May 2012
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**Switzerland: 2012 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; Statement by the Executive Director for Switzerland**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- The staff report for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 20, 2012, with the officials of Switzerland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 17, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 2, 2012 discussion of the staff report that concluded the Article IV consultation.

- Statement by the Executive Director for Switzerland.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

# SWITZERLAND

## STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

April 17, 2012

## KEY ISSUES

**Context**: The Swiss economy is fundamentally strong, but is facing a number of challenges. Headwinds from the euro area debt crisis and a strong currency have slowed growth, created deflationary pressures, and forced the central bank to abandon the floating exchange rate regime. The financial sector is adapting to the new, more stringent regulatory environment but remains vulnerable, including to a domestic housing bubble. The fiscal position is sound, but pressures from population aging are building.

**Exchange Rate Policy**: The exchange rate floor, seen as credible by the markets, has halted appreciation and helped shore up the economy. Once growth recovers and inflation reaches more comfortable levels, maintaining the exchange rate commitment risks stoking inflation and hence a return to free floating would be desirable.

**Financial sector**: Though new regulatory requirements will result in strong capital levels for Swiss SIFIs in the medium term, the transition period is long and large banks are operating with low levels of high-quality capital and high leverage while global financial markets are still unsettled. The risk of a real estate bubble has been heightened by loose monetary conditions, and new macroprudential instruments are under consideration to address this risk.

**Fiscal policy**: In case downside risks to growth materialize fiscal policy should support aggregate demand, but space available under the fiscal rules is limited. Population aging costs will put pressure on social security funds by the end of the decade in the absence of reforms.

Approved By Ajai Chopra and David Marston

Discussions took place in Bern and Zurich on March 9-20. The staff team comprised Ms. Detragiache (head), Ms. Xiao, Mr. Steinlein (all EUR), and Mr. De Carvalho (RES). Messrs. Weber and Peter (OED) participated in the discussions.

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# CONTEXT: A DIFFICULT PATH TO MACROECONOMIC STABILITY DESPITE FUNDAMENTAL STRENGTH

**1. While the Swiss economy is fundamentally strong, ensuring macroeconomic stability has been challenging**. Switzerland is a very open, highly productive, innovative economy, with many successful global companies, a highly skilled workforce and an increasingly open and flexible labor market. Medium-term growth has been good, unemployment is low, there is a track record of low and stable inflation, the public finances are in better shape than in most advanced countries, and the external position is healthy, with a large positive net foreign asset position and current account surplus. Yet, just four years ago, the global financial crisis affected the Swiss economy deeply through the exposure of its large and globalized financial sector. That crisis was ultimately successfully managed, but now macroeconomic stability is being threatened once again by the ramifications of the euro zone crisis. Safe-haven capital inflows from the euro zone turmoil pushed the exchange rate to new heights last summer, just as slower global economic activity was curtailing export growth. To protect the economy, the central bank moved away from the long-standing floating regime and committed to an exchange rate floor. A carefully-charted and well-coordinated set of policies is needed to ensure macroeconomic and financial stability in this new framework.

# RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

## A. GDP Growth is Falling and Inflation is Negative with the Exchange Rate at New Heights

**2. At end-2011, the Swiss economy decelerated sharply from a strong recovery, driven by lower domestic demand and net exports.** After registering a brisk output expansion of 2.7 percent in 2010, the growth momentum tailed off in the second half of 2011, in line with other advanced economies. GDP growth fell from 0.4 percent q-o-q in 2011Q1 to 0.1 percent in Q4 with the economy growing by 1.9 percent for the year. Despite the real income growth, consumption was surprisingly weak, possibly reflecting statistical difficulties in accounting for larger cross-border shopping.[1] With the rapid appreciation of the exchange rate, growth in exports of goods and services halved but remained positive.

[1] Cross-border shopping and private imports via courier and mail are very tentatively estimated at 12-14 CHF billion in 2011. Tax revenue collected on some cross-border shopping flows shows an increase of a third in 2011. If this rate of growth is applied to the total and used to re-estimate the rate of growth of private consumption growth, this rate would go from 0.9 percent to 1.6 percent.

**3. While unemployment is low, the labor market is expected to weaken.** After rebounding from the 2009 recession, the official unemployment rate fell to around 3 percent in 2011, well below that of most other European countries. The slowdown in economic activity is expected to drive the unemployment rate higher, especially in industries hit by the strong franc such as the mechanical and electrical engineering sector and tourism. A decline in employment may also occur in the financial sector, where shrinking value added has so far not been matched by workforce reduction.

**4. Inflation is in negative territory, driven by declining import prices**. In March, headline inflation dropped to -1 percent y-o-y, while core inflation was below -1 percent because of the pass-through from the strong currency. Despite the current negative price growth, the latest survey shows that inflation expectations are firmly anchored in low but positive territory. In its March Monetary Policy Assessment, the SNB forecasted moderate deflation in 2012 and moderate inflation afterwards.

**5. Currency appreciation following intensified safe haven inflows in the summer was halted by the introduction of a floor on the exchange rate.** The Swiss franc has been on an upward trend since 2008, reflecting unwinding of carry trades and, more recently, intensified safe haven capital inflows triggered by the euro area debt crisis. The CHF/euro rate went from 1.6 in late 2007 to almost parity in early August 2011, with a cumulative real effective appreciation of over 30 percent. The appreciation was especially rapid in July 2011, as the euro zone crisis intensified. In early August, the SNB responded through a massive liquidity expansion, carried out through foreign exchange swap operations, the non-renewal of maturing SNB Bills, as well as the repurchase of outstanding SNB Bills. As pressures continued, on September 6 the bank announced that it would defend a floor of 1.2 Swiss francs per euro, thus abandoning the floating exchange rate regime. The new policy has successfully stabilized the nominal exchange rate so far (Selected Issues Paper "Unprecedented Currency Appreciation and Policy Response"). The real exchange rate has depreciated by about 11 percent since the introduction of the floor, thus undoing about one third of the cumulative appreciation since 2007.

**6. Weak foreign demand and the effects of real appreciation have made a dent in export revenues in the second semester, but the current account surplus remains large.** Notwithstanding the slowdown in export growth, the watch-making and, to a smaller degree, the pharmaceutical industries have been buoyant. The net balance of services trade was strong even though tourism and bank financial services have performed poorly, thanks in part to good results in the commodity trading sector. All in all, in 2011 the current account continued to register a large surplus of 14.8percent of GDP despite the large real exchange rate appreciation.[2]

**7. Balance of payment statistics likely overstate the true economic size of the current account.** The foreign-owned component of the retained earnings of Swiss multinationals and the Swiss-owned component of the retained earnings of foreign multinationals are not captured by balance of payment statistics. The SNB estimates the net

[2] For an overview of the Swiss current account and net foreign asset position, see Annex I.

effect of correcting for those biases would reduce the current account balance by about 5 percent of GDP in 2011. In addition, cross-border shopping is largely unaccounted for in import statistics, which further distorts the current account balance upwards. Although the precise size of the underestimate is difficult to gauge, it may have been of the order of 2 percent of GDP in 2011. Nevertheless, the Swiss current account surplus still stands out as sizable relative to other economies that are not commodity exporters even if these factors are taken into account.

**8. The Swiss franc is moderately overvalued.** The Swiss franc is high based on historical values and purchasing power parity comparisons. On the other hand, the external position is strong, and has been resilient to the recent appreciation, with the export sector as a whole holding up well, though some subsectors are undoubtedly suffering. Applying the CGER methodologies to the latest WEO projections yields an overvaluation of 0–15 percent. The top end of the range reflects the equilibrium real exchange rate approach, while the lower end reflects the two methods based on the CA balance. Adjusting the medium-term current account projections by the overestimate identified by the SNB, the CGER calculations yield a misalignment of about 10 percent. This evidence, therefore, points to a moderate overvaluation of the Swiss franc. [3]

## B. The Fiscal Position is Anchored by Fiscal Rules and Discipline but Faces Pressures from Population Aging

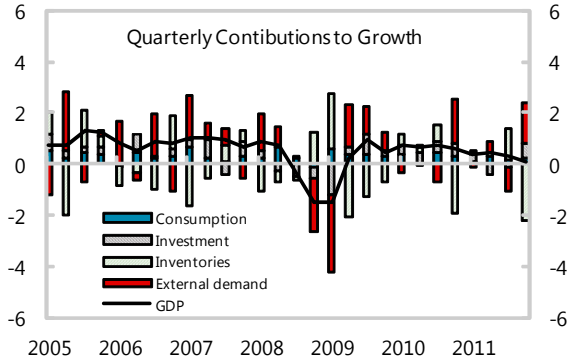
**9. Switzerland's fiscal policy is well anchored in fiscal rules and a culture of fiscal discipline.** Most prominently, at the federal level a "debt brake rule" mandates a structurally balanced budget. In addition, at the subnational level, most cantons have fiscal rules, albeit with varying strength. More broadly, the design of intergovernmental fiscal relations, a no-bailout presumption for cantons and municipalities, and considerable subnational tax autonomy create strong incentives to accept and comply with fiscal rules and foster a general culture of fiscal discipline (Box 1 and Annex II).

**10. The fiscal position is healthy and government debt low, with a broadly neutral stance projected for 2012.** The general government balance, which stayed in positive territory in the 2009 recession, continued to register a surplus in 2011 (estimated at 1/2 percent of GDP on a GFSM basis). In particular, social security swung back into surplus due to reforms to unemployment insurance and a VAT increase earmarked for financing invalidity pensions. In contrast, the federal government surplus disappeared, reflecting in part measures to counteract the effects of the strong Swiss currency (some

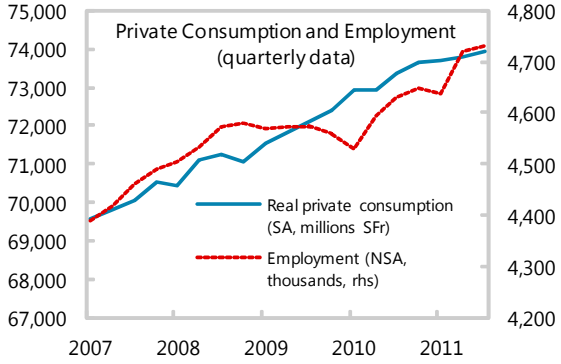
[3] Since the cumulative real appreciation since 2008 has been of about 20 percent, this assessment implies that the real exchange rate was undervalued by about 10 percent at end-2007, when the currency began to strengthen.

## Figure 1. Switzerland: Recent Economic Developments

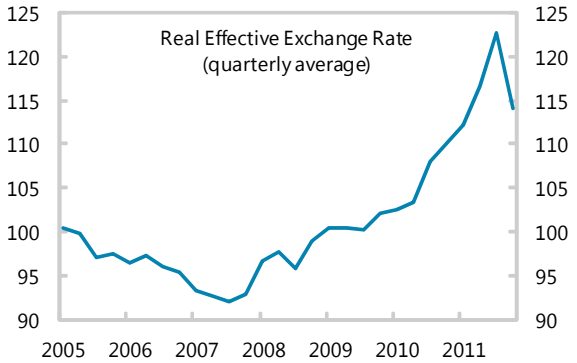
*The rebound in economic activity is losing steam, driven by faltering external demand.*




*Employment growth has slowed and consumption remains stagnant.*

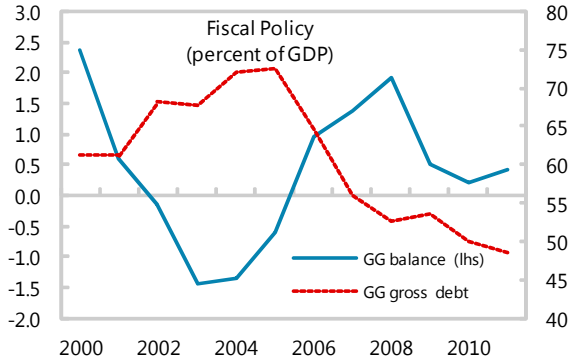



*With a sharp REER appreciation of the Swiss franc, ...*

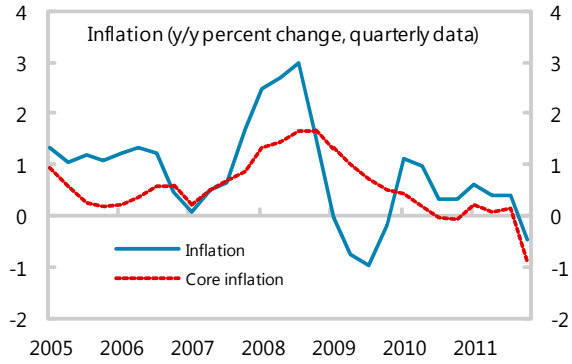



*...both industrial production and exports weakened.*


*Fiscal policy has been little used during the crisis, resulting in persistent surpluses and a declining debt level.*



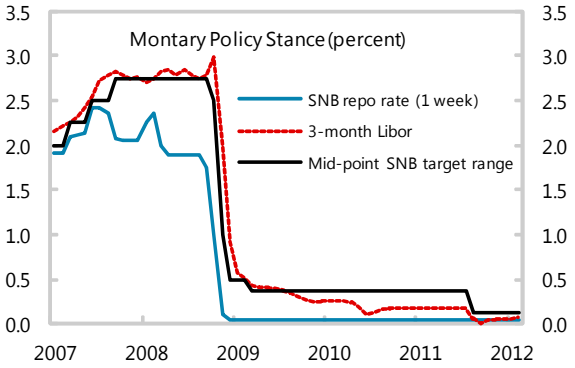

*Deflationary pressures are mounting.*



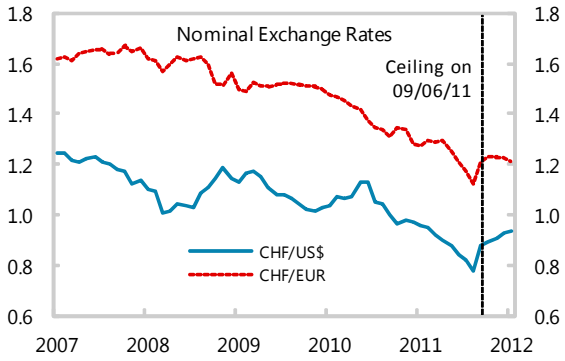

Sources: Haver Analytics; Swiss National Bank; and IMF estimates.

## Figure 2. Switzerland: Monetary and Exchange Rate Policies

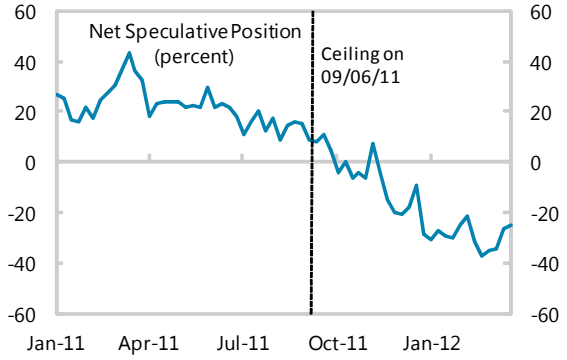
*Monetary policy has been expansionary with near zero interest rates...*



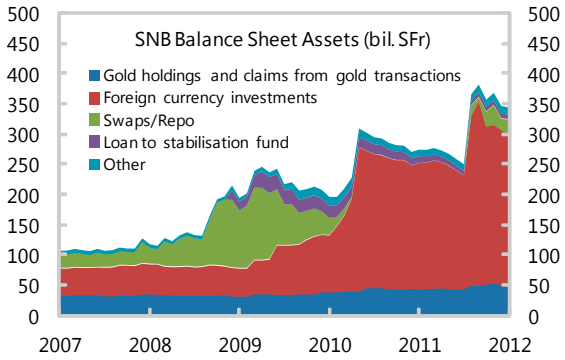

*...and the Swiss Franc has been under appreciating pressure until the introduction of ceiling...*



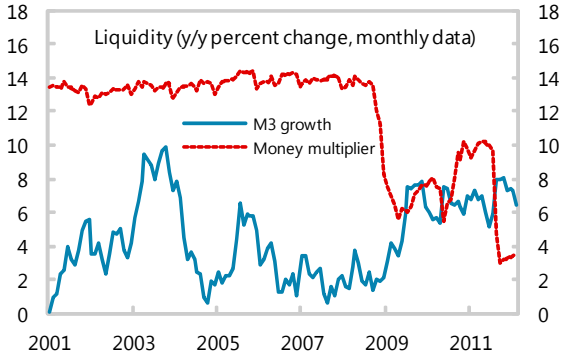

*which has reduced the long speculative positions in the currency derivatives markets.*



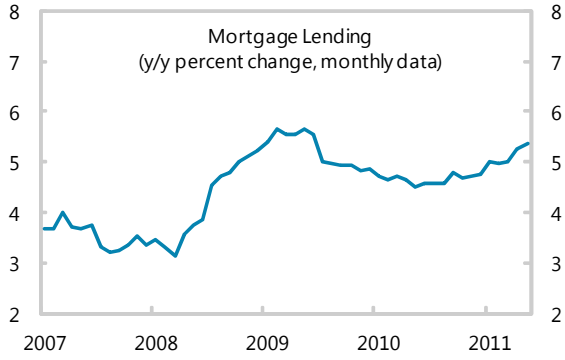

*Foreign exchange intervention has sharply expanded the SNB balance sheet...*




*...and liquidity in the system remains ample...*




*...while mortgage lending growth remains strong.*




Sources: Haver Analytics; Information Notice System; OECD; Swiss National Bank; CFTC, and IMF staff estimates.

