

# The economic situation from the vantage point of the delegates for regional economic relations

Summary report for the attention of the Governing Board of the Swiss National Bank for its quarterly assessment of September 2010

## **Third quarter of 2010**

The SNB's delegates for regional economic relations are constantly in touch with a large number of enterprises from different industries and economic sectors. Their reports, which contain subjective evaluations by these companies, are an important source of information for assessing the economic situation. The following pages contain a summary of the most important results of the talks held in July and August 2010 with some 206 company representatives on the current and future economic situation.

## Summary

The favourable economic trend continued in the third quarter. Compared to the previous year, the recovery in manufacturing was strongest. However, broad-based growth was also apparent in the construction industry and services sector. As a result, the demand for labour also recovered. Companies are less hesitant about expanding their workforces than in the second quarter.

As a result of the stronger demand, industry representatives are looking to the immediate future with confidence. Expectations for the next few months point to positive turnover growth in all three economic sectors, albeit at a somewhat slower pace, especially in manufacturing. The under-utilisation of technical production capacity in the Swiss economy is likely to decrease further.

Despite the favourable development of business activity, however, there were lingering concerns over the sustainability of the international economic recovery. On the one hand, the state of public finances around the world and the potential impact on financial and foreign exchange markets, as well as on aggregate demand in the affected countries, have been a source of uncertainty. On the other hand, a number of representatives felt that the extremely expansionary monetary policy being pursued around the world carries inflation risks, giving rise to fears of sudden interest rate hikes.

Reactions to the appreciation of the Swiss franc varied considerably from one industry to another.

# 1 Business activity

## Manufacturing

In the third quarter, the economic situation in manufacturing improved further, although in a quarter-on-quarter comparison it presented a slightly less positive picture than in the second quarter. Overall, turnover rose sharply year-on-year, with only a few companies posting turnover figures below last year's level. Although starting from very different levels, the textile and clothing industry, chemical industry, pharmaceutical industry, watchmaking industry, metals industry and automotive-related manufacturing industry have all experienced an above-average recovery within the last year. Strong growth impulses also affected the plastics and speciality chemicals industries.

Domestic demand remained an important driver of growth. Demand from emerging markets in Asia, but also in South America, was exceptionally vigorous. Demand impulses also came from the euro area, in particular from the German and French automotive industries.

Stocks of finished products were sharply scaled down over the last few months. As in the previous quarter, inventory levels in all industries were regarded as appropriate. Thus, future demand stimuli will probably continue to result in increased production.

## Construction

Starting from a very good level, the upward momentum in the construction industry gathered pace. Compared to both the previous year and the preceding quarter, respondents reported a clear increase in turnover, with growth stimuli primarily coming from the residential and finishing segments. A growing number expressed concern over the real estate market risks that are inherent in low interest rate policies. However, they still did not discern any sign of a bubble.

## Services

Turnover in the services sector increased significantly between the second and third quarters of 2010. As a result, it clearly surpassed the previous year's level. With a very strong quarter-on-quarter increase in turnover, the IT industry generated the strongest momentum. Robust sales growth was also observed for the hospitality industry, engineering and consultancy firms, and the wholesale and retail

industries. In border regions, however, the weakness of the euro resulted in a migration of spending to neighbouring countries. In the banking industry, turnover varied widely from bank to bank.

# 2 Capacity utilisation

The degree of technical capacity utilisation has improved for all industries since the second quarter, and is approaching normal levels. However, there are still sectoral differences.

The manufacturing industry reports that there is still a slight under-utilisation of capacity overall. However, the phenomenon remains particularly pronounced in the chemical and mechanical engineering industries, and for firms supplying inputs to the watchmaking industry, despite favourable recent business activity in these areas. The metals industry presented a very mixed picture. Capacity utilisation was at a normal level in the food industry.

In the construction industry the level of technical capacity utilisation has increased further, and is now regarded as 'high' – i.e. substantially above the normal full employment level. No companies reported unsatisfactory capacity utilisation.

In the services sector, the under-utilisation of capacity has decreased further, and capacity utilisation is approaching normal levels. For engineering and consultancy firms and real estate agents, capacity utilisation was good. Despite strong growth in turnover, capacity utilisation was still unsatisfactory in the retail and mail order industries, in certain areas of the hotel industry and for travel agents. This phenomenon was also evident in the recruitment industry, as well as for a few banks.

### 3 Demand for labour

In the manufacturing industry, the recovery in business activity once again went hand in hand with a noticeable revival in the demand for labour. More of the remaining short-time work measures were withdrawn, while some companies took on more temporary staff or imposed overtime. In a few cases, companies again began hiring new staff, resulting in a small increase in employment. Overall, staff levels appeared to meet company needs, unlike the second quarter, when companies had indicated that these levels were still somewhat too high. In some cases in the machine and machine tools industries, company representatives mentioned a certain shortage of labour. By contrast, respondents in the area of electrical appliances and equipment manufacturing tended to report that staff levels were too high.

In the construction industry, too, the demand for labour increased, and some companies resorted to stopgap measures such as the employment of temporary staff, in order to cover requirements. Although most of the companies surveyed said they were satisfied with current staff levels, a larger proportion of respondents than in the second quarter reported that these levels tended to be marginally on the low side.

