Executive Summary KOF Economic Forecast, Winter 2019

12 December 2019

This is a summary of the 2019 winter forecast for Switzerland, released by the KOF Swiss Economic Institute at ETH Zurich on 12 December 2019, with a forecast horizon up to the end of 2021.

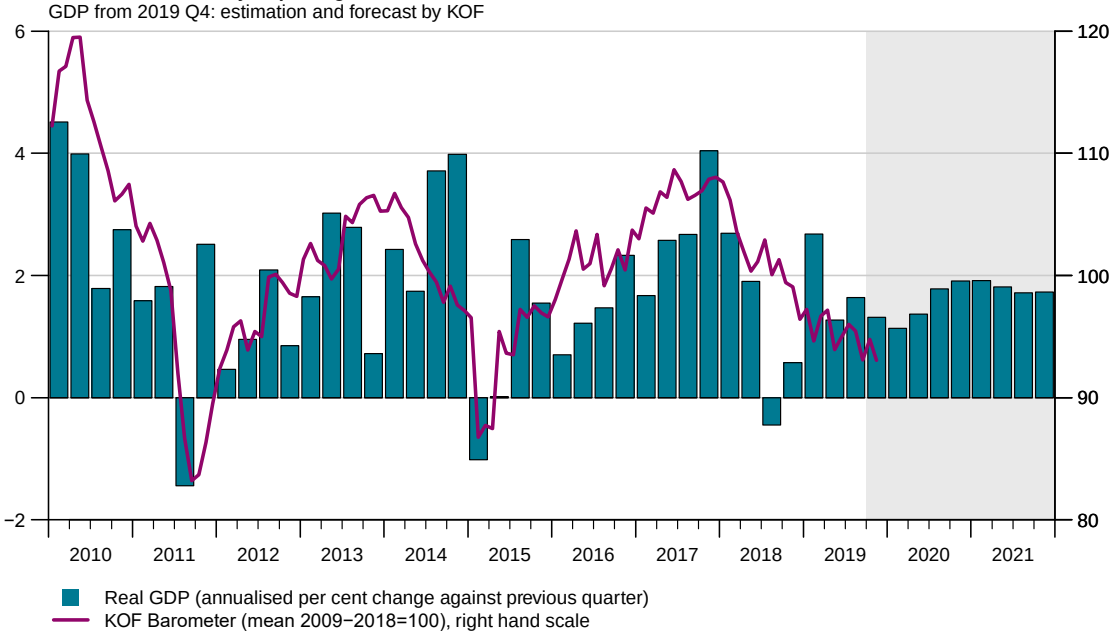
Weak macroeconomic trends

Economic trends in recent months have largely met the expectations outlined in our autumn forecast. This applies to both international and national developments. We therefore continue to expect growth to be below average for the time being. It will only slowly regain some momentum. However, since high revenues from the marketing of broadcasting rights for major international sporting events are expected again for next year, the current weakness will hardly become visible in reported GDP growth rates.

After estimated GDP growth of 0.9 per cent for this year, we are forecasting an increase of 1.8 per cent for 2020 and 1.4 per cent for 2021. The distortion caused by the sharp biennial rise in revenues in connection with major international sporting events is considerable: adjusted for these extraordinary revenues, the growth rates for these three years are 1.4 per cent, 1.4 per cent and 1.8 per cent respectively.

It should be noted in this context that although the licence income in connection with these international sporting events is allocated to organisations based in Switzerland, most of this income is subsequently distributed abroad as transfer payments. Hardly any stimulus for other sectors of the Swiss economy, for the labour market or for tax revenues can therefore be discerned, and Switzerland's national income and wealth are not affected either.

