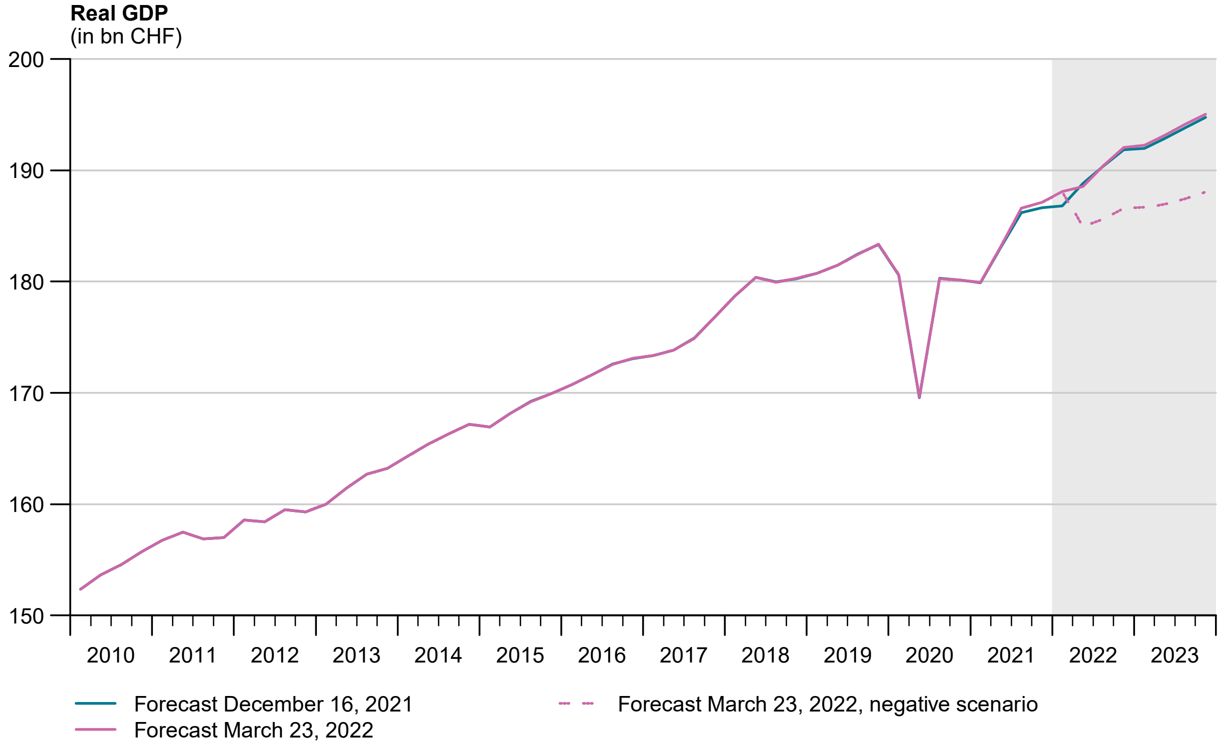
It is worth noting that merchanting now makes a substantial contribution to value added in Switzerland. However, the value added by commodity trading does not follow the usual economic cycle and, what's more, is highly volatile, which makes it very hard to forecast. When compiling its favourable scenario, KOF adopts its usual practice of modelling the performance of commodity trading on a cyclically neutral basis.

The KOF Business Cycle Barometer for Switzerland hit an all-time high in May 2021, since when it has moved back towards its historic average. It fell to 105 points in February 2022, which is still higher than the long-term average. This means that the economic situation should have continued to improve in the first quarter of 2022. However, the underlying data was collected before the recent invasion of Ukraine, which means that the shock caused by this war will not be registered in the KOF Business Cycle Barometer until 30 March. GDP forecasts only appear once per quarter. Because roughly two-thirds of the first quarter of 2022 had already elapsed by the time Russia invaded Ukraine and some sanctions were only gradually imposed and tightened, the Ukraine crisis is likely to have very little effect on the first-quarter data but will have a huge impact on the second quarter.



