

Switzerland: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the 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 2011 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 28, 2011, 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 28, 2011. 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 18, 2011 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the 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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SWITZERLAND

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

April 28, 2011

KEY ISSUES

Growth prospects: Switzerland is experiencing a strong expansion. The recovery has been broad based, with output and employment now above pre-crisis levels. While domestic demand should remain resilient, currency strength and an expected weaker external environment should induce a slowdown, from 2.6 percent in 2010 to 2.4 percent in 2011 and 1.8 percent in 2012. Inflation should remain muted. Main risks relate to international developments, through their possible impact on external demand, supply conditions, or the currency. Longer-run risks to growth are linked to a slowdown in construction and structural changes in the financial sector.

Policy stance: With the output gap closing and a below neutral policy interest rate, monetary accommodation should be withdrawn in the near-term under the baseline scenario. Foreign exchange intervention should be limited to offsetting excessive volatility. Monetary policy tightening will ensure that demand pressures remain moderate and will be consistent with a neutral fiscal stance, as envisaged under the fiscal rule. With government debt at 53 percent of GDP and the budget close to balance, a sound fiscal position should be preserved, including through long term sustainability reforms.

Financial stability: The performance of the financial sector is improving, but areas of vulnerability remain. Gradual interest rate normalization may not be sufficient to address growing interest rate and credit risks associated with mortgage lending, where lending standards are deteriorating. Preventive action, through targeted policy measures, such as system-wide affordability limits or maximum loan-to-value ratios, would be prudent. The legal mandates and powers of FINMA and the SNB in addressing macro-prudential risks should be clarified.

Regulatory and Supervisory Reforms: Priorities include: (i) the approval of the systemically important financial institution (SIFI) legislation; (ii) preserving the additional capital buffers that are at the center of the "too big to fail" proposal; and (iii) continued efforts to strengthen prudential supervision.

Approved By
Anne-Marie Gulde-Wolf
and David Marston

Discussions took place from March 18–28, 2011. The staff team comprised Ms. Waysand (SPR), Messrs. Ross, Tressel; Ms. Xiao, Ms. Detragiache (EUR). Atilla Arda (LEG) joined the mission.

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CONTEXT

1. With output and employment above pre-crisis levels and robust growth, the authorities now face a number of policy challenges. Protracted low interest rates and abundant liquidity implemented during the financial crisis have led to increased risks in the

domestic mortgage market. Although progress has been made in strengthening financial supervision and regulation, comprehensive decisions on addressing systemic risks posed by large banks as well as revisions to the macro-prudential framework are still in train.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Background

2. The economy has experienced a strong recovery. After falling by 1.9 percent in 2009, output grew by 2.6 percent in 2010. The recovery has been broad based, with most sectors returning to pre-crisis levels. Notable exceptions include construction and insurance, which were little affected by the crisis, and financial intermediation, which has not fully rebounded (Figure 1).

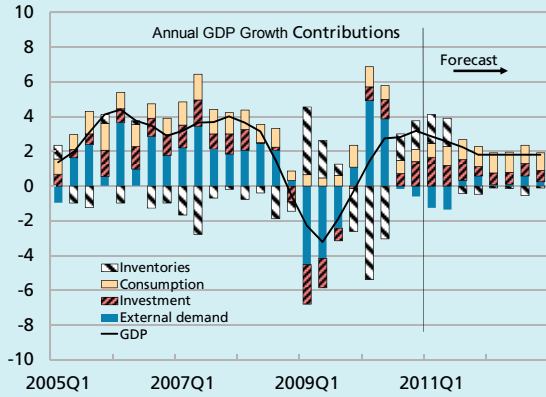
3. Both domestic demand and exports have been supportive. Domestic demand was underpinned by sound balance sheets, low interest rates, and a pick up in employment and immigration. Exports picked up more strongly than expected, on the back of robust external demand and in spite of a 10 percent appreciation in the real exchange rate (Box 1). The growth in goods exports has remained surprisingly brisk, at 10 percent in real terms year-on-year in February of 2011, down from

a peak of about 15 percent over the summer of 2010. The current account surplus has moved from 2.3 percent of GDP in 2008 to 14.2 percent in 2010, as investment income (FDI) flows rebounded, and the trade balance surplus remained well above 3 percent of GDP.

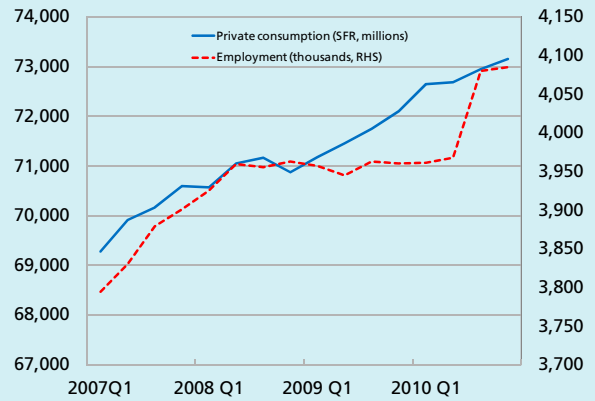
4. The slack in the economy is shrinking. Capacity utilization is around its long-run average in manufacturing, and above that level in construction. Unemployment has decreased to 3.3 percent compared with a high of 4.1 percent during the crisis and a low of 2.5 at the trough of the cycle. Recourse to short-time work schemes has dropped and the number of jobs has picked up by 1.2 percent over one year.

Figure 1 Switzerland—Recent Economic Developments

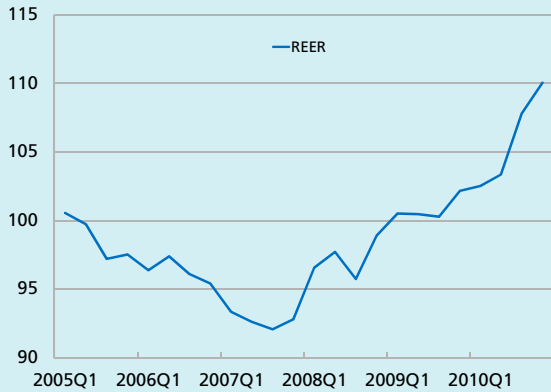
The uptick in economic activity has been strong, and is increasingly led by private domestic demand.



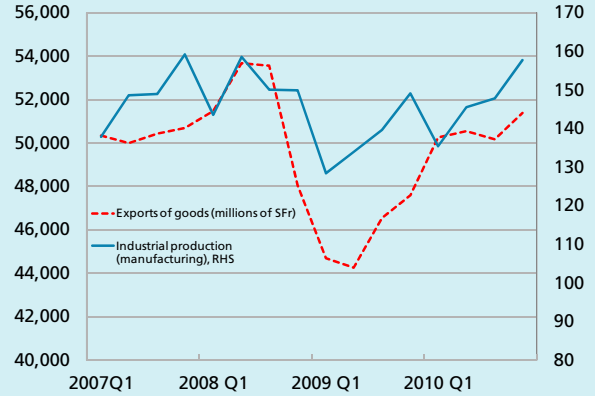
Employment has picked up and consumption remains robust.



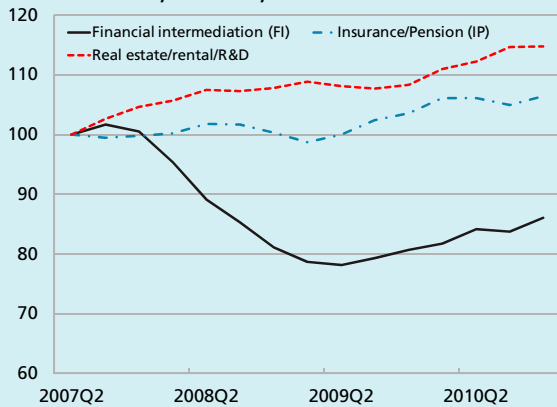
Despite REER appreciation of CHE,...



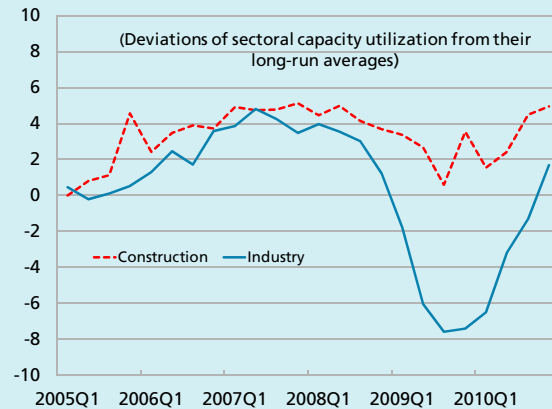
...industrial production has rebounded on the back of dynamic exports...



...outside of financial intermediation, financial services have picked up.



Slack measures indicate a rapid tightening.



Sources: Haver; SNB; and IMF staff estimates.

Box 1 Impact of the Appreciation of the Swiss franc on Exports and Prices

In spite of the recent appreciation of the Swiss franc, performance of the export sector remains satisfactory.

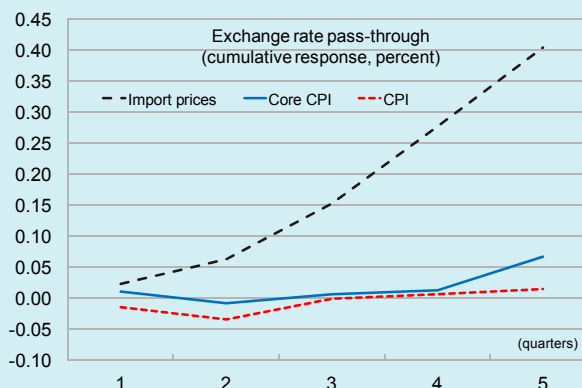
The real effective exchange rate is back at its 1995 peak, but indicators of export performance suggest that exporters remain competitive. Export market shares in goods remain strong, particularly in advanced economies.¹ The trade surplus in goods has risen gradually, driven by trade with non-euro area countries and emerging markets (Switzerland, however, has a structural deficit vis-à-vis the euro area).

The appreciation might dent export performance going forward, with effects differing across export markets.

Estimates of aggregate export exchange rate elasticity indicate that long-run elasticities are significant; with an elasticity of goods exports to the nominal effective exchange rate of about 0.8 (see *Selected Issues Paper*). This aggregate elasticity may reflect not only the direct dampening effect on foreign demand, but also the indirect competitive pressures from trading partners in common export markets. However, estimates based on the analysis of bilateral exports suggest little price elasticity of exports to the euro area, which account for 50 percent of exports, and are mostly driven by demand factors. In contrast, exports to fast growing emerging economies appear more elastic to the NEER, with estimates varying between 0.7 and 1.

The appreciation of the Swiss franc could also affect monetary policy decisions to the extent that it feeds into domestic prices.

A high pass-through might contribute to downward dynamics of core inflation if inflation expectations are negatively affected. However, the existing literature has generally found a low pass-through to consumer prices in developed countries, even if the pass-through to import prices is usually significant, thus allowing expenditure switching effects of exchange rate movements.



Source: Staff estimates.

Estimates for Switzerland confirm that the pass-through to consumer prices is low, implying that the appreciation of the SFr is unlikely to weigh down on consumer prices significantly. Estimates based on an error-correction model suggest that while the impact of the appreciation is high on import prices, the “long-run” exchange rate pass-through for core CPI is very low, between 2 and 4.7 percent.

¹Survey results indicate that manufacturing firms’ margins are negatively affected by the strength of the Swiss franc. Still, volumes have grown faster than expected given foreign demand and exchange rate strength.

5. Still, inflationary pressures remain relatively muted. Robust growth, low interest rates, ample amounts of liquidity, and the surge in oil prices have not translated into high inflation. As of March, headline inflation is 1.0 percent year-on-year with core measures below 1.0 percent. In 2010, nominal wages grew by 1 percent (½ percent in real terms). Thanks to a pick up in productivity, in line with the recovery, unit labor costs fell by 1.5 percent. Wage demands remain subdued according to latest surveys.

6. Concerns regarding real estate and mortgage lending developments have intensified. With real estate prices and mortgage lending volumes continuing to expand, questions regarding loose lending practices have risen (Box 2). While aggregate price indices do not point to an overall misalignment, there are pockets of excesses. For its part, the SNB has stressed that lending standards at some institutions are being relaxed, and that exceptions to lending policies have increased. Anecdotal evidence on rising loan-to-value (LTVs) ratios at some institutions, and the use of second pillar pensions as collateral supports this claim.

Box 2 Are Risks in Residential Construction and Mortgage Markets Rising?

Net immigration flows, low interest rates, and supportive real incomes continue to underpin the Swiss real estate market.

While the growth in residential real estate prices appears relatively subdued in international comparison, prices have accelerated of late. Analysts have also noted the presence of “hot spots” with larger price increases in specific areas (notably Geneva, Zug, and Zurich).

Affordability indicators do not yet show overall significant signs of misalignment. Separately, the ratio of owner occupied apartment prices relative to rental apartment prices has risen sharply from the early 1990s to 2000, reflecting the impact of rent regulation, but it has flattened since then.

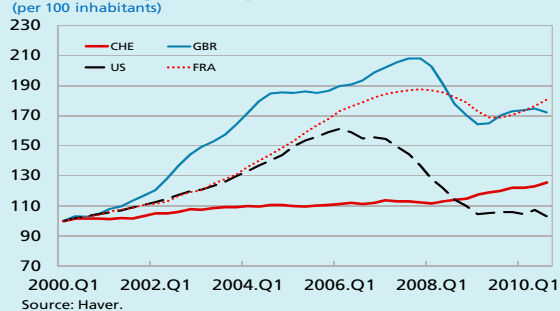
Still, the level of activity in the sector appears elevated, even taking into account population growth due to immigration, suggesting that only some of the growth in activity is due to demographics.

Part of the expansion may be fueled by a relaxation of lending practices. SNB survey data indicates there are substantial “exceptions to lending standards”. In 2009, banks with a total market share of about 25 percent reported exceptions to lending policy for more than 20 percent of new mortgage loans (see Figure 3, final panel). In addition, a sizable portion of the banks failed to respond to the survey—exacerbating uncertainty.

In their internal lending standards, banks assume certain interest rates and maintenance costs for prospective borrowers in order to determine affordability of a mortgage. The long-term average rate on mortgage loans is close to 5 percent, with rates in the 1990’s persistently above 5.5 percent. However, survey data indicates that in 2009, banks with 27 percent market share assume an interest rate of less than 5 percent and maintenance costs of less than 1 percent, suggesting insufficiently conservative affordability criteria.

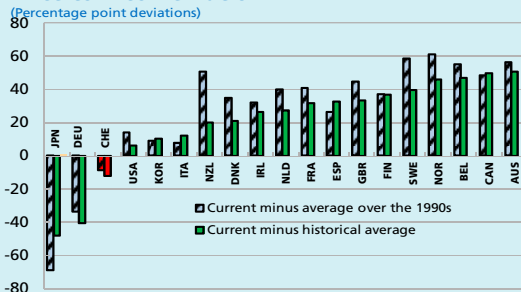
While low, Swiss real estate price inflation has accelerated since late 2008.

Swiss Housing Starts (apartments)



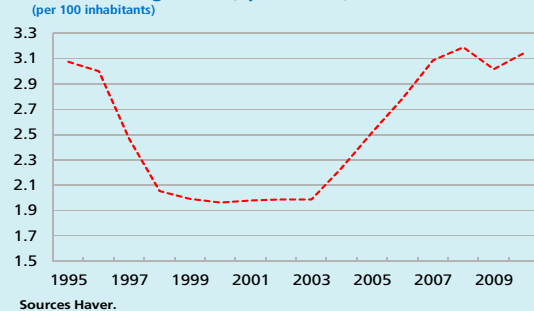
House prices are still below historical averages in relation to household income

Price-to-Income Ratio



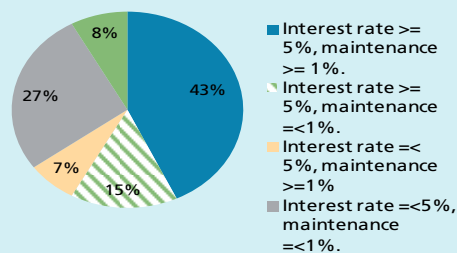
Building relative to population has jumped.

Swiss Housing Starts (apartments)



Internal Lending Standards

Market Share of Banks, by Imputed Interests and Maintenance Costs, in %



B. Outlook and Discussions

7. The recovery should moderate in the near-term. While domestic demand should remain resilient, currency strength and an expected weaker external environment should slow exports. GDP should grow by 2.4 percent in 2011 and 1.8 percent in 2012. The Swiss National Bank (SNB) expects growth to be approximately 2 percent in 2011, while the ministry of the economy (SECO) is projecting around 2 percent for both years.¹ Both staff and the authorities saw little slack left in the economy but agreed that inflation is expected to hover around 1 percent in 2011–12², as wage demands remain contained. Staff estimates point to a limited exchange rate pass through effect on inflation.

