

# 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 December 2010

## **Fourth 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 a valuable source of information for assessing the economic situation. The following pages contain a summary of the most important results of the talks held in October and November 2010 with some 244 company representatives on the current and future economic situation. The selection of companies is made according to a model that reflects Switzerland's production structure. The companies selected differ from one quarter to the next. The reference parameter is GDP excluding agriculture and public services.

## Summary

The favourable economic trend continued in the fourth quarter, albeit with slightly less momentum. Compared to the previous year, the recovery – as in recent quarters – was most evident in manufacturing. The construction industry and the services sector also registered broad-based growth, although at a somewhat lower rate than before. Demand for labour continued to recover. Companies were somewhat less hesitant about expanding their workforces than in the third quarter.

As a result of the observed developments in demand, industry representatives are looking to the immediate future with confidence. Expectations for the coming months point to positive turnover growth in manufacturing, construction and services, though with a certain slackening in momentum, particularly in the construction and, to a lesser extent, the service industry. Technical production capacity in the Swiss economy has now attained normal to good levels in nearly all fields.

Despite the favourable developments in business activity, however, there are lingering concerns over the sustainability of the international economic recovery. On the one hand, the state of public finances at global level 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 feel that the highly expansionary monetary policies still being pursued worldwide harbour inflation risks, giving rise to fears of sudden interest rate hikes.

As in the third quarter, reactions to the appreciation of the Swiss franc vary considerably from one industry to another. Overall, however, businesses are now under distinctly greater pressure (cf. also 'Exchange rate survey: Effects of Swiss franc appreciation and company reactions', pp. 50 et seq.).

## 1 Business activity

### Manufacturing

In the fourth quarter, the economic situation in manufacturing again improved noticeably, both year-on-year and quarter-on-quarter, though the momentum has slowed somewhat compared to the previous quarter. Turnover in real terms rose markedly against the previous year, with only a few companies posting turnover figures below last year's level. Metal processing, mechanical engineering and watchmaking, as well as textile and clothing all made an above-average recovery within the last year. The food, chemical and pharmaceutical industries developed favourably, too.

Domestic demand continued to be an important source of support. Demand from emerging markets in Asia, but also in South America, remained exceptionally vigorous. However, additional new demand also came from the US and the euro area, in particular from Germany. Various industries benefited, directly or indirectly, from strong demand on the part of the European automotive industry.

Stocks of finished industrial products were scaled down somewhat. In the previous quarter, they had still been regarded as slightly too high, this time they were considered to be on the low side. Thus, future demand stimuli will probably continue to result in increased production.

### Construction

The momentum in the construction industry remained exceptionally strong despite a slight slowdown. Turnover levels in the fourth quarter were up both year-on-year and quarter-on-quarter, although the increase was less steep than in the third quarter. The main boost came from residential construction, but the finishing sector also made a considerable contribution. Customers are now predominantly concerned with when work can begin, construction companies for their part increasingly focus on margins when deciding whether or not to accept a project. No end to the positive overall tendency is currently in sight. However, companies' assessments of current and future turnover trends is somewhat less euphoric than in the previous quarter.

In the fourth quarter, several respondents again expressed concern about the increasing real estate market risks inherent in the ongoing low interest rate policy and the strong demand for mortgages that it engenders. They do not discern any sign of a bubble, but prices for land and buildings are deemed to be unrealistic in a growing number of regions.

### Services

As in the quarters before, turnover in the services industry developed favourably and exceeded the levels of both the previous year and the previous quarter. However, compared with the third quarter, the assessments were somewhat less positive. Logistics and transport companies, travel agents, recruitment firms and IT companies recorded the strongest momentum, with turnovers rising very markedly in comparison with the third quarter. The hotel industry – buttressed by tourists and business travellers from Asia – as well as engineering and consultancy firms continued to register robust turnover growth. Developments in the financial services industry again proved highly heterogeneous, but turnover was up overall both year-on-year and quarter-on-quarter. The weakness of the euro remained noticeable in the retail trade, especially in the border regions, with a distinct amount of custom lost to the neighbouring countries.

## 2 Capacity utilisation

The degree of technical capacity utilisation has continued to improve overall since the third quarter. Manufacturing registered a clear improvement, services a slight upturn. Capacity utilisation remains highest in the construction industry. Building construction in particular and civil engineering to a lesser extent registered high utilisation levels and correspondingly tight resources.

The manufacturing industry reported good utilisation of technical capacity overall, following slight under-utilisation in the third quarter. By contrast, the chemical and pharmaceutical industries, as well as individual equipment manufacturing and mechanical engineering companies, still reported

underutilisation. Utilisation levels are good to very good among watchmakers and – most recently – their suppliers, as well as in certain wood processing and textile companies. The food industry reported normal capacity utilisation.

In construction, the level of technical capacity utilisation remains high, albeit not quite as high as in the previous quarter. No companies reported unsatisfactory capacity utilisation. Looking forward, respondents expect a slight relaxation, which would be welcomed by several companies currently working at full throttle.

In the services sector overall, underutilisation of capacity is no longer an issue as normal utilisation has now been reached. Capacity utilisation levels are high in the case of engineering and consultancy firms, software producers, recruitment companies, road transport operators, real estate agencies and real estate management firms. The trade industry reported normal capacity utilisation overall. Underutilisation is in evidence in the hotel and catering industries as well as at fiduciary companies and several banks, despite favourable turnover developments.

