May 2010
IMF Country Report No. 10/140

Switzerland: 2010 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; Statement by the Executive Director for Switzerland, and Informational Annex

The following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 23, 2010, with the officials of Switzerland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 29, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 14, 2010 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Switzerland.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with Switzerland

Approved by Anne-Marie Gulde-Wolf and Martin Mühleisen

April 29, 2010

- This report is based on discussions held in Bern and Zurich during March 15–23. The team comprised Ms. Waysand (head), Messrs. Mehrez and Ross (EUR) and Mr. Goswami (MCM).
- The mission met with Federal Councilor Merz (Head of Federal Department of Finance), Swiss National Bank (SNB) Board Chairman Hildebrand, the Financial Market Supervisory Authority (FINMA) CEO Raaflaub, and other senior officials, think tanks, parliamentarians, and private sector representatives.
- The mission's concluding statement was published on March 23, 2010 and can be found at: http://www.imf.org/external/np/ms/2010/032310.htm.
- Context of past surveillance. In recent years, the Fund and the authorities agreed on the main policy priorities—enhancing financial stability and cushioning the recession, without threatening long term sustainability. Given the size of the financial sector, the Fund has stressed the importance of strong and effective supervision and regulation. The authorities' policy response to the crisis has incorporated key elements of Fund advice from the 2008–09 Article IV consultations, notably the increase in capital and liquidity buffers, strengthened supervisory arrangements, and fiscal stimuli in 2009 and 2010.
- The Swiss franc exchange rate is market determined. The de facto exchange rate arrangement under the AREAER system was reclassified from 'free floating' to 'stabilized' from March 2009 as a result of the SNB intervention in the foreign exchange market to stabilize the Swiss franc against the euro. Starting December 18, 2009 Swiss franc volatility vis-à-vis the euro increased while the SNB intervened occasionally. The arrangement was thus reclassified to 'floating'. Switzerland has accepted the obligations of Article VIII. The exchange rate system is free of restrictions on current international transactions, with the exceptions of those notified to the Fund in accordance with Executive Board Decision 144 and UN-sanctioned restrictions on external payments for security reasons.
- It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Contents Page

I. EXECUTIVE SUMMARY AND STAFF APPRAISAL

1. **A recovery is ongoing.** While domestic demand helped cushion the effects of the trade and financial shocks in the downturn, the economy is now benefitting from the pick-up in world growth and stabilization in financial markets. Latest indicators point to a continuing recovery and GDP is expected to grow by about 1½ percent in 2010 with a further strengthening in 2011 (Figure 1). With substantial slack, and Swiss franc appreciation, inflation should remain muted. However, uncertainties related to global developments are large. Similarly, the medium term prospects of the economy are uncertain, as financial activity and immigration flows—two key drivers of recent growth—may slow down going forward. Given uncertainties and in the absence of near-term threats to price and public finance stability, an exit from the current accommodative fiscal and monetary stance should be cautious.

2. **The challenge for monetary policy is to normalize interest rates, while exiting exchange rate interventions.** The SNB has appropriately applied an expansionary monetary stance with unconventional policies, given deflation risks and zero interest rates. With an improving outlook and concerns over accelerating mortgage credit, the authorities have signaled a desire to normalize interest rates over time. There is, however, considerable uncertainty at this stage, and an inherent tension between appreciation pressures and the desire to raise interest rates.

- The real appreciation reflects continuing trade surpluses, improving growth prospects, and safe haven effects, but model based assessments indicate that the Swiss franc is broadly in line with fundamentals. In this context, the authorities' intentions to return over time to a free floating currency regime are welcome, and interventions, if any, should be limited to resisting short-term disruptive pressures.

- Interest rates should not be raised too early—or without regard to a fundamental strengthening in the currency. Indeed, inflationary pressures are subdued and the long established credibility of the SNB limits the possibility of de-anchoring of expectations. Furthermore, while there is no indication so far that lending standards have materially deteriorated, supervisory/prudential tools (e.g., loan to value restrictions, added capital charges under Pillar II) may be best suited to address these risks if they materialize.

3. **Fiscal consolidation should be limited to what is needed to respect the debt brake rule, while giving more attention to longer term issues.** In spite of the recession and of stimulus measures of around ¾ percent of GDP in 2009 and 2010, the small surplus in 2009 is expected to only turn to a limited deficit in 2010. To comply with the debt brake rule, some consolidation is being contemplated for 2011–13. Prudent fiscal policies resulting in low debt levels have served the country well and are warranted, given large potential liabilities related to the banking sector and ageing effects. Still, consistent underestimate of revenue suggests an increase in potential revenues and points to a possible lesser need of fiscal retrenchment in the short run. Reforms are needed, however, to address the medium term sustainability gap.

4. **The momentum to reinforce financial stability should not be lost.** The authorities' package of measures has helped to stabilize the financial system but also exposed the size of contingent liabilities faced by public finances, and the moral hazard problem associated with the presence of a limited number of systemic banks. It is therefore essential that the ongoing strengthening of supervisory and regulatory frameworks continues.

5. **Risks remain and warrant close monitoring.** Although the two largest banks have strengthened funding and capital positions, their dependence on wholesale funding remains elevated and further asset deterioration cannot be ruled out. Turbulences in the Euro area would be a particular concern—through spillovers to the Swiss banks and economy. Moreover, tax amnesties in third countries are putting some pressures on the wealth management and private banking industry, as may the welcome full acceptance of article 26 of the OECD model tax convention by the authorities. In the insurance sector, some life insurance companies and a re-insurer have been weakened by market developments. While coverage ratios in the second pillar pension sector have picked up to some degree, underfunding remains and may require adjustment.

6. **Although the authorities' steps to strengthen supervision are welcome, more needs to be done.** The supervisory focus on major institutions, oversight of auditors, attention to governance and risk management practices, and cross-border cooperation have improved. The effectiveness of FINMA could be further enhanced. Its in-house supervisory capability should be expanded, thus allowing it to engage more actively on-site with high impact institutions. The independence of the external auditors carrying out on-site supervision could be strengthened, inter alia by having payments to auditors come directly from FINMA. This will clarify lines of control and reinforce the auditors' public responsibilities.

7. **Building on prior initiatives, the authorities should reinforce their regulatory framework to address the "Too big to fail" (TBTF) problem.** Early appropriate measures taken by FINMA include imposing higher capital requirements effective in 2013, the recent development of liquidity benchmarks for the two large banks, and issuance of remuneration guidelines effective from 2010. The report issued by the advisory working group on the TBTF problem identifies a series of possible measures. Once new Basel standards have been issued, the authorities should implement them, and include sufficient add-ons for institutions posing a systemic risk, in order to effectively address moral hazard and to discourage excessive risk taking. Simplifications in the organization and the legal structure of large banking institutions could also be considered to help improve crisis resolution. This may require additional legislation. Progress in these areas will serve the economy well and help foster the reputation of its financial center.

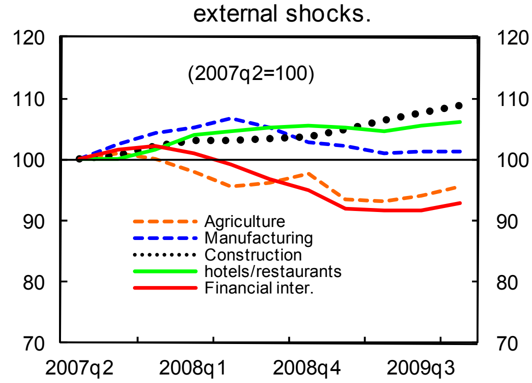
8. **Development of an effective macro-prudential framework will require clarity on responsibilities, access to information, and enforcement power.** According to their mandates, the SNB contributes to the stability of the financial system while FINMA secures the smooth functioning of the financial markets. While some overlap between micro and macro supervision is an inherent feature of the system given the weight of the two large banks, the delineation of responsibilities between the two institutions could be further clarified. The new SNB/FINMA Memorandum of Understanding is a step in the right

direction. There is also a need to ensure that the legal framework is supportive of the respective mandates, with the powers of each institution closely aligned with its mandate, including as regards to information gathering, and enables the findings to be acted upon.

II. Context: Switzerland has Weathered the Global Downturn Relatively Well

9. **The economic contraction in 2009 has been shallower than in most industrial countries** (Figure 2). The economy exited a year-long recession in the second half of 2009, as the decline in exports abated, and the fall in financial intermediation and manufacturing bottomed out. Overall, GDP contraction in 2009, at -1.5 percent, compared favorably with neighboring countries. At first blush, this was somewhat unexpected given the trade and financial sector origins of the shock, and the structure of the Swiss economy. However, the economy's resilience can be linked to strong fundamentals going into the recession and to supportive macro and financial policies. Overall, while export oriented activities have been significantly hit by the trade and financial sector shock, domestic oriented ones have been more resilient.

Sectoral value added reflected external shocks.



Switzerland: Contributions to Growth

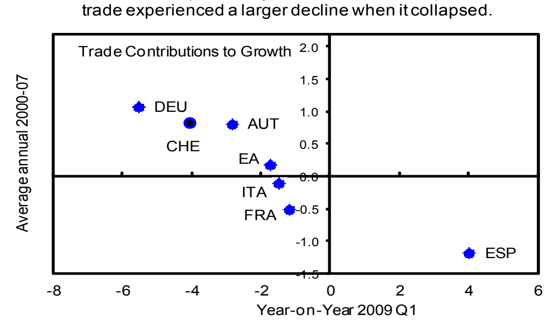
	2007	2008	2008 q1	2008 q2	2008 q3	2008 q4	2009 q1	2009 q2	2009 q3	2009 q4
GDP	3.6	1.8	0.6	0.3	-0.5	-0.7	-1.0	-0.1	0.5	0.7
Total domestic demand	1.2	0.4	-1.3	-0.1	-0.8	1.5	1.4	-0.8	0.1	0.0
Final domestic demand	2.7	1.0	0.8	0.0	0.0	-0.5	-0.7	0.4	1.4	0.8
Consumption	1.4	0.9	0.2	0.4	0.2	-0.1	0.1	0.4	0.6	0.4
Investment	1.2	0.1	0.6	-0.4	-0.2	-0.5	-0.8	0.0	0.8	0.4
Inventories	-1.5	-0.7	-2.1	0.0	-0.8	2.1	2.1	-1.2	-1.3	-0.7
Foreign balance	2.4	1.4	2.0	0.3	0.2	-2.3	-2.4	0.7	0.4	0.7

Source: SECO and staff estimates.

A. The Trade and Financial Shocks Strongly hit the Economy

10. **Manufacturing exports and production declined sharply with the drop in external demand, but picked up in the second half of the year, in line with the global recovery.** Overall, the negative 3 percent contribution of trade to GDP growth in 2009 is a reflection of its

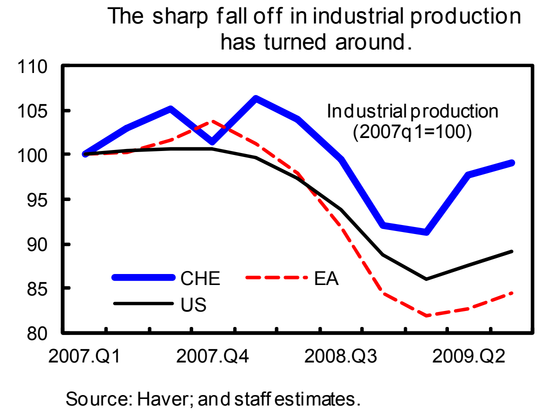
Countries which previously benefited from an expansion in trade experienced a larger decline when it collapsed.



Source: WTO.

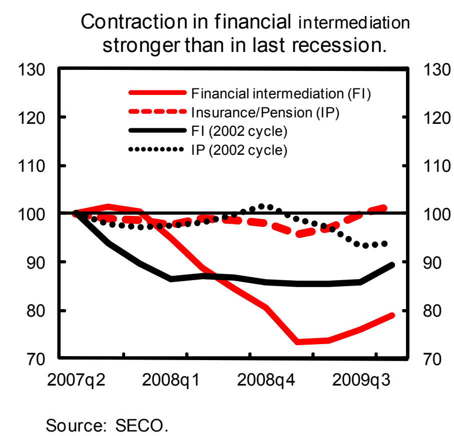
positive contributions in the years preceding the crisis.

11. **In this context, industrial production fell by about 19 percent from its peak to its trough, before recovering by about 8 percent in the latter half of 2009.** While part of Swiss manufacturing production partly consists of goods that are little affected by the cycle (pharmaceuticals and food), a sizable portion is heavily concentrated in the production of capital and intermediary consumption goods—which were more strongly impacted by the collapse in world trade. Capacity utilization reflected these developments – standing at 76 percent, 6 percentage points below its long-run average, at end-2009.



12. **The crisis also had a major effect on financial intermediation value added, and on the current account.**

- The contraction in financial intermediation was much larger than the declines experienced during the mid-1990s and early 2000 recessions.[1] Value added from this activity declined by close to 25 percent (or by some 3 percent of GDP) due to the crisis, before recovering somewhat by the end of the year.



- Losses and write-downs of the large banks occurred in foreign subsidiaries and had a strong impact on the current account.[2] The 2008 current account surplus was revised downward—from 10 to 2 percent of GDP—in August 2009, once the extent of the financial losses became clear (Figure 3; Table 2). Direct investment income fell from SFr 60 to 8 billion

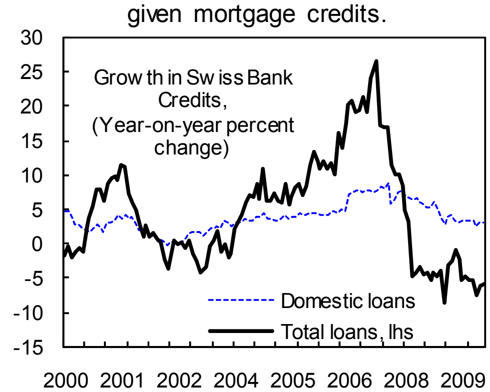
[1] The mid-1990s shock was due to a real estate bubble which spilled over into a domestic banking crisis. The early-2000s shock was due to problems at one of the large Swiss banks as well as weakness in external markets. In both cases financial sector value added fell by about 15 percent from their recent peaks.

[2] A sizable portion of the expansion, and as a result of the crisis, contraction of investment bank balance sheets reflects *repo* and *proprietary trading book* activity. Domestic interbank transactions, including *repos*, are netted from FISIM calculations, while cross-border interbank transactions are explicitly excluded. Market making margins within *proprietary trading book activities* are included in GDP but are small. Gains and losses on proprietary trading only affect the factor income in the balance of payments.

causing the net investment income to move into deficit for the first time ever. The trade balance, however, was in record surplus. With regard to 2009, the current account surplus is projected to have increased to about 9 percent of GDP, as the trade and service surplus continues to expand, and the net investment income moves back to balance.

13. **Still, domestic credit has been relatively dynamic (Figure 4).** Effective stabilization measures taken by the authorities (see below), together with the ability of smaller, domestically oriented, banks to pick up some lending business from larger institutions, helped support credit supply to the economy. While foreign credits haven fallen, pushing down total overall credit growth, mortgage lending (about 80 percent of total credit) was stimulated by lower interest rates and grew by more than 5 percent by end-2009. The SNB stressed that it's lending survey—which over the summer had pointed to some tightening—now indicates that lending conditions were not further tightened.

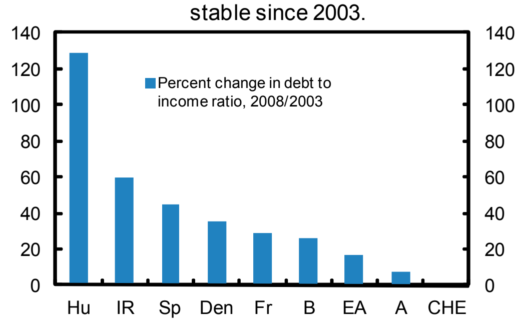
Domestic lending has remained positive given mortgage credits.



B. The Economy Entered the Recession in a Strong Position

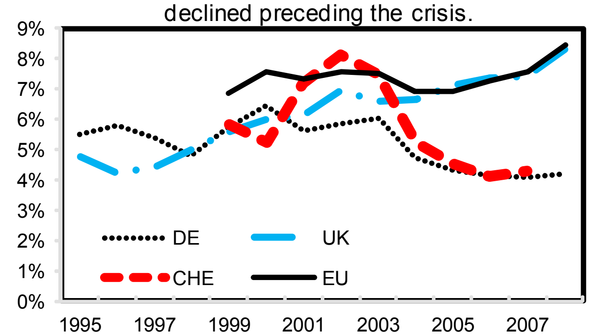
14. **Households and corporations entered the recession with relatively strong balance sheets.** Swiss households' gross debt-to-income ratios, traditionally high but more than matched by their large financial and non financial wealth, have remained stable in recent years. In contrast to most other European countries, non-financial corporate net debts to income ratios declined prior to the crisis and have remained relatively low.

Swiss debt-to-income ratios have been stable since 2003.



Source: Eurostat.

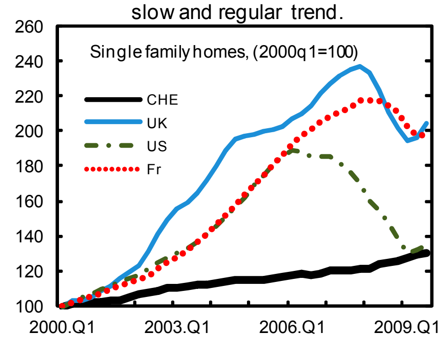
Swiss non-financial corporate net debt to income declined preceding the crisis.



Source: EuroStat.

15. **While housing prices have increased steadily in the last few years, their progression has not reversed with the crisis (Box 1).** Homeownership is at around 37 percent, reflecting nationwide rent control and tax policy (e.g. real estate is subject to wealth, income and capital gain taxes). Overall price increases have been steady and relatively low in international comparisons, and studies suggest they can to a large extend be attributed to fundamentals, in particular the rising number of immigrants.[3] Prices also do not appear misaligned in view of real estate prices to rent ratios, as well as affordability indices, such as real estate prices to income ratios. Reflecting the decline in industrial activity, however, commercial property prices fell by 8.2 percent in 2009.

Swiss real estate price inflation followed a slow and regular trend.



Source: SNB.

Box 1. Swiss Real Estate Cycles

Swiss real estate price inflation has recently been low by international standards, and has not been extremely volatile.