8. However, the degree of export resilience is a key question. The authorities agreed with staff's view that exports have been more resilient than expected from export equations. They noted that some of the impact of the appreciation of the currency was still to come, as most of the appreciation occurred in the second half of 2010, and that tourism exports had already been hit hard by the strong currency. Staff pointed out that longer-than-usual transmission lags of the appreciation of the Swiss franc might explain some of the observed resilience of exports, but that structural changes (such as an increase in the share

¹ Model estimates (such as the one used by KoF) indicate a limited direct effect of oil prices on the economy, reflecting a low share of oil expenditures/GDP and a relatively low share of energy prices in CPI.

² A methodological change regarding clothing and footwear surveys should add 0.2 to 0.3 pps to the headline rate in 2011 due to base effects.

of trade with BRICs in the last few years) may also play a role.

9. While the impact of the crisis on potential output appears limited, a number of factors may still reduce long-run growth. Staff estimates—which are broadly in line with the authorities'—indicate that potential output growth fell to 1.4 percent in 2009, but returned to 1.8 percent in 2011. However, construction and financial intermediation, which contributed around 17 percent of Switzerland's growth since 2003, may falter going forward. Financial sector commission and fee income remains very low, and may have been affected by structural changes, including in private banking. Still, it is too early to definitively state how the financial crisis may have impacted long-term growth prospects. Also, the sustainability of buoyant housing activity (construction and real estate/rent) is unclear, especially as interest rates normalize.

10. Risks mainly relate to international developments. International developments, notably in the euro area, are seen as the main source of uncertainty. Stronger-than-envisaged growth in trading partners or a reduction of euro area debt concerns would constitute upside risks. Recent foreign developments in the Middle East and in Japan could constitute downside risks if they resulted in a further persistent increase in oil prices or disrupted supply chains, as would renewed tensions in the euro area, which could also put pressure on the currency.

MACROECONOMIC POLICY DISCUSSIONS

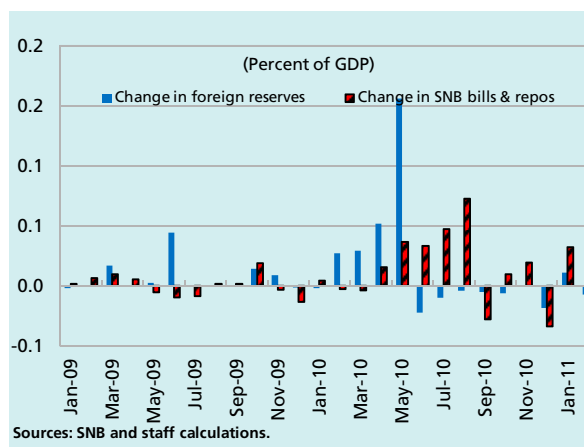
A. Monetary and Exchange Rate Policies

Background

11. The SNB has maintained an expansionary stance. Since January 2009, the SNB has left its target range for the three-month Libor rate unchanged at 0.0–0.75 percent and signaled its intention to keep the Libor at around 0.25 percent. Also, between March 2009 and June 2010, the SNB conducted foreign exchange interventions. In 2009, interventions were conducted to prevent an appreciation against the euro. From December 2009 until June 2010, the intention was to prevent only “excessive” appreciation.

12. Faced with a surge in capital inflows, the SNB intervened heavily in foreign exchange markets in 2010. Between February and April, foreign exchange reserves increased by SFr 59 billion (about 10 percent of GDP), and by an additional SFr 88 billion (16 percent of GDP) in May as the euro area sovereign debt crisis was developing. The operations were mainly in euro-denominated financial assets and, in line with the goal of loosening monetary conditions, were not sterilized until spring 2010, when the SNB started to mop up liquidity by net new issuance of SNB bills (about 20 percent of GDP between April and August). In mid-2010, the SNB noted that the threat of deflation had largely disappeared and while it stressed it would continue to take necessary measures to ensure price stability, interventions ended. Overall, the Swiss franc has appreciated by 10 percent in real effective terms since March 2010.

13. Despite substantial exchange rate appreciation, monetary conditions remain accommodative. While the appreciation has partially offset the decline in real interest rates, with ample liquidity, the growth of monetary aggregates (8–9 percent) and credit (5 percent) remains high (Figure 2). The SNB has repeatedly pointed to the volume of mortgages—and lending standards—as a concern. However, headline inflation is expected to be around 1 percent for 2011 despite a closing output gap. Markets price in a 50 bps increase in the policy rate by the end of the year.



14. The interventions resulted in a sharp increase in foreign currency holdings and in central bank valuation losses. The SNB balance sheet reached 50 percent of GDP at end-2010. The capital-to-asset ratio has fallen to 16 percent compared to 52 percent at end-2007. The SNB reported a loss of SFr 21 billion in 2010, reflecting a marked-to-market loss on the foreign exchange

position.³ The bank nevertheless distributed dividends to the cantons and Confederation as usual. The provisions to the currency reserves were reduced to SFr 0.7 billion from the originally planned SFr 4 billion.

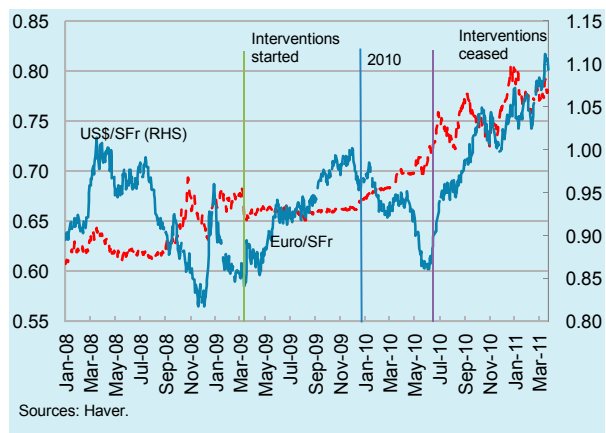
Discussions

15. In absence of significant shocks, normalization of interest rate should begin in the near term.

While inflation expectations remain well anchored, the current interest rate stance is unsustainable as slack is disappearing in the economy. The SNB stated that conditional (no policy change) inflation forecasts show that the current expansionary monetary policy cannot be maintained without compromising price stability in the medium term. The SNB is confident that it is in a sound position to steer the LIBOR rate over time to the level required to maintain price stability with its monetary instruments (reverse repos and SNB bills). Staff and the authorities agreed that exiting the prolonged period of near-zero interest rates will contribute to reducing macro-financial concerns associated with a weakening of mortgage lending standards, but concerns related to the real estate market should also be addressed by macro-prudential instruments.

16. Staff noted that SNB interventions mainly reduced the volatility of the euro/SFr exchange rate. While the Swiss franc experienced wide fluctuations vis-à-vis the US dollar, the interventions reduced the volatility in the SFr / euro

exchange rate, as also confirmed by VIX measures.



17. The SNB, however, argued that the 2010 foreign exchange interventions ensured price stability. Given the zero bound on interest rates, in 2010, the SNB wanted to prevent an excessive tightening of monetary conditions via a stronger Swiss franc, because of deflationary pressures in an uncertain economic environment. The interventions are judged successful, in that they temporarily stabilized the exchange rate and prevented deflation.

18. While staff saw no clear evidence of a current misalignment, the authorities felt that the exchange rate was overvalued. Although the SFr is on the high side in a historical perspective, a CGER based analysis, together with continuing robust trade and stable export market shares, suggest that the currency is not misaligned and is still broadly in line with medium-term macroeconomic fundamentals (Box 3). The SNB's view, based on a combination of a simple PPP approach and an equilibrium real effective exchange rate model, does not take into consideration current account developments as they are seen to be largely influenced by structural factors.

³ Foreign currency losses of SFr 26 billion were partly offset by 5 billion in gold valuation gains. With SFr 2.5 billion in profit distributions to the Confederation and cantons, the "distribution reserve" account was reduced by SFr 25 billion, and now stands at SFr -5 billion.

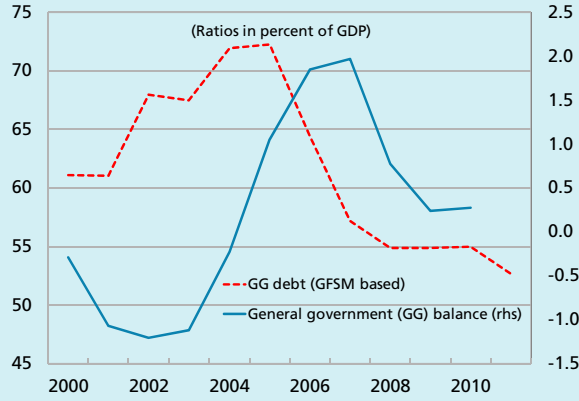
19. Staff stressed that future foreign exchange interventions, if any, should be limited to smooth disorderly movements of the exchange rate. Past foreign exchange interventions smoothed out excessive volatility in the foreign exchange market but staff emphasized that the 2010 experience illustrated the difficulty of leaning against the wind when experiencing significant capital inflows.

20. Questions regarding SNB capital, reserves, and balance sheet management were a key point of discussion. Staff questioned the 2010 distribution of non-existent gains and noted that, going forward, the SNB should give priority to replenishing its capital over distributions of gains to the cantons and Confederation. The level of international reserves and capital should be commensurate with the size and international activities of the financial sector.

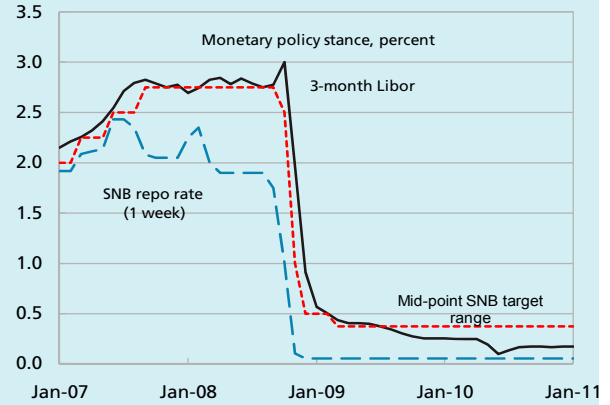
21. The SNB indicated that while 2010 valuation losses were large, they were still tolerable in view of past accumulated surpluses in the distribution reserve. In this respect, the 2010 distribution to cantons and the Confederation was seen by the SNB as still consistent with past agreement, as the position of the distribution reserves was still above a -5bn SFr threshold. To mitigate exchange rate risk, the SNB diversified foreign exchange reserves away from euro-denominated assets (which currently account for around 50 percent of reserves). It will set up a task force to reassess its medium-term desired size of reserves. Future distributions of gains would be set as part of a medium-term strategy, taking into account capital needs.

Figure 2 Switzerland—Fiscal and Monetary Policies

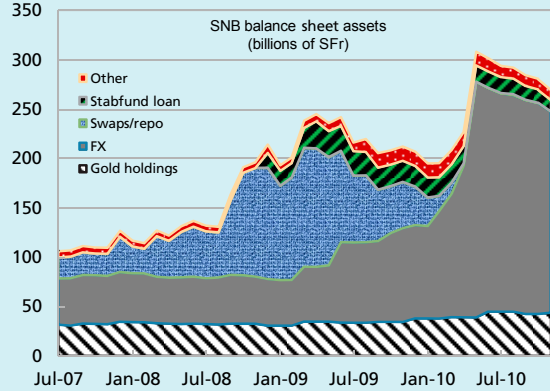
Fiscal policy has been little used during the crisis, resulting in persistent surpluses and declining debt levels



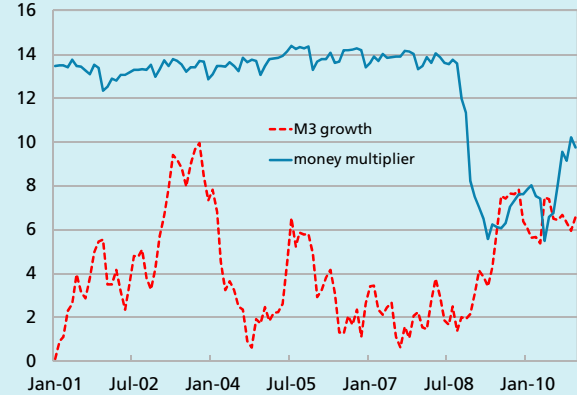
Monetary policy has been expansive with near zero interest rates...



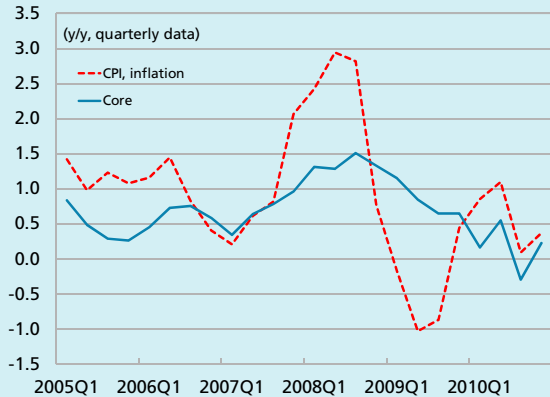
...while foreign exchange intervention has sharply expanded the SNB balance sheet ...



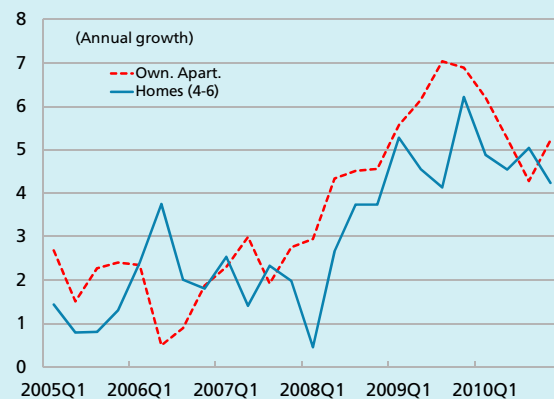
...and liquidity in the system remains ample.



Nevertheless, inflation remains muted...



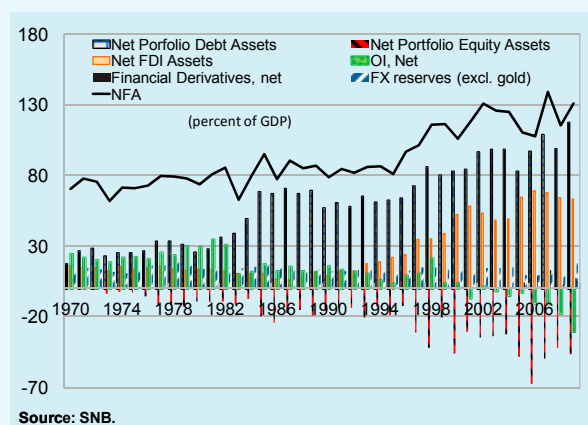
...even as housing prices have increased.



Sources: Haver; SNB; and IMF staff estimates.

Box 3 Switzerland's Net Foreign Asset Position and External Balance Assessment

Switzerland's net foreign asset position (NFA) has risen steadily for several decades, reaching 130 percent of GDP at the end of 2009. The upward trend has been a consequence of saving-investment surpluses. While net investment in fixed income securities remains predominant, Swiss multinationals have increasingly invested abroad resulting in a net FDI position of 63 percent of GDP at the end of 2009. In contrast, as a result of the large mutual fund industry, and because a large share of these multinationals' stocks is owned by non-residents, Switzerland has large net portfolio equity liabilities estimated at 46 percent of GDP at the end of 2009.



	MB2 ^{1/}	ES2 ^{1/}	ERER	Average
Spring 2009	5	-8	5	1
Fall 2009	4	-7	6	1
Spring 2010	1	0	8	3
Fall 2010	2	-1	14	5

Source: CGER (ERER), staff estimates based on CGER (MB2 and ES2)

^{1/} Medium-term CA adjusted for BoP accounting of multinationals' direct investment income and capital gains on equity liabilities to non-resident shareholders (implying a total downward adjustment of 4 percent of GDP for Fall of 2010)

However, the accounting treatment of reinvested earnings and capital gains tends to inflate the current account (CA). Most of the earnings of the multinationals are not paid out as dividends, but are reinvested abroad. These are recorded as direct investment income in the current account, with an offsetting FDI outflow in the financial account. At the same time, capital gains of non-resident investors of Swiss stocks are not recorded as portfolio income outflows. These two factors are subtracted to get a better assessment of the residents' saving-investment balance. Assuming a 3 percent return on multinationals' earnings resulting in capital gains, and subtracting an estimated 3 percent net direct investment income from the current account (estimated from historical data), the required overall downward adjustment in the CA reaches about 4 percent of GDP.

