Coronavirus crisis: What does rising government debt mean for Switzerland and its economy?

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Dear Reader

The coronavirus pandemic in Switzerland has been suppressed more quickly than many people expected. We certainly cannot rule out further local outbreaks or even a second infection wave, but it currently looks likely that contact tracing and targeted quarantine measures can master these more quickly. In other words, it appears reasonable to hope that another comprehensive lockdown will not be necessary.

Thanks to the repeal of the lockdown measures imposed in March, the Swiss economy is gaining momentum. The trajectory of the recovery essentially depends on how quickly consumers and companies in Switzerland and its major trading partners regain their confidence. We anticipate the profile of this economic recovery to resemble a “crooked V”. Three specific factors underpin our expectation of a fairly flat recovery trajectory. First, exports and corporate investment will pick up only slowly. Second, employment will recover more slowly than it declined which will also reduce immigration. Third, the household savings rate will remain at above-average levels for quite some time, despite the substantial income support by the state.

The easing of long-term measures has provided momentum not only to the economy, but also to political debate. The question of how a pandemic can be prevented – or at least better handled – in the future is one burning issue right now, as is the question of whether (and how rapidly) the economic support measures implemented since March should be reversed. Few people would dispute the view that the government, the corporate sector, and the population were not universally prepared for the pandemic. However, the argument that we should impose a more restrictive immigration policy, shape a more autarkic agricultural policy, or resort to exclusively domestic production of protective healthcare material and medications, is highly dubious. In our view, quite the opposite applies: This pandemic has actually emphasized the advantages of an internationally diversified economy in all aspects, given that precisely this characteristic improves the chances of responding flexibly to a crisis of this nature.

The benefits of a flexible response have also become apparent in the area of economic policy. The willingness of the federal government to work with banks to provide rapid and generous support to both companies and workers has greatly mitigated the negative economic consequences of the pandemic. By adopting a more flexible approach to regulation and creating new credit facilities, the Swiss National Bank and FINMA likewise contributed to this process. As we see it, flexibility will be needed in the future too: Insisting stubbornly on the mechanical repayment of the Confederation’s increased debt burden within the six-year timeframe envisaged by the “debt brake” instrument appears to be not only unnecessary, but also counterproductive. That said, it will be crucial to Switzerland’s future success to adhere to the basic principle of fiscal and monetary policy being geared toward long-term stability. We explain over the following pages what we mean by that precisely.

We wish you an enjoyable read as well as a fine and healthy summer.

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Swiss Economy

The recovery has begun
Swiss economic output collapsed during the coronavirus crisis. Yet with the easing of the lockdown measures, the first signs of recovery are now apparent. The robust development of pharma exports, the effectiveness of the government’s emergency measures, and the bottoming-out of purchasing managers’ indices likewise provide grounds for cautious optimism.

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Focus – Swiss government debt

Coronavirus debt not problematic, but debt brake remains expedient
An increase in Swiss government debt in 2020 is unavoidable. However, the new level of debt does not pose a threat to Switzerland’s future fiscal space, the level of interest rates, or the country’s credit rating. A gentle, long-term reduction of the additional debt is therefore not a cause for concern, and is compliant with the special rules of the debt brake mechanism.

Monetary policy

Tapping SNB reserves doesn’t reduce federal debt
If the parliament doesn’t make a decision soon, the debt brake mechanism could trigger six years of fiscal austerity. Some suggest that this could be avoided by tapping the reserves of the Swiss National Bank (SNB). However, this trick will not change the government’s budget constraint.
Swiss Economy

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Historic slump in GDP and consumer spending in Q1 2020

In the first quarter of 2020, Swiss gross domestic product (GDP) recorded a quarter-on-quarter decline of 2.6%. This is the greatest slump since this data was first recorded back in 1980. A combination of businesses closing their doors and general uncertainty led to historic declines in the areas of catering and transport, but also in healthcare and much of the retail sector. Overall, consumer spending in Switzerland declined by 3.5%. This first-quarter slump, which was attributable to the measures to combat the spread of the pandemic, was similar to the decline recorded in Germany, but far less severe than in France and Italy (cf. Fig. 1). By contrast, Sweden, the US, and the UK, which had all imposed less rigorous measures at this point, saw a less pronounced negative trend.

Trough likely to be reached in Q2

The development of consumer spending in the first quarter confirms our estimate that Swiss households spent some 20% less during the lockdown compared to normal times. Since the great majority of the lockdown spans the months of April and May, the slump in consumer spending in the second quarter is likely to be twice as great. On the positive side, however, lockdown-enforced spending restraint is also likely to have seen many households put money aside during this phase. In other words, the financial situation of most households at the end of May when the lockdown was eased was much better than might have been expected following an economic slump of such a historic magnitude. According to our calculations, financial support from the state or unemployment insurance payments has not fully offset the income loss due to unemployment, short-time working, and other working restrictions, which is why the income of the average Swiss household is likely to be just under 5% lower than before. That said, the additional savings made during the lockdown period have more than compensated for this shortfall when viewed across all households.