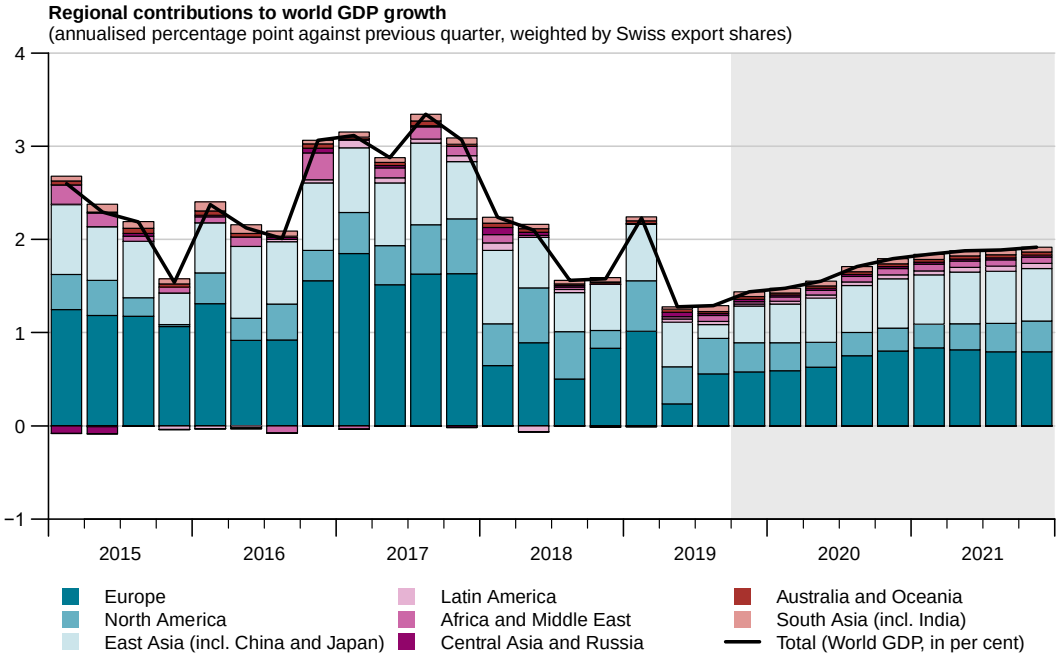
Real GDP without major sporting events and KOF Barometer
GDP from 2019 Q4: estimation and forecast by KOF



Weakness of German industry acting as a drag on manufacturing

The global economy remained weak in the summer half of 2019. Production by German industry has now been declining for more than a year, with negative repercussions for the manufacturing sector in Europe as a whole, including Switzerland. The performance of German industry reflects, on the one hand, an imminent structural change in the automotive industry and, on the other, generally sluggish investment momentum

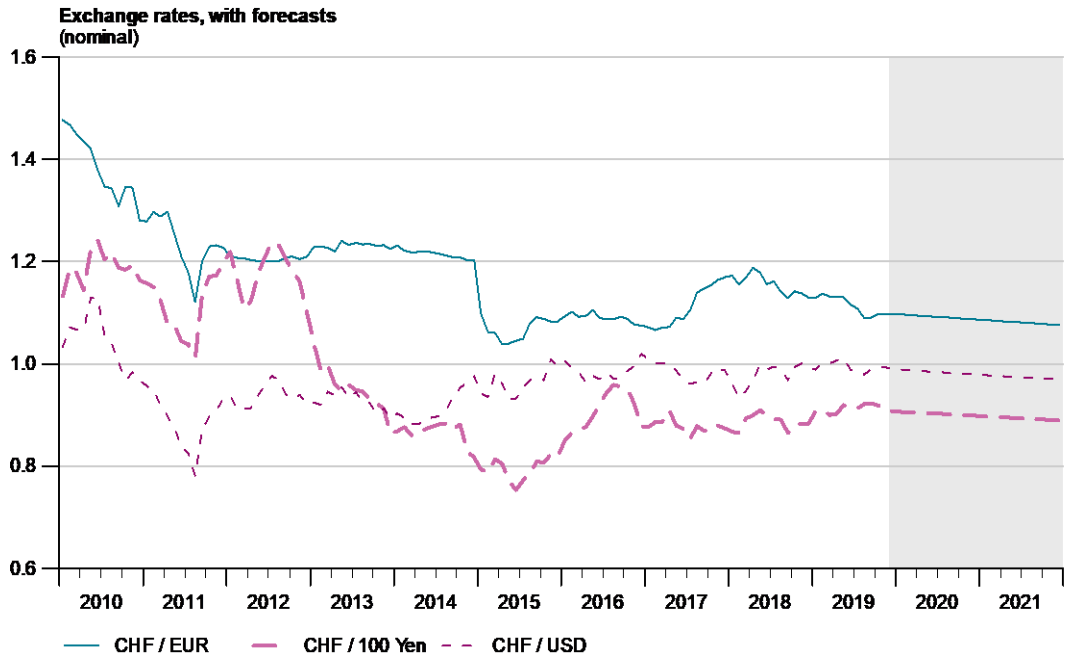
around the world. Global trade and the global economy should continue to grow below potential in this and the coming quarters.