- **Swiss real estate did experience a severe boom-bust cycle during 1987–91, which spilled over to the broader economy.** During this period, signs of overheating on the housing market were pervasive – both on the sale and on the rental side. With households overextended, a sharp rise in interest rates, escalating unemployment, and contracting credit brought real estate values rapidly back to their late-1980 levels. The resulting fallout included numerous foreclosures, consolidation in regional banking (some 200 banks were absorbed), and an unusually long recession with protracted unemployment throughout most of the 1990s. General government debt rose from 31 to 55 percent of GDP from 1990 to 1998—one of the key factors behind the creation of the debt brake rule.

- **Basic misalignment indicators are inconclusive.** Real estate prices have gradually increased in a linear fashion since 2000. Real estate inflation rates during this period have averaged between 4–5 percent per year, resulting in an increase in prices of single family homes and owner occupied apartments over the last 5 years between 20–25 percent. Ascertaining misalignment in Swiss real estate markets is problematic. There are a number of rules and regulations—many implemented in response to the 1990s bust—which make it difficult to determine if any asset class is out of equilibrium. However, a few simple comparisons are possible. The ratio of real estate prices relative to rental prices reveals a strong upward trend from the early 1990s to 2000, but a flattening since then. Also, while real estate price increases have been somewhat more dynamic than nominal incomes in the recent years, affordability measures have not deteriorated in the past 10 years. Still, market observers expect some possible decline in 2010 due to a slowdown in immigration, hence demand, in a market where supply remains dynamic.

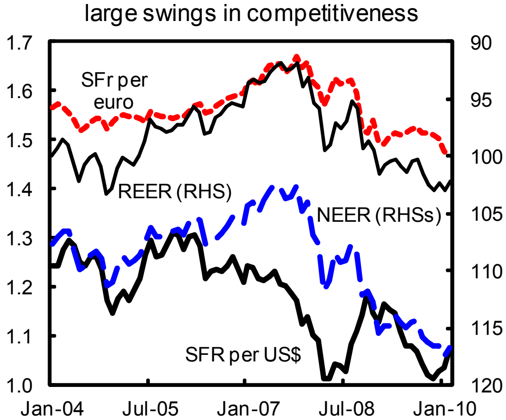
[3] Degen and Fischer (2009), find that an immigration inflow of 1 percent relative to local population, raises the price of Swiss single family homes by 2.7 percent—explaining about two-thirds of the increase in 2001–06.

C. Supportive Policies also Played a Key Role

16. **A broad range of macroeconomic policy actions, and financial sector stabilization measures, have been taken in response to the crisis.** The authorities took a series of measures aimed at stabilizing the financial sector, ensuring ample liquidity and avoiding excessive tightening of the monetary and financial conditions, and supporting demand and limiting labor market adjustment whose effects were reinforced by measures undertaken in partner countries[4] (Box 2).

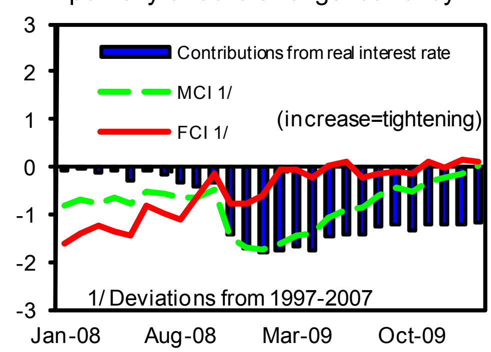
17. **SNB measures contributed to limit the tightening of monetary and financial conditions (Figure 5).** Reductions in real interest rates, and the rebound in equity prices from their early 2009 lows, partially offset the effective appreciation in the currency of about 4 percent in 2009, and 13 percent since the beginning of the crisis.

Exchange rate movements suggest large swings in competitiveness



Source: Swiss National Bank.

Interest rate and equity movements partially offset a stronger currency.



Source: Staff estimates, based on real exchange rates, interest rates, and equities. Real interest rates calculated using core inflation.

18. **The re-pricing of risk of Swiss asset markets reflects the successful stabilization package and improved global environment.** Most measures of financial stress have eased sharply from their early 2009 highs. Interbank liquidity has shown sustained improvements. The CDS spreads on Swiss confederation bonds, which had swelled at the height of the crisis in March 2009, and credit spreads of large banks and insurance companies, have declined significantly.

---

[4] In particular, Swiss banks also benefitted from a variety of actions taken by other authorities. US$ swap lines created to alleviate liquidity shortages, were used to initially finance the SNB loan to the StabFund. The large banks had access to US$ liquidity in the US, and both received funds related to completion of AIG CDS contracts.

Box 2. Main 2009–10 Policy Initiatives

Over the last year the authorities took action in a **broad range of policy areas**.

Regarding **monetary policy**, the SNB lowered the target range to 0 to 0.75 percent in March 2009, and targeted 0.25 percent. It extended the maturity of its repo operations and range of eligible counterparties. It provided liquidity through SFr/EUR swaps, jointly with the ECB, the National Bank of Poland and the National Bank of Hungary. The last such operation was undertaken in January 2010. It engaged in SFr/USD swaps with the Federal reserve, which expired on February, and provided USD liquidity. It also implemented unconventional policy measures—including exchange rate intervention, and purchases of Swiss private bonds—in order to stabilize monetary and financial conditions. The SNB has now shifted to exit mode and is scaling back liquidity since April 2009. Since mid-December, bond purchases have ceased, and only excessive appreciation vis-à-vis the Euro has been prevented.

In the **fiscal area**, the authorities allowed automatic stabilizers full play and enacted the last of three stimulus packages. These packages consisted in public investment in infrastructure and other areas (i.e. applied research, alternative energy production), as well as targeted labor market measures (extension of the duration of short-time work, incentives to hire young entrants on the labor market). These efforts were accompanied by further stimulus at the cantons and municipalities level. Fiscal stimulus is estimated at around ¾ percent of GDP in 2009 and 2010. More structurally, the debt brake rule was expanded to cover extraordinary expenditure effective as of 2010. A higher VAT rate to finance disability insurance was approved.

In the **labor market**, the duration of short time work benefits was lengthened from 12 to 18 months in April 2009, and to 24 months effective April 2010.

Building on measures in 2008, a series of **financial sector** actions were also taken.

- In late 2008, FINMA had already announced new prudential rules for large banks to be effective by 2013: cyclically adjusted capital rules (200% of Basel II norms in good times; 150% in bad times); a leverage ratio cap (set at 5 in good times, 3 in bad times). In 2009, FINMA announced the progressive tightening of capital requirements on Cantonal and Regional banks, from 1 January 2010 . In April 2010, FINMA and the SNB announced a new liquidity regime for the big banks, effective on 30 June 2010, that requires banks to cover the outflows estimated in a stress scenario over a period of at least 30 days.

- In early 2009, the transfer of illiquid UBS assets into *SNB stabilization fund (StabFund)* was completed ($39 billion in total). By year end, the overall risk for the SNB was reduced by about one third. In August, the government sold its 9 percent stake in UBS for a 33 percent profit.

- Deposit insurance coverage was expanded from SFr 30,000 to 100,000 per depositor; the cap on the system-wide liabilities increased from SFr 4 billion to SFr 6 billion; banks were required to hold assets in Switzerland equaling 125 percent of covered deposits; and a quicker payout mechanism implemented.

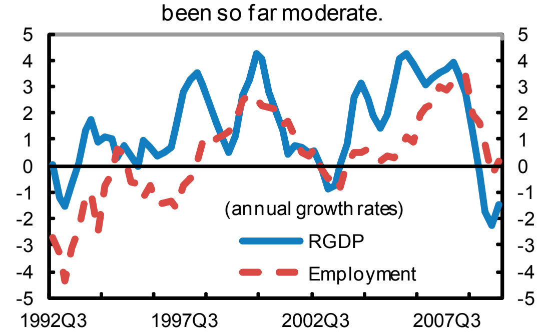
- A "Too Big to Fail" (TBTF) working group, comprising both private and public sector representatives issued an interim report on April 22, with a final report which could be issued during the summer. The report defined TBTF institutions and described broad features of possible measures—notably added capital and liquidity buffers, a tighter limit on risk concentration, and changes in organizational structure to contribute to an orderly resolution in case of crisis. The calibration, however, still needs to be addressed.

- New standards for remuneration schemes of financial institutions with at least SFr 2 billion in capital were implemented. The guidelines stress transparency and risk incentives; greater responsibility for structuring and monitoring the effect of remuneration is given to the firm's boards of directors.

- The FINMA-SNB memorandum of understanding (MoU) was revised. Guidelines and priorities for the cooperation have been codified.

19. **The reaction of the labor market to the recession has been muted—due in part to targeted labor market measures.** Employment has remained surprisingly stable at around 3.9 million, as job losses in manufacturing have been offset by gains in the service and construction sectors. The employment picture partly reflects labor hoarding encouraged by short time work programs (Figure 6). Subsidies for short-time employment cover 80 percent of reduced hours and their duration has been extended twice during the crisis; from 12 to 18 months in April 2009, and to 24 months in April 2010. Nevertheless, because of dynamic growth in the working population, the unemployment rate has increased by about 2 pps, from 2.5 percent in mid-2008 to 4.5 percent in February. The authorities were concerned that depending on growth prospects, workers in short time regimes could be pushed into unemployment. The resilience of employment, together with strong wage growth had played a major role in cushioning consumption during the recession.

Reaction of employment to growth has been so far moderate.



Source: Swiss Federal Statistics Office.

D. Outlook

20. **Looking ahead, a moderate recovery is taking hold.** The authorities noted that despite the current strong growth, Switzerland had not decoupled from the rest of Europe. Thus the sharp rebound in growth in the second half of 2009 should moderate in the course of 2010. Real GDP is projected to expand by 1.6 percent in 2010 and by 1.8 percent in 2011. Manufacturing will strengthen; however, firms' investment will lag given excess capacity in some sectors. Construction should overall continue to grow given order books, partly supported by lagged effects from fiscal stimulus. Real wage and income growth is expected to be sluggish, but some smoothing is expected to continue and consumption is overall expected to grow in line with GDP.

2010 Growth Forecasts
(Percent)

	IMF	SECO	KoF	Consensus 1/
RGDP	1.6	1.4	1.7	1.5
Private consumption	1.4	1.3	2.1	1.1
Investment 2/	1.4	2.0	2.4	-2.3
Exports	2.9	4.5	3.0	…
Imports	3.1	3.2	3.2	…
Memorandum items:				
German 2010 growth	1.2	1.3	1.1	1.7
Swiss 2011 growth	1.8	2.0	2.2	1.8

Sources: SECO, KoF, Consensus forecasts, and IMF WEO.
1/ March 2010 Consensus forecast.
2/ Machinery and equipment investment for SECO and KoF.

21. **Uncertainty surrounding the baseline is mainly related to the global recovery and developments on financial markets.** The baseline scenario is a moderate recovery of Switzerland's main trading partners and financial markets stabilization. There are however large uncertainties resulting notably from the impact of exits from accommodative policies, which could affect growth prospects in the country's partners, and the value of the Swiss franc. Switzerland's direct exposure to Greece is limited.

However, further market turmoil in the euro area could have significant repercussions, given Switzerland's financial and trade links with the euro area. The impact on the currency would be uncertain, as safe haven effects may not be long lasting given spillovers to the Swiss economy. If downside external risks were to materialize, this would lead to a further rise in unemployment as firms would have less incentives to hoard labor. As monetary policy has little margins of maneuver, this would need to be mainly accommodated through fiscal policy.

22. **Potential growth has declined in the short term and uncertainty on the medium run estimates has increased.** The uncertainty around any estimate of potential output during a crisis is large. Overall, there was agreement that the global crisis would have less of an impact on potential growth than the large domestically originated financial shock of the mid-1990s. Many of the mitigating factors that cushioned this recession, including continuing credit supply, are likely to limit the decline in potential growth. Still, there is considerable uncertainty on the evolution of total factor productivity. From a policy point of view, however, the key issue is whether immigration flows will continue, and at what pace. With this in mind, staff's preliminary estimates suggest potential growth has declined to around 1¼ percent in the short-run, mainly due to lower potential employment and capital accumulation, and could return to a medium term growth of around 1 ¾ percent – somewhat smaller than growth observed in the years preceding the crisis (Appendix I).

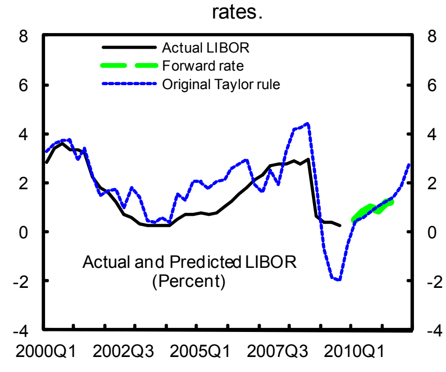
III. CHALLENGES REMAIN

23. **Exit from the current accomodative stance will have to be accompanied by structural measures to strengthen financial stability.** While little short term fiscal consolidation is needed, exit from the current monetary stance is more challenging. Measures to handle the financial crisis have been effective, but risks remain in the financial system and, more broadly, the issues exposed by the crisis – the disproportionate size of contingent liabilities and the moral hazard issue of too big to fail institutions – still have to be addressed.

A. Monetary and Exchange Rate Policy Issues

24. **The SNB has signaled its intention to raise interest rates over time, and to exit from the current exchange rate policy.** The authorities noted that high levels of liquidity and prolonged period of low interest rates may lead to acceleration in mortgage lending and risky lending practices. Under a no policy change assumption, the SNB is projecting inflation to gradually pick up and exceed 2½ percent by mid-2012 (Figure 7). In this context, the current policy stance is seen to be incompatible with long-run price stability. Indeed, forward rates and Taylor-rule estimates—based on

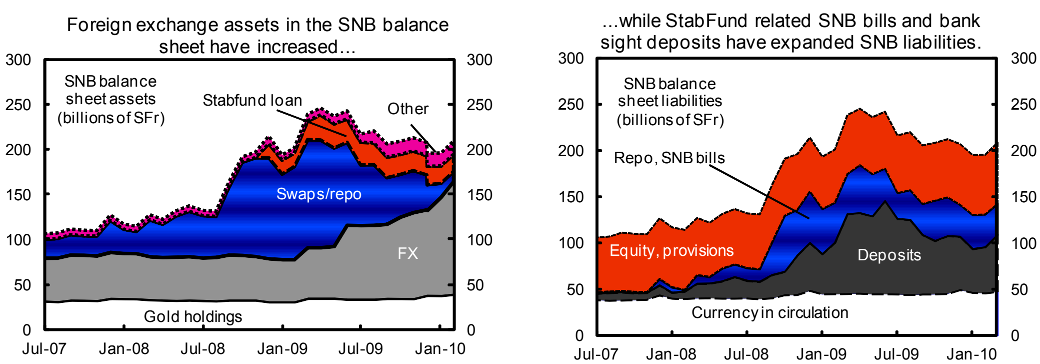
Markets expect a normalization of interest rates.



Source: SNB.

SNB inflation projections—currently suggest an increase of about a ½ percent by-end 2010. However, the authorities recognize that while their inflation projections signal that the current monetary policy cannot be maintained in the long run without incurring inflation risks, considerable uncertainty is attached to the inflation forecasts.

25. **Liquidity is being mopped up but the SNB's balance sheet growth will not be fully reversed.** Repos and swap instruments have been allowed to expire, and short-term SFr SNB bills are being used to further scale back liquidity. However, the SNB views the increase in foreign exchange reserves and private sector bonds as a more permanent part of its balance sheet, and acknowledges that it is therefore subjected to more currency and credit risk (Box 3). The loan corresponding to the funding of the StabFund also remains on SNB's balance sheet. Looking ahead, while models suggest that even in a moderately pessimistic scenario, the remaining assets would generate a significant amount of cash to pay down the loan, the SNB could suffer losses–given that the first loss buffer of about $4 billion has been exhausted. The authorities noted that this was one of the factors behind the SNB's planned increase in capital. Accordingly, the SNB plans to increase provisions drawn from annual profits in 2009–13, and to reduce the amount distributed to the cantons in the form of dividends.



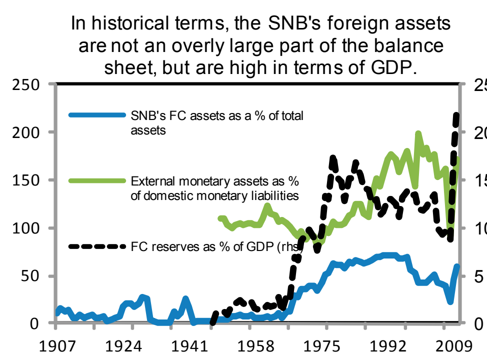
Sources: SNB April 2010 Monthly Statistical Bulletin; IMF staff estimates.

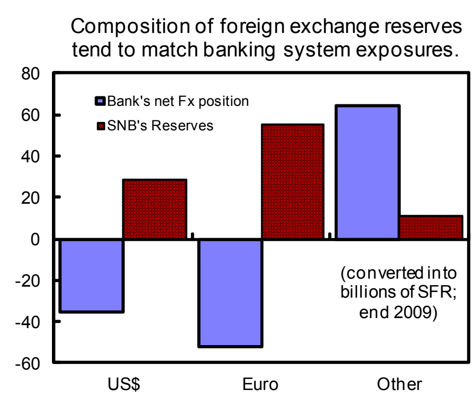
26. **Since December, the authorities are only preventing *excessive* appreciation of the Swiss Franc vis-à-vis the euro**. During this period, the SFr/euro rate has appreciated by 4 percent—the effective appreciation of the SFr has, however, been more limited at 3 percent. Latest data indicate that interventions have continued in the first quarter of 2010—leading to a pick up in the size of the balance sheet. Pointing to strong fundamentals, and notably to a projected return of current account surpluses as a share of GDP to double digit territory, staff noted that the currency did not appear to be misaligned (Box 4)—a view shared by the authorities. The authorities also indicated that the objective was, over time, to return to a free floating currency regime. Staff endorsed this intention and noted that interventions, if any, should be limited to resist disruptive short term movements in the effective exchange rate.

Box 3. Exchange Market Intervention and Foreign Currency Reserves

Given safe haven flows, periodically the SNB has been confronted with a choice of accommodating the demand for Swiss francs or allowing the currency to appreciate. The first option may not always be available in an environment of frequent low interest rates and may endanger price stability, while the second reduces competitiveness of Switzerland's large export sector.

In this context, currency intervention by the SNB has been used from time to time to smooth out disorderly fluctuations, resulting in large variations in the stock of foreign currency reserves.[1] In particular, since unconventional measures were introduced in March, 2009 the SNB has more than doubled its stock of foreign currency reserves, moving from about SFr 45 billion in 2007 to some SFr 95 billion by-end 2009, and to SFr 125 billion by end-March 2010. While large in comparison to many other industrial country central banks, a substantial amount of *precautionary* reserves can make sense given the SNB's LoLR responsibilities, and the relative size and exposure of the banking system. At the end of 2009, the size and currency composition of foreign currency reserves matched up well against the banking system's net foreign currency exposures. Also, while high, the stock of reserves did not appear out of line with past trends in key metrics. However, it has since then risen, reflecting recent interventions.





