INTERNATIONAL MONETARY FUND

Switzerland: Staff Concluding Statement of the 2018 Article IV Mission

March 26, 2018

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.

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.

The Swiss economy has adjusted to the large cumulative exchange rate appreciation that took place since the global financial crisis. As one of the most open and sophisticated economies, Switzerland has long been at the forefront of product and technology innovation, which has underpinned a secular trend real appreciation. However, following the global financial crisis, safe-haven inflows and operational limits on interest rates caused the exchange rate to temporarily overshoot its long-run trend, slowing output and employment growth, even as the current account surplus remained broadly unchanged. More recently, efficiency gains have helped to restore firms' profit margins, positioning the domestic economy to benefit from the recent acceleration in world activity.

Outlook and risks

The strengthening global recovery alongside reduced safe-haven appreciation pressure is expected to energize the Swiss economy. A boost to investment and net exports from the tailwind of strong external demand, together with faster expansion of household spending owing to rising employment, are forecast to lift GDP growth to around 2¼ percent in 2018, before it gradually moderates to 1¾ percent over the medium term as the global cycle matures. Stronger external demand will temporarily increase the current account surplus, which is expected to settle at around 9 percent of GDP, although adjusted for measurement issues, the underlying current account would be lower. Rising capacity utilization and a tightening labor market are projected to lift inflation to the middle of the target band.

Positive surprises to this outlook are possible, although risks appear tilted downward. Swiss GDP growth could exceed forecasts if the global upswing were faster and more

sustained than is currently envisaged. On the other hand, several adverse factors could weaken the outlook. Rising international trade tensions could impact Switzerland's externally-oriented economy. More uncertain geopolitics could rekindle safe-haven inflows, sharply appreciating the franc and eroding competitiveness in less-productive sectors. A resurgence in global inflation could trigger an abrupt policy tightening by major central banks, leading to volatility spikes in financial markets and spillovers to Swiss property prices. Uncertainty regarding long-term Swiss-EU relations could affect cross-border flows. Further delays in meeting international standards on corporate income taxation could reduce Switzerland's appeal as an investment destination.

Monetary and exchange rate policy

The improved outlook for the Swiss and the world economies, together with normalizing steps by major central banks, has relieved pressure on domestic monetary policy. The Swiss National Bank's (SNB's) two-pronged approach of negative interest rates and unsterilized foreign currency purchases has in recent years supported the return of modest inflation and the recovery of growth while shielding the economy from safe-haven surges. However, both tools face limits, and the need for further loosening was alleviated by the strengthening economy and modest reversal of appreciation pressures since mid-2017.

Any future tightening of monetary policy should depend on domestic conditions while also taking account of policy decisions by major central banks. With GDP growth expected to overshoot potential only temporarily, and underlying inflation forecast to rise more slowly than in the US or euro area, the domestic cyclical outlook does not suggest the need for a near-term tightening of monetary policy. Nonetheless, unexpected events could change this assessment, and avoiding falling behind the curve will be important to prevent the need for a potentially-disruptive catchup response.

Exit from the SNB's accommodative policies during the current economic upswing is unlikely to return the pre-crisis configuration of tools. If—as markets currently expect—policy rates of major central banks peak well-below pre-crisis levels, scope for the SNB to raise its policy rate may be constrained, especially if re-widening the negative interest rate differential against other currencies is desired. The SNB, alongside other central banks, is likely to maintain a considerably larger balance sheet than prior to the crisis, with divestments falling well-short of the previous buildup to avoid excessive tightening of monetary conditions.

A clear assignment of policy tools would enhance effective communication and avoid the impression of targeting the exchange rate. Given lags in policy transmission, the interest rate is best suited for addressing slow-moving cyclical conditions and expected inflation. On the other hand, intervention should be reserved for responding to foreign

exchange market surges that would otherwise cause temporary volatility in inflation and output, while still accommodating a modest secular trend real appreciation.

Fiscal policy

Switzerland's fiscal position remains strong, with sustained small surpluses and declining public debt. The tax burden is relatively low by international comparison and spending is contained. Moreover, a tendency to underspend budgeted allocations at the federal level leads to modest structural surpluses (after adjusting for one-off items and cyclical conditions), reflecting a tightening bias in the design and execution of the debt brake rule (with similar rules at sub-national levels). As a result, the cumulative surplus in the compensation account, which can only be used to cover revenue shortfalls, rose to nearly 4 percent of GDP in 2017.

Recent measures to curtail within-year underspending are welcome, although the tightening bias in the rule's design remains. While having had little impact in 2017, new measures to raise spending execution closer to budgeted levels (including reserve funds to carry over investment allocations to subsequent years) are expected to gain effectiveness over time. Spending outside the perimeter of the debt brake rule can also be stepped up, but at the cost of lower budget transparency and efficiency. Nonetheless, operating the rule's ex post provision symmetrically—by permitting spending to catch up in the following year in response to a structural surplus—would achieve the stated objective of structural neutrality, result in moderately-higher fiscal spending each year and allow the rule to better serve its countercyclical function in the event of a downturn. A symmetric rule would also support a better macroeconomic policy mix—with a somewhat looser fiscal policy and a less accommodative monetary policy—in order to relieve pressure on monetary policy tools during periods of low inflation. In addition, as currently specified, the rule is independent of the level of public debt. Consideration could be given to allowing a larger (smaller) countercyclical response when debt is below (above) long-term sustainable levels.

