UBS Outlook Switzerland

July 2024 | Chief Investment Office GWM | Financial analysis

The Swiss economy:

Falling from grace?

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UBS Outlook Switzerland
3Q 2024

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Regional CIO Switzerland:
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Editor:
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Editorial deadline:
14 June 2024

Desktop Publishing:
CIO Content Design

Cover photo:
UBS

Languages:
English, German, French and Italian

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ubs.com/outlook-ch-en

Editorial

Daniel Kalt
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Dear Reader,

In March 2012, two-thirds of Swiss voters rejected the popular initiative "six weeks vacation for all". Although sometimes mocked abroad, this vote is also often used, to demonstrate what the country is really made of. It is characterized by a population with a deep-rooted concept of subsidiarity and one that makes decisions with foresight and with regard to economic competitiveness. Switzerland is also defined by a strong sense of direct democracy, ensuring the will of the people is reflected in its economic policy.

However, approval of the popular initiative for a 13th monthly OASI pension payment in March 2024 has shaken the self-awareness of Swiss economic policymaking. Is Switzerland at risk of losing its position as an economic leader?

Germany has been subject to such a fall from grace. Just over 10 years ago, our northern neighbor's economy was still considered to be rock-solid during the European debt crisis. However, the issue of whether Germany is now the "sick man of Europe" is being increasingly debated. A lack of investment and reforms, as well as strategic missteps in energy policy have undermined its economic strength. This is also evident in prospects for growth. Germany has gone from having the highest growth potential of all large EU member states to the lowest.

Even star pupils cannot evade turbulence—this is enough to prompt us to take a closer look at the current situation in Switzerland.

I hope you enjoy reading this issue!

The Swiss economy: Falling from grace?

Switzerland's status as an economic showcase is called into question by weaker per capita growth than in Germany and the US, increasing competition from Asia for local exports, and the fiscal consequences of demographic change. Nonetheless, the country and companies will be able to defend their status if they take the right measures, such as making better use of labor market potential.

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Switzerland ranks highly in terms of economic competitiveness, making it a leader in Europe. However, the approval of the popular initiative for a 13th monthly OASI pension payment this March has raised some doubts about whether it remains committed to defending this position. At the same time, the debate about the extent to which Germany currently represents "the sick man of Europe" highlights how quickly even leaders can fall from grace.

At first glance, the Swiss economy looks exemplary—in terms of growth, exports and fiscal policy. However, a closer look reveals challenges and risks. What measures can Swiss policymakers and individual firms take to overcome these challenges and ensure that Switzerland and its companies continue to serve as a role model?

The title of leader is not an end in itself. A strong rating from rating agencies helps to lower credit costs. A competitive export industry combined with strong growth can help to prevent or at least cushion conflict over resource allocation in society.

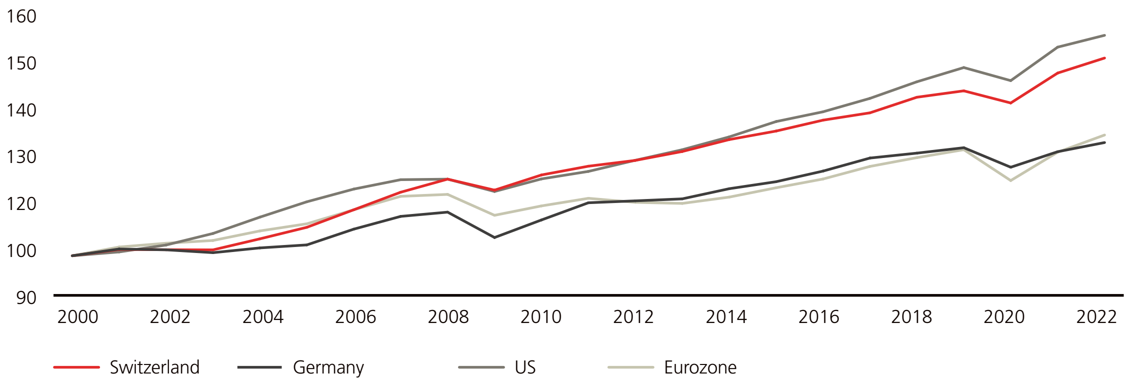
Swiss growth put to the test

Growth in Switzerland has been more dynamic in the last two decades than for its neighbors. Since 2000, the Swiss economy has grown by almost 50% in both cumulative and real terms. This compares with just over 30% for the Eurozone, and less than 30% for Germany over the same period. OECD data show that of major developed economies, only the US had a slightly better performance, with cumulative growth of just under 55% (Figure 1).