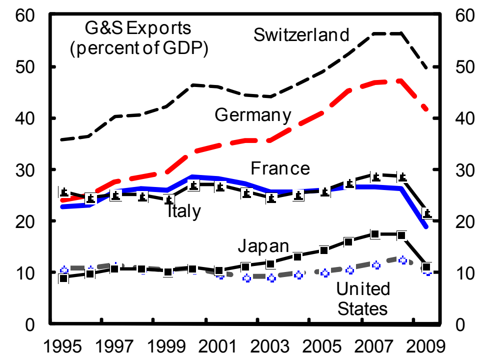
---

[1] Some 69 episodes of currency intervention occurred between 1987 and 1995—with all but three interventions undertaken jointly with the U.S. Federal Reserve and German Bundesbank. An explicit exchange rate target, however, was implemented only once before 2009. In that episode (1978–79), a target of "well over 80 francs per 100 German marks" was set. Given the DM-Euro rate, this translates to an exchange rate of about SFr 1.57 per Euro today or about 1.51 in real terms.

Box 4. Competitiveness

Switzerland is a highly competitive economy. Exports to GDP have increased over time and external trade has been an important growth driver, contributing about a third to average 1990–2008 growth. The trade balance surplus has continued to expand, and after marked declined in financial flows in 2008, the current account surplus has quickly snapped back. Importantly, market shares and export prices have generally remained stable even during the sharp drop in global trade— and appreciation of the Swiss franc. Switzerland also consistently ranks high in cross-country comparisons (e.g., World Economic Forum) of competitiveness.

Export dependence has been high and rising.



Source: WEO.

CGER estimates indicate competitiveness remained stable, despite the appreciation of the Swiss franc. According to the *External Sustainability* approach, the medium term current account surplus substantially exceeds what is required to keep the net foreign asset level stable, implying a strong competitive advantage. However, as noted in past staff reports, several factors, notably Switzerland's role as an international wealth manager, help to keep current account surpluses high—effectively overstating competitiveness. The *Macrobalances* approach reflects the difference between the actual current account and a computed norm based upon structural factors and taking into account the fact that Switzerland is a financial center. This method implies a small competitive advantage. The *Equilibrium Exchange Rate* approach—which compares actual and estimated equilibrium real exchange rates—indicates a minor competitive disadvantage. However, use of other real exchange rates (e.g., ULC based) suggests that this may be overstated. On net, the average of the three methodologies suggests that the currency could be slightly undervalued—consistent with the authorities' analysis. Thus, while uncertainty is high, the Swiss franc does not appear to be misaligned. These results are broadly unchanged from a year ago. In particular, the possible downside risks mentioned last year have not materialized—while current account surpluses have been affected by the crisis, they have rebounded and are expected by staff, and the authorities, to be back in double digit territory in the medium-run.

Switzerland: Competitiveness Assessment 1/

	Macro-Balances	External Sustainability	Equil. Real Ex. Rate	Average
Fall 2008	-1.4	-9.0	1.2	-3.1
Fall 2009	-4.1	-15.2	6.1	-4.4

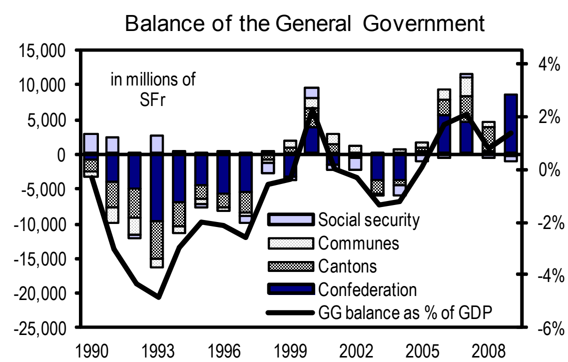
Source: IMF staff estimates.

1/ A negative number indicates a competitiveness advantage.

27. **There is agreement on the inherent tension between raising interest rates and the appreciation pressures, and on subdued inflation prospects in the short-term (Figure 6).** While inflation and inflation expectations have picked up, staff and the authorities project inflation in 2010–11 to remain under 1 percent given the sizable slack in the economy, muted wage demands and pass-through from past currency appreciation.[5] The authorities agreed that while they saw current stance as incompatible with price stability in the medium-term, uncertainty was high and it was too early to raise rates. Moreover, preliminary indications suggested that lending standards have not materially deteriorated, and prudential tools were seen as possibly useful if this risk materialized. The SNB is monitoring the situation and in addition to its quarterly survey on credit standard, it is currently conducting a specific survey on newly issued mortgages to households.

B. Fiscal Policies

28. **In spite of the recession and of the stimulus efforts, local authorities and the federal government still registered surpluses in 2009.** Since the start of the debt brake in 2003–04, the general government balance had swung from a 2 percent of GDP deficit to a surplus of about1 percent in 2008 (Tables 4 and 5). A surplus was still registered in 2009. At federal level, revenues were more resilient than expected and expenditures—notably interest outlays—lower[6]. Since 2004, the federal debt brake's notional reserve account accumulated approximately SFr 13 billion, or about 2.2 percent of GDP (Box 5). The debt to GDP ratio shrank from about 55 percent in 1998 to just above 40 percent in 2009. While the general government debt in many other European economies soared during the recent economic crisis, Swiss general government debt remained stable, and is about 30 percentage points below the EU average. This solid fiscal position is reflected in a low risk premium, similar to Germany.



29. **In 2010, general government balance is projected to swing into a small deficit.** While expected to respect the debt brake, federal government balance is estimated by the government to swing into a small federal deficit—reflecting some lagged effects of the recession on revenues, stimulus related measures, and a marginal impact of tax measures

---

[5] Studies indicate that a 1 percent exchange rate appreciation leads to a decline of 0.18 pps in headline inflation after twelve months.

[6] Taxes paid by banks had already declined in 2008, from SFr 4.5 billion in 2006 to SFr 0.6 billion.

(0.1 percent of GDP). Social security is expected to register a higher deficit (-0.6 percent of GDP, after -0.2 percent in 2009), as a result of the labor market situation, and local authorities to see their situation deteriorate.

Box 5: Switzerland's Debt Brake Rule

The *"debt brake"* was introduced in 2003 after a series of large deficits in the 1990s. The rule sets an annual upper limit on federal expenditure, based on projected cyclically-adjusted federal revenues. This allows deficits when the economy is below potential and requires surpluses in the opposite cases. The cyclical position of the economy is estimated using a modified HP filter, with a lower smoothing parameter for the last two observations to correct for the end-point bias problem.

Ex-post balances feed into a *notional compensation account*, used to ensure that slippages do not accumulate and that nominal debt is contained. If a negative balance in excess of 6 percent of expenditure builds up, it must be reduced below this threshold within three years.

The debt brake rule was amended as of 2010 to include extraordinary one-off expenditures. The balance between extraordinary expenditure and extraordinary revenue is maintained in a separate notional account. Deficits in any given year have to be compensated within six years. Application to lower levels of government is also being contemplated.

30. **As it expects federal balance to turn into a small structural deficit in 2011, the government expects some consolidation need of around 0.3 percent of GDP.** For 2011–13, planned permanent tax reductions, including tax allowances for large families and adjustment to income tax brackets, will amount to SFr 1.3 billion per annum. All in all, with stimulus measures ceasing to weigh on the budget but an expected increase in interest outlays, the government estimates the necessary effort required to maintain expenditures below potential revenues under the debt brake to be between SFr 1.3 to 2 billion over 2011–13.

Overall Fiscal Balance
(Percent of GDP)

	2008	2009	2010 Proj.	2011 Proj.
Federal government				
Ordinary balance	1.3	0.5	0.2	0.4
Cyclically adjusted balance	1.2	0.7	0.4	0.6
General government				
Ordinary balance	2.0	0.3	-1.0	-0.8
Cyclically adjusted balance	1.7	1.0	-0.3	-0.2

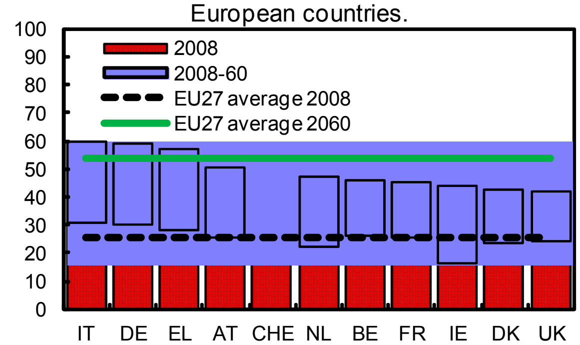
Sources: Swiss Federal Finance Administration and staff estimates.

31. **While respecting the debt brake rule is necessary, and given the fragile recovery and expected tightening of monetary conditions, staff noted that consolidation should in the short run be calibrated to what the rule requires.** Less consolidation effort might be needed in view of the consistent under-evaluation of some revenues in the recent years. In

particular, withholding tax revenues estimate—currently an average of the last 10 years performance—could better reflect more recent outcomes. The authorities acknowledged this possibility, but argued that withholding taxes were volatile and that they saw merits in keeping an estimation method with a strong smoothing power.

32. **However, medium term challenges still have to be addressed.** The dependency ratio is projected to double by 2060, in line with the European average. According to the 2008 Long-Term Sustainability report, public expenditures will increase by 5 percent of GDP by 2050 as a result of ageing, with roughly equal increases in old age and disability insurance expenditures, and in health and long term care. The first pillar pension system will swing into deficit within 5–10 years. Regarding disability insurance, the temporary increase in VAT will cover its deficit for the next six years. The authorities agreed with the need to address medium-term fiscal pressures rising from an ageing population, and concurred with the view that ambitious reforms would be needed (e.g., parametric adjustments in the old-age insurance system).

Old age dependency ratios of selected European countries.

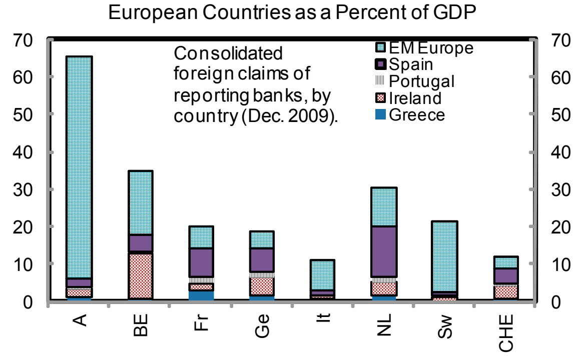


Source : Eurostat, EUROPOP 2008 convergence scenarios.

C. Financial Stability

33. **A number of risks remain.** The banks have largely written down their losses, shed some SFr 1½ trillion in assets from mid-2007 to end-2009, de-risked their balance sheets, and strengthened their funding and capital positions. At end-2009, Tier 1 capital ratios at UBS and Credit Suisse stood at 15 and 16.3 percent respectively—an improvement of 4 and 3 pps over the year (Figure 8). Similarly, leverage ratios (Tier 1 capital to total assets) have improved to 2.3 and 3.5 as of end-2009, for UBS and Credit Suisse respectively. Still, although the banks have largely reduced their risks, the impact of further asset deterioration—either from legacy assets exposures or from other categories of risk—could be substantial given the still sizeable exposures of Swiss banks. Banks would in particular be exposed to turbulences in the Euro area, if unchecked, but more

Exposure to Emerging Market (EM) and Selected European Countries as a Percent of GDP



Source: BIS and staff estimates.

through their impact on their counterparties and from the knock-on effects on the Swiss economy than through their direct exposure. At the same time, dependence on wholesale funding still appears to be elevated, requiring careful monitoring by the authorities.

34. **The business models of banks will come under some pressure.** While by the last quarter of 2009 the two large banks had restored some profits, favorable refinancing conditions will subside at some point. Net new money flows also remained negative in one of the banks. Potentially stricter ring fencing of capital and liquidity for subsidiaries in third countries may also adversely affect the risk and liquidity management of the large cross border banks, and dent their profitability. Moreover, full acceptance by Switzerland of Article 26 of the OECD model tax convention, together with tax amnesties and disputes over tax-related client data, are likely to result in further outflows of banking assets. This was seen by large banks as having a limited impact on their activity – as some of the outflows were moving to their on-shore banking activities—but should expose the private banking industry to consolidation pressures.

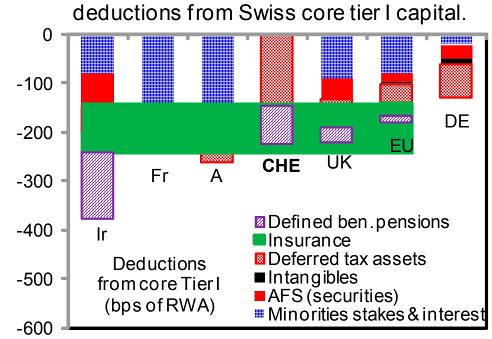
Liquidity Ratios by Region 1/

	Dec-07	Jun-08	Dec-08	Jun-09
		(in percent)		
Wholesale Funds				
Euro Zone	61.7	61.3	62.6	59.1
UK	56.5	58.3	62.6	58.3
US	45.0	44.0	42.8	41.7
Switzerland	72.7	73.3	74.8	71.5
ST Borrowings / Total Liab.				
Euro Zone	22.7	21.4	21.7	18.9
UK	18.9	10.9	16.3	8.9
US	21.3	19.5	19.3	15.5
Switzerland	11.6	7.3	9.4	6.4
Liquid Assets / Total Assets				
Euro Zone	10.8	11.2	10.6	10.5
UK	10.7	8.9	9.1	8.9
US	7.4	8.1	10.9	8.6
Switzerland	12.9	13.3	16.2	14.8

Source: Bloomberg
1/ Based on top 36 LCFIs with headquarters with headquarters in the regions.

35. **Importantly, banks will need to adapt to new regulatory requirements, notably from revisions to Basel II.** New Basel proposals would imply lower leverage and lower return on equity. The two large Swiss banks would be particularly affected by the exclusion of hybrid capital and deferred tax assets from the definition of Core Tier 1, the likely new benchmark for capital. Only about 64 percent of the current capital structure of the two large Swiss banks qualifies for the Core Tier 1 definition according to current proposals. Also, higher capital requirements for the trading portfolio as well as and higher capital charges for OTC derivatives that are not cleared and settled through central counterparties would likely put pressure on earnings, and more stringent liquidity coverage requirements could increase funding costs.

Deferred tax and pension assets imply deductions from Swiss core tier I capital.

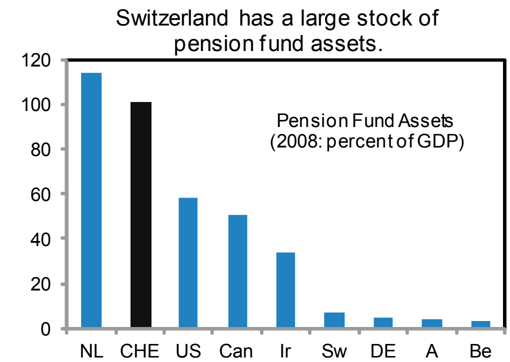


Source: Morgan Stanley and staff estimates.

36. **Some weaknesses also linger in the insurance sector.** Life insurance companies have been affected by low interest rates and financial market developments, weakening the financial health of some. The situation of non-life insurers has improved, reflecting better

investment outcomes and higher premiums. While the reinsurance sector has strengthened through de-risking and capital increases, residual risks from securitized products remain.

37. **Although the asset values of the occupational pension funds have recovered, some underfunding risk remains.** The decline in share prices, and lower interest rate environment, led to an underfunding of the some second pillar Pension funds. About 26 percent of the registered pension funds remained underfunded at end-2009, versus 46.5 percent at end-2008 (4.2 percent, end-2007). The overall funding gap was about SFr 35 billion (6.5% of GDP), of which pension funds with a state guarantee accounted for 73 percent of the total deficit.



D. Regulation and Supervision

38. **The authorities have undertaken a review of supervisory actions.** FINMA, the integrated supervisor, is drawing lessons from its underestimation of the systemic risks from rapid on and off-balance sheet expansion that were building up within the Swiss financial system before the crisis.[7]

39. **FINMA noted its progress in strengthening supervision.** It has increased its focus on major institutions, oversight of auditors, and governance and risk management practices. It also has expanded cross border cooperation through supervisory colleges. Regarding insurance supervision, FINMA has expanded application of the Swiss Solvency Test, and will implement it fully in 2011.The authorities felt that resources were not a problem. FINMA has increased its headcount to the projected 355 full-time equivalents, and was creating a surplus that will be used to build a one year budgetary reserve fund.

There is broad agreement that the financial turmoil highlighted the risks posed by large financial institutions—and the need to address the "too big to fail" problem. The authorities acknowledged that support for UBS has exacerbated moral hazard and undermined market discipline, and that the economy was exposed to disproportionate risks. Against this background, a broad based advisory working group—made up of public and private sector representatives—has issued on April 22nd an interim report outlining possible measures to reduce the probability and the impact of failures.

---

[7] See FINMA (2009), *"Financial market crisis and financial market supervision"*, and *"FINMA Strategic Objectives"*.

While reiterating a broad support to retain the current universal bank model, the working group identified as possible proposals imposing higher capital buffers, reinforcing liquidity requirements, defining more stringent limit on single counterparty exposure, and requiring organizational structures that would allow for orderly resolution. It also noted that contingent capital instruments could play a useful role. These proposals were seen as more suitable than new taxes. The working group will produce a final report in the summer of 2010.

40. **However modalities still have to be defined**.

- While the authorities are calling for meaningful progress on cross border resolution at international level, the working group agreed that internal banking structures should allow for a continuation of vital functions in case of a crisis, without necessitating a rescue of the entire group.

- With debates on risk weights, definitions of higher quality capital, and liquidity requirements still unfinished at the international level, the authorities have indicated they plan to re-examine all these issues depending on Basel outcomes and stressed that they will maintain top-ups on forthcoming international standards. The working group noted that capital add-ons should be adjusted to the degree of systemic relevance, and signaled its intention to keep working on the progressiveness of such add-ons. The mission felt that calibration of these requirements will determine their capacity to effectively address moral hazard, and to discourage excessive risk-taking.

- The working group stressed that while FINMA had a statutory basis for raising the capital and liquidity requirements for banks of systemic relevance, a legislative framework is needed for implementation. . The framework would define criteria for systemic relevance, make additional requirements mandatory, and strengthen the legal basis to address group structures. The mission noted that the framework should ensure that regulators define requirements on economic grounds.

