Switzerland: Staff Concluding Statement of the 2016 Article IV Mission

September 26, 2016

Introduction

The Swiss economy weathered relatively well the sharp appreciation that followed the exit from the exchange rate floor. While GDP growth decelerated by half in 2015, flexibility by firms and the labor market helped to cushion the effect on output, which grew by a respectable 0.8 percent. The appreciation and fall in world oil prices lowered the Swiss-franc price of imports, boosting the purchasing power of Swiss consumers. In contrast, prices of domestic products, which more likely reflect Swiss cyclical conditions, declined only modestly. The improved terms of trade helped to widen the current account surplus.

Economic performance continued to firm during the first half of 2016. Growth recovered further, supported by both domestic and external demand. Deflation continued to unwind as the effect of the early 2015 appreciation on price growth dissipated and the Swiss franc remained broadly stable against the euro. With real activity gradually strengthening and unemployment at low levels, the output gap continued to narrow.

Outlook and risks

Growth is expected to continue to recover this year and next, stabilizing at a moderate 1¾ percent over the medium term. GDP is expected to expand by 1.5 percent this year, with inflation reaching around zero percent by year end. The output gap is forecast to close gradually over time, returning inflation to the middle of the target band. However, inflation will remain below levels in key trading partners, facilitating a steady reduction of the real exchange rate, which we consider moderately overvalued. Net exports are likely to make a smaller contribution to growth than in the past owing to the weaker outlook for trade partners' demand, leading to some narrowing of the current account surplus.

Risks to the outlook, while two sided, are tilted to the downside:

- ***Improved effectiveness of unconventional monetary policies*** implemented by the major central banks should increase global demand and support Switzerland's large export sector. However, this could be offset by a further decline in the trade content of global demand.

- ***A resurgence of global financial market volatility*** could trigger further capital inflows into Switzerland that would appreciate the already overvalued franc and weaken GDP growth. These effects could spill over to the real estate market where house prices and household debt are elevated and banks are heavily exposed to mortgage lending.

- ***Renewed concerns about the financial health of large foreign cross border banks*** could impact the large Swiss banks through counterparty risk and financial market contagion.

- There could be ***negative impacts on Swiss-EU economic relations*** in the event that no mutually acceptable solution can be found in ongoing discussions regarding immigration.

Monetary and exchange rate policy

The SNB's two pronged policy approach has helped to reduce deflation pressures. This approach operates mainly through the exchange rate channel, using negative interest rates and foreign exchange intervention as key instruments. However, banks have so far shielded retail depositors from negative interest rates, while transmitting them to large depositors. Banks have also preserved their profits by passing along part of the cost to mortgage borrowers. The shift to a negative nominal policy rate also partly compensated for the drop in inflation, limiting the increase in the real policy rate. Foreign exchange intervention has been used to react to large safe-haven inflow surges, as well as on a smaller scale in response to incipient inflows. As a result, the franc has been broadly stable against the euro and did not experience a sharp appreciation following the Brexit vote.

Some refinements could improve the assignment of policy tools and simplify communications. Calibrating the negative interest rate differential so as to discourage persistent inflows that can cause prolonged deflation and weaken activity is appropriate. On the other hand, exchange rate purchases should be reserved mainly to respond to episodic capital inflow surges to prevent sudden, large exchange rate appreciations. Some widening of the current effective interest rate differential—either by lowering the exemption threshold or the marginal policy rate—could therefore be considered to reduce the frequency of small-scale interventions. This would also slow the increase in the SNB's already large balance sheet, which continues to trend upward relative to GDP and is subject to valuation changes that can affect public finances.

However, operational considerations could at some point constrain the room for maneuver. Competition between banks and other lenders could over time bid down bank lending rates, and eventually push a wider set of deposit rates into negative territory, increasing incentives for cash hoarding. In addition, diversification of investments can reduce but not eliminate valuation risks on the SNB's balance sheet. Beyond monetary policy, addressing the large gap between domestic saving-investment may be warranted.

Fiscal policy

Switzerland's "debt brake" rule, which mandates the federal budget to maintain a balanced structural position, has delivered a sizable reduction in public debt. Under the rule, general government debt as a share of GDP has remained on a declining path. Automatic stabilizers operating through taxes and unemployment benefits also help to dampen the business cycle. In addition, the rule has built-in flexibility to allow extraordinary spending under the "exceptional financial circumstances" clause, which will be utilized again for migration-related spending in 2017.

