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SWITZERLAND

2013 ARTICLE IV CONSULTATION

May 2013

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 19, 2013, 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 23, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its May 8, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Switzerland.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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SWITZERLAND

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

April 23, 2013

KEY ISSUES

With the exchange rate floor in place for over a year, the Swiss economy has been relatively stable, but managing the new regime has required large foreign exchange interventions. The balance sheet of the Swiss National Bank (SNB) has reached an unprecedented size. The resulting liquidity expansion, in tandem with low interest rates, is increasing risks in the mortgage market. The large systemic banks are striving to strengthen their capital base and adjust to the new regulatory environment, while the strategy to address the "too big to fail" problem is under implementation. The fiscal position is strong.

Exchange Rate Policy: Exit from the exchange rate floor would be premature as inflation is still too low, the output gap negative (though small), and the risk of renewed safe haven inflows significant. In case of large new inflows, negative interest rates on bank reserves could be considered, while sustained capital outflows, if any, should be used to gradually unwind past interventions.

The Mortgage Market: With interest rates at historical lows and mortgage debt high, recent prudential measures to reduce risks are welcome, while additional policy actions, including tax reforms and affordability limits, should be prepared in case pressures continue.

"Too Big to Fail" Banks: To further reduce the risk posed by the very large financial sector, the large banks' capitalization and restructuring plans should be closely monitored to ensure that leverage is rapidly brought in line with peers. Further progress is necessary in addressing cross-border aspects of bank resolution and resolvability.

Approved By
Ajai Chopra and David Marston

Discussions took place in Bern and Zurich on March 8–18. The staff team comprised Ms. Detragiache (head), Ms. Xiao, Mr. Tchaidze (all EUR), and Mr. Lundback (MCM). Messrs. Weber and Peter (OED) participated in the discussions.

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INTRODUCTION

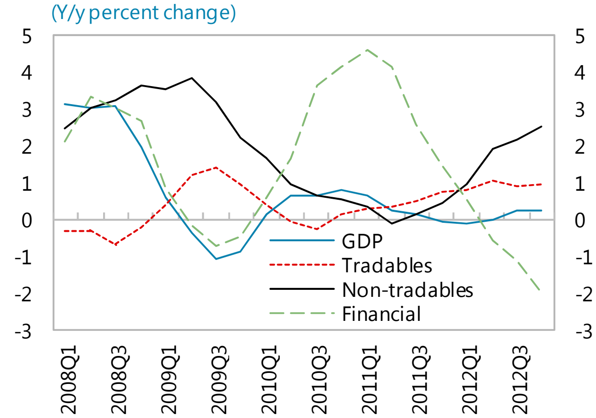
1. **The exchange rate floor has helped economic stability, but challenges continue to lie ahead.** The floor was introduced in September 2011 as a temporary emergency measure to contain spillovers from the euro area sovereign crisis in the form of a large portfolio reallocation toward "safe haven" Swiss assets. In the last consultation, the Fund endorsed the floor as appropriate given the lack of alternative instruments to prevent further, massive tightening of monetary conditions through a sharp exchange rate appreciation. The floor successfully stemmed inflows and reduced uncertainty, helping Switzerland avoid a recession and contain deflation risks. However, as the euro area crisis intensified again in the spring and summer of 2012, the SNB had to intervene heavily, and its balance sheet reached the unprecedented size of 85 percent of GDP. Since then, market sentiment has stabilized, but with a slow global recovery ahead, unresolved issues still surrounding the euro area crisis and exceptionally loose monetary policy in most advanced countries, safeguarding macroeconomic stability in Switzerland will remain challenging. In addition, the large and globalized financial sector poses risks given global fragilities.[1]

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. GDP Growth has Decelerated and Inflation Remains Negative

2. **At end-2012, the Swiss economy continued to decelerate, driven by lower net exports.** GDP growth fell from 0.5 percent q-o-q in 2012Q1 to 0.2 percent in Q4, and the annual growth rate for 2012 was only 1.0 percent, about half of that of 2011 (Figure 1). Domestic demand was resilient, largely supported by a strong rebound in private consumption as wage increases and negative inflation raised real disposable income. However, export growth slowed considerably and the external sector's contribution to growth shrank, turning negative for the first time since 2009.