41. **Reforms of compensation frameworks at financial institutions have passed.** FINMA implemented minimum standards for remuneration schemes of financial institutions with at least SFr 2 billion in capital. These guidelines—based on FSB principles—focus on transparent remuneration schemes and aim at reducing the incentives to take inappropriate risks that could threaten the stability of financial institutions. They give greater responsibility for structuring and monitoring the effect of remuneration to the boards of directors of firms.

42. **As part of the construction of a macro-prudential framework, FINMA and the SNB have deepened collaboration in order to address systemic risk.** According to their respective mandates, the SNB contributes to the stability of the financial system while FINMA secures the smooth functioning of the financial markets. Both institutions saw an overlap between micro (FINMA) and macro (SNB) supervision given the weight of the two

large banks, and recently signed a Memorandum of Understanding to reinforce their collaboration on financial stability issues. This MoU provides for the creation of a high level Steering Committee to set guidelines and priorities for this cooperation, sets out a mechanism for SNB to request information from FINMA and to ask it to take measures within its area of responsibilities, and foresees the possibility of joint, co-chaired, work. Beyond this improved cooperation, however, the SNB considers it necessary to be able to independently examine the two large banks and to implement prudential measures. Moreover, both institutions were concerned that decisions to implement differential capital and liquidity requirements could be legally challenged. In light of these concerns, which cannot be addressed by a MoU, further consideration could be given to revising the legislative framework to design proper allocation of responsibilities between SNB and FINMA, backed by respective powers that are aligned with the mandates.

43. **As the proposal to overhaul the deposit insurance system has been rejected, consideration is being given to make the 2008 deposit insurance reforms permanent.** With measures taken during the crisis set to expire by end-2010, the authorities proposed to further strengthen the system by creating a partial ex-ante funding mechanism and by shortening repayment periods. The authorities viewed this proposal as a good way to address the current pro-cyclicality of the system. However, the proposal was rejected, given concerns over costs from banks. Under these circumstances, consideration is now being given to convert these temporary measures into law.

Table 1. Switzerland: Basic Data

Area and population			
Total area	41,293 square kilometers	GDP per capita (2008, in US$)	64,851
Total population (end-2008)	7.7 million	GNP per capita (2008, in US$)	60,303

	2007	2008	2009	2010 1/	2011 1/
	(Percentage changes at constant prices, unless otherwise indicated)				
Demand and supply					
Total domestic demand	1.3	0.4	1.7	1.5	0.8
Private consumption	2.4	1.7	1.2	1.4	1.5
Public consumption	0.5	-0.1	2.5	2.4	-0.8
Gross fixed investment	5.5	0.4	-4.1	1.4	0.3
Final domestic demand	2.9	1.1	0.1	1.5	0.9
Inventory accumulation 2/	-1.5	-0.7	1.5	0.0	-0.1
Foreign balance 2/	2.4	1.4	-3.0	0.2	1.0
Exports of goods and nonfactor services	9.5	2.9	-10.0	2.9	4.6
Imports of goods and nonfactor services	6.0	0.4	-5.9	3.1	3.3
GDP	3.6	1.8	-1.5	1.6	1.8
Nominal GDP (billions of Swiss francs)	521.1	541.8	538.2	550.5	566.4
Employment and unemployment					
Employment (percent change)	1.0	0.3	-1.5	-2.1	1.0
Unemployment rate (in percent)	2.5	2.7	4.1	3.9	3.5
Output gap (in percent of potential)	1.6	0.9	-1.9	-1.7	-1.4
	(Percentage changes, unless otherwise indicated)				
Prices and incomes					
GDP deflator	2.5	2.2	0.8	0.7	1.1
Consumer price index	0.7	2.4	-0.5	0.7	1.0
Nominal wage growth	1.6	2.0	2.7	1.0	1.8
Unit labor costs (total economy)	-0.9	0.5	2.7	-2.6	1.0
	(In percent of GDP)				
General government finances					
Revenue	36.6	36.2	37.9	35.6	35.9
Expenditure	34.5	35.4	36.5	36.7	36.8
Balance	2.1	0.8	1.4	-1.0	-0.9
Ordinary balance	2.0	2.0	0.3	-1.0	-0.8
Cyclically adjusted ordinary balance	1.4	1.7	1.0	-0.3	-0.2
Gross debt	43.6	41.1	38.8	39.8	38.6
	(Percentage changes in annual averages)				
Monetary and credit data					
Broad money (M3)	2.1	2.2	5.8	...	...
Domestic credit	7.0	3.2	4.2	...	...
	(Period averages in percent)				
Interest rates					
Three-month rate	2.2	1.5	0.3	...	...
Yield on government bonds	2.9	2.5	2.2	...	...
	(In percent of GDP)				
Balance of payments					
Current account	10.0	2.4	8.3	9.1	9.5
Trade balance	2.0	2.8	3.0	2.9	3.0
Net investment income	4.1	-4.5	2.6	3.4	4.0
Other	3.9	4.1	2.7	2.7	2.6
	(Levels)				
Exchange rates 3/					
Swiss francs per U.S. dollar (annual average)	1.20	1.08	1.07	...	...
Swiss francs per euro (annual average)	1.65	1.59	1.46	...	...
Nominal effective rate (avg., 1990=100)	106.1	112.4	118.3	...	...
Real effective rate (avg., 1990=100) 4/	98.0	103.1	108.4	...	...

Sources: IMF, World Economic Outlook database; Swiss National Bank; and Swiss Institute for Business Cycle Research.

1/ Fund staff estimates and projections unless otherwise noted.
2/ Change as percent of previous year's GDP.
3/ 2009 values as of March 3, 2010.
4/ Based on relative consumer prices.

Table 2. Switzerland: Balance of Payments, 2007–15 1/

			Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015
	(In billions of Swiss francs, unless otherwise indicated)								
Current account	**52**	**13**	**45**	**50**	**54**	**58**	**61**	**66**	**73**
Trade balance	10	15	16	16	17	18	18	19	19
Exports	207	217	186	209	220	240	259	284	309
Imports	-197	-202	-170	-192	-203	-222	-241	-265	-290
Service balance	44	50	42	43	44	46	47	49	52
Net investment income	21	-25	14	19	23	25	27	30	34
Net compensation of employees	-12	-14	-14	-14	-15	-16	-17	-17	-18
Net private transfers	-8	-11	-11	-11	-11	-11	-11	-12	-12
Net official transfers	-3	-3	-3	-3	-3	-3	-3	-4	-4
Private capital and financial account	**-48**	**-10**	**2**	**-20**	**-54**	**-58**	**-61**	**-66**	**-73**
Net foreign direct investment	-17	-50	-6	-24	-27	-28	-28	-28	-28
Net portfolio investment	-23	-38	-21	-16	-41	-44	-48	-54	-61
Net banking sector	6	63	43	20	22	23	25	26	27
Other 2/	-14	15	-14	-1	-8	-9	-10	-11	-12
Official reserve flows	**-4**	**-3**	**-47**	**-30**	**0**	**0**	**0**	**0**	**0**
	(In percent of GDP, unless otherwise indicated)								
Current account	**10.0**	**2.4**	**8.3**	**9.1**	**9.5**	**9.9**	**10.1**	**10.7**	**11.4**
Trade balance	2.0	2.8	3.0	2.9	3.0	3.0	3.0	3.1	3.0
Exports	39.7	40.0	34.5	37.9	38.8	41.1	43.2	45.9	48.6
Imports	-37.7	-37.3	-31.6	-35.0	-35.8	-38.1	-40.2	-42.8	-45.5
Service balance	8.5	9.2	7.9	7.8	7.8	7.8	7.8	8.0	8.2
Net investment income	4.1	-4.5	2.6	3.4	4.0	4.3	4.5	4.8	5.4
Net compensation of employees	-2.4	-2.5	-2.5	-2.5	-2.6	-2.7	-2.8	-2.8	-2.7
Net private transfers	-1.5	-2.0	-2.0	-2.0	-2.0	-1.9	-1.9	-1.9	-1.8
Net official transfers	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Private capital and financial account	**-9.2**	**-1.8**	**0.4**	**-3.7**	**-9.5**	**-9.9**	**-10.1**	**-10.7**	**-11.4**
Net foreign direct investment	-3.2	-9.2	-1.2	-4.3	-4.7	-4.7	-4.6	-4.4	-4.3
Net portfolio investment	-4.5	-7.0	-4.0	-2.8	-7.3	-7.6	-8.0	-8.7	-9.5
Net banking sector	1.1	11.6	8.0	3.6	3.9	4.0	4.1	4.2	4.3
Other 2/	-2.6	2.8	-2.5	-0.2	-1.4	-1.5	-1.7	-1.8	-1.9
Official reserve flows	**-0.8**	**-0.6**	**-8.7**	**-5.4**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Net IIP (in percent of GDP)	144	141	150	156	161	167	172	178	184
Official reserves									
(billions of U.S. dollars, end period)	74.7	68.8	135.8	160.3	…	…	…	…	…
Reserve cover (months of imports of GNFS) 3/	4.5	3.6	8.1	8.7	...	...	...	...	...

Sources: IMF, World Economic Outlook database; and Swiss National Bank.

1/ Fund staff estimates and projections unless otherwise noted.

2/ Includes errors and omissions.

3/ Official reserves for 2010 are as of end-March 2010.

Table 3. Switzerland's International Investment Position, 2005–09
(in millions of Swiss francs, unless otherwise indicated; total at year's end)

	2005	2006	2007	2008	2009
Foreign assets	**2,720,208**	**3,016,898**	**3,585,830**	**3,080,386**	**3,089,138**
Direct investment 1/	567,752	694,600	764,631	808,566	829,325
Portfolio investment	958,336	1,072,345	1,190,815	938,187	1,065,538
Other assets	1,118,326	1,171,285	1,545,355	1,254,746	1,054,611
Reserve assets	75,794	78,668	85,029	78,887	139,664
Foreign liabilities	**2,104,037**	**2,389,111**	**2,833,288**	**2,416,512**	**2,382,663**
Direct investment 1/	223,636	323,645	431,307	467,122	477,945
Portfolio investment	773,126	903,140	882,077	625,395	705,911
Other liabilities	1,107,275	1,162,326	1,519,904	1,323,995	1,198,807
Net investment position	**616,171**	**627,787**	**752,542**	**663,874**	**706,475**
Direct investment 1/	344,116	370,955	333,324	341,444	351,380
Portfolio investment	185,210	169,205	308,738	938,187	1,065,538
Other assets and liabilities	11,051	8,959	25,451	-69,249	-144,196
Reserve assets 2/	75,794	78,668	85,029	78,887	139,664
Memorandum items: 3/					
Foreign assets	587	615	688	569	574
Foreign liabilities	454	487	544	446	443
Net investment position	133	128	144	123	131

Source: March 2010 SNB Monthly Bulletin.
1/ Expansion of reporting population in 2004.
2/ In 2005, distribution to Confederation and cantons of proceeds from gold sales.
3/ In percent of GDP.

Table 4. Switzerland: Federal Government Finances, 2007–13

			Est.	Projections			
	2007	2008	2009	2010	2011	2012	2013
	(Billions of Swiss francs)						
Revenue 1/	58.7	64.5	67.9	60.8	63.0	63.9	65.6
Ordinary Revenue	58.1	63.9	60.9	60.8	62.5	63.9	65.6
Taxes	53.3	58.8	55.9	56.5	57.5	59.0	60.6
Income Tax	15.4	17.5	17.9	17.3	17.1	17.6	18.1
Withholding Tax	4.2	6.5	4.4	4.6	4.6	4.6	4.6
VAT	19.7	20.5	19.8	20.1	21.4	22.0	22.7
Other	14.0	14.3	13.8	14.4	14.4	14.8	15.2
Nontax revenue	4.8	5.1	5.1	4.4	5.0	4.9	5.0
Expenditure 1/	54.2	64.0	59.3	60.3	61.4	62.4	63.9
Ordinary Expenditure	54.0	56.6	58.2	59.8	60.2	62.4	63.9
Wages and salaries	4.5	4.6	4.8	4.9	5.0	5.1	5.1
Goods and services	2.8	3.3	3.6	3.8	3.9	3.9	4.0
Interest payments	4.0	3.8	3.3	2.9	3.8	3.8	3.8
Transfers	35.2	37.1	38.2	39.7	39.5	41.4	42.9
Capital expenditure	6.3	6.6	7.2	7.1	6.6	6.9	6.9
Overall balance	4.6	0.5	8.6	0.6	1.6	1.5	1.7
Ordinary Budget balance	4.1	7.3	2.7	1.0	2.3	1.5	1.7
	(Percent of GDP)						
Revenue	11.3	11.9	12.6	11.1	11.1	11.0	10.9
Ordinary Revenue	11.1	11.8	11.3	11.1	11.0	11.0	10.9
Taxes	10.2	10.8	10.4	10.3	10.2	10.1	10.1
Income Tax	3.0	3.2	3.3	3.1	3.0	3.0	3.0
Withholding Tax	0.8	1.2	0.8	0.8	0.8	0.8	0.8
VAT	3.8	3.8	3.7	3.7	3.8	3.8	3.8
Other	2.7	2.6	2.6	2.6	2.5	2.5	2.5
Nontax revenue	0.9	0.9	0.9	0.8	0.9	0.8	0.8
Expenditure	10.4	11.8	11.0	11.0	10.8	10.7	10.7
Ordinary Expenditure	10.4	10.4	10.8	10.9	10.6	10.7	10.7
Wages and salaries	0.9	0.8	0.9	0.9	0.9	0.9	0.9
Goods and services	0.5	0.6	0.7	0.7	0.7	0.7	0.7
Interest payments	0.8	0.7	0.6	0.5	0.7	0.7	0.6
Transfers	6.8	6.9	7.1	7.2	7.0	7.1	7.1
Capital expenditure	1.2	1.2	1.3	1.3	1.2	1.2	1.2
Overall balance	0.9	0.1	1.6	0.1	0.3	0.3	0.3
Cyclically adjusted balance	0.7	0.0	1.8	0.3	0.4	0.3	0.3
Ordinary Budget balance	0.8	1.3	0.5	0.2	0.4	0.3	0.3
Cyclically adjusted balance	0.6	1.2	0.7	0.4	0.6	0.4	0.3
Gross debt	23.2	22.5	20.6	21.7	21.0	20.8	20.6

Sources: Federal Ministry of Finance; and IMF staff estimates.

1/ Includes the balance of the Confederation and extrabudgetary funds (Public Transport Fund, ETH, Infrastructure Fund, Federal Pension Fund).

Table 5. Switzerland: General Government Finances, 2007–13
(In billions of Swiss francs, unless otherwise specified)

			Est.	Projections			
	2007	2008	2009	2010	2011	2012	2013
Federal Government 1/							
Revenues	58.7	64.5	67.9	60.8	63.0	63.9	65.6
Ordinary Revenue	58.1	63.9	60.9	60.8	62.5	63.9	65.6
Expenditures	54.2	64.0	59.3	60.3	61.4	62.4	63.9
Ordinary Expenditure	54.0	56.6	58.2	59.8	60.2	62.4	63.9
Balance	4.6	0.5	8.6	0.6	1.6	1.5	1.7
Ordinary Balance	4.1	7.3	2.7	1.0	2.3	1.5	1.7
Cantons							
Revenues	78.2	75.8	76.7	77.0	80.0	82.6	86.2
Expenditures	74.5	72.4	76.7	78.3	81.8	84.2	86.6
Balance	3.7	3.4	-0.1	-1.3	-1.8	-1.7	-0.4
Municipalities							
Revenues	49.1	47.4	47.9	47.3	49.0	50.6	52.3
Expenditures	46.5	46.6	48.1	48.5	49.7	50.6	51.5
Balance	2.6	0.8	-0.2	-1.2	-0.7	0.0	0.8
Social security 2/							
Revenues	52.1	50.8	53.1	53.3	56.0	56.8	57.8
Expenditures	51.6	51.3	54.0	56.6	57.8	55.3	57.3
Balance	0.5	-0.5	-0.9	-3.2	-1.8	1.4	0.5
General Government							
Revenues	190.8	195.9	203.8	195.9	203.2	208.1	214.6
Expenditures	179.9	191.8	196.4	201.7	208.2	207.3	212.6
Balance	10.9	4.1	7.4	-5.8	-5.0	0.8	2.0
Ordinary Balance	10.5	10.9	1.5	-5.3	-4.2	0.8	2.0
Gross debt							
Federal Government	120.9	121.7	110.9	118.4	115.5	115.9	116.4
Cantons	61.5	56.1	54.8	57.0	56.7	55.7	58.6
Communes	44.6	44.8	43.2	43.6	43.4	42.5	41.8
General government	227.0	222.5	208.9	219.0	218.7	220.2	222.4
			(Percent of GDP)				
General Government							
Revenue	36.6	36.2	37.9	35.6	35.9	35.7	35.8
Expenditure	34.5	35.4	36.5	36.6	36.8	35.6	35.4
Balance	2.1	0.8	1.4	-1.0	-0.9	0.1	0.3
Ordinary Balance	2.0	2.0	0.3	-1.0	-0.8	0.1	0.3
Federal government	0.8	1.3	0.5	0.2	0.4	0.3	0.3
Cantons	0.7	0.6	0.0	-0.2	-0.3	-0.3	-0.1
Municipalities	0.5	0.1	0.0	-0.2	-0.1	0.0	0.1
Social security	0.1	-0.1	-0.2	-0.6	-0.3	0.2	0.1
Memorandum items:							
Cyclically adjusted balance	1.5	0.4	2.1	-0.4	-0.4	0.5	0.5
Cyclically adjusted ordinary balance	1.4	1.7	1.0	-0.3	-0.2	0.5	0.5
Gross debt							
Federal government	23.2	22.5	20.6	21.5	20.4	19.9	19.4
Cantons	11.8	10.3	10.2	10.4	10.0	9.6	9.8
Communes	8.6	8.3	8.0	7.9	7.7	7.3	7.0
General government	43.6	41.1	38.8	39.8	38.6	37.8	37.1

Sources: Federal Ministry of Finance; and IMF staff estimates.

1/ Includes the balance of the Confederation and extrabudgetary funds (Public Transport Fund, ETH, Infrastructure Fund, Federal Pension Fund).

2/ Includes old age, disability, survivors protection scheme as well unemployment and income loss insurance.