0.15 percent of GDP) introduced in August 2011. The projected fiscal stance in 2012 and beyond is broadly neutral, with a small deficit at the federal level compensated by surpluses in the other components of general government. The debt-to-GDP ratio is projected to fall further to some 45 percent of GDP in 2015 (on a GFSM-basis).

**11. However, fiscal policy faces longer-term challenges from population aging and there are contingent liabilities from the financial sector.** Without reforms, the increase in public aging-related expenditure will start to bite in earnest around the end of the decade and is projected by the authorities at some 4 percent of GDP by 2050. This increase is about equally distributed between the pay-as-you-go pension pillar and the health care system (including long-term care).[3] In addition, several second-pillar pension funds (of public entities) have a public guarantee and are partly underfunded, while almost all cantonal banks benefit from an unrestricted guarantee from their respective canton. Furthermore, in a tail risk scenario of a severe global financial crisis, government support to the financial sector may become necessary.

**Box 1. Switzerland: Fiscal Discipline in a Federal System[1]**

Switzerland is a confederation with highly decentralized public finances, including considerable sub-national tax autonomy. All government levels have demonstrated remarkable fiscal discipline. This success rests on two pillars: streamlined intergovernmental fiscal relations with a no-bail-out presumption, and effective fiscal rules at each level of government.

Intergovernmental fiscal relations, reformed in 2008, feature a rationalized system of task assignments with clear responsibilities across government levels as well as a simplified and rules-based fiscal equalization scheme. The system ensures a close connection between spending decisions and the responsibility for their financing. Equally crucial is a well-tested and deeply-engrained presumption that lower government levels will not be bailed out by the Confederation in case of financial difficulties. Together, these factors limit any deficit bias in the system.

These characteristics also create the basis for the acceptance of and compliance with fiscal rules both at the federal and cantonal level. In addition, these rules avoid over-complexity and are hence tractable both from a technical and political economy perspective.

1/ For more details, see Annex II.

[4] See Eidgenoessische Finanzverwaltung (2012): "Langfristige Perspektiven 2012", Bern. The health care cost projections take non-demographic factors, such as technological progress, into account

## C. The financial sector is restructuring while risks are building up in the mortgage market

**12. The very large and internationally exposed financial sector is a source of risk to the economy, but new legislation will force systemically important banks (SIBs) to hold more capital than peers.** After one of the large banks was rescued in 2008, the authorities addressed the TBTF problem in Switzerland through a new legislative package centered on significantly higher capital requirements for systemic banks. The TBTF legislation, which came into effect in March, requires SIBs to hold a minimum 10 percent Common Equity Tier 1 capital ratio and 19 percent Total Capital, well above Basel III standards. [5] The new standards will be fully phased in by 2019. The legislation also mandates SIBs to make progress toward increasing resolvability.

**13. After a marked improvement in 2010, the performance of the two large banks worsened in 2011.** In response to the new regulatory environment, the two large banks are restructuring their activities by reducing risk-weighted assets and increasing reliance on client-driven revenues and fee-based services. In 2011, as financial market turbulence and low customer activity hurt investment banking revenue, the two large Swiss banks lagged behind other global SIFIs in overall income generation. Although asset quality is better than peers, at over 80 percent the cost/income ratio is comparatively high and it has been negatively affected by the currency appreciation. All in all, profitability plunged in 2011, with ROA falling by 40 percent to less than 0.3 percent and ROE dropping from double digits to below 7 percent.[6] On the other hand, CDS spreads remain significantly below those of peers, suggesting that markets see Swiss large banks as relatively well positioned to withstand current financial turmoil.

**14. Although they comfortably fulfill current regulatory capital requirements, large banks have a thin layer of high quality capital.** The two large banks have an average Tier I capital ratio of 15 percent and core Tier I capital ratio of 12 percent, well above the average of other global SIFI peers (12 percent and 10 percent respectively)[7]. However, because these ratios are computed under Basel II (or Basel 2.5 rules), they include low quality capital such as deferred tax assets and hybrids, which would not be available to absorb losses in a crisis, and assign low risk weights to certain exposures.[8] Based on a more stringent capital quality indicator such as the ratio of tangible common equity to tangible assets (TCE), the large Swiss banks are below peers and have made little progress since 2009. Thus, significant progress will have to be made to satisfy the new, more

[5] The 9 percent above the minimum may consist of contingent capital. For more information, see Switzerland, Staff Report for the 2011 Article IV Consultation, IMF Country Report 11/115.

[6] Large Swiss banks are also facing elevated legal risks related to legacy assets, customer tax compliance, and, LIBOR manipulation.

[7] The global SIFI peers comprise the G-SIFI group (excluding the two Swiss banks) identified by the FSB.

[8] Under Basel III rules, risk weights on trading book, and counterparty exposures, among others, will have to increase. An impact study by the Basel Committee estimates the average increase in risk-weighted assets for internationally active banks at 23 percent.

stringent requirements as they come into force.

**Capital Ratios for Swiss Large Banks and Global Peers, 2011**

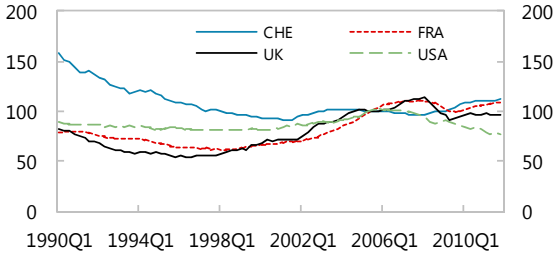
| | Swiss SIFIs | Peers |
|---|---|---|
| Tier 1 Ratio (in percent) | 15.6 | 12.3 |
| Tangible Common Equity to Tangible Assets (in percent) | 2.7 | 3.7 |

**15. Banks' liquidity profile has improved, but dependence on wholesale funding remains elevated.** Swiss large banks have loan/deposit ratios below peers and share of liquid assets comparable to peers, and comply with the Swiss liquidity requirement mandating them to be able to cover liquidity needs over a 30-day horizon under stress. However, the banks may still be especially vulnerable to disruptions in wholesale funding markets over a longer horizon, as their reliance on wholesale funding stands at over 70 percent, while peers have reduced this dependence to less than 60 percent. One of the large banks relies particularly heavily on money market funds for its U.S. dollar funding.[9]

**16. Domestic mortgage credit and real estate prices continue to rise briskly, heightening the risk that a bubble may be forming**. With short-term interest rates close to zero and abundant liquidity, mortgage rates have fallen to historic lows (about 2.5 percent on a 10-year, fixed-rate loan). Although average price growth seems contained relative to other countries, housing prices are high relative to income and there are signs of overheating in "hot spots" (such as the Geneva, Zurich, and Zug areas) and market segments (condominiums), as well as evidence of loose lending policies in some banks.

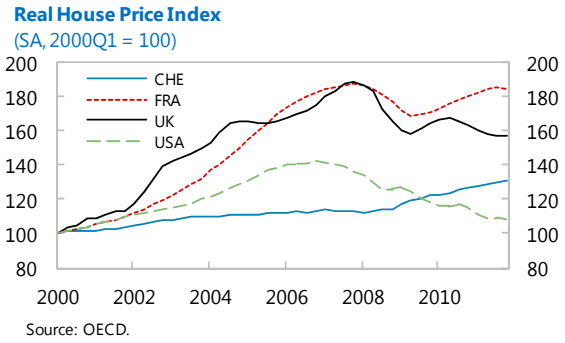
**17. Domestically-oriented banks and insurance companies are exposed to the housing market**. Aggressive mortgage lending and more reliance on fixed-rate longer maturity mortgages have increased interest rate and credit risk, especially for cooperative banks and cantonal banks, although there is a large variation among individual banks and among bank categories. The insurance sector is also exposed to the Swiss real estate market (14 percent of total assets). The authorities have warned about the financial stability risks associated with mortgage lending since 2010.

**Price-to-Income Ratio**
(SA, 2005 = 100)




Source: OECD.

[9] This funding structure partly reflects the banks' business model and their large U.S. operations. During the last financial crisis, large banks received liquidity support through the SNB, which could provide funding in U.S. dollars thanks to a swap line with the U.S. Federal Reserve.

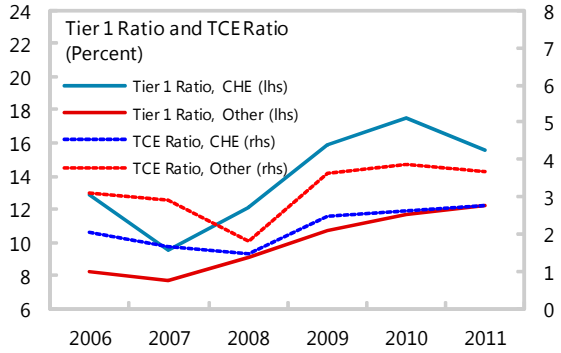



**18. Recent tax developments have put the private banking industry under pressure.** An international push to broaden cross-border cooperation in tax compliance is challenging long-standing bank secrecy principles and practices in the Swiss private banking industry. In an effort to address legacy issues and improve tax transparency, Switzerland has signed several withholding tax agreements with other countries, including most recently with Austria and the U.K. In 2011, a number of Swiss banks (including one of the two SIBs) have been placed under investigation in the U.S. for allegedly helping clients evade taxes; one small bank in this group has been indicted and broke itself up preemptively. To help bring about a settlement, the Swiss parliament recently broadened the scope of administrative assistance offered to U.S. tax authorities under the double taxation agreement (whose ratification is, however, still pending in the U.S.). Following these developments, the Swiss wealth management business has seen outflows from European countries and the U.S., which have been partly offset by inflows from other countries. An additional development which might have an impact on the sector is the recent revision of the FATF standards which included tax crimes among the money laundering offenses. Some consolidation is expected to take place in the sector.

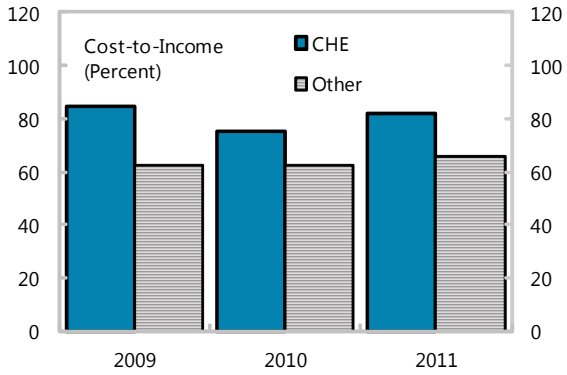
**19. Insurance companies are coping with the low interest rate environment, strong competition, and natural catastrophes.** Premiums for life, non-life, and reinsurance companies have grown moderately in 2011, but underwriting results are still weak. Low interest rates affect Swiss life insurance companies more than other European competitors because they have more traditional business. To reduce pressure, the guaranteed payout rate on life insurance policies (the BVG) was lowered to 1.5 percent from the beginning of 2012 after remaining at 2 percent for three years, but this has not been enough to narrow the gap with falling government bond yields. Among nonlife insurers, strong competition has put pressure on rates, while high claims related to natural catastrophes weakened the underwriting results of reinsurers in 2011. To boost financial results, some insurers have continued to rely on reserve releases. Insurers' exposure to euro area countries under market scrutiny appears moderate. The full implementation of the Swiss Solvency Test (SST) has improved awareness of risk sources and enhanced understanding of profit and risk drivers and guarantees. All nonlife insurers and reinsurers and the majority of life insurers passed the 2011 SST.

## Figure 3. Swiss SIFIs and Other Global SIFIs: Peer Comparison in Financial Performance

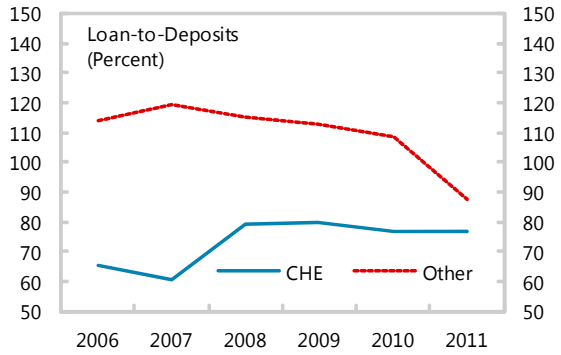
*Regulatory capital ratios of the big banks have continued to improve, but captial quality remains lower...*



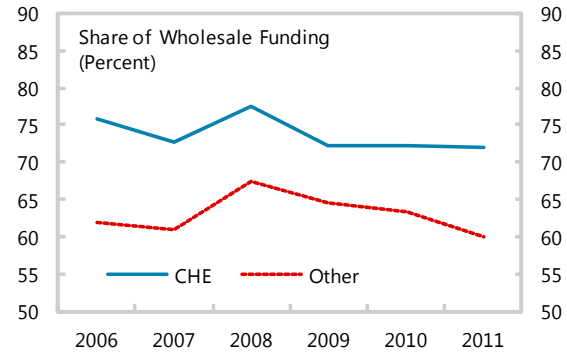

*...and cost-to-income remains higher than peers.*



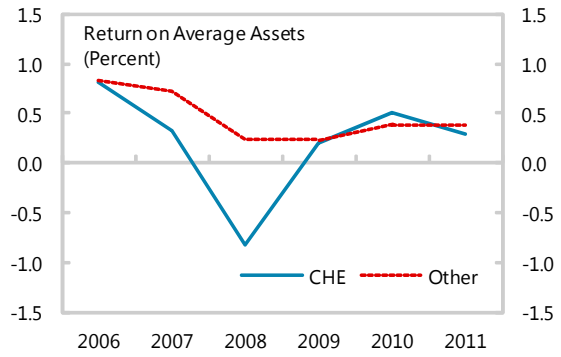

*Despite a stable loan-to-deposit ratio...*



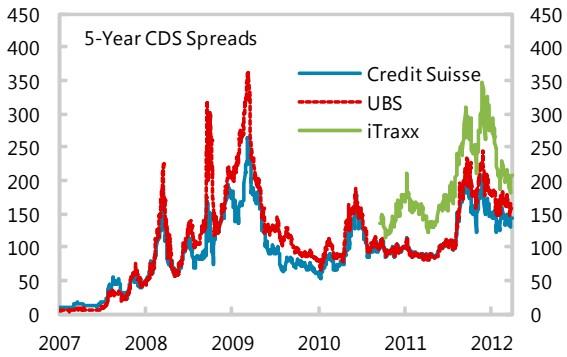

*...dependence on wholesale funding remains elevated.*




*Performance has slided...*




*...and credit worthiness has deteriorated.*




Sources: Bloomberg; Datastream; SNL; and IMF staff calculations.

# OUTLOOK AND RISKS

## The Central Scenario is Benign, but Risks Are Sizable

**20. The economy is expected to stagnate in 2012 and regain momentum in 2013.** In the near term, flagging demand abroad and the lagged effects of past appreciation will continue to slow exports and investment, while subdued employment growth will further weaken household disposable income and private consumption. GDP growth is expected to register at 0.8 percent in 2012, picking up steam in 2013 as the contractionary effect of the exchange rate appreciation peters out.[10] In line with the WEO baseline scenario of a subdued global recovery, GDP growth should reach 1.7 percent and strengthen thereafter. With the exchange rate pass-through receding over time, positive growth in domestic good prices, and firmly anchored inflation expectations, the risk of an entrenched deflation is limited.

**21. Risks to the outlook mainly relate to euro area developments and the large financial sector (Box 2)**. Swiss banks have foreign claims accounting for more than 60 percent of bank assets or three times GDP, the highest among advanced economies. They are most exposed to the U.S. and the U.K., while exposures to euro area countries under market scrutiny are moderate.[11] However, the economy has close trade ties with the euro zone, so an intensification of the confidence crisis in the region would trigger an adverse trade shock that might tip the economy into a recession. A worsening euro area crisis would also likely accelerate safe haven capital flows into Switzerland putting the currency under pressure. If the floor was abandoned and the exchange rate appreciated, large bank losses on direct exposures to euro area countries would be aggravated by exchange rate movements given the currency mismatch in the banks' cost/revenue structure; the crisis would also have the knock-on effect of dampening investment banking and wealth management business. In a tail risk scenario of a severe euro zone crisis, the Swiss economy would likely be dragged into a more serious and protracted recession than in 2009. A possible freeze in global wholesale funding markets, upon which the two large Swiss banks are heavily reliant, would compound the real shock.

