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## BRUNETTI VIEW Q2 2021

Published: May 7 2021





## A truly exceptional economic situation

The global economy is still under the spell of the COVID-19 pandemic, but at least there is light at the end of the tunnel. This is due to the vaccination campaign, which has gained noticeable momentum in the meantime. We are not over the mountain yet, but it should only be a few more months before life returns to normal to a large extent. It is still too early to make a definitive assessment of the crisis and how it has been overcome, but in the meantime we have relatively good data confirming how extraordinary the economic effect of this event was and is.

### **Recovery scenario clearly in the spotlight**

In the last Brunetti View we outlined three very different scenarios. From today's perspective, we can state that the recovery scenario that was rated (with reservations) as the most likely at that time, clearly has the highest probability today. We are unlikely to see a classic V-course with a strong slump followed by a rapid, equally strong upswing, but at least the depression scenario with an L-course seems to have been averted in the meantime thanks to the success of the vaccination. The most plausible scenario today seems to be a W-course. A strong slump in spring 2020 was followed by an almost equally strong upswing in summer, until the second wave of the pandemic brought another downturn in autumn and winter, which will hopefully be replaced by a strong recovery from early summer 2021.

In the meantime, SECO has published the first GDP estimate for the entire year 2020 and it shows us how extraordinary this economic slump was; the recession after the Great Financial Crisis seems almost conventional in comparison. It is worth taking a closer look at these figures, as they form a crucial basis for assessing the dynamics of the coming economic development.

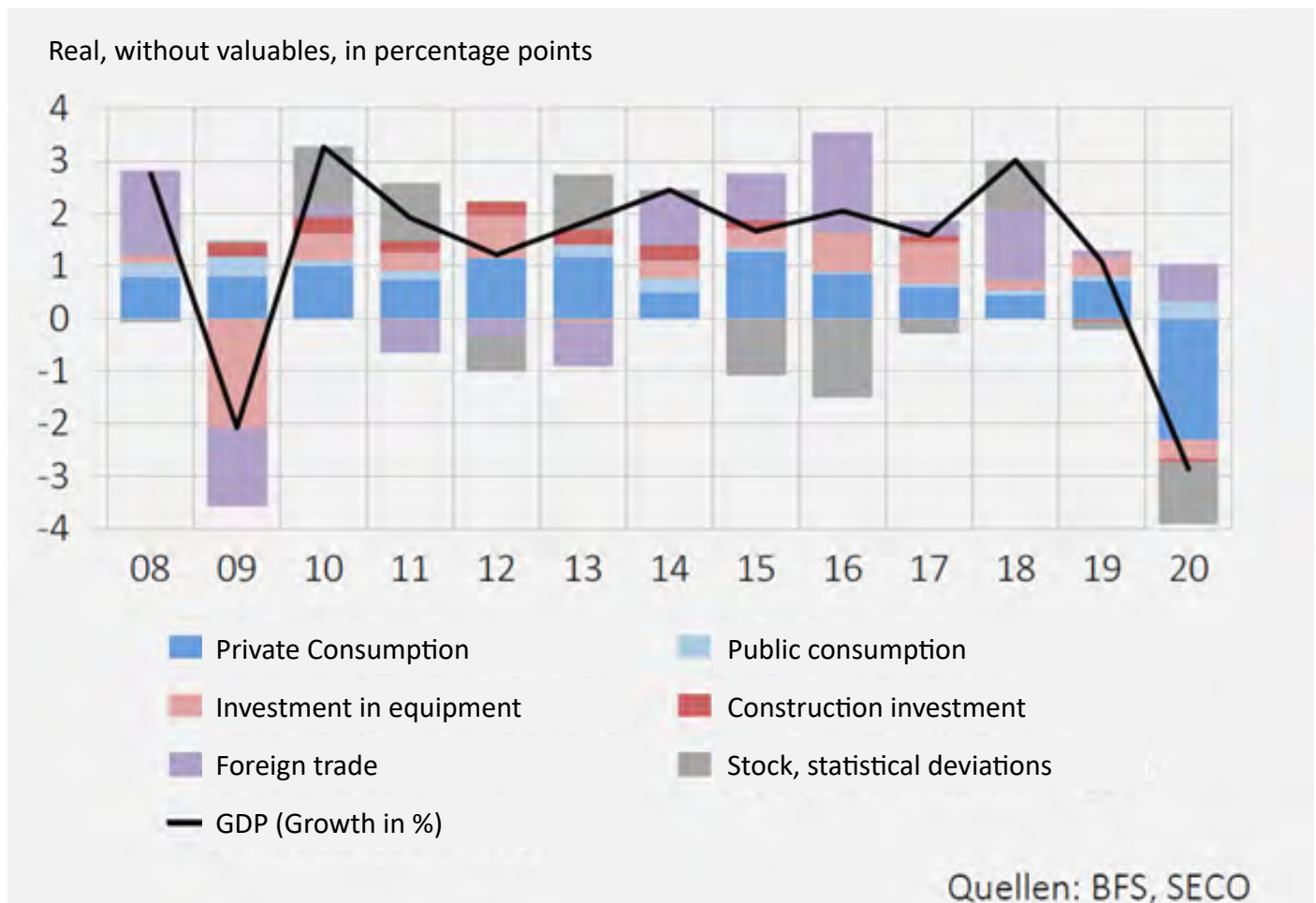
How special the recent economic development was, can be seen when we analyse the course from the perspective of the components of aggregate demand; these are, after all, the focus of every economic analysis. The SECO chart shows how the annual growth from 2008 to 2020 may be explained by the most important demand components. The so-called growth factors are shown here; they represent which part of the growth can be attributed to consumption, investments and foreign trade. Adding up the contributions of the individual components yields the annual growth (shown in the figure with points in each year connected by a black line).

