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CONCLUDING STATEMENT

Switzerland: Staff Concluding Statement of the 2024 Article IV Mission

FOR IMMEDIATE RELEASE

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.

Bern – March 28, 2024: *The Swiss economy boasts strong fundamentals but faces several challenges. After a strong post-pandemic recovery, a weakening in main trading partners' growth, coupled with tighter financial conditions, has slowed growth. Growth is expected to recover gradually this year, but uncertainties remain. With inflation comfortably back in the 0-2 percent price stability range, the SNB appropriately reduced its policy rate in its March meeting. Fiscal fundamentals are strong with low debt levels but mounting spending pressures need to be addressed. Remaining future financing gaps in the pension system, including stemming from the recent vote on a 13th month pension payment, need to be closed. The financial sector is resilient with strong buffers, but vulnerabilities from the real estate sector remain. The state-facilitated acquisition of Credit Suisse by UBS has stabilized the financial markets, but the experience and prospects also call for strong financial sector reforms. Structural policies aimed at addressing labor shortages and skill gaps will help promote inclusive growth. The start of negotiations with the EU is welcome, given significant implications for medium-term prospects.*

Context and Outlook

Growth is expected to recover gradually, with employment remaining strong. Weak external demand and tighter financial conditions lowered growth to 0.8 percent in 2023. A gradual recovery in external demand, lower inflation, and monetary policy easing are projected to increase growth to 1.3 percent (1 percent adjusted for sports events) in 2024 and 1.4 percent (1.7 percent adjusted for sports events) in 2025. The labor market remains resilient, although unemployment is projected to increase modestly in 2024 to 2.3 percent, from a historic low of 2 percent, and there are continued signs of staffing shortages in some sectors. The external current account surplus declined to 7.6 percent in 2023 with a higher services deficit, weaker than implied by medium-term fundamentals and desirable policies based on a preliminary analysis.

Inflation is back within the range of price stability. Headline inflation decreased to 1.2 percent in February, driven by a decline in imported goods prices. Core inflation has also decelerated

to 1.1 percent, driven by a decline in prices of non-energy goods, but services inflation remains more persistent. Ongoing rent increases linked to higher reference rates and an increase in electricity prices in January will increase inflation in the first half of the year, but headline inflation this year is projected to remain within the price stability range, at around 1.5 percent.

The outlook is marked by uncertainty, while risks remained balanced. As an open economy, Switzerland faces downside risks from the intensification of regional conflicts, deepening geoeconomic fragmentation, or in case of slower-than-expected progress of negotiations with the EU. On the other hand, a faster decline in global inflation and subsequent easing of financial conditions could lead to higher growth.

Fiscal Policy

The overall fiscal surplus is projected to remain at around 0.5 percent of GDP in 2024. At the confederation level, consolidation measures will help meet the debt-brake rule in 2024. However, defense, infrastructure, and demographics-linked spending is expected to remain elevated. The overall surplus is mainly driven by the cantons and social security funds (including stemming from higher receipts from the VAT hike). Given the authorities' fiscal framework, the broadly unchanged fiscal stance is appropriate as it balances the need to avoid impeding the ongoing modest recovery, while creating fiscal space to address accumulating spending pressures.

The federal authorities plan to reduce gradually the accumulated balance of the amortization account, limiting headwinds to growth. The account reflects recently-accumulated extraordinary outlays and earlier pandemic-related outlays, totaling CHF 27.2 billion in 2023. A temporary amendment of the Financial Budget Act extended the deadline for amortization to 2035, with the option of further prolonging to 2039, if necessary. The authorities should continue to adjust plans as needed to avoid headwinds to growth. In addition, to gradually phase out extraordinary expenditures, the federal authorities have decided to finance asylum-related expenditures within the ordinary budget by no later than 2028.

