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Evaluation of the effects of the Ukraine war on Switzerland‘s economy

The economic environment is simply not coming to a rest. We have barely overcome the most problematic effects of the Corona saga when the next shock hits the global economy: the war in Ukraine. And while the effects of the pandemic were already hard to predict, this conflict may create even more economic uncertainties. It´s needless to mention that the human suffering of the affected population is huge and completely unnecessary. It seems clear that the current, very favourable forecasts are to be revised. But we are completely in the dark about how much we have to downgrade. From a swift end of the conflict, to a continuation of the warlike actions for months, to a large-scale spread with further military escalations and a spillover of the conflict to other countries, hardly anything can be ruled out.

Against this background and with focus on Switzerland we would like to outline here the most important channels of impact of the war on the economic development, on the already alarming inflation and, based on this, derive the challenges for the economic policy decision-makers.

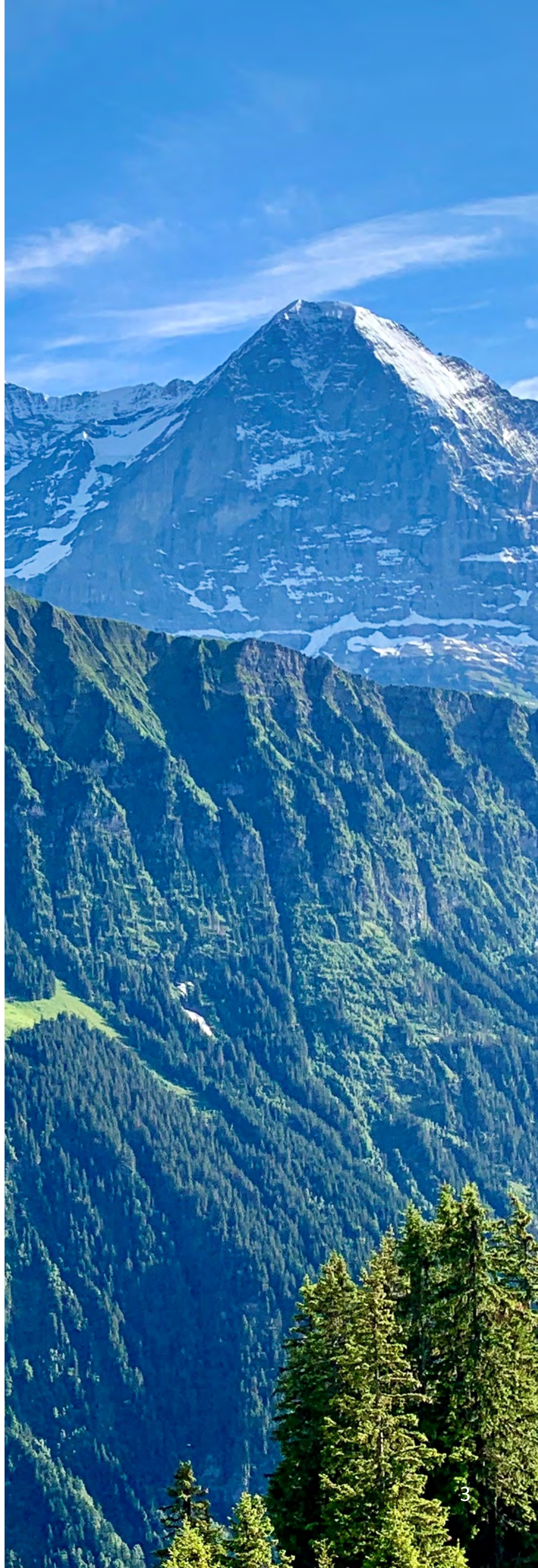
Effects on the economy

Without the Ukraine conflict, the indicators for the global economy would be pointing to a boom. Due to the diminishing effects of the pandemic, investment and consumption have recovered significantly and the catch-up effects suggest a continuation of this trend. The Ukraine war is now undoubtedly clouding this favourable situation. Considering all the uncertainties, we discuss two scenarios here.
If we assume in a first scenario that the conflict remains geographically and temporarily limited and the sanctions do not intensify significantly, then the effects on the Swiss economy would probably be rather moderate. Direct foreign trade with Russia (export ratio 1.2%) and Ukraine (0.2%) is negligible, so that only sectoral, but hardly overall economic effects can be expected there. Transit trade would be particularly affected, as business with Russia accounts for almost 20% of the volume. Because of its relatively high share of about 5% of the Swiss GDP, a noticeable effect on the economy can be expected from this side. However, there are only few jobs in transit trade. In addition to the effects on inflation, which we discuss below, the rise in commodity prices has negative effects on the purchasing power of households and thus on