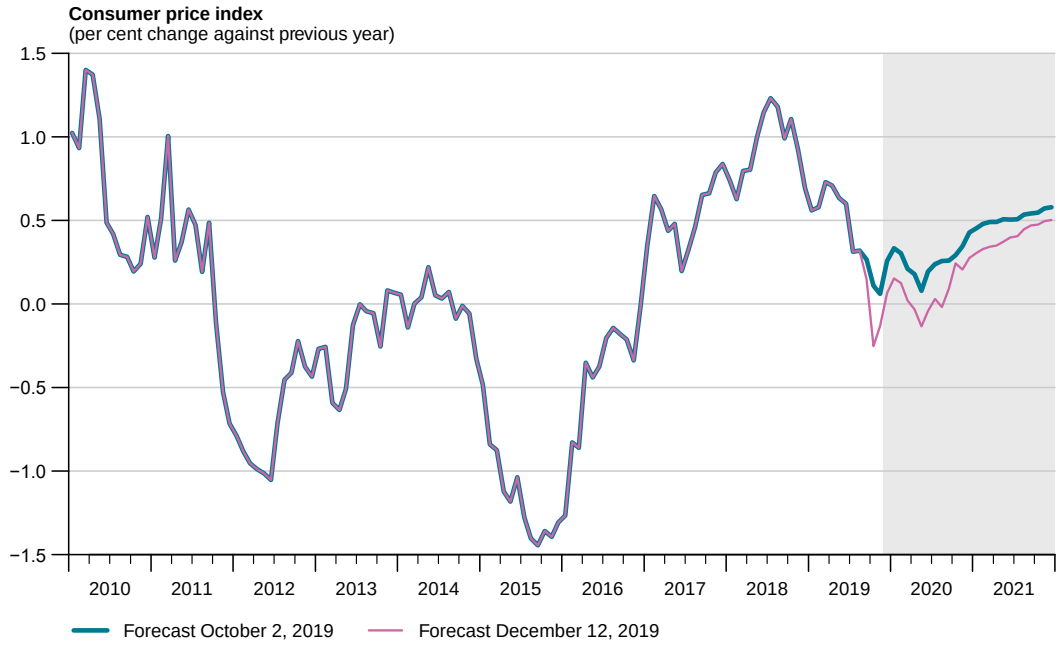
Nonetheless, the risk of significant setbacks has declined recently. This can be partly attributed to a slight easing of tensions in the trade dispute between the United States and China, although the potential for surprises can never be ruled out. Moreover, the risk of a no-deal Brexit has diminished.

ECB adopting a wait-and-see stance, removing the need for SNB to cut rates

Most central banks in the industrialised countries, but also in emerging markets, have taken a wait-and-see approach after some of them have relaxed their policies during the course of the year. Against the backdrop of stabilising economic indicators, the new President of the European Central Bank (ECB), Christine Lagarde, has for the time being also adopted a wait-and-see stance. We do not expect to see any further monetary policy measures from the ECB at the moment. This fact, together with the relatively stable situation on the currency markets, means that we expect the Swiss National Bank (SNB) to keep its policy unchanged as well. However, by deciding in September to increase its flexibility in calculating negative interest rates, the SNB has slightly expanded its monetary policy scope.



This removes the need to lower key interest rates at the end of this year, after we had predicted a rate cut in our autumn forecast. For Switzerland we now expect to see negative short-term and long-term interest rates remain stable at today's level until the end of the forecast period. We are also forecasting a stable exchange rate for the Swiss franc. Contrary to our exchange-rate predictions of recent years, we now expect the Swiss franc to appreciate in nominal terms against the euro by around one per cent annually, an order of magnitude corresponding to the inflation difference between the two currency areas. This inflation difference is expected to hold during the forecast period. Growth in Swiss consumer prices will hover slightly above zero.