Table 6. Switzerland: Structure of the Financial System

	2004	2005	2006	2007	2008	2009
Banks	338	337	331	330	328	327
Cantonal banks	24	24	24	24	24	24
Large banks	3	2	2	2	2	2
Regional and savings banks	83	79	78	76	76	75
Raiffeisen banks	1	1	1	1	1	1
Other banks	188	189	183	183	180	180
Trading banks 1/	8	7	7	7	..	..
Stock exchange banks	53	56	52	48	48	49
Other banks	4	4	4	6	9	9
Foreign controlled banks	123	122	120	122	123	123
Branches of foreign banks	25	28	29	30	31	31
Private bankers	14	14	14	14	14	14
Concentration						
Banks 2/	66	67	72	71	65	60
			(in billions of SFr)			
Assets						
Banks	2,491	2,846	3,194	3,458	3,080	2,676
Cantonal banks	314	327	343	357	389	404
Large banks	1,644	1,910	2,198	2,341	1,885	1,453
Regional and savings banks	81	84	86	85	90	92
Raiffeisen banks	106	108	114	123	132	140
Other banks	314	382	410	488	519	525
Trading banks 1/	43	45	46	47		
Stock exchange banks	86	106	122	145	131	138
Other banks	4	3	4	7	56	59
Foreign controlled banks	182	228	239	288	332	328
Branches of foreign banks	15	17	23	34	24	24
Private bankers	17	17	19	30	41	39
Insurance companies - Life	303	298	281	287	281	..
Insurance companies - General	536	567	569	594	570	..
Pension funds	484	543	583	605	539	..
			(in billions of SFr)			
Deposits						
Banks	1,044	1,211	1,374	1,519	1,395	1,399
Cantonal banks	180	186	192	200	234	251
Large banks	577	700	834	913	722	649
Regional and savings banks	51	54	54	53	55	57
Raiffeisen banks	71	73	75	80	86	94
Other banks	153	185	206	252	274	317
Trading banks	27	28	29	29	..	..
Stock exchange banks	47	61	66	83	85	96
Other banks	2	3	2	3	35	38
Foreign-controlled banks	76	93	108	137	154	182
Branches of foreign banks	2	2	2	7	4	6
Private banks	11	11	11	13	20	25

Source: Swiss National Bank; Swiss Federal Statistical Office; FINMA.

1/ Trading banks reclassified in 2008 as stock exchange or other banking institutions.

2/ Share of the three largest banks in total assets of the sector (in percent).

Table 7. Switzerland: Financial Soundness Indicators

	2004	2005	2006	2007	2008	2009 1/
Banks						
Capital adequacy						
Regulatory capital as percent of risk-weighted assets	12.6	12.4	13.4	12.1	14.8	17.9
Regulatory Tier I capital to risk-weighted assets	13.3	13.0	13.4	11.6	12.3	15.2
Asset quality and exposure						
Non-performing loans as percent of gross loans	0.9	0.5	0.3	0.3	0.5	0.4
Sectoral distribution of bank credit to private sector (percent) 1/						
Households	65.2	66.6	68.5	71.5	65.4	67.1
Industry and manufacturing	3.7	3.4	3.0	3.4	3.0	3.0
Construction	2.1	1.9	1.7	1.8	1.6	1.6
Retail	3.7	3.6	3.1	3.3	3.1	3.1
Hotels and restaurants / Hospitality sector	1.4	1.3	1.2	1.2	1.1	1.1
Transport and communications	1.1	1.1	1.0	1.1	0.9	0.9
Other financial activities	2.2	2.4	3.1	5.2	7.0	0.4
Insurance sector	0.5	0.4	0.4	0.4	0.8	0.5
Commercial real estate, IT, R&T	12.2	12.1	11.0	5.9	11.0	11.4
Public administration (excluding social security)	3.1	2.6	2.4	1.1	1.8	0.0
Education	0.2	0.2	0.2	0.2	0.2	0.1
Healthcare and social services	1.3	1.3	1.1	1.1	1.0	1.0
Other collective and personal services	1.5	1.5	1.3	1.7	1.2	1.0
Other	0.5	0.5	0.6	0.6	0.6	7.6
Earnings and profitability						
Gross profits as percent of average assets (ROAA)	0.8	0.9	0.9	0.7	0.3	0.5
Gross profits as percent of average equity capital (ROAE)	14.3	18.0	17.7	15.4	5.4	8.2
Net interest income as percent of gross income	36.4	30.9	27.4	28.1	36.3	30.5
Non-interest expenses as percent of gross income	62.7	59.2	63.0	70.4	85.5	80.1
Liquidity						
Liquid assets as percent of total assets	24.5	24.7	25.2	27.1	29.2	27.6
Liquid assets as percent of short-term liabilities	59.6	59.4	60.4	63.9	67.1	64.3
Net long position in foreign exchange as a percentage of tier I capital	15.5	30.6	21.9	13.7	-16.1	-0.2

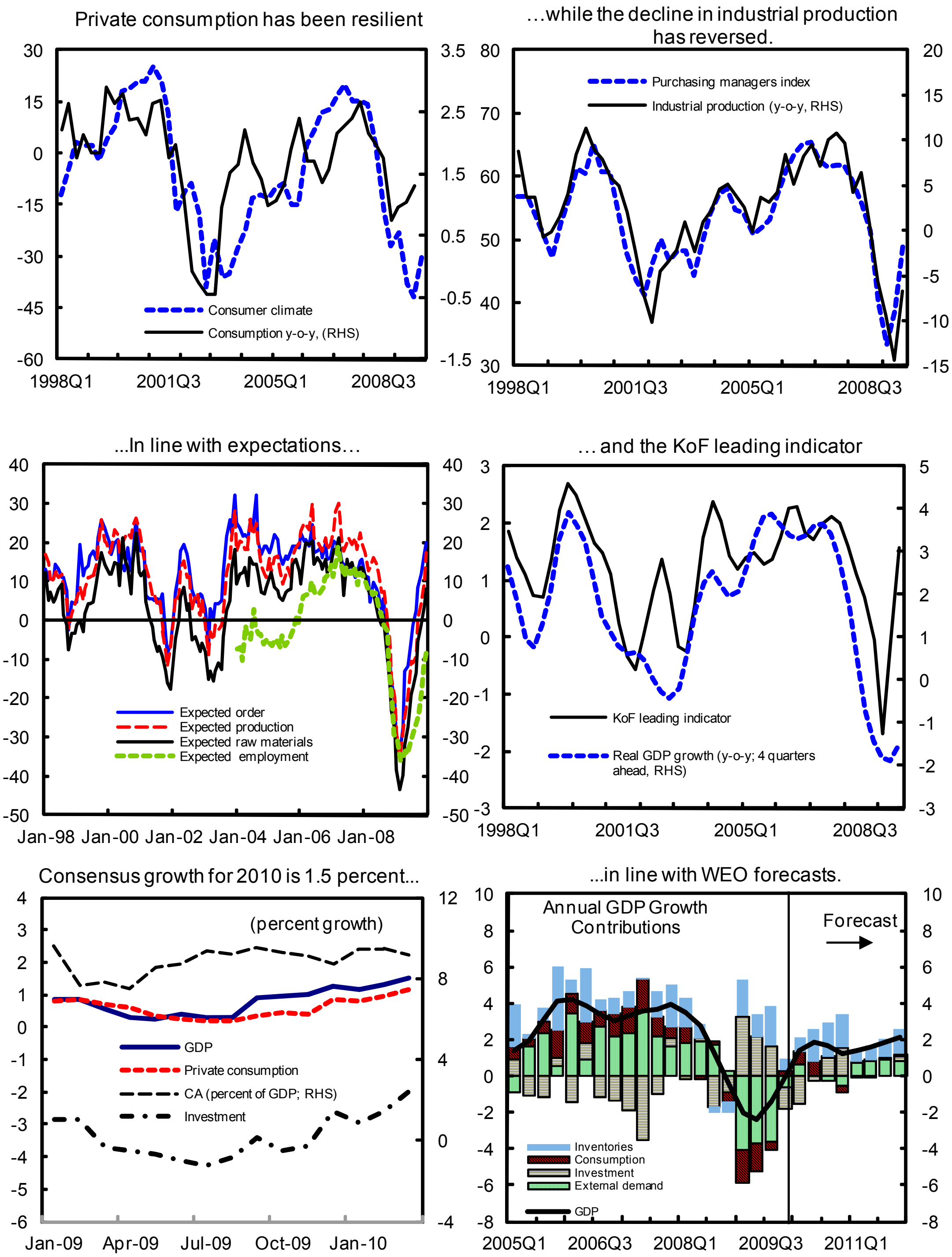
Source: Swiss National Bank.
1/ Provisional data.
2/ As a percent of total credit to the private sector.

Table 8. Switzerland: Major Financial Institutions---Key Indicators, 2003–09
(Millions of Swiss francs, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009
Credit Suisse							
Total assets	962,164	1,089,485	1,339,052	1,255,956	1,360,680	1,170,350	1,031,427
Shareholders equity	34,692	36,273	42,118	43,586	43,199	32,302	37,517
Total operating income	26,322	27,033	30,489	38,143	39,321	9,268	33,617
Net income	4,999	5,628	5,850	11,327	7,754	-7,687	6,555
o/w fees and commissions	12,917	13,323	14,323	17,647	19,329	14,812	13,750
trading income	3,528	3,675	5,634	9,428	6,148	-9,880	12,151
RoA	0.52	0.52	0.44	0.90	0.57	-0.66	0.64
Gearing ratio 1/	27.73	30.04	31.79	28.82	31.50	36.23	27.49
RoE	14.41	15.52	13.89	25.99	17.95	-23.80	17.47
Tier 1 ratio (percent)	11.70	12.34	11.31	13.90	11.10	13.30	16.30
Number of employees	…	41,200	44,600	44,900	48,100	47,800	47,600
S&P long-term rating	AA-	AA-	AA-	AA-	AA-	A+	A+
UBS							
Total assets	1,553,979	1,737,118	2,060,250	2,396,511	2,272,579	2,014,815	1,340,538
Shareholders equity	33,659	33,941	44,324	49,686	35,585	32,531	41,013
Total operating income	32,957	35,971	39,896	47,484	31,721	796	22,601
Net income	5,904	7,357	9,442	11,527	-5,247	-20,724	-2,125
o/w fees and commissions	17,345	19,416	21,436	25,881	30,634	22,929	17,712
trading income	3,756	4,972	7,996	13,318	-8,353	-25,820	-324
RoA	0.38	0.42	0.46	0.48	-0.23	-1.03	-0.16
Gearing ratio 1/	46.17	51.18	46.48	48.23	63.86	61.94	32.69
RoE	17.54	21.68	21.30	23.20	-14.74	-63.71	-5.18
Tier 1 ratio (percent)	12.00	11.90	12.90	11.90	8.80	11.00	15.40
Number of employees	65,879	67,407	69,569	78,140	83,560	77,783	65,233
S&P long-term rating	AA+	AA+	AA+	AA+	AA	A+	A+
Swiss Re							
Total assets	169,698	184,440	221,299	291,300	307,287	239,877	240,604
Shareholders equity	18,511	19,177	24,393	30,884	31,867	20,453	26,201
Total operating income	36,430	36,093	38,012	40,771	42,874	24,978	33,383
Net income	1,702	2,475	2,304	4,560	4,162	-864	506
RoA	1.00	1.34	1.04	1.57	1.35	-0.36	0.21
Gearing ratio 1/	9.17	9.62	9.07	9.43	9.64	11.73	9.18
RoE	9.19	12.91	9.45	14.76	13.06	~~23.67~~ -4.22	~~51.78~~ 1.93
Number of employees	7,886	8,359	8,882	9,586	10,891	11,560	10,552
S&P long-term rating	AA	AA	AA	AA-	AA-	A+	A+
Zurich Financial Services 2/							
Total assets	317,642	350,887	339,612	374,781	389,344	327,944	368,914
Shareholders equity	18,934	20,515	22,426	25,587	28,804	22,103	29,678
Total operating income	57,208	61,214	67,186	65,002	55,163	32,349	70,272
Net income	2,009	2,466	3,214	4,620	5,626	3,116	3,236
RoA	0.63	0.70	0.95	1.23	1.44	0.95	0.88
Gearing ratio 1/	16.78	17.10	15.14	14.65	13.52	14.84	12.43
RoE	10.61	12.02	14.33	18.06	19.53	~~7.09~~ 14.09	~~9.2~~ 10.90
Number of employees	>50,000	>50,000	>55,000	>55,000	>60,000	57,609	56,668
S&P long-term rating	AA	AA	AA	AA-	AA-	AA-	AA-

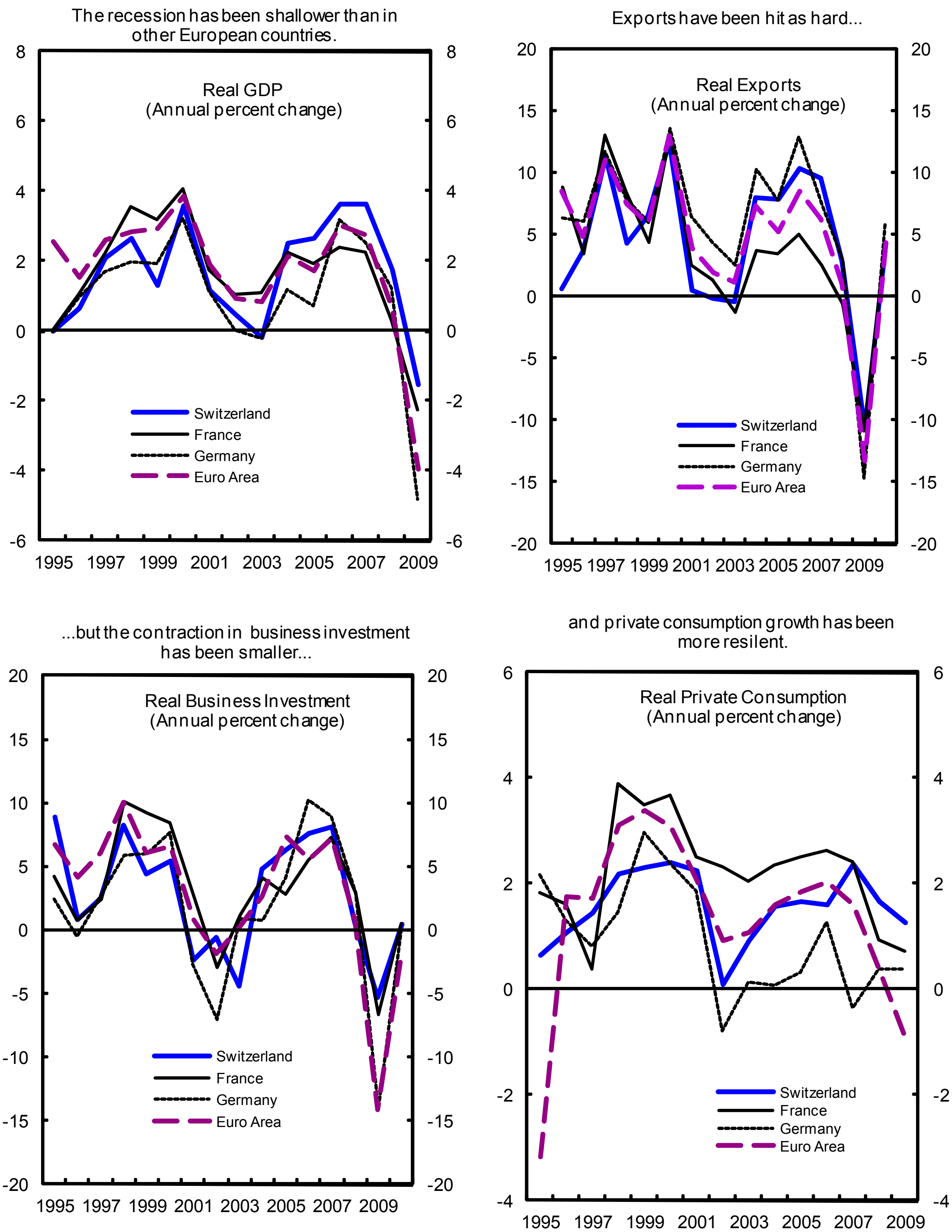
Sources: Company reports; and IMF staff estimates.
1/ Total assets divided by shareholders equity.
2/ In millions of US$, unless otherwise indicated.

Figure 1. Switzerland: Developments and Outlook
(Year-on-year growth rates in percent, unless otherwise indicated)



Sources: SNB; SECO; and IMF staff estimates.

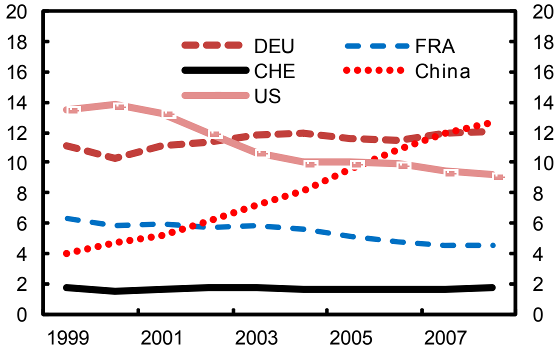
Figure 2. Switzerland: Comparative Economic Performance, 1995-2009



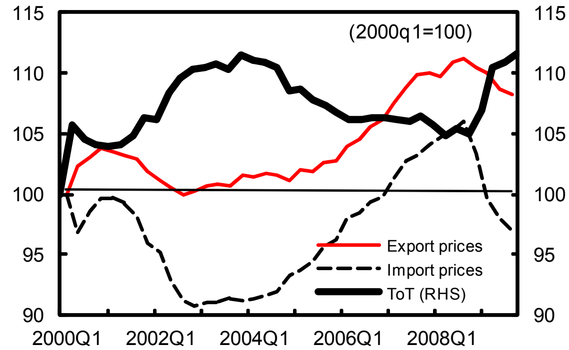
Source: WEO.

Figure 3. Switzerland: External Developments

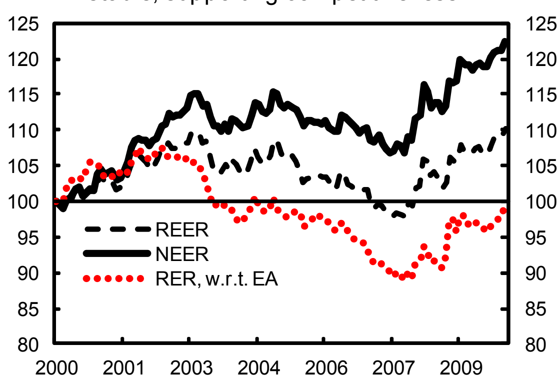
Swiss manufacturing export market shares have remained stable...



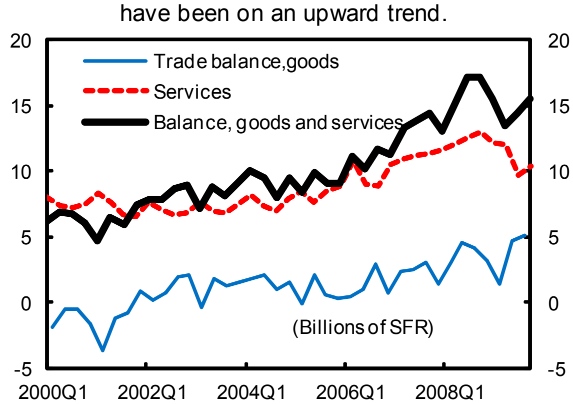
...while terms of trade have improved.