consumer demand for other goods. Finally, uncertainty remains about the duration and extent of the conflict, which can also slow down investment demand. All these effects taken together, the economic effects in this scenario are likely to be limited. Institutes that recently reviewed their forecasts hardly reduced their prediction of growth in the Swiss economy, averaging just below 3% in 2022. The pandemic recovery still clearly dominates the effects of the Ukraine war.

Of course, one can contemplate many developments for a second, negative scenario. For the time being, the most plausible scenario seems to be that the conflict remains limited, but sanctions would be significantly tightened again. At the centre of this situation there would probably be a halt to the import of raw materials from Russia. This would lead to a massive additional increase in energy prices in particular and probably trigger a recession in many European countries. This is plausible, as 55% of Germany‘s natural gas imports, 35% of its oil imports and 50% of its coal imports come from Russia. Even if Switzerland‘s direct dependence is significantly lower, the indirect economic effects via foreign trade would hit us hard. In the event of such a development, SECO expects growth to fall to around 1% in 2022. This is not a recession, but an abrupt halt to the upswing.

Effects on inflation

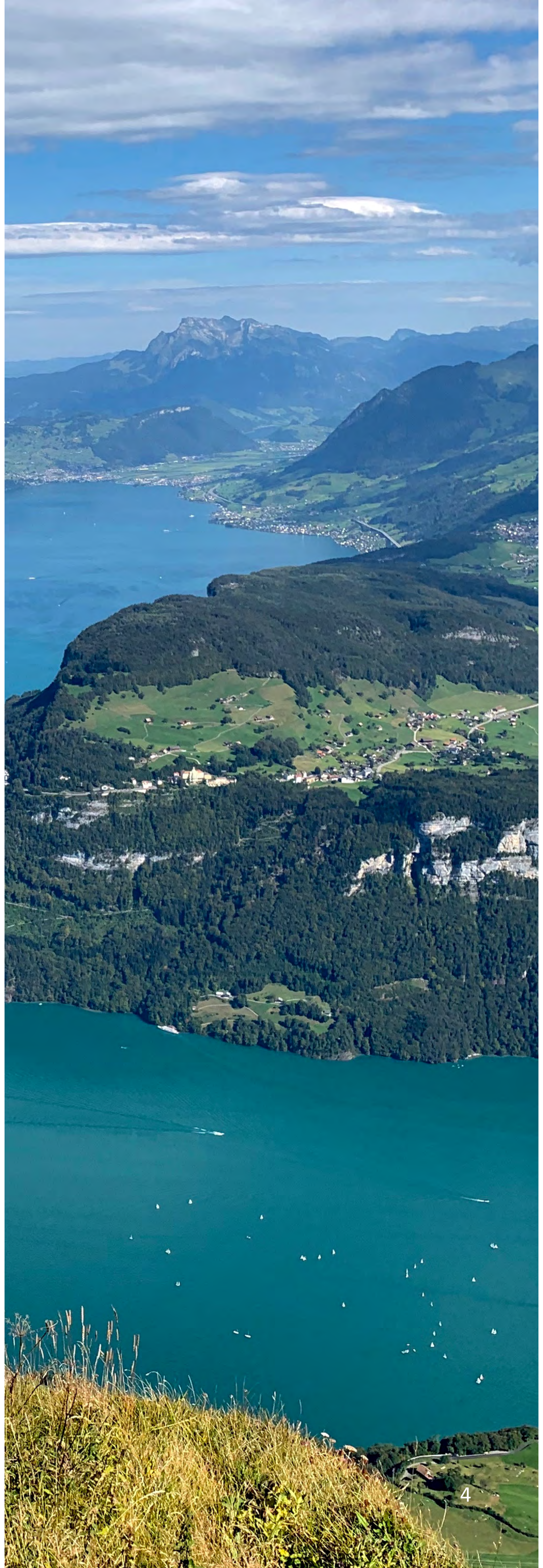
Potentially more problematic than the direct economic effect of the conflict could be the impact on inflation. As stated and explained in the last View, inflation has risen sharply recently, particularly in the US, but increasingly also in the EU. Since then, this has become even more pronounced, with US inflation reaching almost 8% even before the outbreak of the conflict. In this overheated situation, the commodity price increases triggered by the Ukraine war act as a powerful accelerant. Certainly, these recent price shocks will further fuel short-term inflation. Without a rapid easing of the situation, however, the additional inflationary pressure will persist for months and even intensify in the event of a possible expansion of the sanctions as described above. This will diminish the hope of a one-time price rise and thus increase the risk of wage-price spirals and a persistent rise in inflation expectations. This has already increased noticeably since the beginning of the war and with each further prolongation of the conflict, the inflation dynamic is likely to become more problematic.