Economic impact of the war in Ukraine on the Swiss economy limited in the favourable scenario
Had it not been for Russia's invasion of Ukraine, the latest forecast for GDP growth in 2022 – adjusted for sporting events – would have been around 3.2 per cent (3.3 per cent including sporting events). Compared with this counterfactual growth rate, which is largely driven by the recovery from the pandemic restrictions, KOF now predicts that growth in the favourable scenario will be 2.9 per cent (3.0 per cent including sporting events). It is assumed that the negative impact that the war is having on the world economy will mainly be restricted to the second quarter of this year, even though many of the sanctions imposed on Russia will remain in force thereafter. Since neither Russia nor Ukraine are major trading partners of Switzerland, however, the damage inflicted by any disruption of trade flows will remain limited, even if individual firms are severely affected. The Swiss financial sector is unlikely to be at risk, despite the fact that the private assets of some wealthy Russian individuals have been frozen, because Switzerland's financial exposure to Russia is fairly limited. The impact that the war in Ukraine has on the Swiss economy will therefore mainly be reflected in the resultant price increases, the deterioration in general sentiment, and the lower levels of export demand from countries that are more closely interconnected with the Russian and Ukrainian economies than Switzerland is.

GDP adjusted for sporting events is expected to grow by 2.3 per cent (2.0 per cent including sporting events) in 2023. Although this rate is well below that for 2022, it is still above the potential growth rate. This normalisation can be attributed to the fact that the catch-up effects following the coronavirus pandemic are gradually subsiding. This favourable scenario does not take account of any potential deterioration in the epidemic situation that might require the reintroduction of restrictions, nor does it include the possibility of longer-term chaos in Ukraine. The clearly negative output gap of just under minus 3 per cent in 2020 steadily decreased in 2021 and, in the favourable scenario, is likely to have closed towards the end of the first quarter of this year. On average it will be slightly positive in 2022 and is expected to account for roughly 0.6 per cent of GDP in 2023.



Negative scenario: much lower growth
KOF's negative scenario assumes that all Russian exports of energy and commodities to the EU will be halted and that all Russia-related commodity trading routed via Switzerland will also be completely discontinued. In contrast to the usual practice of modelling the performance of commodity trading on a cyclically neutral basis, merchanting activity immediately falls by 10 per cent in this case before stabilising at 6 per cent below the favourable scenario. Around 80 per cent of Russian oil is routed via merchanting firms in Switzerland. Trade in Russian commodities is likely to account for roughly 10 per cent of total merchanting activity in Switzerland, with the latter in turn accounting for around 5 per cent of GDP. KOF expects the Swiss franc's exchange rate to appreciate rapidly and sharply against the euro (8.2 per cent compared with its pre-pandemic level) and to appreciate by around 2.5 per cent against the currencies of other trading partners. Starting in the third quarter of 2022, the Swiss franc will appreciate by an annual 2 per cent against all currencies instead of appreciating by 1 per cent in the favourable scenario. These currency appreciations in both scenarios correspond to the inflation differentials between consumer prices in the OECD countries and the Swiss deflator for private consumption, which means that the real exchange rates – after their one-off appreciation – remain unchanged until the end of the forecasting period.

Given these assumptions, the GDP growth rate adjusted for sporting events would be only 1.0 per cent in 2022 (1.1 per cent including sporting events), which is roughly 2 percentage points lower than in the favourable scenario. In 2023 it would decline to 0.8 per cent (0.5 per cent including sporting events), which would still be around 1.5 percentage points lower than in the favourable scenario.

The most striking difference between the negative scenario and the favourable scenario can be seen in the forthcoming second quarter of this year. Whereas a moderate but still positive growth rate is being forecast in the favourable scenario, it is expected to fall to around minus 6 per cent on an annualised basis in the negative scenario. This would not, however, lead to a recession in the technical sense (two successive quarters of negative growth) because the forecast for the third quarter will be slightly positive on the back of a modest rebound following the sharp decline. Despite this correction in the third quarter, however, the output gap would remain clearly negative. In this negative scenario the labour market would also come under pressure. Severely affected sectors, such as parts of manufacturing industry, would see job losses lasting several quarters. Employment, measured in full-time equivalents, would contract overall in the second and third quarters of this year. This would merely be followed by a tentative recovery, which would cause unemployment to pick up again. These joblessness figures would, however, appear fairly modest, with the rate of those registered as unemployed rising from a seasonally adjusted 2.2 per cent at present to an average of 2.4 per cent next year.

