Executive Summary KOF Economic Forecast, Summer 2019

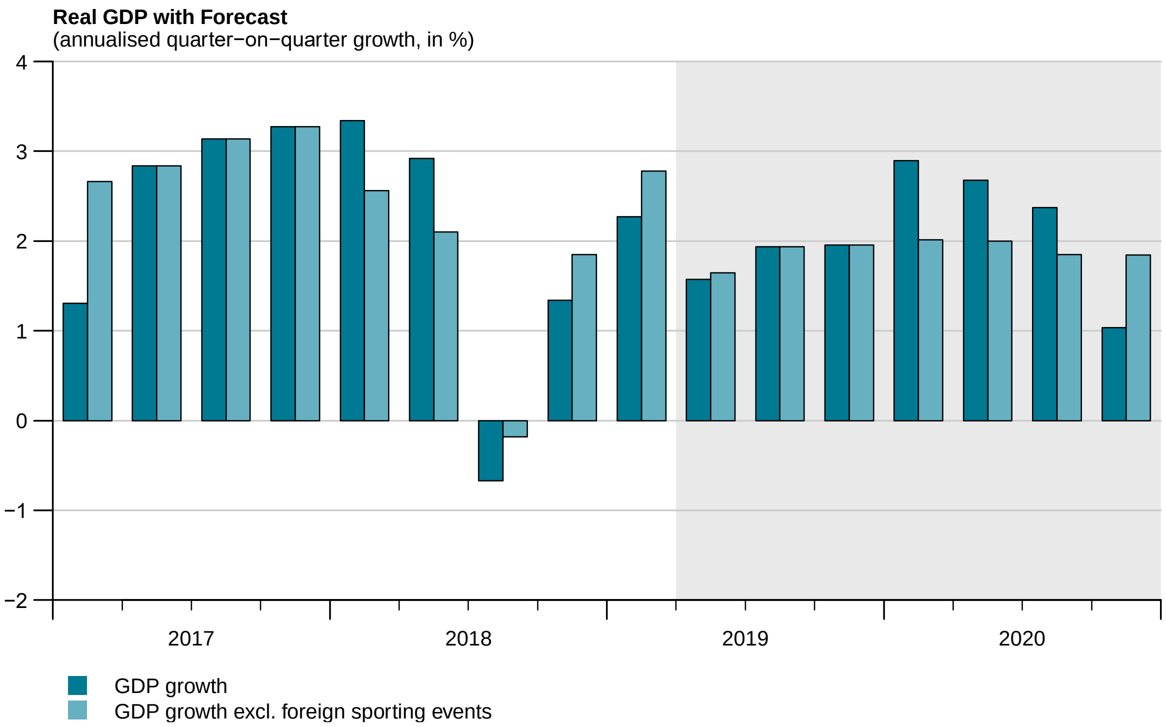
13 June 2019

This is a summary of the 2019 summer forecast for Switzerland, released by the KOF Swiss Economic Institute at ETH Zurich on 13 June 2019, with a forecast horizon up to the end of 2020.

After a weak second half of 2018 the world economy regained momentum in the first quarter of 2019. Nonetheless, the growth prospects for this and the next few quarters are somewhat muted, with risks on the downside. According to calculations by the State Secretariat for Economic Affairs (SECO), economic growth in Switzerland in the recent past has been significantly stronger than we estimated in March. The first quarter of this year saw the highest growth rate in gross value added – adjusted for the revenues from major international sporting events – since autumn 2017. In addition, the initial estimate for the fourth quarter of last year has been revised upwards by an annualised 0.7 percentage points. These data thus suggest that the economy has performed quite well since the summer. This has caused our annual GDP growth forecast for 2019 to be adjusted by around 0.6 percentage points; it now stands at 1.6 per cent, or 1.8 per cent excluding revenues from sporting events. For next year we expect GDP to increase by the same order of magnitude (1.9 per cent); we reckon it will rise by 2.3 per cent including revenues from major sporting events.