In Switzerland, too, the inflation rate has risen to over 2% in the meantime, but overall inflationary pressure still seems to be much lower in this country. This is largely due to the recent appreciation of the franc, which is moderating inflation via import prices. But there are also increasingly clear signals of strong price pressure in Switzerland.

Economic policy dilemma

Before the Ukraine conflict, the risk of overheating in the presence of a combination of rising inflation and a post-Corona boom was at the centre of macroeconomic concerns. The correct economic policy response to this was clear: a rapid transition to a more restrictive fiscal and, above all, monetary policy. With the economic disruption caused by the war, the much more problematic stagflation scenario is now becoming more and more plausible, i.e. rising inflation combined with a lame-duck economy. Such a development poses a dilemma for monetary policy, since inflation would require rising interest rates and the contraction falling (or at least constant) ones. The more recessionary the conflict would appear, the more pronounced the dilemma would be. According to my assessment, the Fed, in particular, will not let the downturn risks prevent it from countering inflation with a more restrictive monetary policy. A further strengthening of the inflation dynamic would exponentially increase the costs of the eventually inevitable inflation fight. The just decided interest rate hike just decided, and even more so the unequivocal prioritisation of fighting inflation in the Fed's communication, is encouraging in this regard. It remains to be hoped that the ECB will not use the recession risk of a possible negative scenario as an opportunity to further delay the urgently needed normalisation of monetary policy. Swiss monetary policy is somewhat less challenged as long as inflation dynamics remain comparatively low.



Conclusion

Overall, the Ukraine war has clouded the economic environment. However, unless there is a complete geographical and military escalation, an economic slump of major proportions is not to be expected. Even in relatively negative scenarios, the effect would be significantly smaller than the economic slump triggered by the pandemic. From an economic point of view, the main risk is that rising commodity prices will trigger a self-reinforcing inflationary spiral in an already overheated environment. Against this background, it can be assumed that the fight against inflation will remain the main objective of macroeconomic policy in the coming months.

For Switzerland, even in relatively negative scenarios with a significant expansion of sanctions, a noticeable downturn is to be expected, but not a recession. The resilience of the local economy is stronger than in most trading partner countries, in large part thanks to the strength of the franc and the disproportionate focus of exports on the pharmaceutical industry, which is resistant to cyclical fluctuations. This relatively positive assessment applies to the economy as a whole, but individual industries and companies that focus on Russian customers or are heavily dependent on energy can obviously be hit much harder.

About the author of the Brunetti View

Prof. Dr. Aymo Brunetti is Professor of Economic Policy and Regional Economics at the Department of Economics of the University of Bern. Up until 2019 he also headed up the Federal Advisory Council for the Future of the Swiss Financial Centre (Beirat des Bundes für die Zukunft des schweizer Finanzplatzes). He was previously Head of the Economic Policy Directorate of the State Secretariat for Economic Affairs (SECO) and informal national chief economist. From 2012–13, he chaired a group of experts led by the Swiss Minister of Finance, which drew up proposals for overcoming the challenges facing the Swiss wealth management industry. He was then Chair of the high-ranking Expert Group of the Federal Government and commissioned a report on the advancement of Swiss financial market strategy.

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