Despite a goal of structural balance, some aspects of the rule could lead to some underspending. This tendency could place additional pressure on monetary policy during periods of below trend growth. With some two thirds of the budget pre-committed as transfers to other levels of government, spending compression is focused on the remaining relatively narrow set of categories, including education. Allowing underspent amounts to be used the following year would alleviate this issue.

In the event of a severe recession discretionary fiscal expansion would be an important instrument. With moderate public debt, negative borrowing costs, and broadly balanced budgets, Switzerland has ample fiscal space to respond to a prolonged recession with discretionary fiscal stimulus in order to support growth and inflation. This could also avoid overburdening monetary policy.

Pension reform will help address longer-term fiscal challenges. Population aging is projected to substantially increase fiscal spending on pensions and healthcare over the longer run. The authorities are proactively considering measures to generate resources to cover future age-related costs, including gradually raising retirement ages and VAT rates. Timely implementation of these proposals will help ensure the sustainability of the social safety net.

Financial stability issues

Sustained low interest rates could raise financial stability risks. Low rates and flattened yield curves are apparent in many countries, reflecting structural trends and other factors. They are also evident in Switzerland, where yields on sovereign bonds across all maturities are negative, consistent with high household and corporate savings and a preference for domestic assets. Maturity transformation as a business model is coming under pressure and nominal rigidities, such as minimum guaranteed returns and scope to shift into cash, constrain flexibility and could encourage search for yield. The authorities should therefore guard against any possible build-up of systemic risk that could arise in these circumstances.

Elevated household debt and banks' concentrated exposure to mortgages could be key amplifiers in the event of macroeconomic shocks. House prices have recently stabilized and mortgage lending has eased, reflecting the series of macroprudential measures introduced during 2012-14 as well as some slowdown in population growth. Nonetheless, the level of house prices relative to income has grown significantly since the great recession and debt per borrower is high given the relatively low level of home ownership. In addition, more than 80 percent of banks' domestic loans are mortgages, while insurance companies and pension funds have increased their exposure to real estate. The high level of household debt could increase the severity and duration of shocks to the real economy and financial sector, especially if unemployment were to increase sharply.

New property-related macroprudential measures should be readied in case risks re-emerge and supervisory arrangements should be further strengthened in line with the 2014 FSAP. This would allow a prompt response, including in the build-to-rent segment where higher risk weights and/or faster amortization schedules relative to owner-occupied properties would be appropriate. Greater recourse to legally-binding regulation could ensure timely adjustments as well as uniform standards for all mortgage providers. Refining supervisory arrangements for external audits of banks—as recommended in the 2014 FSAP—are also warranted. The stepped up frequency of on-site inspections is welcome. In view of the low interest rate environment, a lower guaranteed minimum return on pension funds and collective life insurance products is warranted, and consideration could be given to specifying the return in real, rather than in nominal, terms.

The new Swiss regulations on the systemically-important banks (SIBs) appropriately reflect the systemic risk characteristics of these banks. In particular, given the large size of the two systemically important global banks, relative to the Swiss economy and potential role in global risk propagation, the requirements introduced in July 2016 on leverage ratios and too-big-to-fail regulations are appropriately more stringent than international minimum standards. This will help safeguard the Swiss economy from inward spillovers. Attention should also be given to risk weights used in internal ratings-based models and greater disclosure of weights as part of the forthcoming revision to Basel requirements could help to strengthen credibility.

Structural issues

Continued structural reform is needed to raise productivity and ensure long-run sustainable growth. Preserving continued close economic ties with the EU by reaching pragmatic solutions is essential given sizable trade and other economic linkages. Immigration has brought significant benefits for growth and fiscal sustainability by helping to offset the decrease in the Swiss working-age population. Harmonizing the taxation of domestic and foreign firms under the corporate tax reform III by reducing the upper rate will reduce disincentives that may have discouraged smaller firms from investing and growing their business. A government scheme to use fully-rebated taxes to significantly cut carbon dioxide emissions is innovative and could be a model for other countries. Reforms to facilitate full-time female labor force participation, such as lowering the marginal tax rate on second incomes, and enhancing education outcomes by increasing equality of access could also boost potential growth over the medium term.

Switzerland continues to make progress with implementing international standards on corporate taxation, AML/CFT and automatic exchange of tax information. These efforts to increase transparency in the financial sector help to level the playing field across participating countries while also protecting the integrity of Switzerland as an international financial center. Corporate Tax Reform III will help realign the corporate tax code with ongoing international initiatives to counter base erosion and profit shifting while preserving competitiveness of its corporate tax regime.

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