Swiss Economics

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Debt crisis 2.0? Where "normal" interest rates will become a problem

Monitor Switzerland | Q2 2022

Consensus Economics
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Editorial

Dear Reader

Most conversations with company owners at the moment follow a similar pattern: Order books are full, but there is a shortage of both material and labor. Quite clearly, global supply chain problems are preventing companies from fully meeting the surge in demand that has followed the lifting of coronavirus measures, while a shortage of specialist personnel is acting as a drag on capacity expansion.

But what might be a serious challenge for individual companies is actually of benefit to the overall economy – at least from a short-term perspective. Due to the strong sense of individual job security, consumers are still in a buying mood, despite the grim news flow from Ukraine and widespread fears of inflation. Furthermore, strong employment growth and the fact that an increasing number of workers are able to switch to better-paid jobs are compensating overall for the inflation-related loss of purchasing power. For example, the total amount paid out in wages across Switzerland in the first quarter of 2022 rose more strongly than inflation. At the same time, the growing trend toward local procurement is creating incentives for increased investment in Switzerland: According to our survey, around 20% of companies are ramping up their investment plans due to supply chain problems. In view of all this, we continue to expect the Swiss economy to record above-average growth this year, despite all the challenges it faces (for more on our economic forecasts, see page 6).

Healthy parameters are of central importance for a prospering economy in the longer term. Companies must be able to acquire the necessary preliminary goods and services and have access to a sufficient pool of specialist labor, which in turn requires open borders and a high level of education/training. In addition, price stability must be ensured. On page 18 you can read why the Swiss National Bank (SNB) will soon also start to normalize monetary policy – despite being under less pressure than its foreign counterparts – and initiate its first key rate hike in Switzerland. With interest rates now rising generally, an increasing number of investors are starting to worry that record high government debt mountains around the world will soon no longer be affordable. In our focus article from page 12 onward, we identify the countries in which debt really could become a problem, but also why the immediate risk of a debt crisis is low. Incidentally, this analysis also shows that Switzerland stands out with its particularly robust fiscal policy – thanks to the debt brake. Against a backdrop of rising interest rates, however, the rigid conditions that this imposes could become even tighter.

We wish you an enjoyable read.

André Helfenstein
CEO Credit Suisse (Switzerland) Ltd

Claude Maurer
Chief Economist Switzerland

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Is government debt sustainable in the face of rising interest rates?

Government debt is at an all-time high following the COVID-19 pandemic, while central banks are scaling back bond purchases and increasing interest rates. Rising financing costs call into question how sustainable these debt levels are. Thanks to the currently low debt servicing costs and the long residual maturity of bonds, the immediate risk of a debt crisis is low. From 2028 the latest, however, the interest rate reversal is likely to restrict fiscal space significantly in a number of advanced economies.

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Exiting negative rates

Following the upgrade of our inflation forecast, we now expect the Swiss National Bank (SNB) to proceed with a first policy rate increase this year. Subsequent steps will likely follow.

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Inflation weighs only moderately on consumption momentum

Thanks to the lifting of coronavirus measures, economic momentum remains predominantly positive. At 2.5%, economic growth should be above-average in 2022. For 2023 we are expecting growth to slow to 1.6%, however.

Economic growth accelerates in Q1 2022

Gross domestic product (GDP) in Switzerland recorded a quarter-on-quarter rise of 0.5% in the first quarter of 2022. In other words, growth momentum accelerated compared to the final quarter of 2021 despite the wave of Omicron and Russia's invasion of Ukraine. Consequently, the coronavirus measures weighed on the economy less strongly than in earlier waves of the virus, particularly as the majority of measures were rescinded by mid-February already. GDP is now 2.4% higher than the pre-pandemic level. From an economic perspective, therefore, Switzerland has emerged from the pandemic in relatively good shape (cf. Fig 1).

Lifting of COVID-19 measures provides stimulus

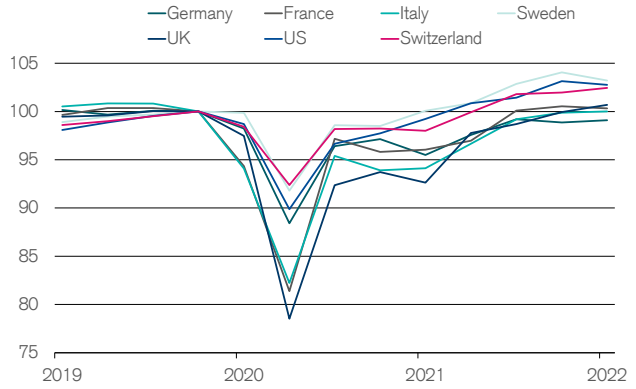
The positive economic momentum created by the full lifting of the coronavirus measures should influence economic activity over the coming months too. According to our estimates, the gross contribution to consumer spending from the lifting of the COVID-19 measures will be around twice as great in the second quarter as in the previous quarter. The PMI for the services sector, which reflects developments in consumer activity, has been comfortably in the growth zone since February (cf. Fig. 2). In addition, although the future development of the pandemic cannot be predicted, the experiences of previous waves point to the economic damage of any further wave in the fall being kept within limits.

Robust labor market situation supports consumer spending

So far, the war in Ukraine has been felt through significant energy price rises and a deterioration in general consumer sentiment. According to April's survey of consumer sentiment, expectations of future economic development are far more negative than back in January (cf. Fig. 3). By contrast, perceptions of job prospects have improved a lot, this being a direct consequence of strong employment growth and a decline in the unemployment rate (see box on labor market, page 8). In other words, the Swiss generally see their own employment situation as good despite an array of economic concerns – and the former tends to sway spending decisions. Moreover, the rise in inflation has so far not reduced purchasing power in Switzerland overall. Thanks to high employment growth and switches to better-paid positions, the total amount of wages paid out in Switzerland has risen by 3.9%, higher than the rise in inflation (2.1%).

Fig 1: Swiss economic output well above pre-pandemic level

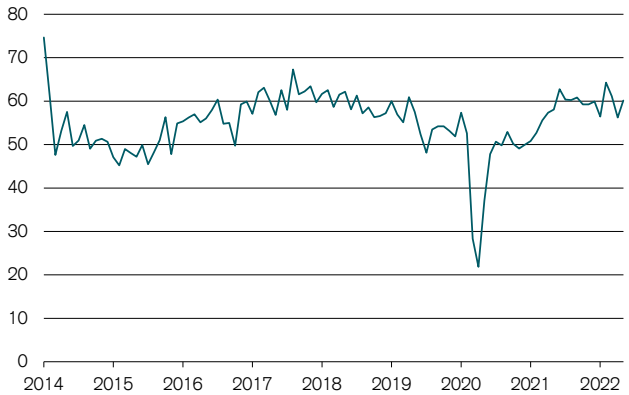
Real gross domestic product, seasonally adjusted, Q4 2019 = 100



Source: Refinitiv Datastream, Credit Suisse. Last data point: Q1 2022

Fig 2: PMI for services sector points to solid growth

Growth threshold = 50



Source: procure.ch, Credit Suisse. Last data point: May 2022

Inflation not proving an excessive drag

According to our forecasts, the inflation rate will remain above 2.0% until the year-end before gradually receding (2022 annual average: 2.3%, cf. box on inflation, page 8). Thanks to the vibrant labor market situation (employment growth of 1.7% and wage growth of 0.8%), the loss of purchasing power in the economy overall should be limited, however. In addition, our analyses of the price elasticities of consumer demand show that the negative effect of inflation on the general momentum of consumer spending should also be limited. Since 1982, a rise in the inflation rate by one percentage point has reduced consumer spending by 0.11%-0.13% on average (depending on the estimation method). Overall, consumer spending should be significantly higher in 2022 than in 2021 (+4.0%). By contrast, the rise in government spending compared to 2020 and 2021 should slow, as these two years involved significant expenditure on vaccines and testing. We are nonetheless still expecting an above-average rise in government spending of 2.5%, not least due to the cost of managing the wave of refugees arriving from Ukraine.

Supply situation remains difficult

At the same time, companies face widespread difficulties in their supply chains. According to participants in our monthly survey of purchasing managers, 62% of companies fear production outages over the next six months due to a lack of preliminary goods and services or raw materials. Moreover, there is no sign of a return to normality on the short-term horizon: 80% of purchasing managers only expect a return to normality next year or thereafter. Accordingly, companies are adjusting their supply chains and their investment behavior. As a general trend, local procurement is more the focus, which in turn involves greater investment in Switzerland. For example, the survey shows that one manufacturer in every five is ramping up investment volumes – with 4% even doing so significantly. By contrast, only 10% intend to invest less, with just 3% having imposed an investment freeze (cf. Fig. 4). Given widespread pressure to increase productivity, capital expenditure can therefore be expected to rise by 2.5%, despite all the uncertainty and rising interest rates. Meanwhile, construction investment reported a decline in the first quarter, among other things due to a shortage of construction materials. We are expecting a slight decline of 0.2% for the year as a whole here, despite order pipelines being well-filled.