**22. In addition, a "boom-bust" pattern in the real estate market would strongly affect domestically-oriented banks and the insurance sector.** Given their large exposures, both sectors would suffer should a housing price bubble develop and then burst. Difficulties for the insurance sector would likely spill over to banks, as bank financing is partially provided by insurance firms, reinforcing the adverse spiral.

**The authorities' view**

**23. The authorities were somewhat more sanguine than staff with regards to**

[10] A VAR analysis suggests that the output response to REER shocks is relatively quick, peaking after two quarters (Annex III).

[11] According to BIS data, the direct exposure of Swiss banks and major insurance companies to Greece, Ireland, Portugal, Italy, Spain, and Belgium accounts for two percent of total assets. Although the direct exposure is moderate relative to total assets, it is much higher relative to GDP (5 percent).

**the baseline scenario, but shared staff's assessment of the main risk factors**. Growth was seen as weak in 2012 in spite of recent signs of stabilization, with a somewhat stronger rebound in 2013 compared to staff (GDP growth of 1.8–2.1 percent). The difference was largely due to the authorities' more optimistic assumptions on the external environment. The authorities agreed with staff that downward pressures on inflation would be contained under the baseline scenario, as price declines have not spread to nontraded goods or wages.

**BOX 2. SWITZERLAND: RISK ASSESSMENT MATRIX**

| Nature/Source of Main Risks | Overall Level of Concern | |
|---|---|---|
| | Likelihood of Realization of Risks in the Next 1-5 years (high, medium, low) | Expected Impact if Risk is Realized (high, medium, low) |
| Intensification of the sovereign debt crisis in the euro zone. | Medium<br>Despite policy actions taken in relieving stress, the euro zone situation remains fragile. | Medium<br>Given the close trade links of the Swiss economy with the euro zone, the deepening of the crisis would trigger an adverse trade shock that would not only put the brakes on the economy but even tip it into a recession.<br><br>Safe haven capital inflows would likely accelerate, putting the currency floor under pressure and requiring large scale intervention.<br><br>The resulting monetary expansion would exacerbate pressures on the housing market in the short run and create excessive inflationary pressures in the medium term.<br><br>The Swiss financial sector has moderate direct exposures to euro zone countries under market pressure. However, global SIFIs in both banking and insurance have complex balance sheets and are heavily interconnected, so losses through indirect exposures cannot be ruled out. Small cushion of high quality capital in bank SIFIs is a concern. Disruptions in wholesale funding markets could cause liquidity problems. |
| Boom and bust in the housing | Medium<br>Low interest rates and ample | Medium<br>With both the banking and |

| | | |
|---|---|---|
| market. | liquidity continue to drive prices higher.<br><br>Macroprudential framework is under construction and the proposed set of instruments may have limited preventive powers.<br><br>However, price growth has been contained so far relative to other bubble cases (except in some "hot spots"). | insurance industries exposed to the real estate markets, the collapse of the housing prices would weaken the financial health of both sectors.<br><br>The credibility of the exchange rate commitments might be called into question. |
| Recurrence of a global financial crisis | Low<br>This is a tail-risk. | High<br>The Swiss economy would be dragged into a more severe and protracted recession than the 2009 one.<br><br>With two global SIFIs in the banking sector and two in the insurance sector the potential for widespread damage is high if a freeze in global wholesale funding markets and extensive contagion were to recur. Public intervention through the provision of guarantees or injection of capital may be needed. |

# POLICY DISCUSSIONS

## A. Overview

**24. With a relatively benign central scenario, macroeconomic policies should focus on reducing vulnerabilities to the several risk factors that cloud the horizon.** Under the baseline scenario, output will be close to potential in 2012 and thereafter, and inflation will go back to historical levels by 2013. Against this background, the return to a floating exchange rate and more neutral monetary stance needs to be well-timed and carefully orchestrated to avoid sparking inflationary pressures or fueling a new round of excessive currency appreciation. In the meantime, the risk of unstable housing price developments has to be kept in check through macroprudential tools, new and untried instruments in the Swiss context. As monetary policy has reached its limits, possible new external recessionary impulses will need to be addressed through fiscal policy, by making effective use of the limited available space under the fiscal rules. In the financial sector, risks from a turbulent external environment call into question the current, protracted timetable for transitioning to new regulatory standards.

## B. Monetary and Exchange Rate Policies—Safeguarding Credibility

**25. The introduction of the exchange rate floor was an appropriate policy response to the risk of economic contraction and deflation.** In the summer of 2011, with the economy slowing down rapidly, negative inflation, and uncertainty in the euro area spurring capital inflows and pushing the exchange rate to historic heights, the risk was sizable that continuing exchange rate appreciation might lead to entrenched deflation and a recession. Furthermore, alternative policy options were limited, with interest rates at the zero bound, fiscal policy governed by the debt brake rule, and quantitative easing constrained by the small size of the domestic bond market (Selected Issues Paper and Box 3).

**26. The new strategy has successfully stabilized the exchange rate so far on the strength of the credibility of the SNB commitment.** Available data suggests that very little if any intervention has been needed to maintain the floor, as the SNB commitment successfully curbed speculative bets on further Swiss franc appreciation and reduced the attractiveness of Swiss-franc denominated assets as safe haven investments. This contrasts with the limited effectiveness of previous foreign exchange interventions. Sizable inflation differential with major trading partners, if sustained, will continue to reduce the real exchange rate overvaluation.

**27. The currency should be allowed to float freely again once inflation goes back to comfortable levels and growth picks up.** While the economy is stagnant and inflation is forecasted to remain too low, the exchange rate floor helps to protect the economy from further contractionary pressures. In this situation, if capital inflows intensified, then intervention to defend the floor would appropriately result in a more expansionary monetary stance. On the other hand, once growth rekindles and inflation returns to normal levels, delaying the return to a freely floating currency could carry the risk of stoking inflation, in case money supply had to be expanded pro-cyclically to absorb renewed capital inflows. In such a situation, the willingness of the SNB to do "whatever it takes" to enforce the floor might be called into question.

**The authorities' view**

**28. The SNB viewed the exchange rate floor as an emergency measure, and hence temporary in nature**. Concerning exit, the bank considered that the most favorable scenario was one in which, as the economic situation stabilized, the exchange rate weakened and traded above the floor. On the other hand, an exit while the floor continued to bind would be more difficult and would have to be carefully managed.

**Box 3. The Swiss Response to Capital Inflows: Lessons for Other Countries?** [1]

The introduction of the exchange rate floor by the SNB last September has stabilized the exchange rate and the economy so far. Should other countries with currency appreciation pressures follow in the SNB's footsteps? Several considerations suggest that other countries should be careful to emulate the Swiss approach, particularly where macroeconomic conditions, initial policy stance, and policy levers differ substantially from those of Switzerland:

1. It is too early to judge whether the exhange rate floor has been a complete success, as a smooth return to normal monetary policy has not yet been accomplished.

2. The floor was introduced in an environment where the risk of a sharp contraction and deflation was significant. If capital inflows and exchange rate pressure occur against the background of above-target inflation, loose fiscal policy, and strong domestic demand, a commitment to defend an exchange rate floor through unlimited monetary expansion would not be desirable or, most likely, credible: in these circumstances, defending the floor would exacerbate macroeconomic imbalances.

3. Even if exchange rate pressures occur where inflation is low and aggregate demand is weak, alternative policy tools may be available. Many countries have room to lower domestic nominal interest rates to discourage inflows; even with the policy rate at zero, quantitative easing or fiscal policy can be used to stimulate aggregate demand; and capital flow management measures might be considered. In Switzerland, interest rates are close to zero, quantitative easing is precluded by the small size of the domestic bond market; discretionary fiscal policy is constrained by fiscal rules; and capital flow management measures would be complex to design and costly given the country's role as an international financial center.

[1] For a detailed analysis and assessment of the SNB policies in 2011, see Selected Issues Paper "Unprecedented Currency Appreciation and Policy Response".

## C. Containing Risks in the Mortgage Market—An Appropriate Macroprudential Toolkit

**29. Overheating in the real estate market may hurt the economy and endanger the current monetary framework.** With the new exchange rate policy, the SNB's willingness to expand liquidity unboundedly to fulfill its exchange rate commitment is fundamental to credibility. If signs that abundant liquidity was fuelling a housing bubble were to emerge, this willingness might be called into question, threatening the framework.

**30. To ward against this risk, monitoring and supervision in the mortgage market are being stepped up.** During the 2011 consultation, staff stressed the need to move

beyond traditional Swiss bank self-regulation in the mortgage market. The authorities have recently strengthened monitoring and supervision in this area, including through a new survey of lending practices and new, more precise guidelines for mortgage lending. These guidelines are adopted by the industry but approved and monitored by the supervisor (FINMA).

**31. A proposal to introduce new macroprudential instruments has been put forward.** A joint working group of the Federal Department of Finance (FDF), FINMA, and the SNB has proposed to amend the bank capital ordinance to implement early the counter-cyclical capital buffer (CCB) contemplated under Basel III. The buffer would be activated by the Federal Council upon request of the SNB and after consultation with FINMA. Banks would then have up to 12 months to raise their capital level. In addition, the working group proposed to improve the classification of risk weights in mortgage lending by taking into account the debtor's risk profile and assigning a 100 percent weight to high risk exposures. Finally, under the proposal the SNB's would be given power to request information from banks when such information is not already available from FINMA.

**32. The preventive power of the envisaged macroprudential measures would be strengthened by adding minimum affordability ratios to the toolkit**. With most domestically-oriented banks comfortably meeting current regulatory capital requirements, the proposed CCB and new risk weights will likely result in a small increase in mortgage interest rates which might not discourage imprudent lending and borrowing behavior when interest rates are at historical lows. Hence, instruments that more directly address such behaviors could usefully be added to the toolkit. One such instrument is a minimum affordability ratio, forbidding mortgages with debt service-to-income (DTI) ratios above a certain threshold. Loan-to-value (LTV) ratios could also be considered, but may require supervisory monitoring of real estate valuations to ensure that these valuations are not inflated by overly optimistic estimates.[12] In addition, the envisaged activation process for the CCB could usefully be streamlined to ensure that the instrument can be deployed sufficiently quickly.

**33. Broader reforms to reduce or eliminate the preferential tax treatment of mortgage debt service should be considered**. As in other countries, in Switzerland mortgage interest payments are deductible from taxable income, so that households have incentives to increase mortgage debt. Homeowners are taxed on the imputed rents from their property (net of maintenance expenses), so a reduction in the tax benefit from mortgages would have to be balanced by a change in the taxation of imputed rents. [13]

**The authorities' view**

**34. The authorities were confident that the planned macroprudential tools would have some preventive effects, and rejected affordability limits as too "market unfriendly."** The authorities noted that the need to set aside more capital would

[12] DTI and LTV ratios have been used, for example, in Canada, Hong Kong SAR, Korea, the Netherlands, and Norway. For a review of experiences, see "How to Deal with Real Estate Booms," IMF WP 11/91.

[13] For an in-depth discussion, see OECD, 2011 Country Report on Switzerland.

discourage mortgage growth, though they acknowledged that domestically-oriented banks were mostly well capitalized. They also noted that the measures would build buffers in the banking sector to absorb potential mortgage-related losses. Introducing affordability limits, on the other hand, would be equivalent to forbidding certain types of mortgages, an excessive restriction of private contracting freedom. The likelihood that reforms of housing taxation would muster the necessary political support was seen as low.

## D. Reducing Financial Vulnerabilities

**35. More rapid implementation of Basel III and TBTF capital requirements is warranted**. The two large Swiss banks, are still weakly capitalized relative to peers in terms of high-quality capital while they face sizable risks, such as direct and indirect exposures to the euro zone crisis, legal contingent liabilities, and exposure to the Swiss mortgage market. In addition, heavy reliance on wholesale funding is a vulnerability factor. Thus, it will be important for banks to build capital more rapidly, including by restricting cash distributions and raising external capital as early as feasible, as subdued profitability prospect makes it challenging to rely on retained earnings only. While raising capital in current market conditions may be costly, in a stress scenario this cost would likely become prohibitive, while market discipline would require banks to improve their capitalization rapidly. Banks have moved ahead with issuance of contingent capital (CoCos); however, the loss-absorbing capacity of these instruments remains untested.[14]

**36. There is progress on bank resolvability, a key plank of the TBTF strategy.** The new TBTF legislation requires SIBs to prepare a recovery and resolution plan to ensure the continuity of systemically important functions in Switzerland in case of financial distress. The legislation also creates incentives for banks to make further progress toward global resolvability, as such progress may result in rebates on capital requirements. The size of the rebates will depend on progress in achieving structural, financial, and operational unbundling. The SIBs will also be affected by new resolvability requirement in the U.S. and U.K., where they have large operations, and recovery and resolution plans will be evaluated by supervisors in all three countries. Progress has been made in upgrading the Swiss bank resolution framework, where reforms will grant FINMA new powers to intervene distressed banks.

**37. Microprudential supervision is being upgraded, but reliance on external auditors remains a problem.** FINMA has adopted a risk-based approach in all areas of supervision and increased on-site reviews and regulatory audits. However, the outsourcing of supervisory work to auditors (hired by the banks) is still prevalent. In addition, a costly "rogue trader" scandal at one of the SIBs last fall has highlighted the need to enhance the oversight of risk management and internal controls of large banks. Resources should be further expanded to broaden FINMA's in-house supervisory capacity.

[14] So far, three Swiss banks have successfully issued CoCos with differing convertibility or write-down features.

**38. In the insurance sector, implementation of the Swiss Solvency Test (SST) by all insurers and reinsurers should improve risk management.** Given pressures from strong competition and low interest rates, it is important to ensure the proper operation of the SST for all insurers. In 2011, FINMA rendered about 30 decisions on internal model approval requests, with full approval granted in 25 percent of the cases. The supervisory agency is also focusing efforts on less transparent intra-group transactions in order to identify and eliminate unlimited guarantees. In light of the relatively high level of intra-group balances, the oversight of intra-group connections needs to be strengthened to contain contagion risk arising from significant or undesirable transactions.

**The authorities' view**

**39. The authorities recognize that large banks remain thinly capitalized but are confident that progress under the new regulatory framework will be adequate.** The authorities agreed that fast progress was desirable, were closely monitoring bank capital building progress, and were ready to act if banks did not fulfill the new requirements as they came into force. They also expected market discipline to put pressure on banks to move faster, and noted that forcing more transparent bank reporting of capital adequacy according to the full Basel III standards would foster such discipline. They also considered that CoCos would help mitigate the risk of low capitalization, as these instruments would be loss-absorbing. The authorities underscored the importance of rapid progress towards resolvability, acknowledged the complexity of the issue in a global context, and stressed that the Swiss approach was to put the banks in charge of devising convincing solutions. On supervision, they noted that there was ongoing progress in building up in-house capacity, but also pointed out that reliance on external auditors allowed for the flexibility of quickly putting into place supervisory capacity in specific areas. Finally, on risk management, FINMA has asked large banks to assess internal control procedure to prevent unauthorized trading against prudent practices, and will take action if needed.

## E. Fiscal Policies—Standing Ready for Cyclical Support and Reforming Aging-Related Spending

**40. The fiscal stance is appropriately neutral given growth prospects, but fiscal policy should be ready to support aggregate demand to the extent feasible under fiscal rules if the outlook deteriorates.** From a longer-term perspective, fiscal policy should be conservative in light of population aging and financial sector risks (including from guarantees for cantonal banks and public pension funds). However, available leeway under the fiscal rules and additional room that may emerge during budget implementation should be used to prop up aggregate demand in case the envisaged

recovery stalls in the course of the year. Fiscal multipliers are estimated to be similar to those of other advanced small open economies (see Annex IV).

**41. Rapid progress in tackling the cost of an aging population is needed and automatic adjustors ("fiscal rules") for pensions would be useful.** Given the long gestation periods associated with the related reforms, time is running out quickly. Specifically in the pension system, equalization of the male and female retirement age and pension indexation to inflation only (rather than both inflation and wages) should be considered. In addition, automatic adjustors of the pension age and/or benefits to life expectancy would be a useful tool to reduce the need for repeated and often difficult reform discussions. Furthermore, as regards health care, recent reforms, including with respect to hospital financing, are welcome and should be carefully monitored. A further strengthening of coordination mechanisms, including across government levels, could facilitate the design of additional measures.

**The authorities' view**

**42. The authorities expressed skepticism about discretionary fiscal policy.** They noted that the philosophy behind the debt brake rule is to eschew discretionary fiscal policy, and emphasized the built-in role of automatic stabilizers. This determination was confirmed by the reluctance by parliament to go beyond the fiscal measures for mitigating appreciation effects introduced in August 2011. From a practical perspective, feasible timely and targeted projects would be difficult to find, in particular infrastructure projects would not be advisable given the high degree of capacity utilization in the construction sector.