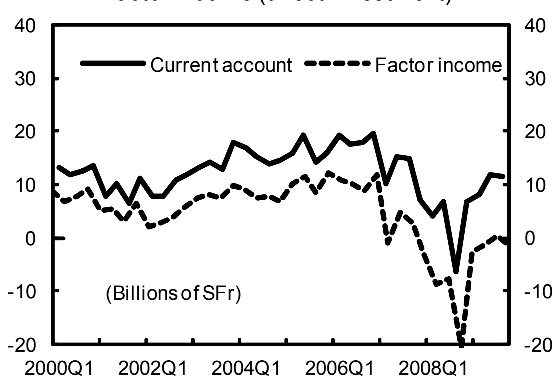
Low inflation has kept the REER relatively stable, supporting competitiveness.



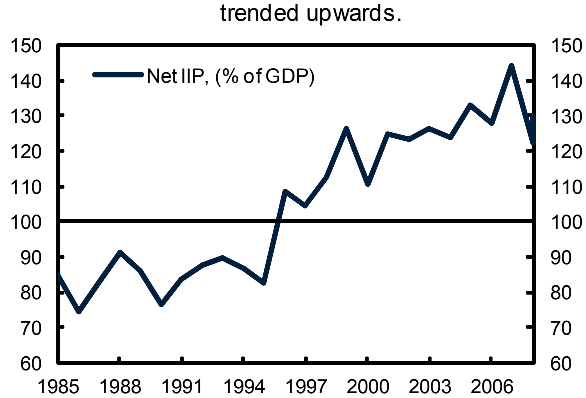
...while the trade and service balances have been on an upward trend.



Current account has rebounded due to factor income (direct investment).

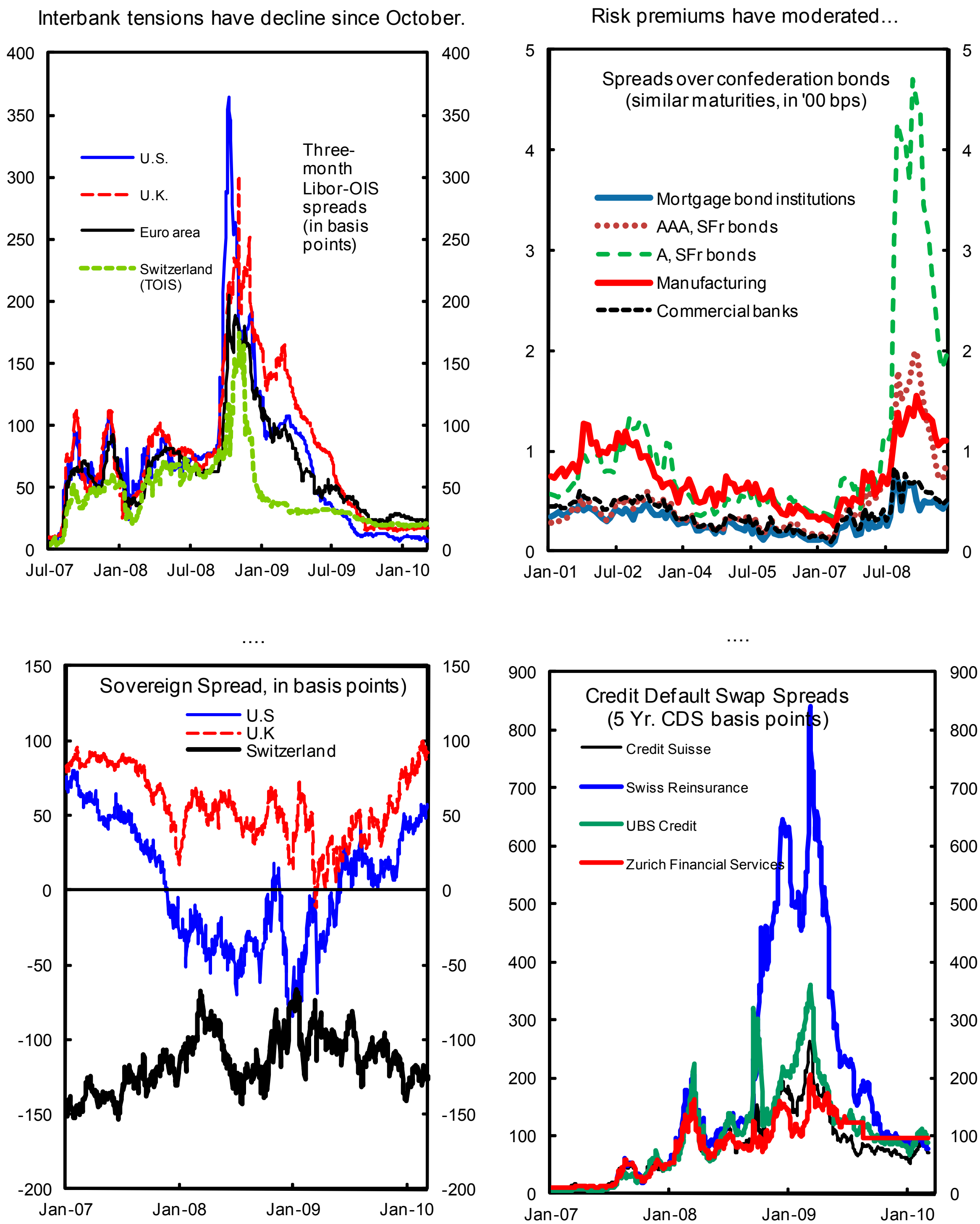


Net international investment position has trended upwards.



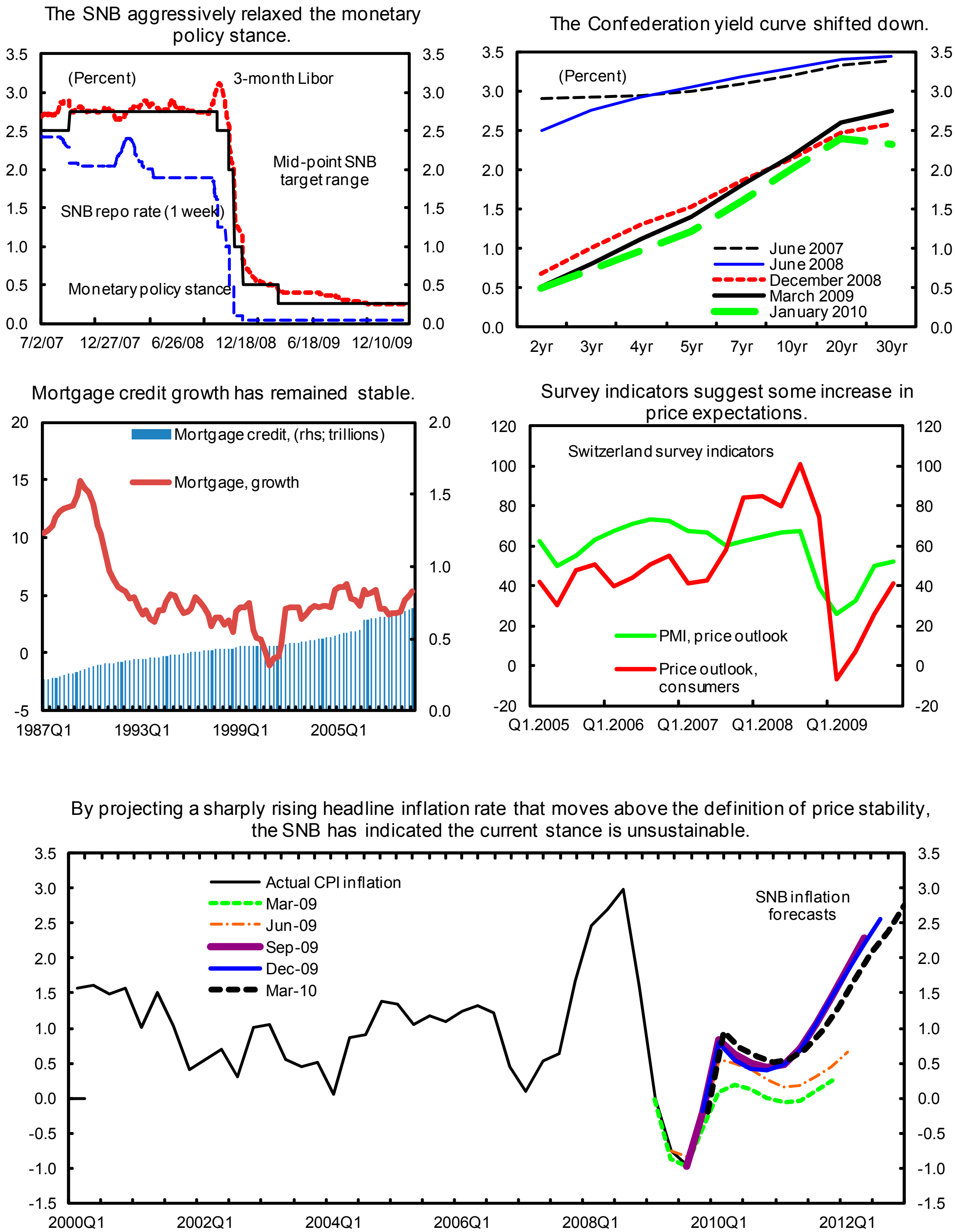
Sources: Swiss National Bank; WTO; and IMF staff estimates.

Figure 4. Switzerland: Developments in Credit



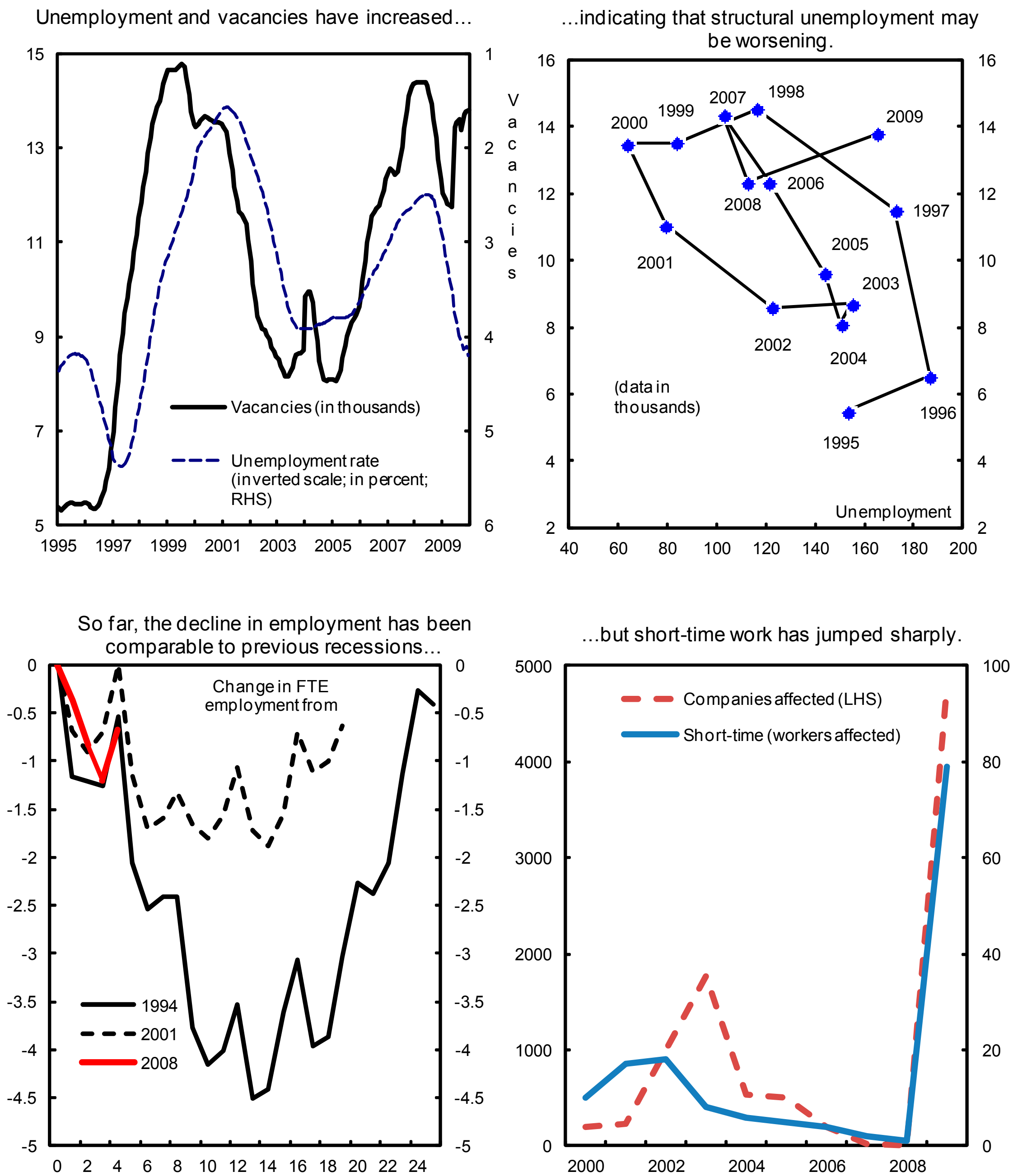
Sources: SNB Monthly Statistical Bulletin; SNB Bulletin of Banking Statistics; and IMF staff estimates.

Figure 5. Switzerland: Monetary Developments



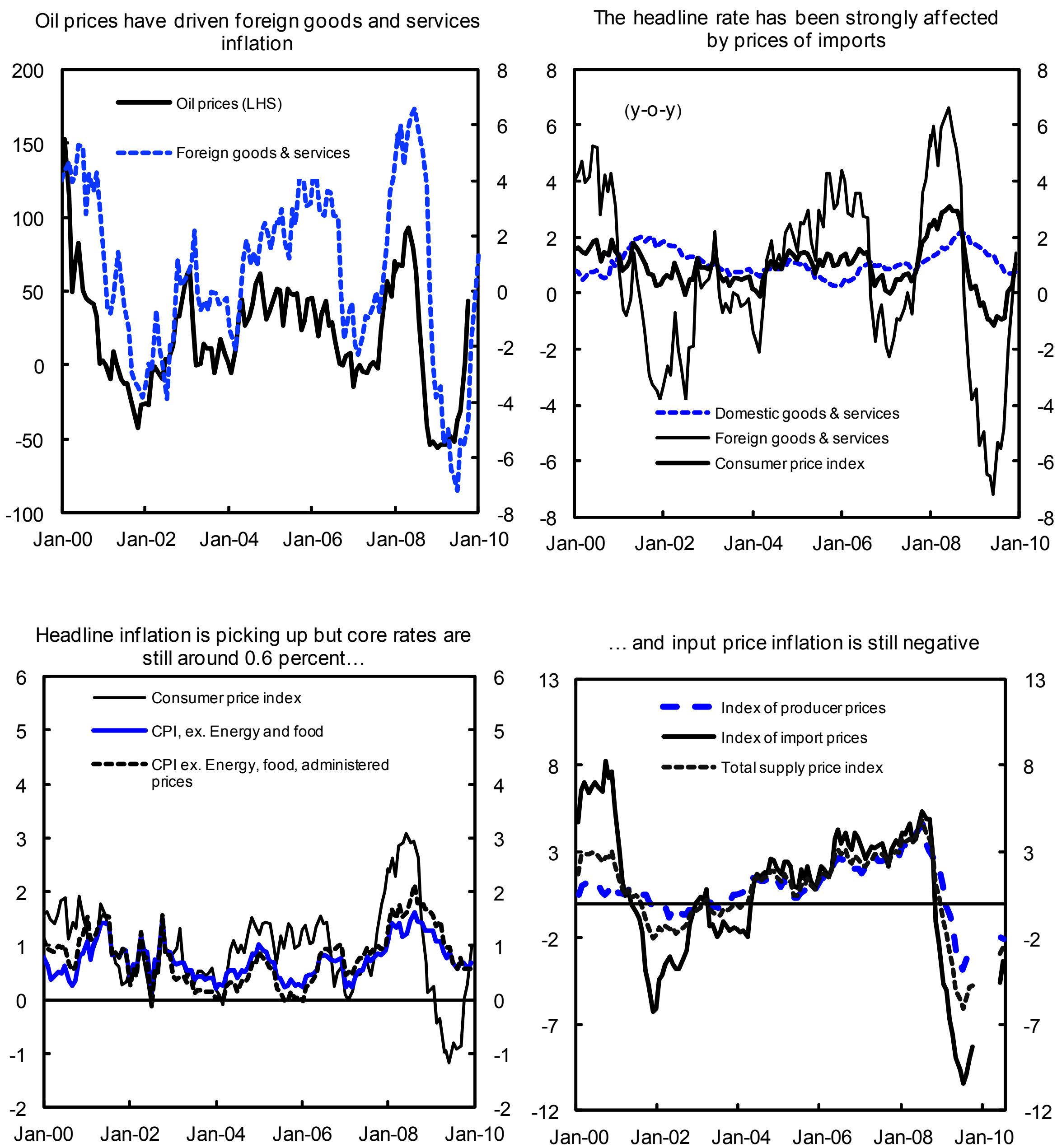
Sources: SNB; and IMF staff estimates.