International environment

Russia's invasion of Ukraine and its unleashing of military force there are likely to act as a significant drag on the recovery from the COVID-19 pandemic for the time being. This heightened uncertainty is expected to reignite the problem of international supply shortages. KOF assumes in its favourable scenario that the fighting in Ukraine will cease at some point in the second quarter of 2022 and that the sanctions imposed in mid-March will not be tightened further. The global economy is likely to weaken in the second quarter of this year especially. The supply-side shock will be felt particularly in countries that are heavily reliant on commodities and industrial intermediate products. Rising energy and commodity prices will act as a drag on the European economy. In addition to Russia, Ukraine is also a major supplier of intermediate goods for industrial products – especially in the automotive sector – and is an exporter of food. The war is expected to disrupt supplies from these countries for the time being. Surging energy, commodity and food prices will raise production costs worldwide. Commodity and energy shortages caused by the war in Ukraine are likely to push up inflation even further – especially in Europe. The recovery from the COVID-19 pandemic will therefore generally be weaker than had been expected as late as December 2021. Assuming its favourable scenario, KOF expects global GDP – weighted according to Swiss exports – to grow by 3.2 per cent this year and 2.6 per cent in 2023.

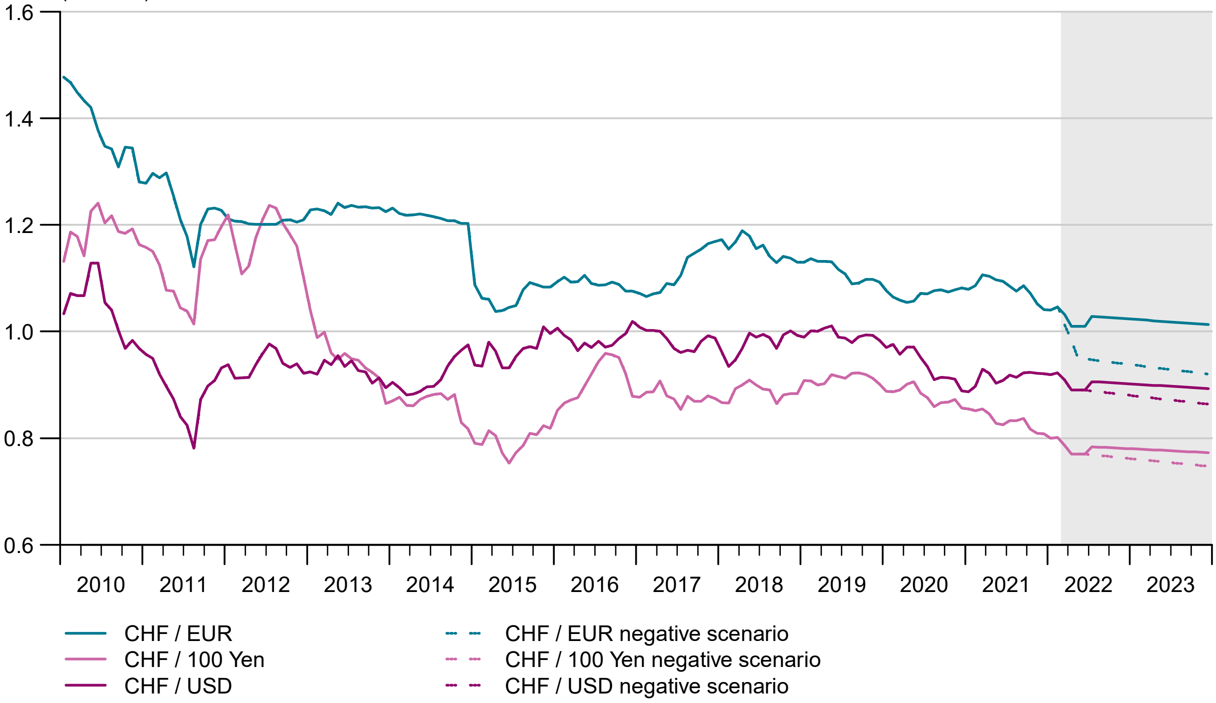
Developments in Switzerland

As an export-led economy that is highly interconnected, especially in Europe, Switzerland is affected by the negative international economic impact of the war. But Switzerland does not rely on Russian energy exports as much as some other European countries do. Another notable factor here is that chemical and pharmaceutical products account for roughly 40 per cent of Switzerland's exports. Export demand for these products is less cyclically sensitive than in other parts of manufacturing industry. Assuming its favourable scenario, KOF therefore expects exports to rise by 6.3 per cent in 2022 and to grow by 5.0 per cent next year.

The most noticeable catch-up effects following the COVID-19 pandemic will be seen in consumer spending, which will report above-average growth of 4.6 per cent in 2022 and a highly respectable 3.0 per cent in 2023. This trend will be accompanied by a corresponding normalisation of the savings ratio (voluntary saving as a percentage of disposable income), which will decline from 28.0 per cent in 2021 to 24.1 per cent in 2022 and then 22.9 per cent in 2023.