**43. On aging costs, the authorities concurred with the case for additional reforms, but were concerned about the political acceptability of automatic benefit adjustors, which may take discretion away from the political process.** As a potential alternative, they mentioned a stipulation mandating the government to pass reforms in case of financial imbalances in the social security funds, e.g. when the liquidity reserves of the public pay-as-you-go pillar fall below a certain percentage of annual expenditure. In parallel, temporary benefit and/or contribution measures to ensure liquidity would come into force (e.g. the suspension and/or postponement of the regular pension increases in line with inflation and/or wages). This would build pressure for a political consensus on more fundamental reforms while still keeping discretion about how such reforms should look like.

# STAFF APPRAISAL

**44. The economy is well positioned to return to moderate growth in the second part of this year, but uncertainty is high.** As global demand picks up and the tradable sector adjusts to the new level of the exchange rate, output growth should recover in the second part of the year, with the output gap remaining close to zero and unemployment increasing modestly. Inflation should turn positive once exchange rate pass-through effects peter out. Possible financial sector ramifications of sovereign and banking sector

fragilities in the euro zone are the main downside risk.

**45. The introduction of the exchange rate floor in September 2011 was appropriate in light of risks**. With economic indicators pointing downwards, negative inflation, and uncertainty in the euro area spurring capital inflows and pushing the exchange rate to historic heights, continuing exchange rate appreciation might have caused entrenched deflation and a recession. Furthermore, alternative policy options were limited, with interest rates at the zero bound, discretionary fiscal policy limited by the debt brake rule, and quantitative easing constrained by the small size of the domestic bond market. The SNB exchange rate commitment, which is seen as credible by the markets, has stabilized the currency and is thus helping shore up the economy.

**46. Once economic conditions normalize, a return to a freely floating currency would be desirable.** While the exchange rate floor has been successful, once an economic recovery gets under way and deflation risks recede the SNB should move back to a free float. Delaying exit would carry the risk of stoking inflation, especially in case money supply had to be expanded pro-cyclically to absorb renewed capital inflows. A strong economy and resurgent inflation might also undermine the credibility of the commitment to defend the floor.

**47. The current fiscal stance is appropriate but would need to be loosened if support for the still fragile economic growth is needed.** From a longer term perspective, a conservative fiscal policy is appropriate in view of potential fiscal risks related to the financial sector (including cantonal banks and public pension funds) and the cost of an aging population. In the short term, the current broadly neutral stance is appropriate. However, in case the envisaged recovery stalls it would be advisable to use countercyclically the limited leeway available under the fiscal rules.

**48. In parallel, measures to tackle the financial consequences of population aging should gain center stage and include additional "fiscal rules"**. Under unchanged policies, the increase in aging-related expenditure will already start to bite in earnest around the end of this decade. Consequently, time for reform preparation and implementation is running out quickly. Specifically, a "fiscal rule" that automatically links the retirement age and/or pension benefits to life expectancy could usefully be introduced. Such a rule would reduce the need for repeated and often difficult reform discussions.

**49. Rapid implementation of Basel III and TBTF capital requirements as well as progress on bank resolvability are paramount**. The TBTF legislation, recently approved by Parliament, will substantially raise the requirements for high quality capital in systemically important banks and is welcome, but it has a relatively long implementation period. Although this is in line with Basel III, it may be particularly detrimental in the case of the two large Swiss banks, because of their high vulnerability to risks that were not sufficiently recognized under Basel II and heavy reliance on low quality capital that will be phased out under the new rules. Thus, during the transition rapid progress to strengthen the quantity and quality of capital in large banks is needed, especially in light of the continued fragilities in the global financial

system. In parallel, since more capital alone cannot fully eliminate TBTF risk, progress toward improving bank resolvability should continue.

**50. A broad set of macroprudential instruments is urgently needed to address rising mortgage market risks**. Since monetary conditions might remain loose for some time, the risk that a bubble may form is intensifying. Stepped up monitoring and supervision will help contain risks in domestically-oriented banks, where mortgage loan concentration is high. The Basel III counter-cyclical capital buffer and higher risk weights on riskier mortgages, if implemented, will usefully increase the buffer to absorb possible mortgage-related losses and may help prevent imprudent lending and borrowing behavior, However, the effectiveness of these measures warrants close monitoring, and more direct tools such as minimum affordability ratios should also be included in the macroprudential toolkit so that they could be readily deployed in case a housing bubble starts to develop. Improving access to bank information would also help the SNB better fulfill its macroprudential oversight responsibility. Furthermore, consideration should be given to reducing tax incentives for households to take on mortgage debt.

**51. Efforts to upgrade bank and insurance microprudential supervision are welcome and more progress is encouraged.** The adoption of a risk-based approach in all areas of supervision, increased on-site reviews, and stronger supervisory involvement in regulatory audits should improve the quality of supervision. However, resources should be further expanded to broaden in-house supervisory capacity and reduce reliance on external auditors. In the insurance sector, the implementation of the SST by all insurers has helped improve solvency and risk management in the industry. Given the relatively high level of intra-group balances in insurance companies, the oversight of intra-group connections needs to be strengthened to contain contagion risk.

**52. It is recommended that the next Article IV consultation with Switzerland be held on the usual 12-month cycle.**

**Table 1. Switzerland: Selected Economic Indicators, 2008–13**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| | | | | Projections | | |
| **RGDP (percent change)** | 2.1 | -1.9 | 2.7 | 1.9 | 0.8 | 1.7 |
| Total domestic demand | 0.5 | 0.6 | 1.6 | 0.9 | 0.9 | 2.0 |
| Final domestic demand | 1.3 | 0.0 | 3.0 | 1.8 | 1.2 | 1.7 |
| Private consumption | 1.4 | 1.4 | 1.7 | 1.0 | 1.1 | 1.5 |
| Public consumption | 2.7 | 3.3 | 0.8 | 1.7 | 1.0 | 0.7 |
| Gross fixed investment | 0.5 | -5.5 | 7.8 | 4.0 | 1.5 | 2.6 |
| Inventory accumulation 1/ | -0.7 | 0.6 | -1.3 | -0.8 | -0.3 | 0.2 |
| Foreign balance 1/ | 1.6 | -2.4 | 1.2 | 1.0 | 0.0 | 0.0 |
| Nominal GDP (billions of Swiss francs) | 545.0 | 535.6 | 550.6 | 564.8 | 570.5 | 583.9 |
| **Savings and investment (percent of GDP)** | | | | | | |
| Gross national saving | 23.3 | 30.3 | 34.3 | 34.6 | 34.1 | 34.3 |
| Gross domestic investment | 21.2 | 19.3 | 19.2 | 19.8 | 22.3 | 23.1 |
| Current account balance | 2.2 | 11.0 | 15.0 | 14.8 | 11.8 | 11.3 |
| **Prices and incomes (percent change)** | | | | | | |
| GDP deflator | 2.4 | 0.2 | 0.1 | 0.7 | 0.2 | 0.6 |
| Consumer price index | 2.4 | -0.5 | 0.7 | 0.2 | -0.5 | 0.5 |
| Nominal wage growth | 1.9 | 2.1 | 0.8 | 1.2 | 1.0 | 1.7 |
| Unit labor costs (total economy) | 2.9 | 4.5 | -2.0 | -0.6 | 0.2 | 0.0 |
| **Employment and slack measures** | | | | | | |
| Unemployment rate (in percent) | 2.6 | 3.7 | 3.8 | 3.1 | 3.4 | 3.6 |
| Output gap (in percent of potential) | 2.6 | -0.6 | 0.4 | 0.6 | -0.1 | -0.1 |
| Capacity utilization | 86.9 | 78.2 | 81.1 | 84.3 | … | … |
| Potential output growth | 1.6 | 1.3 | 1.7 | 1.7 | 1.6 | 1.7 |
| **General government finances (percent of GDP)** | | | | | | |
| Revenue | 34.5 | 34.9 | 34.3 | 35.2 | 34.9 | 34.8 |
| Expenditure | 32.6 | 34.4 | 34.0 | 34.7 | 34.7 | 34.6 |
| Balance | 1.9 | 0.5 | 0.2 | 0.4 | 0.2 | 0.2 |
| Cyclically adjusted ordinary balance | 0.9 | 0.7 | 0.1 | 0.2 | 0.2 | 0.3 |
| Gross debt 2/ | 52.6 | 53.6 | 50.1 | 48.6 | 48.9 | 47.8 |
| **Monetary and credit (percent change, averages)** | | | | | | |
| Broad money (M3) | 4.9 | 2.6 | 2.2 | 2.2 | … | … |
| Domestic credit, non-financial | 3.2 | 3.7 | 2.1 | 3.7 | … | … |
| Three-month SFr LIBOR | 0.7 | 0.3 | 0.2 | 0.1 | … | … |
| Yield on government bonds (7-year) | 2.7 | 1.8 | 1.3 | 1.6 | … | … |
| **Exchange rates (levels)** | | | | | | |
| Swiss francs per U.S. dollar (annual average) | 1.1 | 1.1 | 1.0 | 0.9 | … | … |
| Swiss francs per euro (annual average) | 1.6 | 1.5 | 1.4 | 1.2 | … | … |
| Nominal effective rate (avg., 2005=100) | 101.4 | 105.9 | 113.1 | 127.3 | … | … |
| Real effective rate (avg., 2005=100) 3/ | 97.9 | 101.6 | 107.5 | 118.0 | … | … |

Sources: Haver Analytics; IMF's Information Notice System; Swiss National Bank; and IMF Staff estimates.

1/ Contribution to growth.

2/ Reflects new GFSM 2001 methodology, which values debt at market prices.

3/ Based on relative consumer prices.

**Table 2. Switzerland: Balance of Payments, 2008–13**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| | | | | Projections | | |
| | In billions of Swiss francs, unless otherwise indicated | | | | | |
| **Current account** | **12** | **59** | **83** | **84** | **67** | **66** |
| Goods balance | 15 | 17 | 13 | 16 | 10 | 10 |
| Exports | 217 | 188 | 204 | 209 | 205 | 217 |
| Imports | -202 | -172 | -191 | -192 | -195 | -208 |
| Service balance | 50 | 46 | 51 | 50 | 45 | 44 |
| Net investment income | -26 | 23 | 46 | 45 | 42 | 42 |
| Net compensation of employees | -13 | -14 | -15 | -16 | -17 | -18 |
| Net private transfers | -14 | -13 | -13 | -12 | -12 | -12 |
| Net official transfers | 0 | 0 | 0 | 0 | 0 | 0 |
| **Private capital and financial account** | **-13** | **-27** | **-107** | **-110** | **-67** | **-66** |
| Capital transfers | -4 | -4 | -5 | -4 | -9 | -10 |
| Financial account | -9 | -23 | -103 | -105 | -58 | -56 |
| Net foreign direct investment | -33 | 1 | -46 | -62 | -60 | -60 |
| Net portfolio investment | -39 | -32 | 31 | -5 | 64 | 65 |
| Net other investment 1/ | 66 | 54 | 51 | 5 | -62 | -60 |
| o/w net banking sector | 63 | 43 | 15 | -3 | -62 | -60 |
| Official reserve flows | -4 | -47 | -138 | -43 | 0 | 0 |
| **Net errors and omissions** | **1** | **-32** | **24** | **26** | **0** | **0** |
| | (In percent of GDP, unless otherwise indicated) | | | | | |
| **Current account** | **2.2** | **11.0** | **15.0** | **14.8** | **11.8** | **11.3** |
| Goods balance | 2.8 | 3.1 | 2.5 | 2.9 | 1.8 | 1.7 |
| Exports | 39.8 | 35.2 | 37.1 | 36.9 | 36.0 | 37.2 |
| Imports | -37.0 | -32.1 | -34.6 | -34.0 | -34.2 | -35.5 |
| Service balance | 9.2 | 8.6 | 9.2 | 8.8 | 7.8 | 7.6 |
| Net investment income | -4.8 | 4.3 | 8.3 | 8.0 | 7.3 | 7.1 |
| Net compensation of employees | -2.4 | -2.6 | -2.7 | -2.8 | -3.1 | -3.0 |
| Net private transfers | -2.6 | -2.5 | -2.3 | -2.1 | -2.0 | -2.0 |
| Net official transfers | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Private capital and financial account** | **-2.3** | **-5.1** | **-19.5** | **-19.4** | **-11.8** | **-11.3** |
| Capital transfers | -0.7 | -0.7 | -0.8 | -0.8 | -1.6 | -1.7 |
| Financial account | -1.6 | -4.4 | -18.6 | -18.6 | -10.2 | -9.6 |
| Net foreign direct investment | -6.0 | 0.2 | -8.4 | -11.0 | -10.5 | -10.3 |
| Net portfolio investment | -7.1 | -6.0 | 5.6 | -0.9 | 11.1 | 11.1 |
| Net other investment 1/ | 12.2 | 10.2 | 9.2 | 0.8 | -10.8 | -10.4 |
| o/w net banking sector | 11.5 | 8.1 | 2.8 | -0.5 | -10.8 | -10.4 |
| Official reserve flows | -0.8 | -8.7 | -25.0 | -7.5 | 0.0 | 0.0 |
| **Net errors and omissions** | **0.2** | **-5.9** | **4.4** | **4.6** | **0.0** | **0.0** |
| **Memorandum items:** | | | | | | |
| Net IIP (in percent of GDP) | 120.6 | 140.4 | 137.7 | 154.2 | 162.9 | 168.8 |
| Official reserves 2/ | | | | | | |
| (billions of U.S. dollars, end period) | 90 | 144 | 244 | 290 | … | … |
| Reserve cover (months of imports of GNFS) 2/ | 3.9 | 7.7 | 13.0 | 16.0 | … | … |

Sources: Haver Analytics; Swiss National Bank; and IMF staff estimates.
1/ Includes derivatives and structured products.
2/ Official reserves for 2011 are as of end-December 2011.

**Table 3. Switzerland: General Government Finances, 2008–15**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | | | | | Projections | | | |
| | (In billions of Swiss francs, unless otherwise specified) | | | | | | | |
| **Federal Government 1/** | | | | | | | | |
| Revenues | 62.6 | 60.6 | 61.3 | 63.9 | 63.1 | 63.5 | 65.5 | 67.8 |
| Expenditures | 57.3 | 58.1 | 59.4 | 63.5 | 64.0 | 64.8 | 66.6 | 68.7 |
| Balance | 5.3 | 2.5 | 1.9 | 0.3 | -0.9 | -1.3 | -1.1 | -0.9 |
| **Cantons** | | | | | | | | |
| Revenues | 75.3 | 75.2 | 76.5 | 81.2 | 82.1 | 84.7 | 88.1 | 91.5 |
| Expenditures | 71.9 | 73.1 | 74.8 | 81.6 | 81.4 | 83.4 | 86.4 | 89.4 |
| Balance | 3.4 | 2.2 | 1.7 | -0.4 | 0.6 | 1.3 | 1.7 | 2.1 |
| **Municipalities** | | | | | | | | |
| Revenues | 41.1 | 41.8 | 41.8 | 43.7 | 44.2 | 45.2 | 46.6 | 47.9 |
| Expenditures | 40.7 | 42.5 | 42.4 | 43.6 | 44.5 | 45.3 | 46.2 | 47.2 |
| Balance | 0.4 | -0.8 | -0.6 | 0.1 | -0.3 | -0.1 | 0.3 | 0.7 |
| **Social security 2/** | | | | | | | | |
| Revenues | 51.5 | 52.7 | 53.1 | 57.8 | 58.7 | 59.9 | 61.0 | 61.9 |
| Expenditures | 49.8 | 53.9 | 54.9 | 55.1 | 57.0 | 58.5 | 58.6 | 60.4 |
| Balance | 1.7 | -1.2 | -1.7 | 2.7 | 1.7 | 1.5 | 2.3 | 1.5 |
| **General Government** | | | | | | | | |
| Revenues | 188.2 | 187.0 | 188.6 | 198.9 | 199.2 | 203.4 | 210.0 | 216.5 |
| Expenditures | 177.7 | 184.3 | 187.4 | 196.2 | 198.3 | 202.2 | 206.8 | 213.1 |
| Balance | 10.4 | 2.8 | 1.2 | 2.7 | 0.9 | 1.2 | 3.1 | 3.4 |
| **Gross debt** | | | | | | | | |
| Federal Government | 154.481 | 143.038 | 142.228 | 142.758 | 147.707 | 148.76 | 147.676 | 151.342 |
| Cantons | 71.6 | 70.9 | 70.2 | 68.1 | 67.4 | 66.5 | 65.1 | 64.1 |
| Communes | 59.4 | 61.3 | 63.0 | 63.2 | 63.5 | 63.9 | 64.6 | 65.3 |
| General government | 286.5 | 287.2 | 275.9 | 274.8 | 279.4 | 280.0 | 278.1 | 281.4 |
| | | | | (In percent of GDP) | | | | |
| **General Government** | | | | | | | | |
| Revenue | 34.5 | 34.9 | 34.3 | 35.2 | 34.9 | 34.8 | 35.0 | 35.0 |
| Expenditure | 32.6 | 34.4 | 34.0 | 34.7 | 34.7 | 34.6 | 34.4 | 34.5 |
| Balance | 1.9 | 0.5 | 0.2 | 0.5 | 0.2 | 0.2 | 0.5 | 0.6 |
| Federal government | 1.0 | 0.5 | 0.3 | 0.1 | -0.2 | -0.2 | -0.2 | -0.1 |
| Cantons | 0.6 | 0.4 | 0.3 | -0.1 | 0.1 | 0.2 | 0.3 | 0.3 |
| Municipalities | 0.1 | -0.1 | -0.1 | 0.0 | -0.1 | 0.0 | 0.1 | 0.1 |
| Social security | 0.3 | -0.2 | -0.3 | 0.5 | 0.3 | 0.2 | 0.4 | 0.2 |
| **Memorandum items:** | | | | | | | | |
| Structural balance | 1.1 | 0.7 | 0.1 | 0.2 | 0.2 | 0.3 | 0.6 | 0.6 |
| Gross debt | | | | | | | | |
| Federal government | 28.3 | 26.7 | 25.8 | 25.3 | 25.9 | 25.5 | 24.6 | 24.5 |
| Cantons | 13.1 | 13.2 | 12.8 | 12.0 | 11.8 | 11.4 | 10.8 | 10.4 |
| Communes | 10.9 | 11.5 | 11.4 | 11.2 | 11.1 | 11.0 | 10.8 | 10.6 |
| General government | 52.6 | 53.6 | 50.1 | 48.6 | 49.0 | 48.0 | 46.3 | 45.5 |

Sources: Federal Ministry of Finance; and IMF staff estimates.