Figure 6. Switzerland: Labor Market Developments



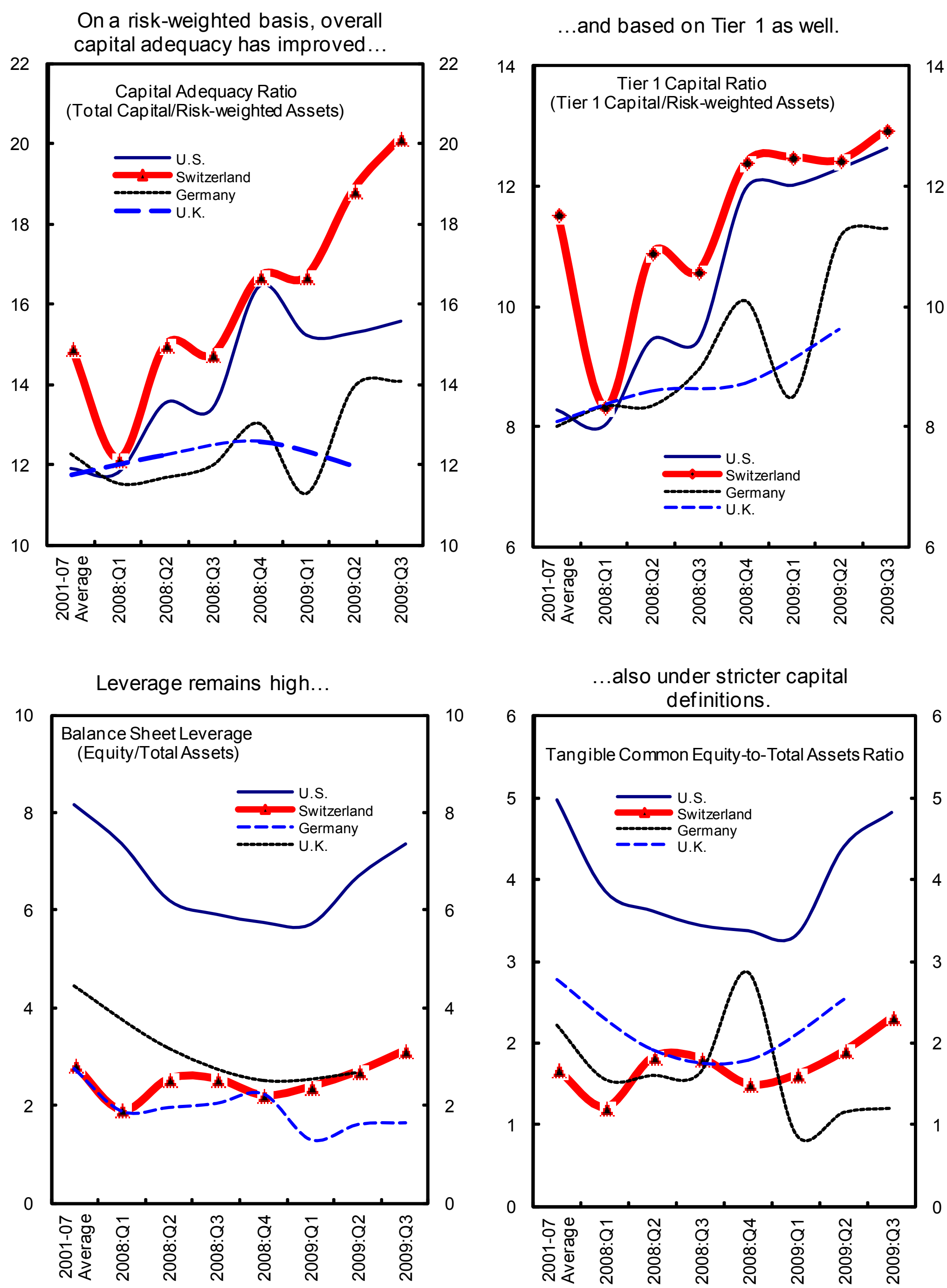
Sources: SECO, Swiss Federal Statistics office, SNB; and IMF staff estimates.

Figure 7. Switzerland Inflation Developments



Sources: SNB and IMF staff estimates.

Figure 8. Switzerland: Banking Sector - Capital Ratios 1/
(Percent)



Source: Bloomberg.
1/ The data covers only the largest banks in the system. For Switzerland and Germany, two banks each; for the U.K., four banks; and for the U.S., seven banks. U.S. averages and 2008 first quarter data exclude Goldman Sachs and Morgan Stanley in the first two panels.

ANNEX I. POTENTIAL GROWTH IN THE AFTERMATH OF THE FINANCIAL CRISIS[8]

INTRODUCTION

Potential output is a key ingredient in the formulation of fiscal and monetary policies. For example, Switzerland's 'debt brake rule' requires an estimation of potential output[9], as expenditures are required to remain below a threshold determined by potential revenues. Similarly, estimates of slack are crucial in determining SNB inflation projections.

The Swiss case is especially interesting given its large financial center and immigration experience. Switzerland benefited from the expansion in global finance and lower risk aversion, but has clearly suffered from the financial crisis. At the same time, it has tapped into an expanded pool of labor in the run-up to the financial turbulence through large inflows of highly skilled labor. This immigration has raised labor supply, and its quality, increasing potential growth. The key question going forward is how the financial shock will impact these two main growth drivers.

Research suggests extreme financial crises can permanently reduce potential output.[10] Furceri and Mourougane (2009) find that financial crises in OECD countries permanently reduce potential output by 1½ to 2½ percent on average, with the severity increasing with the size of the crisis. Similarly, Koopman and Székely (2009) find that EU potential output should fall by some 5 percent of GDP as a result of the financial crisis. The October 2009 WEO also concludes that based on past financial shocks, "real output in advanced economies is unlikely to rebound to its pre-crisis trend".

Potential growth may be affected through reductions in labor, capital and total factor productivity (TFP) contributions. Potential labor supply may be hindered by a: (i) rise in structural unemployment which increases the NAIRU; (ii) decrease in participation rates as discouraged workers drop out of the labor force; (iii) loss of labor skills from prolonged unemployment stays; and most importantly in the Swiss case (iv) reduction in net immigration flows. Capital may contribute less to growth as scrapping rates may increase because of reallocations and cost of capital increases renders some investment unprofitable. Finally, the impact of the recession on productivity growth is in theory seen as ambiguous; in particular, while some restructuration due to the crisis may enhance overall efficiency, spending in innovation is pro-cyclical and likely to be affected by the rise in funding costs, and as some areas of business have been changed or stopped.

---

[8] Prepared by Gil Mehrez and Kevin Ross.

[9] Estimation is made by the authorities using a HP filter.

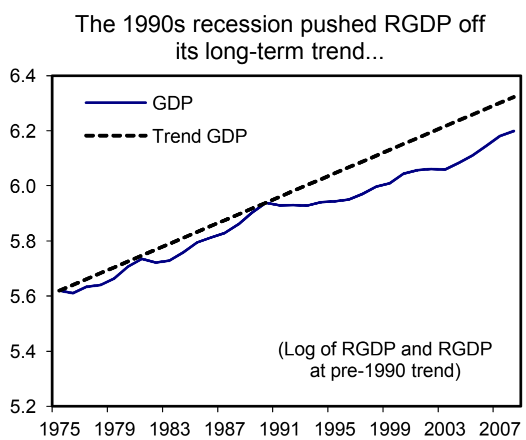
[10] See Furceri, D. and Mourougane A., (2009), "The Effect of Financial Crisis on Potential Output: New Empirical Evidence from OECD Countries," *OECD Economics Department Working Papers No. 699*; Koopman G. and Székely I. (2009), "The Financial Crisis and Potential Growth: Policy Challenges for Europe," ECFIN Economic Brief Issue 3 June 2009.

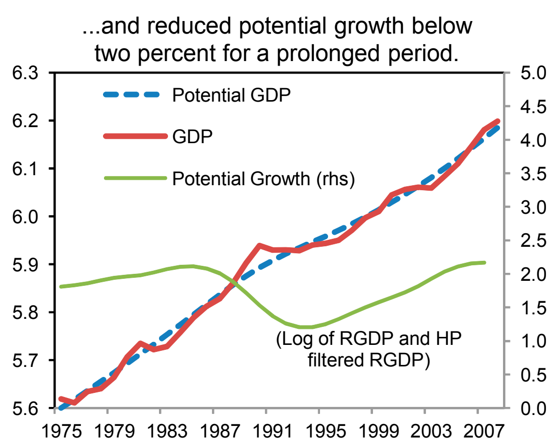
With this in mind, we provide a preliminary estimate of Swiss potential output based on a production function approach. Potential growth is estimated to have fallen to about 1¼ percent in 2009. Looking ahead, there is wide uncertainty. We estimate that potential growth would slowly recover, mainly because of slower employment growth associated with a decrease in immigration, before reaching its long term average of 1¾ percent.

Past Experience with Financial Crisis

At first blush, the 1990s recession might appear to provide a good benchmark in analyzing the possible impact on potential growth.

- On average, real GDP grew at an annual rate of 1.7 percent between 1976 and 2008. However, growth has been uneven, with recessions at the beginning of each decade followed by recoveries of differing speeds. While most recessions were mild, the 1990s recession associated with a real estate bust and ensuing banking crisis was longer and more severe (Box 1 in staff report). As demonstrated by simple HP filtering methods, as well as by a PF approach, this shock had a permanent impact on potential output.





- A growth accounting decomposition indicates that the decline in potential output was mainly due to a fall in labor growth (reflecting lower immigration), while the drop in capital accumulation and productivity growth were much smaller. The increase in the unemployment rate from around 1 percent pre-1990 to about 5 percent in the mid-90s reversed the inflow of foreign workers. During 1992–99, the number of foreign workers (including cross borders commuters) declined from 1.2 million to 0.95 million, representing 7 percent drop in labor supply.

Switzerland: Contributions to Real GDP Growth

	RGDP	Contributions		
Period	growth	Capital	Labor	TFP
1976-2009	1.66	0.67	0.24	0.75
1976-1990	2.34	0.84	0.55	0.95
1991-2003	0.92	0.64	-0.18	0.47
2004-2008	2.80	0.41	0.97	1.42
2009	-1.53	0.35	0.27	-2.15

Source: SNB; and staff estimates.

Although the 1990's Swiss recession provides insights and had been similar to what is unfolding in many other industrial countries with concurrent credit and housing crises, the current Swiss slowdown appears to be less severe. The crisis during the 90s that originated in a real estate sector had weakened corporate balance sheets and households wealth, and set off a crisis at the regional banks. In contrast, during the current recession, the real estate sector has been stable, corporate and household balance sheet has been relatively solid, and the domestic banking sector has been sound.

Financial Shocks and Potential Growth

The financial sector has been a strong driver of growth in recent years. Financial intermediation accounted for 7.3 percent of total value added (10.3 percent including insurance and pensions) and 6 percent of employment. In terms of growth rates, financial intermediation directly contributed about 1 percentage point to Swiss real GDP growth between 2004 and 2007.

Switzerland: Financial Sector Value Added 1/ 2/

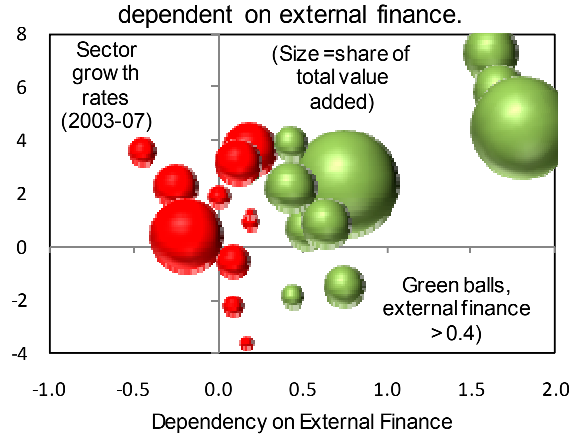
	2007	2008	2009
Financial intermediation 3/	9.5	8.2	7.3
o/w fees / commissions	3.8	3.3	2.9
o/w FISIM	5.7	4.9	4.4
Insurance and pension	3.1	3.0	3.0

1/ Sources: SECO and staff estimates.
2/ In percent of value added.
3/ Financial intermediation services *directly* measured reflects fees and commissions. *Indirect* measurement (FISIM), reflects lending and deposits, as well as interest rate effects.

Financial turbulence can impact potential growth through two channels.

- The financial shock *directly* lowers intermediation value added through a reduction in fees and commissions, and interest income. In this regard, financial sector value added, as a percentage of total value added has declined by 2 percentage points since 2007.[11] This is due both to lower fees/commissions given lower wealth management balance sheet valuations, volumes, and turnover and a lower income from lending and deposit services. Looking ahead, the reduction in volumes of assets under management may imply a permanent loss.

Some faster growing sectors are more dependent on external finance.



- With regard to the *indirect* impact, there is evidence that fast growing sectors tend to be more dependent on external finance. Indeed, the structure of the Swiss economy would suggest this possibility.[12] Thus, the crisis could reduce potential

[11] During 2004–07, the financial sector grew by 4 percentage points per year faster than the rest of the economy. A drop in financial sector growth rates to the economy-wide average would have implied a decline of about 0.4 of a percentage point in overall growth.

[12] The bubble chart matches Swiss sectoral growth rates with the sectors dependence on external finance, as defined by Rajan and Zingales (1998).

growth to the extent that overall credit availability declines. However, in contrast to many other countries, the impact of the financial crisis on credit flow in Switzerland has been limited so far and credit has continued to expand. This is because the financial crisis has affected mainly the external operations of large Swiss banks, while banks with a domestic focus (and the large banks' domestic operations) have been left relatively unscathed.

PRODUCTION FUNCTION APPROACH

The production function approach maps input factors into a potential growth estimate. Over the 2004–08, growth was about 2.8 percent, with labor, capital stock, and total factor productivity (TFP) growth contributing approximately 0.4, 1.0, and 1.4 percentage points, respectively. Given the absence of major imbalances and dissimilarities with the 1990s recession (e.g., absence of credit and housing shocks), we estimate how the recession may impact factor inputs—and thus potential growth.

A. Labor supply

Reflecting higher unemployment and hence a decline in foreign workers flows, employment growth is projected to slow down in the short run. After growing rapidly prior to the recession, employment stagnated since the second half of 2008 and unemployment surged. Still, the growth of foreign workers decelerated somehow but remained strong during 2009 – resulting in a still strong positive contribution of labor to potential growth in 2009. Looking forward, with a large labor hoarding, the inflow of foreign workers, and hence labor supply, should be curbed in the short run. In addition, we expect a somehow smaller contribution of labor growth from residents – as higher unemployment may weigh on labor force participation, while prolonged stays in unemployment increase skill mismatch. In the medium run, we assume that the annual growth rate of migrant worker inflows will decline –from 4 percent in the booming years to 2 percent. As a result, labor growth is expected to decline to about 0.8 percent during 2010–11 – resulting in labor contributions close to the ones estimated by the SNB (0.5 percent) - before gradually increasing to its long run rate.

B. Capital stock

Investment is expected to remain muted in the short run. Lower employment growth (i.e., higher capital to labor ratio), and reduction in the availability and higher cost of credit combined with increased risk aversion should reduce planned investment. Substantial slack in capacity utilization would also tend to support this view.

C. Total Factor Productivity

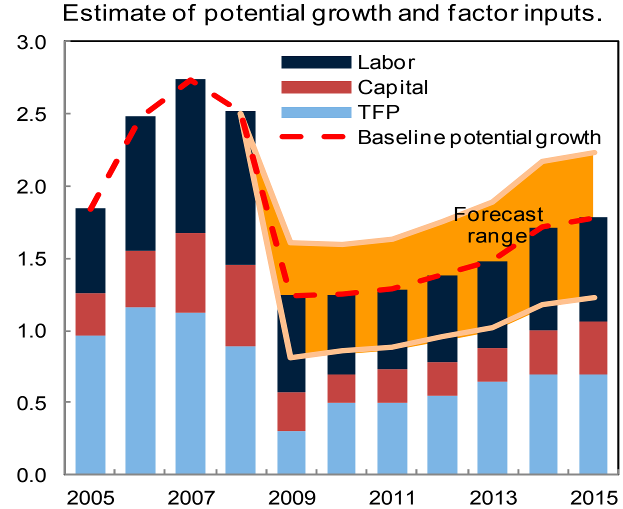
Going forward, we forecast that overall TFP will decline moderately. The financial crisis is likely to reduce the productivity growth in the financial sector and economy wide as the financial sector alters its business models, some innovative activities decline, and positive spillovers decline with the lower global growth. However, considering that the size of the financial sector is only 10 percent of total output, and that the impact on domestic credit has been small, we expect that the decline in TFP will be modest. We assume that TFP will grow at about 0.5 percent and then steadily returns to its long-time trend of 0.8 percent, but recognize the large uncertainty associated with projecting TFP following a financial crisis.[13]

D. Aggregated impacts on potential growth

Overall, the potential growth would appear to have declined to about 1 ¼ percent in 2009–11. Combining the effect of employment, capital, and TFP, we estimate that potential growth will be around 1 ¼ percent, followed by a gradual rebound to its long term average growth of 1 ¾ percent.

Uncertainty around the estimates is exceptionally high. In times of significant regime change—as in the current circumstances—there are obvious risks that past observations can no longer provide valid economic inferences. Thus, while our analysis based on past episodes and on an evaluation of labor, capital and TFP behavior, can shed some light on the possible direction of structural changes, there is a large degree of imprecision.

Estimate of potential growth and factor inputs.



[13] See, for example, the European Commission, Directorate-General for Economic and Financial Affair occasional paper 49 (June 2009) "Impact of the current economic and financial crisis on potential output" (http://ec.europa.eu/economy_finance/publications/publication15479_en.pdf) for a discussion on the uncertainty surrounding TFP growth after financial crises.

INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2010 Consultation with Switzerland

(In consultation with other Departments)

April 29, 2010

Contents Page

Appendices

I. SWITZERLAND: FUND RELATIONS
(As of March 31, 2010)

I. **Membership Status:** Joined 5/29/92; Switzerland has accepted the obligations of Article VIII, Sections 2, 3 and 4.

II. **General Resources Account:**	SDR Million	% Quota
Quota	3,458.50	100.00
Fund holdings of currency	2,696.88	77.98
Reserve position in Fund	761.66	22.02

III. **SDR Department:**	SDR Million	% Allocation
Net cumulative allocation	3,288.04	100.00
Holdings	3,429.33	104.30

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund[1/]:**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal					
Charges/Interest	0.25	0.25	0.25	0.25	0.25
Total	0.25	0.25	0.25	0.25	0.25

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. **Exchange Rate Arrangement:**

The exchange rate of the Swiss franc is determined by supply and demand in the foreign exchange market and is currently classified as a floating regime. The Swiss National Bank reserves the right to intervene in the foreign exchange market. All settlements are made at free market rates. Switzerland maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for restrictions in place for security reasons notified to the Fund pursuant to Decision No. 144-(52/51).

On April 20, 2010, Switzerland notified the IMF of the exchange restrictions that have been imposed against certain countries, individuals, and entities, in accordance with relevant UN Security Council resolutions and EU regulations.

In accordance with UN Security Council resolutions, restrictions are currently in place with respect to specific individuals and entities associated with the former government of Liberia, Iraq, Osama bin Laden, the Taliban, and the Al-Qaïda network**,** specific individuals and entities posing a threat to international peace and security in Côte d'Ivoire, in the Democratic Republic of the Congo (DRC), impeding the peace process in Sudan, engaged in the Democratic People's Republic of Korea's (DPRK) Weapons of Mass Destruction (WMD)–related programs, ban on financing and financial services related to the provision of arms and related materiel to Lebanon, specific individuals and entities involved in the nuclear and/or ballistic missile programs of the Islamic Republic of Iran, financing and financial services related to the provision of arms and related materiel, and to military activities in Somalia, and Eritrea. The lists of individuals and entities against which financial sanctions are in force are based on the decisions by the competent UN Security Council sanctions committee and are amended regularly.