Fig. 1: Comparison of Q1 slump in consumer spending
Quarter-on-quarter change in consumer spending in Q1 2020, real in %

Fig. 2: Savings rate unusually high
in %

Source: Datastream, State Secretariat for Economic Affairs (SECO), Credit Suisse
Source: Swiss Federal Statistical Office; from 2019: Credit Suisse estimates
Record-high savings level offers potential for rebound in consumer spending

The savings ratio, which measures household savings as a proportion of income, has risen to a historic peak as a result. A higher propensity to save is not unusual in times of economic uncertainty: Figure 2 shows that the “voluntary savings ratio” (savings outside of mandatory pension provision) has changed during recessions in the past, whereas “enforced saving” (mandatory pension provision) barely reacts to changes in the economic environment. Compared to similar phases in the past, however, the current rise in the voluntary savings ratio (from around 13% to 22%) is probably well beyond what was intended. We are therefore expecting households to spend a significant proportion of these additional savings over the next few months. Specifically, we estimate that two-thirds of the accumulated funds – or some CHF 5.5 bn – will be plowed back into the economy, thereby reversing around a half of the decline in consumer spending.

Ending of the lockdown has immediate positive effect, …

The rise in the Purchasing Managers Index (PMI) for the services sector in May gives some idea of how rapidly the economic situation is improving following the lifting of lockdown restrictions (cf. Fig. 3). Just two weeks after the start of the second phase of easing, the services PMI had reversed almost a half of the historic slump recorded in March and April. Other indicators of the state of the economy corroborate this positive picture: According to analyses of the MonitoringConsumptionSwitzerland project, bank card purchases at the end of May were already well above average, and twice as high as at the trough during the lockdown in April – even when taking into consideration the less widespread use of cash for hygiene reasons. At the same time, according to mobility data published by the Swiss Economic Institute of ETH Zurich (“KOF“), economic and social activity was halfway back to its normal level by this point, while according to the website TrendEcon, Google search queries pointed to consumer sentiment being back to the buoyant level witnessed before the coronavirus crisis. The “Fever Curve for the Swiss Economy”, which is plotted daily by researchers at the University of Neuchâtel on the basis of financial market data and news reports, is now already back down below the level it was prior to the lockdown, and in line with levels recorded at the start of March.

…but the road back to normality will be a long one

Despite this initial recovery, however, consumer spending is still some way from being back to normal. The PMI for the services sector remains well below the growth threshold, and therefore continues to point to declining sales. In addition, we assume that the second stage of the recovery will proceed much more slowly. First, the physical supply in shops and businesses remains restricted due to the ongoing coronavirus measures. Second, consumers remain unsettled: Both the fear of becoming infected and concerns over job security are weighing on sentiment. Third, immigration into Switzerland is slowing because of closed borders and fewer new hires. For 2020 as a whole, we are anticipating net immigration of between 35,000 and 40,000 persons (down from 53,000 the previous year). Unlike in former crises (financial crisis, euro crisis, franc shock), a key prop of consumer spending is now experiencing a phase of weakness. Overall, we are expecting consumer spending to decline by 2.1% for 2020 as a whole.
Pharma sector supports development of exports

Switzerland’s foreign trade figures for the first quarter show how advantageous the high weighting of the pharma sector (50% of exports) and its low short-term economic sensitivity currently are for the development of exports. According to the State Secretariat of Economic Affairs (SECO), goods exports actually rose by 3.4% despite a significant decline in the exports of cyclically sensitive industrial companies. In the foreign trade figures published by the Federal Customs Administration, the dramatic differences between the various sectors are very apparent (cf. Fig. 4): Watch exports essentially collapsed, while the exports of mechanical engineering, electric, and metalworking companies (MEM industry) in April were almost a fifth below their levels of the start of the year.

Silver linings in Asia for the MEM industry

For exporters of investment goods, however, the turning point should come soon. MEM exports in April to countries that had already been able to loosen their coronavirus restrictions at that point – such as China, Hong Kong, and Japan – have once again risen. This fuels hope that the situation will soon stabilize in Europe. By contrast, the later arrival of coronavirus in the US and the delay in lockdown measures there suggests that the demand for Swiss MEM exports stateside could decline further over the next few months. In addition, the situation of the watchmaking industry, which is heavily dependent on international consumer sentiment, can be expected to remain problematic for a good while yet. So while the worst is likely to be over soon for the majority of export sectors, the road back to normality will still be a long one. Global trade is likely to suffer for some time from subdued demand (particularly for investment goods) and restricted transport capacities. In particular, intercontinental mobility is likely to remain restricted for a prolonged period, which is why we are expecting export volumes in 2020 to work out some 6.5% lower than in the previous year, despite the robustness of pharma exports.

Demand weakness partially passed on to other countries

However, the negative contribution of foreign trade to Swiss GDP is lower than the decline in exports would suggest at first glance. This is because fewer input goods are required from abroad. According to estimates of the Organisation for Economic Cooperation and Development (OECD), input goods and services from abroad make up an average of around a third of the value of Swiss industrial exports. The import share is high for consumer goods too, and is estimated to be as much as two-thirds in the case of the particularly cyclical consumer durables. Due to the weakness of consumer demand, Switzerland imports lower volumes of these goods as well. Because of the sharp decline in imports, Switzerland’s surplus in goods trading with the rest of the world (exports minus imports, i.e. the net contribution to GDP) was CHF 4.3 bn in April, higher than at any point since the foreign trade statistics were first compiled.