1/ Includes the balance of the Confederation and extrabudgetary funds (Public Transport Fund, ETH, Infrastructure Fund, Federal Pension Fund).

2/ Includes old age, disability, survivors protection scheme as well unemployment and income loss insura

**Table 4. Switzerland: SNB Balance Sheet**

(Millions of Swiss francs; unless otherwise indicated)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Gold | 28,050 | 32,221 | 34,776 | 30,862 | 38,186 | 43,988 | 49,380 |
| Foreign currency reserves | 46,585 | 45,592 | 50,586 | 47,429 | 94,680 | 203,810 | 257,504 |
| IMF, international, and monetary assistance loans | 349 | 567 | 555 | 571 | 5,905 | 4,971 | 4,923 |
| Swiss franc repos | 26,199 | 27,127 | 31,025 | 50,321 | 36,208 | . | 18,468 |
| U.S. dollar repos | . | . | 4,517 | 11,671 | . | . | 371 |
| Swaps against Swiss francs | . | . | . | 50,421 | 2,672 | . | . |
| Money market, Swiss franc securities, other | 7,805 | 6,307 | 5,467 | 23,049 | 29,614 | 17,187 | 15,433 |
| Total assets | 108,988 | 111,813 | 126,927 | 214,323 | 207,264 | 269,955 | 346,078 |
| **Liabilities** | | | | | | | |
| Currency in circulation (banknotes) | 41,367 | 43,182 | 44,259 | 49,161 | 49,966 | 51,498 | 55,729 |
| Sight deposits | 9,653 | 8,357 | 10,563 | 51,173 | 57,102 | 48,917 | 216,701 |
| Repo, SNB bills and time liabilities | . | . | 5,223 | 53,839 | 27,473 | 121,052 | 15,086 |
| Foreign currency and other liabilities | 322 | 84 | 1,200 | 1,700 | 6,820 | 5,897 | 5,441 |
| Provisions and equity capital | 57,647 | 60,191 | 65,682 | 58,449 | 65,902 | 42,591 | 53,122 |
| Total liabilities | 108,988 | 111,813 | 126,927 | 214,323 | 207,264 | 269,955 | 346,078 |
| **Memorandum items:** | | | | | | | |
| Nominal GDP (billions of Swiss francs) | 450 | 467 | 484 | 494 | 485 | 498 | 507 |
| Balance sheet, percent of GDP | 24.2 | 24.0 | 26.2 | 43.4 | 42.8 | 54.2 | 68.3 |
| Banknotes, percent of total liabilities | 38.0 | 38.6 | 34.9 | 22.9 | 24.1 | 19.1 | 16.1 |
| Refinancing operations, percent of total assets | 24.0 | 24.3 | 28.0 | 52.5 | 18.8 | … | 5.4 |
| Provisions and equity capital, percent of total asse | 7.2 | 5.6 | 4.3 | 10.8 | 14.3 | 6.4 | 4.5 |
| Monetary base 1/ | 41,871 | 43,124 | 44,198 | 49,562 | 99,087 | 90,208 | 137,728 |

Sources: SNB; and IMF staff estimates.
1/ Currency in circulation and sight deposits of domestic banks.

**Table 5. Switzerland: Financial Soundness Indicators**

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 1/ | Date |
|---|---|---|---|---|---|---|---|---|---|
| **Banks** | | | | | | | | | |
| **Capital adequacy** | | | | | | | | | |
| Regulatory capital as percent of risk-weighted assets | 12.6 | 12.4 | 13.4 | 12.1 | 14.8 | 17.9 | 17.3 | 16.1 | Jun-11 |
| Regulatory Tier I capital to risk-weighted assets | 13.3 | 13.0 | 13.4 | 11.6 | 12.3 | 15.2 | 15.6 | 15.05 | Jun-11 |
| Non-performing loans net of provisions as percent of tier I capital 2/ | -1.4 | -1.2 | -1.2 | … | … | … | … | … | |
| **Asset quality and exposure** | | | | | | | | | |
| Non-performing loans as percent of gross loans | 0.9 | 0.5 | 0.3 | 0.3 | 0.5 | 0.5 | 0.5 | … | |
| Sectoral distribution of bank credit to the private sector (percent) 3/ | | | | | | | | | |
| Households | 65.2 | 66.6 | 68.5 | 71.5 | 65.4 | 67.1 | 68.3 | 68.8 | |
| Agriculture and food industry | 1.3 | 1.2 | 1.4 | 1.4 | 1.3 | 1.3 | 1.3 | 1.2 | |
| Industry and manufacturing | 3.7 | 3.4 | 3.0 | 3.4 | 3.0 | 3.0 | 3.0 | 2.9 | |
| Construction | 2.1 | 1.9 | 1.7 | 1.8 | 1.6 | 1.6 | 1.6 | 1.7 | |
| Retail | 3.7 | 3.6 | 3.1 | 3.3 | 3.1 | 3.1 | 3.1 | 3.1 | |
| Hotels and restaurants / Hospitality sector | 1.4 | 1.3 | 1.2 | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 | |
| Transport and communications | 1.1 | 1.1 | 1.0 | 1.1 | 0.9 | 0.9 | 0.9 | 0.7 | |
| Other financial activities | 2.2 | 2.4 | 3.1 | 5.2 | 7.0 | 0.4 | 0.4 | 0.5 | |
| Insurance sector | 0.5 | 0.4 | 0.4 | 0.4 | 0.8 | 0.5 | 0.5 | 0.4 | |
| Commercial real estate, IT, R&D | 12.2 | 12.1 | 11.0 | 5.9 | 11.0 | 11.4 | 11.4 | 12.4 | |
| Public administration (excluding social security) | 3.1 | 2.6 | 2.4 | 1.1 | 1.8 | 0.0 | 0.0 | 0.0 | |
| Education | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | |
| Healthcare and social services | 1.3 | 1.3 | 1.1 | 1.1 | 1.0 | 1.0 | 1.1 | 1.1 | |
| Other collective and personal services | 1.5 | 1.5 | 1.3 | 1.7 | 1.2 | 1.0 | 1.0 | 1.0 | |
| Other 5/ | 0.5 | 0.5 | 0.6 | 0.6 | 0.6 | 7.6 | 7.6 | 5.0 | |
| **Earnings and profitability** | | | | | | | | | |
| Gross profits as percent of average assets (ROAA) | 0.8 | 0.9 | 0.9 | 0.7 | 0.3 | 0.5 | 0.7 | 0.8 | Jun-11 |
| Gross profits as percent of average equity capital (ROAE) | 14.3 | 18.0 | 17.7 | 15.4 | 5.4 | 14.5 | 21.0 | 12.6 | Jun-11 |
| Net interest income as percent of gross income | 36.4 | 30.9 | 27.4 | 28.1 | 36.3 | 30.4 | 27.9 | 29.4 | Jun-11 |
| Non-interest expenses as percent of gross income | 62.7 | 59.2 | 63.0 | 70.4 | 85.5 | 80.1 | 73.3 | 69.6 | Jun-11 |
| **Liquidity** | | | | | | | | | |
| Liquid assets as percent of total assets | 24.5 | 24.7 | 25.2 | 27.1 | 29.2 | 27.7 | 23.5 | 22.4 | Jun-11 |
| Liquid assets as percent of short-term liabilities | 59.6 | 59.4 | 60.4 | 63.9 | 67.1 | 64.3 | 53.8 | 50.7 | Jun-11 |
| Net long position in foreign exchange, % of tier I capital 1/ | 15.5 | 30.6 | 21.9 | 13.7 | -16.1 | -23.2 | -41.1 | -35.3 | Jun-11 |

Source: Swiss National Bank.
1/ End-2011 unless otherwise specified.
2/ For 2007–08, these ratios were calculated using Basle I as well as Basle II methodologies. Therefore, interpretation must be done carefully since they can vary within +/- 10%.
3/ As percent of total credit to the private sector.

**Table 6. Switzerland: General Government Operations, 2001–09**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|---|
| | (In billions of Swiss francs, unless otherwise specified) | | | | | | | | |
| Revenue | 158.9 | 161.4 | 161.1 | 164.7 | 171.1 | 179.7 | 187.7 | 188.2 | 187.0 |
| Taxes | 93.8 | 95.7 | 94.5 | 97.7 | 102.2 | 108.3 | 114.6 | 122.6 | 121.2 |
| Taxes on income, profits, and capital ga | 53.9 | 56.3 | 55.1 | 56.7 | 60.5 | 64.7 | 69.4 | 75.2 | 74.6 |
| Taxes on goods and services | 27.7 | 27.5 | 28.1 | 29.1 | 30.3 | 31.5 | 32.4 | 29.4 | 28.6 |
| Taxes on int. trade and transactions | 1.1 | 1.1 | 1.1 | 1.1 | 1.0 | 1.0 | 1.0 | 6.2 | 6.2 |
| Other taxes | 11.1 | 10.8 | 10.3 | 10.8 | 10.5 | 11.0 | 11.8 | 11.8 | 11.8 |
| Social contributions | 32.8 | 33.5 | 32.7 | 31.9 | 32.4 | 33.5 | 35.1 | 37.1 | 38.1 |
| Grants | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | -1.4 | 0.1 | 0.2 |
| Other revenue | 32.3 | 32.1 | 33.8 | 35.0 | 36.3 | 37.8 | 39.3 | 28.3 | 27.5 |
| Expenditure | 156.3 | 162.0 | 167.4 | 170.7 | 173.9 | 174.9 | 180.5 | 177.7 | 184.3 |
| Expense | 153.8 | 159.3 | 164.6 | 168.5 | 172.3 | 173.7 | 179.1 | 177.7 | 182.9 |
| Compensation of employees | 44.2 | 46.1 | 47.7 | 48.4 | 49.2 | 49.9 | 52.2 | 42.7 | 43.3 |
| Purchases/use of goods and services | 21.4 | 22.0 | 22.6 | 22.9 | 23.5 | 23.8 | 24.4 | 22.1 | 22.7 |
| Interest | 8.3 | 7.8 | 6.9 | 6.6 | 6.9 | 7.2 | 6.9 | 6.5 | 5.7 |
| Social benefits | 49.0 | 51.7 | 55.2 | 56.6 | 58.4 | 58.6 | 59.6 | 60.5 | 64.3 |
| Expense n.e.c. | 31.0 | 31.8 | 32.3 | 33.9 | 34.3 | 34.2 | 36.0 | 45.9 | 46.8 |
| Net acquisition of nonfinancial assets | 2.5 | 2.7 | 2.8 | 2.2 | 1.6 | 1.3 | 1.4 | 0.1 | 1.4 |
| Net operating balance | 5.1 | 2.1 | -3.5 | -3.8 | -1.2 | 6.0 | 8.6 | 10.5 | 4.2 |
| Net lending /borrowing | 2.6 | -0.6 | -6.4 | -6.1 | -2.7 | 4.8 | 7.2 | 10.4 | 2.8 |
| Net acquisition of financial assets | 3.0 | 5.0 | -4.1 | 0.8 | 14.6 | 6.1 | 26.0 | 20.4 | 8.0 |
| Net incurrence of liabilities | 0.1 | 5.5 | 2.1 | 6.6 | 16.9 | 1.0 | 18.4 | 9.6 | 5.2 |
| | | | | (In percent of GDP) | | | | | |
| Revenue | 36.9 | 37.2 | 36.8 | 36.5 | 36.9 | 36.6 | 36.0 | 34.5 | 34.9 |
| Taxes | 21.8 | 22.0 | 21.6 | 21.6 | 22.0 | 22.1 | 22.0 | 22.5 | 22.6 |
| Taxes on income, profits, and capital ga | 12.5 | 13.0 | 12.6 | 12.6 | 13.0 | 13.2 | 13.3 | 13.8 | 13.9 |
| Taxes on goods and services | 6.4 | 6.3 | 6.4 | 6.4 | 6.5 | 6.4 | 6.2 | 5.4 | 5.3 |
| Taxes on int. trade and transactions | 0.2 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 1.1 | 1.2 |
| Other taxes | 2.6 | 2.5 | 2.3 | 2.4 | 2.3 | 2.2 | 2.3 | 2.2 | 2.2 |
| Social contributions | 7.6 | 7.7 | 7.5 | 7.1 | 7.0 | 6.8 | 6.7 | 6.8 | 7.1 |
| Other revenue | 7.5 | 7.4 | 7.7 | 7.8 | 7.8 | 7.7 | 7.5 | 5.2 | 5.1 |
| Expenditure | 36.3 | 37.3 | 38.3 | 37.8 | 37.5 | 35.7 | 34.6 | 32.6 | 34.4 |
| Expense | 35.7 | 36.7 | 37.6 | 37.3 | 37.2 | 35.4 | 34.4 | 32.6 | 34.1 |
| Compensation of employees | 10.3 | 10.6 | 10.9 | 10.7 | 10.6 | 10.2 | 10.0 | 7.8 | 8.1 |
| Purchases/use of goods and services | 5.0 | 5.1 | 5.2 | 5.1 | 5.1 | 4.8 | 4.7 | 4.1 | 4.2 |
| Interest | 1.9 | 1.8 | 1.6 | 1.5 | 1.5 | 1.5 | 1.3 | 1.2 | 1.1 |
| Social benefits | 11.4 | 11.9 | 12.6 | 12.5 | 12.6 | 11.9 | 11.4 | 11.1 | 12.0 |
| Other expense | 7.2 | 7.3 | 7.4 | 7.5 | 7.4 | 7.0 | 6.9 | 8.4 | 8.7 |
| Net acquisition of nonfinancial assets | 0.6 | 0.6 | 0.6 | 0.5 | 0.3 | 0.3 | 0.3 | 0.0 | 0.3 |
| Gross operating balance | 1.2 | 0.5 | -0.8 | -0.8 | -0.3 | 1.2 | 1.7 | 1.9 | 0.8 |
| Net lending /borrowing | 0.6 | -0.1 | -1.5 | -1.3 | -0.6 | 1.0 | 1.4 | 1.9 | 0.5 |
| Net acquisition of financial assets | 0.7 | 1.1 | -0.9 | 0.2 | 3.1 | 1.2 | 5.0 | 3.7 | 1.5 |
| Net incurrence of liabilities | 0.0 | 1.3 | 0.5 | 1.5 | 3.6 | 0.2 | 3.5 | 1.8 | 1.0 |

Source: Federal Ministry of Finance.

# ANNEX I. A LONG-TERM PERSPECTIVE ON THE SWISS EXTERNAL ACCOUNTS

**1. Switzerland has run sizable current account surpluses for longer than any other advanced economy**.[1] Since the early 1990s, its current account has trended upwards, reaching a peak at 15 percent of GDP in 2006, and again in 2010–11. This long-term improvement is accounted for by the growing surplus in the investment income account and by rising positive balances in the goods and services account.