Growth in Price Deflators
(Y/y percent change)



Source: Haver.

3. **Unemployment is low and immigration is fueling labor force growth.** Unemployment was below 3 percent, though it increased slightly in 2012. In contrast with other European countries where population

[1] An FSAP update, planned in conjunction with the 2014 Article IV consultation, will provide a more detailed assessment of financial stability in Switzerland.

growth is small or negative, population and the labor force have been growing relatively fast in Switzerland, especially after the free movement of labor agreement with the E.U. was phased in beginning in 2002. The flows consist mostly of highly educated workers and display less sensitivity to the business cycle.

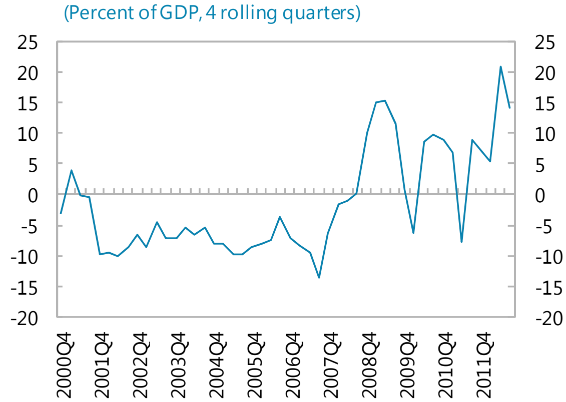
4. **Inflation remains negative, while expectations are anchored in positive territory.** Core and headline consumer price inflation are negative as the pass-through from the past exchange rate appreciation continues to run its course. Inflation measured by the GDP deflator was positive in 2012, in spite of the lasting decline in prices of financial services, and nominal wages are growing. While short-term inflation expectations, as measured by the SNB quarterly survey, are close to zero, medium-term expectations (from a Deloitte survey) remain in line with the SNB's definition of price stability.

B. Defending the Exchange Rate Floor Required Large-Scale Intervention

5. **When safe haven inflows resumed in mid–2012, the SNB intervened heavily to defend the floor.**[2] While little exchange rate pressure was evident for the first eight months of the new exchange rate regime, safe haven inflows resumed with the intensification of the euro zone crisis in May 2012, and the SNB engaged in extensive interventions during May–August. As a result, its FX reserves increased by over 65 percent (Figure 2), and its balance sheet reached 85 percent of GDP, the largest among major central banks. The expansion in reserves was largely matched by an increase in bank sight deposits (excess reserves) at the SNB. Even though broad money has accelerated, money multipliers remain low.

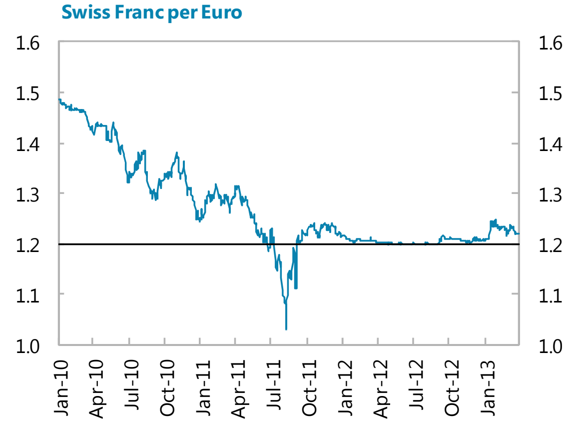
6. **As tensions in the euro area abated in the fall of 2012, pressures on the Swiss franc waned**. Interventions stopped and the currency has traded above the floor since January 2013, as market sentiment toward the euro area improved (Box 1). However, reserves have not declined.

Net Private Flows
(Percent of GDP, 4 rolling quarters)



Sources: SNB; and IMF staff calculations.

Swiss Franc per Euro



Source: Haver Analytics.

[2] "Safe haven inflows" should be interpreted as including inflows by foreign residents, repatriation of foreign investments by domestic residents, and diminished outflows by domestic residents.