Existing fiscal space affords valuable flexibility for a discretionary stimulus to support activity during a severe or prolonged downturn. This fiscal space exists in financial market and macroeconomic terms, as indicated by persistent modest structural surpluses, low public debt and negative interest spreads on sovereign bonds. This contrasts with monetary policy, where further large-scale accommodation could be constrained. The debt brake rule envisages such a role for fiscal policy through the "exceptional financial circumstances" clause that allows temporary suspension of the rule, and which was invoked during the global financial crisis.

Financial stability

Considerable progress has been made in strengthening banking sector resilience. Capital and liquidity buffers have increased across all categories of banks. A series of macroprudential and regulatory measures were introduced in 2012-14 targeting systemic risk in the real estate market. For the global systemically-important banks, too-big-to-fail regulations are appropriately calibrated to the relatively small size of their home-country's economy.

Sustained low interest rates are encouraging risk taking in some market segments. Measures taken during 2012-14 were effective at containing property prices and moderating mortgage credit growth. More recently, however, low and flattened yield curves have reignited search for yield, and competition from nonbanks is putting downward pressure on interest rates on loans. Domestically-oriented banks have stepped up the pace of mortgage lending and increased duration mismatch. Lending standards have slipped, with a significant share of new mortgages clustering near the indicative minimum down-payment level and falling short of loan affordability norms. Construction of new rental properties continues even though vacancy rates are rising. These developments have occurred from a starting point of high concentration of bank lending into mortgages and high house prices and mortgage debt relative to income. In addition, domestic balance sheets are heavily exposed to real estate, directly through property ownership and indirectly through savings in bank deposits, pension and insurance vehicles, and holdings of real estate-linked equities and investment funds. This high exposure could generate adverse wealth effects that amplify the effect of a fall in real estate prices.

Reinforcing the macroprudential framework for real estate is needed. A gradual unwinding of ultra-loose global financial conditions would help to support financial stability, while a rapid tightening—which cannot be precluded—could be disruptive. Measures requiring banks to hold additional capital if they choose to assume more risk helps to absorb future losses but may not curtail the buildup in risk if banks have ample capital buffers or if higher risk is priced into interest rates. Also, current self-regulation by banks may not fully internalize the additional system-wide risk their lending generates.

Several measures are advised. Stricter regulatory limits on loan-to-value and debt-to-income ratios should be adopted, with only limited exemptions allowed. The tax deductibility of mortgage interest payments for private households should be removed alongside the elimination of taxation of imputed rental income. Mortgages on investment property should carry a surcharge on the applicable risk weight in a manner consistent with Basel requirements. Intensified monitoring of individual banks that are active in locally and regionally concentrated markets is advised. Guarantees on cantonal banks should be removed. To prevent regulatory arbitrage, nonbank mortgage lending should be subject to

similar standards as for banks, where it is not already the case. Financial sector oversight should remain vigilant and independent.

Structural issues

Population aging makes pension system reform essential. Life expectancy in Switzerland is high and rising, but has not been reflected in the official retirement age, which remains 65 for men and 64 for women against an average life expectancy of 83 years. Longer expected time in retirement encourages people to save increasing amounts, which tends to compress investment yields and induce even higher saving, supported by tax incentives for pension contributions. Working longer or linking the official retirement age to life expectancy may be a more effective way of improving system viability and ensuring the public has sufficient resources when they retire. Immigration and raising the full-time employment of women—whose participation is discouraged by high childcare costs—remain important sources of new pension contributors. For the second pillar, sustainability would be improved by linking the guaranteed conversion rate to the market yield on a long-term sovereign bond and life expectancy at retirement.

A flexible and dynamic economy affords resilience to appreciation pressures, and all sectors should benefit from Switzerland's highly-profitable activities. High value-added sectors bring numerous advantages to the Swiss economy, but also pull up wages and prices. The resulting real appreciation may encourage offshoring of production with re-shoring of profits that gradually reduce the sensitivity of GDP and the current account to the exchange rate. Nonetheless, more labor-intensive, less internationally-mobile sectors that compete in foreign markets may still be affected unless they raise productivity. Improving competitiveness in sectors where productivity growth is lagging is therefore essential. Adopting the recently-proposed corporate income tax (CIT) reform could support this goal by lowering the cost of investment for SMEs. Continued adequate funding of science, technology, engineering and mathematics (STEM) education and expanding the pool of highly-skilled Swiss and foreign workers would help to sustain innovation and ensure a workforce ready for life-long learning. These measures help to preserve Switzerland's high-and-stable share of labor income in GDP and low inequality of post-redistribution income.

Maintaining Switzerland's reputation as a global business destination and innovation leader requires regulatory certainty and continued adherence to international commitments. Meeting international standards on CIT in a timely manner is critical to dispel uncertainty and avoid reputational risk that could negatively impact investment and growth. The reform is also an opportunity to revisit tax competitiveness in light of international developments and to encourage R&D activities and SME investment. CIT rates are expected to become less dispersed across firms and cantons, implying some tradeoff between investment and revenue. The proactive and balanced approach to regulation of fintech and

initial coin offerings signals Switzerland's receptiveness to cutting-edge technologies. The authorities are cognizant of the associated money laundering risks, and checks are required when converting into and out of fiat money. However, to better address risks inherent in cross-border activity, stronger safeguards for preventing abuse of crypto assets are needed at the international level. More broadly, Switzerland is in the process of addressing remaining deficiencies in its AML/CFT regime, following its mutual evaluation of the FATF. The strengthened supervisory focus on cyber risk in the financial sector is welcome. Switzerland continues to make progress on improving tax transparency, with the first automatic exchange of tax information due this year and expanding its list of partner countries.

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We thank the Swiss authorities and our private sector counterparts for their hospitality and productive discussions.