Taking into account these corrections, estimates drawing on the CGER methodology suggest the SFr is still broadly in equilibrium, in spite of its appreciation.¹ According to the latest estimate of the External Sustainability approach, the medium-term corrected CA is about in line with what is required to stabilize the net foreign asset position, while it was estimated to be above in 2009. According to the Macro Balance approach, the medium-term corrected CA is also broadly in line with its medium-term fundamentals (the fiscal balance, demographic factors, the oil balance, the income level and output growth). The Equilibrium Real Exchange Rate approach implies an overvaluation driven by the recent nominal effective appreciation above its historical average and given stable terms of trade.

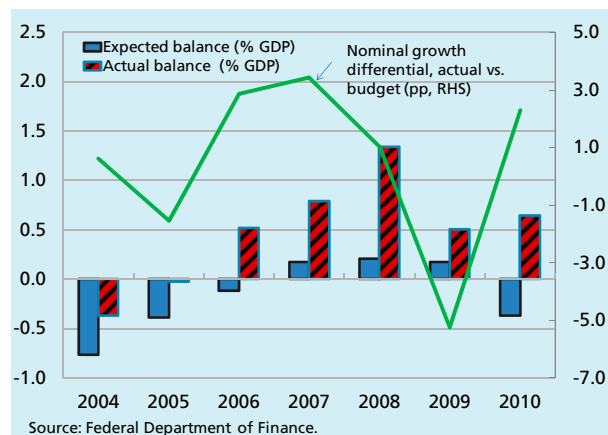
¹ According to the Spring 2011 CGER assessment, the Swiss franc remains broadly in line with fundamentals despite a REER close to historical highs.

B. Fiscal Policy

Background

22. The Swiss fiscal position has been little affected by the crisis. With limited fiscal stimulus measures during the crisis (0.4 percent of GDP at central government level, and an estimated 1.4 percent overall) and relatively small automatic stabilizers, Switzerland is exiting the crisis with comparatively strong fiscal balances. The central government balance reached a surplus of 0.5 percent of GDP in 2010, compared with 0.8 percent in 2007, while the general government also remained in surplus (0.2 percent of GDP in 2010 compared with 1.9 percent in 2007) despite a sharp increase in the social security deficit. Overall, the general government debt-to-GDP ratio is at 55 percent of GDP on a GFSM basis (down from 57 percent in 2007).

23. Persistent over-performance at the central level can be tied to recurrent conservative revenue and expenditure forecasts. The “debt brake rule”, requiring a structural balance over the cycle for the Confederation budget has been regularly over-achieved over the last six years mainly on the back of stronger than expected revenues, including from withholding and income taxes, and under-spending. This has led to regular structural surpluses and a build-up of some SFr 15 billion (3 percent of GDP) since 2007 in the nominal compensation account. Given that only structural deficits are clawed back in future budgets, these surpluses have gone toward debt reduction.



24. The fiscal stance is expected to be broadly neutral in the near term. Under the baseline scenario, small surpluses are expected to persist at the general government level over a medium-term horizon. At the Confederation level, the surplus will be negatively affected in the next few years by envisaged tax reforms (including the elimination of stamp taxes on bond issuance and corporate taxes on reinvested capital) and reduced future distributions of SNB gains. This will be compensated by a planned consolidation, in accordance with the “debt brake” rule (0.5 percent of GDP over three years).

25. Recent attempts to limit imbalances due to ageing pressures were not fully successful. Ageing-related expenditures are expected to rise by 5 percent of GDP by 2050.⁴ Parametric reforms of old age insurance, aimed at increasing the female retirement age (from 64 to 65 years), was defeated in Parliament. In addition, a government proposal to reduce pension fund conversion rates from 6.8 to

⁴ Report on the long-term sustainability of public finances in Switzerland, Federal Department of Finance, April 2008.

6.4 percent by 2016 was not accepted in a national referendum.

26. However, unemployment insurance has been significantly reformed. To tackle the structural deficit of the unemployment insurance system (about SFr 1 billion annually), the contribution rate has been increased from 2.0 to 2.2 per cent of annual salary (up to a limit of SFr 126,000) and a solidarity contribution of 1 per cent has been introduced for salaries between SFr 126,000 to 315,000. At the same time, compensation will be more closely tied to contribution periods, and waiting periods, based on income, will be extended. These two reforms should enable the system to get back to balance.

Discussions

27. While the reduction in debt levels is helpful from a sustainability point of view, staff noted that the debt brake rule did not appear to be implemented as originally envisaged. The authorities agreed that structural surpluses had accumulated, and stressed that internal budgetary reforms should improve the accuracy of their projections. They agreed revenues had been underestimated and spending over-estimated, which had led to the persistent over-performance. Estimates of income and withholding taxes are now being revised upward to better reflect trends. On the spending side, the extension of performance based budgeting, which provides for more reallocation possibilities, is seen as a way to reduce the need for spending units to include budgetary cushions.

28. Staff supported adherence to the debt brake rule and emphasized the importance of addressing longer-term budgetary issues.

Continued adherence to the debt brake rule is consistent with the need for fiscal prudence in a country with a large financial sector, and in view of ageing pressures. Implementation of the rule, however, should be improved. At this juncture, and given the need for a gradual tightening of monetary policy, a neutral stance is appropriate. Attention should also focus on medium-term challenges. There is, in particular, a need for a parametric reform of the old age insurance system.

29. While noting some progress, the authorities recognize that sustainability of public finances should be further improved.

The authorities are well aware that sustainability of old age insurance is still not ensured. The authorities are considering applying automatic remedial actions on benefits and contributions to disability and old age pensions if funds fell below certain thresholds. Previous attempts to implement fiscal rules to these accounts have failed in Parliament in the past; however, the Federal Council has signaled its intent to continue to pursue this legislation.

30. The authorities indicated that fiscal equalization between the cantons and Confederation has been successful.

Earmarked or restricted transfers have been reduced while unrestricted transfers have expanded—significantly improving cantonal financial autonomy. The minimum level of per capita tax revenue (85 percent of the Swiss average) has been reached for all but two cantons, while cantonal tax competitiveness has

been maintained. Based on the report on fiscal equalization effectiveness, the Federal Council has proposed to retain the current system for the next

four years (2012–15), with a small increase in the Confederation's contribution.

FINANCIAL SECTOR POLICIES

A. Financial Sector Stability

Background

31. Large public intervention—along with a rebound in international markets—has stabilized the financial sector. In addition to providing ample liquidity, the SNB set up a bad-bank scheme (the “Stabilization Fund”) for UBS with \$39 billion of assets, while the government injected capital (SFr 6 billion)—before exiting in August 2009. The authorities also increased the deposit insurance coverage and announced a tightening in capital and liquidity requirements. In 2010, banks generally reported higher profitability, better asset quality, and stronger capital and liquidity buffers (Figure 3).

32. Large banks remain highly leveraged, dependent on wholesale funding, and need to improve the quality of their capital. Despite comfortable Tier I regulatory ratios, more stringent indicators such as tangible common equity ratios position the large Swiss banks at the bottom relative to peers, reflecting their large recourse to lower quality capital. In addition, the banks remain highly leveraged relative to peers, and their business model is based on heavy reliance on wholesale funding. Cross-border exposures are also comparatively large (see Annex I). Market assessment of the banks' credit risk has improved sharply since the height of the crisis, but remains above pre-crisis levels.

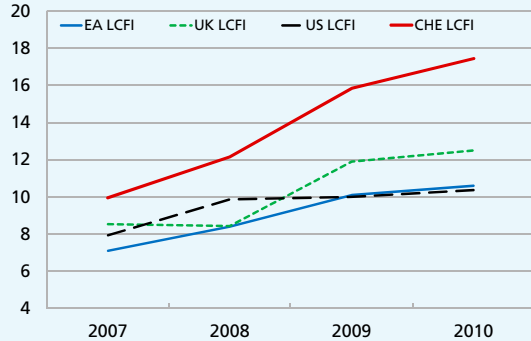
33. While less leveraged, domestically-focused banks are exposed to the domestic mortgage market. Because of competitive pressures, interest margins and profitability are falling for domestically-oriented banks. Less favorable refinancing conditions as interest rates go up will weigh on bank interest margins. In addition, cantonal and cooperative banks have the bulk of their assets in Swiss mortgages.

34. Credit and interest rate risks are increasing in mortgage lending activities. An environment of low interest rates, abundant liquidity, and strong competition has led to an increase in risk taking. There is evidence of declining lending standards in the mortgage market, including vis-à-vis less affluent households. In addition, the sensitivity of banks' balance sheets to interest rate risk has increased, as fixed-rate longer maturity mortgages are becoming more common and hedging practices by banks have not kept up.

Figure 3 Switzerland—Financial Sector Developments 1/

Regulatory capital ratios of the big banks have improved...

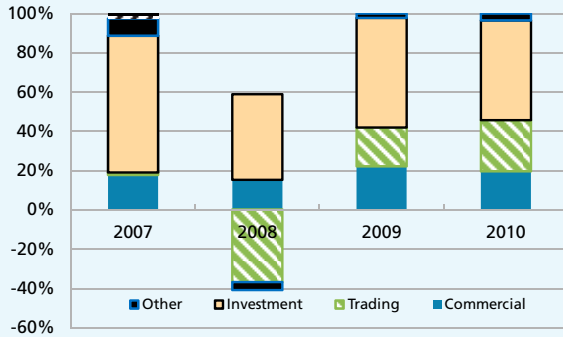
Tier 1
(Percent)



The rebound in revenue is driven by trading and investment banking...

Revenue Sources of the Big Swiss Banks

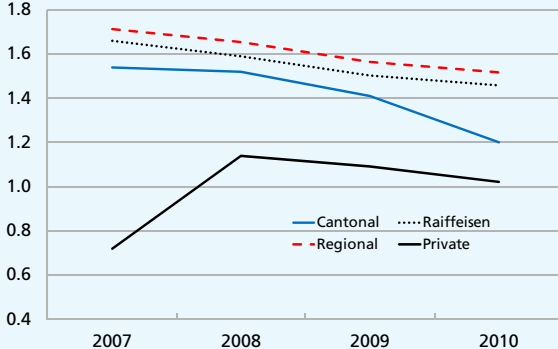
(SFr billions)



Increasing competition has led to falling interest margin of domestic banks...

Net Interest Margin

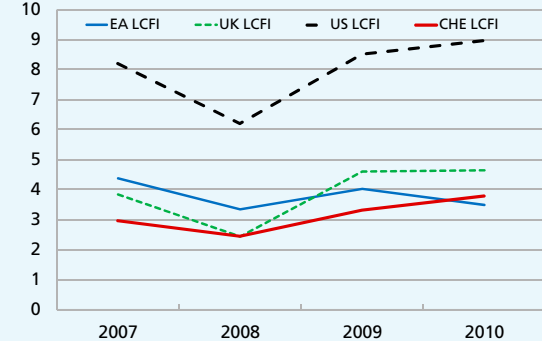
(Percent)



1/ Accounting differences are not adjusted.
Sources: Haver; SNB; and IMF staff estimates.

...but leverage remains high.

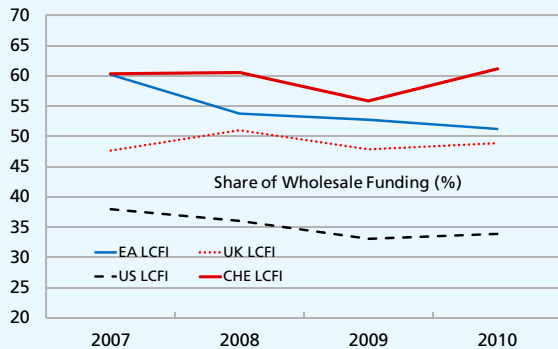
Equity/Assets
(Percent)



...and the big banks continue to rely heavily on wholesale funding.

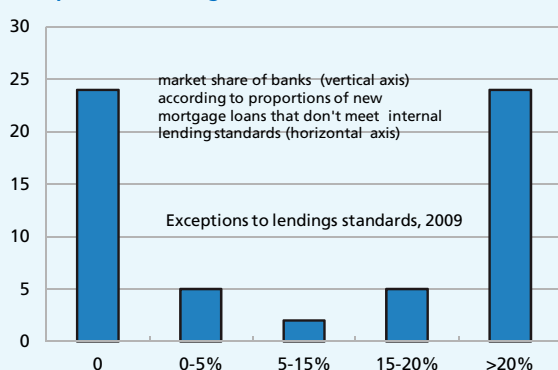
Share of Wholesale Funding

(Percent)



...and exceptions to lending standards have risen.

Exceptions to lending standards, 2009



35. Reforms in the regulatory environment will force changes. Adaptation to more stringent capital and liquidity requirements has already begun and will continue in the medium term. This process will likely induce some changes in business models, especially for the more complex institutions operating cross-border, and may weigh on profits.⁵ In the private banking segment, there is a need to continue to adapt to higher standards on client tax compliance. A possible reduction in tax-sensitive wealth management flows may induce some consolidation over the medium (see Annex II).

36. In the insurance sector, implementation of the Swiss Solvency Test (SST) has made an impact. The SST came into full effect from the beginning of this year (see Annex III). Switzerland is the first country to move towards risk-based insurance supervision. All insurance companies must accrue risk-bearing capital required to cover their target capital. Failure to meet the test has already triggered corrective measures in some companies.

37. Some insurers may find it challenging to meet the SST and some pension funds remain underfunded. The current environment of low interest rates is particularly difficult for life insurers, given negative spreads between earnings and guaranteed payouts. Non life insurers are less affected by low interest rates and benefit from positive results, but competition is increasing. Reinsurance companies exhibit improved (and/or solid) recapitalization and solvency margins. Preliminary claim estimates from Japan's earthquake

⁵ Acknowledging the changed environment, Credit Suisse revised down its medium-term return-on-equity target from 18 percent to 15 percent.

and tsunami indicate that the cost is manageable (nuclear contamination is not covered). Pension fund performance has improved, but under funding remains widespread, especially for funds with a public guarantee.

38. On the asset side, exposure to Swiss real estate is substantial for some insurers. Overall, about 14 percent of insurance companies' investments are in real estate, mostly in Switzerland. Should a "boom-bust" pattern develop, the insurance sector, along with domestically-oriented banks, would be affected. The sector would incur investments losses and could require recapitalization. Bank funding would also be impacted, as bank financing is partially provided by insurance firms. Insurers' exposure to euro area countries where debt concerns have arisen appears limited.

Discussions

39. The authorities indicated a greater emphasis on the use of stress tests. Semi-annual tests are conducted with the two large banks since the beginning of 2009. The latest test available (June 2010) indicates that even under a severe global shock the two large banks would meet FINMA's requirements. A new test is being conducted on the basis of end-2010 exposures. FINMA is exchanging information about scenarios with the European Banking Association, and considers its scenarios more severe. FINMA also plans to introduce regular stress tests for medium-size banks.

40. In the insurance sector, the SST was seen as an important supervisory tool. FINMA stated that it was monitoring risks closely, notably assets and liabilities of life insurers, credit risk issues

with large counterparties in non-life companies, and the technical provisions. Staff welcomed the SST's full implementation and noted its findings should continue to be acted upon. It was important for companies to apply prudent reserving standards. Some measures may also be needed to restore funding ratios by increasing contributions, reducing mandatory pay-out ratios, and taking a risk-based approach to funding requirements.

41. The authorities pro-actively have raised concerns about the mortgage market. The authorities are monitoring mortgage-related risks, both at the level of individual institutions (FINMA) and through ad hoc surveys (SNB). The SNB has warned publicly about loosened lending standards, while FINMA has asked the Bankers Association to tighten its lending standards. Moral suasion is being exerted on some banks. FINMA has also taken action in the case of banks using unsatisfactory risk-management practices, and it will perform ad hoc stress tests in the second half of 2011 to evaluate the

B. Micro-prudential Supervision

43. Progress has been made in stepping up supervisory efforts. FINMA has developed a new risk-based supervisory approach for each of its fields of activities. In addition, it has increased its on-site inspections, hired more personnel, and taken measures to strengthen the effectiveness of external auditors and ensure proper supervision of cross-border institutions.

44. FINMA sees further need for improvement in some specific areas. Its resources devoted to the enforcement function have been shown to be below peers. FINMA also sees the

quantitative impact of a downturn in local housing markets.

42. However, staff stressed that mortgage developments required pre-emptive measures, including through macro-prudential instruments. While overall housing prices have not accelerated as fast as in a typical real estate bubble, preventive action is warranted to address both financial stability and social concerns. Part of the solution lies in stepped-up micro-prudential measures, such as capital add-ons for banks with lax practices. However, system-wide measures should also be envisaged unless self-regulation is sufficiently stepped up and applied to all financial institutions engaged in mortgage lending. Possibly useful measures included imposing maximum loan-to-value ratios, which have helped contain booms in other countries (Global Financial Stability Report, Spring 2011), requiring more conservative affordability assessments, or imposing system-wide capital add-ons based on mortgage lending evolutions.

possible need to extend the scope of supervision to new entities.