C. The External Sector Continues to Perform Relatively Well

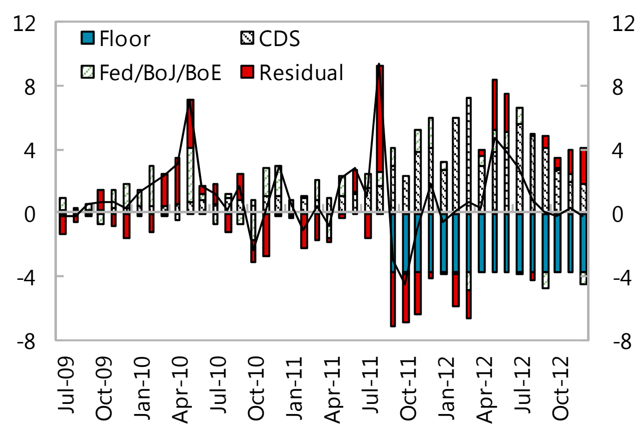
7. **Following the introduction of the floor, the real exchange rate has depreciated but is still moderately overvalued.** The negative inflation differential with trading partners is gradually undoing the earlier real exchange rate appreciation, thus shoring up competitiveness (Figure 3). Since the introduction of the floor, the NEER and the REER-ULC have depreciated by some 6 percent, while REER-CPI has depreciated by 8 percent, though current levels of these measures still reflect sizable appreciation since the financial crisis began. In light of this appreciation, and while there have been difficulties in some segments, all in all Swiss exports have performed well in recent years (Box 2). Preliminary estimates using the External Balance Assessment methodology suggest an overvaluation of 5-10 percent.

Box 1. Understanding Pressures on the Swiss Franc

The Swiss franc has long been actively used in global financial markets. With low interest rates and a relatively stable nominal exchange rate, in the years preceding the global financial crisis the Swiss franc was used as a funding currency in carry-trade transactions and as a currency of denomination for loans in some emerging European countries and Austria. After interest rates fell in advanced countries in 2008–09, the Swiss franc's attractiveness as a funding currency waned and the currency began to appreciate. Later on, turmoil in the euro area enhanced the Swiss currency's role as a safe haven, while aggressive unconventional monetary policies by major central banks made other advanced-country assets less attractive.

The relative importance of these factors in determining pressures on the Swiss franc can be analyzed using the Exchange Market Pressure index (EMP), a weighted average of the changes in nominal exchange rate against euro and the changes in central bank's FX reserves.[1] Regression analysis of the empirical determinants of the EMP for Switzerland suggests strong influence of two factors since mid-2009: the euro area sovereign debt crisis (measured by CDS spreads of the euro area countries under market pressure) and unconventional monetary policies in major advanced countries (measured by the expansion of the balance sheet of the U.S. Federal Reserve, Bank of England, and Bank of Japan). The analysis also suggests that the introduction of the exchange rate floor significantly reduced exchange rate pressures.

Exchange Market Pressure Index and Contributions of Various Determinants



Source: IMF staff estimates.

1\ See Selected Issues Paper "Understanding Pressures on the Swiss Franc."

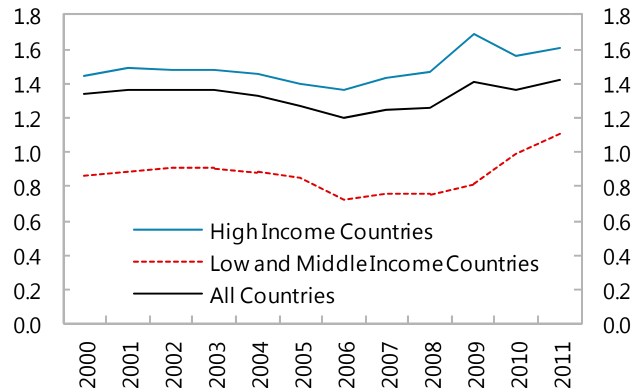
Box 2. Competitiveness of the Swiss Economy

Sharp appreciation of the Swiss franc in 2007–11 has raised concerns about possible negative effects on the Swiss external performance. However, in spite of significant movements in the exchange rate and variability in the market share of other competitors, the market shares of Swiss goods—both globally and in specific country/product segments—have been broadly stable.[1]

How can this be explained? First, significant exporting industries such as pharmaceuticals and watches and precision instruments produce goods particularly valued for their brands or special characteristics. Hence, these products face limited price competition and their exports depend mainly on the cyclical position in the destination economies rather than the real exchange rate.