**2. The strong investment income performance reflects the large net foreign asset position and the high yield earned on the sizable net direct investment position**. The surplus in goods trade reflects strong export performance in technology intensive and highly-specialized sectors such as watches, medical equipment, and pharmaceuticals. The latter benefited also from growing global health related expenditures. The widening surplus in services trade is fully accounted for by the merchanting sector, while the surplus in banking financial services has shrunk since the global financial crisis.[2]

**3. To assess external performance in the case of Switzerland, it may be more useful to examine directly the country's net foreign asset position rather than the current account, as the latter is somewhat misleading**.[3] Swiss net foreign assets have grown from 83 percent of GDP in 1995 to 138 percent of GDP in 2010. This is an impressive build-up, but far less than what would be implied by the accumulation of current account surpluses. In fact, the rate of accumulation of NFA has been on average 3½ percent of GDP per year over the last 15 years, vis-à-vis an average current account surplus of over 10 percent. The discrepancy, which has been noted before (Stoffels and Tille 2007), arises because valuation changes have affected foreign assets differently from foreign liabilities. More specifically, over 2000-10 capital gains have been close to zero on foreign liabilities but negative on foreign assets, reflecting in part the different asset composition (Swiss foreign liabilities have a larger share of equities) but also adverse valuation effects due to the long-run appreciation of the exchange rate.[4]

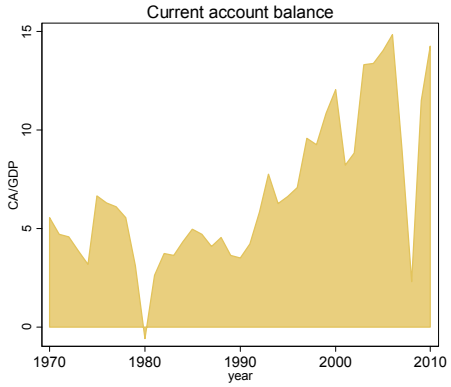
[1] As noticed by IMF research since at least the mid-1990s (e.g. Mauro 1995).

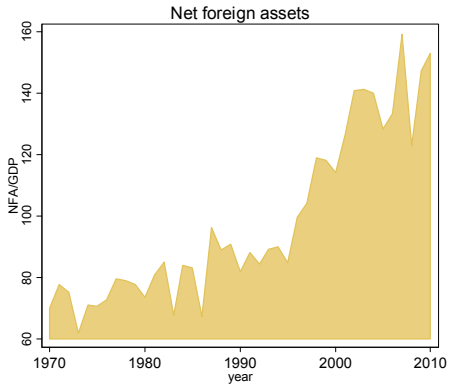
[2] Merchanting is the activity of buying commodities from a nonresident and subsequently selling them to another nonresident without the good entering the country.

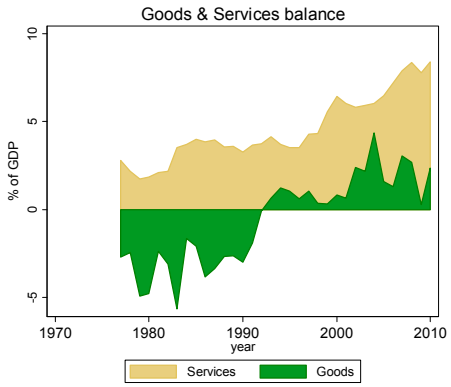
[3] For instance, the accounting treatment of investment income overestimates the Swiss current account surplus as retained earnings of Swiss multinationals are treated as income inflows, with no discounting for the foreign ownership of Swiss multinationals. In 2011, this generated a 5 percent upward bias in the current account (Swiss National Bank 2006; private communication with SNB officers).

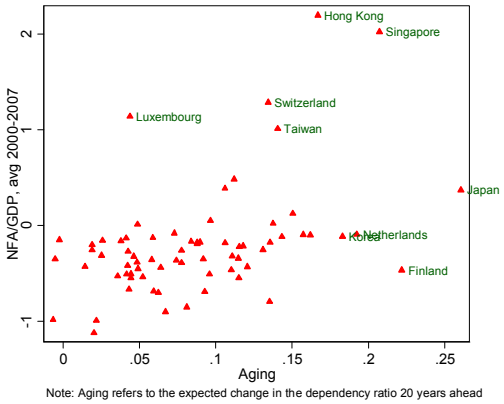
[4] Stoffels and Tille (2007) calculated that a 10 percent appreciation of the Swiss franc would have reduced the value of the gross international asset position by 29 percent of GDP in 2005. The SNB estimates valuation changes due to exchange rate movements at about 70 percent of GDP over 2002–10.

(continued)




Note: Aging refers to the expected change in the dependency ratio 20 years ahead

**4. What may explain the build-up in the Swiss NFA?** The literature has found that rich countries and those with a large share of the population nearing retirement tend to have a larger net foreign asset position. Adding to the effect of a demographic structure conducive to NFA accumulation, the nature of the pension system may lead to high savings rates by households: Switzerland has a well developed system of mandatory second-pillar retirement saving, which accounts for half of overall household saving and 15 percent of gross national saving (Jarrett and Letremy, 2008). These pension funds held assets worth more than 100 percent of GDP already in 2009, one of the highest GDP shares in the OECD. In addition, Switzerland's role as an international financial center may play a role in an explanation, as it is well known that such centers tend, on average, to run large current account surpluses and accumulate positive net foreign asset positions (Lee et al., 2008). However, so far there is no theoretical explanation of why this should be the case.

**5. Whatever their fundamental determinants, the large current account balance surplus and net foreign asset build-up are likely to play an important role in**

**exchange rate determination**. While short-term movements in exchange rates are usually dominated by monetary and other high frequency factors, the currencies of countries with large NFA positions tend to have more appreciated real exchange rates (Lee et al., 2008) and their trade balance tends to deteriorate in the long-run (Lane and Milesi-Ferretti, 2002). This happens because a larger external wealth allows for higher consumption and trade deficits, which in equilibrium is accommodated by an increase in the price level of the country receiving the international transfers, as in the classic "transfer problem" analyzed by Keynes (Lane and Milesi-Ferretti, 2004). Thus, also in the case of Switzerland, the large net foreign asset position may be a long-term factor pushing up the exchange rate.

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# ANNEX II. SWITZERLAND: FISCAL DISCIPLINE IN A FEDERAL SYSTEM

**1. Switzerland is a confederation of 26 cantons and almost 2600 municipalities. Its public finances are highly decentralized** (see table 3). In particular, subnational governments have considerable autonomy in determining key parameter of the bulk of taxes they receive, such as the tax rate. As a result, there is a substantial degree of heterogeneity across cantons in the level and nature of taxation, and tax competition is an important characteristic of the system.

**2. The remarkable degree of fiscal discipline in this federal system rests on two pillars**: (1) inter-governmental fiscal relations with a streamlined task distribution and close links at the same government level between spending decisions and the responsibility for their financing; these features restrain task duplications and, together with a no bail-out presumption, limit any deficit bias at lower government levels; and (2) effective fiscal rules that avoid over-complexity and, hence, remain tractable both from a technical as well as political economy perspective.

## Inter-Governmental Fiscal Relations

**3. The current system of inter-governmental fiscal relations was reformed recently.** After a long preparation period, the new system became effective in 2008. The reform covered both the distribution of tasks across levels of government and the fiscal equalization mechanism.

**4. The distribution of tasks across government levels was streamlined**. Out of 40 areas for which the confederation and cantons used to have joint responsibility, 17 are now exclusively assigned to one of the two levels. As for the areas were a joint responsibility remains, there is a clearer division of labor between strategic tasks (assigned to the federal level) and operational tasks (allocated to the cantons). Cooperation among cantons has also been enhanced.

**5. Simultaneously, the volume of ear-marked transfers was substantially reduced, and the fiscal equalization scheme was rationalized to two mechanisms**: [1]

(a) Compensations for different fiscal resource potentials across cantons. These compensations are financed by both the federal level and relatively better-off cantons.
(b) Compensations for differing fiscal needs arising from either varying socio-demographic or geographic characteristics. The former criterion benefits mostly urban areas, while the latter is to the advantage of mainly peripheral cantons with low population density. These compensations are exclusively financed by the federal level.

**6. A presumption of "no bail-out" at both the cantonal and municipal level, which avoids "fiscal moral hazard"**. This presumption has been confirmed in the 1990s when several cantons were in dire financial straits due to their guarantees to cantonal

[1] In addition, the reform includes compensation payments to ease the transition from the old to the new system for some cantons. These payments are going to be successively reduced over a time period of almost thirty years unless abolished earlier by parliament during regular reform reviews.

banks. At the municipal level it was corroborated in 2003 when the Swiss Federal Court decided in the case of a municipality (Loèche les Bains) that the canton Valais was not responsible for its liabilities. In addition, cantonal ratings differ significantly and would not appear to assume federal bail-out support, and the variation of spreads across cantons suggests a close link with their fiscal position and the strength of their fiscal rules.[2]

**7. The new system has put in place better incentives for each level of government.** This rationalized system of intergovernmental fiscal relations, coupled with the credible no-bail out presumption and traditionally high tax autonomy, provides for a close link between spending decisions and the responsibility for their financing at the same government level. This sets the right incentives for a responsible use of public resources and the acceptance of and compliance with fiscal rules.[3]

## Fiscal Rules

**8. Fiscal rules exist at both the federal and the subnational level.** The most prominent Swiss fiscal rule is the so-called "debt brake" rule at the federal level. It is, in essence, a cyclically-adjusted balanced budget rule with an error-correction mechanism in the form of a notional "compensation account". The latter accumulates deviations of budget outcomes from rule requirements and mandates additional consolidation efforts once a negative balance of 6 percent of expenditure is reached.

**9. Operationally, the rule is mapped into annual expenditure ceilings.** These floors can only be raised in exceptional circumstances that are out of the control of the authorities, such as a severe recession. The severity of a recession is determined through a number of indicators and any deviation from the fiscal rule requires an absolute majority in both chambers of parliament.[4]

**10. The federal fiscal rule led to a substantial reduction in the debt-to-GDP ratio.** It was enshrined into the constitution and became effective in 2003 after a string of large deficits in the 1990s. After its inception, the federal debt-to-GDP ratio fell by some 10 percentage points, not least due to the asymmetry of the rule which allows for overperformance.

**11. At the subnational government level, most of the cantons have fiscal rules as well.** These are very heterogeneous and vary with respect to the target, operational implementation, exemption clauses, and sanctioning mechanisms. [5] Municipal finances are subject to the oversight by the respective canton.

**12. Absorbing the imminent aging-related expenditure increases would benefit**

[2] See, e.g., Feld, Lars P. et al. (2012): "Sovereign Bond Market Reactions to Fiscal Rules – The Swiss Experience", Freiburg/Mannheim (version of January 2012).

[3] Furthermore, strong elements of direct democracy, although difficult to emulate in other countries, foster the articulation of these incentives.

[4] See, e.g., "Botschaft ueber die 2. Stufe der konjunkturellen Stabilisierungsmassnahmen", February 11, 2009, box on page 14.

[5] For an overview on the details of the different rules, see Konferenz der Kantonalen Finanzdirektorinnen and Finanzdirektoren (2009): "Finanzpolitische Regeln der Kantone: Ausgaben-, Defizit-, and Schuldenbremsen",

**from additional "fiscal rules" that anchor long-term sustainability.** In particular the pay-as-you-go pension pillar would gain from automatic adjustors of the pension age and/or benefits to life expectancy. This would be a useful tool to reduce the need for repeated and difficult reform discussions and potentially ad-hoc reform decisions.

**13. The Swiss system of fiscal federalism is working well**. To summarize, a rationalized system of intergovernmental fiscal relations (including clear task assignments, rationalized financial equalization flows, a no-bail-out presumption, and a considerable degree of tax autonomy) has delivered a general culture of fiscal discipline and laid the basis for a credible commitment to and consistent compliance with fiscal rules.

# Annex III. The Short-Term Effect of Real Appreciation on Swiss Economic Growth: A VAR Analysis

**1. Using a VAR framework, this annex provides a quantitative assessment of the effect of exchange rate on Swiss GDP growth**. The Swiss franc appreciated in real effective terms by almost 30 percent between 2008Q3 and 2011Q3, with an appreciation of similar size occurring in bilateral terms against the euro. Real appreciation is usually thought to slow down economic activity, as demand shifts away from domestic output. While the Swiss economy did experience a recession in 2009, growth recovered swiftly as the world economy improved in 2010 and early 2011 even though the real exchange rate continued to strengthen, suggesting that the positive effect of the world recovery dominated the contractionary effect coming from the exchange rate.

**2. To quantify the importance of global and country specific shocks in Switzerland, we estimate a vector autoregression (VAR).** The model has six endogenous variables and 8 lags (as determined by Akaike tests for lag length). The model distinguishes between global variables, i.e. those that are not affected by Swiss specific developments, and Swiss macroeconomic variables. That is made operational by constraining the effect of Swiss variables on global variables to be nil. The global variables we include are the world GDP growth (world) and the log change in oil prices in US dollars (*dloilp*). For the Swiss economy, we include GDP growth (*growth*), the differential in short-term interest rates between Switzerland and the euro area (Germany before the euro adoption) (*dshort*), the log change in the real effective exchange rate (*dlreer*) and CPI inflation (*infl*).

**3. In the preferred specification, we estimate the model on quarterly data spanning from 1991Q1 to 2011Q4. The identification** of the structural shocks is based on a Cholesky decomposition with world GDP growth going first, and then followed by the change in oil prices, Swiss GDP growth, the differential in interest rates, the change in the REER, and CPI inflation. The VAR is estimated so that in the reduced form Swiss variables do not enter the equations for world GDP and oil prices.

**4. The main results are as follows (see Figures 1A-1B)**:

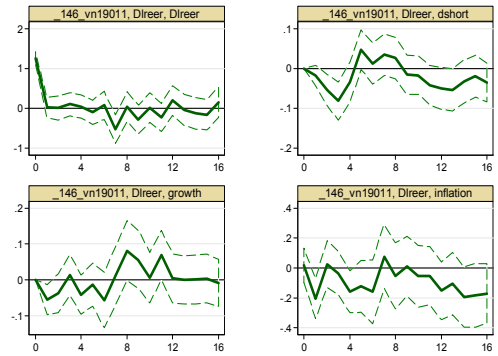
- The real exchange rate has had trend appreciat*ion wi*th some fluctuations around this trend.[1] Shocks to *the* real exchange rate tend to vanish after a few years. A typical REER shock (a one-standard deviation shock) causes a quarter*ly app*reciation of about 1¼ percent on impact.
- During the sam*ple pe*riod, real appreciati*ons* have been followed by brief but economically and statistically significant reductions in the differential between Swiss franc and euro short- term rates (Figure 1A). This is probably because monetary policy tends to respond to

[1] This trend is in evidence well before the beginning of our sample period – since at least the mid 1970s.

unexpected movements in the real exchange rate aiming to counter its effects on output or inflation.

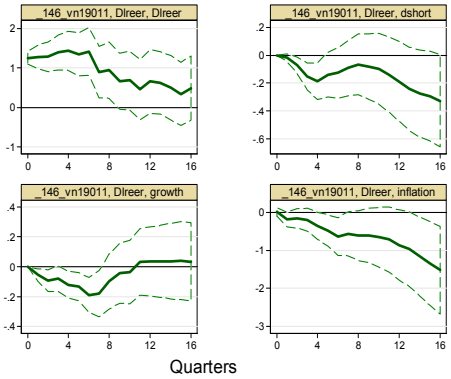
- The peak impact of real appreciation on GDP growth rates happens in the second quarter after the REER shock (Figure 1A). Thus, the lag in the effect is relatively short. The cumulative effect on GDP is statistically significant and sizeable. A one standard deviation shock to REER causes a loss of about 0.2 percent in the GDP level relative to baseline, over 2 years (Figure 1B).
- The effect on inflation is not immediate and is relatively small (for the typical REER shock, the price level is less than 0.1 percentage point lower after 2 years).

Figure 1A
Response to a REER shock




90% confidence intervals

Figure 1B
Cumulative response to a REER shock




90% confidence intervals

**5. To gauge the impact of real appreciation (*dlreer*) on growth, we compare its magnitude to the impact of shocks to the interest rate differential (*dshort*) and world GDP growth rate (*world*).** It turns out that a typical shock to world GDP has a larger estimated effect on the Swiss GDP growth than a shock to dlreer and dshort (Figure 2), and the effect of the interest differentials has the opposite sign than expected.

**6. Next we consider a variance decomposition of Swiss GDP growth.** At all horizons, the effect of global GDP growth looms large, dominating the effect of own shocks to Swiss GDP and those of oil prices, monetary policy or real exchange rate (Figure 3).

**7. Finally, we consider how much the recent real appreciation has contributed to weakness in GDP growth.** To this end, we recover the structural shocks to the real exchange rate equation since 2008Q1 and calculate the impulse they generate to GDP growth going forward. In our preferred estimates, the REER equation has some explanatory power for GDP growth and its residuals since 2007, while negative for a few quarters, have been sharply positive over 2011 (Figure 3). According to the model, past movements in the real exchange rate will cut quarterly growth by about 1 percentage point between 2011Q4 and 2012Q4, with some of this effect offset from 2013 onwards. This confirms that the Swiss economy is facing headwinds in the near term as a consequence of the appreciation of the Swiss franc during the last few years.