## Very different recessions in 2009 and 2020

The development of the entire period shown is interesting, but we want to focus here on the two recessions of 2009 ("Great Financial Crisis") and 2020 ("Great Pandemic"). In 2009 we experienced a recession that -- not in terms of magnitude but in terms of its composition -- was relatively conventional in the historical context. We see a significant decline in foreign trade and in equipment investment, which is very typical for recessions in Switzerland. Economic fluctuations here are usually triggered by fluctuations in foreign trade and investment in equipment is the part of investment activity that companies can easily postpone, which

is why it usually declines sharply during recessions. Back then, consumption (private and public) and construction investment had a stabilising effect. In particular, the stabilising effect of the very important private consumption is typical for recessions because, usually in an economic downturn, daily consumer spending is not (or cannot) be cut back as much; it is oriented less to current and more to long-term average income.

## Growth contributions of the components of aggregate demand





If we look at the current recession triggered by the COVID-19 pandemic, just about everything really relevant is different. Absolutely unusual and never seen before in Switzerland is the strongly negative growth contribution of consumption. Unlike usually, this time it did not stabilise at all, but with a very high negative growth contribution it was actually a catalyst that worsened the slump. Also very untypical was the behaviour of foreign trade, which, unlike normally, stabilised the economy this time, thus making a significantly positive contribution to growth. How can these highly unusual developments be explained? The slump in consumption is of course due to the fact that a great part of consumption was no longer possible with the lockdown in spring 2020, which means that the voluntary and forced social distancing caused a slump in consumer demand. The effect was so strong that the catch-up effect in the second half of the year was not nearly enough to turn the consumption contribution into positive over the whole year. In the case of foreign trade, a central role was probably played by the fact that pharmaceutical exports, which account for almost half of goods exports in Switzerland, remained dynamic during the crisis. The other components of aggregate demand performed as expected in a recession, but were not particularly strong given the very severe crisis. Investment in equipment made a negative contribution to growth, but this was much smaller than in 2009, especially since investment-intensive sectors, and here again especially the pharmaceutical industry, were hardly affected by the crisis. As one would expect, the automatic government stabilisers played an important role, with the result that the contribution of public consumption to growth was positive; the extent here was roughly comparable in the two recessions. A word on the item "inventories, statistical deviations": This is not measured directly and, in addition to changes in inventories, mainly contains substantial statistical errors. Accordingly, this demand component cannot and should not be interpreted too strongly.



## Outlook

The data for 2020 show that there is a very significant catch-up potential, especially in consumption, which by far is the most important component of aggregate demand. A great deal of involuntary saving took place during the pandemic and as soon as this is possible again, the accumulated consumer demand should take full effect and thus provide a strong tailwind for economic development in the coming quarters. In addition, a marked improvement in the outlook should boost equipment investment. If there are no unpleasant surprises on the pandemic front, strong growth impulses can therefore be expected in the second half of the year. Most economic forecasts are therefore optimistic.

Against this backdrop, it should not be forgotten that in our last View we pointed out a third possible development, namely the overheating scenario. This

scenario is imminent if demand grows much more strongly than supply, thus fuelling inflation. This would force the monetary policy to quickly abandon its very expansive course, which would probably be associated with rising interest rates. Accordingly, voices have recently become much louder on the financial markets warning of a rise in inflation and turbulence triggered by this. At the moment, the overheating scenario has become more likely in my assessment, but the scenario of a healthy recovery still dominates in most of the important economic forecasts. In my opinion, inflation risks should be weighted more strongly in the current situation than before the crisis.

## 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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