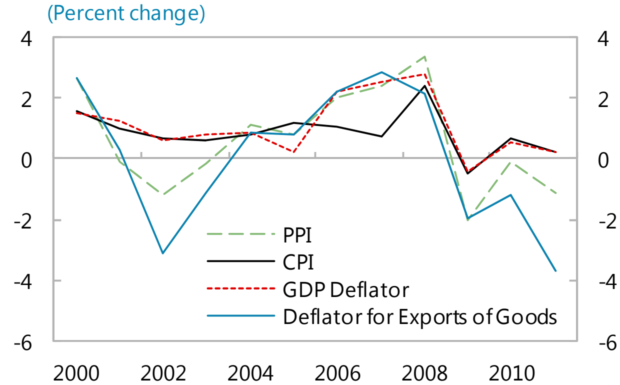
In addition, Swiss exporters have protected their market share by limiting the pass-through of exchange rate changes to export prices. In fact, export prices have declined significantly since the appreciation began. This may reflect adjustments in real wages through longer working hours, declines in imported input prices, productivity gains, as well as willingness to accept temporarily lower profit margins.

Imports from Switzerland as a Share of Total Imports



Sources: UN Comtrade; and IMF staff calculations.

Measures of Inflation
(Percent change)



Sources: Haver Analytics; and IMF staff calculations.

1/ See Selected Issues Paper "How Did the Swiss Economy Adjust to Exchange Rate Appreciation?"

8. **After shrinking in 2011, the current account surplus is estimated to have widened again in 2012, reflecting favorable net interest income.** The current account surplus was 8.4 percent of GDP in 2011 and preliminary data suggest that it widened to some 13½ percent of GDP in 2012 mostly because of a rebound in net investment income. The latter, however, is large, very volatile, and subject to large revisions, so preliminary figures should be interpreted with caution.[3] Net investment income is also responsible for the bulk of the fluctuations in the Swiss current account.

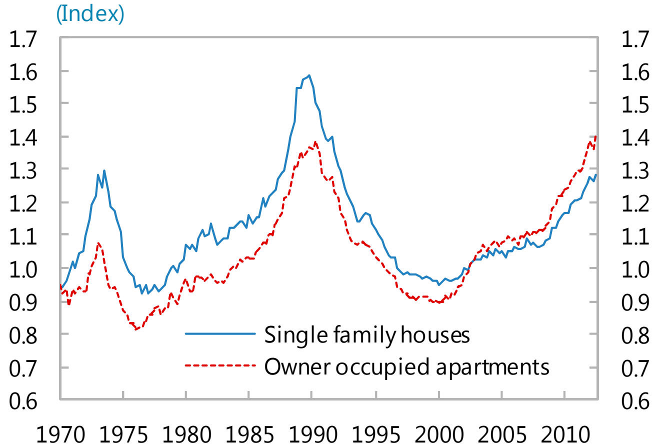
[3] Current account estimates are subject to very large revisions as data on investment income of corporations, a significant component, become available over time. For example, the current account in 2011 was recently revised from 14.8 to 8.4 percent of GDP.

9. **The assessment of the current account is complicated by measurement and other issues and is subject to unusual uncertainty**. First, merchant services, i.e. services by international commodity trading companies based in Switzerland, have become increasingly important and contribute up to 4 percent of GDP to the current account surplus, though some of these companies have only limited activities in Switzerland. Second, Swiss multinationals firms are often partly owned by foreigners through portfolio shares. Thus, a part of the retained earnings of these companies should be attributed to foreign shareholders, rather than counted as domestic income. According to SNB estimates, this accounting discrepancy has added to the Swiss current account 2.3, 4.9, and 2.0 percent of GDP in 2009, 2010, and 2011 respectively. Finally, cross-border shopping, i.e. direct purchases by households while abroad or mail/courier deliveries from France and Germany, while extremely difficult to evaluate, may not be fully reflected in imports and thus overstate the current account by a potentially non-trivial amount[4].