Figure 1

Switzerland growing faster than its neighboring states

GDP, real, indexed 2000 = 100



Sources: OECD, UBS

Switzerland is also defined by high labor market participation. At 84.1%, the employment rate here is considerably higher than in the US (74%), the Eurozone (74.5%), and Germany (79.7%).

Switzerland ahead of neighbors but lagging the US
However, a more in-depth look at economic growth also shows that Switzerland has lost some of its lead over its international peers. Swiss gross domestic product (GDP) per capita has increased by more than 20% since the turn of the millennium, exceeding Eurozone growth. But the increase in per-capita economic output in Germany was just under 25% and more than 30% in the US (Figure 2) in this period, according to OECD data.

The stronger growth in Germany can be explained by the fact that its labor market integrated significantly more people in the last 20 years. While the German employment rate stood at 65% at the turn of the millennium, it has recently climbed to over 79%, significantly closing the gap with Switzerland (to just under 4.5 percentage points).

The sharp increase in German per capita growth is therefore likely to be due in large part to higher labor market participation. Looking at growth per employed person, adjusted for the effect of growing labor market participation, Switzerland recorded an increase of three percentage points over Germany.

Compared to the US, however, the gap really widens when the working population is taken into account. US GDP per employed person has increased by more than 30% since 2000. This compares with an increase of only around 15% in Switzerland. The sharp US growth is likely to have been partly driven by the technology sector. Excluding this, the cumulative growth of the economy as a whole in the US is just under 50% since 2000 and therefore similar to that of Switzerland. However, US per capita growth remains stronger than in Switzerland, even without the IT sector.

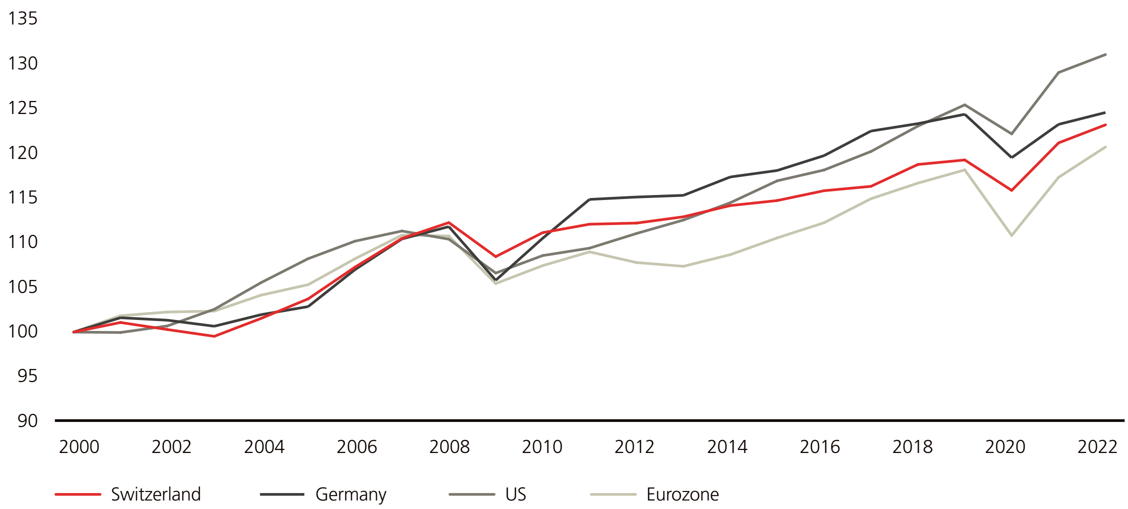
That said, US government debt per capita has increased threefold since 2007, compared with an increase of less than 50% in Switzerland. This suggests the stronger growth in the US has been enabled or at least supported by fiscal policy stimulus.

Still some potential in the labor market
Measured by GDP, Swiss public debt is less than 40%. This figure is nearly 70% in Germany and even exceeds the 100% mark in the US. Switzerland's relatively low public debt raises the question as to whether the government should use the fiscal latitude to enhance productivity growth. As a share of GDP, the IT sector in Switzerland is only half as big as in the US. Switzerland could specifically promote this sector through measures as for example increased patent boxes.

Figure 2

Switzerland falling behind on per capita growth

GDP per capita, real, indexed 2000 = 100



Sources: OECD, UBS

Despite high labor market participation, this area also offers potential for improvement. The employment rate among older people is relatively low by international standards and the share of part-time work is above average. At around 12%, the employment rate of people aged 65 and above in Switzerland is only half that of the US. At the same time, Switzerland has the second-highest share of part-time work compared to EU member states.