45. Progress in supervision is welcome and should continue. In addition to the areas identified by FINMA, and consistent with past (FSAP) advice, the independence of FINMA auditors should be improved, including by requiring their compensation to come directly from FINMA rather than the banks. In addition, FINMA should be allowed to define the auditors' mandates. Staff supported extending supervision to entities that could pose a significant risk to financial stability. Finally, strengthening the

supervision of cross-border institutions should be a continued priority, in collaboration with foreign

supervisors.

C. Macro-prudential Supervision and Regulation

Background

46. A number of steps have been taken to improve inter-agency cooperation with respect to financial stability. In February 2010, the SNB and FINMA signed a bilateral Memorandum of Understanding (MoU) describing responsibilities and cooperation. A tripartite agreement (FINMA, SNB, and the Federal Department of Finance) on collaboration, information exchange, and crisis management was signed in early 2011.

47. However, under the current framework, macro-prudential powers and responsibilities are not clearly specified. Under current legislation, neither the SNB, FINMA, or the Federal Council, has a general macro-prudential mandate or has the authority to set macro-prudential instruments, such as for example, loan-to-value or affordability ratios, or banking-system-wide capital add-ons.

48. The SNB is required to contribute to financial stability in the context of its price stability objective. The SNB Act does not provide for system-wide macro-prudential tools, instead its policy instruments (such as interest rate setting, reserve requirements, and debt instruments) are limited to the conduct of monetary policy.

49. FINMA's supervisory mandate does not provide the power to set system-wide instruments. As micro-prudential supervisor, FINMA can impose capital add-ons institution by institution if that is needed to strengthen an institution's

solvability and step-up its supervision efforts. It can also rely upon moral suasion to influence the self-regulation of the Bankers Association.

50. Views about a macro-prudential framework differ across institutions. To fulfill its task to "contribute to financial stability", the SNB would like to have formal decision-making powers regarding certain macro-prudential tools, independent access to information, and a requirement for other financial regulators to consult the SNB early in the formulation of financial sector regulation. FINMA has stated that the current setup is adequate, and has warned against the sharing of macro-prudential responsibilities which could create uncertainties among market participants. FINMA has also noted that time varying capital requirements and affordability ratios may constitute a sufficient set of macro-prudential instruments.

Discussions

51. Staff stressed that the macro-prudential framework could be strengthened by clarifying the role and responsibilities of the SNB and FINMA, where necessary by revising relevant legislation. The uncertainty regarding the legal basis for macro-prudential instruments in the face of the current loosening of mortgage lending standards is indicative of the need to define a macro-prudential framework. The framework should clarify responsibilities at key stages of macro-prudential surveillance (assessment of risks, warnings and policy recommendations, and regulatory and supervisory

action), and ensure effective coordination and cooperation.

52. A revised framework should clearly align mandates of the SNB and FINMA with responsibilities and instruments (see *Selected Issues Paper*). The financial stability mandate of the SNB must be strengthened, and include a distinct set of objectives, functions and tools. The SNB would need broader access to information, including over individual financial institutions. FINMA's mandate might also need to be broadened to widen its supervisory perspective to include the stability of the financial system and relevant tools. Building on SNB and FINMA's expertise, instruments calibrating cycle variation could be vested in the SNB, and prudential system-wide instruments could be given to FINMA,

complementing its envisaged power under the TBTF proposals. While there is no clearly accepted framework at an international level, the authorities should effectively utilize the expertise and resources of both the SNB and FINMA. Macro-prudential supervision will have to take into account the fact that a large part of Swiss banking activities are performed overseas.

53. A working group will be established under the aegis of the Federal Department of Finance to consider improvements of macro-prudential oversight. Its mandate is still to be defined. The parliament is expected to comment on the issue by mid-year.

D. The Too Big To Fail (TBTF) Proposal

Background

54. The Swiss authorities have started to address systemic risks. Early in the crisis the authorities expanded supervision of the large banks, increased capital top-ups on Basel II requirements (200 percent in "good times" and 150 percent in "bad times"), added a FINMA-defined leverage ratio (minimum amount of tier 1 capital required for a given balance sheet size, excluding domestic loans of 5 percent), and introduced remuneration guidelines aimed at reducing excessive risk-taking. They also defined in June 2010 a new liquidity regime requiring the two largest banks to cover their potential liquidity needs over a 30-day horizon in case of a widespread loss of confidence during severe market stress.

55. In late April, the Federal Council sent to Parliament draft legislation which addresses the systemic risks of big banks. The legislation broadly follows the recommendations of the TBTF Commission, a group which included bank representatives (see Annex IV). While recognizing the validity of the universal business model, the core measures focus on ensuring sufficient liquidity and capital buffers for TBTF banks partly in the form of contingent convertible capital (CoCo). Banks can obtain rebates on the "progressive" buffer (above the required 13 percent, of which 10 percent has to be equity)—which currently amounts to close to 6 percent given banks' balance sheets—by providing evidence of increased resolvability.

Discussions

56. Staff stressed that the increase in capital buffers envisaged within the TBTF proposal is a crucial feature of the proposal that should be preserved. Capital rebates should only be given if significant measures have been taken to reduce systemic risks. Improving the resolvability of large cross-border banks, however, would probably require an international agreement or an enhanced framework for coordination. Finally, the law should provide sufficient legal certainty to create incentives for banks to build up their capital in the next few years.

57. The authorities indicated that they would take into account international developments as well as Swiss characteristics. The rebate is seen as conditional upon a significant improvement in global resolvability. Emergency plans or proof of retaining domestic operations would not be sufficient. However, defining and guaranteeing

international resolvability will be difficult given current cross-border legal frameworks and agreements.

58. The authorities emphasized the role of contingent capital (CoCos). They saw them as a robust instrument for bailing in bank creditors, particularly when they are located in different jurisdictions. In addition, the low-trigger CoCo buffer would provide enough capital to finance a bridge bank, thereby ensuring smooth bank resolution. While some banks have suggested that CoCos trigger events might actually be destabilizing, the authorities feel that the possible dilution of shareholders would provide a strong incentive to curb ex ante risky behavior. Costs would be higher, and profits lower, but risk levels would be reduced.

E. Deposit Insurance

59. A new law has made permanent the higher ceiling for bank deposit protection introduced on a temporary basis during the crisis. Deposits are protected up to SFr 100,000, a threshold comparable with the one adopted in EU countries. The scheme is financed by the banking system up to a maximum of SFr 6 billion. A proposal to further strengthen the system by creating a partial ex-ante funding mechanism and by shortening repayment periods was withdrawn given concerns over its costs. The new law also extends FINMA's powers to resolve failing banks, specifically through the creation of a bridge bank.

STAFF APPRAISAL

60. Macroeconomic policies have supported a swift exit from the recession. The authorities implemented accommodative monetary and fiscal policies, and took quick and decisive action to help stabilize the financial sector. Nevertheless, some of these policies have created new risks (e.g., in the mortgage market), which will need to be addressed. With the recovery firmly established, the authorities must now exit from their expansionary monetary policy while proceeding with key financial sector reforms that reduce the probability and costs of financial turmoil. While these reforms may prove contentious, it is critical that progress is achieved to safeguard financial stability.

61. In the absence of shocks, the SNB should start tightening the policy rate in the near term. While inflation expectations remain well anchored, the current near-zero level of the policy rate is unsustainable in the medium term. Monetary policy normalization will also contribute to reducing macro-financial concerns, including a loosening of lending standards in the mortgage market. Concerns related to mortgage lending should be addressed by macro-prudential instruments, as monetary tightening is not likely to suffice.

62. Interventions on the foreign exchange market, if any, should be limited to smoothing disorderly movements of the exchange rate. While the Swiss franc is on the high side in a historical perspective, continuing robust trade performance and large current account surpluses suggest that the currency is still broadly aligned with medium-term macroeconomic fundamentals.

63. In the medium term, the SNB should give priority to strengthening its capital. Like many central banks, the SNB is exiting the crisis with an inflated balance sheet and a weakened capital position. The level of international reserves and capital should be commensurate with the size and international activities of the financial sector. Future distributions of gains to the cantons and Confederation should be subject to the ability of the SNB to replenish its capital.

64. In view of the gradual tightening of monetary policy, a neutral fiscal stance is appropriate. With limited fiscal stimulus measures and automatic stabilizers, Switzerland is exiting the crisis with comparatively strong fiscal balances. Going forward, the fiscal stance is expected to remain broadly neutral—consistent with the debt brake rule.

65. Fiscal prudence is warranted given Switzerland's large financial sector, and ageing pressures. Continued adherence to the fiscal rule should contribute to a gradual decline in the debt to GDP ratio under the baseline scenario. Implementation of the rule will be supported by ongoing efforts to improve the accuracy of budget planning both on the revenue and on the expenditure side, and develop performance budgeting. Attention should also focus on medium-term challenges. Measures should continue to be taken to ensure sustainability of public finances, including a parametric reform of the old age insurance system.

66. Although banking sector performance has improved, the authorities need to remain vigilant. Large banks remain more leveraged and dependent on wholesale funding than peers, and have large cross-border exposures. Risks for smaller banks are concentrated in mortgage lending. In addition, all banks have to adapt to regulatory changes, which will weigh on their profitability.

67. The loosening of mortgage lending standards and increasing interest rate risk call for pre-emptive measures. Micro-prudential measures can address concerns at individual institutions. However, macro-prudential measures should also be envisaged, unless system-wide self-regulation is sufficiently stepped up. Possible measures include imposing maximum loan-to-value ratios, requiring more conservative affordability assessments, or imposing system-wide capital add-ons based on mortgage lending evolutions.

68. In the insurance sector, risks should continue to be monitored and managed. Some insurers may find it challenging to boost their capital because of subdued profitability prospects and the need to strengthen reserves. Insurers—particularly in the life insurance industry—have relatively high exposures to the Swiss real estate market, and risks associated with mortgage lending, and certain products warrant continued close monitoring. Continued under funding in pension funds, especially for those with a public guarantee, should be addressed.

69. The adoption of draft TBTF legislation is instrumental in reducing the risks related to the two large banks. Over the year, Parliament will be considering a draft law that would, inter alia,

substantially increase capital buffers held by the two large banks. These buffers are key to reducing risks posed by systemic institutions. Thus rebates, if any, should be applied prudently.

70. Progress made in stepping up micro-prudential supervision efforts, including ensuring proper supervision of cross-border institutions, should continue. FINMA's strategy to increase on-site inspections, hire more personnel, and strengthen the effectiveness of external auditors is appropriate. Areas where continuing efforts are necessary include: strengthening the independence of regulatory auditors from banks and allowing FINMA to define their mandates, increasing resources for the enforcement function in line with international peers, and moving to supervise unsupervised entities if they pose a significant risk.

71. The macro-prudential framework should be strengthened and roles and responsibilities of the SNB and FINMA clarified. As suggested by ongoing discussions surrounding the situation in the mortgage market, the framework for using "macro-prudential" policies largely remains to be defined. The respective mandates of the SNB and FINMA could usefully be clarified, where necessary by revising relevant legislation, and the legal basis for system-wide policies should be strengthened. While there is no single international model for such a framework, authorities should utilize the expertise and resources of both FINMA and the SNB.

72. It is recommended that the next Article IV consultation with Switzerland be held on the standard 12-month cycle.

Table 1 Switzerland: Selected Economic Indicators, 2008–12

	2008	2009	2010	2011 ^{1/}	2012 ^{1/}
RGDP (percent change)	1.9	-1.9	2.6	2.4	1.8
Total domestic demand	0.2	0.7	0.6	3.1	1.7
Final domestic demand	1.2	-0.5	2.0	2.4	1.9
Private consumption	1.3	1.0	1.7	1.7	1.7
Public consumption	1.7	1.6	-1.6	0.7	0.7
Gross fixed investment	0.5	-5.5	4.7	5.2	3.0
Inventory accumulation ^{2/}	-0.9	1.1	-1.3	0.6	-0.2
Foreign balance ^{2/}	1.7	-2.5	2.0	-0.4	0.3
Nominal GDP (billions of Swiss francs)	544.2	535.3	546.2	564.7	580.7
Savings and investment (percent of GDP)					
Gross national saving	23.4	31.2	33.3	34.0	34.3
Gross domestic investment	21.1	19.7	19.0	20.8	21.5
Current account balance	2.3	11.5	14.2	13.2	12.8
Prices and incomes (percent change)					
GDP deflator	2.5	0.3	-0.5	1.0	1.0
Consumer price index	2.4	-0.5	0.7	0.9	1.0
Nominal wage growth	1.9	2.1	1.0	2.0	2.0
Unit labor costs (total economy)	3.5	5.0	-1.5	-0.4	0.2
Employment and slack measures					
Unemployment rate (in percent)	2.5	3.6	3.6	3.4	3.3
Output gap (in percent of potential)	2.3	-1.0	-0.1	0.4	0.5
Capacity utilization	86.9	78.2	81.1	84.3	...
Potential output growth	1.7	1.4	1.7	1.8	1.8
General government finances (percent of GDP)					
Revenue	34.3	35.2	34.6	34.7	34.6
Expenditure	32.3	34.4	34.4	34.4	34.0
Balance	2.0	0.8	0.2	0.3	0.6
Cyclically adjusted ordinary balance	1.1	1.1	0.3	0.1	0.4
Gross debt ^{3/}	54.8	54.9	55.0	52.7	51.2
Monetary and credit (percent change, averages)					
Broad money (M3)	4.9	2.6	2.2	...	...
Domestic credit, non-financial	4.9	8.0	8.2	...	...
Three-month SFr LIBOR	0.7	0.3	0.2	...	...
Yield on government bonds (7-year)	2.7	1.8	1.3	...	...
Exchange rates (levels)					
Swiss francs per U.S. dollar (annual average)	1.1	1.1	1.0	...	...
Swiss francs per euro (annual average)	1.6	1.5	1.3	...	...
Nominal effective rate (avg., 2005=100)	101.4	105.9	113.1	...	...
Real effective rate (avg., 2005=100) ^{4/}	97.9	101.6	107.5	...	...
Sources: IMF, World Economic Outlook database; Swiss National Bank; and HAVER.					
^{1/} Fund staff estimates and projections unless otherwise noted.					
^{2/} Contribution to growth.					
^{3/} Reflects new GFSM 2001 methodology, which values debt at market prices.					
^{3/} 2010 values as of February 28, 2011.					
^{4/} Based on relative consumer prices.					

Table 2 Switzerland: Balance of Payments, 2008–16 ^{1/}

	2008	2009	Projections						
			2010	2011	2012	2013	2014	2015	2016
(In billions of Swiss francs, unless otherwise indicated)									
Current account	13	61	78	75	74	75	76	78	78
Goods balance	15	17	18	17	17	18	18	19	19
Exports	217	188	204	220	230	246	262	279	298
Imports	-202	-172	-186	-203	-213	-228	-244	-261	-279
Service balance	50	42	48	45	44	45	46	46	46
Net investment income	-25	29	40	41	43	43	43	45	46
Net compensation of employees	-13	-13	-14	-15	-16	-16	-17	-17	-18
Net private transfers	-11	-10	-10	-10	-10	-10	-11	-11	-11
Net official transfers	-3	-3	-4	-4	-4	-4	-4	-4	-4
Private capital and financial account	-24	-34	-78	-75	-74	-75	-76	-78	-78
Capital transfers	-4	-4	-1	-8	-9	-10	-11	-12	-11
Financial account	-20	-31	-77	-67	-65	-65	-65	-66	-67
Net foreign direct investment	-43	-7	-24	-37	-42	-42	-42	-42	-42
Net portfolio investment	-39	-32	-18	-46	-41	-42	-44	-45	-49
Net other investment ^{2/}	66	55	100	16	17	19	20	21	24
o/w net banking sector	63	43	100	16	17	19	20	21	24
Official reserve flows	-4	-47	-135	0	0	0	0	0	0
Net errors and omissions	11	-27	0	0	0	0	0	0	0
(In percent of GDP, unless otherwise indicated)									
Current account	2.3	11.5	14.2	13.2	12.8	12.6	12.4	12.3	12.0
Goods balance	2.8	3.1	3.3	3.0	2.8	3.0	3.0	2.9	2.9
Exports	39.9	35.2	37.4	39.0	39.6	41.2	42.7	44.3	46.0
Imports	-37.1	-32.1	-34.1	-36.0	-36.7	-38.2	-39.7	-41.3	-43.0
Service balance	9.1	7.9	8.7	8.0	7.6	7.5	7.5	7.3	7.1
Net investment income	-4.6	5.5	7.2	7.3	7.4	7.1	7.0	7.1	7.0
Net compensation of employees	-2.4	-2.5	-2.5	-2.6	-2.7	-2.7	-2.7	-2.7	-2.7
Net private transfers	-2.0	-1.9	-1.8	-1.8	-1.8	-1.8	-1.7	-1.7	-1.7
Net official transfers	-0.6	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Private capital and financial account	-4.3	-6.4	-14.2	-13.2	-12.8	-12.6	-12.4	-12.3	-12.0
Capital transfers	-0.7	-0.7	-0.2	-1.4	-1.5	-1.7	-1.8	-1.9	-1.7
Financial account	-3.6	-5.8	-14.1	-11.8	-11.2	-10.9	-10.6	-10.4	-10.3
Net foreign direct investment	-8.0	-1.3	-4.3	-6.5	-7.1	-7.0	-6.8	-6.6	-6.4
Net portfolio investment	-7.1	-6.0	-3.3	-8.2	-7.0	-7.1	-7.1	-7.2	-7.6
Net other investment ^{2/}	12.2	10.2	18.3	2.8	3.0	3.1	3.2	3.4	3.6
o/w net banking sector	11.5	8.1	18.3	2.8	3.0	3.1	3.2	3.4	3.6
Official reserve flows	-0.8	-8.7	-24.7	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	2.0	-5.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Net IIP (in percent of GDP)	123	143	154	161	168	174	180	185	190
Official reserves ^{3/}									
(billions of U.S. dollars, end period)	69	136	265	...	...	...	...	...	...
Reserve cover (months of imports of GNFS) ^{3/}	3.7	8.1	15.1	...	...	...	...	...	...