KOF expects government consumption to make a negative contribution to growth during the forecasting period. The discontinuation of the exceptional levels of expenditure relating to the pandemic means that government spending will fall by a substantial 2.6 per cent in 2022 and by a still significant 1.9 per cent in 2023.

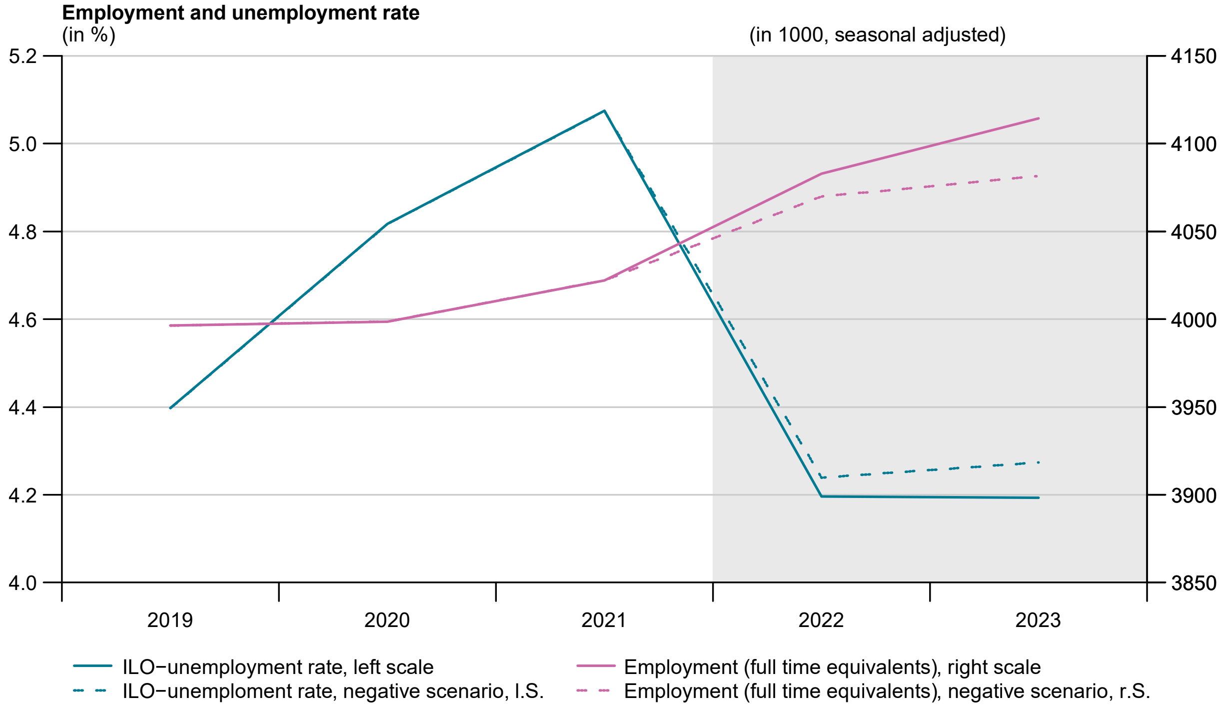
Exchange rates, with forecasts
(nominal)



The impact that the Ukraine crisis has on Switzerland's GDP in the negative scenario is considerable, amounting to a 2-percentage-point loss compared with the baseline scenario in 2022 and a 1.5-percentage-point loss in 2023, because the Swiss economy would be hit by three negative shocks simultaneously in this unfavourable scenario: an oil price shock, a currency appreciation shock similar to that in 2015, and an international demand shock.

Broken down by sector in the negative scenario, the amount by which value added in manufacturing industry differed from the favourable scenario would constitute a loss of 3.6 per cent in the third quarter of 2022 and a loss of as much as 4.8 per cent in the fourth quarter of this year. The retail, wholesale, transport and hospitality sectors would report substantial losses of 2.8 per cent in the third quarter and 3.9 per cent in the fourth quarter. The losses in the financial sector (including business-related services) would be hardly any lower, while in the construction industry they would still be considerable at 2.6 per cent in the third quarter and 3.3 per cent in the fourth quarter. The losses in consumer-related services and the public sector would be relatively modest at 1.0 per cent in the third quarter and 1.8 per cent in the fourth quarter.