Fig. 5: Manufacturing PMI points to end to decline in investment

PMI > 50 = growth; investment in plant & equipment vs. previous year, real

Fig. 6: Pharma sector also provides support on investment side

Development of different categories of plant & equipment investment, Index 2008 = 100, real (in brackets: proportion of total plant & equipment investment)

Source: procure.ch, State Secretariat for Economic Affairs (SECO), Credit Suisse forecasts  
Source: State Secretariat for Economic Affairs (SECO), Credit Suisse

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During the lockdown, all investment other than that of an urgent nature was likely halted. Accordingly, investment in plant and equipment declined by 4.0% in the first quarter, and we are expecting this decline to accelerate in the second quarter. With the lockdown measures eased, however, a recovery should set in. Ultimately, the obstacles to a renewed lockdown are high, given the decline in case numbers and greater understanding of the virus, which is why companies are likely to anticipate an improvement in the situation over the remainder of 2020. After all, the end of the decline in the PMI for the manufacturing sector shortly after the easing of measures in May points to an improvement in plant and equipment investment (cf. Fig. 5). The developments of the manufacturing PMI in Asia (where lockdowns were lifted earlier) likewise suggests that the slump in investment in plant and equipment in Switzerland is likely to prove shorter and less pronounced than in the financial crisis of 2009.

Furthermore, it is likely that investment in the "research & development" area (almost a third of plant & equipment investment) and the "software and databases" area (17% of plant & equipment investment) will cushion the decline in overall investment. Even during the financial crisis, these two categories proved impressively immune to the economic downturn (cf. Fig. 6). Moreover, the former is dominated by the strongly growing pharma sector, while the latter can be expected to benefit from the rapid wave of digitalization due to the increasing trend of home working and webshops. Overall, we are forecasting an average decline in plant and equipment investment of 4.0% for 2020.

With negative growth of 2.5%, construction investment is likely to have declined as well, even though interest rates remain extremely low and the majority of building sites continued operations throughout the lockdown. The uncertainty has had a negative effect, however. In addition, rising vacancies in the rental apartment segment will lead to a decline in new projects. According to our forecasts, public spending in this area should increase significantly this year and thus make a welcome contribution to the stabilization of the economy (+3%).

With lockdown measures having eased, the Swiss economy has immediately picked up. Following an initial spurt, however, the progression of this recovery is likely to prove fairly sluggish. Accordingly, the development of GDP over the year as a whole is likely to resemble a "crooked V". That said, the unprecedented nature of the coronavirus crisis means that any forecast inevitably involves a huge amount of uncertainty. In view of the ever more numerous silver linings appearing on the horizon, we maintain our optimistic view compared to other institutions. Aspects boosting our confidence here include the robust development of pharma exports so far, the effectiveness of state measures to protect individual incomes and prevent corporate bankruptcies, and the end to the decline of PMIs. However, we too do not expect the recovery in 2021 to prove strong enough to restore GDP to its pre-crisis levels by the end of that year. More precisely, we anticipate that GDP will slump by 4% in 2020 (forecast 17.4.2020: -3.5%) and grow by 3.5% in 2021.

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Inflation

The prices of 35% of all goods and services in Switzerland are currently lower than they were a year ago, with the decline coming in at more than 2% for around 20% of them. A number of price declines are probably only temporary, as products that could not be sold during the lockdown are currently being offloaded at a discount. However, in view of weak demand for the foreseeable future and the decline in global market prices of crude oil, negative inflation rates should be a widespread phenomenon over the coming months too. For 2020 we are anticipating an average inflation rate of –0.7%, while for 2021 we are expecting a slight price increase of 0.3%.

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Labor market

Between the end of February and the end of May, the number of unemployed rose by more than 38,000 (+32%), while the unemployment rate rose from 2.5% to 3.4% (not seasonally adjusted). Around a quarter of this increase is attributable to the hotel & catering sector alone. Thanks to the massive use of short-time working in many sectors, a more drastic surge in the number of unemployed persons has been avoided so far. Over the next few months, however, we are likely to see further recruitment freezes, restructurings, and bankruptcies – and therefore a further rise in unemployment. We expect the unemployment rate to rise to more than 4.0% by the end of the year (average 2020: 3.5%; 2021: 3.8%).

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Immigration

In the first quarter of 2020, net migration of foreigners into Switzerland amounted to 19,900, a year-on-year rise of 30%. The processing of residence permit applications was suspended only on March 25 (with a few exceptions), with visas then losing their validity. Consequently, immigration numbers are set to decline markedly in the coming months. The processing of residency applications restarted on May 11, when the first easing measures were introduced (e.g. family members permitted to move to Switzerland). The issuance of new permits for Schengen states and third countries remains on hold until June 15, however. Moreover, demand for labor is likely to suffer for even longer from the economic downturn.

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**Pharmaceutical industry**

While coronavirus-related lockdowns in key export markets led to a slump in demand in many sectors, pharma exports increased further in the first quarter of 2020. Among other things, their relatively sharp rise in March was attributable to hospitals and doctors (for fear of supply shortages) as well as private individuals (seeking to reduce the number of doctor visits) stockpiling supplies of key medications. We are expecting this effect to cancel out over the remainder of the year. On the other hand, pharma exports in the therapeutic area should benefit from a return to normal operations in hospitals and medical practices.