Sources: IMF, World Economic Outlook database; and Swiss National Bank.

^{1/} Fund staff estimates and projections unless otherwise noted.^{2/} Includes errors and omissions.^{3/} Official reserves for 2010 are as of end-January 2011.

Table 3 Switzerland: General Government Finances, 2008–14

(In billions of Swiss francs, unless otherwise specified)							
	2008	2009	Est. 2010	2011	Projections 2012 2013 2014		
Federal Government ^{1/}							
Revenues	62.6	60.6	61.7	62.8	64.5	65.6	67.4
Expenditures	57.1	57.9	59.2	63.1	64.4	66.3	68.0
Balance	5.5	2.7	2.5	-0.3	0.0	-0.7	-0.6
Cantons							
Revenues	74.5	75.2	77.4	81.3	84.2	87.8	91.5
Expenditures	71.1	72.9	75.1	79.2	81.4	84.3	87.1
Balance	3.4	2.3	2.3	2.1	2.8	3.4	4.4
Municipalities							
Revenues	40.8	42.4	43.2	44.8	46.0	47.3	48.8
Expenditures	40.8	42.6	43.3	44.4	45.1	46.0	46.8
Balance	0.1	-0.2	-0.1	0.5	0.8	1.3	2.0
Social security ^{2/}							
Revenues	50.8	52.7	51.6	54.7	55.6	56.5	57.3
Expenditures	49.1	53.9	55.1	55.5	55.6	57.0	57.3
Balance	1.7	-1.2	-3.5	-0.8	0.0	-0.5	0.0
General Government							
Revenues	186.7	188.3	189.1	195.9	201.1	206.2	212.4
Expenditures	176.0	184.1	187.8	194.3	197.5	202.7	206.7
Balance	10.7	4.2	1.3	1.5	3.6	3.6	5.8
Gross debt							
Federal Government	166.7	154.3	153.8	155.4	156.9	158.4	159.5
Cantons	71.6	70.9	76.2	72.6	71.5	70.9	71.8
Communes	58.4	60.6	59.8	59.2	59.2	60.0	61.3
General government	298.5	293.7	300.2	297.4	297.4	298.6	301.4
(in percent of GDP)							
General Government							
Revenue	34.3	35.2	34.6	34.7	34.6	34.5	34.6
Expenditure	32.3	34.4	34.4	34.4	34.0	33.9	33.7
Balance	2.0	0.8	0.2	0.3	0.6	0.6	0.9
Federal government	1.0	0.5	0.5	-0.1	0.0	-0.1	-0.1
Cantons	0.6	0.4	0.4	0.4	0.5	0.6	0.7
Municipalities	0.0	0.0	0.0	0.1	0.1	0.2	0.3
Social security	0.3	-0.2	-0.6	-0.1	0.0	-0.1	0.0
Memorandum items:							
Structural balance	1.3	1.1	0.3	0.3	0.4	0.5	0.9
<i>Gross debt</i>							
Federal government	30.6	28.8	28.2	27.5	27.0	26.5	26.0
Cantons	13.2	13.3	14.0	12.9	12.3	11.9	11.7
Communes	10.7	11.3	11.0	10.5	10.2	10.0	10.0
General government	54.8	54.9	55.0	52.7	51.2	50.0	49.1
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 insurance.							

Table 4 Switzerland: SNB Balance Sheet

(Millions of Swiss francs; unless otherwise indicated)						
	2005	2006	2007	2008	2009	2010 ^{1/}
Assets						
Gold	25,483	31,228	34,776	30,862	38,186	43,988
Foreign currency reserves	45,584	45,400	50,586	47,429	94,680	203,675
IMF, international, and monetary assistance loans	1,828	1,102	961	1,296	7,136	6,038
Swiss franc repos	22,005	21,005	31,025	50,321	36,208	-
U.S. dollar repos	-	-	4,517	11,671	-	-
Swaps against Swiss francs				50,421	2,672	-
Money market, Swiss franc securities, other	6,789	6,077	5,062	22,324	28,383	16,118
Total assets	101,689	104,812	126,927	214,323	207,264	269,819
Liabilities						
Currency in circulation (banknotes)	37,195	38,134	44,259	49,161	49,966	51,498
Sight deposits	9,630	7,647	10,563	51,173	57,102	48,917
Repo, SNB bills & time liabilities	-	-	5,223	53,839	27,473	121,052
Foreign currency and other liabilities	159	99	1,200	1,700	6,820	5,890
Provisions and equity capital	54,705	58,931	65,682	58,449	65,902	42,463
Total liabilities	101,689	104,812	126,927	214,323	207,264	269,819
Memorandum items:						
NGDP (billions of Swiss francs)	463.8	490.5	521.1	541.8	535.6	549.7
Balance sheet, percent of NGDP	21.93	21.37	24.36	39.56	38.70	49.08
Banknotes, percent of total liabilities	36.58	36.38	34.87	22.94	24.11	19.09
Refinancing operations, percent of total assets	21.64	20.04	28.00	52.45	18.76	-
Provisions and equity capital, % of total assets	53.80	56.23	51.75	27.27	31.80	15.74
Monetary base ^{2/}	44,740	45,530	46,803	77,418	89,156	87,635
Sources: SNB; and IMF staff estimates.						
^{1/} Data as of December, 2010. Nominal GDP for 2010 is taken from WEO forecasts.						
^{2/} Currency in circulation and sight deposits of <i>domestic banks</i> .						

Table 5 Switzerland: Financial Soundness Indicators

	2004	2005	2006	2007	2008	2009	2010 ^{1/}
Banks							
Capital adequacy							
Regulatory capital as percent of risk-weighted assets ^{2/}	12.6	12.4	13.4	12.1	14.8	17.9	17.3
Regulatory Tier I capital to risk-weighted assets	13.3	13.0	13.4	11.6	12.3	15.2	15.6
Non-performing loans net of provisions as percent of capital ^{3/}	-1.2	-1.0	-1.0	-0.9	1.3	0.3	-0.5
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) ^{4/}							
Households	65.2	66.6	68.5	71.5	65.4	67.1	68.3
Agriculture and food industry	1.3	1.2	1.4	1.4	1.3	1.3	1.3
Industry and manufacturing	3.7	3.4	3.0	3.4	3.0	3.0	3.0
Construction	2.1	1.9	1.7	1.8	1.6	1.6	1.6
Retail	3.7	3.6	3.1	3.3	3.1	3.1	3.2
Hotels and restaurants / Hospitality sector	1.4	1.3	1.2	1.2	1.1	1.1	1.1
Transport and communications	1.1	1.1	1.0	1.1	0.9	0.9	0.9
Other financial activities	2.2	2.4	3.1	5.2	7.0	0.4	0.5
Insurance sector	0.5	0.4	0.4	0.4	0.8	0.5	0.6
Commercial real estate, IT, R&D	12.2	12.1	11.0	5.9	11.0	11.4	12.0
Public administration (excluding social security)	3.1	2.6	2.4	1.1	1.8	0.0	0.0
Education	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Healthcare and social services	1.3	1.3	1.1	1.1	1.0	1.0	1.1
Other collective and personal services	1.5	1.5	1.3	1.7	1.2	1.0	1.0
Other ^{5/}	0.5	0.5	0.6	0.6	0.6	7.6	5.3
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
Gross profits as percent of average equity capital (ROAE)	14.3	18.0	17.7	15.4	5.4	14.5	21.0
Net interest income as percent of gross income	36.4	30.9	27.4	28.1	36.3	30.4	27.9
Non-interest expenses as percent of gross income	62.7	59.2	63.0	70.4	85.5	80.1	73.3
Liquidity							
Liquid assets as percent of total assets	24.5	24.7	25.2	27.1	29.2	27.7	23.5
Liquid assets as percent of short-term liabilities	59.6	59.4	60.4	63.9	67.1	64.3	53.8
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

Source: Swiss National Bank.

1/ End-2010 data are provisional.

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/ Until 2004, general loan-loss provisions were made; as of 2005, specific loan-loss provisions have been carried out.

4/ As percent of total credit to the private sector.

5/ Mining and extraction, production and distribution of electricity, natural gas and water, financial intermediation, social security, ex-territorial bodies and organizations, other.

ANNEX I. FINANCIAL AND RISK ANALYSIS OF SWISS BANKS¹

1. This annex examines the financial soundness and risk dynamics of Swiss banks. It focuses on profitability, capital adequacy, capital quality, liquidity, and funding. A peer comparison of the two largest Swiss banks with LCFIs in the euro area, U.K. and U.S. and with smaller Swiss banks is done using financial statement data for 2007–10.²

Peer Comparisons

2. The profitability of the large banks has continued to improve, although interest margins remain low. With the bottom line of UBS turning positive and continued profits of Credit Suisse, profitability measured by return on average assets (ROAA) and return on average equity (ROAE) increased significantly in 2010. Their ROAA more than doubled to 0.5 percent and the ROAE more than tripled to 14 percent in 2010, better than peers. Unlike 2009, UBS was a big contributor in 2010. Also, while asset quality of the big banks is the highest among peers, their net interest margins are one of the lowest, reflecting the continued reliance on fees and commissions as well as trading income.

3. The profitability of domestically focused banks has moderated. Cantonal banks, regional banks, Raiffeisen group, and private banks were hit much less hard than big banks and

continued to earn profits during the crisis. However, the profitability of banks with a domestic focus was either flat or on a decline in 2010, partly driven by falling interest margins. The ROAA of cantonal, regional, and private banks is generally higher than the large banks, while their ROAE is much lower, reflecting lower leverage.

4. Regulatory capital ratios of the big banks have strengthened, but the quality of the capital is low and leverage remains high.

The Tier 1 ratio of the big banks increased to over 17 percent in 2010, the highest among peers. However, more stringent capital quality indicators such as the (un-weighted) tangible common equity ratio of the big banks are much lower than peers (2.6 percent), reflecting large recourse to hybrids and deferred tax assets. Also, the ratio of equity to assets (3.8 percent) remains lower than some of the peers, suggesting still high leverage.

5. Large banks' credit risk—as indicated by CDS spreads—has receded from its peaks, but remains above pre-crisis levels.

The CDS spreads of UBS have converged to those of Credit Suisse, indicating a comparative risk reduction. However, the CDS spreads of the two banks are still higher than the pre-crisis level, suggesting credit risk remains elevated.

6. Reflecting different business models, domestically oriented banks report lower leverage than large banks.

Regional banks have the lowest Tier 1 ratio (11 percent) among all Swiss banks while private banks have the highest Tier 1 ratio (19 percent). The average equity to assets ratio

¹ Prepared by Yingbin Xiao.

² As with any kind of international comparisons, different accounting and regulatory treatments could affect the assessment in a complicated way. As adjusting the difference is beyond this annex, the results should be interpreted with caution.

of non-big banks is about 8 percent, more than double that of the big banks. The difference between regulatory standards and crude measure of leverage reflects the impact of regulatory treatment of different business models.

7. Although more stringent liquidity requirements have reduced liquidity risk, large banks' dependence on wholesale funding has increased. New liquidity requirements in place since June 2010 require the two big banks to cover potential liability needs over a 30-day horizon in case of a widespread confidence loss during a period of market stress. In response, the two big banks have increased the share of liquid assets and reduced the share of short-term borrowing. Nonetheless, after a decline in 2009, wholesale financing has climbed back to about 60 percent of total funding, the highest among peers.

8. Swiss banks remain vulnerable to cross-border spillovers. Despite the retrenchment from cross-border lending, Swiss banks' foreign exposure represents 58 percent of total bank assets, the highest among advanced economies. Swiss banks' exposure to euro area countries where debt issues have arisen is limited. The two countries that Swiss banks are most exposed to are the U.S. and U.K., with claims to the U.S. representing about 133 percent of GDP and claims to the U.K. representing 40 percent of GDP. Claims to Japan account for 16 percent of GDP.

Conclusions

9. Profitability is likely to be muted going forward. As favorable refinancing conditions, now in effect, subside near-term and more stringent capital and liquidity requirements take hold

profitability will decline. Although safe haven considerations have dominated in the short-run, a possible fall in tax sensitive wealth management flows over the medium term would also weigh on profits. For the domestically-focused banks, a decline in net interest margins, and possible weakness in mortgage lending in the context of looser standards, would limit profit growth and raise their vulnerability to interest rate hikes. For private banks, profits are likely to be negatively affected by the strength of the Swiss franc and by regulatory uncertainty about banking secrecy and tax environments. These developments may pressure the private banking sector to consolidate.

10. Big banks should continue to deleverage, enhance capital quality, and build stronger liquidity buffers. Despite the substantial reduction in leverage, especially from foreign business, leverage of the big banks still ranks high. Although the big banks have high regulatory capital ratios, their capital consists of a large share of low quality capital. Hybrids and deferred tax assets account for about one third of Tier 1 capital on average for the two big banks, which leaves a much smaller portion of capital qualifying as core Tier 1 under Basel III. With a subdued profitability outlook, the internal build-up of high quality capital is limited. High reliance on wholesale funding would render the big banks vulnerable to funding shocks, as evidenced during the crisis. The "too big to fail" proposal would help address these issues.

11. Pre-emptive measures are needed to address weaknesses in mortgage lending standards and associated risk management practices. Falling interest margins and increasing competition have led to looser mortgage lending

standards. As shown in the latest *SNB Financial Stability Report*, exceptions to lending policies have been increasing. With interest rates at historically low levels and a rising share of fixed-rate, long duration mortgages, the interest rate risk of banks has risen. If tightened self-regulation is not sufficient to curb banks' and other lenders' risky behavior, macro-prudential measures will have to be implemented.

Figure 1 Switzerland and Peers: Financial Soundness of Banks, 2007-2010 1/



1/ Accounting differences are not adjusted.
Sources: Bank scope; Bloomberg; and IMF staff calculations.

ANNEX II. SWITZERLAND: WEALTH MANAGEMENT AND ONGOING CHANGES IN THE TAX ENVIRONMENT

Importance of Wealth Management

1. Wealth management is a main pillar of Switzerland's financial center franchise.

While the banking industry in Switzerland generally follows a universal banking model, Swiss banks have been known historically for their wealth management services.

- *Wealth management encompasses financial services provided to private, corporate or institutional clients who own a certain amount of assets. Assets under management comprise all invested assets held under a discretionary or advisory asset management mandate. This would include securities held in client portfolios, fiduciary accounts, and savings and time deposits.*
- *Two thirds of banks offer whole or significant components of the value chain of wealth management. Two universal banks, 70 private banks, 10 cantonal banks, and 130 foreign banks are the traditional wealth management institutions. At the same time, many investment funds, life insurance companies, securities traders, and well over 1,000 independent asset managers based in Switzerland also provide wealth management services. Assets under management are well over US\$5 trillion, or 10 times Swiss GDP. Around 60 percent is*

from foreign institutional or private investors.¹

- *Swiss banks are among the world's leading wealth managers. According to the Boston Consulting Group, Swiss banks are global leaders in cross-border (offshore) private banking with a market share of nearly one third or 28 percent.*

International Cooperation in Tax Matters

2. Switzerland is a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

The forum is attempting to implement a global standard for transparency and cooperation in international tax matters, with particular stress on combating tax fraud and tax evasion. Switzerland is a member of its Steering Group and Peer Review Group. Members go through a two-stage review process. The first stage centers on whether tax-relevant information is available to national authorities and legislation is in place for a cross-border exchange of information. The second stage focuses on reviewing the effectiveness of information exchange. The evaluation of phase one for Switzerland should be completed by mid-2011.