D. The Financial Sector is Restructuring While Very Low Interest Rates Fuel Risks in the Mortgage Market

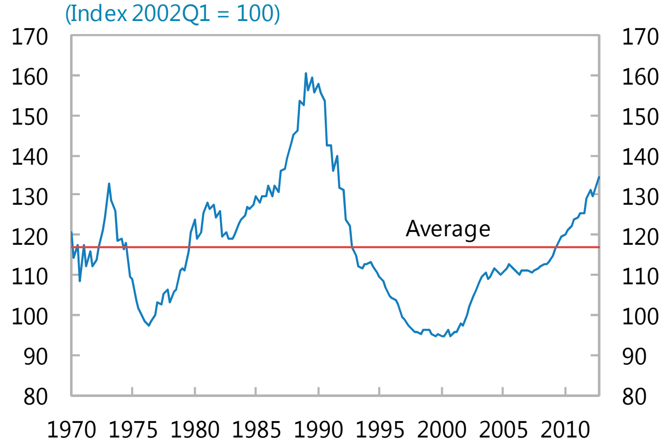
10. **The two large banks are undertaking ambitious capitalization plans while heavy reliance on internal risk models raises concerns.** Significant operational risk costs (e.g. the LIBOR scandal, a "rogue" trader scandal, retrocession fees, tax evasion, and subprime mortgage cases in the U.S.) have taken a toll on profitability, but capitalization is improving through earnings retention, issuance of new capital, some balance sheet reduction, and, especially, through substantial lowering of Risk-Weighted-Assets (RWA). Both banks are adjusting their business models to optimize the use of capital, which has become a more binding constraint than in the past; one of the banks plans to reduce dramatically investment banking and refocus its operations on less capital-intensive wealth

Real Estate Prices
(Index)



Sources: IFS; Wuest&Partner; and IMF staff calculations.

Price-to-Rent Ratio for Owneroccupied Apartments
(Index 2002Q1 = 100)



Source: Swiss National Bank.

[4] Preliminary estimates using the External Balance Assessment methodology suggest that the cyclically-adjusted current account surplus in 2012 is some 5 percentage points above the level implied by fundamentals and desirable policy settings, mostly reflecting the large preliminary estimate of net investment income. Given the nature of net investment income data and other factors discussed above, there are considerable uncertainties around this assessment.

management, while the other is also reducing its investment banking activities, but to a lesser extent. As a result, the two banks should be able to comply with new regulatory capital requirements well ahead of schedule. The reliance on RWA reduction to improve capital ratios, however, raises concerns that internal risk models may not adequately capture risk, especially as banks become more capital constrained. Such concerns are being addressed at the international level within a broader project for regulatory consistency by the Basel Committee for Banking Supervision (BCBS), in which Swiss banks are included. The liquidity position of the two Swiss SIFIs appears to be strong.[5]

11. **Progress in lowering leverage has been limited so far, but it will have to accelerate.** Basel III capital requirements were introduced at the beginning of this year and the Swiss TBTF legislation requires large banks to hold additional buffers. Despite high regulatory capital ratios, the leverage of the two big banks is high compared with other global banks and displays only small improvements, since the new minimum regulatory leverage ratio is gradually being phased in and is not binding yet (Figure 4). As this ratio is tightened going forward, the challenge for the two big banks will be to reduce total assets or increase capital. This process may require further substantial changes in business models. Lingering uncertainties about the direction of regulatory reforms in other countries, however, complicate long-term strategic decision-making.

12. **The reform of the banking resolution framework is advancing domestically, but key cross-border aspects remain to be settled.** A new Banking Insolvency Ordinance, designed to meet the requirements of the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions," went into effect in November, 2012. The main changes relate to bank restructuring, including provisions regulating creditor bail-in. In parallel, progress is being made in formulating recovery and resolution plans for the two big banks. However, cooperation agreements with major foreign host supervisors to facilitate global resolvability are still missing, and progress is dependent on developments at the international level and in other regions, including the U.K. and the U.S.