By offering financial incentives such as subsidizing external childcare, individual taxation or tax advantages for older employees, the Swiss government could use its financial headroom to better harness the existing labor force potential.

Solid export growth?

Swiss exports have enjoyed a solid performance in the last 20 years despite the strength of the Swiss franc. Nominal exports have more than doubled, from CHF 127 billion in 2000 to CHF 274 billion in 2023. Growth during this period was also positive in real terms, albeit less strong (40%). A closer look at the individual sectors shows that the pharma industry is the main driver of this growth, in both nominal and real terms. The value of pharma exports has increased by 375% since 2000 (by 120% in real terms). They now account for more than 40% of goods exported (Figure 3).

Precision instruments and the watch industry provide further growth momentum. Watch exports increased in nominal terms by 160% between 2000 and 2023, and now account for 10% of Swiss exports. Although fewer watches are being exported since 2000, the watch industry still succeeded in achieving higher revenue thanks to the increased demand for luxury models. This price effect is reflected in the nominal representation of the exports.

Innovation and quality can therefore allow the Swiss export industry with its highly specialized goods to escape intense price competition to a certain extent.

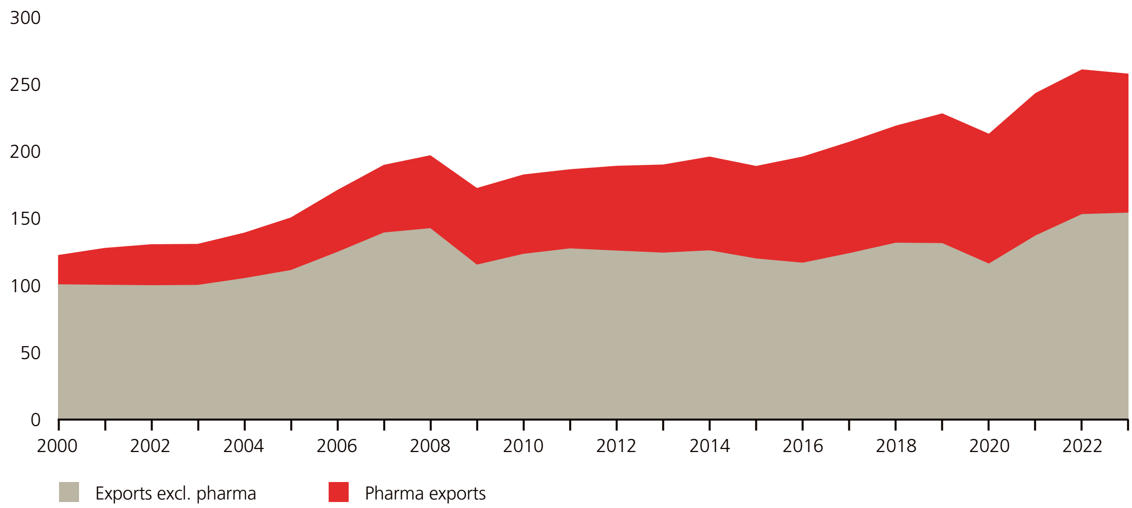
Stagnating sectors and lurking risks

However, not all sectors had such a positive performance. Exports in the important machinery and electronic sectors, in particular, have fallen in the last 20 years in both nominal and real terms. This shows that sectors such as mechanical engineering are increasingly up against foreign competition. We can see in the German automotive industry that even specialized pioneering sectors are not immune from foreign competition: German carmakers are under pressure from Chinese competitors, especially in the area of electromobility.

Figure 3

Pharma sector drives export growth

Nominal exports in CHF billion



Sources: Macrobond, UBS

The high export dependency on pharmaceutical products raises questions about concentration risks for the Swiss economy. Although pharma manufacturers have a comparative advantage globally, thanks to their experience and high quality standards, this lead is shrinking. The Asian market, particularly China, has generated an important growth impetus for the Swiss pharma industry in recent years and is likely to remain an important sales market in the future. At the same time, the Chinese pharma industry has caught up and poses serious competition.

Tapping the innovative potential

High costs require Switzerland to focus more on innovation and technological leadership than other countries to remain globally competitive. If one takes the density of startups as a measure of innovation and technology leadership, Switzerland does well by international standards (Figure 4). Its high level of innovation is one reason for this positive result: Switzerland was ranked first out of 132 countries in the 2023 Global Innovation Index (GII) for the thirteenth time in a row.