¹ Independent asset managers are estimated to manage more than SFr 500 billion of assets as of end-2009, (Swiss Bankers Association).

3. **Switzerland has agreed to extend administrative assistance in tax matters.**

In March, 2009 Switzerland announced it would include Article 26 of the OECD Model Tax Convention² in its double taxation agreements (DTAs), allowing for administrative assistance to foreign countries. In other words, the Swiss government will no longer distinguish between tax fraud and tax evasion for purposes of providing international cooperation in tax matters. As of December 2010, some 31 DTAs have been negotiated, with 12 approved by the Swiss Parliament. The ordinance on executing “administrative assistance” within DTAs was approved by the Federal Council in September 2010. The ordinance regulates administrative requests, procedures for the release of information, appeal processes, as well as the ban on administrative assistance in the case of stolen bank data.

Ongoing discussions with the E.U., E.U. countries, and the U.S.

4. **The E.U. directive on savings taxation applies to interest income paid to residents across E.U. member states.** The Savings Directive is based on a “coexistence model”, with the automatic exchange of information or taxation at its source.³ To prevent E.U. taxpayers from avoiding

this directive through non-E.U. financial centers, the E.U. negotiated bilateral agreements with Andorra, Liechtenstein, Monaco, San Marino, and Switzerland. In 2004, the E.U. and Switzerland signed a bilateral agreement, which introduced a withholding tax on the savings income of E.U. residents paid through a Swiss intermediary—without reporting the name of the account holder. The retention tax, which started out at 15 percent, is set to move to 35 percent as of July 2011. Three quarters of the revenue is allocated to E.U. member states, while in analogy to the E.U.-Directive, a quarter is retained for administrative expenses (cantons receive 10 percent of the Swiss share). In 2009 some SFr 534 million was retained, with SFr 401 transferred to E.U. member states.

5. **Work is under way within the E.U. to close gaps in the directive on the taxation of savings income.** The E.U. wants to include additional financial instruments (e.g., structured products, life insurance, and investment funds) not currently covered by the directive, and prevent circumvention of the directive by applying it not only to individuals, but also to legal entities (i.e., third party legal trusts; foundations). While these revisions will be subject to further negotiations on amending the bilateral agreement between the E.U. and Switzerland, the Swiss authorities do not envisage changes to the coexistence model.

6. **In October 2010, both the United Kingdom and Germany entered into preliminary bilateral tax agreements with Switzerland, which would implement a withholding tax with final character.** While details still need to be decided, the agreement would impose final withholding taxes on future

² The OECD’s Model Tax Convention serves as the basis for more than 3,000 bilateral double taxation agreements (DTAs). It contains 31 articles, with article 26 governing the exchange of information among tax authorities.

³ Belgium, Luxembourg, and Austria have chosen taxation at source; all other EU members use the automatic exchange of information.

income generated by accounts held by German and U.K. residents in Switzerland. Moreover, with a goal of regularizing accounts, a regularization tax would be levied on accounts which have never been declared.

7. With the delivery of administrative assistance, the U.S. has ceased legal action against UBS. By August 2010, the Federal Tax Administration (FTA) had examined approximately 4,450 UBS client accounts under the agreement with the United States. The delivery of data by Switzerland to the United States was largely completed by mid-November after expiry of the appeal periods. Overall, more than 4,000 cases have been supplied to the United States to date. Subject to the outcome of pending appeals before the Swiss Administrative Court or in the case of no appeals, information on a number of additional accounts covered by the agreement and the treaty request will be delivered to the IRS during 2011.

8. The U.S. Foreign Account Tax Compliance Act (FATCA) will induce compliance costs. The act introduces a 30 percent withholding tax on all payments by foreign financial institutions (FFIs) to U.S. persons and U.S. controlled foreign entities, unless certain reporting requirements to the IRS are met. The definition of FFIs is broad and includes banks, insurance firms, securities traders, hedge funds, and private equity investments.

Impact on Swiss banking

9. Swiss wealth management institutions are adapting to new international requirements on tax transparency. The Swiss financial regulator (FINMA) has stressed that cross border risks oblige banks to establish principal compliance measures in managing international operations and place additional emphasis on their building a fully compliant off-shore banking model.

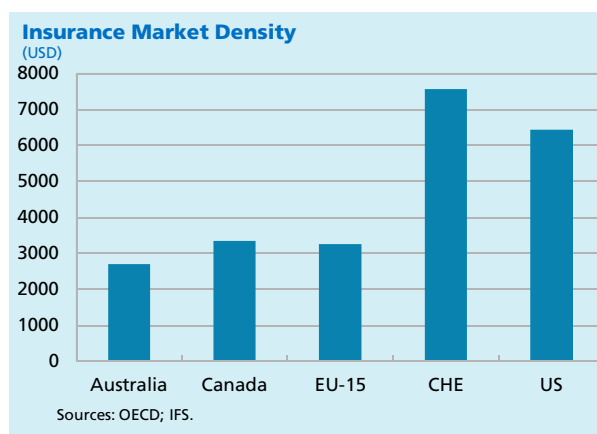
10. Estimates of the impact of recent tax developments on the Swiss financial sector are at this stage somewhat speculative. Large Swiss banks have noted that funds managed for wealthy clients could be withdrawn because of recent changes to the Swiss approach in international cooperation on tax matters. UBS has estimated that between SFr 15 and 40 billion could be withdrawn, while Credit Suisse has projected a range of SFr 20 to 30 billion. Some observers have estimated the amount of “undeclared money” at between SFr 300 billion to 1 trillion. However, others have noted that much of these funds are likely to be in Switzerland for confidentiality and stability reasons and a much smaller portion are likely to be there due to tax advantages.

11. Overall, any estimate of how these tax issues will affect Switzerland is subject to wide uncertainty. Current effects of these policy changes would be masked by ongoing inflows related to the country’s safe-haven attributes.

ANNEX III. SWISS INSURANCE SECTOR: FINANCIAL AND RISK PROFILE¹

Introduction

1. Switzerland is a leading insurance center with highly developed markets. In 2009, domestic gross premiums amounted to US\$57 billion, about \$7,571 per capita, the highest density (premiums/population) in the world. The penetration rate (premiums/GDP) is also high at 10 percent, twice the EU-15 average. The penetration rate and density of the non-life insurance market in Switzerland are lower than those of the life insurance market.



2. The Swiss insurance market is highly concentrated, especially in life and reinsurance. As of end-2009, there were 258 private insurance and reinsurance companies operating in Switzerland, of which 21 Swiss life insurers, 4 foreign life insurers, 79 Swiss non-life insurers, 46 foreign non-life insurers, 40 health insurers, and 68 reinsurers. The market share of foreign insurers in the Swiss domestic market is quite small, at about three percent. The 10 largest

insurers account for about 83 percent of gross premiums written. The top five life insurers represent about 77 percent of the Swiss life insurance market, the top five non-life insurers take 67 percent of the Swiss non-life insurance market, while the top three reinsurers maintain about 79 percent of the Swiss reinsurance market.

3. Swiss insurers rely heavily on international markets. Because of the saturation of the domestic market, about 70 percent of their global premiums (some SFr 127 out of 183 billion) are sourced from abroad. While about 40 percent of direct life premiums resulted from Swiss business, over 65 percent of non-life business was written abroad and about 94 percent of reinsurance premiums came from foreign business. As of the beginning of 2010, Swiss insurers employed about 0.12 million staff, with 60 percent posted abroad.

Profitability Analysis

4. Profitability has improved steadily since 2009. Despite mixed results, the sector has started to recover from the global financial crisis. Faced with falling life insurance premiums and only slightly increasing non-life insurance premiums, insurers have continued to take cost-cutting measures. Recovering capital markets have led to investment gains and significantly fewer write downs on investments. Major insurers' ROE has improved from the trough in 2008 to over 7 percent recently. As shown in Figure 2, the profitability of Swiss insurers was hit less hard

¹ Prepared by Yingbin Xiao.

during the crisis and the rebound is steadier than U.S. and other advanced European insurers.

5. The profitability of Swiss non-life insurers is on par with U.S. competitors—and above European counterparts. The non-life insurance sector generates about 80 percent of the net income of the Swiss insurance industry. Despite the continued growth in the non-life insurance industry, insurers' operating profitability is eroding. The main insurers' average combined ratio (sum of expense ratio and loss ratio) rose to 95 percent in 2010. With weakening underwriting results taking place in other major markets, Swiss non-life insurers are more profitable than other advanced European insurers.

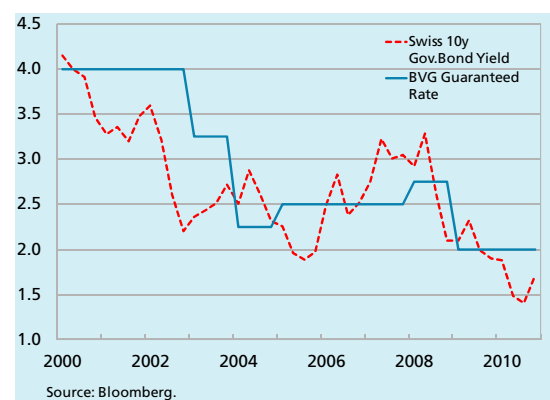
6. The low interest rate environment is a major challenge for life insurers. Benefiting from the financial market turnaround and cost containment measures, the operating margins of life companies began to recover in the second half of 2009, but sustained low interest rates have weighed on further profitability improvement. Although the crediting rate for "Berufliche Vorsorge Gesetz" (BVG) group life policies was lowered to 2 percent in 2009 and kept at that level in 2010, spreads between guaranteed crediting rates and government bond yields narrowed or even turned negative in 2010, which makes it challenging for life insurers to earn these guaranteed rates and could lead to some excessive risk-taking behavior of insurers.

7. Swiss insurers' profitability is likely to be under pressure going forward. For the non-life industry, the relatively high degree of

segmentation and saturation tends to result in intense competition, which could lead to softening rates and reduced premium income in some non-life business lines. The industry would also be affected by catastrophic events. For the life insurance industry, premium growth in traditional life products will be limited and covering relatively high guaranteed interest rates in a low interest rate environment would remain a challenge. For both the non-life and life industry, investment results could improve, but will not reach the pre-crisis levels. The moderate investment income could only partially offset weak underwriting results. In addition, more stringent capital requirements could weigh on profitability in the near term and volatile capital markets could cause uncertainty about future investment income.

Capital Analysis

8. Swiss insurers have been able to rebuild their capitalization since 2009. With capitalization being hit during the financial crisis, Swiss insurers have materially de-risked their



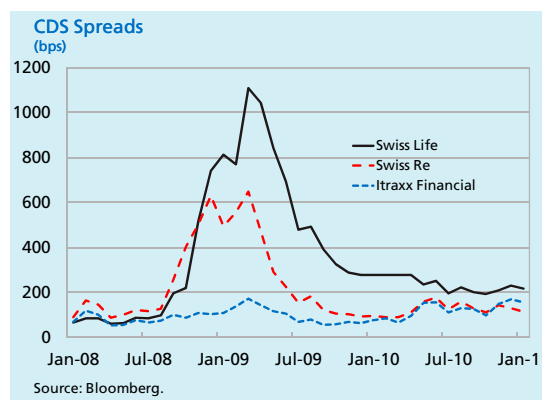
balance sheets, divesting or hedging large portions of their risky assets. The recovery of stock and corporate bond markets, both severely hit in the

crisis, contributed significantly to the improved capital position. A sharp rise in the value of government bonds because of the decline in risk-free rates to record low levels in 2010 also helped to strengthen the industry's capital base. With recovering financial markets and improving earnings, major Swiss insurers have not only replenished capital, but also boosted the share of shareholders' equity to levels at or even exceeding pre-crisis positions. Consequently, companies are no longer raising capital, but increasingly returning it through dividends and/or stock buyback programs.

9. Main insurers' solvency margins have also been strengthened. In 2009, Solvency I ratios of Swiss Life, Swiss Re, and Zurich Financial Services reached 164 percent, 236 percent, 195 percent respectively (Figure 2). By comparison, the average advanced European Solvency I ratios for life, non-life, composite, and reinsurance companies were about 300 percent, 360 percent, 260 percent, and 290 percent respectively. Although simple comparisons suggest that solvency ratios of the three insurers fall short of the European average, this has to be interpreted cautiously as Solvency I ratios are not harmonized across jurisdictions. Solvency I ratios of major Swiss insurers continued to improve in 2010.

10. In line with European developments, credit risks of main Swiss insurers have fallen from 2009 peaks, but still remain above pre-crisis levels. The CDS spreads of both Swiss Life and Swiss Re have registered a dramatic drop, but Swiss Life is still perceived to be riskier than average

European financial firms. The current credit ratings of Swiss Life, Swiss Re, and Zurich Financial Services are BBB+, A+, and AA- by S&P and A1 for Swiss Re and Zurich Financial Services by Moody's.



11. Despite some challenges, the full implementation of the Swiss Solvency Test (SST) would boost the sector's economic solvency and enhance its resilience to adverse shocks. Subdued profitability prospects limit internal capital generation. Less prudent reserving standards and reserve releases in previous years used to boost technical results may increase the under-reserving risk of some companies and result in the need to strengthen reserves. SST came into full effect from the beginning of this year, which has rendered Switzerland the first country to move towards risk-based insurance supervision. All insurance companies must accrue risk-bearing capital required to cover their target capital. While a higher proportion of insurance companies failed the test in 2009 compared to 2008, corrective measures were taken and 2010 results showed some improvement.

Investment Analysis

12. The investment profile of the Swiss insurance industry is diversified, but differs substantially among life, non-life, and reinsurance sectors. The industry as a whole invests mostly in fixed-income, equity, and real estate. Fixed-income securities (including loans) are the largest asset class, amounting to 55 percent of total invested assets, while equity and real estate (including mortgages) accounting for 18 percent and 14 percent of total investments respectively (Figure 2). The overall exposure to alternative investments is moderate at about 4 percent, while exposure to U.S. subprime securities is very low. The life sector has the highest exposure to fixed income and real estate while reinsurance has the highest exposure to equity.

13. Risk arising from Swiss insurers' exposure to real estate and mortgage lending is contained so far, but could be a source of concern going forward. While the average share of real estate investment by European insurers is about four percent, Swiss insurers, especially life insurers, are more heavily invested in real estate than insurers in other European markets. The fact that the property portfolios of Swiss insurance companies largely consist of properties in Switzerland—which have not experienced so far economy-wide house price bubbles like those experienced in the U.K., U.S., Ireland, or Spain, and Swiss insurers tend to invest in residential properties, whose prices are less affected by the economic cycle—has helped contain the risk. However, with historically low mortgage rates and some loosening of lending standards, Swiss real estate and mortgage markets have shown some

signs of risk build-up. The rapid increase in residential real estate price and mortgage volume since 2009 and weak risk management practices by some banks and insurance companies could lead to an abrupt correction once interest rate normalization commences. Hence, the concentration risk in real estate should be monitored closely.

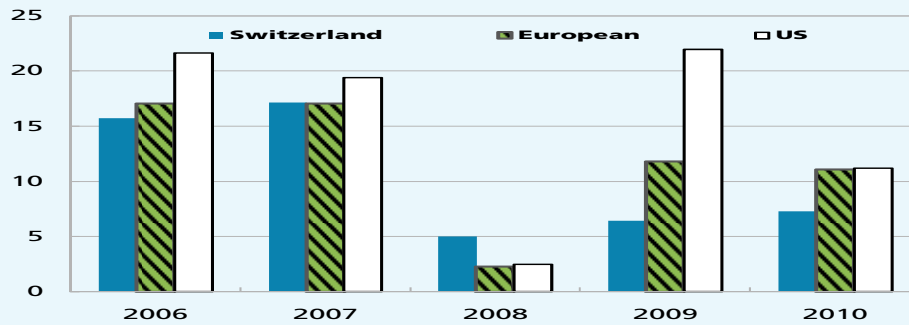
14. Swiss insurers' exposure to European peripheral seems manageable. Over half of the Swiss insurance industry's sovereign, as well as corporate bond holdings are held in Switzerland, the U.S., and U.K., while only two percent in euro area countries where debt concerns have arisen.