### 3 Demand for labour

In the manufacturing industry, the recovery in business activity continued to go 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 extra staff on a temporary basis or imposed overtime. Companies also began hiring new staff again, with employment increasing slightly as a consequence. Overall, manufacturing companies considered the level of employment as somewhat on the low side, after it had been roughly in line with requirements in the third quarter. Company representatives from the watchmaking industry and their suppliers, as well as from individual pharmaceutical companies, indicated a shortage of labour. Personnel resources were also tight among wood processing firms. Certain metal production and processing companies, by contrast, deemed their workforces to be on the high side.

Demand for labour continued increasing in the construction industry, although the rise was less steep than in the previous quarter. Some companies resorted to stopgap measures such as employing temporary staff or requiring employees to work overtime in order to cope with the workload. In certain cases, orders were refused owing to capacity bottlenecks.

In the services sector, staff levels were generally considered appropriate to a little too low. A need to hire staff was indicated in particular by IT, logistics, engineering and recruitment firms, whereas fiduciary companies reported a slight employee surplus.

In general, difficulties in finding new staff have increased somewhat. Compared to the previous quarter, recruitment has become more arduous and time-consuming, especially in the manufacturing industry. Finding workers in the construction industry has remained roughly as difficult as before. Transport operators, IT companies and travel agents appear to have more difficulty in recruitment than previously. Well qualified personnel tended to be hard to find across the board. Although the free movement of persons has eased the situation overall, the labour market in certain job sectors appears to have dried up. The retail and wholesale industries, by contrast, are hardly faced with such problems. Representatives said that recruitment had, in fact, become somewhat easier than usual.

Per capita labour costs increased slightly in most business sectors. Compared to the previous quarter, wage pressure increased, especially in the manufacturing industry. Companies in textiles, mechanical engineering and watchmaking were confronted with higher per capita labour costs. As in the previous quarter, wages tended upwards most distinctly in the construction industry. In the services sector, rising labour costs were recorded primarily at IT, transport and engineering firms. A number of companies are planning increases in real wages for 2011, particularly in areas of manufacturing where there is a backlog and the availability of workers on the job market has declined.

## 4 Prices, margins and earnings situation

Higher production and sales volumes again 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 is to launch new products. Margins are likely to remain under pressure in the foreseeable future. On the one hand, companies expect purchase prices to trend upwards. On the other hand, it will hardly be possible to raise sale prices in Swiss francs to the same extent, due to strong competition and the exchange rate effect. Nevertheless, manufacturing companies consider the chances of being able to push through sale price increases to be somewhat higher than in the previous quarter. Ultimately, however, this depends very much on specific corporate 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 appraisal of the situation improved somewhat. Purchase prices (commodities) are expected to be slightly higher than anticipated in the quarter before. Rather more companies now have the impression that they can implement higher sale prices.

Representatives of the services sector, too, regard the level of their profit margins as normal to slightly unsatisfactory. As in the quarter before, the overall result was negatively influenced mostly by the clearly unsatisfactory interest rate margins of banks. Competition in banking remains fierce particularly in mortgage business. Moreover, exchange rate developments are putting a strain on earnings from asset management. Profit margins are also regarded as unsatisfactory by hotel owners, recruitment firms, as well as certain retailers and wholesalers. By contrast, engineering, fiduciary and consultancy firms as well as real estate management companies reported a comfortable margin situation.

## 5 Impact of Swiss franc appreciation

In the October and November 2010 survey, the exchange rate topic was again raised with companies, as it had been in the previous quarter. When asked specifically about the impact of the appreciation of the Swiss franc on their business, 45% of the companies said they had experienced negative effects overall. This is well above the percentage in the third quarter. 42% of the companies surveyed stated that the appreciation had not affected their business, and 13% reported positive effects. The impact varied considerably from one production industry to another. The survey results are discussed in detail in the section 'Exchange rate survey: Effects of Swiss franc appreciation and company reactions' (pp. 50 et seq.).

## 6 Outlook

The great majority of manufacturing companies are anticipating growth in real turnover and higher capacity utilisation in the coming six months. The employment outlook for this period is also largely positive, with further staff increases planned. This represents a marked improvement compared to the third quarter outlook. However, looking beyond the next six months, respondents expressed greater reservations regarding the sustainability of the current momentum.

Companies in the construction industry remain largely optimistic, anticipating a further slight growth in turnover, albeit not to the same extent as in the previous quarter. Residential construction companies expect capacity utilisation to remain stable at its current high level; hardly any anticipate a further increase. Several industry representatives expect a decline in capacity utilisation. Employment is likely to stay largely unchanged.

In the services sector, expectations with regard to business activity over the next six months remain favourable. Particularly optimistic appraisals

of turnover prospects were evident among travel agencies, recruitment firms, in the IT industry, in wholesale and retail, and in the catering industry. Financial service providers, firms working in real estate, consultancies and fiduciary companies were also confident. Consequently, representatives from the services sector anticipated a slight increase in technical capacity utilisation and in employment.

The most frequently mentioned risks include the uncertainty regarding the sustainability of the global recovery, the risks in connection with the debt situation of European states and banks, further exchange rate movements and the future interest rate situation. Several company representatives again expressed a certain unease about the persistently low interest rate level and the potential risk of inflation.

Investment plans showed a slight upward tendency in the manufacturing industry and services sector; less so, though, than in the third quarter. This applies to both equipment investment and construction investment. The generally higher capital expenditure mainly reflects the need to carry out previously deferred replacement investment, to a lesser extent also the intention to expand existing production capacity. Stagnating investment is expected in the construction industry.