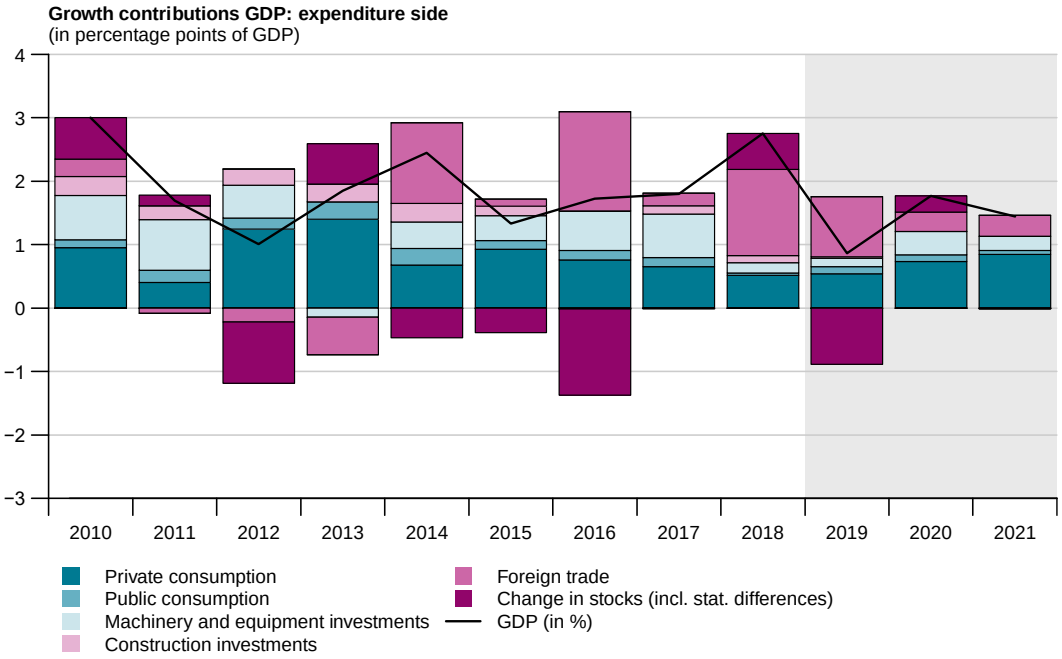


Despite a weak international economy, companies questioned in KOF's business tendency surveys continue to be confident. Only the responses from industry and wholesalers are becoming increasingly negative. Despite the strengthening of the Swiss franc, the tourism sector – often one of the worst-affected industries when confronted with a generally sluggish macroeconomic environment – is still quite optimistic. The same applies to the retail sector.

Consumer spending again a key driver of economic activity

Although Swiss domestic demand is stabilising, we do not expect it to provide any significant impetus in the forecast period. In view of the corporate tax reform that has now been finally adopted and will come into force in 2020 and the associated revenue shortfalls, government spending is likely to grow only moderately. The construction sector is also unlikely to generate much stimulus; given the rising vacancy rates, negative growth rates can be expected for residential construction particularly in the near future.

Private consumption, on the other hand, should prove to be a key pillar of the economy, as has often been the case in the past. Since we expect real wages to rise slightly, we are actually forecasting that – despite moderate net immigration – consumer spending will grow modestly overall in the next two years. The classic driver of economic activity alongside exports, however, is investment in equipment, which is highly sensitive to sentiment. Given the weakness of industry, we expect companies to adopt a wait-and-see approach towards expansion investment for the time being. In the transport sector, however, considerable investment is still being made in rail and aircraft, with the delivery dates for large aircraft resulting in volatile investment data.