Unchanged growth forecast of 2.5% for 2022 and 1.6% for 2023

Overall, we are sticking with our forecast issued last fall, namely that GDP growth in 2022 should be above-average at 2.5%. However, the catch-up effects following the lifting of coronavirus measures in Switzerland and many other countries will increasingly weaken. As an additional factor, there is a lack of new growth drivers given the difficult situation faced by the world economy against a backdrop of rising inflation, monetary tightening, and geopolitical uncertainties. We are therefore predicting a slowdown in growth momentum to 1.6% for 2023.

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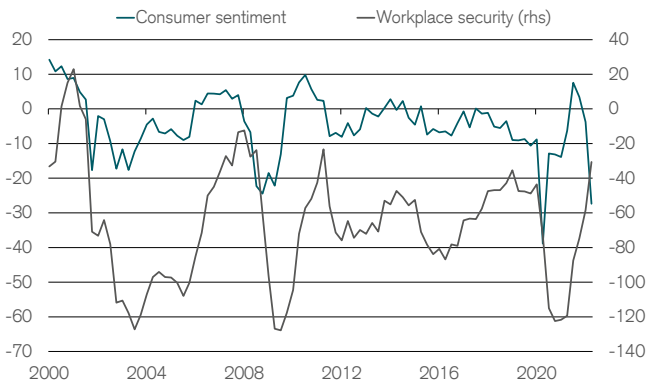
Fig 3: A spectrum of economic fears – but greater perceived job security

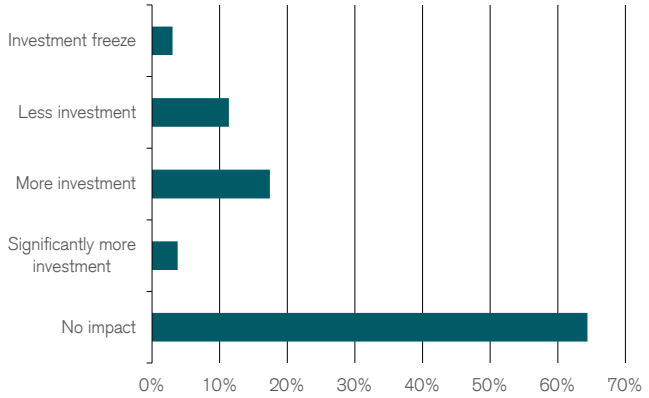
Index from survey



Source: State Secretariat for Economic Affairs (SECO), Credit Suisse.
Last data point: April 2022

Fig 4: Supply chain problem actually has a slightly positive impact on investment

Answers to the question "How have supply chain problems changed your investment plans?"



Source: procure.ch, Credit Suisse

Inflation

Prices in May 2022 were 2.9% up on the previous year. The rate of inflation is currently being driven up significantly by price rises in just a few categories of the average basket of goods used to calculate inflation. For example, the rise in rents (1.4%) added more than 0.2 percentage points to the rate of inflation, while the rise in oil prices pushed this up by a further 1.0 percentage points. By contrast, the rate of inflation was reduced by 0.1 percentage points thanks to a fall in medication prices (–2.0%). Overall, consumer prices can be expected to rise by 2.3% this year and by 1.0% next year.

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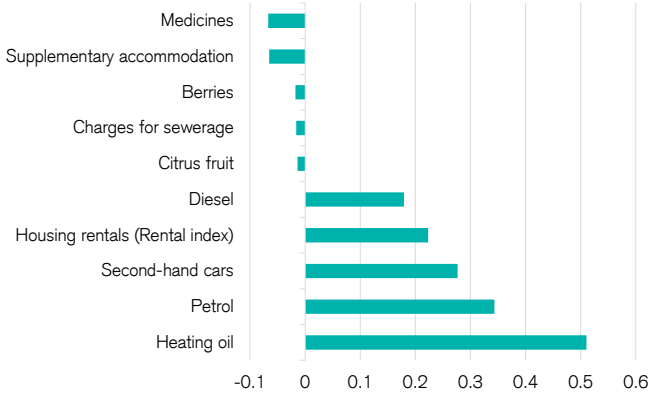
Rents have contributed most to rising inflation

Contribution to the rate of inflation in May 2022, five largest inflationary and disinflationary categories, in percentage points



Source: Federal Statistical Office, Credit Suisse. Last data point: May 2022.

Labor market

The rise in economic uncertainty has so far had almost no impact on the labor market. In many sectors, it is a shortage of specialist personnel that is the dominant theme. Above all in health care and IT – but also in hotels & catering, corporate services, and construction – a particularly large number of companies viewed their current staffing levels as too low at the start of the second quarter of 2022. Accordingly, there are now many vacant positions in these areas. Compared to the prior year, full-time equivalent employment increased by 2.6% in the first quarter of 2022. For 2022 as a whole we are anticipating average employment growth of 1.7%.

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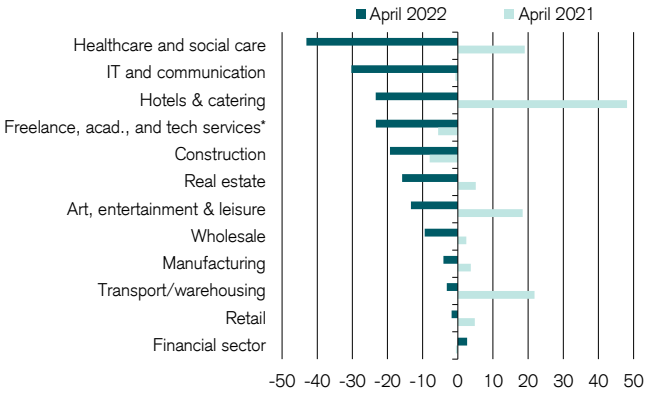
Many sectors facing personnel shortages

Balance between proportion of companies who view current staffing levels as too high (+) and those viewing them as too low (-), in percentage points, selected sectors



* Freelance, academic, and technical services
Source: Economic research unit of ETH Zurich (KOF), Credit Suisse

Immigration

Switzerland has taken in some 54,000 refugees since the start of the war in Ukraine. Thanks to protection status "S", refugees not subject to an asylum procedure have a provisional right to stay for at least a year and are able to work. After five years at the earliest, these vulnerable persons receive a "B" residence permit, time-limited up to the point when the protection status is lifted. Around 57% of protection seekers are capable of working and around 1000 of them have already found a job – a number that is on the rise. Their professional qualifications are more or less equivalent to those of the first-generation immigrants from all countries in the permanent residential population.

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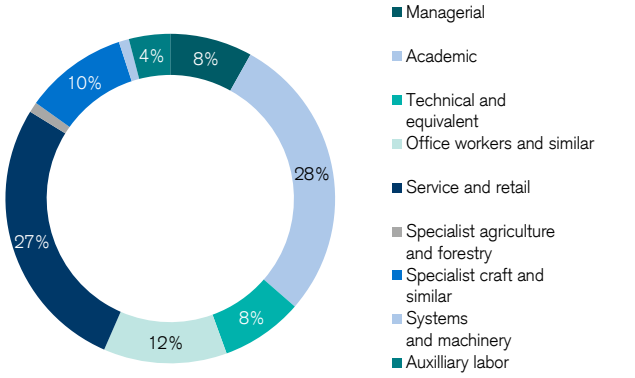
Qualification of refugees with Ukrainian nationality

Distribution of workers by major professional group, random sample of 1774 files, of which 1338 contained professional details



Source: State Secretariat for Migration, Credit Suisse

Pharmaceutical industry

In the first quarter of 2022, pharma exports recorded growth of 3.8% compared to the prior-year quarter. Although exports to the most important destination market, the US, rose once again (+15%), declines were apparent in exports to Germany, China, and Spain. Pharma exports to Spain surged dramatically in 2021 due to the manufacture of vaccines, but have recently reverted back to near pre-pandemic levels. Generally speaking, pharma exports should develop positively over the coming months too, but growth rates compared to those recorded in 2020 and 2021 should not be expected.