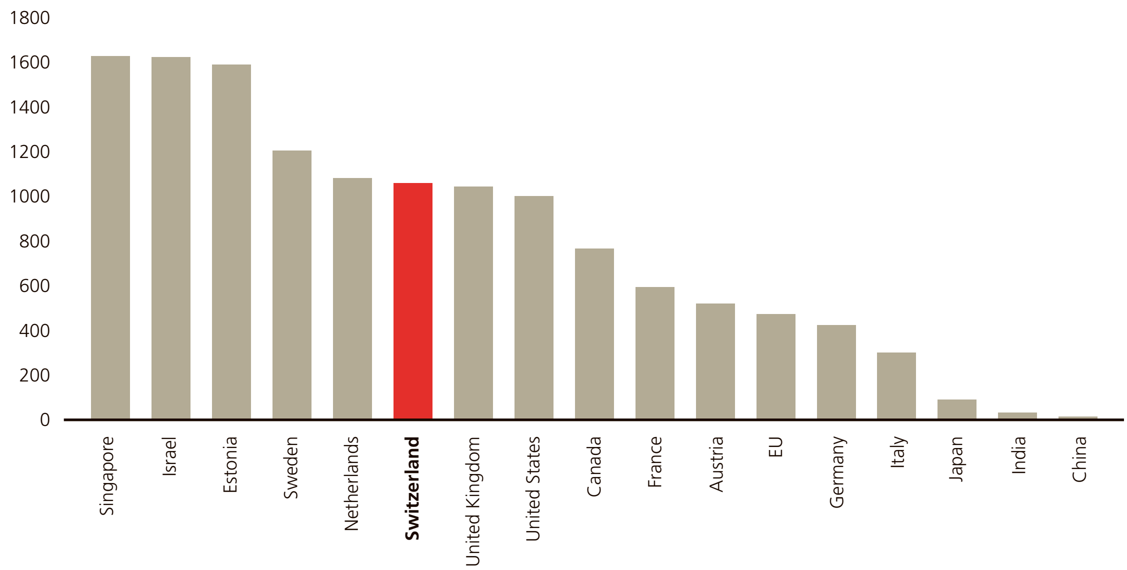
But the political disputes with the EU pose a problem: Switzerland was downgraded to a "non-associated third country" in July 2021, making it more difficult for Swiss researchers to access the Horizon Europe research funding program, among other things. This impedes cooperation and impacts Switzerland as a research location. Such restrictions are also challenging, as Swiss companies and startups rely on the international markets, given the small size of the domestic pool in many sectors—including for sales and financing.

According to a report published by BAK Economics (2023)[1], a raft of business regulations are another stumbling block for Swiss industry. The study refers to the high level of regulation, which is sometimes reflected in the relatively long duration of procedures, for example for company startups and product approvals. The lengthy procedures also suggest a lack of digitalization, especially in public services. However, innovation and technology leadership are decisive for strengthening existing sectors and tapping new sectors, thereby reducing cluster risk.

Figure 4

Relatively high startup density in Switzerland

Number of startups per million workers (16 to 64 years), 2023



Sources: Dealroom.co, United Nations, UBS

[1] See BAK Economics (2023): Global Industry Competitiveness Index (GICI) 2023 – analysis of the competitiveness of Switzerland's chemical-pharmaceutical industry, BAK Economics study conducted on behalf of scienceindustries, the Business Association Chemistry Pharma Life Sciences.

Demographic change as a major fiscal challenge

Switzerland has long enjoyed a leadership position in terms of fiscal policy. The debt-to-GDP ratio declined from 52% (according to International Monetary Fund calculation methods) in 2000 to 39% in 2022. During this period, US national debt doubled (Figure 5).

Nonetheless, Switzerland's fiscal policy faces immense challenges in the years ahead. These include the net-zero target for greenhouse gas emissions and the rising geopolitical tensions. National defense spending stood at 1.3% of GDP in 1991 compared with only 0.7% in 2021. An increase in defense expenditure to 1% of GDP would lead to additional annual expenditure of around CHF 2.5 billion. If we take the NATO target of 2% of GDP as a benchmark, Switzerland would have to boost spending by more than CHF 10 billion per annum.

However, demographic changes represent the greatest challenge, in our view. Switzerland must contend with a growing number of pensioners relative to the working population, while life expectancy is steadily increasing. This deterioration in the old-age dependency ratios is placing the OASI under pressure, and an aging population could lead to higher healthcare spending (for example, for long-term care).

