## DOMESTIC ECONOMY

**After a swift and strong recovery in the second half of 2020, the business cycle outlook for the Liechtenstein economy has recently worsened.** As a small and open economy, Liechtenstein was particularly strongly affected from the slump in the global economy in 2020, but recovered quickly on the back of a strong rebound in global trade. Along with the broad-based moderation in global economic activity, the domestic economy has cooled down considerably since the turn of the year, with current geopolitical and economic challenges rendering the development over the third and fourth quarter highly uncertain. In line with these developments, quarterly estimates for Liechtenstein's real GDP for the first and second quarter are below the 2021 average according to flash estimates calculated by the Liechtenstein Institute.

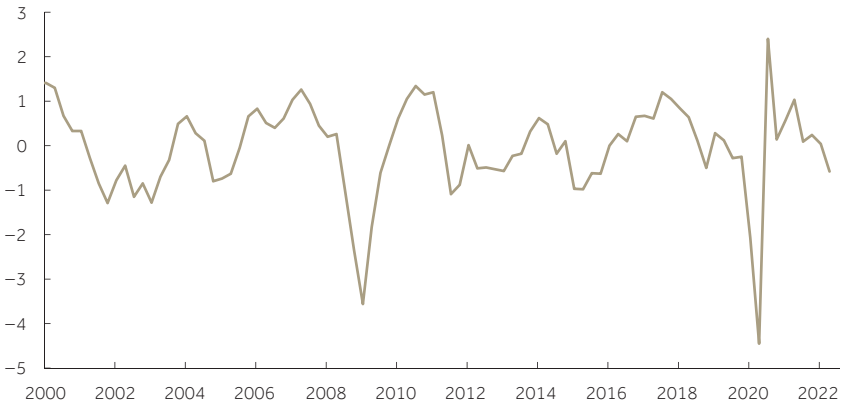



***Figure 5***
*Business cycle indicator "KonSens" (index)*

*Source: Liechtenstein Institute.*

**Cyclical indicators reflect that various and – to some degree – counteracting business cycle dynamics are currently at play.** The KonSens, a quarterly index that summarises 16 data series, which are indicative for domestic business cycle developments, turned negative in the second quarter of 2022 (Fig. 5). The index fell from slightly above 0 to −0.6 in the second quarter, indicating economic growth below historical average. Liechtenstein's economy is thus still quite robust in light of the worldwide downturn and its usual sensitivity to international trade fluctuations. Goods exports, an important indicator for Liechtenstein's economy because of the large industrial sector, remained relatively stable over the last quarters, although the level of exports remained below the pre-pandemic average (Fig. 6). By contrast, survey data capturing sentiment among consumers and producers fell markedly. Overall, signals from single business cycle indicators vary strongly, reflecting a large degree of uncertainty over current and future business cycle dynamics.

**The generally high sensitivity of Liechtenstein's economy vis-à-vis the global business cycle suggests a pronounced impact in case of a global recession.** Small and open economies like Liechtenstein react particularly sensitively to a drop in global economic activity. Figure 7 shows the historical sensitivity of Liechtenstein and various OECD countries to a drop in global output (proxied by OECD GDP) estimated with data from 1998Q1 to 2019Q4. On average, a drop in OECD GDP of one percent translates into a 3.6 percentage points reduction of Liechtenstein's GDP, while larger countries often exhibit elasticities below one. Notably, the Liechtenstein economy did not react as strongly to the world-wide COVID-19 recession as

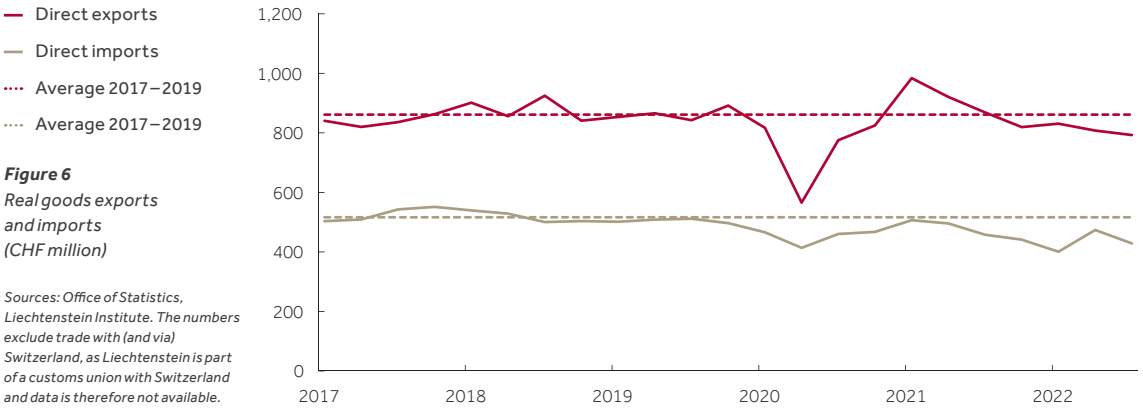



***Figure 6***
*Real goods exports and imports (CHF million)*

*Sources: Office of Statistics, Liechtenstein Institute. The numbers exclude trade with (and via) Switzerland, as Liechtenstein is part of a customs union with Switzerland and data is therefore not available.*