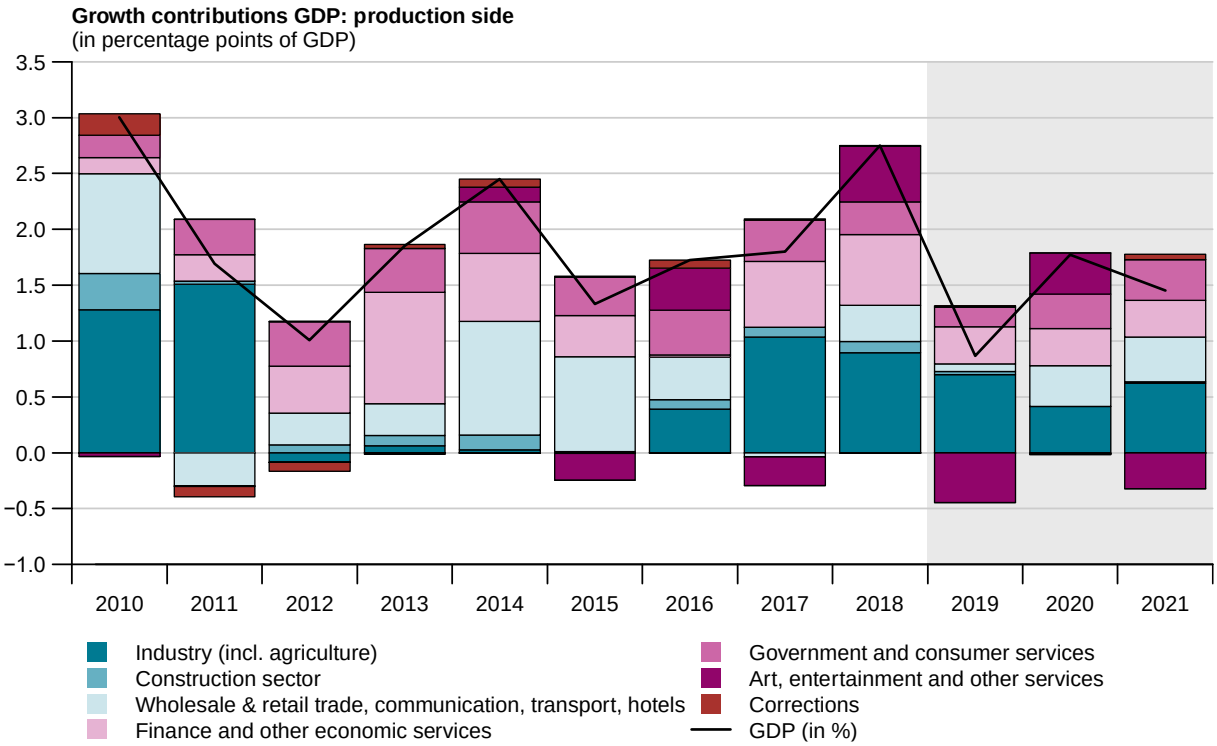


Employment set to grow more slowly than in recent years

Subdued prospects at home and abroad will also slightly impair the dynamism of the Swiss labour market. Employment growth in Switzerland was already slowing noticeably in the summer half of 2019 after many new jobs had been created in the first quarter of the year. In addition to faltering job growth, the last few months have also seen negative signals coming from various leading indicators on the labour market. Temporary employment, for example, has fallen considerably in recent months, according to figures published by the industry association 'swissstaffing' in Switzerland. The number of individuals on short-time working has also fallen significantly. The decline in employment among these categories of workers does not bode well, as they are usually the first to feel an economic downturn.

The outlook for the labour market in the coming year is correspondingly subdued. Employment growth is likely to be well below the rates of the last two years, and industrial employment will actually decline. As a result, unemployment will rise only slightly over the forecast horizon. The International Labour Organization expects the unemployment rate to average 4.5 per cent next year. The unemployment rate as defined by Switzerland's