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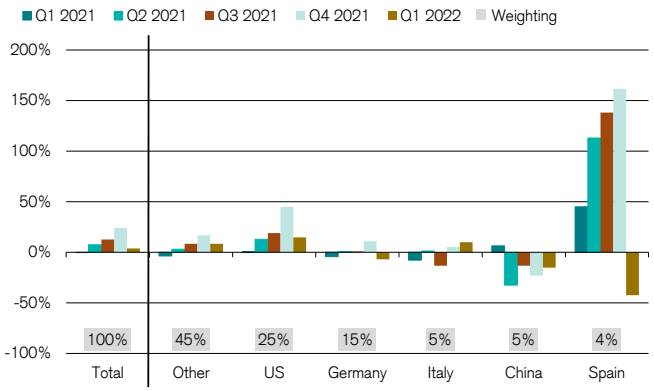
Declining exports to Spain in Q1 2022

Pharma exports compared to prior-year quarter, seasonally adjusted



Source: Swiss Federal Customs Administration, Credit Suisse

Mechanical engineering, electrical and metal industry (MEM)

MEM exports rose in the first quarter of 2022. Here all key export markets other than the US recorded a year-on-year rise. Meanwhile, the great majority of the MEM companies surveyed by the Swiss Economic Institute of ETH Zurich ("KOF") are anticipating higher procurement and sales prices over the coming months. This would suggest that companies will be passing on their higher production costs, at least in part, to clients. At the same time, supply chain problems and possible production outages in China as a result of COVID-19 lockdowns harbor risks for MEM exports.

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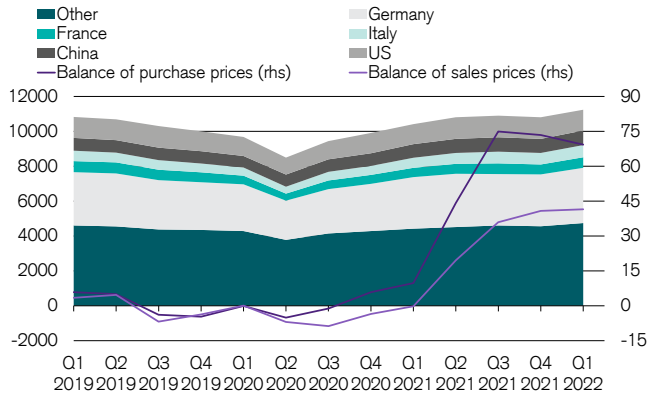
Higher procurement and sales prices expected

Quarterly MEM exports in CHF mn, by country, seasonally adjusted; balance of companies expecting higher procurement/sales prices and those anticipating a decline, in %.



Source: Federal Customs Administration, KOF, Federal Statistical Office, Credit Suisse

Watch industry

Watch exports continued their recovery, reaching a new high of more than CHF 2 billion in March. The US replaced Hong Kong as the leading export destination in 2021, and has recorded further strong in-creases over the last few quarters too. Consumers also appear to have rediscovered their spending appetite in Europe. By contrast, the recovery in Hong Kong proved sluggish, and exports to mainland China even declined. Here the authorities' zero-tolerance approach to COVID-19 and suppressed consumer sentiment are likely to prevent any rapid recovery.

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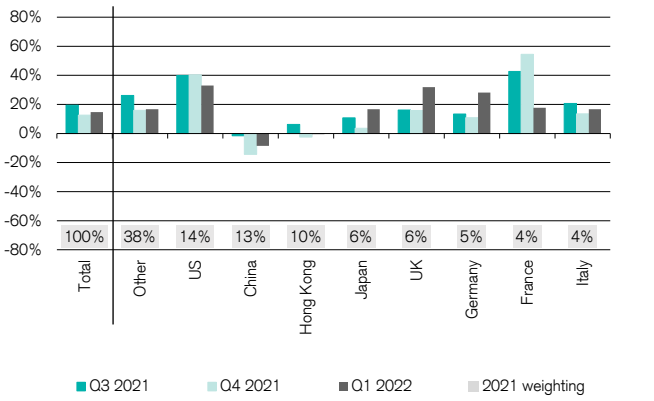
US now the leading export destination for Swiss watches

Watch exports compared to prior-year quarter, seasonally adjusted



Source: Swiss Federal Customs Administration, Credit Suisse

Retail trade

Sales in the Swiss retail sector recorded a year-on-year decline in the first quarter of 2022 for the third quarter in succession. This was attributable to the dwindling special effect of COVID-19, with sales in the food, consumer electronics, and DIY/garden areas falling short of the levels recorded during the pandemic. At the same time, the normalization had a positive impact on sales in the clothing/shoes, personal care and healthcare areas. The recovery can be expected to continue in these segments over the coming months. By contrast, food sales are likely to remain below the levels recorded during the pandemic.

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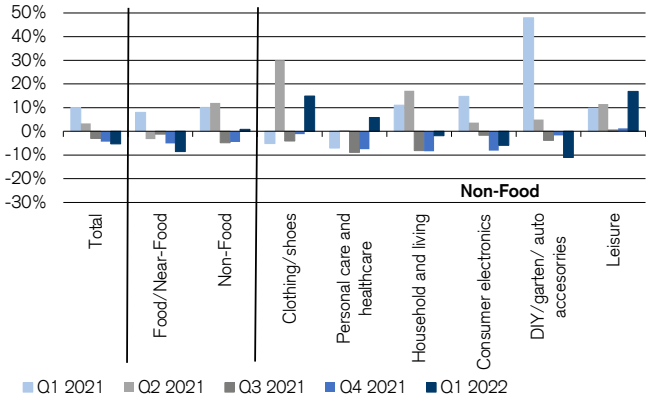
Retail sales normalize

Nominal retail sales, seasonally adjusted, year-on-year quarterly change



Source: GfK, Credit Suisse

Tourism

The widescale rollback of COVID-19 measures has given a boost to tourism in both Europe and Switzerland. Accordingly, the number of guests from these regions has risen since the end of 2021. By contrast, the overnight stays of tourists from Asia and Oceania are still languishing at less than 20% of their pre-pandemic levels. Due to the Ukraine crisis, there is unlikely to be any immediate recovery in the number of guests traveling to Switzerland from far-away continents. On the other hand, the recovery of tourism within Europe can be expected to persist.

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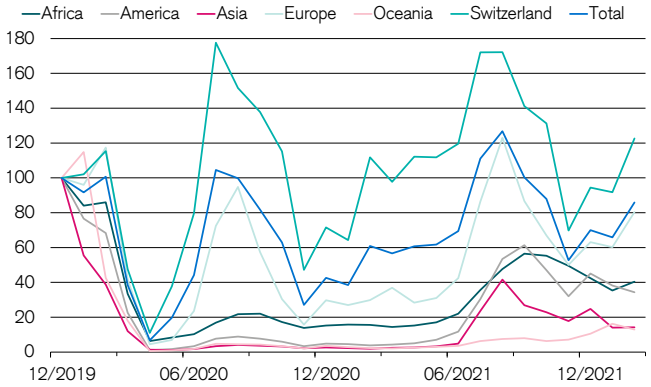
No return of guests from Asia and Oceania yet

Overnight stays, indexed, average 2019 = 100, by continent of origin



Source: Federal Statistical Office, Credit Suisse

Information technology (IT)

Following on from a period of very optimistic sentiment in the IT sector at the start of the year, a noticeable cooling became apparent from the start of the second quarter of 2022. That said, the balance between companies who view their business situation as positive and those that view it as negative still stands at 40%. The repercussions for international value creation chains of the conflict in the Ukraine and China's zero-tolerance policy toward COVID-19 are likely to have been the key factor in the deterioration of sentiment. These challenges and the resulting price inflation can be expected to weigh on the IT sector over the coming months too.

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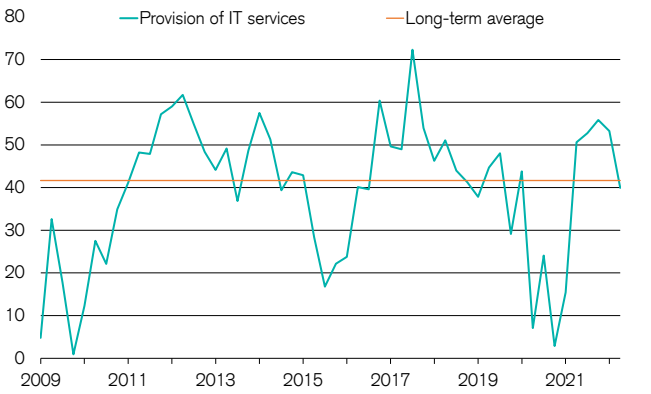
Business situation cools and reverts to long-term average

Balance between companies who view their business situation as positive and those that view it as negative, in %, long-term average



Source: Economic research unit of the ETH Zurich (KOF), Credit Suisse

Is government debt sustainable in the face of rising interest rates?

Government debt is at an all-time high following the COVID-19 pandemic, while central banks are scaling back bond purchases and increasing interest rates. Rising financing costs call into question how sustainable these debt levels are. Thanks to the currently low debt servicing costs and the long residual maturity of bonds, the immediate risk of a debt crisis is low. From 2028 the latest, however, the interest rate reversal is likely to restrict fiscal space significantly in a number of advanced economies.