**Engineering, electrical and metal industry (MEM)**

The disruption to supply chains and the reluctance of companies to invest because of the coronavirus crisis were already weighing on Swiss MEM exports in the first quarter. Purchasing managers’ indices suggest that the negative picture in the export regions of Europe and the US is unlikely to improve significantly over the next couple of months. Only in China does the situation appear to have stabilized thanks to the resumption of economic activity. We are expecting demand to recover in this market accordingly.

**Watch industry**

Unlike in the case of MEM exports, the key to the development of Swiss watch exports is not manufacturing sentiment but consumer sentiment abroad. The latter has now deteriorated drastically, albeit with something of a time lag. Watch exports remained robust in January and February before experiencing a significant slump in March. Only exports to the US developed positively in that month, but the subsequent lockdown in the US will have put an end to this positive trend. A sharp decline in income and greater of consumers will also weigh on the watch industry going forward.
Retail trade

The impact of the coronavirus crisis on sales in the stationary retail trade in the first quarter differed widely from segment to segment. The closure of national borders – equivalent to a ban on “shopping tourism” – and of restaurants and bars gave a significant boost to the sales of food retailers in March. However, the negative impact of the lockdown on sales in the majority of non-food segments was already starkly apparent from mid-March onward. We are expecting a strengthening of this negative trend for the second quarter, as the lockdown was at its most severe between April and mid-May.

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Tourism

The proliferation of coronavirus and the subsequent closure of borders worldwide triggered an unprecedented slump in overnight stays in Switzerland in March. The decline was particularly dramatic for the visits of European and Swiss guests in that month. However, we are also anticipating a major deterioration in the figures for US guests in the second quarter. Although business operations have gradually resumed since mid-May, a combination of the slow opening of borders and operating restrictions (including compliance with social distancing regulations) should continue to have a negative impact on the tourism sector for the foreseeable future.

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Information technology (IT)

Sentiment has also deteriorated dramatically in what is otherwise typically a fairly optimistic IT sector. The balance between companies who view their business situation as positive and those that view it as negative currently stands at just 7%. Only during the financial crisis of 2009 has this figure been lower. As all key customer industries of IT service providers have slumped in the face of the coronavirus crisis, we are expecting only a slow recovery in sentiment.

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Focus – Swiss government debt

Coronavirus debt not problematic, but debt brake remains expedient

An increase in Swiss government debt in 2020 is unavoidable. However, the new level of debt does not pose a threat to Switzerland’s future fiscal space, the level of interest rates, or the country’s credit rating. A gentle, long-term reduction of the additional debt is therefore not a cause for concern, and is compliant with the special rules of the debt brake mechanism.

Between March and May 2020, when far-reaching restrictions were in place to combat the pandemic, the Federal Council decreed measures costing more than CHF 70 bn (cf. Fig. 1). In terms of the expenditure level, however, Switzerland is slightly below mid-pack in an international comparison. When measured as a proportion of gross domestic product (GDP), countries such as Germany, France, and Italy have provided significantly greater liquidity assistance, while the direct fiscal stimulus has also been greater in Germany and the US (cf. Fig. 2).

However, the pure scope of the announced measures is not the only criterion of an effective fiscal response. Far more important – particularly during the lockdown, which virtually paralyzed the economy overnight – is a prompt implementation of the measures with a minimum of red tape, and to assist those that have been affected the most. Judged against these criteria, the Swiss measures appear to have been effective (cf. Fig. 3). The infrastructure for paying out the COVID-19 bridging loans to companies via commercial banks, including a refinancing facility with the Swiss National Bank (SNB), was in place within a week of being announced, and was made great use of in the first few days in particular. Likewise, existing automatic stabilizers such as short-time working guaranteed the prompt support for household incomes.

Fig. 1: Fiscal measures in Switzerland
in CHF mn

- Liquidity measures
- Short-time working and unemployment insurance
- Direct payments to households
- Direct payments to companies
- Medical and international collaboration
- Other

Source: Federal Council

Fig. 2: International comparison of fiscal packages
as % of GDP, index from 0 to 100

- Fiscal stimulus
- Deferrals
- Liquidity assistance
- Debt ratio (RHS)
- Stringency Index (RHS)

Source: Bruegel, Federal Social Insurance Office, Federal Tax Administration, OxCGR Team of the Blavatnik School of Government, Credit Suisse

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Unemployment would be ten percentage points higher without short-time working

Short-time working, which already proved its worth as a cushioning tool during the financial crisis of 2009, has also prevented an abrupt rise in the unemployment rate in the current recession. If all the 1.9 million employees who were put on short-time working by May had instead lost their jobs, the Swiss unemployment rate would have risen to a heady 46% (cf. Fig. 4). Experience shows, however, that companies use short-time working to a far lesser extent than they applied for. According to our estimates of the actual degree of utilization, the unemployment rate in Switzerland would now amount to some 14% – similar to that of the US, where the instrument of short-time working does not exist.