Figure 2
Comparing the cumulative impact of shocks on GDP

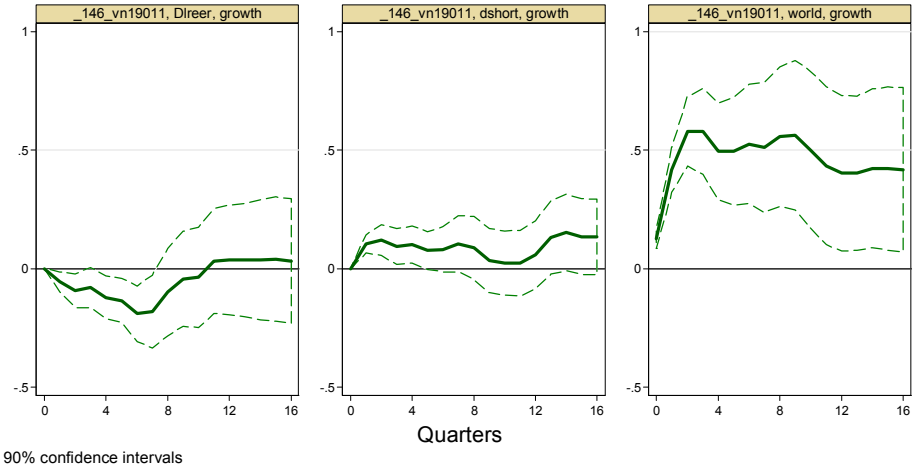
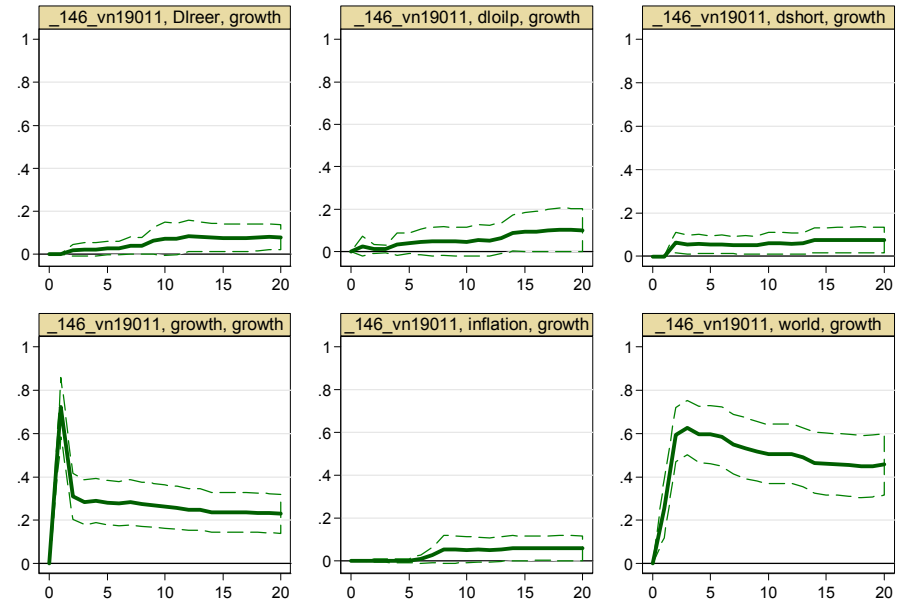


Figure 3
GDP growth: Variance decomposition




90% confidence intervals

# ANNEX IV. FISCAL MULTIPLIERS IN SWITZERLAND

**1. Economic research on the size of fiscal multipliers points to a wide range of values**, depending on the model, monetary policy assumptions, the type and persistence of government spending and tax cuts, their financing, and the degree of excess capacity in the overall economy or the affected sectors.[1]

**2. Empirically, recent work by the OECD on the effects of stimulus measures in the 2008–09 crisis confirms theoretical expectations** that fiscal multipliers in Switzerland are smaller than in larger and more closed economies. However, they are not negligible and in a similar range as in other small open economies.

**3. These estimates are based on an average of simulation results from various macro models surveyed in the OECD study**. Only simulations in which monetary policy is set to be accommodative are considered, in line with current Swiss circumstances, and the multipliers take openness into account. However, they should be considered as an upper bound, as they are not adjusted for other factors that played a role in 2008/2009 and may play a role in a new downturn as well – such as an increase in the propensity to save in crisis times. For evaluating the fiscal packages of the 2008/2009 crisis, the OECD has therefore made some judgmental adjustment to the above multipliers and computed so-called "reference multipliers."[2] In addition, the study usefully computes separate multipliers for different expenditure and tax categories. In the case of Switzerland, as for other countries, increases in government investment have the largest effect on output, followed by government consumption, while increases in transfers or tax cuts have smaller effects. [3]

**4. In conclusion, these results suggest that a fiscal stimulus in Switzerland would be effective in mitigating an economic downturn, even if the exact magnitude of its impact remains hard to predict**.

[1] See, e.g., Ramey, Valerie A. (2011), "Can Government Purchases Stimulate the Economy?", JEL, 49:3, 673-685; and IMF (2008), World Economic Outlook, Chapter 5.

[2] For details on the applied methodology, see OECD Economic Outlook – Interim Report (March 2009)

[3] Furthermore, the Swiss research institute KOF estimated a GDP multiplier of 0.3 in the first year of a construction stimulus, assuming spare capacity in the construction sector. Unpublished simulations of the Swiss Federal Finance Administration feature an expenditure multiplier of 0.6 in the first year. See, respectively, KOF (2009), "Beschaeftigungswirkungen eines Investitionsprogramms fuer die Schweiz, Simulationen mit dem KOF-Makromodell", Zuerich; and, Eidgenoessische Finanzverwaltung (2009), „Politique Conjoncturelle de la Confédération", Working Paper 11, Bern;

**Short-term Fiscal Multipliers 1/**

| | Expenditure | | | Revenue | |
|---|---|---|---|---|---|
| | Government consumption | Transfers to Households | Investment | Indirect Tax | Personal Income Tax |
| United States | 0.90 | 0.70 | 1.10 | -0.40 | -0.70 |
| Japan | 0.90 | 0.70 | 1.10 | -0.40 | -0.70 |
| Germany | 0.60 | 0.50 | 1.00 | -0.30 | -0.50 |
| France | 0.80 | 0.60 | 1.00 | -0.30 | -0.60 |
| Italy | 0.80 | 0.60 | 1.00 | -0.30 | -0.60 |
| United Kingdom | 0.70 | 0.60 | 1.00 | -0.30 | -0.60 |
| Canada | 0.70 | 0.55 | 1.00 | -0.30 | -0.55 |
| Belgium | 0.50 | 0.40 | 0.90 | -0.20 | -0.40 |
| Switzerland | 0.60 | 0.45 | 0.90 | -0.30 | -0.45 |
| Netherlands | 0.50 | 0.40 | 0.90 | -0.20 | -0.40 |
| Sweden | 0.60 | 0.45 | 0.90 | -0.30 | -0.45 |

1/ Percentage effect on GDP, averaged over the first and second year, of a 1 percent of GDP change in the relevant budget compenent. Estimates are based on the survey of results described in box 3.1 of the OECD Economic Outlook Interim Report of March 2009, adjusted for openness as measured by the ratio of import to the sum of GDP and imports

Source: OECD Economic Outlook, Interim Report (March 2009), Appendix 3.2.

**OECD Reference Multipliers**

| | Expenditure | | | | | | Revenue | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Government consumption | | Transfers to Households | | Investment | | Indirect Tax | | Personal Income Tax | |
| | Year 1 | Year 2 | Year 1 | Year 2 | Year 1 | Year 2 | Year 1 | Year 2 | Year 1 | Year 2 |
| United States | 0.70 | 0.80 | 0.50 | 0.80 | 0.90 | 1.10 | -0.20 | -0.30 | -0.30 | -0.5 |
| Japan | 0.70 | 0.80 | 0.50 | 0.80 | 0.90 | 1.10 | -0.20 | -0.30 | -0.30 | -0.5 |
| Germany | 0.40 | 0.50 | 0.30 | 0.50 | 0.80 | 1.00 | -0.10 | -0.20 | -0.20 | -0.3 |
| France | 0.60 | 0.70 | 0.40 | 0.70 | 0.80 | 1.00 | -0.20 | -0.20 | -0.20 | -0.4 |
| Italy | 0.60 | 0.70 | 0.40 | 0.70 | 0.80 | 1.00 | -0.20 | -0.20 | -0.20 | -0.4 |
| United Kingdom | 0.50 | 0.60 | 0.40 | 0.60 | 0.80 | 1.00 | -0.20 | -0.20 | -0.20 | -0.4 |
| Canada | 0.50 | 0.60 | 0.40 | 0.60 | 0.80 | 1.00 | -0.10 | -0.20 | -0.20 | -0.4 |
| Belgium | 0.30 | 0.40 | 0.20 | 0.40 | 0.70 | 0.90 | -0.10 | -0.10 | -0.10 | -0.2 |
| Switzerland | 0.40 | 0.50 | 0.30 | 0.50 | 0.70 | 0.90 | -0.10 | -0.20 | -0.20 | -0.3 |
| Netherlands | 0.30 | 0.40 | 0.20 | 0.40 | 0.70 | 0.90 | -0.10 | -0.10 | -0.10 | -0.2 |
| Sweden | 0.40 | 0.50 | 0.30 | 0.50 | 0.70 | 0.90 | -0.10 | -0.20 | -0.20 | -0.3 |

Source: OECD

INTERNATIONAL MONETARY FUND

# SWITZERLAND

## STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 17, 2012

Prepared By

European Department
(in consultation with other departments)

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# FUND RELATIONS

(As of March 29, 2012)

**Membership Status:** Joined 5/29/92; Switzerland has accepted the obligations of Article VIII, Sections 2, 3 and 4, and maintains a system free of restrictions on the making of payments and transfers for current international transactions except for restrictions in place for security reasons notified to the Fund pursuant to Decision No. 144-(52/51).

On March 16, 2012 Switzerland notified the IMF of the exchange restrictions that have been imposed against certain countries, individuals, and entities, in accordance with relevant UN Security Council resolutions and EU regulations.

**General Resources Account:**

| | SDR Million | Percent Quota |
|---|---|---|
| Quota | 3,458.50 | 100.00 |
| Fund holdings of currency | 2,077.02 | 60.06 |
| Reserve position in Fund | 1,381.49 | 39.94 |
| New arrangement to borrow | 839.70 | |

**SDR Department**

| | SDR Millions | Percent Allocation |
|---|---|---|
| Net cumulative allocations | 3,288.04 | 100.00 |
| Holdings | 3,196.97 | 97.23 |

**Outstanding Purchases and Loans:** None

**Financial Arrangements:** None

**Projected Payments to Fund[1/]:**

| | | Forthcoming | | | |
|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 |
| Principal | | | | | |
| Charges/Interest | 0.15 | 0. 18 | 0. 18 | 0.18 | 0. 18 |
| Total | 0.15 | 0. 18 | 0. 18 | 0.18 | 0. 18 |

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears wil be shown in this section.

**Exchange Rate Arrangement:**

The de jure exchange rate arrangement is free floating; the exchange rate of the Swiss franc is determined by market forces in the foreign exchange market. However, the Swiss National Bank (SNB) reserves the right to intervene in the foreign exchange market. All settlements are made at free market rates. On September 6, 2011, the SNB set a minimum exchange rate of CHF 1.20 per euro to stop the appreciation of the franc and committed to defending the limit by buying foreign currency in unlimited quantities. The SNB publishes information regarding its foreign exchange transactions in its annual accountability report. In 2011, to combat the massive overvaluation of the Swiss franc and to enforce the minimum exchange rate, the SNB purchased foreign currency to a value of approximately CHF 17.8 billion. The purchases were made with a wide range of counterparties in Switzerland and abroad. Effective September 6, 2011, the de facto exchange rate arrangement is other managed.

**Technical Assistance:** None

**Resident Representatives:** None

**Other:** FSAP Update, November 2006

# STATISTICAL ISSUES

Switzerland's economic and financial statistics are adequate for surveillance purposes. Switzerland generally publishes timely economic statistics and posts most of the data and the underlying documentation on the internet. In June 1996, Switzerland subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are currently posted on the Dissemination Standards Bulletin Board. Switzerland is in full observance of SDDS requirements, and it is availing itself of the SDDS's flexibility options on dissemination of production index data (for periodicity and timeliness) and of wages and earnings data (for periodicity). However, a number of statistical gaps and deficiencies remain, mainly reflecting a lack of resources and the limited authority of the Federal Statistical Office (BfS) to request information:

- reliable general government finance statistics appear with considerable lags, mainly due to delays in compiling fiscal accounts at the level of cantons and communes;
- pension statistics are published with a long lag;
- GDP by industry appears with a considerable lag.

To address deficiencies, the authorities are taking or intend to take the following steps:

In 2009, the SNB for the first time complemented its publication on the financial wealth of private households with an **estimation of assets held in real estate**. The SNB has revised its **loan survey** with effect from the reference date of 31 March 2009, providing, e.g., a more detailed breakdown by industry for the services sector. At the beginning of 2010, the SNB started to **publish** results from its **monthly survey on the cost of borrowing**. Also in 2010, the SNB introduced a survey on the **quality of banks' credit portfolios**, based on the concepts of probability of default and expected loss. In 2011 the SNB collected—in the context of its surveys on payment transactions—**data on customer payments**. In order to gain information on the effects of the financial crisis on domestic bank lending, the SNB has been collecting **qualitative** data on the lending policies of about 20 banks since the first quarter of 2008. The results of the survey complement the quantitative data obtained from existing statistics and was transformed into part of the **bank lending survey** starting in 2011. Work is under way to completely revise the **survey on trade in services**. The collection of data based on the new survey started in 2012, providing among other things a detailed country breakdown.

**Annual national accounts** were upgraded in 2003 to the *European System of Accounts 1995* (ESA95) and with the release of the Q4 2004 data, the State Secretariat for Economic Affairs (SECO) revised accordingly its **quarterly national account estimates**. The main innovations in the new national accounts were in investment (with detail on information and communications technology), private and public consumption (hospitals were transferred to the private sector), and the use of chain price indices (without adjustment for quality). SECO started publishing a quarterly production account in March 2006. In October

2008, SECO added income approach estimates (at current prices only) to its quarterly national accounts.

In 2004, a **cooperation agreement in the fields of statistics** was concluded with the EU for the harmonization of several Swiss statistical domains with EU standards. The treaty entered into force in 2007. The agreement was updated in 2010 and now includes BOP data, as well as various new provisions aiming at an ever greater compatibility with EU statistics, notably in the fields of national accounts (additional national accounts data: short-term public finance statistics, quarterly non-financial accounts for general government), external trade and labor force surveys.

The Federal Finance Administration has finished **revamping fiscal statistics** with the adoption of the *Government Finance Statistics Manual 2001*, the reform of the accounting standards for cantons and communes (*Harmonisiertes Rechnungslegungsmodell der Kantone HRM2*) and the introduction of full accrual budgeting and accounting at the level of the federal government (*Neues Rechnungsmodell Bund NAM*) along the lines of the International Public Sector Accounting Standards (IPSAS). Figures according to the new accounting standards have been produced for the federal government (*NAM*) 2008 and for some cantons (*HRM2*) for 2009. Figures according to GFSM2001 have been reported beginning in 2009. A ROSC mission on fiscal transparency took place during January 16–29, 2009. In order to counter the lags in the compilation of the general government finance statistics, the Federal Finance Administration will start to produce **quarterly estimates** in 2012 for the most important aggregates at all levels of government (Confederation, Cantons, Communes, Social Security). Moreover, efforts are ongoing to implement harmonized accounting standards across all levels of government.

**Quarterly balance of payments and international investment position** data are compiled by the SNB and meet international standards. However, monetary gold transactions relating to sales of gold reserves not required for monetary policy purposes have not been correctly reflected in the balance of payments. For legal reasons, and until the distribution of the proceeds of gold sales between the SNB and the Federal Department of Finance was concluded in February 2005, the proceeds of the gold sales not needed for monetary purposes were considered as part of the official reserves in the balance of payments. After that date, they appear in the position "other assets of the SNB" in the balance of payments.

Switzerland has continued to provide data on **Financial Soundness Indicators (FSIs)** and participated in the 2009 **Coordinated Direct Investment Survey**. The data and metadata for both these initiatives have been posted on the IMF website.

