Switzerland—2010 Article IV Consultation
Conclusions of the Mission

March 23, 2010

1. **While the recession has been severe, Switzerland has weathered the global downturn relatively well.** In spite of its openness and large financial sector, Switzerland has been less affected by the crisis and the decline in world trade than most of its neighbors. Supportive policies, strong balance sheets, the lack of a boom-bust real estate and credit cycle, and a muted reaction of employment to growth, have enabled domestic demand to cushion the extent of the downturn.

2. **A moderate recovery is ongoing, but substantial uncertainty remains.** The severe recession ended in the second half of 2009, as the decline in exports abated, and the fall in financial intermediation and manufacturing bottomed out. Latest indicators point to a continuing recovery with some improvement in the labor market. Looking ahead, we expect GDP to grow by about 1½ percent in 2010-11 after contracting by 1.5 percent in 2009. With slack in the economy, and Swiss franc appreciation, inflation should remain muted. However, uncertainties are wide and related to global developments, including in financial markets. Similarly, the long term prospects of the economy are unclear, as financial activity and immigration flows—two key drivers of recent growth—may slow down going forward.

3. **In this context, any exit from expansionary polices should be gradual.** While normalization of monetary policy will imply an exit from foreign exchange interventions, and a rise of interest rates, the tightening of monetary and financial conditions should remain cautious. Similarly, fiscal tightening should be limited to only what is needed to comply with the "debt brake" rule.

4. **Most importantly, the momentum to reinforce financial stability should not be lost.** The crisis underlined the importance of strengthening financial stability. The measures taken by the authorities, and improvement in financial markets, have proved effective in stabilizing the financial system. However, the crisis also exposed the moral hazard problem and the potentially disproportionate public finance liabilities associated with large systemic banks. Thus supervision and regulation should be strengthened further. Capital and liquidity standards should continue to include substantial add-ons to internationally agreed requirements in the spirit of the authorities' 2008 decision.

Monetary and Exchange Rate Policies

5. **The SNB appropriately maintained an expansionary policy stance over the past year.** Faced with concerns over deflation and tightening conditions despite near zero interest rates, the SNB implemented *unconventional policy measures* since March 2009. These included purchases of Swiss franc private sector bonds to affect risk premia in select

segments, a further extension of repo maturities to ensure liquidity, and unsterilized intervention to prevent further appreciation of the Swiss franc against the euro. Taken together, these measures pushed the 3-month Libor rate to the lower end of the current 0-0.75 percent target range and partially stabilized monetary conditions in the face of persistent appreciation pressure on the Swiss franc.

6. **The SNB has signaled its desire to normalize rates over time.** While inflation is expected to be muted in the near-term, the SNB projects it to gradually pick up and exceed 2 percent by 2012 under a no policy change assumption. Moreover, in recent communications the SNB has stressed that a prolonged period of low interest rates may create an acceleration in mortgage lending and risky lending practices. While liquidity has been scaled back since April 2009, from mid-December, bond purchases have ceased, and only *excessive* appreciation vis-à-vis the Euro has been prevented. Indeed markets expect some increase in interest rates by end 2010.

7. **The challenge ahead will be to normalize monetary policy, which will entail exiting unconventional measures**. Although the currency has appreciated by 12 percent since mid-2007 in real effective terms, it does not appear to be misaligned. The real appreciation reflects continuing trade surpluses, improving fundamentals, and safe haven effects. In these circumstances, foreign exchange interventions may be used to resist short term disruptive pressures.

8. **Interest rate should not be raised too early—or without regard to a strengthening in the currency**. Indeed, inflationary pressures are subdued given slack in the economy, and as a result of the appreciation of the currency. Rapid changes in the inflation environment appear unlikely. Furthermore, preliminary indications suggest that lending standards have not materially deteriorated. If mortgage lending appears to be excessive and accompanied by a weakening of lending standards, prudential / supervisory tools implemented by relevant authorities (e.g., added capital charges under Pillar II) may be best suited to limit this growth.

Fiscal Policy

9. **The fiscal position continued to remain robust during the downturn—while providing some support to the economy.** Prudent fiscal policies resulting in a low debt level have served the country well and are warranted, in view of large potential liabilities related to the banking sector and of the effects of ageing. The strong fiscal position allowed the authorities to undertake countercyclical fiscal measures (excluding automatic stabilizers) amounting to about 0.4 percent of GDP at the federal level and about 1 percent of GDP at the general government level in 2009, without pushing the balances into deficits. In particular, the federal government achieved a small surplus in 2009, due mostly to above average withholding tax receipts and lower interest payments.

10. **Looking ahead, the government expects some consolidation need of around 0.3 percent of GDP starting in 2011.** The government projects the 2010 outcome to be a small deficit—reflecting some lagged effects of the recession on revenues and stimulus related expenditures. For 2011-13, planned permanent tax reductions will amount to SFr 1.3 billion per annum. All in all, the necessary effort required to maintain expenditures below potential revenues under the debt brake is estimated to be between SFr 1.3 and SFr 2 billion over 2011-13. This estimate is based, in particular, on an assumption of SFr 3.6 billion in withholding tax revenues.