Measures give rise to costs and a deficit

The fiscal responses in Switzerland and elsewhere resemble each other closely in one particular point: The aid packages do not just consist of measures that automatically trigger expenditure. In other words, the actual additional expenditure incurred by the Confederation will be less than the nominal CHF 70 bn of the announced package of measures. For example, bridging loans are liabilities that will only end up being realized if the corresponding companies default. In addition to the actual expenditure, however, the slump in receipts for direct federal tax, value added tax, and withholding tax will affect the Confederation’s finances. Based on the measures announced between March and May, we are therefore estimating the deficit for 2020 to be in the region of CHF 38 bn. In a negative scenario with a 100% degree of utilization of short-time working, a reported unemployment rate of 7%, and an annual GDP decline of 10%, this deficit estimate would rise to CHF 44 bn. The Federal Council itself currently anticipates a shortfall of between CHF 30 bn and CHF 50 bn.

Extraordinary expenditure for compliance with the debt brake

Although Switzerland’s debt brake mechanism permits a certain level of surplus expenditure in a recession, a deficit of this magnitude would breach the rules, and would therefore have to be compensated for in the years immediately following. That said, Swiss legislation envisages the possibility of incurring extraordinary expenditure for “exceptional and uncontrollable events”, a description that quite clearly fits the recent pandemic. The Federal Council has already announced that it will be classifying the lion’s share of the recent fiscal measures as extraordinary expenditure. An extraordinary deficit may be whittled down more slowly. Moreover, in recent years a buffer of CHF 3.4 bn has been accumulated in an amortization account envisaged for this purpose.

Enforced austerity looms over the next six years unless parliament acts

But as this buffer is nowhere near sufficient in the current case, surpluses would have to be generated over the next six years. For example, if fiscal measures that have a direct impact on expenditure and the supplementary financing for the unemployment insurance (ALV) are both classified as extraordinary expenditure, some CHF 4.5 bn would have to be saved every year until 2026. The average surpluses built up since the debt brake was introduced amount to just CHF 1.8 bn annually, however. In other words, the surpluses would have to be more than doubled with wide-ranging cuts in order to meet this requirement. Thanks to the safeguard clause, however, parliament has the option of extending the six-year repayment deadline in special cases, which means it can even mitigate this problem.

Fig. 3: Switzerland leads the way in rapidity of paying out loans

Beginning of lockdown in turquoise, date of first loan payout in blue

Source: Federal Council, German Federal Ministry of Finance, Federal Reserve Bank of St. Louis, Credit Suisse
Financing through existing liquidity and new debt

In view of the extraordinary situation, we can assume that parliament will want to exercise a degree of circumspection in its fiscal policy. In our view, parliament would be ill advised to have its course of action dictated by fears of excessive federal government indebtedness. While the Confederation’s debt ratio will rise in 2020, it will do so much less sharply than the deficit would suggest at first glance. In particular, the federal government can fall back on high liquidity reserves to finance expenditure. Prior to the start of the lockdown in March, its liquid assets amounted to CHF 24 bn, although a substantial proportion of this is likely to be held as a liquidity buffer in view of the uncertain tax receipts situation. In addition to using up its cash holdings, the Confederation can also sell its unplaced own tranches of sovereign bonds (valued at CHF 5.5 bn), rather than issuing debt. That said, these own tranches are normally used to support liquidity in the Swiss government bond market. We are therefore expecting only around CHF 2.5 bn of the above amount to be used to raise cash. Based on these considerations, we estimate that – even in a negative scenario involving a deficit of CHF 50 bn – the Confederation will have to raise a maximum of CHF 36 bn of new debt in the form of short-term money market debt register claims or longer-term Confederation bonds.

Consequences for debt ratios

This would see the Confederation’s debt ratio increase from 13.9% as per the end of 2019 to an estimated 19.4% as per the end of 2020. Based on the simplified assumption that the debt level of the cantons and the municipalities remains unchanged, the Maastricht debt ratio would rise from 26.7% in 2019 to 34.1% in 2020. Despite such a rise in the national debt, Switzerland would still hold up well in an international comparison – not least, because the public sector in other countries is likewise taking on considerable amounts of additional debt (cf. Fig. 5).

A comparison of debt ratios

The most commonly used yardstick is the Maastricht debt ratio, for which the Eurozone – in keeping with its convergence criteria – has established a maximum level of 60% of GDP. The equivalent figure for Switzerland in 2019 was 26.7%. However, countries outside of Europe do not use this measure.

For global comparisons, it is therefore more expedient to use the debt ratio calculated by the International Monetary Fund (IMF). In contrast to the Maastricht approach, however, this method classifies not only debt securities and loans as debt, but all borrowed capital, including the claims of insurance companies and pension funds; hence, this ratio typically works out higher – in the case of Switzerland, for example, at 38.6% in 2019.

Whereas the Maastricht and IMF debt ratios consolidate the general government sector (i.e. the Confederation, cantons/states and municipalities, but also social security funds), the Confederation’s debt ratio only takes into account the federal budget. It is therefore significantly lower, and amounted to 13.9% in 2019.