could have been expected in terms of Liechtenstein's historical sensitivity. This can be explained, among other factors, by the nature of the COVID-19 recession, which mainly affected the economy through domestic demand, a channel which is relatively less important in Liechtenstein compared to larger countries. If current disruptions in energy markets and the geopolitical situation more generally will trigger a broad-based global recession, a stronger response of the Liechtenstein economy along the lines of the historical business cycle sensitivity is to be expected.[3]

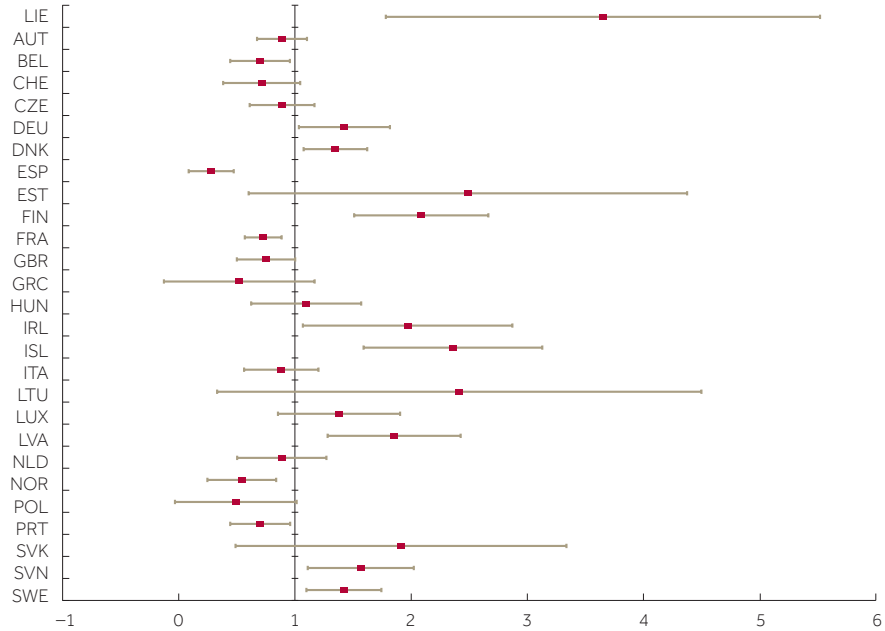



***Figure 7***
*Sensitivity of domestic to global GDP (estimated elasticity and confidence bands)*

*Sources: Liechtenstein Institute, FMA.*

3 *In this context, see also Brunhart, A., Geiger, M. and Ritter, W. (2022). Besonderheiten der Corona-Rezession und die Rolle des Binnenmarktes, LI-Focus 1/2022.*

**While Liechtenstein exhibits a high amplitude in terms of business cycle volatility, employment and business activity have remained remarkably resilient over the past decades.** Thanks to a highly competitive economy, total employment (41,352 employees at end-2021) exceeds the number of inhabitants (39,315) in Liechtenstein. More than half of employees are commuters, mostly living in Switzerland and Austria. Liechtenstein's labour market is highly resilient, with unemployment rates and employment growth hardly related to the business cycle (for an in-depth analysis, see Box 2 in last year's Financial Stability Report 2021). This general observation was once again confirmed during the COVID-19-related recession in 2020, with the unemployment rate peaking at 2.1%. Also, structural characteristics of Liechtenstein's economy contribute to the high resilience of the private sector vis-à-vis macroeconomic shocks. First, Liechtenstein's industrial and manufacturing sector comprises highly successful niche players in global markets and is remarkably innovative, also in light of extremely high private spending on research and development. Second, high equity ratios among non-financial corporations (NFC), also on the back of respective tax incentives, as well as zero debt (and high financial reserves) in the public sector contribute to a high level of resilience of the economy. Third, the highly specialised economy benefits from its strong international integration, including full access to the European Single Market through its membership in the European Economic Area (EEA) as well as to Switzerland, based on its customs union since 1923. The currency union with Switzerland also contributes significantly to the stability of both the financial sector and the economy as a whole. Finally, private wealth and incomes are very high, with Liechtenstein's Gross National Income (GNI) per capita being among the highest in the world. High income and wealth increase the resilience of private households and the economy, as temporary shocks can be better cushioned. Strong capital and liquidity indicators in the banking sector (as explained in detail in the next chapter) also support the economy's stability as a whole, as unexpected adverse developments can be absorbed by the financial sector without any negative implications for credit supply or financial stability.