Conclusions

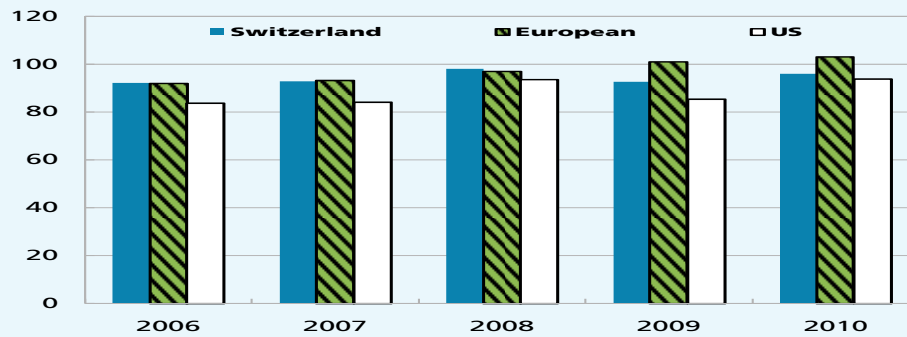
15. The profitability, capital, and investment analysis shows that despite the recovery of the Swiss insurance sector, challenges and risks remain. Profitability is likely to be subdued because of weak underwriting results and moderate investment results. The full implementation of the SST is an important step forward to enhance the sector's resilience while some companies may find it challenging to boost their capital because of the subdued profitability prospects and the need to strengthen reserves. The impact of the interest rate depends not only on the direction, but also on the speed. A sustained low rate or an abrupt increase of interest rates would negatively affect the insurance sector while the benefit of a progressive increase of interest rates would outweigh the cost. Risks associated with the real estate market warrant continued close monitoring and effective management.

Figure 2 Switzerland: Financial Soundness of Insurers, 2006-2010

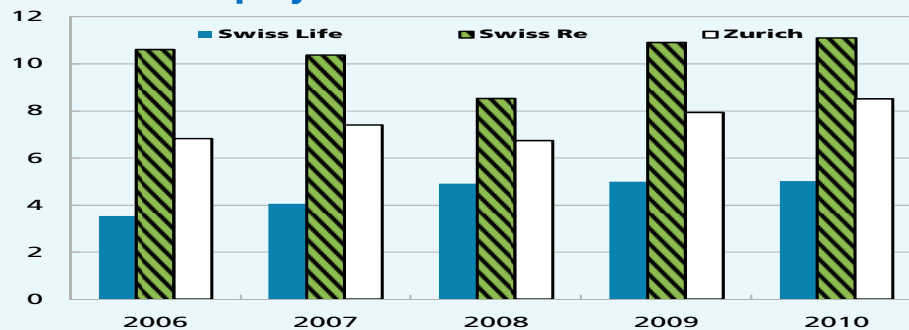
ROE



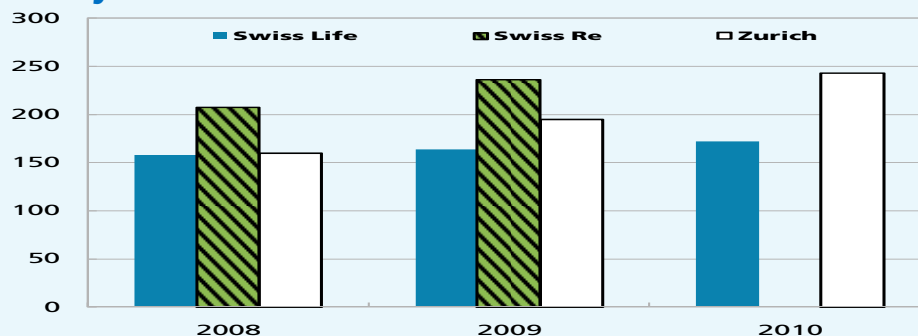
Combined Ratio



Shareholders' Equity as Percent of Assets



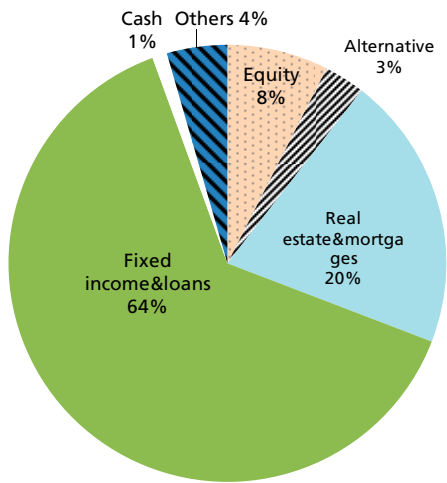
Solvency I Ratio



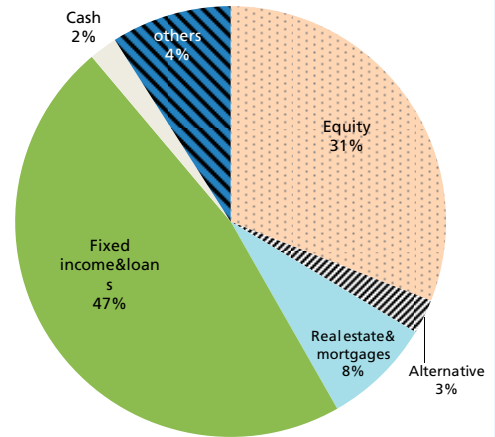
Sources: Company reports and IMF staff estimates.

Figure 3 Switzerland Insurers: Investment Profile, 2009

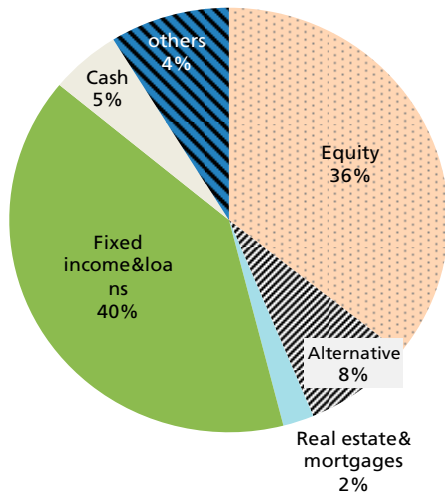
Life



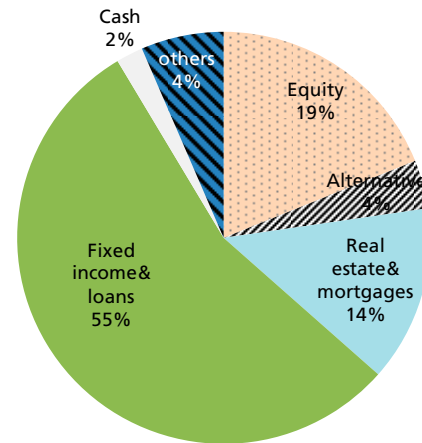
Nonlife



Reinsurance



Insurance Industry



Sources: FINMA and IMF staff estimates.

ANNEX IV. PROPOSALS BY THE TOO BIG TO FAIL COMMISSION ON SYSTEMICALLY IMPORTANT COMPANIES

A. Introduction

1. The Swiss Federal Council established a commission of experts in November 2009 to examine how to limit the risks posed by large companies. Their mandate included: (i) defining the term “too big to fail” (TBTF)¹; (ii) analyzing benefits and costs of large companies; (iii) indicating how risks could be reduced while accounting for profitability and competition; and (iv) proposing solutions. The commission included governmental authorities and private sector participants. On October 4, 2010, the Swiss TBTF Commission issued its final proposal. These were presented as an unanimously agreed upon package deal, with specific legislative recommendations endorsed by the Swiss National Bank (SNB) and the financial regulator (FINMA).

B. Details of the proposal

2. The core measures focus on capital structure, liquidity, risk diversification, and organizational structure. Certain measures—e.g., bank levies and direct restrictions on activities—have been ruled out.

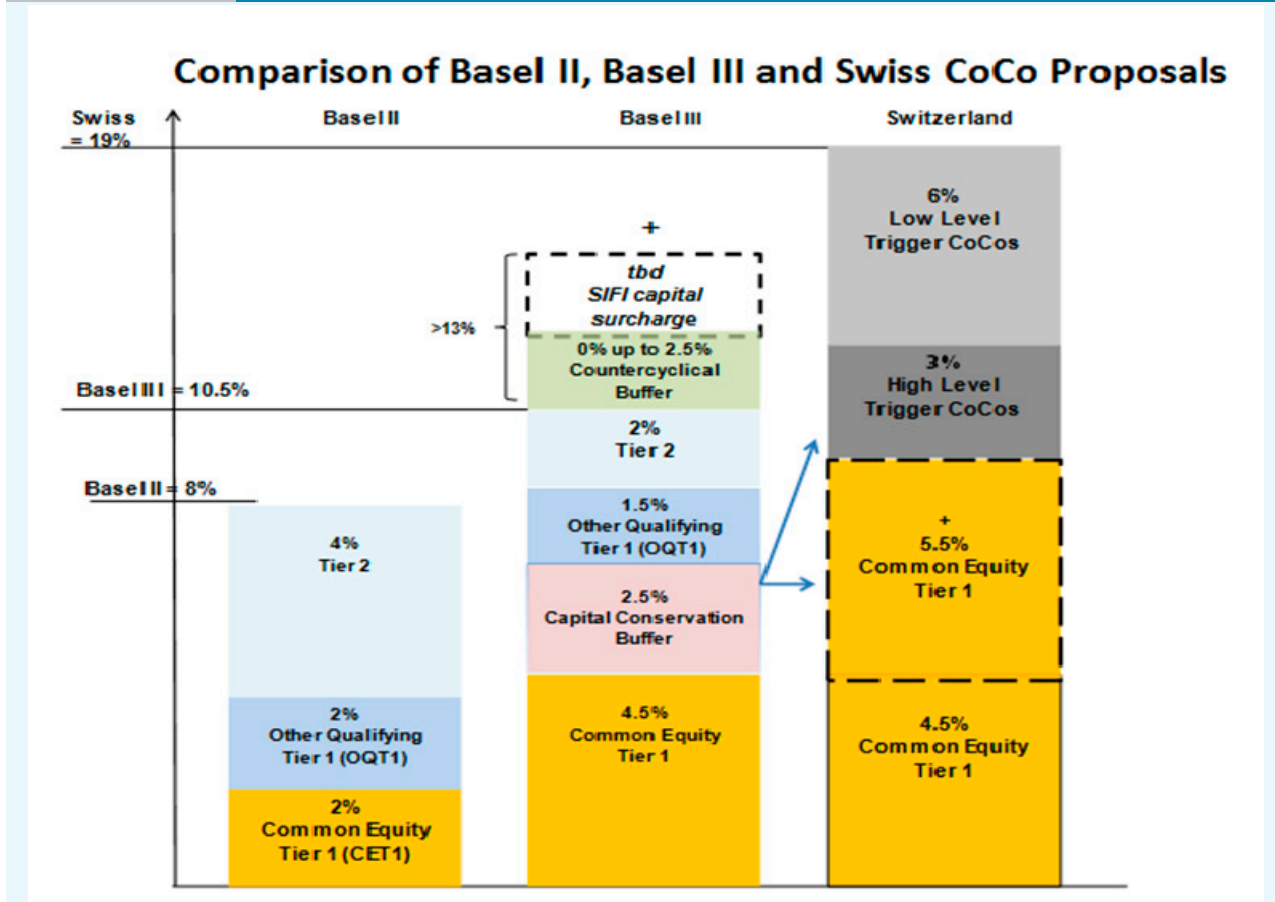
¹ The TBTF definition focused on companies that performed essential services to the economy. Using specific criteria (size and concentration, interconnectedness, and lack of substitutability) the authorities found that the TBTF problem was confined to the Swiss banking sector. The Swiss insurance industry did not meet the criteria of a TBTF industry.

Capital Structures

3. The proposal aims to increase the quality and size of capital requirements. Pre-crisis capital structures included heavy use of instruments that could not be forced to absorb losses unless the bank was declared insolvent. The Swiss proposal is to strengthen capital by insuring that non-equity instruments (i.e., contingent capital or CoCos) are designed to absorb losses on a contractual basis, by converting into equity (or written down) based on trigger events.

4. Capital structures will contain three components that go beyond Basel III requirements (Figure 1). The minimum Basel common equity requirement of 4.5 percent of risk weighted assets is supplemented by: (i) a *loss absorbing buffer* of 8.5 percent, of which 5.5 percent has to be common equity and the rest may be contingent convertible bonds with a high conversion trigger (7 percent of core Tier I); and (ii) a *progressive capital component* depending on the market share and total assets of banks, which would represent 6 percent with current sizes. The progressive component may consist entirely of CoCos with a lower trigger point (5 percent of core Tier I). The authorities have indicated that if there is a counter-cyclical buffer under Basel III, there would also be one under the Swiss approach. A leverage ratio of 5 percent will also be applied. At this rate, the leverage cap falls just below risk weighted asset requirements, and is non-binding.

Figure 1 Comparison of Basel and Switzerland’s TBTF Capital Structures



5. **CoCo instrument details are to be determined by the issuing bank.** The bank will determine the amount of CoCos to be issued, their tranches via staggered issue dates, maturities, and conversion rates. The trigger would be contractually pre-defined but the conversion price is not required to be pre-determined. Write-downs are possible. Pre-conversion, all contingent capital would be classified as dated subordinated debt with non-deferrable coupons. FINMA will decide if this capital program fulfils regulatory capital requirements. Also, the authorities intend to make the domestic issuance of SFr CoCo bonds less costly by eliminating the issue tax on debt capital—and in a

second step—by implementing changes to the withholding tax regime.

Liquidity

6. **Liquidity measures will follow standards implemented in June 2010.** The new standards, which focus on the ability to cover a month of outflows under stress scenarios more conservative than Basel, will continue to apply. Regulators will monitor international work on the *Net Stable Funding Ratio*, to see whether amendments of the current standards will be needed.

Risk Diversification

7. Risk diversification measures follow adjustments made in E.U. rules. Switzerland has adopted E.U. rules that limit inter-bank claims through the application of higher risk rates (from 20 to 100 percent) and outright caps. This applies to some 40 banks that use an “international approach” to risk diversification requirements. Requirements for the remaining domestic banks will be adjusted to reduce interconnectedness throughout the Swiss banking system. The authorities will also look at tightening total risk concentrations, and ways to reduce operational dependency of small and medium size banks on the two large banks.

Organizational Structures and Possible Capital Rebates

8. The TBTF commission proposed that large bank organizational structures be designed to ensure systemically important functions in the event of insolvency. Large banking groups have complex interconnected legal structures with assets and systemically important functions spread across subsidiaries and supervisory jurisdictions. Unbundling and continuity of these critical functions may be impossible in the event of a bank failure. Under the proposals, at a *minimum*, banks will need to prove—through the development of an “emergency plan”—that systemically important functions in the event of insolvency will be maintained. Continuation of systemically important functions may require

transfers of these functions to a “bridge bank”, endowed with sufficient capital.²

9. If banks exceed the minimum and implement organizational measures to reduce national and international systemic risks, they may take advantage of capital rebates.

Supplemental capital reduces the risk of insolvency, and if necessary, helps to facilitate orderly restructuring or resolutions. However, clearly implemented organizational measures (beyond emergency planning) can improve resolvability and limit financial repercussions. Thus the proposals envisage capital rebates from the third progressive capital component. While this component theoretically covers capital needed to capitalize a bridge bank and ensure viability of the residual going concern for at least 1 year, it also covers risks to continuation of essential functions. The sense of the rebate is to recognize that organizational efforts (e.g., simpler structures, alignment of assets and staff) beyond emergency plans can reduce these risks.

² The “emergency plan” must specifically demonstrate how the continuation of systemically important functions will take place, taking into account questions of complexity, legal obstacles, timing, and required resources. Also, it is important that the plan is structured to avoid possible complications from “unequal treatment” of creditors and other challenges that may occur under Swiss bankruptcy law.



SWITZERLAND

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 28, 2011

Prepared By

Staff Representatives for the 2011 Consultation with
Switzerland (In consultation with other Departments)

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APPENDIX I. SWITZERLAND: FUND RELATIONS

(As of March 31, 2011)

I. 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.

II. General Resources Account

	SDR Million	Percent Quota
Quota	3,458.50	100.00
Fund holdings of currency	2,540.76	73.46
Reserve position in Fund	917.79	26.54

VI. Projected Payments to Fund^{1/}:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2011	2012	2013	2014	2015
Principal					
Charges/Interest	0.16	0.19	0.19	0.19	0.19
Total	0.16	0.19	0.19	0.19	0.19

^{1/} When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. Exchange Rate Arrangement:

The exchange rate of the Swiss franc is determined by supply and demand in the foreign exchange market and is currently classified as a free floating regime. The Swiss National Bank reserves the right to intervene in the foreign exchange market. All settlements are made at free market rates. Switzerland maintains an exchange system free of

III. SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	3,288.04	100.00
Holdings	3,252.27	98.91

IV. Outstanding Purchases and Loans:

None

V. Financial Arrangements: None

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 2, 2011 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.

