INTERNATIONAL MONETARY FUND

Switzerland: Concluding Statement of the 2015 Article IV Mission

March 23, 2015

> A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.
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> The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Key recommendations

- *Ease monetary policy further to help limit an expected slowdown in growth and reduce risks related to very low inflation.*
- *To further support growth, allow fiscal automatic stabilizers to operate freely. If the downturn is more severe than expected, consider discretionary fiscal easing.*
- *Adopt pension reform to ensure the sustainability of the safety net for future generations.*
- *Raise banks' minimum leverage ratio requirements to more ambitious levels to ensure banks have adequate capital to weather future shocks without recourse to public support.*
- *Pay bank auditors from a FINMA-managed, bank-financed fund rather than by the bank that is being audited to avoid conflicts of interest.*

Economic outlook and risks

1. **Economic growth in Switzerland is likely to slow in the near term while inflation becomes more negative**. Switzerland's economy has performed relatively well in the aftermath of the global financial crisis, with growth reaching 2 percent in 2014. However, exchange rate appreciation in early 2015 has left the Swiss franc overvalued and weakened the near-term outlook. In particular, GDP growth is expected to ease to around ¾ percent in

2015, mainly due to weaker net exports. The strong franc, together with lower oil prices, is also likely to drive inflation down to around -1½ percent by late 2015.

2. **Over the medium term, the economy is expected to recover gradually**. As the economy adjusts to the exchange rate appreciation, growth is projected to rise gradually back to around 2 percent over the medium term while inflation increases to around 1 percent.

3. **However, this central scenario is subject to important risks**. The duration of the downturn in both growth and inflation is highly uncertain and could be more protracted than projected. Specific risks include the following:

- ***Risks related to low inflation***. Operating in an environment of very low inflation may prove more challenging than assumed in the central scenario. With inflation expected to stay at low levels even in the medium term and with global equilibrium real interest rates having fallen substantially over the last decade, monetary policy may have difficulty reducing the real interest rate in response to future shocks, given constraints on further significant reductions in nominal interest rates.

- ***Uncertainty about EU relations and immigration***. Last year's vote to move away from the free movement of labor with the EU has created substantial uncertainty about medium-term growth prospects, as such a move may reduce labor force growth, restrict firms' ability to recruit personnel, increase the fiscal challenges of population aging, and reduce Swiss firms' access to EU markets if existing cooperation agreements with the EU are revised. This uncertainty may also weigh on investment. A constructive resolution of this uncertainty would help underpin economic recovery.

- ***Global economic environment***. This risk goes in both directions. On one hand, downside surprises to global growth and further bouts of global risk aversion could fuel franc appreciation and deflationary pressures and reduce growth. On the other hand, growth in Europe and other advanced economies could also surprise on the upside (e.g., due to a larger-than-expected boost from lower oil prices), supporting a more competitive franc, faster Swiss growth, and a quicker exit from deflation.

Monetary and exchange rate policy

4. **Further monetary easing would support adjustment**. Easing would help limit the near-term growth slowdown and lessen exchange rate overvaluation. Boosting inflation closer to 2 percent over the medium term would also reduce risks associated with operating in a low-inflation environment.

5. **Monetary easing could perhaps be achieved via a program of pre-announced asset purchases**. Such purchases could consist of foreign-currency assets—and perhaps some domestic assets, though scope for this is more limited—with the pace of purchases adjusted as necessary in response to developments. In addition, the policy rate should be maintained at its current negative level for now, as this has been helpful in reducing franc

appreciation and deflationary pressures. Central bank communication should also be geared toward ensuring that inflation expectations do not become entrenched at low levels. As the balance sheet of the Swiss National Bank (SNB) is likely to remain large for a prolonged period with large fluctuations in mark-to-market profits, the SNB should also prioritize provisioning over transfers to its distribution reserve to help ensure that its capital remains in line with risks.

Fiscal policy

6. **Fiscal policy can also support recovery**. In the central scenario, automatic stabilizers should be allowed to operate fully, as allowed under Switzerland's debt-brake rule, which has served Switzerland well. If the economic slowdown is significantly more severe or protracted than envisaged, discretionary fiscal stimulus could also be employed by triggering the rule's temporary escape clause to help boost growth and inflation and avoid overburdening monetary policy.

7. **Pension reforms will help address longer-term fiscal challenges**. Population aging is projected to substantially increase fiscal costs related to pensions and healthcare over the longer run. To help address this challenge, the government has proposed a comprehensive pension reform, including measures to equalize retirement ages for men and women and to reduce the rate at which pension savings are converted into pension annuities. Such reforms will help ensure the sustainability of the social safety net and its continued availability for future generations.

Financial sector policies

8. **Switzerland continues to take measures to strengthen its financial sector**. The banking system remained profitable in 2014 despite costs related to fines and litigation. Switzerland's most systemically important banks also continued to make organizational changes to improve resolvability and marginally increased their capital ratios. In addition, the authorities have taken measures to further strengthen financial sector regulation and supervision, including by tightening lending standards for mortgages. These steps appear to be helping to dampen the previously rapid pace of house price growth and contain the build-up of associated financial stability risks, though such indications are still tentative.

9. **Notwithstanding this progress, continued efforts are needed to complete the post-crisis transition to a safer financial sector**. Risks remain—for example, the level of mortgage debt is still high and growing as a percent of GDP. The framework for financial sector regulation and supervision can also be further strengthened, as detailed in last year's Financial Sector Assessment Program report. Encouragingly, the authorities have announced plans to adopt further measures to address many of these issues, including as a follow-up to the recommendations of the December 2014 "Brunetti Report." Such efforts are important not only for Switzerland, but also to promote global financial stability, given the prominent role of the Swiss banking and insurance sectors.

10. **Priority measures going forward include the following**:

- Continue to monitor closely financial stability risks related to Switzerland's housing market and its high levels of mortgage debt. If risks do not decline, consider tighter and more binding prudential measures, such as explicit limits on the percent of new mortgages that can exceed a given debt-service-to-income or debt-to-income ratio.

- Press the largest banks to continue rapidly bringing their leverage ratios into line with other large international banks and raise minimum leverage ratio requirements to more ambitious levels.

- Continue to refine FINMA's use of external auditors, including by periodically rotating auditing firms; providing more guidance on their supervisory focus; paying auditors from a FINMA-managed, bank-financed fund rather than by the bank that is being audited to avoid conflicts of interest; and intensifying FINMA's own onsite inspections, including by increasing the number of deep dives.

- Increase banks' disclosure requirements regarding capital-weights to enhance transparency and bolster understanding of, and credibility in, banks' soundness and business strategies.

- Continue to monitor closely the possible effects on the financial sector of the recent exchange rate appreciation and low interest-rate environment. The second factor is particularly important for life insurers and defined-benefit pension plans. To ensure the sustainability of the latter, the minimum rate of return (currently 1¾ percent) that applies to some plans and that is established by the government should be reduced to bring it into line with market rates.

- Overhaul the deposit insurance scheme to bring it into line with emerging international best practices, including by building up dedicated ex-ante funding with a back-up credit line from the authorities, reforming the scheme's governance so that a majority of board members are independent of the banking industry, and allowing the scheme to finance resolution measures.

- Continue discussions with international counterparts to define detailed implementation on agreed measures to make the largest banks resolvable without public-sector support.

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