**Public finances have remained remarkably sound.** Liechtenstein's public finances are characterised by virtually zero debt and large financial reserves. Sound public finances and the preservation of high financial reserves, to cushion for unforeseen shocks to the economy and to stay independent from international debt markets, are generally uncontroversial among all political parties in parliament. On the back of an ambitious structural reform package after the global financial crisis, with cuts in government spending and increasing tax revenues, Liechtenstein has reported budget surpluses since 2014. In 2020, despite increased spending in the context of the pandemic, the budget surplus at the general government level amounted to CHF 445 million or about 7.5% of GDP. A one-off profit tax revenue of approximately CHF 300 million more than offset the fiscal costs of the government's support packages and the pandemic-related shortfalls in revenues. Moreover, high investment income (i.e. gains from invested financial reserves) also contributed significantly positively to the overall budget surplus. The budget balance on the state level remained significantly positive in 2021 (reporting a surplus of CHF 224 million or about 3.5% of GDP). Fiscal numbers for the general government level, including the community level and social insurances, for the year 2021 will only become available in early 2023, but a significant budget surplus can be expected.

**While financial market turbulences since the start of the year will likely lead to the first budget deficit in almost a decade, financial reserves will remain extraordinarily high.** For the current year, adverse developments in stock and bond markets will weigh on the budget balance against the background of high financial reserves which are invested in global markets. By mid-2022, the government expected a deficit of

about 300 million for the current year due to adverse investment performance, while the primary budget balance – i.e. in Liechtenstein without the losses on financial investments (i.e. there are virtually no interest payments, as the state has no debt) – will remain slightly positive. In any case, financial reserves of the public sector will remain extraordinarily high. Net assets of the public sector amounted to CHF 9.4 billion at the end of the year 2020 (i.e. more than 140 % of GDP), of which CHF 3.9 billion were held by social insurances (41 %), CHF 3.5 billion at the state level (37 %), and the remaining CHF 2.0 billion (22 %) at the community level. Against this background, public finances are well-equipped for the challenges ahead, even in the case of a negative budget balance in 2022.

**While overall indebtedness in the economy is low in international comparison, the high indebtedness of private households remains the Achilles' heel of the economy.** The total debt-to-GDP ratio – defined as the sum of the indebtedness of both the (non-financial) private and public sector to GDP – is relatively low in Liechtenstein, estimated at around 167 % of GDP at the end of 2021. While the public sector has virtually no debt and large financial reserves, the non-financial corporate (NFC) sector is characterised by high equity and low debt levels, also due to corresponding tax incentives. We estimate the indebtedness of the NFC sector to about CHF 2.9 billion (or 45 % of GDP).[4] Private indebtedness is therefore highly concentrated in the household sector. According to recent estimates, private household indebtedness amounted to approx. 122 % of GDP at the end of 2021, a slight increase from last year's numbers. While the high headline number is not directly comparable to other countries due to differences in data sources and the underlying definitions of the variables, Liechtenstein's household indebtedness ranks highest among all EEA countries. Against this background, the elevated level of household debt is one of the main systemic risks to financial stability in Liechtenstein. The issue has also remained a strong focus of macroprudential supervision and policy over the past year.

## FINANCIAL MARKET DEVELOPMENTS

**Some of the risks highlighted in last year's Financial Stability Report have materialised since the turn of the year.** One year ago, the report warned that long-term yields could abruptly move higher, based on the striking disconnection between inflation and interest rate developments, particularly in the United States. The decoupling between the two variables was based on the idea of a "temporary" increase in inflation on the one hand, and extraordinary expansive monetary policy on the other, which may have resulted in distorted market prices. As we know today, the assumption of "transitory" inflation was misguided, and the abrupt increase in interest rates has hit financial markets at full tilt.

**Central banks around the world have – eventually – reacted to the strong rise in inflation by tightening monetary policy.** In the United States, the Federal Reserve finally put an end to its hesitancy and started to increase the federal funds rate in January 2022. Since then, several interest rate hikes have followed amidst further rising inflation rates, bringing the policy rate to the current level of 3.75 – 4 %. In the euro area, the ECB was even more hesitant to increase policy rates. On the back of the continuation of its asset purchase programme (APP), the ECB decided to follow its own forward guidance and kept its policy

4 *Data availability on private indebtedness is limited in Liechtenstein. For details regarding data sources, please refer to last year's Financial Stability Report 2021.*