Only slight increase in real wages

Employment grew sharply in many sectors in 2018. Overall, full-time equivalent employment increased by 1.8 per cent, which constitutes the highest rate since 2012. This in turn reduced the number of unemployed people in Switzerland: according to figures published by SECO, the seasonally adjusted unemployment rate fell to a low of 2.4 per cent. The unemployment rate according to the internationally comparable definition used by the International Labour Organization (ILO), which had been fluctuating around 5 per cent for years, also fell slightly, to 4.6 per cent on a seasonally adjusted basis.



The favourable dynamics of the labour market continued at the beginning of 2019. Over the coming quarters, however, the labour market is likely to perform somewhat more moderately owing to the gloomy global outlook. Overall, we expect employment to grow by 1.3 per cent in full-time equivalent terms in 2019. Notice, however, that this quite remarkable increase is mainly attributable to the high growth rate in the first quarter of 2019 – we expect significantly lower quarterly growth rates over the further course of this year. The number of people in employment according to the Federal Statistical Office (FSO) is set to grow by 0.9 per cent this year. According to the ILO definition, the forecast dynamics of the labour market are likely to reduce unemployment somewhat; for the year as a whole we expect an average rate of 4.3 per cent. By contrast, registered unemployment according to SECO will remain at the current rate of 2.4 per cent during 2019.

Although the Swiss economy was booming in 2018, it was an unfavourable year for wage income. Despite the fact that GDP grew by 2.6 per cent, real wages fell by 0.4 per cent in 2018 according to the Swiss Wage Index (SWI) after having stagnated in 2017. We currently expect nominal wages to rise by 0.7 per cent in 2019 according to the SWI. After adjusting for inflation, however, this results in only a slight increase in real wages. Nominal and real wage growth should be somewhat higher in 2020.

Private consumption will again grow only modestly in 2019. This is mainly due to low population and wage growth rates. Consumer sentiment has also deteriorated somewhat recently. This is in line with recent trends in retail sales: during the first four months of this year, sales were down compared with the same period last year. However, only non-food sales are weak, while retail sales of food, beverages and tobacco have remained fairly stable. More robust growth in private consumption can be expected from 2020 onwards. This stimulus will come especially from an increase in wages.

Disbursements from two infrastructure funds

Construction investment slowed in 2018, with a particularly weak fourth quarter. However, the first quarter of 2019 saw a distinct upswing on the back of favourable weather conditions. The slowdown in the economic environment as well as the build-up of excess capacities (weak demand, rising vacancy rates, falling property prices) in the residential sector are dampening construction investment during the forecast horizon. However, disbursements from two infrastructure funds are stimulating investment in roads and railways. Investment in other types of infrastructure is on the rise too. In particular, civil engineering companies' outlook is fairly optimistic according to the KOF Business Tendency Survey of the construction sector. Non-residential construction is on a recovery path, driven by investment from pharmaceutical and biotech companies as well as investment in the healthcare sector.

In contrast to the short but pronounced investment cycles often observed in the past, the Swiss economy has recently experienced a relatively protracted investment cycle with – by historical standards – moderate growth rates. This investment cycle ended with one negative quarter and one stagnating quarter in the second half of 2018. In the near future we expect investment to grow at rates similar to the historical average. Although the currently fairly normal amount of capacity utilisation will not boost investment, it will help sustain investment levels. In addition, deliveries of new aircraft and rail vehicles will increase investment in machinery and equipment and cause sharp fluctuations.

Tax reforms will create incentives to save at all levels of government

Switzerland's sound financial situation and the improving public finances of its cantons and municipalities are creating scope for raising government expenditure this year and next. The latest quarterly data already suggest a slight increase. At 1.4 per cent in real terms and slightly more than 2 per cent in nominal terms, growth in government consumption should reach its ten-year average this year and next. This stimulus is coming, firstly, from the general adjustment in inflation at the federal level and in some cantons and, secondly, from additional jobs created in the public sector. In addition, spending on equipment is likely to grow strongly at the federal level. On the other hand, the implementation of the new corporate tax reforms in 2020 and 2021 will create incentives to save at all levels of government. The currently planned expenditure increases can therefore be regarded as temporary.

