Switzerland—2014 Article for Consultation

Press Release

Bern, March 24, 2014

Key recommendations

- *The exchange rate floor should remain in place for now, as inflation is near zero and the risk of a resumption in safe haven inflows is still material.*
- *In the mortgage market, with past measures being insufficient, it is urgent to implement stronger demand-side measures.*
- *Largest banks should continue to reduce leverage and more is needed to achieve cross-border resolvability.*
- *More resources are required for extending FINMA's intensive banking supervision across the sector; more guidance to auditors performing supervisory audits is desirable.*
- *Deposit insurance needs to be brought into line with international best practices.*

Outlook and recent developments

1. **The economy has picked up speed and growth should continue at the current pace in 2014.** While domestic demand supported growth in 2013, foreign demand including from the euro area is expected to increasingly provide momentum. In the baseline scenario, we expect growth of about 2 percent this year and the next as the slack in the economy is being eliminated.

2. **There are no inflationary pressures in sight.** Wages and domestic prices are rising modestly, while lower inflation in the euro area and the strong franc are pulling down imported inflation. The real exchange rate is stable and remains moderately overvalued, but this is no longer having a significant negative effect on the overall external performance.

3. **The banking sector is exhibiting divergent trends.** The balance sheets of the two large banks continue to shrink as the banks strive to meet new regulatory requirements. Meanwhile, domestically-oriented banks have grown substantially, fuelled by increases in real estate lending, and becoming increasingly exposed to shocks from sharp price corrections and higher interest rates.

Monetary and exchange rate policy

4. **Monetary and exchange rate conditions have improved since last year but have not normalized thus far**. There has been no need for foreign exchange market intervention since the fall of 2012. Nevertheless, improved market confidence toward the euro area and tapering of unconventional monetary policies in the U.S. have yet to translate into sizable capital outflows. As a result, the franc continues to trade close to floor. This likely reflects Switzerland's continued role as a safe haven against the background of volatile international capital markets.

5. **The exchange rate floor continues to be a necessary element of the monetary policy framework.** Inflation is still at the bottom of the SNB target range, and renewed exchange rate appreciation, as might arise from a new bout of safe haven inflows, would quickly bring back deflationary pressures. Thus, monetary conditions need to remain expansionary and the exchange rate floor needs to remain in place. Negative interest rates on banks' excess reserves may need to be introduced in case of renewed strong pressures on the franc. The SNB balance sheet is likely to remain extended for a prolonged period with large fluctuations in mark-to-market profits, and provisions need to be strengthened to bring capital in line with risks.

The housing market

6. **Imbalances in the housing market continue to build up, though perhaps at a somewhat slower pace.** Prices for owner occupied apartments, which have grown at 6 percent per year on average since 2008, slowed to 4.3 percent year-on-year in the second half of 2013, still well above income growth. Signs of a cooling off in mortgage lending are tentative, with the acceleration in the buy-to-let segment a special concern. In addition,

surveys of the quantitative lending standards used by banks to grant mortgages give only mixed signals despite the tightening of self-regulation measures.

7. **Stronger policies to curb the demand for mortgages are needed to reduce the risk of a sharp adjustment down the road.** Expectations of continued low interest rates are fueling housing demand and pushing prices up. The recent hike in the Countercyclical Capital Buffer is welcome, but its impact is not sufficient as capital is not a constraint across the domestically oriented banking sector. More aggressive policies to discourage vulnerable households from taking on too much mortgage debt need to be in place. To this end, existing self-regulation measures should be tightened, for example to speed up loan amortization. Parallel measures to curb mortgage growth in the buy-to-let segment should also be put in place. However, given the limited effect of self-regulation so far, stricter direct regulation may be necessary, including mandatory affordability caps and maximum loan-to value ratios. This would be an appropriate time to phase out tax incentives that encourage borrowing to finance home buying.

Medium-term prospects and policies

8. **The recent popular vote to move away from the free movement of labor with the EU has increased uncertainty about medium-term economic prospects.** Immigration has increased the labor force by about one percentage point per year since the free movement of labor accord with the EU came into force. Immigrants account for a large share of the work force in many important sectors. Uncertainty as to the ability to recruit the needed personnel in the future may discourage new investment in these sectors. Additional uncertainty may arise as some key cooperation agreements with the EU could be called into question. A rapid resolution of this uncertainty would be important to underpin the economic recovery.

9. **Slower immigration will increase the challenges of an aging population, and the new legislative pension reform proposal is welcome**. The proposal aims at placing first and second pillar pensions on a sustainable financial basis in light of population aging. Aligning the retirement age of women to that of men is sensible, and placing the social

security funds under a fiscal rule, as are most cantonal budgets and the federal budget, should reduce fiscal risks going forward.

10. **The authorities are exploring avenues to reform the corporate income tax**. Specifically, they are seeking to eliminate the favorable tax treatment on income from foreign activities granted to multinational corporations by a number of cantons. We welcome this initiative and encourage the authorities to take into account ongoing international efforts to counter base erosion and profit shifting. The strategy to build buffers in the federal budget for possible burden sharing of the fiscal costs with the cantons should facilitate this reform.

Financial sector policies

11. **The Swiss financial sector is strengthening and continued reform will foster further progress.** The recent assessment undertaken under the IMF's Financial Sector Assessment Program finds that the position of the Swiss banks has improved markedly since the Global Financial Crisis, and recommends additional measures to strengthen the soundness and resilience of the financial system, which is important for global financial stability given the prominent role of the Swiss banking and insurance sectors. Amongst these recommendations are:

- Press the largest banks to continue efforts to rapidly bring their leverage ratios into line with other large international banks and ensure an ambitious minimum leverage ratio requirement.

- Increase resources available to FINMA for banking supervision, in particular so that it can extend its intensive supervision in the sector beyond the largest banks.

- Refine FINMA's use of external auditors for onsite supervision of the banks, including through periodic rotation of auditing firms, ensuring auditors are paid from a FINMA-managed bank-financed fund, and providing more guidance on their supervisory focus.

- Continue discussions with international counterparts to reach agreement on measures to make the largest banks resolvable without public sector support.

- Overhaul the deposit insurance scheme to bring it into line with emerging international best practices and the schemes being established in the region. A new scheme should involve greater transparency to depositors on coverage conditions, commitment to faster payouts, ex ante financing in a dedicated fund, and the fund to have powers to take action other than bank closure when there is a cheaper alternative.

- Continue to review closely the business plans of life insurance companies, in particular their adaptation to an expectation of protracted low interest rates.

- Put Switzerland at the cutting edge of financial sector transparency, including for instance as regards risk weights in banks' internal models, so as to enhance understanding of, and credibility in, the banks' soundness and strategies.

We would like to thank the authorities and private sector counterparts for their cooperation and hospitality.