The ways in which the negative scenario differs from the favourable scenario on the demand side are described below. Exports will grow by only 2.2 per cent (instead of 6.3 per cent) in 2022 and by 3.7 per cent (instead of 5.0 per cent) in 2023. The niche export markets that Switzerland operates in will prevent more drastic losses here. Consumer spending will remain fairly robust, achieving growth of 4.4 per cent (instead of 4.6 per cent) in 2022 and 2.1 per cent (instead of 3.0 per cent) in 2023. The loss of real income here will be partly offset by a sharper decrease in the savings ratio. Gross fixed capital formation is likely to be highly restrained. Construction investment is set to stagnate (instead of growing by 0.3 per cent) in 2022, while it will actually decline by 2.6 per cent (instead of increasing by 0.4 per cent) in 2023. Equipment investment will contract by 0.4 per cent (instead of rising by 1.5 per cent) in 2022 and will shrink by 0.5 per cent (instead of increasing by 2.8 per cent) in 2023. Government spending in the negative scenario will not differ significantly from the favourable scenario during the forecasting period. Consequently, we do not believe it is likely from a political perspective that the government will meet current demands for economic support packages and subsidies to be provided for households affected by war-related price rises.



Labour market

The Swiss labour market has performed well in recent months, creating many new jobs. KOF Business Tendency Surveys have revealed growing complaints about staff shortages. Consequently, the number of those registered as unemployed has fallen sharply. The rate of those registered as unemployed in Switzerland at the end of March was 2.2 per cent and had thus returned to its pre-pandemic level. The favourable scenario assumes that the war in Ukraine will have a limited impact on employment and unemployment in Switzerland. Although employment growth throughout the remainder of 2022 will slow, most workers will not need to worry about losing their jobs. However, unemployment will stop declining in the autumn, after which the unemployment rate is expected to flatline up to the end of the forecasting period. In the negative scenario, on the other hand, employment will contract during the summer half-year of 2022. This would cause unemployment to pick up again, as described above.

Heightened inflation

The current rise in inflation both domestically and internationally has undergone a qualitative shift as a result of the Ukraine crisis. Whereas this heightened inflation was previously often seen as a temporary phenomenon, this optimistic view now appears less compelling. The war has ensured that inflation is likely to rise more sharply and not decline quite as rapidly as previously assumed. There are initial signs that long-term inflation expectations in Switzerland may have already increased (see box). In contrast to other parts of Europe and the United States, however, where inflation is already heading towards double digits, inflation in Switzerland remains moderate. Although Swiss consumer prices in the favourable scenario will rise by 1.6 per cent in 2022, this increase will fall to 0.8 per cent in 2023. Assuming the negative scenario, inflation will temporarily exceed the range of up to 2 per cent that the Swiss National Bank (SNB) defines as price stability. While the consumption deflator would rise by 2.2 per cent for 2022 as a whole, it would increase by only 0.9 per cent in 2023.

Forecasting risks

KOF has tried to mitigate the considerable forecasting risks currently facing us by describing different scenarios. We refer to one of these two scenarios as ‘favourable’ because it assumes what are likely to be the best possible outcomes of the war in Ukraine and the COVID-19 pandemic. The latter is assumed to be essentially over, while the former is assumed to be swiftly concluded – at least militarily – so that it acts as only a temporary drag on economic activity and growth.

The negative scenario assumes that the war will escalate further and the fighting will continue for longer, with the West imposing even tougher sanctions on Russia and Russia responding by taking retaliatory measures, which would have a corresponding impact on the economy. Given the uncertainty surrounding military action, the enforcement of sanctions that have already been approved, and the potential for a significant escalation of the economic war between the West and Russia, our negative scenario is perhaps somewhat pessimistic but nonetheless lies within the realms of what is currently conceivable. Any further escalation – such as the risk of the conflict spreading to include direct hostilities between Russian and NATO forces, thereby posing the threat of nuclear war – lies outside the bounds of what can be sensibly analysed using the tools of economic forecasting.

What would probably be less of a catastrophe – but, nonetheless, would certainly be conceivable given the experience of the last two years – is the negative risk that the coronavirus pandemic is not in the process of becoming an endemic situation but, on the contrary, that it is resurging and could impair economic activity. On the other hand, neither of our scenarios assumes that mandatory certification or contact restrictions will be reintroduced in Switzerland. However, our endemic scenario might appear to be over-optimistic in retrospect given the risk that new and dangerous variants of the virus could emerge and the danger that the Swiss population’s immunity to the variants currently circulating could wane more quickly than anticipated.

Further information on KOF’s economic forecast is available here:
https://www.kof.ethz.ch/en/forecasts-and-indicators/forecasts/kof-economic-forecast.html →