High debt and rising interest rates spark fear of potential debt crisis

Both fiscal policy expenditure to support the economy during the COVID-19 pandemic and the slump in tax receipts due to the recession left a gaping hole in government budgets. As a result, the average level of government debt relative to gross domestic product (GDP) reached an all-time high (cf. Fig. 1). A half of advanced economies now have a debt-to-GDP ratio of more than 60%, up from around just a third of the countries back in 2007. Moreover, after years of declining interest rates, a trend reversal is imminent. The combination of rising interest rates and record-high debt ratios is fueling fears of a renewed debt crisis similar to that triggered by the impending bankruptcy of Greece and other members of the eurozone in the years 2010–2012.

Level of debt alone no reliable indicator for the likelihood of a debt crisis

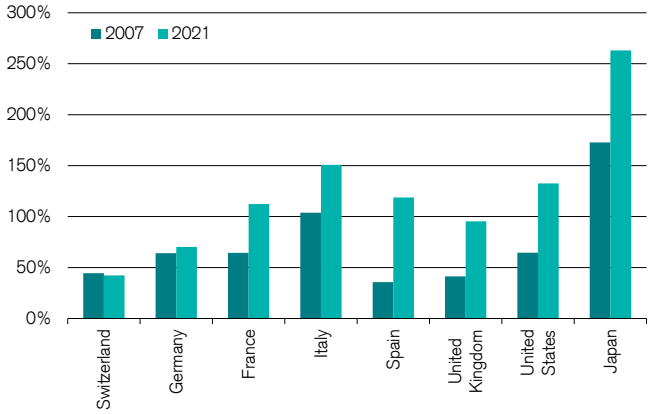
However, there is no generally valid threshold above which government debt becomes "dangerous". The relevant factor is whether a country can afford its debt servicing costs. As long as a country is able to meet its debt obligations and find creditors, it can theoretically roll over its debt into perpetuity. Economists therefore look at interest expenditure as a percentage of economic output when analyzing the affordability of government debt. Debt sustainability in general is influenced by a number of variables: In addition to the nominal level of debt, these include future deficits, the overall level of interest rates, country-specific risk premiums, refinancing risk, and economic growth. In the following paragraphs, we evaluate these indicators in order to gauge the sustainability of public debt.

Analysis of debt sustainability for Switzerland's key trade partners

Our analysis covers Switzerland and its key trade partners (Germany, France, Italy, Spain, the UK, and the US) as well as Japan. The latter is an interesting case due to its extraordinary high level of debt. We exclude China from this analysis – despite its significance as a trade partner – because the debt dynamics in emerging countries differ significantly from that in advanced economies.

Fig. 1: Government debt levels of advanced economies have risen sharply since the financial crisis

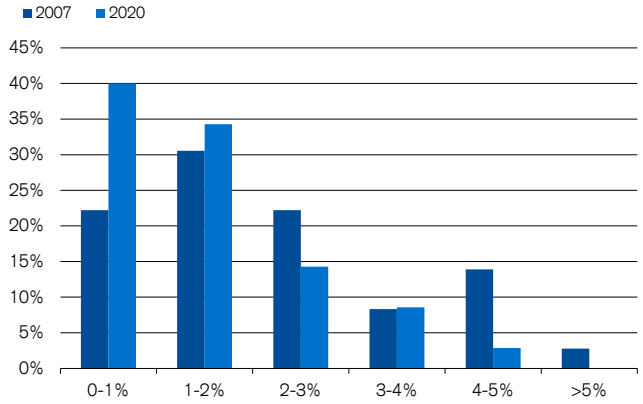
General government (including social security) gross debt ratio, as % of GDP, 2007 vs. 2021



Source: International Monetary Fund (IMF), Credit Suisse

Fig. 2: Thanks to the low interest environment, interest expenditure has declined significantly despite rising levels of debt

Distribution of interest expenditure in advanced economies , as % of GDP, 2007 vs. 2020



Source: International Monetary Fund (IMF), Credit Suisse

Interest burden has fallen despite rising debt, ...

First, it is worth pointing out that debt servicing costs relative to GDP have declined significantly since the financial crisis despite rising debt ratios (cf. Fig. 2), because interest rates have proportionally fallen further than debt levels have risen. This has alleviated the burden on government budgets in recent years. In view of the imminent interest rate turnaround, this trend should now reverse – but not overnight. Depending on the average residual maturity of their debt portfolios and the resulting refinancing risk, governments have a certain amount of time in which to prepare for changed financing parameters.

... and the refinancing risk has also declined thanks to higher residual maturities, ...

The treasury departments of governments have exploited the record-low interest rates of recent years to extend the average maturity of their debt portfolios and lock in the benefit of low interest rates for a longer period (cf. Fig. 3). Only in the US and Italy has the maturity profile remained more or less constant compared to the last debt crisis – in the case of the former, at a relatively low level of 5.6 years. Leading the way is the United Kingdom with 14.6 years. Spain has managed to increase its residual maturity by 1.5 years, France by 1.2 years. In Switzerland, the residual maturity of Confederation bonds has also been pushed up markedly in order to benefit from low interest rates for longer. However, in 2020 the overall residual maturity fell back to 2016 levels for a short period as the federal treasury issued an unusually large volume of short-term money market paper in order to finance measures to combat the effects of coronavirus.

... so that the rise in interest rates will only be felt with a time lag

The current rise in the level of interest rates will therefore not impact government budgets immediately, which in turn gives governments time to consolidate. In Fig. 4 we simulate how the expected increases in key rates up to 2023 (as forecast by us) could influence effective interest rates – i.e. the average interest rates across all maturities weighted with the outstanding amounts in question. What emerges is that even at the end of 2023 refinancing costs will remain far lower than during the debt crisis. In some cases, the effective average rate of interest will even decline slightly in the short term as old legacy debt is refinanced more cheaply.

Relevant medium-term factors: interest rates, growth, and primary balance

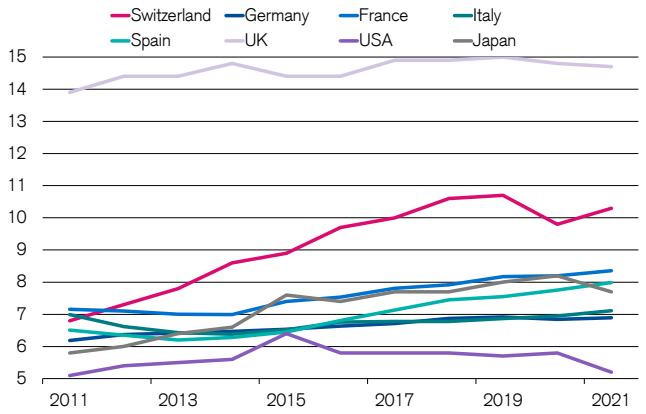
But governments will have to face the music at some stage. Although rising interest rates are unlikely to trigger a debt crisis in the short term, this in no way represents a green light for ongoing deficits. In the medium term, the rising interest rate burden may become a problem even with a neutral primary balance. The primary balance is the budget result after deducting all interest revenues and expenditures, which makes it a metric for evaluating government budgets irrespective of debt levels and their financing.

Debt ratios may rise even with a neutral primary balance

Even on the assumption that countries will be able to deliver a neutral primary balance in the future, the debt servicing costs of Italy, the US, France, and Spain will be so high within a few years that their debt ratios will rise further purely as a result of interest payments. By economic metrics, debt becomes unsustainable from this point onward. Specifically, this is the case if the real interest rate for bonds rises above the growth rate of the economy, i.e. if the so-called interest rate-growth differential is positive. Where this occurs, debt servicing costs exceed the growth of GDP (i.e. of the denominator of the debt ratio), and the debt ratio grows even if the government budget is balanced.

Fig. 3: Governments have increased the residual maturity of their debt in order to benefit from low interest rates for longer

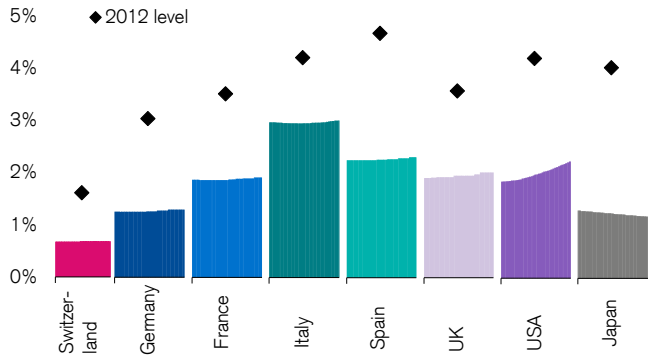
Average residual maturity of outstanding bonds and bills, in years



Source: International Monetary Fund (IMF), Federal Finance Administration (FFA), Credit Suisse

Fig. 4: Up to the end of 2023, rising key rates will drive up effective interest rates on government debt only slowly

Average interest rate May 2022 – end 2023 based on key rate forecasts; assumes constant residual maturity and yield curve shape; av. int. rate during 2012 debt crisis



Source: International Monetary Fund (IMF), Refinitiv Datastream, Credit Suisse

Trend reversal in interest rate-growth differential

Over the last few years, the situation has been precisely the opposite: The interest rate level has languished below the growth rate, enabling governments to stabilize their debt ratios despite running a small primary deficit. According to our forecasts for key rates and the effective interest rate as per Fig. 4 and using the growth and inflation forecasts of the International Monetary Fund (IMF), the interest rate-growth differential will revert to the positive range in the future, albeit at different speeds for different countries (cf. Fig. 5).