One thing common to all these ratios is that they refer to gross debt, i.e. they do not offset liabilities against financial assets. Another common factor is that they do not take into account implicit government debt, such as future liabilities arising from pension claims due to demographic change.
Debt levels hardly appear to be tying governments’ hands

In the current crisis, a higher debt ratio does not appear to be restricting the ability of the developed countries to act, at least not to any great degree. In the comparison illustrated in Figure 2, there is no identifiable correlation between the scope or type of measures and the debt burden built up prior to the crisis. The expected damage to the economy, as gauged by the Stringency Index of measures to combat the pandemic, does not appear to have been the driving factor in the design of fiscal support packages either. Whether or not there are or have been other objective economic factors that governed the response of governments has yet to be determined.

Low interest rates make new debt levels manageable

From a pure cost perspective, higher debt for Switzerland does not appear to be a problem, as the public sector can raise funds in the capital market at negative interest rates. In 2019, for example, the average interest rate of auctioned bonds with a residual term of 17.5 years – which is quite high in an international comparison – amounted to just -0.12%. The yields on Swiss government bonds have not changed materially since then. Paradoxically, therefore, the raising of new debt at current market terms would actually remove some of the burden on the federal budget in the next few years from a financing perspective.

Passive deleveraging thanks to negative interest rates

On the assumption that the budget will be balanced again from 2022 onward, nominal new debt from 2020 would essentially decline of its own accord over the years if interest rates remain low or even negative. If the primary budget is balanced, the debt ratio (i.e. the ratio of debt to GDP) declines if GDP growth is higher than the average rate of interest. Indeed, this “passive deleveraging” has also been crucial to reducing the debt ratio in the past. Figure 6 shows that the debt ratio has declined much more sharply than outstanding debt since the debt brake was introduced in 2003. In other words, in addition to the actual reduction in debt, positive GDP growth has made its own significant contribution. Even with a muted long-term growth outlook, it appears highly probable that GDP growth rates will remain above the average rate of interest in the future, as we explain below.

Simulation: passive deleveraging possible within a generation

A simulation involving a one-time raising of CHF 36 bn of new debt in 2020 at current market terms shows that the debt ratio of the Confederation would be back at its 2019 level within 17 years. Assuming a small primary surplus of 0.1% of GDP, which has been achieved every year since the introduction of the debt brake and can be used to actively pay down debt, this period shrinks to just 13 years (cf. Fig. 7).

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1 This simulation is based on the IMF forecast of annual GDP growth of 1.6% from 2022, an inflation rate of 1% from 2022, a yield on newly issued bonds of -0.59%, and a 16% rate of refinancing for legacy debt in keeping with the practice of recent years.
A key question, however, is whether interest rates really will remain low for future refinancing. Three factors are decisive for refinancing costs: the global interest rate environment, the borrower’s creditworthiness, and the resulting credit rating. A strong rise in global real interest rates without a simultaneous sharp acceleration in growth would only be conceivable in a scenario of pronounced deflation. However, the anti-deflationary monetary policy of the major central banks makes any decline in prices extremely unlikely. As things stand, demographic development and weak productivity growth are both arguments in favor of persistently low real interest rates. Moreover, the international comparison in Figures 8 and 9 shows that higher government debt does not automatically translate into higher interest rates. Even though Japan has been by far the most indebted state in the world for quite some time and its rating is worse than that of the US, investors absorb all new bond issues without demanding higher risk premiums. As we see it, this has less to do with the Bank of Japan’s expansionary monetary policy – central banks have only a temporary impact on real interest rates – and more to do with the high savings rate of the Japanese private sector. In Switzerland, the savings rate is also high by international standards.

Even the creditworthiness – i.e. credit rating – of a borrower does not directly depend on their level of outstanding debt. More important here are other factors such as the growth model, the strength of institutions, security risks, the balance of payments, the level of private debt, and the debt service ratio. It is therefore hardly possible to estimate the specific consequences of a higher level of government debt in Switzerland without complex valuation models. However, a comparison with neighbor Germany – which likewise has an AAA rating – would appear reasonable, given the similar parameters of a strong export economy, a stable political environment, and a debt brake enshrined in the constitution. Germany’s rating during the euro crisis of 2010 to 2012, when its Maastricht debt ratio rose to 80%, was on the verge of being downgraded, but this never actually materialized. For Switzerland to reach a Maastricht debt ratio of 80% would require the general government sector to take on new debt of CHF 350 bn. In other words, from a variety of standpoints Switzerland could easily cope with a much greater new debt burden than the currently expected CHF 36 bn.

The question therefore arises as to whether the debt brake and a certain amount of budget discipline “in good times” is actually necessary at all. We can answer this question in the affirmative from both a political and economic standpoint. First, the debt brake mechanism has the effect of preventing political profligacy, and depoliticizes the discussion over additional state spending by essentially specifying the circumstances in which deficits are justifiable. As the experiences of the 1990s and since the introduction of the debt brake show, automatic mechanisms for controlling the longer-term development of the national budget are more beneficial than discretionary responses on a case-by-case basis. Second, the intention to reduce the debt ratio strengthens the political consensus in favor of extraordinary support measures to combat any future crisis – even if the crisis will not be a “once-in-a-century” recession caused by a pandemic.
Furthermore, just because interest rates have been low in the past does not mean they will remain that way forever, thereby guaranteeing the low cost of financing government debt. While indeed a number of convincing economic indicators suggest that there will be no change in interest rates for the foreseeable future, fiscal policy should not rely on this favorable scenario but must remain flexible if it is to deal with future shocks. Last but not least, the debt brake is hugely important as a signal to investors, as it shows the government’s willingness to preserve its solvency in the long term. A number of academic studies show that a credible fiscal rule is actually more important to the investors’ confidence in a country’s creditworthiness than the country’s actual level of outstanding debt.