13. **Historically low interest rate and abundant liquidity are fueling the housing market, heightening vulnerability to price corrections and interest rate increases.** Mortgage lending growth has accelerated to about 5 percent per year since 2009, and mortgage debt recently reached about 140 percent of GDP, high in both international and historical comparisons.[6] Mortgages are traditionally of fairly short maturity, implying frequent refinancing and exposure to changes in interest rates. However, maturity has been lengthening recently, as households seek to take advantage of currently low interest rates. Thus, more of the interest rate risk is being shifted to banks, which hedge this risk only partially. Housing price growth continues at around 4–6 percent per year for owner-occupied apartments, well above nominal GDP growth. While average housing prices are not accelerating as in typical bubble episodes, there is evidence of bubble-like dynamics in "hot spots" such as Geneva. Furthermore, quantitative lending surveys suggest there has been no tightening of lending standards during 2012. The confluence of these developments raise concerns

[5] See Selected Issues Paper "The Swiss G-SIBs: The Ongoing Challenges."

[6] See Selected Issues Paper "The Swiss Housing Market: Where are the Risks?"

about overly leveraged borrowers and growing bank exposure to the risk of a price correction or interest rate increase. The authorities have taken several measures to contain risks (Box 3), but so far there are no clear signs of an impact, though implementation lags may be at work.

14. **The insurance industry is in a transformative phase in a challenging environment.** Life insurers struggle as yields on safe assets are very low. FINMA has intensified supervision, asked for remedial actions where needed, and offered relief through a temporary adjustment of the Swiss Solvency Test (SST), which will expire at end-2015. The non-life insurance business performed well in 2012. On the regulatory front, a new Insurance Insolvency Ordinance came into force this year aiming to protect policy holders and to facilitate smooth bankruptcy proceedings. As cross-border cooperation in this regard is important for some Swiss insurers, FINMA is actively participating in international initiatives, and addresses crises preparedness as the group supervisor. A few Swiss insures may also be designated as globally systemically important, which is not expected to necessitate difficult adjustments.

15. **The authorities are taking measures to enhance the implementation of international standards related to AML/CFT and exchange of information for tax purposes.** The Federal Council has submitted for public consultation draft measures to classify serious tax offences as predicate offenses for money laundering, increase the transparency of legal entities, systematically identify the beneficial owners of legal entities, and strengthen due diligence requirements for politically exposed persons.

Box 3. Measures to Address Developments in the Housing and Mortgage Market

(i) New requirements for mortgage financing were drawn up by the Swiss Bankers Association as minimum regulatory standards and were approved by FINMA, the microprudential supervisor. The standards consist of a minimum down payment of 10 percent of the lending value of the property from the borrower's own funds, which may not be obtained by pledging or early withdrawal of Pillar 2 pension assets; and mortgages must be paid down to two thirds of the collateral value within a maximum of 20 years.

(ii) Mortgages that do not comply with the new minimum standards are allowed but subject to a risk weight of 100 percent.

(iii) Mortgages exceeding 80 percent of the property value will have a risk weight of 100 percent applied to the part of the loan exceeding the 80 percent threshold.

(iv) Banks using an internal ratings-based approach have to apply a bank-specific multiplier when calculating risk-weights for Swiss residential mortgages. The multiplier is to be applied to new and renewed mortgages.

(v) Banks will have to hold a countercyclical capital buffer (CCB) of 1 percent of their risk-weighted, direct or indirect mortgage-backed positions secured by residential property in Switzerland starting September 30, 2013.

The first two measures have been phased in since mid-2012, the third and fourth measures went into effect at the beginning of 2013, while the CCB was activated on February 13, 2013.

E. The Fiscal Position is Strong

16. **Anchored in fiscal rules and discipline, the fiscal position is healthy, with a broadly neutral stance projected for 2013.** In Switzerland, discretionary fiscal policy is limited by the structurally balanced budget rule ("debt brake") at the federal level and other fiscal rules at the cantonal level. The former caps the federal expenditure while allowing tax revenues to act as automatic stabilizers. With conservative budget planning and execution, the federal government has consistently outperformed the fiscal rule. In 2012, the general government's balance is estimated to register a small surplus of 0.3 percent of GDP (on a GFSM basis), a slight improvement over 2011. Reforms to unemployment insurance and a VAT increase earmarked for financing invalidity pensions allowed the social security funds to improve its balance, while the federal government, cantons, and municipalities ran small deficits. The fiscal stance in 2013 is forecast to be broadly neutral, with a small deficit at the federal level and municipalities compensated by surpluses in the other components of the general government. The debt-to-GDP ratio is expected to fall further to about 45 percent of GDP in 2016 (on a GFSM-basis).