Debt sustainability looks questionable in the medium term for Italy, the US, France, and Spain

In Switzerland and Germany, the differential should remain negative until the end of the decade, even if central banks increase key rates by 25 basis points (bps) a quarter between now and the end of 2025. In other words, these two countries should continue to be able to at least stabilize their debt levels despite running primary deficits, because GDP growth will finance the rising cost of debt servicing. In the US, by contrast, even balanced primary budgets will not be sufficient to stabilize the debt ratio from 2027 onward. Spain and France will face this problem from 2028. Meanwhile, Italy will have to be generating primary surpluses from as early as mid-2025 in order to prevent its debt ratio from rising purely as a result of the increased cost of servicing debt.

Expensive problems are an obstacle to credible consolidation strategies

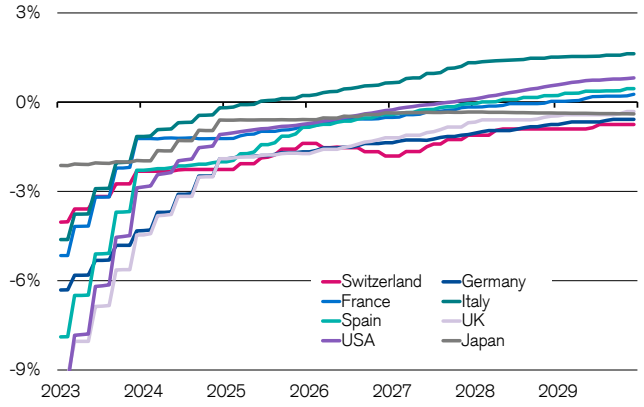
Yet the assumption alone of countries posting a level primary balance is optimistic. Of the countries analyzed, only Switzerland, Germany, and Italy were not running a primary deficit prior to the pandemic. Due to the high cost of servicing its legacy debt burden, however, even Italy's budget surplus has not been high enough to reduce the country's debt ratio meaningfully. Now, all countries are confronted with an array of expensive problems. Given the planned investment in energy transition, high defense expenditure for armaments and cybersecurity, and the unresolved problem of financing national pension systems, the comprehensive consolidation of government budgets over the coming years has become more unlikely. The budget forecasts of the IMF (cf. Fig. 6) likewise do not suggest that these countries will manage this – with the exception of the UK, Germany and Switzerland. Accordingly, Italy, France, Spain, and the US could have a debt sustainability problem from the middle resp. the end of the current decade. In the absence of any credible fiscal strategy for the meantime, markets could lose confidence in these countries, thereby increasing the probability of a debt crisis.

Six indicators for assessing debt risk

When all the observed indicators are taken into consideration, the overall risk of a debt crisis can be evaluated as follows: A debt crisis is more likely if debt levels are no longer sustainable in an economic sense, i.e. if the real level of interest rates exceeds the real growth rate. Moreover, if gross debt, debt servicing costs, and primary deficits are high relative to economic output, the debt sustainability problem is exacerbated. Finally, a low residual maturity of the debt portfolio and a high or volatile country risk premium also have the effect of increasing the risk of a debt crisis.

Fig. 5: In the absence of budget consolidation, Italy, the US, France, and Spain will have a debt sustainability problem soon

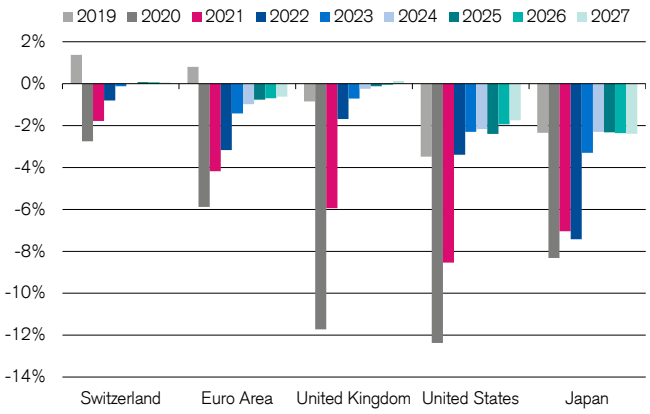
Difference between real interest rate and growth rate. Based on Credit Suisse forecasts for key rates up to 2023 and a 25 bps rise every quarter thereafter until end of 2025; including IMF inflation and growth forecasts up to 2027 and trend assumptions for the period thereafter



Source: International Monetary Fund (IMF), Refinitiv Datastream, Haver Analytics, Credit Suisse

Fig. 6: Active consolidation of government debt looks unlikely given the expensive problems countries face

Forecast of general government (incl. social security) primary deficits, as % of GDP



Source: International Monetary Fund (IMF), Credit Suisse

Box: Country risk premiums, confidence crises, and the special case of the US

A debt crisis can come about in two ways: One way is a deterioration of the fundamental fiscal position, whereby debt rises to a level that governments can no longer service in the prevailing interest rate environment. The other way is a rise in the country-specific risk premium – which in addition to risk-free long-term interest rates determines the level of interest rates for government bonds – which makes servicing the debt impossible despite a fundamentally solid fiscal position. The latter occurs when markets lose trust in a country's ability to pay. This often goes hand in hand with a deterioration in the fundamental fiscal position, but it may also be driven by other factors such as political instability.

While countries cannot influence the development of long-term interest rates – they are primarily determined by inflation and growth expectations – the country-specific risk premium depends greatly on the actions of the government in question and the confidence that creditors have in the ability of a country to meet its payment obligations. For example, if a government has never been insolvent, it increases its credibility as a borrower.

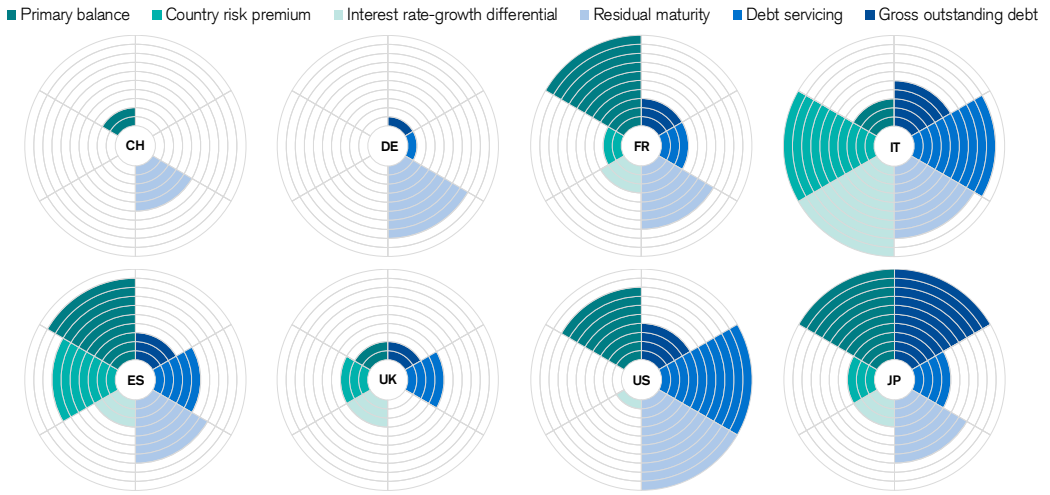
This is true of the US and explains why its risk premium is so low, even though fundamental fiscal policy indicators (such as the level of debt, primary deficit, and refinancing risk) are less solid in an international comparison. Investors have such a high level of trust in the US dollar and the US government as a borrower that the interest rate on US government bonds is even used as a risk-free reference interest rate. Most other countries do not enjoy this luxury. However, these countries can increase market confidence in their solvency in other ways. One avenue is a debt brake mechanism enshrined in the constitution, as found in Germany and Switzerland. This has the effect of limiting any debt sustainability risk beyond a rise in the general interest rate environment.

Italy stands out with highest risk in the overall picture

In Fig. 7 we set out these six indicators for all investigated countries in a uniform way: The higher the figure, the more problematic the position of a country relative to the others. What emerges is that there are significant differences between countries. Switzerland stands out with its particularly robust situation, whereas the fiscal positions of Japan, the US, and Italy look more precarious. Japan is a special case, because while the level of debt here is extraordinarily high and unlikely to decline, the cost of servicing this debt should pose no problem for the foreseeable future due to an extraordinary low interest rate outlook. For the debt of the US, three of the six indicators point to heightened risk, but investor trust reflected in the low risk premium compensates for this to a certain degree. In Italy, by contrast, a fundamentally poor fiscal position goes hand in hand with heightened (and volatile) risk premiums. This combination looks problematic, particularly if political stability should deteriorate and drive up risk premiums as a result. From this standpoint, the impending parliamentary elections in Italy next year could lead to stress in bond markets.