It is difficult to predict the impact on federal finances, as demographic change will happen over a long period of time and estimates will therefore be very sensitive to underlying assumptions (for example, about growth). The Federal Department of Finance assumes that, unless countermeasures are taken, the Swiss debt ratio will likely rise 20 percentage points by 2060. This would undermine the progress made over the past 30 years. A UBS study on the future of the OASI, *OASI: A question of perspective,* estimates that the additional costs due to demographic change over the next few decades could grow to three times today's GDP.

The approval of the initiative for a 13th OASI pension underlines the potential for future fiscal imbalances. According to the Federal Office of Social Insurance calculations, the 13th OASI pension will reduce the OASI return by a cumulative sum in excess of CHF 30 billion between 2026 and 2033 alone. Having spent many years on a path of fiscal virtue, Switzerland is in danger of veering off course.

Combination of stability measures

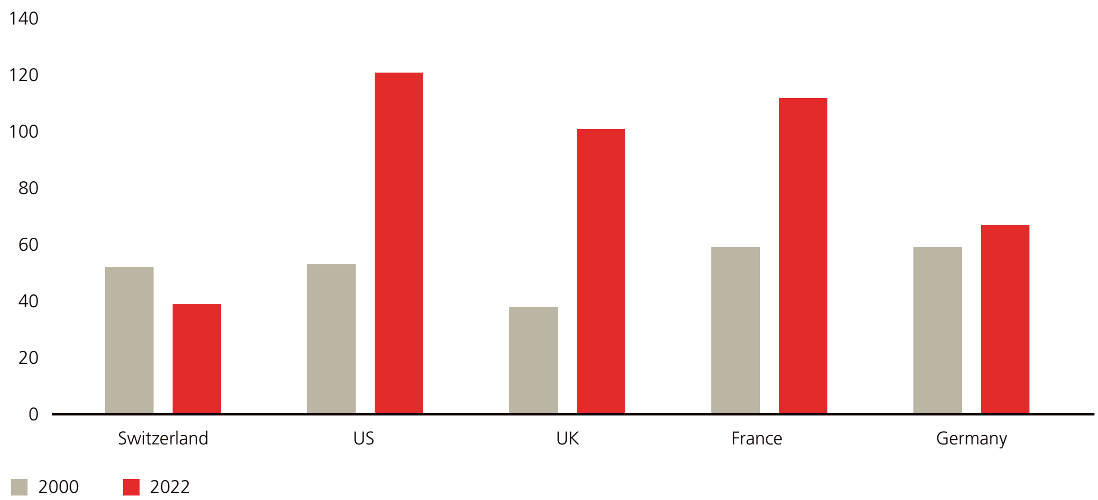
There are two different routes to prevention without massively inflating debt levels: Revenue must be increased or expenditure reduced.

According to UBS calculations, contributions to the OASI would have to increase by nearly 2 percentage points to rebalance Pillar 1 of our retirement provision system. Alternatively, we would need a 2 to 3 percentage point increase in VAT. However, the proposals for financing the 13th OASI pension payment are not taken into account here. At the same time, these measures on the revenue side would see consumers' purchasing power erode.

Figure 5

Exemplary Swiss fiscal policy in the last two decades

Government debt as a percentage of GDP (according to IMF definition)



Source: Macrobond, UBS

On the expenditure side, an increase in the retirement age to 67 for both genders before the acceptance of the 13th OASI pension payment would have been almost enough to rebalance Pillar 1. In addition, an increase in the retirement age would boost the labor force potential at the same time. However, a longer working life does not lead to lower healthcare costs. This suggests a combination of different measures is needed.

Different measures to retain Switzerland's leadership status

Switzerland can retain its status as Europe's economic policy role model, provided it takes the right steps. Growth potential and fiscal sustainability would be supported by making better use of the domestic labor market potential and extending working life. Optimization of regulations and closer networking with the EU are other elements that need to be addressed, in our view.

However, greater state support, whether for innovation or better utilization of the labor market, is at odds with fiscal sustainability. It is also doubtful whether government spending can really motivate older people to work for longer or encourage part-time workers to increase their hours. Additionally, measures such as industrial policy are not part of the tradition of liberal Swiss economic policy. A cautious approach must be taken here.

Not only economic policy is being challenged. Companies are also facing difficulties. In recent years, the state has helped to cushion companies from macroeconomic shocks (such as the pandemic). If there is significantly less fiscal room for maneuver, companies can probably expect less support than before.

An increase in the retirement age means that companies will also have to be prepared to continue employing older workers and offer them attractive working conditions. The resounding rejection of the pension initiative—at the same time as the marked acceptance of the 13th OASI pension payment—demonstrates considerable reservations among workers about a higher retirement age.

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Version B/2024. CIO82652744