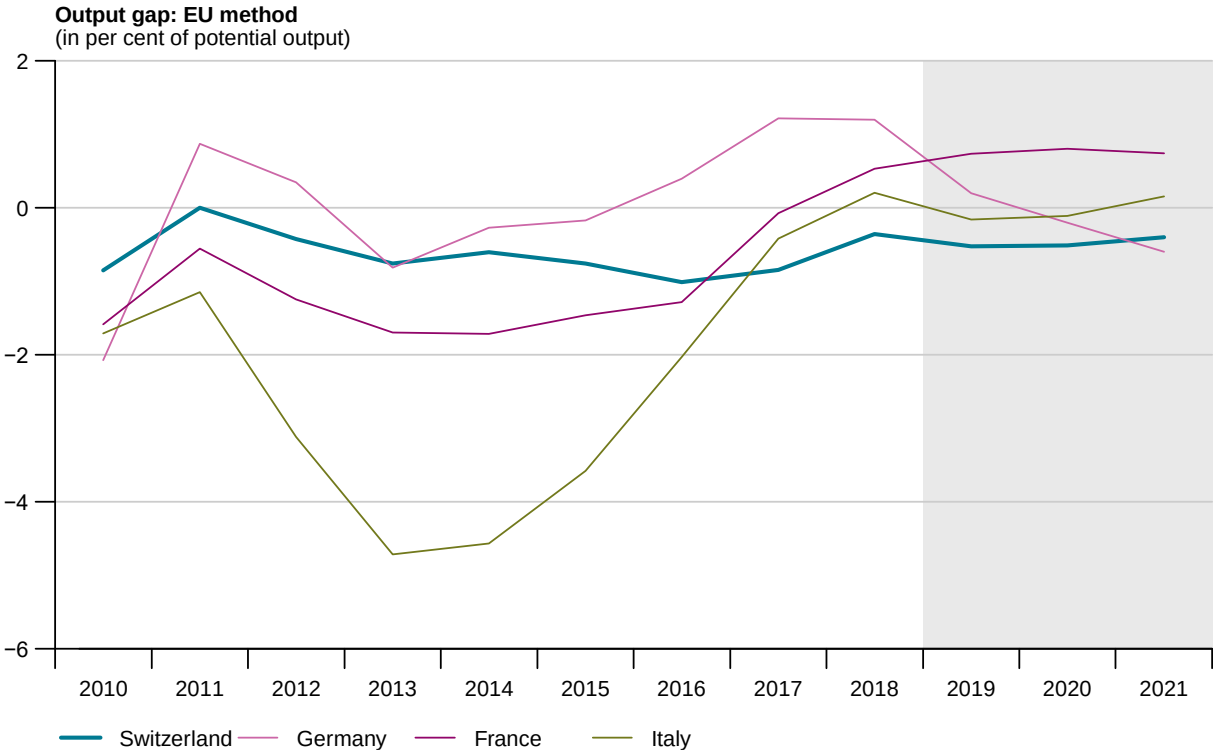
State Secretariat for Economic Affairs (SECO), which only includes those registered with a job centre, should average around 2.4 per cent for 2020.



Pharmaceutical sector becoming increasingly important

The pharmaceutical sector, with its increasing market share, has made a significant contribution to the growth in gross value added in industry over the past 20 years. The abolition of the euro-Swiss franc exchange-rate floor in 2015 expanded the pharmaceutical sector's share of industry as a whole even more during the period from 2015 to 2017. The pharmaceutical sector's dominance of Swiss industry translates into the gross value added by the country's macroeconomy. Prior to 2015 the pharmaceutical sector's contribution to the overall annual economic growth rate was approximately one quarter of a percentage point. This increased to more than half of a percentage point in the period from 2015 to 2017. The phase immediately after abolition of the exchange-rate floor was especially strongly influenced by the pharmaceutical industry. The pharmaceutical sector's share of total value added in Switzerland rose from 2.1 per cent in 1997 to 4.2 per cent in 2014 and 5.3 per cent in 2017. Over the coming years we expect the pharmaceutical sector to continue to play a major role in Swiss industry and the country's macroeconomy.

In our forecast, capacity utilisation in the economy will remain below average. Although the output gap will narrow somewhat over the forecast period, it will not close. This means that no pressure on goods prices and wages can be expected to come from capacity utilisation.



Forecasting Risks

The governing party of Prime Minister Boris Johnson is predicted to win an outright majority in the UK general election being held on 12 December. In this event it is likely that the United Kingdom will leave the European Union on 31 January next year. KOF's forecast assumes that this exit will be completed without causing any economic disruption. Any further delay to Brexit – for example, if the election were to produce a hung parliament – would increase uncertainty even more and therefore pose a downside risk to the economy.

The Swiss pharmaceutical industry has a high and growing trade surplus with the United States, which is a thorn in the side of the Trump administration. There is a risk that the US government will exert pressure on Switzerland in the form of customs duties on pharmaceutical imports from Switzerland.

Because Switzerland has its own currency that is not pegged to one or more leading currencies, exporters face a risk that the Swiss franc might appreciate sharply as a result of geopolitical upheavals or financial crises and its 'safe haven' status. It should be emphasised here that this risk is not reflected in our recent technical assumptions about the euro-Swiss franc exchange rate, i.e. that the franc might appreciate in nominal terms by an amount that corresponds to the inflation differential with the euro area.

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 →