Fig. 7: Italy, Japan, and the US appear relatively challenged according to various debt sustainability indicators

Standardized figures; large area indicates a poor relative position. Gross debt as per 2022, residual maturity as per 2021, debt servicing costs as per 2020, forecasts for primary balance and interest rate-growth differential in 2027, country risk premium according to Damodaran (2022) based on ratings and sovereign credit default swap spreads



Source: International Monetary Fund (IMF), Damodaran (2022): Country Default Spreads and Risk Premiums, Refinitiv Datastream, Haver Analytics, Credit Suisse

Improvements in the euro architecture have made Europe more resilient

Nonetheless, the risk of a wide-scale debt crisis in Europe similar to that of the period 2010–2012 is currently low. When viewed on aggregate across all countries, Europe's fiscal situation is superior to that of the US, for example. In order to tackle the heightened risk of individual countries better, the European Union has significantly improved its institutional architecture since the euro crisis. The European Stability Mechanism (ESM), the Outright Monetary Transactions (OMTs) of the European Central Bank ("Whatever it takes"), and the common debt for the Recovery and Resilience Facility (RRF) in the context of the pandemic have all made the eurozone more resilient.

Risk of debt crisis low but rising in medium term

While government debt levels are historically high, other metrics suggest a relatively stable situation, at least in the short term. The interest rate trend reversal will only exercise an influence on government budgets after a significant time lag, above all thanks to the long average residual maturity of existing debt. In the medium term, however, we will see a balancing act between the need for consolidation on the one hand and growth-damaging austerity on the other.

Interest rate trend reversal will limit fiscal space

Toward the end of the decade, the fiscal space for some countries will be squeezed dramatically. The kind of comprehensive fiscal policy support that governments provided during the COVID-19 pandemic will no longer be possible everwhere, at least not without subsequent tax rises or a reduction in expenditure in order to finance the interest rate burden. It is therefore not surprising that the US and Europe are currently taking advantage of what is still a relatively low interest rate environment to finance long-term growth-enhancing investment programs.

Debt sustainability not a problem in Switzerland, but debt brake limits options

When looking at all the indicators that we analzse in this study, Switzerland stands out with a particularly robust fiscal policy situation. This is surely attributable to constitutional the debt brake, which has now been in force for almost two decades. The sustainability of government debt is therefore not even a question in Switzerland, which would be able to keep its debt ratio stable even if it posted budget deficits. Yet precisely for this reason, the outlook for Swiss budget policy in the next few years does not differ greatly from that of other countries: Rather than the level of debt, it is the tight corset of the debt brake that will limit the federal government's fiscal space in the face of rising interest expenditure. In the longer term, therefore, the expensive problems of the future could result in tax increases or expenditure cuts in Switzerland too.

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Exiting negative rates

Following the upgrade of our inflation forecast, we now expect the Swiss National Bank (SNB) to proceed with a first policy rate increase this year. Subsequent steps will likely follow.

Relatively moderate inflation allows for relatively slow rate increases

As the European Central Bank (ECB) appears set to raise its policy rate several times this year, bringing it into positive territory by year-end, the conditions for a first policy rate increase in Switzerland without risking a sharp appreciation of the Swiss franc should improve. However, the pace of policy rate increases by the SNB will likely be slower than the ECB's, as inflationary pressures remain much more moderate in Switzerland than in the Eurozone. Indeed, despite our latest inflation forecast upgrade from 1.8% to 2.3% on average in 2022, we expect the inflation rate to fall below 2% by Q1 2023 (Figure 1), which would be within the definition of price stability.

Wider interest rate spread should help reduce appreciation pressure on the CHF

As other central banks will likely raise their policy rates rapidly over this year to tame elevated inflation in their regions, the interest rate difference between other currencies and the Swiss franc will increase, which will lower the attractiveness of the latter. However, the current situation is ambiguous for the SNB. On the one hand, it has called the Swiss franc "highly valued" since the summer of 2017 (Figure 2), thereby signaling a preference for a weaker Swiss franc. On the other hand, any depreciation of the Swiss franc raises inflation through an increase of the import prices. Overall, we believe that the SNB will not wait for a substantial depreciation of the Swiss franc to start raising its policy rate, while it will likely avoid adding too much appreciation pressure on the currency by lifting its policy rate too soon and too fast.

No reduction of SNB balance sheet

So far, the SNB has not shared any plan about the reduction of its balance sheet. In our view, the negative policy rate is more costly than a large balance sheet. We therefore believe that any active reduction of the balance sheet is unlikely before the SNB policy rate has reached at least 0%.

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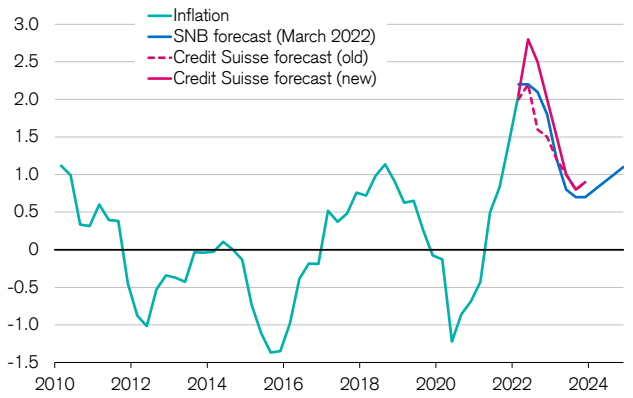
Fig. 1: Inflation should fall below 2% in Q1 2023

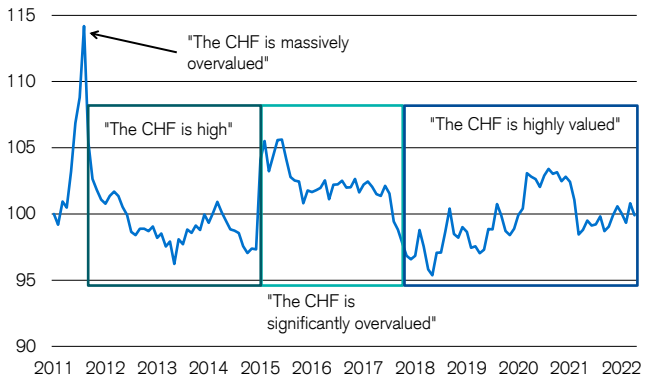
Inflation rate, in %



Source: Refinitiv Datastream, SNB, Credit Suisse. Last data point: Q1 2022.

Fig. 2: How the SNB has assessed the valuation of the Swiss franc

CHF real effective exchange rate, Jan 2011 = 100. An upward move reflects an appreciation of the CHF



Source: Refinitiv Datastream, SNB, Credit Suisse. Last data point: April 2022.

COVID-19 loans

Banks participating in the COVID-19 loan program have requested borrowers to start paying back their COVID-19 loans since the end of March 2022. The Swiss Bankers' Association recommended the measure and the government supported it. Consequently, the volume of paid-back credits has increased significantly since our last update, from CHF 4715 m (3 March) to CHF 5777 m. Defaults have risen from CHF 355 m to CHF 431 m, while CHF 13.2 m (+4.2 m) could be recovered from previously defaulted loans. Outstanding COVID-19 credits have declined to CHF 10.7 bn.

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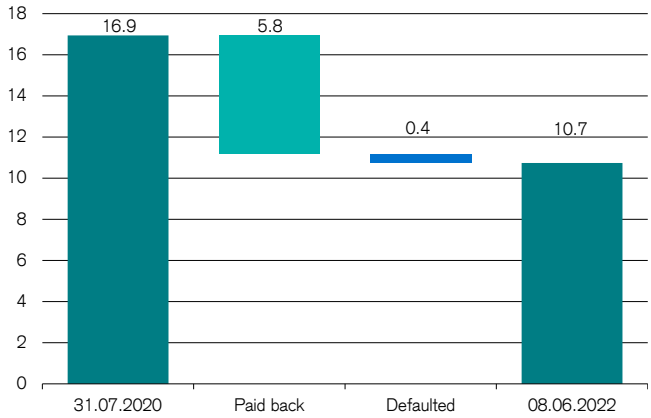
More than a third of all COVID-19 loans paid back

Outstanding COVID-19 loans, in CHF bn



Source: SECO, Credit Suisse

SNB profit

The SNB reported a loss of CHF 32.8 bn for Q1 2022, the largest quarterly loss since Q1 2020. The loss is mostly due to price losses on the SNB bond and equity holdings, as well as a stronger CHF. Since the end of Q1, bond and equity prices have declined further, adding to the loss. However, the CHF has weakened, which should compensate somewhat for the loss. Alone with the rise of the USD to parity with the CHF, the SNB should book a profit of around CHF 28 bn, while an EUR/CHF exchange rate at 1.04 implies a profit of around CHF 6 bn for the SNB.