Despite the implementation of the corporate tax reforms at the end of the forecast horizon, the public finances in aggregate should remain healthy. Revenue growth is benefiting from the strength of the labour market, allowing the federal government and the cantons to report significant surpluses. Social security funds are also profiting from the healthy state of the labour market. The Old-Age and Survivors' Insurance (OASI) fund also receives extra income from the additional contributions paid by employers and employees, as decided in May's plebiscite on the combined corporate tax and old-age pension funding reforms. The majority of municipalities, on the other hand, appear to be running a structural deficit. Most of them have been reporting deficits since 2009. This trend is likely to continue during the forecast horizon.

Switzerland's foreign trade delivered a robust performance in the first quarter of 2019. Thanks to the unexpectedly strong economic performance of key sales markets in North America and Europe, exports of goods and services grew at an annualised rate of 8.4 per cent. In particular, pharmaceutical goods and watches were exported in increasingly large volumes. In services trade, licence revenues rose especially sharply. On the other hand, exports of cyclically sensitive goods produced in the machinery, electronics and metal industries remained weak. Tourism exports also stagnated at the beginning of the year. Supported by strong domestic demand and high export growth, total imports expanded sharply in the first quarter of 2019, rising at an annualised rate of 8.3 per cent. Against the backdrop of the slowing global economy and the recent appreciation of the Swiss franc, export growth should level off in the coming quarters. Furthermore, a change in accounting practices should have a dampening effect on exports of goods: some exports of pharmaceutical products will be switched from the trade in goods to trading in commodities. Imports will continue to grow significantly thanks to the consistently robust domestic economy. Foreign trade as a whole should therefore impair GDP growth in the coming quarters.

Industry supports Swiss economy

The currently healthy state of the Swiss economy is mainly due to manufacturing. Since the Swiss franc has weakened in recent years and, adjusted for inflation, has reached a level similar to that prior to the abolition of the euro minimum exchange rate in January 2015, manufacturing has again become internationally competitive. With the exception of firms supplying the German car industry, most Swiss exporters operate in production areas that are not directly affected by increased US tariffs. For these businesses there is a good chance that demand for their products will continue to rise. Some Swiss companies that manufacture in China are more likely to be affected, but this will hardly impact production in Switzerland. The pharmaceutical industry in particular has little cause for concern. However, the watch industry could experience a drop in demand from China, the United States and other countries if corporate profits were to fall sharply. Manufacturers of capital goods, on the other hand, could benefit from shifting production capacities away from China and the US. The retail sector is now also performing somewhat better, even though structural changes in the retail trade and trans-border shopping are continuing to cause problems. The decline in retail value added has ended, and we expect to see a modest increase during the forecast period. Recent rises in retail production have come primarily from companies engaged in commodity trading, and these have continued to grow lately. They profit from fluctuating raw material prices and, generally, more from rising prices than falling ones.

According to the Federal Statistical Office, annual inflation has been just over half of 1 per cent for the last three months. Domestic and foreign goods (excluding petroleum products) have both contributed similarly to inflation. As expected, increases in rents remained subdued in May. Nominal wage growth is also slow, thus dampening the rise in inflation. Despite the more optimistic economic outlook compared with the spring forecast, our inflation estimate remains unchanged. Annual inflation should abate further over the course of the year and then rise again slightly next year. We continue to expect an average inflation rate of 0.5 per cent this year and 0.6 per cent next year.

Long-term bond yields have recently hit all-time lows, which suggests that financial markets expect monetary policy to revert to an even more expansionary stance. Reporting a modest decline in realised inflation in its latest statement, the Federal Open Market Committee (FOMC) hinted at the possibility that interest rates might move in either direction. Its policy of balance sheet reduction ('quantitative tightening') is still supposed to end in September of this year. At its May meeting, the European Central Bank (ECB) amended its forward guidance to emphasise that it would not alter interest rates before the first half of 2020. We expect rates to remain on hold in all major currency areas for at least the next twelve months. In order to keep the interest rate differential vis-à-vis the euro area more or less constant, we expect the Swiss National Bank (SNB) to follow ECB policy. We will therefore not see any interest rate hikes before the spring of 2020. The fact that domestic inflation remains subdued is a further reason not to raise interest rates.

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 →