11. **Consolidation should be limited to what is needed to respect the debt brake rule; however, estimating potential revenue is a challenge.**

- While respect of the debt brake rule is necessary, it is important to avoid excessive consolidation that may be unwarranted ex-post given the fragile recovery and expected tightening of monetary conditions.

- Estimation of potential revenue is, however, delicate. On the one hand, planned tax reductions suggest a decline in potential revenue. On the other hand, the better than projected performance of the last few years may reflect a permanent revenue increase. In particular, withholding tax receipts have constantly exceeded their budgeted amount since 2005.

- There is a trade-off between smoothing fluctuations of estimated revenues from withholding tax, and hence allowed expenditures, and being able to capture permanent changes more quickly. In this respect, the use of a 10-year average to estimate withholding tax receipts may lead to overly conservative projections. We would recommend moving to a shorter time horizon.

12. **Medium-term pressures rising from an ageing population need to be addressed.** According to the 2008 Long-Term Sustainability report, public expenditures will increase by 5 percent of GDP by 2050 as a result of ageing. The first pillar pension system will swing into deficit within 5-10 years and demographics will increase health expenditures. Furthermore, although the recent VAT increase covers the deficits in the disability insurance system in the short run, it does not offer a permanent solution. The government is discussing further reform in this area.

Financial Stability Issues

13. **While measures taken by the authorities—and the global recovery in financial markets—have been effective in stabilizing the financial sector, some risks remain.** Internationally oriented institutions were hard hit by the financial crisis, while institutions with a domestic focus have fared better. The two systemically important banks have largely written down their losses, and strengthened their funding and capital positions. However,

challenges remain. Further asset deterioration cannot be ruled out and dependence on wholesale funding in some areas is still elevated. Banks would in particular be exposed to turbulences in the Euro area, through their impact on their counterparties and from the knock-on effects on the Swiss economy. Looking ahead, favorable refinancing conditions will subside and business models will have to adapt. Moreover, the wealth management and private banking industry will be under pressure and is likely to experience some outflows as a result of tax related issues.

14. **Some weaknesses also linger in the insurance sector.** Life insurance companies have been affected by low interest rates and financial market developments, weakening the financial health of some. The situation of non-life insurers has improved, reflecting better investment outcomes and higher premiums. While the reinsurance sector has strengthened through de-risking and capital increases, residual risks from securitized products remain. Coverage ratios in the second pillar pension sector have picked up to some degree, but underfunding remains and may require adjustment if the situation does not improve further.

15. **The authorities' steps to strengthen the prudential regulatory framework are to be commended.** The crisis revealed, on a global basis, the need for higher capital and liquidity requirements. This is especially important for Switzerland given the relative size of the financial sector. In this context, FINMA, in close cooperation with the SNB, rightly imposed higher regulatory capital requirements in 2008 and is currently formulating liquidity benchmarks for the two large banks. FINMA has also issued remuneration guidelines effective in 2010 to better align compensation to the long term performance of the firm. Capital and liquidity requirements will be recalibrated once new Basel standards have been issued.

16. **The momentum to address the "too big to fail" (TBTF) problem should not be lost.** A broad based working group has been constituted in Switzerland to devise recommendations on the TBTF issue. FSB-led work on this topic is focusing on reducing the probability of a failure through higher capital and liquidity requirements, strengthening macro and micro supervisory processes, and improving financial sector resilience to failures. Once new Basel standards are issued, the authorities should, in particular, ensure that sufficient add-ons are imposed to address the TBTF issue, and avoid retracting from their previously defined requirements. Changes in the organization and the legal structure of large banking institutions could also be considered. This may require additional legislation. Progress in these areas will serve the economy well and help foster the reputation of its financial center.

17. **FINMA has made progress in strengthening supervision, but more needs to be done.** FINMA has increased its focus on major institutions, oversight of auditors, and governance and risk management practices. It also has expanded cross border cooperation through colleges. While these steps are welcome, the effectiveness of FINMA could be further enhanced. FINMA's in-house supervisory capability should be enhanced, thus

allowing it to engage more actively on-site with high impact institutions. The independence of the external auditors should be better ensured. For example, payments to auditors should come directly from FINMA. This will clarify lines of control and reinforce the auditors' public responsibilities.

18. **Addressing systemic risks requires clarity on responsibilities, access to information, and enforcement power.** According to their mandates, the SNB contributes to the stability of the financial system while FINMA secures the smooth functioning of the financial markets. While the overlap between micro and macro supervision is an inherent feature of the system given the weight of the two large banks, the delineation of responsibilities between the two institutions could be further clarified. The recently signed Memorandum of Understanding between SNB and FINMA is a step in the right direction. There is also a need to ensure that the legal framework is supportive of the respective mandates, including as regards to information gathering, and enables the findings to be acted upon.

19. **In the absence of more substantive reform, the 2008 improvements to the deposit insurance fund should be preserved.** The government proposed reform would have set up an independent public fund with partial prefunding and shorter repayment period. Given the rejection of the new proposal, 2008 improvements to depositor protection and capacity absorption of the fund, which is due to expire at the end of 2010, should be preserved.

We thank the authorities and all our other counterparts for their hospitality and the open and fruitful discussions.