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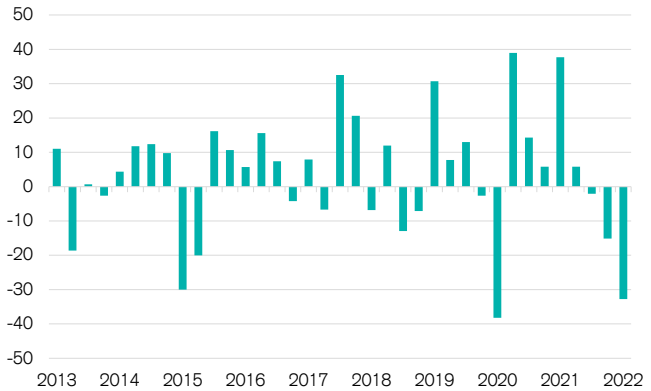
Third consecutive quarterly loss for the SNB in Q1 2022

Quarterly net income, in CHF bn



Source: Bloomberg, Credit Suisse. Last data point: Q1 2022.

SNB foreign currency interventions

While the SNB said that it allowed the CHF to appreciate in Q4 2021 and Q1 2022, it nevertheless purchased foreign currencies over this period. The SNB reported purchases of CHF 12.7 bn of foreign currencies in Q4 2021 and we estimate that the central bank's foreign exchange interventions in Q1 2022 amounted to CHF 5.5 bn (official data will be released at the end of June). In an environment where central banks are tightening their monetary policy, we expect SNB's interventions on the foreign exchange market to become less and less frequent.

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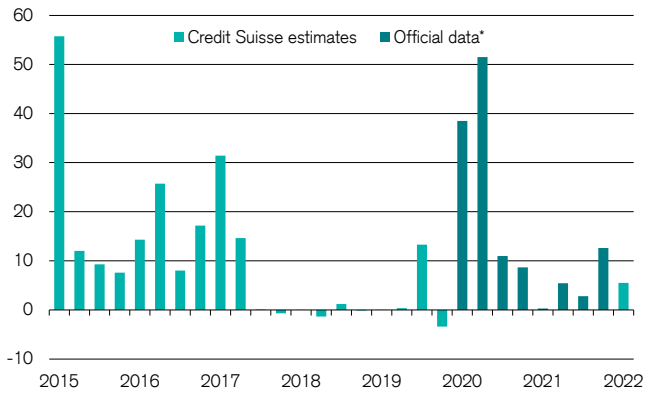
Foreign currency purchases have become less frequent

Net foreign currency purchases by the SNB, in CHF bn



*Available from Q1 2020. Source: SNB, Credit Suisse. Last data point: Q1 2022.

Owner-occupied housing

Demand for owner-occupied housing is currently much higher than the corresponding supply. Price growth is very high – and indeed accelerating – as a result of this demand overhang: Within the space of just a year, prices rose by 7.5% for condominiums and 8.7% for single-family homes. Over the next few quarters too, the prices of owner-occupied housing can be expected to rise further. However, the rate of increase is likely to weaken given higher interest rates for fixed mortgages, strong recent price growth, and strict regulation.

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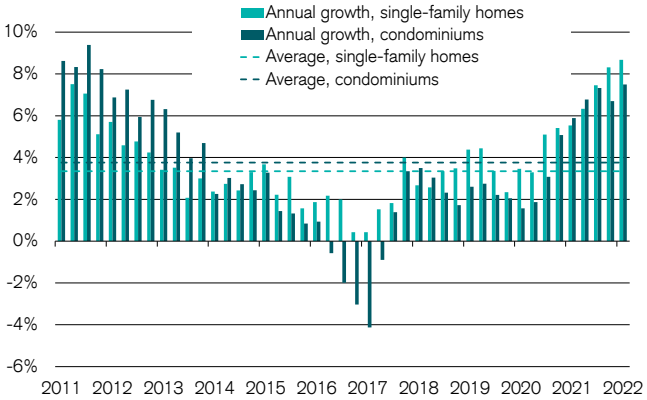
Growth in residential property prices accelerates further

Price development in mid-range segment; dotted lines: average 2000–2021



Source: Wüest Partner. Last data point: Q1 2022.

Rental apartments

The rental apartment market is currently characterized by both a rise in demand and a decline in supply. This so-called "pork cycle" has put an end to a downturn lasting many years, during which vacancies rose and downward pressure on advertised rents increased. All the signs now point to recovery: The vacancy rate has been declining since 2021, the supply rate is likewise falling, and the average time-on-market has now shrunk to its lowest level since 2015. Accordingly, a trend reversal in rents has become established and is likely to persist.

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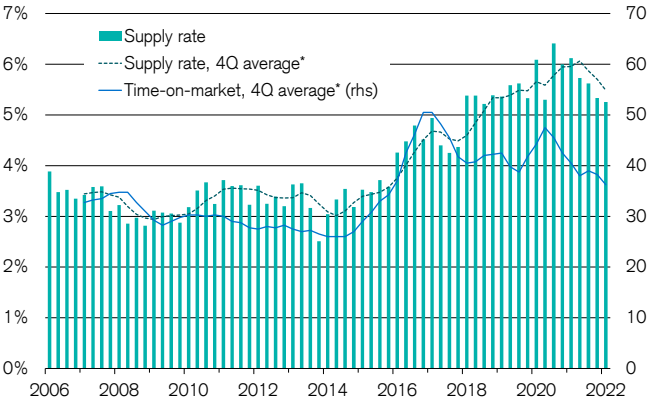
All signs point to recovery

Supply rate as % of existing housing stock, time-on-market in number of days



* Moving average over four quarters
Source: Meta-Sys, Credit Suisse. Last data point: Q1 2022.

Office property

At CHF 1,586 million, the 12-month total of building permits issued for office projects was recently some 18% below its long-term average. Investors are therefore clearly being circumspect with their office property investments, holding back from new projects until greater clarity emerges with regard to the need for future space. Only in the area of conversion applications, which have been above their long-term average since September 2021, has there been a significant increase over the last semester. In the majority of large and mid-sized centers, this reticence on the part of investors is likely to be a major factor preventing any significant buildup of imbalances going forward.

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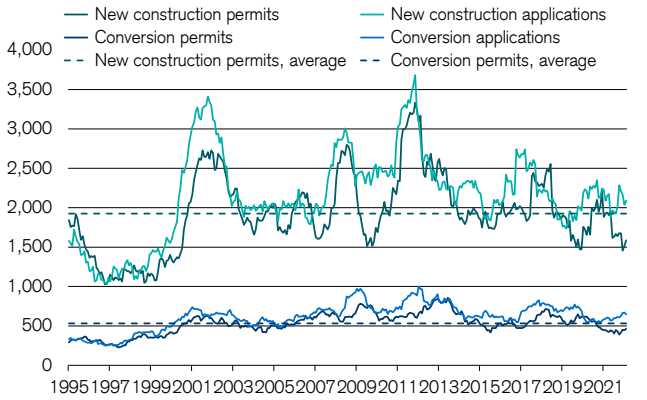
Reticence in newbuild activity in office property segment

Building permits and planning applications, moving 12-month total, in CHF mn



Source: Baublatt, Credit Suisse. Last data point: 02/2022.

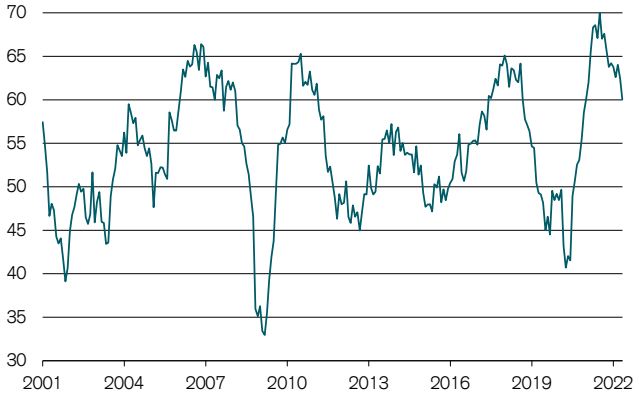
Credit Suisse Leading Indicators

Purchasing Managers' Index (PMI)

Purchasing managers stand at the beginning of the production process. The PMI uses this forward-looking feature to forecast the level of economic activity. The index is based on a monthly survey conducted by procure.ch, the industry body for purchasing and supply management. Purchasing managers respond to eight questions on output, backlog of orders, purchasing volumes, purchase price, delivery times, stocks of purchases, stocks of finished goods, and employment. They indicate whether activity levels are higher, the same, or lower than in the preceding month. The percentage share of responses stating "higher" and "no change" are used to calculate the sub-indices, though only half of the "no change" share of responses is included. The PMI lies between 0 and 100, with a figure of more than 50 indicating an expansion of activity compared with the previous month.