With regard to **AML/CFT**, the FATF Plenary decided in October 2009 that Switzerland had made significant progress in addressing the deficiencies which were identified in its 2005 mutual evaluation report, and on that basis, decided to remove Switzerland from the "regular follow-up" process. Switzerland reported further improvements to its AML/CFT System in 2011 within the context of its biennial update, while some shortcomings remain (for instance, in the area of beneficial ownership).

| Table of Common Indicators Required for Surveillance (As of April 11, 2012) | | | | | |
|---|---|---|---|---|---|
| | Date of Latest Observation | Date Received | Frequency of Data[6] | Frequency of Reporting[6] | Frequency of Publication[6] |
| Exchange Rates | Apr 12 | Apr 12 | D and M | M and M | D and M |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | Mar 12 | Apr 12 | M | M | M |
| Reserve/Base Money | Mar 12 | Apr 12 | M | M | M |
| Broad Money | Mar 12 | Apr 12 | M | M | M |
| Central Bank Balance Sheet | Mar 12 | Apr 12 | M | M | M |
| Consolidated Balance Sheet of the Banking System | Mar 12 | Apr 12 | M | M | M |
| Interest Rates[2] | Mar 12 | Apr 12 | D and M | M and M | D and M |
| Consumer Price Index | Mar 12 | Apr 12 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4] | 2010 | Apr 12 | A | A | A |
| Revenue, Expenditure, Balance and Composition of Financing – Central Government[3] | Feb 12 | Mar 12 | M | M | M |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | Q4/11 | Mar 12 | Q | Q | Q |
| External Current Account Balance | Q4/11 | Apr 12 | Q | Q | Q |
| Net International Investment Position | Q4/11 | Apr 12 | Q | Q | Q |
| Exports and Imports of Goods and Services | Feb 12 | Apr 12 | M | M | M |
| GDP/GNP | Q4/11 | Mar 12 | Q | Q | Q |
| Gross External Debt | 2011 | Mar 12 | Q | Q | Q |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic non-bank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA)

INTERNATIONAL MONETARY FUND
*Public Information Notice*
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/45
FOR IMMEDIATE RELEASE
May 8, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Concludes 2012 Article IV Consultation with Switzerland

On May 2, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

## Background

Faced with headwinds from the euro area debt crisis and a strong currency, the economy slowed down in late 2011, and inflation turned negative as exchange rate appreciation was passed through to import prices. While export growth has weakened, the external sector continues to perform relatively well, thanks to specific sectoral strengths and high investment income flows. The outlook for 2012 is of a gradual recovery, as foreign demand picks up, the economy adapts to the higher level of the exchange rate, and monetary policy remains accommodative. However, downside risks, especially from external developments, are significant.

Monetary policy had to contend with severe exchange rate appreciation pressures in the summer, when safe haven flows from the euro area crisis intensified and the Swiss franc reached close to parity vis-à-vis the euro (a real effective appreciation of over 30 percent since end-2007). After bringing the policy rate to zero and effecting a massive liquidity expansion, in early September the Swiss National Bank committed to defend an exchange rate floor of 1.20 Swiss francs per euro, moving away from the floating regime. The exchange rate has since

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

traded closely to the floor, and the negative inflation differential with trading partners is helping undo the real appreciation.

With loose monetary conditions, domestic mortgage credit and real estate prices continue to rise briskly, and concern is growing that a bubble may be forming, endangering exposed domestically-oriented banks and insurance companies. To address this risk, a government working group has recommended strengthening the macroprudential toolkit by introducing the Basel III counter-cyclical capital buffer (CCB), improving the classification of risk weights in mortgage lending, and broadening the SNB's power to request information from banks.

The financial sector is adapting to the new, more stringent regulatory environment, including the recently approved "too big to fail" legislation requiring systemically important banks to hold more capital than Basel III. After a marked improvement in 2010, the performance of the two large banks worsened in 2011, with income generation lagging other global peers. Although they comfortably fulfill current regulatory capital requirements, these banks still have a relatively thin layer of high quality capital and, given their business model, rely heavily on wholesale funding.

The fiscal position is healthy and government debt low, with a broadly neutral stance projected for 2012. Fiscal rules at both the federal and cantonal level and well-designed inter-governmental fiscal arrangements provide a foundation for fiscal discipline. In the medium-term, however, pressures from population aging are building.

**Executive Board Assessment**

Executive Directors noted that, notwithstanding Switzerland's strong economic fundamentals and policy frameworks, downside risks stemming mostly from the euro area crisis and vulnerabilities in the domestic financial sector clouded the near-term outlook. Against this background, Directors stressed the importance of pragmatic and flexible policy responses in the period ahead.

Directors considered the authorities' decision to continue to defend an exchange rate floor appropriate in light of the slow pace of activity and remaining deflation risks. They encouraged, however, the Swiss National Bank to return to a freely floating exchange rate regime once the growth and inflation outlook normalizes. In this context, Directors noted the dual risks of removing the exchange rate floor too soon or maintaining it for too long in the face of persistent capital inflows, and encouraged the authorities to exit from the current arrangement with great care.

Directors considered the authorities' fiscal plans appropriately calibrated to build buffers against contingent liabilities in the financial sector and the prospective budgetary impact of population aging. Nonetheless, should downside risks materialize, a number of Directors saw room for additional fiscal measures to support aggregate demand in line with existing fiscal rules. To better cope with the fiscal implications of population aging over the longer term, Directors advocated further reforms to the pension system, including measures to index benefits or the retirement age to life expectancy.

Directors commended the authorities for the passage of the "too-big-to-fail" legislation but emphasized the need for further progress in bolstering the loss-absorbing capital of systemically important banks. They noted that although these banks fulfill current capital requirements, there

is scope to raise their high-quality capital. Directors recognized, however, that more capital alone cannot fully eliminate “too-big-to-fail” risks and supported continued efforts toward improving bank resolution mechanisms and strengthening financial oversight, including by broadening in-house supervisory capacity.

Directors supported the steps taken to contain risks in the mortgage market and the real estate sector. Given constraints on monetary policy, they viewed macroprudential measures as the appropriate instruments to address such risks, and encouraged the authorities to consider a broad toolkit, including Basel III countercyclical capital buffers, increased risk-weights for riskier mortgage loans, and other macroprudential and fiscal measures.

Switzerland: Selected Economic Indicators, 2008–13

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| | | | | | Projections | |
| RGDP (percent change) | 2.1 | -1.9 | 2.7 | 1.9 | 0.8 | 1.7 |
| Total domestic demand | 0.5 | 0.6 | 1.6 | 0.9 | 0.9 | 2.0 |
| Final domestic demand | 1.3 | 0.0 | 3.0 | 1.8 | 1.2 | 1.7 |
| Private consumption | 1.4 | 1.4 | 1.7 | 1.0 | 1.1 | 1.5 |
| Public consumption | 2.7 | 3.3 | 0.8 | 1.7 | 1.0 | 0.7 |
| Gross fixed investment | 0.5 | -5.5 | 7.8 | 4.0 | 1.5 | 2.6 |
| Inventory accumulation 1/ | -0.7 | 0.6 | -1.3 | -0.8 | -0.3 | 0.2 |
| Foreign balance 1/ | 1.6 | -2.4 | 1.2 | 1.0 | 0.0 | 0.0 |
| Nominal GDP (billions of Swiss francs) | 545.0 | 535.6 | 550.6 | 564.8 | 570.5 | 583.9 |
| Savings and investment (percent of GDP) | | | | | | |
| Gross national saving | 23.3 | 30.3 | 34.3 | 34.6 | 34.1 | 34.3 |
| Gross domestic investment | 21.2 | 19.3 | 19.2 | 19.8 | 22.3 | 23.1 |
| Current account balance | 2.2 | 11.0 | 15.0 | 14.8 | 11.8 | 11.3 |
| Prices and incomes (percent change) | | | | | | |
| GDP deflator | 2.4 | 0.2 | 0.1 | 0.7 | 0.2 | 0.6 |
| Consumer price index | 2.4 | -0.5 | 0.7 | 0.2 | -0.5 | 0.5 |
| Nominal wage growth | 1.9 | 2.1 | 0.8 | 1.2 | 1.0 | 1.7 |
| Unit labor costs (total economy) | 2.9 | 4.5 | -2.0 | -0.6 | 0.2 | 0.0 |
| Employment and slack measures | | | | | | |
| Unemployment rate (in percent) | 2.6 | 3.7 | 3.8 | 3.1 | 3.4 | 3.6 |
| Output gap (in percent of potential) | 2.6 | -0.6 | 0.4 | 0.6 | -0.1 | -0.1 |
| Capacity utilization | 86.9 | 78.2 | 81.1 | 84.3 | … | … |
| Potential output growth | 1.6 | 1.3 | 1.7 | 1.7 | 1.6 | 1.7 |
| General government finances (percent of GDP) | | | | | | |
| Revenue | 34.5 | 34.9 | 34.3 | 35.2 | 34.9 | 34.8 |
| Expenditure | 32.6 | 34.4 | 34.0 | 34.7 | 34.7 | 34.6 |
| Balance | 1.9 | 0.5 | 0.2 | 0.4 | 0.2 | 0.2 |
| Cyclically adjusted ordinary balance | 0.9 | 0.7 | 0.1 | 0.2 | 0.2 | 0.3 |
| Gross debt 2/ | 52.6 | 53.6 | 50.1 | 48.6 | 48.9 | 47.8 |
| Monetary and credit (percent change, averages) | | | | | | |
| Broad money (M3) | 4.9 | 2.6 | 2.2 | 2.2 | … | … |
| Domestic credit, non-financial | 3.2 | 3.7 | 2.1 | 3.7 | … | … |
| Three-month SFr LIBOR | 0.7 | 0.3 | 0.2 | 0.1 | … | … |
| Yield on government bonds (7-year) | 2.7 | 1.8 | 1.3 | 1.6 | … | … |
| Exchange rates (levels) | | | | | | |
| Swiss francs per U.S. dollar (annual average) | 1.1 | 1.1 | 1.0 | 0.9 | … | … |
| Swiss francs per euro (annual average) | 1.6 | 1.5 | 1.4 | 1.2 | … | … |
| Nominal effective rate (avg., 2005=100) | 101.4 | 105.9 | 113.1 | 127.3 | … | … |
| Real effective rate (avg., 2005=100) 3/ | 97.9 | 101.6 | 107.5 | 118.0 | … | … |

Sources: Haver Analytics; IMF's Information Notice System; Swiss National Bank; and IMF Staff estimates.

1/ Contribution to growth.

2/ Reflects new GFSM 2001 methodology, which values debt at market prices.

3/ Based on relative consumer prices.

**Statement by Mr. Rene Weber, Executive Director for Switzerland**
**and Mr. Marcel Peter, Senior Advisor to the Executive Director**
**May 2, 2012**

On behalf of our Swiss authorities, we would like to thank the staff for once more putting together a substantive and helpful report. The authorities welcome the candid policy recommendations, which add considerable value to domestic policy discussions. In most respects, they share the staff's appraisal of the challenges going forward. The authorities also value the emphasis the report puts on the risks to the economic outlook, and they appreciate the risk matrix. They believe this report is a good example of the progress being made in improving risk assessments in Fund surveillance.

## Outlook

The IMF's latest scenario for the Swiss economy is very much in line with that of our authorities and most forecasters. While the domestic-oriented parts of the economy, like the construction sector, are faring reasonably well, the industries exposed to foreign competition remain under pressure. There is thus a high degree of heterogeneity within the economy.

However, while the labor market continues to perform well and leading indicators are pointing upward again, the economic outlook depends crucially on the international environment. The key assumption behind the authorities' expectation of a gradual recovery this year and next is that the euro area manages to progressively overcome its debt crisis. This prospect is, of course, far from ensured. There are also domestic risks, above all the rising imbalances in the Swiss housing market. The ratio of mortgage credit to GDP has reached an all-time high, and property prices have risen much faster than rents. The authorities thus agree with staff that uncertainty is high, and that the downside risks are significant.

One aspect where the authorities' view notably differs from the staff's is the output gap. Their estimate of the output gap suggests that it reopened in 2011 and is still negative.

## Monetary policy

In line with staff, our authorities consider the Swiss franc still overvalued. The overvaluation continues to generate deflationary pressures and represents a significant challenge to the export-oriented sectors. They share the staff's assessment that the introduction of the exchange rate floor in September 2011 was an appropriate policy response to the risk of deflation and economic contraction. In particular, and as emphasized by the staff, other policy options were limited, with policy rates at the zero lower bound, asset purchases constrained by the size of the bond market, and fiscal policy governed by the structural balance rule, the so-called debt brake (see below). The exchange rate floor is a tool that is

used to achieve the Swiss National Bank's (SNB) mandate of price stability, taking into account business cycle developments.

Our authorities emphasize that they will enforce the minimum exchange rate of CHF 1.20 per euro with the utmost determination. This floor will remain in place as long as warranted by the outlook for inflation and growth. The SNB stands ready to take further measures at any time if the economic outlook and the risk of deflation so require. This being said, the SNB agrees with staff's assessment that a return to a freely floating exchange rate regime is desirable, once economic conditions normalize.

**Fiscal policy**

Switzerland's government finances are sound. In 2011, the general government fiscal balance has been in surplus for the sixth consecutive year. This year, the fiscal position is expected to weaken somewhat as a result of slowing growth due to the continued strength of the Swiss franc and poor economic conditions in the EU. The social security funds (unemployment insurance) will be particularly affected by a renewed economic slowdown. In addition, the federal accounts will have to absorb the costs of structural tax reforms and the reduction in the SNB's distribution of profits.

In this context, our authorities stress their firm commitment to uphold the current fiscal strategy—namely compliance with the requirements of the debt brake rule in the short and medium term, and maintaining expenditure growth at a sustainable level. They consider a structurally balanced budget as the best way forward, especially in an environment of high uncertainty.

Our authorities remain skeptical on the use of discretionary fiscal policy to support aggregate demand. Switzerland's experience with fiscal stimulus measures has been mixed. Most recently, the stabilization programs in 2009-2010 as well as the measures adopted in 2011 to support the export sector demonstrated the difficulties of designing fiscal stimuli in a timely, targeted, and temporary manner. The main countercyclical role should thus be played by automatic stabilizers, which were strengthened through the introduction of the debt brake framework.

Regarding long-term fiscal pressures, our authorities share the Fund's assessment on the urgency to find a solution to the increasing costs of ageing. They consider fiscal rules a promising tool to ensure the financial stability of social insurances, while enabling parliament to retain discretionary power in this area. A fiscal rule has successfully been implemented for unemployment insurance, and a new rule is currently being debated in parliament for disability insurance. Designing a similar approach for public old-age pensions is more complex and will require great care, as this pay-as-you-go insurance is only one element of the three-pillar system.

**Financial sector policies**

Our authorities share the Fund's assessment of the main challenges to ensure financial stability: the need to strengthen the large banks' capitalization, implement organizational measures to increase resolvability, and address the risks associated with the build-up of imbalances in the domestic mortgage and real estate markets.

While our authorities agree with the staff's view that the large banks remain thinly capitalized according to high-quality capital indicators, including simple leverage ratios, they also note that they are well capitalized relative to peers in terms of regulatory Tier 1 capital. As highlighted by the staff, the comparatively low CDS spreads for the large Swiss banks suggest that markets consider them well prepared to withstand financial turmoil. Nonetheless, our authorities agree with the staff that progress to strengthen the quantity and quality of capital is needed.

Our authorities are committed to addressing the weaknesses exposed by the financial crisis. Work is well under way to implement advanced regulatory and supervisory frameworks. While the Basel III framework is due to enter into force on January 1, 2013, a comprehensive SIFI/TBTF-framework and a fully risk-based insurance supervision (Swiss Solvency Test, SST) are in place. The SIFI legislation does not only aim at increasing the resilience of systemically important banks but also establishes strong incentives for these institutions to reduce their systemic impact and to improve their global resolvability. Our authorities share the staff's view that this legislation will be instrumental in reducing systemic risk in the domestic banking system.

**Macroprudential framework**

Our authorities broadly share the staff's view on the need for macroprudential instruments to address the risks stemming from developments in the domestic mortgage and real estate markets. The counter-cyclical buffer is designed to target imbalances building up in particular market segments, such as residential mortgages. The proposed activation process ensures that a decision is taken within two months at the most, which the authorities consider sufficiently timely. Also, our authorities stress that the 12 months granted to banks to raise capital levels constitute a maximum. In case of substantial undesirable developments, shorter deadlines would be imposed to increase the stabilizing effect of the buffer. With regard to the minimum affordability ratios proposed by the staff, the FDF and FINMA are in discussions with the banks on tightening the self-regulation pertaining to the mortgage market. Such enhanced industry standards could have a similar effect like an affordability ratio, while avoiding an overly interventionist approach.

Our authorities share the staff's view on the preferential tax treatment of mortgage interest payments. From a financial stability view, and as elaborated on in the February 2012 report of the joint Financial Stability Working Group, policies that promote excessive household indebtedness should be avoided. However, the authorities note that a reform aimed at reducing or eliminating the tax deductibility of mortgage interest payments is currently not likely to obtain the necessary political support.

**Financial Sector Stability Assessment**

As a member with a systemically important financial sector, Switzerland is committed to meeting its obligation to conduct a mandatory Financial Sector Stability Assessment within the agreed cycle. The Swiss authorities have requested such an assessment under the FSAP that is scheduled to take place towards the end of 2013.