Deleveraging too quickly would nonetheless be counterproductive. We nonetheless point out that paying back debt all too quickly within six years, as the extended debt brake rule currently demands, would be damaging for the economy. The necessary austerity measures would either weigh on households and depress consumer demand, or damage conditions for companies and thereby obstruct productivity increases. Both cases would delay the economic recovery. Alternatively, such measures would increase the pressure on the SNB to make higher distributions, which in turn could jeopardize its monetary policy independence (cf. monetary policy section). Moreover, the explanations above make it clear that the level of government debt is not the most relevant criterion for the government credit rating, its fiscal room for maneuver, or investor confidence. 2020 is an exceptional year, and should be treated as such in the context of public finances. It is therefore advisable to make one-time use of the special rules of the debt brake and extend the debt repayment period for the extraordinary deficit, without setting aside funds now – such as SNB distributions – to pay down this debt.

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Tapping SNB reserves doesn’t reduce federal debt

If the parliament doesn’t make a decision soon, the debt brake mechanism could trigger six years of fiscal austerity. Some suggest that this could be avoided by tapping the reserves of the Swiss National Bank (SNB). However, this trick will not change the government’s budget constraint.

Due to the COVID-19 crisis, the Confederation (and the cantons) will incur large deficits. At the federal level, the debt brake mechanism requires the Confederation to pay back such deficits within six years. There is therefore a risk that the COVID-19 crisis has triggered six years of fiscal austerity in the form of spending cuts and tax hikes. Meanwhile, the SNB has accumulated large retained earnings on its balance sheet; its reserve for future profit distribution stood at CHF 84 bn at the end of March. As the Constitution entitles the Confederation to one third of the SNB profit, there are potentially CHF 28 bn available to the federal government. Taking this into account, proposals have been made to avoid austerity and to finance public spending related to the COVID-19 crisis through an extraordinary profit distribution by the SNB.

At first, this seems like a good solution, not least because the SNB would paradoxically make extra profits by transferring its retained earnings to the Confederation. This is because, to implement this transfer, the SNB would have to issue new money on which it earns a negative interest rate of −0.75%. This would appear to be at least as profitable as if the Confederation were to borrow funds at negative rates, despite the fact that it can borrow money for up to 50 years at a negative interest rate. What are the issues? First, as the Confederation is the beneficial owner of only one third of the profits of the SNB (the cantons are entitled to the other two thirds), financing fiscal spending at the federal level with a transfer of central bank equity capital is, broadly speaking, equivalent to the Confederation borrowing at −0.25%. This rate is actually somewhat higher than the current borrowing rate of the Confederation!

A second issue is that when the Confederation raises funds on the capital market, market forces determine the borrowing costs, and each investor decides whether they are willing to lend to the Confederation. In contrast, in the case of money creation, the burden of the negative policy rate would fall on the banks. Unlike investors, who can freely decide whether to lend to the Confederation, the banks would be obligated to keep the newly created money deposited at the SNB. Even if some of the negative rate could be passed on to depositors, this specific tax seems more distorting than the market-determined negative interest rate in capital markets. Finally, and most importantly, the transfer from the SNB does not change the government’s net debt position. While the transfer would help the Confederation avoid raising its gross debt, its net debt would not be affected because it would have lost the SNB’s retained earnings, which are part of its wealth.

In our view, financing the deficit related to the COVID-19 crisis with an extraordinary profit distribution by the SNB also raises institutional concerns. Embarking on six years of extreme austerity, as foreseen by the debt brake mechanism, is almost certainly highly counterproductive. However, using monetary policy instruments to bypass the democratically legitimized debt brake constraints would mix fiscal and monetary policy and potentially put the independence of the SNB at risk. A much cleaner solution would be if the parliament eased the debt brake constraints to allow the Confederation to borrow as much as is required to offset the extreme shock that was incurred, while significantly extending the time for repaying the debt. We hope that the parliament will opt for this solution rather than leaning on the SNB to solve this problem.
Monetary policy I Monitor

Foreign currency purchases

We estimate that the SNB has bought around CHF 70 bn of foreign currencies since March 2020 to prevent the Swiss franc from appreciating too much. Recent comments from SNB board members in the Swiss media suggest that the SNB currently favors foreign currency purchases over policy rate cuts to dampen appreciation pressures on the franc. As the government has also substantially eased fiscal policy, we believe that foreign exchange interventions by the SNB will face less criticism from foreign authorities.

US dollar liquidity

Similar to the repercussions of the global financial crisis, stress in the US dollar funding markets has led to a rise in USD borrowing costs for banks without access to funding from the US Federal Reserve (Fed). Since the SNB has a swap line with the Fed, it can exchange Swiss francs against US dollars and then lend these US dollars to banks in Switzerland at relatively attractive conditions. During the COVID-19 crisis, the demand for US dollars among banks in Switzerland has been lower than during the global financial crisis. Nevertheless, banks have borrowed as much as USD 10 bn from the SNB.