The federal authorities' fiscal framework has anchored fiscal policy well, but challenges are emerging due to accumulating spending pressures. The debt-brake rule has facilitated a considerable reduction in public debt, supported countercyclical fiscal policy, and has flexibly accommodated emergency spending needs. Going forward, spending pressures are mounting, however, including stemming from defense spending and social insurance. To ensure adherence to the debt-brake rule, the authorities have rationalized statutorily-earmarked budget items, closing structural financing deficits until 2025. Additional measures are needed to close federal structural deficits for 2026-27. In this context, the authorities have initiated an expenditure review with the aim of proposing solutions by this summer. In addition, the recently passed referendum on a 13th monthly pension payment might increase the federal government's yearly contribution from 2026.

A comprehensive medium-term plan will be needed to address structural spending needs on aging, climate change, and defense. Given the fiscal framework, the options would include a combination of further spending reprioritization and revenue increases. The forthcoming fiscal sustainability report will estimate the fiscal costs stemming from demographic-dependent expenditure pressures and climate mitigation measures to reach the net zero target and therefore will provide a basis for formulating policy proposals.

Monetary Policy

With inflation comfortably within the 0-2 percent price stability range, the SNB lowered its policy rate on March 21 by 25 basis points to 1.5 percent, ahead of other major central banks. Medium-term inflation expectations remain well anchored at around 1.2 percent. Upward pressures to inflation—stemming from second-round effects from rent increases—have been lower than expected, and imported inflation has been contributing negatively to headline inflation. To counter risks of inflation settling at very low rates and to guard against costs associated with negative interest rates, the policy rate cut ahead of other central banks was appropriate. Going forward, monetary policy should remain responsive to incoming data, while taking into account international monetary policy developments. If resilient labor markets, still-large household (pandemic-related) excess savings, and easing of monetary conditions lead to more persistent inflation, the SNB could keep its current stance, as other central banks lower rates. If inflation continues to surprise on the downside, the SNB should continue to cut rates.

Despite a reduction in 2023, the SNB's balance sheet is large at around 100 percent of GDP. The SNB reported an overall loss of CHF3.2 billion in the financial year 2023, down from a loss of CHF132 billion in 2022, which precludes profit transfers to the government during 2024. Given the risks associated with a large balance sheet, the SNB should continue to build equity from retained earnings, and if the opportunity arises, gradually reduce its still-large balance sheet.

Ongoing pilots by the SNB related to the possible use of a wholesale digital currency (CBDC) provide opportunities to better understand the possible implications of different types of settlement options.

Financial Sector Policies

The financial sector is resilient, but there are vulnerabilities that call for close monitoring**.** The higher interest rate environment has broadly benefited the financial sector, leading to higher profitability. Capital buffers are above regulatory requirements, and NPLs have remained low. Real estate prices and mortgage markets have adjusted somewhat given higher interest rates, but vulnerabilities remain, including due to affordability risks. While direct exposures of banks to commercial real estate are modest, data gaps prevent obtaining a comprehensive view of direct and indirect exposures of the financial sector to domestic and cross border markets, as well as identifying interlinkages across different financial institutions.

Given the temporary component of bank profitability, high exposures to residential real estate, and global uncertainty regarding the prospects of commercial real estate, continued vigilance is warranted. In this context, conserving a part of profits to strengthen capital buffers should be encouraged. The authorities should also consider expanding the macroprudential toolkit by including borrower-based measures, such as binding Loan-To-Value (LTV), Debt-to-Income (DTI), or Debt-Service-To-Income (DSTI) requirements. Given that the sectoral countercyclical capital buffer (CCyB) is already at the maximum level, if vulnerabilities increase, the authorities should consider activating the broad-based CCyB. Consideration could also be given to a positive neutral CCyB, to allow more flexibility to respond in times of stress. To limit risks, it is also important to take a forward-looking perspective in the assessment of risks and resilience of private banks. More broadly, to better monitor vulnerabilities, the authorities should continue with their efforts to close data gaps. Basel III rules have been adopted in 2023; the amended Capital Adequacy Ordinance will enter into force in January 2025. The

authorities' efforts to continuously improve and advance regulations on investment schemes, financial infrastructure, fintech, insurance as well as sustainable finance, will help strengthen Switzerland's position as financial center. To address housing affordability concerns, the authorities' action plan— encouraging housing production by fostering great density and streamlining procedures, while putting an emphasis on affordable housing—is welcome.