In the services sector, staff levels were generally considered appropriate to a little too low. The IT and financial services segments both indicated a need to recruit, as did engineering firms.

In general, respondents again felt that it was less difficult than usual to recruit new staff. However, the construction industry and the financial industry continued to be exceptions to this general rule, and recruitment in the hospitality industry also appeared to be harder than would normally be the case. Highly qualified personnel still tended, in general, to be difficult to find.

In most areas of manufacturing, per capita labour costs remained very stable. Indeed, compared to the data for the previous quarter, wage pressure has fallen somewhat. One exception is the watchmaking industry, where real wages increased year-on-year. As in the second quarter, wages also trended slightly upwards in the construction industry and the services sector, particularly in the IT industry, transportation, and trade. In the construction industry, the trend strengthened. A number of companies are planning increases in real

wages for 2011, particularly in areas of manufacturing where there is a backlog.

### 4 Prices, margins and earnings situation

Certainly, higher production and sales volumes improved profit margins, as fixed costs were more fully absorbed. However, as in previous quarters, margins in manufacturing were regarded as significantly narrower than normal. In many cases, the only way to increase them was to launch new products. Margins are likely to remain under pressure in the short term. On the one hand, companies expect that purchase prices will only increase minimally, reflecting the anticipated cooling of the global economy. The appreciation of the Swiss franc will continue to dampen this effect somewhat. On the other hand, sale prices in Swiss francs will tend to remain stable or even decrease slightly as a result of intense competition and the exchange rate effect. Some companies from various sectors will try to push through price increases, although this may depend upon specific company and market conditions.

In the construction industry, profit margins are judged to be between close to normal and slightly unsatisfactory. Compared to the previous quarter, the assessment of the situation is less negative. The expectation of increasing purchase prices in the second quarter has given way to more stable price expectations. In addition, rather more companies have the impression that they can impose higher sale prices. Competition with foreign suppliers, particularly in Germany, has further intensified as a result of the depreciation of the euro.

Representatives of the services sector regard the level of their profit margins as normal to slightly unsatisfactory. The overall result was negatively influenced by the clearly unsatisfactory interest rate margins of banks; competition remains particularly fierce in mortgage business. Profit margins are also regarded as unsatisfactory by job recruitment offices, engineering firms, some retailers and wholesalers and the hotel industry.

## 5 Impact of Swiss franc appreciation

In the survey conducted in July and August 2010, companies were also asked about the exchange rate. When asked specifically about the impact of the appreciation of the Swiss franc on their business, more than half of the companies said they had not experienced any noticeable effects overall. Almost one-fifth of the companies reported positive effects. Slightly over one-quarter of the companies had experienced mildly or strongly negative effects.

However, these effects varied considerably, depending on the production sector in question. Manufacturing was most negatively affected by the strength of the Swiss franc. Some 60% of companies spoke of difficulties of this kind, particularly companies active in the manufacture of preliminary products (chemical products, plastics), in the capital goods industry (production of electrical equipment as well as large segments of the machine industry) and in the metal industry. The negative effects mainly took the form of greatly reduced profit margins and, to a lesser extent, a decline in sales volumes. By contrast, positive effects were derived mainly from lower import prices and – in some cases – lower investment costs.

In both the services sector and the construction industry, the great majority of companies were unaffected by the strength of the Swiss franc. Even in the hotel industry, only very limited negative effects were reported in the period through to summer.

## 6 Outlook

The revival in confidence in the manufacturing industry, which has been underway since the second half of 2009, continued. The majority of companies are anticipating growth in turnover and higher capacity utilisation. The employment outlook for the next six months is also cautiously optimistic, with companies expecting a slight rise in employment. At the beginning of the year, respondents were still anticipating no change in staff levels. A return to higher labour productivity remains a widespread goal.

In the construction industry, companies remain optimistic and are expecting further slight growth in turnover. In residential and finishing, companies are anticipating a stabilisation of capacity utilisation at the current high level. Only a few companies expect that capacity will increase further while no respondents expect capacity to decrease. Employment is likely to increase slightly.

In the services sector, expectations with regard to business activity over the next six months have improved. Particularly optimistic appraisals of turnover prospects were evident in the IT industry, in wholesale and retail, and in automotive sales. Providers of financial services and hospitality industry representatives were also confident. Consequently, representatives from the services sector anticipated a gradual increase in technical capacity utilisation and a slight rise in employment.

However, uncertainties persist regarding the prospects for the European economy, potential exchange rate movements, and the future interest rate situation. Rapid changes in these parameters, in particular, would significantly cloud the picture. The increasing number of media reports of a possible double dip originating in the US are also giving rise to uncertainty. Consequently, slightly more respondents now believe that a negative scenario could eventuate. Nevertheless, investment plans have been stepped up in all sectors, compared to the previous quarter. This applies to both equipment investment and construction investment. However, this more vigorous capital expenditure mainly reflects the need to carry out previously deferred replacement investment, rather than an intention to expand existing production capacity.