COVID-19 loans

Banks have issued around CHF 13.5 bn in COVID-19 loans to SMEs so far. The government guarantees 100% of these loans, which have a 0% interest rate. In addition, banks have issued around CHF 1.7 bn in so-called “COVID-19 plus loans”, i.e. loans of more than CHF 500,000, of which the government guarantees up to 85%. According to media reports, it appears that many companies borrowed on a precautionary basis and have only spent a portion of the money so far. With the demand for loans flattening and low utilization, there should therefore only be a modest increase in leverage among SMEs.
COVID-19 initially crippled the residential property market. This setback proved short-lived, however. Thanks to persistently low interest rates, residential property remains attractive to first-time buyers. Consequently, homeowners are unlikely to find themselves in payment difficulties, even if they do suffer income problems. That said, the demand shock is unlikely to be fully overcome until next year at the earliest. We are therefore expecting a slight decline in prices in 2020, despite the shock-related paralysis proving only brief.

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Rental apartments

The temporary closure of borders, together with the sharp deterioration of both consumer sentiment and the labor market, is likely to lead to the demand for rental apartments being some 8,000 units lower in 2020 than the previous year. COVID-19 is having a slowing effect on the supply side of the market too, but much less strongly than on the demand side. As a result, the vacancy rate for rental apartments should rise to around 2.9% by June 2020. This will put rental income under additional pressure, particularly outside of the urban agglomerations. By contrast, a combination of persistently low interest rates and high demand on the part of investors should ensure that markdowns on property values remain the exception for the time being.

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Office property

In the short term, office properties have been relatively unaffected by COVID-19. The majority of tenants have switched their workforces to home working, from where business operations are largely preserved. For landlords, the lost income this year is likely to end up in low single-digit percentage territory. In the medium term, however, the recession will reduce employment in Switzerland. We are therefore expecting demand for office space to decline by some 770,000 m² by the end of the year. Moreover, in the long term the greater acceptance of “home office” since the onset of the COVID-19 pandemic and the resulting potential savings can be expected to lead to a further decline in demand for office space.

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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.

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.

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 Switzerland1. 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.

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

Source: procure.ch, Credit Suisse

Source: PMIPremium, Credit Suisse

Source: CFA Society Switzerland, Credit Suisse

Source: CFA Society Switzerland, Credit Suisse
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.

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.

Macro Momentum Indicator

The Credit Suisse Macro Momentum Indicator (MMI) condenses the current performance of key Swiss economic data to a single figure. Data from economic surveys, consumption, the labor market, lending and the export economy are used to calculate a standardized momentum that is then weighted with the applicable correlation to GDP development. Values above (below) zero point toward an acceleration (slowdown) of the Swiss economy in the last three months compared with the past six months.
Forecasts and Indicators

Forecasts for the Swiss Economy

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<td>GDP (YoY, in %)</td>
<td>-1.3</td>
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<td>-3.6</td>
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<td>Consumer spending</td>
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<td>Gross capital investment</td>
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<td>Construction investment</td>
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<td>-3.0</td>
<td>-3.0</td>
<td>3.0</td>
<td>3.0</td>
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<td>3.0</td>
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<td>Investment in plant and equipment</td>
<td>-1.6</td>
<td>-11.0</td>
<td>-2.7</td>
<td>-1.0</td>
<td>2.0</td>
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<td>Exports (goods and services)</td>
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<td>-9.0</td>
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<td>7.0</td>
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<tr>
<td>Imports (goods and services)</td>
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<td>Inflation (in %)</td>
<td>-0.1</td>
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<td>-0.9</td>
<td>-0.6</td>
<td>-0.4</td>
<td>0.4</td>
<td>0.6</td>
<td>0.5</td>
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<td>Unemployment (in %)</td>
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<td>4.1</td>
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<td>3.8</td>
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<td>Employment growth FTEs (YoY, in %)</td>
<td>0.3</td>
<td>-2.0</td>
<td>-3.0</td>
<td>-1.5</td>
<td>-0.5</td>
<td>0.5</td>
<td>0.9</td>
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<td>Net immigration (in thousands)</td>
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<td>Nominal wage growth (YoY, in %)</td>
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<td>Public debt (in % of GDP)</td>
<td>-3.5</td>
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Source: Federal Statistics Office, State Secretariat for Economic Affairs SECO, Credit Suisse

Interest Rates and Monetary Policy Data

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<td>SNB target range (in %)</td>
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<td>-0.75</td>
<td>-0.75</td>
<td>648.1</td>
<td>598.4</td>
<td>562.7</td>
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<td>10-year government bond yields (in %)</td>
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<td>-0.2</td>
<td>-0.2</td>
<td>2.6</td>
<td>1.9</td>
<td>5.3</td>
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<td>M1 money supply (%, YoY)</td>
<td>0.8</td>
<td>0.2</td>
<td>3.6</td>
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<td>M2 money supply (%, YoY)</td>
<td>1.9</td>
<td>1.3</td>
<td>3.7</td>
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<tr>
<td>M3 money supply (%, YoY)</td>
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<td>Foreign currency reserves (CHF bn)</td>
<td>811.9</td>
<td>781.4</td>
<td>788.0</td>
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Source: Datastream, Bloomberg, Credit Suisse
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