The state-facilitated acquisition of Credit Suisse by UBS has stabilized the financial markets and is progressing as planned, but it also poses challenges. The combined bank, with assets of 180 percent of GDP, is the largest G-SIB relative to its host economy. The complexity of the combined bank's global operations also makes supervision more challenging. In the event of a future crisis, the previous merger options may no longer be feasible. This highlights the importance of ensuring implementability of the bank's recovery plan and conducting a resolvability assessment. Competition and concentration risks should be closely monitored.

Several measures introduced over the past year will contribute to strengthening the financial sector framework. These include new liquidity requirements for systemically-important banks, increased resources for supervision of UBS, extension of eligibility for emergency liquidity assistance (ELA) against collateral to all banks, and a proposal on the public liquidity backstop to parliament.

Lessons from the CS case should inform further reforms to strengthen the regulatory and supervisory framework. FINMA and the SNB have published assessments, and a review by the government of the Swiss TBTF framework is expected in April. The IMF will start a Financial Sector Assessment Program (FSAP) review for Switzerland later this year. Recommendations from the 2019 FSAP remain important and highlight the need to increase the powers and resources of the supervisor to enable early and effective intervention. Key recommendations included implementing a risk-focused and forward-looking supervisory approach, reducing reliance on external auditors, strengthening recovery and resolution planning and implementability (including powers to require changes to bank structures to resolve banks), introducing enforcement powers through sanctions, fines, and disclosure of enforcement actions, and reforming the deposit insurance scheme. Looking ahead, the authorities should also address issues related to capital and liquidity requirements and introduce an effective PLB (currently submitted to Parliament for deliberation). Following the extension of ELA eligibility, more work needs to be done to ensure banks' collateral preparedness.

Structural Policies

Continued efforts are needed to prepare labor markets for demographic headwinds. The labor market has performed well overall, with a high level of labor force participation and low unemployment. However, despite some easing, recruiting challenges persist, and aging will exacerbate skill shortages in the medium term. Further incentivizing labor-force participation of women, older workers, and migrants would help address widening skill gaps. Reducing childcare costs and easing tax disincentives for dual-earner families would help increase female participation. Consideration should be given to increasing the retirement age and incentives for longer careers, to both help support labor participation and improve the sustainability of the pension system. Continued emphasis on vocational education will also help close emerging skill gaps.

Pension reforms are advancing, but additional actions are needed to close future financing gaps. The increase in the VAT rate and in the retirement age for women were important steps

towards Pillar I pension sustainability through 2030. However, spending pressures will continue. In this context, further reforms are to be submitted in 2026 to stabilize 2030-40 Pillar I financing. In addition, the recently passed 13th monthly pension payment will require additional funding of at least CHF 4 billion a year from 2026. The authorities are preparing a proposal for measures to close this gap. Reforms under Pillar II, including lowering of the conversion rate, and contribution salary threshold, have been approved by parliament and are subject to a referendum in Fall 2024.

Switzerland has made further progress on climate policy. The passage of a revised version of the CO_2 Act is welcome, as it clarifies the policy framework for 2025-2030. Some provisions of the CO_2 Act are less ambitious than what had been initially proposed and might require acquiring more emissions-reduction credits from international partners.

The resumption of negotiations with the EU is a welcome step to strengthen the economic partnership, secure participation in the single market, and improve resilience. Overall, continued efforts to expand trade partnerships will help guard against geoeconomic fragmentation risks.

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