Industrial Activity

PMI index > 50 = growth



Source: procure.ch, Credit Suisse

Credit Suisse Export Barometer

The Credit Suisse Export Barometer takes as its basis the dependence of Swiss exports on foreign export markets. In constructing the export barometer, we have drawn together important leading industry indicators in Switzerland's 28 most important export markets. The values of these leading indicators are weighted on the basis of the share of exports that goes to each country. The export barometer consolidates this information to produce a single indicator. Since the values in question are standardized, the export barometer is calibrated in standard deviations. The zero line corresponds to the growth threshold. The long-term average growth of Swiss exports of approximately 5% is at 1.

Exports

In standard deviation, values > 0 = growth

Source: PMIPremium, Credit Suisse

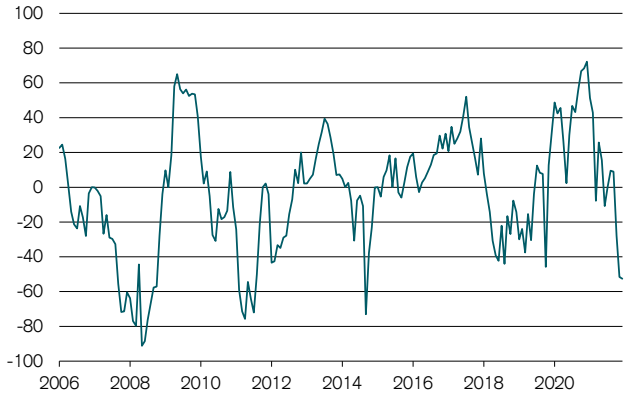
CS CFA Society Switzerland Index

Financial analysts have their finger on the pulse of the economy. Since 2017, we have been conducting a monthly survey of financial analysts jointly with CFA Society Switzerland under the heading Financial Market Test Switzerland[1]. Analysts are questioned not only about their assessment of the current and future economic situation as well as the rate of inflation but also about financial market issues such as equity market performance and interest rate forecasts. The CS CFA Society Switzerland Index represents the balance of expectations regarding the development of Swiss economic activity over the coming six months.

[1] Published as the Credit Suisse ZEW Index from 2006 until 2016

Economic Activity

Balance of expectations, values > 0 = growth



Source: CFA Society Switzerland, Credit Suisse

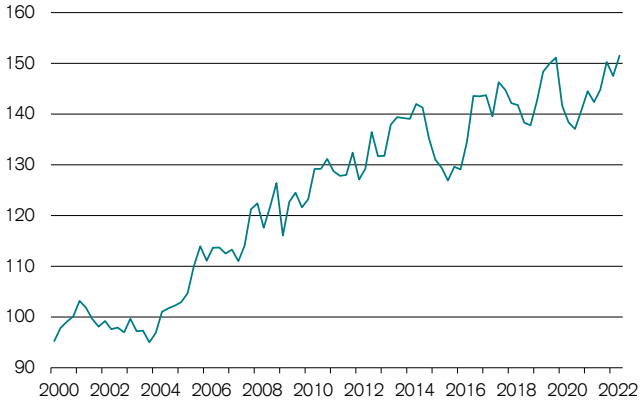
Credit Suisse Leading Indicators

Swiss Construction Index

The Swiss Construction Index is published once a quarter jointly by Credit Suisse and the Swiss Contractors' Association (SCA). It serves as a leading indicator for the state of Switzerland's construction sector by forecasting the volume of work in the core construction business in the coming quarter. The indicator is calculated by Credit Suisse and is based mainly on a quarterly survey conducted by the SCA among its members. Additional data is provided by the Swiss Federal Statistical Office and Baublatt. The Construction Index was launched in the first quarter of 1996.

Construction Industry Climate

1st quarter 1996 = 100



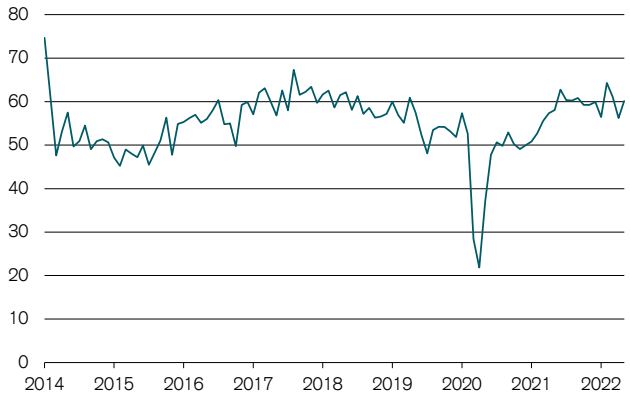
Source: Swiss Contractor's Association, Credit Suisse

PMI Services

Procure.ch, the professional association for purchasing and supply management and Credit Suisse launched a PMI for the services sector in 2014. The Services PMI is structured in exactly the same way as its industry counterpart. Values over 50.0 points mean expansion. It is based on a survey of purchasing managers from Swiss service providers. There are six subcomponents: type of business, new orders, order book, purchasing prices, sales prices and number of employees.

Activity in the services sector

PMI Services index > 50 = growth



Source: procure.ch, Credit Suisse

Forecasts and Indicators

Forecasts for the Swiss Economy

	2022	2022P	2022P	2022P	2023P	2023P	2023P	2023P	2022P	2023P
	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2	Quarter 3	Quarter 4		
GDP (YoY, in %)	4.4	2.9	1.2	1.5	1.4	1.7	1.6	1.6	2.5	1.6
Consumer spending	7.5	4.2	1.7	3.0	1.6	1.6	1.6	1.6	4.0	1.6
Government expenditure	4.1	2.6	2.3	0.9	1.0	1.0	1.0	1.0	2.5	1.0
Gross capital investment	1.1	1.3	1.6	2.0	1.5	1.4	1.4	1.4	1.5	1.4
Construction investment	-1.9	0.0	0.0	1.0	0.4	0.4	0.4	0.4	-0.2	0.4
Investment in plant and equipment	2.8	2.0	2.5	2.6	2.0	2.0	2.0	2.0	2.5	2.0
Exports (goods and services)	12.6	4.5	1.6	0.0	4.0	4.0	4.0	4.0	4.5	4.0
Imports (goods and services)	12.0	4.0	1.4	1.0	3.0	3.0	3.0	3.0	4.5	3.0
Inflation (in %)	2.1	2.8	2.5	2.0	1.5	1.0	0.8	0.9	2.3	1.0
Unemployment (in %)	2.3	2.2	2.2	2.2	2.2	2.3	2.3	2.3	2.2	2.3
Employment growth FTEs (YoY, in %)	2.6	2.2	1.2	0.9	0.6	0.9	0.8	0.9	1.7	0.8
Net immigration									60,000	
Nominal wage growth (YoY, in %)									0.8	1.7

Source: Federal Statistics Office, State Secretariat for Economic Affairs SECO, Credit Suisse

Forecasts for the World Economy

	Forecasts				Structure		Significance for Switzerland	
Forecasts	**GDP** YoY, in %		**Inflation** YoY, in %		**Population** In million	**GDP** In USD billion	**Share of exports** In %	**Share of imports** In %
	2022	**2023**	**2022**	**2023**	**2021**	**2021**	**2021**	**2021**
World	3.2	2.8	6.7	3.8	7,763	96,293	100	100
US	2.7	2.3	7.6	3.8	332	22,998	18.1	6.0
Euro zone	2.4	2.0	7.0	2.3	343	14,505	51.5	66.8
Germany	1.5	2.0	7.2	2.5	83	4,226	17.0	27.4
France	2.8	1.8	5.0	2.4	65	2,935	5.7	7.6
Italy	2.4	1.8	6.8	2.0	59	2,101	6.0	9.4
UK	3.7	0.9	7.9	4.4	68	3,188	3.0	2.2
Japan	1.0	1.2	1.5	0.8	126	4,937	2.9	2.0
China	5.3	4.9	2.1	2.0	1,413	17,458	6.0	8.9

Source: Datastream, International Monetary Fund, Credit Suisse

Interest Rates and Monetary Policy Data

	Current	3-month	12-month		06/2022	05/2022	06/2021
SNB target range (in %)	-0.75	-0.75	-0.25	M0 money supply (CHF bn)	757.2	750.0	720.4
10-year government bond yields (in %)	1.1	1.1	1.2	M1 money supply (%, YoY)	3.3	4.2	7.3
				M2 money supply (%, YoY)	0.0	0.7	5.3
				M3 money supply (%, YoY)	-0.1	0.7	4.9
				Foreign currency reserves (CHF bn)	955.9	937.3	934.1

Source: Datastream, Bloomberg, Credit Suisse

Impressum

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8 June 2022

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