In accordance with EU regulations, restrictions are currently in place with respect to specific individuals associated with the previous government of the former Republic of Yugoslavia, Zimbabwe, Myanmar, specific individuals and entities associated with the government of Belarus, specific individuals associated with the military government of Guinea as well as financial services and financing related to the provision of arms and related materiel to Guinea. The lists of targeted individuals are identical to the list in the corresponding EU regulations.

VIII. **Technical Assistance:** None

IX. **Resident Representatives:** None

X. **Other** FSAP Update, November 2006

II. Switzerland: Statistical Issues

Switzerland's economic and financial statistics are adequate for surveillance purposes. Switzerland generally publishes timely economic statistics and posts most of the data and the underlying documentation on the internet. In June 1996, Switzerland subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are currently posted on the Dissemination Standards Bulletin Board. Switzerland is in full observance of SDDS requirements, and it is availing itself of the SDDS's flexibility options on dissemination of production index data (for periodicity and timeliness) and of wages and earnings data (for periodicity).

However, a number of statistical gaps and deficiencies remain, mainly reflecting a lack of resources and the limited authority of the Federal Statistical Office (BfS) to request information:

- reliable general government finance statistics appear with considerable lags, mainly due to delays in compiling fiscal accounts at the level of cantons and communes;
- pension statistics are published with a long lag;
- GDP by industry appears with a considerable lag.

To address deficiencies, the authorities are taking or intend to take the following steps:

From July 2006, the SNB conducts the monthly survey on the cost of borrowing. In January 2010, it started to publish data from this survey. Data on household wealth—encompassing both financial and real estate assets and not only, as was the case before, financial assets—was published for the first time in 2009. In 2009, the SNB revised its credit survey, among other things, to better reflect loans granted to the service sector. In conjunction with the SNB's centennial, **long-run historical time series** covering monetary aggregates, capital markets, the SNB balance sheet, and the banking sector have been published. Under the agreement with SFBC on reciprocal exchange of data, the SNB has since 2007, been collecting the new capital adequacy statement information, in accordance with Basel II. Since 2007, the SNB has conducted surveys of Liechtenstein-based companies when preparing its balance of payments and international investment position. In order to gain information on the effects of the financial crisis on domestic bank lending, the SNB has been collecting **qualitative** data on the lending policies of about 20 banks since the first quarter of 2008. The results of the survey complement the quantitative data obtained from existing statistics. This supplementary quarterly survey is only temporary and not published.

Annual national accounts were upgraded in 2003 to the *European System of Accounts 1995* (ESA95) and with the release of the Q4 2004 data, the Secretariat for Economics (SECO) revised accordingly its **quarterly national account estimates**. SECO started publishing in March 2006 a quarterly production account and since October 2008 the quarterly income approach of GDP (at current prices). The main innovations in the new national accounts were in investment (with detail on information and communications technology), private and public consumption (hospitals were transferred to the private sector), and the use of chain price indices (without adjustment for quality).

In 2004, a **statistical cooperation agreement** was concluded with the EU as part of Bilateral II for the harmonization of several Swiss statistics with EU standards. In 2010 the agreement will be updated.

The Federal Finance Administration has **revamped fiscal statistics** with the adoption of the *Government Finance Statistics Manual 2001*, the reform of the accounting standards for cantons and communes (*Harmonisiertes Rechnungslegungsmodell der Kantone HRM2*) and the introduction of full accrual budgeting and accounting at the level of the federal government (*Neues Rechnungsmodell Bund NAM*) along the lines of the International Public Sector Accounting Standards (IPSAS). Figures according to the new accounting standards have been produced for the federal government (*NAM*) for 2008 and for some cantons (*HRM2*) for 2009. Figures according to GFSM2001 have been reported beginning in 2009. A ROSC mission on fiscal transparency took place during January 16–29, 2009.

Quarterly balance of payments and international investment position data are compiled by the SNB and meet international standards. However, monetary gold transactions relating to sales of gold reserves not required for monetary policy purposes have not been correctly reflected in the balance of payments. For legal reasons, and until the distribution of the proceeds of gold sales between the SNB and the Federal Department of Finance was concluded in February 2005, the proceeds of the gold sales not needed for monetary purposes were considered as part of the official reserves in the balance of payments. After that date, they appear in the position "other assets of the SNB" in the balance of payments.

Switzerland participates in the **Coordinated Compilation Exercise for Financial Soundness Indicators (FSIs).** Data and metadata on a benchmark set of indicators of the soundness of the financial system (for year-end 2008) has been posted on the IMF website.

The authorities have made progress in completing the implementation of the **FATF AML/CFT recommendations.** The federal law implementing the revised FATF Recommendations was adopted by the Swiss Parliament in October 2008 and entered into force on February 1, 2009. Supervisory ordinances on the private insurances, gaming, banking and non banking sectors have also been adopted, and a revised banking association due diligence code has come into force in mid-2008. The Swiss authorities last reported on these reforms to the FATF in October 2009.

I. Table of Common Indicators Required for Surveillance
(As of April 19, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Apr 10	Apr 10	D and M	M and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar 10	Apr 10	M	M	M
Reserve/Base Money	Mar 10	Apr 10	M	M	M
Broad Money	Mar 10	Apr 10	M	M	M
Central Bank Balance Sheet	Mar 10	Apr 10	M	M	M
Consolidated Balance Sheet of the Banking System	Mar 10	Apr 10	M	M	M
Interest Rates[2]	Mar 10	Apr 10	D and M	M and M	D and M
Consumer Price Index	Mar 10	Apr 10	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4]	2008	Dec 09	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government[3]	Feb 10	Mar 10	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4/09	Mar 10	Q	Q	Q
External Current Account Balance	Q4/09	Apr 10	Q	Q	Q
Exports and Imports of Goods and Services	Feb 10	Apr 10	M	M	M
GDP/GNP	Q4/09	Mar 10	Q	Q	Q
Gross External Debt	2009	Mar 10	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA).

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/61
FOR IMMEDIATE RELEASE

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with Switzerland

On May, 14, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

Although Switzerland was hard hit by the global crisis, the 1.5 percent contraction in 2009 compares favorably with most industrial countries. After a year long decline in real GDP, the economy exited the recession in mid-2009. While this resilience was unexpected given the origins of the global recession and structure of the Swiss economy, it can be linked to strong fundamentals and to supportive policies. In particular, households and firms were in a comfortable financial condition before the crisis; Switzerland did not experience a boom-bust credit and real estate cycle; and private consumption continued to be supported by immigration flows and dynamic revenues, in a context of negative inflation and muted adjustment on the labor market. Overall, export oriented and financial sectors were significantly impacted by the global downturn but most domestic oriented activities held up relatively well.

In response to the crisis, the authorities took a series of actions in a broad range of policy areas. The SNB continued to implement an expansionary monetary policy,

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

leaving the 3-month Libor target range at 0 to 0.75 percent since March 2009 and actively pursuing quantitative easing measures, including foreign exchange intervention to limit upward pressure on the Swiss franc. In the fiscal area, the authorities allowed automatic stabilizers to fully play and enacted the last of three stimulus packages, focused on public infrastructure investment as well as labor market measures that increased short time work benefits.

Financial sector measures also helped to stabilize financial markets and reduce systemic risk. In 2008, the authorities strengthened capital requirements for the two largest banks, transferred illiquid assets of one large bank to a "bad bank", and expanded deposit insurance coverage. In 2009, they tightened capital requirements for cantonal and regional banks, reduced by about one third the risk of the StabFund, and set new remuneration guidelines for large financial institutions. Moreover, authorities created a "Too big to Fail" working group that is examining ways to address the moral hazard issue, and large contingent liabilities, associated with a financial sector with large institutions. It will produce a final report in the summer of 2010. Finally, guidelines for cooperation on financial stability issues between the SNB and the financial supervisor (FINMA) have been clarified in a revised memorandum of understanding.

The authorities are now contemplating how to exit from current accommodative stance. Since December the SNB has only prevented excessive appreciation in the Swiss franc against the euro—and has signaled its intention to normalize rates over time. While the fiscal impulse should be positive in 2010, the government expects some consolidation in 2011–13 in line with debt brake fiscal rule.

While leading indicators suggest that the recovery is ongoing and becoming broader based, uncertainty remains. Economic growth is expected to increase to 1.6 percent in 2010—and strengthen further to 1.8 percent in 2011, as exports and financial sector activity improve. Inflation has turned positive, but is expected to remain under 1 percent, given the effects of past appreciation of the currency, and the remaining slack in the economy. However, there are large uncertainties related to global developments.

Executive Board Assessment

Directors agreed with the thrust of the staff appraisal. They commended the authorities for Switzerland's strong macroeconomic fundamentals and pro-active policy response which contributed to the resilience of the economy during the global crisis. Economic recovery is ongoing although uncertainties relating to external developments persist. In the absence of near-term threats to price and public finance stability, Directors supported a cautious exit from the current accommodative fiscal and monetary stance.

Directors considered the current expansionary monetary policy to be appropriate. They welcomed the liquidity support measures recently taken by the Swiss National Bank in response to renewed stress. Directors agreed that the main monetary policy challenge will be to normalize interest rates while exiting exchange rate interventions. Most Directors supported the view that the Swiss franc is not misaligned and that the current real appreciation pressure mostly reflects a strengthening of fundamentals. Directors endorsed the authorities' intention to return to a free floating currency regime and most Directors stressed that any intervention should be limited to resisting disruptive pressures. Directors recommended that interest rates should not be raised prematurely and that prudential tools may be best suited to address any deterioration in lending standards.

Directors commended the authorities for their strong fiscal performance. They noted that prudent fiscal policies, which also result in low debt, should be maintained given the potential liabilities relating to the financial sector and the medium-term effects of population ageing. In light of the risks to growth, a few Directors considered that the fiscal consolidation envisaged by the authorities should be calibrated precisely to what is needed to respect the debt brake rule.

Directors commended the authorities for their financial stabilization measures and encouraged them to preserve the momentum to reinforce financial stability. Persistent sizable contingent liabilities and remaining risks to the financial system require continued close monitoring, and Directors welcomed the authorities' efforts to strengthen supervision. Going forward, the effectiveness of the Financial Market Supervisory Authority (FINMA) could be further enhanced through an expansion of its in-house capabilities and measures to reinforce the independence of its auditors. Directors welcomed steps taken by the authorities to prevent the use of the financial system to avoid tax compliance and their commitment to implement internationally agreed standards.

Directors welcomed the authorities' efforts to address the "too big to fail" (TBTF) problem as well as the preliminary report and recommendations of the TBTF working group. They broadly supported the recommendations to impose higher capital buffers and reinforce liquidity requirements for institutions posing a systemic risk. Directors encouraged the authorities to contemplate measures, including simplifications in the organization and legal structure of large banking institutions, to help improve crisis resolution.

Directors welcomed the new SNB/FINMA Memorandum of Understanding, which reinforces collaboration on financial stability issues. They saw scope for further clarification of responsibilities and stressed the need to align legal powers with respective mandates.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Switzerland: Selected Economic Indicators

	2006	2007	2008	2009	2010 1/
Real economy					
Real GDP (percentage changes)	3.6	3.6	1.8	-1.5	1.6
Real total domestic demand (percentage changes)	1.4	1.3	0.4	1.7	1.5
CPI (year average)	1.1	0.7	2.4	-0.5	0.7
Unemployment rate (in percent of labor force)	3.0	2.5	2.7	4.1	3.9
Gross national saving (percent of GDP)	36.0	31.7	22.9	28.9	30.1
Gross national investment (percent of GDP)	20.8	21.7	20.5	20.6	20.9
Public finances (percent of GDP)					
Federal government ordinary balance	0.8	0.8	1.3	0.5	0.2
General government ordinary balance 2/	1.6	2.0	2.0	0.3	-1.0
Gross public debt	47.2	43.6	41.1	38.8	39.8
Balance of payments					
Trade balance (in percent of GDP)	1.8	2.0	2.8	3.0	2.9
Current account (in percent of GDP)	15.2	10.0	2.4	8.3	9.1
Official reserves (end of year, US$ billion) 3/	65.1	74.6	68.8	135.8	160.3
Money and interest rates					
Domestic credit (annual average)	5.5	7.0	3.2	4.2	…
M3 (annual average)	2.4	2.1	2.2	5.8	…
Three-month Libor rate (in percent)	1.6	2.2	1.5	0.3	…
Government bond yield (in percent)	2.5	2.9	2.5	2.2	…
Exchange rate					
Exchange rate regime				Free float	
Present rate (April 20, 2010)				SwF 1.06 per US$1	
Nominal effective exchange rate (1990=100)	108.4	106.1	112.4	118.3	…
Real effective exchange rate (1990=100) 4/	101.7	98.0	103.1	108.4	…

Sources: IMF, International Financial Statistics; IMF, World Economic Outlook; and IMF staff projections.

1/ Staff estimates and projections.
2/ Including Confederation, cantons, communes, and social security.
3/ Official reserves for 2010 are as of end-March 2010.
4/ Based on consumer prices.

Statement by Rene Weber, Executive Director for Switzerland and
Marcel Peter, Senior Advisor to Executive Director
May 14, 2010

1. On behalf of the Swiss authorities, we would like to thank staff for once again presenting a well-researched staff report that provides a thorough, objective, and insightful analysis of the macro-economic situation. The policy dialogue has been excellent and we share staff's opinion on the challenges going forward in most respects. We also welcome the candid policy recommendations, which add considerable value to our domestic policy discussions.

2. We agree with staff that Switzerland will experience a gradual recovery after a shallow recession. Domestic demand has held up especially well throughout the recent crisis period, which could not be entirely expected from the outset. We are pleased to note that, for the first three months of 2010, exports have picked up again, growing at 4.3 percent. Industry surveys point to further optimism for the coming months. In the labour market, we observe an earlier than expected drop in the unemployment rate. While we remain cautiously optimistic, our current GDP growth forecast is in line with staff's.

Monetary Policy

3. Our authorities fully share the staff's appraisal of the Swiss monetary policy stance. The challenge of normalizing interest rates while exiting intervention has become even greater following the recent pressure on the Swiss franc due to global financial market uncertainty. The appreciation of the Swiss franc implies a tightening of monetary conditions but has negative side effects to the extent that it reduces the room for maneuver for normalizing interest rates. This situation is particularly unwelcome given the acceleration in mortgage lending activity. There is thus a serious risk that appreciation may become a source of disequilibrium between economic sectors.

4. The current monetary stance is very loose, and there is a need to normalize interest rates over time. The repo rate at 0.05 percent is close to zero, and the 3-month Libor, at about 0.25 percent, is at its desired level within the target range (which is set at 0 percent and 0.75 percent since March 2009). The latest inflation forecast published by the Swiss National Bank (SNB) shows that price stability is not threatened in the short run. Inflation should remain contained in 2010 and 2011. However, the current expansionary monetary policy cannot be maintained without compromising medium to long-term price stability. Assuming no policy change, inflation is forecast to exceed 2 percent by 2012. Such a situation is not compatible with what the SNB considers as price stability.

5. However, as inflation will not be tolerated, neither will be deflation. The global economy is still fragile and large uncertainties remain. The recent events are a proof of it. Should external shocks persist and appreciation pressures intensify, the danger of deflation cannot entirely be ruled out. As a consequence, the SNB will continue to act decisively to prevent an excessive appreciation of the Swiss franc.

Financial Stability

6. Our authorities are well aware that the reform momentum for strengthening the domestic framework underpinning financial stability needs to be maintained. In particular, capital and liquidity standards will continue to include substantial add-ons to internationally agreed requirements, reflecting the systemic importance of large and complex financial institutions for the economy. In addition, the organization and the legal structure of large banks should be modified in such a way that, in a crisis, the authorities will be able to preserve those functions of a bank that are essential for the real economy and are not forced to rescue the bank in its entirety.

7. There is a clear agenda for further strengthening financial market regulation and supervision. An expert committee commissioned by the government is currently considering the challenges posed by ”too big to fail“ institutions for Switzerland in depth and has already published an interim report. This report outlines the thrust of further action on the regulatory side, which the government has endorsed. The core elements are increases in the capital, liquidity, and risk diversification requirements that should reduce the likelihood of insolvency of a systemically important bank. In its final report expected for end-August 2010, the committee will put forward an overall package of measures, including concrete proposals for changes to the Banking Law.

8. Our Swiss authorities are fully supportive of a strong financial center that serves the interests of the entire economy. Given the economic importance of the financial sector—the financial sector generates about one tenth of Switzerland’s overall value added and contributes nearly six percent to total employment—the government has reviewed the strategic positioning of the financial centre and set the course for future financial market policy. A report entitled “Strategic directions for Switzerland’s financial market policy” has been published, proposing measures to enhance competitiveness and market access, and mitigate risks. However, public policy is to be limited to assuring a conducive and coherent regulatory and supervisory framework. To this end, Switzerland is committed to implementing agreed international standards and it will conduct a peer review by the Financial Stability Board in 2011.

Fiscal Policy

9. Fiscal developments have been generally positive. The general government accounts again registered a surplus in 2009 amounting to 0.7 percent of GDP, which is remarkable under the circumstances and given expansionary fiscal policy. At the general government level, discretionary measures and automatic stabilizers have provided and will provide a combined fiscal stimulus of around 1.6 percent of GDP in 2009 and of 1.3 percent of GDP in 2010. These estimates are based on a survey carried out by the authorities in 2009 and are higher than staff estimates. The debt-to-GDP ratio declined further to below 40 percent.

10. The fiscal outlook for 2010 is somewhat worse, with all levels of government turning into deficit. Our authorities currently project a general government deficit of 1.2

percent of GDP, slightly higher than the staff's projections. Yet the cantons, municipalities, and social security institutions are expected to narrow their deficits from 2011 onwards. Our authorities project a faster recovery in cantonal finances than staff, mainly on account of lower projected growth in expenditure. Gross debt levels are expected to decrease not only at the federal level but also at sub-national levels, where more and more cantons are adopting fiscal rules similar to the debt-brake. From 2011 onwards, a consolidation effort of 0.3 percent of GDP is needed at the federal level to meet the requirements of the debt brake.

11. As staff notes, the deterioration in the federal fiscal balance is mainly due to the implementation of several tax reforms that will result in annual structural revenue losses of roughly 1.6 billion Swiss francs according to the latest estimates. Staff argues that revenues have been consistently underestimated in recent years, pointing to a lesser need for fiscal consolidation in the short run. Our authorities conclude that potential revenues have not increased significantly. They remain firmly committed not to compromise the consolidation efforts of previous years and will implement the fiscal rule consistently, thereby ensuring a balanced budget over the medium term.