In accordance with UN Security Council resolutions, restrictions are currently in place with respect to specific individuals and entities associated with the former government of Liberia and Iraq; specific individuals and entities associated with Osama bin Laden, the Taliban, and the Al-Qaida network; specific individuals and entities posing a threat to international peace and security in Côte d'Ivoire; in the Democratic Republic of the Congo (DRC); impeding the peace process in Sudan; engaged in the Democratic People's Republic of Korea's (DPRK) Weapons of Mass Destruction (WMD)–related programs, ban on financing and financial services related to the provision of arms and related materiel to Lebanon; specific individuals and entities involved in the nuclear and/or ballistic missile programs of the Islamic Republic of Iran; prohibition for the Iranian Government and Iranian nationals to acquire an interest in any commercial undertaking involving uranium mining, material and equipment on the "Trigger List" and items and technology related to ballistic missiles; financing and financial services related to the provision and the acquisition of arms and related materiel, and to

military activities in Eritrea; financing and financial services related to the provision of arms and related materiel, and to military activities in Somalia. The lists of individuals and entities against which financial sanctions are in force are based on the decisions by the competent UN Security Council sanctions committee and are amended regularly.

In accordance with EU regulations, restrictions are currently in place with respect to specific individuals associated with the previous government of the former Republic of Yugoslavia, specific individuals associated with the governments of Zimbabwe, Myanmar and Guinea; specific individuals and entities associated with the government of Belarus. The lists of targeted individuals are identical to the list in the corresponding EU regulations.

VIII. Technical Assistance: None

IX. Resident Representatives: None

X. Other: FSAP Update, November 2006

APPENDIX II. SWITZERLAND: 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 the second quarter of 2011 the SNB will start to collect—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. This supplementary survey will be transformed into a permanent survey starting in the second quarter of 2011. Work is under way to completely revise the **survey on trade in services**. The collection of data based on the

new survey will start 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 will report further improvements to its AML System in October 2011 within the context of its biennial update.

Table of Common Indicators Required for Surveillance (As of April 11, 2011)					
	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶
Exchange Rates	Apr 11	Apr 11	D and M	M and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Mar 11	Apr 11	M	M	M
Reserve/Base Money	Mar 11	Apr 11	M	M	M
Broad Money	Mar 11	Apr 11	M	M	M
Central Bank Balance Sheet	Mar 11	Apr 11	M	M	M
Consolidated Balance Sheet of the Banking System	Mar 11	Apr 11	M	M	M
Interest Rates ²	Mar 11	Apr 11	D and M	M and M	D and M
Consumer Price Index	Mar 11	Apr 11	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government ^{3,4}	2009	Apr 11	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government ³	Feb 11	Mar 11	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Q4/10	Mar 11	Q	Q	Q
External Current Account Balance	Q4/10	Apr 11	Q	Q	Q
Net International Investment Position	Q4/10	Apr 11	Q	Q	Q
Exports and Imports of Goods and Services	Feb 11	Apr 11	M	M	M
GDP/GNP	Q4/10	Mar 11	Q	Q	Q
Gross External Debt	2010	Mar 11	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. 11/62
FOR IMMEDIATE RELEASE
May 26, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with Switzerland

On May 18, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.¹

Background

The economy has experienced a strong, broad-based recovery. After falling by 1.9 percent in 2009, output grew by 2.6 percent in 2010. Domestic demand was underpinned by sound balance sheets, low interest rates, and a rebound in employment and immigration. Exports increased more strongly than expected, on the back of robust external demand and in spite of a 10-percent appreciation in the real effective exchange rate. Trade and current account surpluses have continued to expand. Capacity utilization, particularly in construction, is now above its long-term average while the unemployment rate has gradually declined. Despite the surge in oil prices and declining slack in the economy, inflationary pressures, so far, remain muted. House prices have accelerated but there is so far no evidence of a widespread misalignment.

Monetary policy has supported a swift exit from the recession. The Swiss National Bank (SNB) continues to implement an expansionary monetary policy, with the 3-month Libor target range at zero to 0.75 percent since March 2009. From that date until mid-2010, the SNB pursued foreign exchange interventions to limit upward pressure on the Swiss franc.

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>.

Fiscal policy provided limited stimulus during the crisis given small automatic stabilizers, a moderate package of policy measures, and conservative application of the debt brake fiscal rule. Thus, overall fiscal balances were little affected by the downturn.

The global market recovery, and favorable financing conditions, together with financial sector measures have contributed to improving banks' profitability, and capital and liquidity positions in 2010. However, there is evidence of increased risk taking in mortgage lending, in the context of persistently low interest rates and high competition among banks.

Recommendations from the "too big to fail" commission, now under discussion in Parliament, include supplementing minimum Basel common equity requirements with loss-absorbing buffers in the form of contingent convertible capital, which may be lowered depending on measures to reduce inter-connectedness and complexity. Regarding supervision, the Financial Market Supervisory Authority (FINMA) has developed a new risk-based approach, increased on-site inspections, hired more personnel, and taken steps to improve the effectiveness of external auditors. Inter-agency cooperation has been strengthened with a new tripartite Memorandum of Understanding on collaboration, information exchange, and crisis management.

With the recovery firmly established, the authorities are contemplating an exit from their expansionary monetary policy. Fiscal policy is projected to be broadly neutral. The recovery is expected to gradually moderate in the near-term. Growth is projected to slow to 2.4 percent in 2011 and to 1.8 percent in 2012. While domestic demand should remain resilient, the delayed effects of currency appreciation and a weaker external environment will slow exports and reduce the trade surplus. Headline and core inflation should remain muted at around 1 percent in 2011–12. However, there are large uncertainties related mainly to global developments.

Executive Board Assessment

Executive Directors commended the authorities for their pro-active policy response, which contributed to a swift and broad-based economic recovery. Directors noted that uncertainties relating to external developments are likely to persist, weighing on the near-term growth outlook. In the medium term, continued financial sector reforms will be key to reducing vulnerabilities.

Most Directors supported a prompt withdrawal of the monetary stimulus, absent new shocks, and concurred that interventions on the foreign exchange market should be limited to reducing excessive exchange rate volatility. Directors took note of the differences between staff and authorities on the assessment of the exchange rate misalignment, with many stressing the uncertainties surrounding the assessment. Directors noted that, while the normalization of the monetary policy stance will contribute to reducing macro-financial concerns, it may not suffice to address loosening lending standards in the mortgage market. They recommended, therefore, that macro-prudential measures also be considered, unless system-wide self-regulation is sufficiently stepped up.

Directors welcomed Switzerland's comparatively strong fiscal position. In view of the prospective tightening of monetary policy, they agreed that a neutral fiscal stance is appropriate. Directors supported continued adherence to the "debt brake" rule and, in light of the large financial sector and ageing pressures, encouraged further efforts to buttress fiscal sustainability, including a parametric reform of the old age insurance system.

Directors noted that banks' performance has improved, but vulnerabilities remain. They commended the authorities for their efforts to promote "too big to fail" legislation aimed at reducing the risks posed by the two largest banks, and looked forward to a swift adoption of the law. Directors encouraged further progress in micro-prudential supervision, including on a cross-border basis, by increasing on-site inspections and strengthening the independence of external auditors from banks. Directors stressed the importance of continuing to monitor risks in the insurance sector, where reduced profitability prospects and the need to strengthen reserves could hinder recapitalization efforts.

Directors encouraged a strengthening of the macro-prudential framework, clarifying roles and responsibilities of the SNB and FINMA, where necessary by revising relevant legislation, and establishing the legal basis for system-wide policies to address macro financial stability issues.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2011 Article IV Consultation with Switzerland is also available.

Switzerland: Selected Economic Indicators

	2007	2008	2009	2010	2011 ^{1/}
Real economy					
Real GDP (percentage changes)	3.6	1.9	-1.9	2.6	2.4
Real total domestic demand (percentage changes)	1.4	0.2	0.7	0.6	3.1
CPI (year average)	0.7	2.4	-0.5	0.7	0.9
Unemployment rate (in percent of labor force)	2.8	2.5	3.6	3.6	3.4
Gross national saving (percent of GDP)	30.9	23.4	31.2	33.3	34.0
Gross national investment (percent of GDP)	22.0	21.1	19.7	19.0	20.8
Public finances (percent of GDP)					
Federal government balance	0.8	1.0	0.5	0.5	-0.1
General government balance ^{2/}	1.8	2.0	0.8	0.2	0.3
Gross public debt	57.2	54.8	54.9	55.0	52.7
Balance of payments					
Trade balance (in percent of GDP)	1.8	2.8	3.1	3.3	3.0
Current account (in percent of GDP)	8.9	2.3	11.5	14.2	13.2
Official reserves (end of year, US\$ billion) ^{3/}	74.6	68.8	135.8	265	...
Money and interest rates					
Domestic credit (annual average)	-0.2	4.9	8.0	8.2	...
M3 (annual average)	1.7	4.9	2.6	2.2	...
Three-month Libor rate (in percent)	2.8	0.7	0.3	0.2	...
Government bond yield (in percent)	2.8	2.7	1.8	1.3	...
Exchange rate					
Exchange rate regime				Free float	
Present rate (April 20, 2011)				SwF 0.89 per US\$1	
Nominal effective exchange rate (2005=100)	96.1	101.4	105.9	113.1	...
Real effective exchange rate (2005=100) ^{4/}	93.6	97.9	101.6	107.5	...

Sources: IMF, International Financial Statistics; IMF, World Economic Outlook; and IMF staff projections.

^{1/} Staff estimates and projections.

^{2/} Including Confederation, cantons, communes, and social security.

^{3/} Excluding gold.

^{4/} Based on consumer prices.

**Statement by Rene Weber, Executive Director for Switzerland
and Peter Marcel, Senior Advisor to Executive Director
May 18, 2011**

1. On behalf of our Swiss authorities, we would like to thank staff for once again presenting a useful staff report, which includes a thorough and insightful analysis of the macro-economic situation with a particular and appropriate focus on financial sector issues. We share staff's opinion regarding the policy challenges going forward on most aspects. The candid policy recommendations are welcome and add considerable value to the topical domestic policy discussions in Switzerland.

Outlook

2. The growth outlook for the Swiss economy is positive overall. Available data for end-2010 and the beginning of 2011 continue to paint a solid picture of the Swiss economy, although this outlook is tempered by the strong appreciation of the Swiss franc. External and domestic demand will likely have contributed positively to growth during the first months of 2011. Unemployment is falling and the output gap is practically closed. The government projects only slightly lower GDP growth in 2012 than this year (2.1 percent in 2011 and 1.9 percent in 2012).

3. However, the net trade contribution to Swiss GDP will be low on average in 2011. Besides the dampening effects of the currency appreciation in real terms, a weaker international environment is likely to contribute to a slowdown. Business sentiment as measured by surveys had reached relatively high levels during the first semester 2010, but has not improved further since. During the last months, new orders in the chemical industry, an important segment of the Swiss industry, have declined considerably. On the positive side, corporate balance sheets are healthy and liquid, and international competitive pressures should continue to elicit productivity gains.

Monetary Policy

4. Our authorities share the staff's appraisal that there is a need to normalize the monetary policy stance in the near term. Absent significant shocks or risks to the outlook, the current expansionary policy cannot be maintained without compromising price stability in the longer term. Conditional on an unchanged policy rate, CPI inflation is forecast to stay below 1 percent during 2011, but it is expected to exceed this mark in 2012 and surpass 2 percent by the end-2013. Normalization is also needed to reduce macro-financial concerns, even though monetary tightening alone may not suffice. It may have to be complemented by the use of macroprudential instruments.

5. Since the beginning of the international financial crisis, the Swiss franc has come under significant appreciation pressure. This pressure increased further in spring 2010 with the escalation of the debt crisis in the euro area. Given the zero bound on interest rates, the Swiss National Bank (SNB) intervened to prevent an unwanted tightening of monetary conditions via an excessive appreciation of the Swiss franc. In mid-2010, as

uncertainties abated and the economic outlook improved, the SNB stopped its interventions and started to mop up liquidity.

6. The strong appreciation of the Swiss franc over the second half of 2010—which even accelerated at year-end—resulted in a substantial valuation loss on foreign exchange reserves. Profits were nonetheless distributed because of past accumulated surpluses and the Confederation’s and the cantons’ need for budget planning dependability. To mitigate the exchange rate risks inherent in holding foreign exchange reserves, the SNB continues to build up its capital and diversify its foreign exchange reserves.

7. Our authorities do not share the staff’s assessment that the exchange rate is broadly in line with fundamentals. Rather, the SNB considers the Swiss franc to be overvalued, as clearly shown by the results from the IMF’s equilibrium real effective exchange rate approach. The SNB does not consider the other two approaches that are used in the CGER methodology—the macro-balance and the external sustainability approach—to be very relevant for Switzerland. Both of these approaches rely on estimates of an equilibrium current account, something that is very difficult to estimate in the Swiss case because Swiss current account figures are essentially influenced by structural factors (such as large investment income from multinationals, trade in services, and the mandatory pension system) and not by the exchange rate. Even the adjusted numbers in Box 3 do not do full justice to the inadequacy of these approaches in the Swiss case.

Financial stability

8. Our authorities share the staff’s assessment of Switzerland’s main challenges for financial stability, namely the need to strengthen the large banks’ capital base and to prevent an overheating in the real estate market. On the former, the large banks’ leverage remains high relative to peers, despite recent improvements and notwithstanding above-average Tier 1 ratios, and the quality of their capital will need to be improved. It is envisaged that systemically important banks build up their capital well above international standards in the next few years (see ¶ 9). On overheating, the authorities are closely monitoring risks to financial stability stemming from the real estate market and they share the staff’s view that corrective measures to address these risks need to be considered. Specific measures already taken comprise: (i) data collection to further improve monitoring quality, (ii) an initiative to revise the Swiss Bankers Association’s self-regulation for mortgage lending, and (iii) an intensification of microprudential supervision. The Financial Market Supervisory Authority (FINMA) could, in addition, require capital add-ons.

Too-big-to-fail (TBTF) legislation

9. The Swiss authorities welcome the staff’s assessment that the proposed legislation on strengthening financial sector stability (TBTF) is instrumental in reducing systemic risk in the economy. The combined impact of the strong measures relating to capital, liquidity, and organization will be key for the effectiveness of this legislation. The proposal currently being debated in parliament does not only aim at increasing the resilience of systemically important banks, but would also establish strong incentives for

these institutions to reduce their systemic impact and to improve their international resolvability.

Macprudential framework

10. Our authorities appreciate the in-depth analysis of the framework for macroprudential oversight. They consider the staff's concrete proposals as a helpful contribution to the discussion. They note, however, that international experience and guidance on best practices remains limited at present and that there is no broadly accepted framework, let alone a "one-size-fits-all" concept. Further analysis, taking account of the specific structure of the Swiss financial system, will thus be needed to formulate a macroprudential framework for Switzerland. This framework will have to be based on, and combine, the expertise of both the SNB and FINMA and to account for the experience gained during the crisis.

11. The Federal Department of Finance has set up a high-level working group to (i) assess the organization of macroprudential surveillance in Switzerland and the need for additional macroprudential instruments and (ii) evaluate the need to adapt the legal framework, inter alia to ensure that the SNB can fulfill its financial stability tasks, including with regard to crisis prevention. This further work should help clarify the division of responsibilities between the various authorities and assign the instruments accordingly. The working group will submit its report in the fall 2011.

Fiscal Policy

12. The fiscal outcome for 2010 benefited from a much stronger than expected performance of the Swiss economy, resulting in a general government surplus of 0.2 percent of GDP rather than a budgeted deficit of 1.5 percent. This swing from deficit to surplus was most notable at the federal level. The 2010 federal budget as well as those of sub-national entities were based on economic forecasts that pointed to a severe recession in 2009 followed by a tentative recovery in 2010. Although in retrospect the recession was the worst since the 1970s, it was not as severe as predicted at the time of budgeting, and the strength of the recovery exceeded all expectations.

13. As noted by staff, the requirements of the Swiss debt brake rule have been regularly surpassed over the last six years. This has helped to move federal debt onto a more sustainable path and has led to a significant reduction in interest payments. However, budgetary overperformance has focused the authorities' attention on the estimation methods for receipts, in particular from the withholding tax. In light of the latest outturns, this tax estimate will be revised upward to better take account of its more recent trend.

14. The medium-term budgets of the Confederation are expected to deteriorate somewhat due to various structural tax reforms. At the sub-national level, however, balances are improving further. The figures of the social-security accounts—which recorded an increase in the deficit of roughly 1 percent of GDP between 2008 and 2010—will improve as well and reach balance by 2012, partly due to the reform of unemployment insurance.

15. As a further sign of fiscal prudence, debt levels are expected to continue their decline, notwithstanding their small uptick in 2010. Since many cantons and municipalities have adopted and implemented their own debt brake or other fiscal rules, our authorities believe that the basis for the debt consolidation called for by staff is solidly in place.