17. **However, there are spending pressures over the medium term and long-term challenges from population aging.** The proposed package for the new energy strategy (as Switzerland is phasing out its sizable nuclear power energy capacity) and planned spending increases in education, research and innovation are on the horizon. To finance these expenditures and revenue shortfalls from some planned tax reforms, a new consolidation package has been adopted to achieve cuts of CHF 700 million (0.1 percent of GDP) each year starting in 2014. From a more long-term perspective, spending pressures will also arise from population ageing. A recently published "Pensions 2020" reform program proposes to (i) harmonize reference age for men and women and make benefit plans more flexible for both the old-age and survivor insurance and occupational benefit plans; (ii) provide incentives for continued employment until the reference age and beyond; and (iii) reduce the attractiveness of early retirement. Regarding occupational benefit plans, the guidelines propose to (i) adjust the minimum conversion rate to take into account higher life expectancy and lower interest rates; (ii) look for compensatory measures to maintain level of benefits, including for the intermediate generation; and (iii) evaluate institutional measures to expand the supervisory control by FINMA.

OUTLOOK AND RISKS

18. **The economy is expected to regain momentum only gradually.** Recovering external demand and the stable exchange rate will provide some impetus to exports and investment, though slower employment growth will dampen private consumption somewhat. Growth is expected to increase from 1.0 percent in 2012 to 1.3 percent in 2013 and 1.8 percent in 2014, in line with a baseline scenario of subdued global recovery. The output gap will remain negative and unemployment should increase slightly.

19. **Risks to the outlook mainly relate to spillovers from international developments, exchange rate movements, and the large financial sector.** Switzerland has close economic and financial ties with the euro area, the U.S., and the U.K. Accordingly, economic developments in these three economic areas are key for Switzerland. Concerning the euro area, relative to last year the tail risk of a severe financial crisis and recession has been reduced by policy actions. Nonetheless, the sovereign debt crisis may be rekindled by policy slippages or adverse economic shocks. In such a scenario, safe haven capital flows would restart, putting the Swiss currency under pressure and requiring again a large scale SNB foreign exchange market intervention. Staff views the likelihood and impact of such a scenario as intermediate. In addition, if the crisis intensified beyond what has been experienced so far, the Swiss financial sector may be affected through direct and indirect exposures. A resumption of capital inflows may also result from spillovers from the U.S., Japan, or the U.K. if further monetary easing is enacted. In the medium term, failure to adequately address fiscal challenges could undermine confidence in other major currencies, resulting in pressures on the Swiss franc. Staff views the risk of such a scenario as intermediate/low and its impact as intermediate.

20. **Financial distress in one of the Swiss SIFIs would also have adverse outward spillovers.** While regulatory reforms and ongoing restructuring efforts are improving resilience, the two large banks remain highly internationally interconnected, leveraged, with large wholesale funding positions, and are thus vulnerable to instability in the global financial sector. In particular, measures of marginal conditional value at risk (CoVar) show that distress in either of the Swiss SIFIs would make a relatively large contribution to distress in the European banking sector.[7]

21. **There are also upside risks to growth.** A stronger-than expected recovery might take hold in major advanced countries and emerging markets, spilling over to Switzerland through external demand. Under this scenario, major central banks may exit from unconventional monetary policies more rapidly than currently anticipated and a fast portfolio reallocation away from CHF-denominated assets could follow. This would allow the SNB to rapidly unwind past interventions, but may also cause an earlier-than-expected increase in long-term interest rates in Switzerland, with potentially adverse consequences for the domestic mortgage market.[8]

The authorities' view

22. **The authorities were more sanguine than staff with regards to the baseline scenario, but shared staff's assessment of the main risk factors.** While growth was seen as subdued in 2013, a stronger rebound was envisaged in 2014, with GDP growth at around 2percent. The difference was largely due to the authorities' more optimistic assumptions on the external environment. The authorities agreed with staff that downward pressures on inflation would be

[7] See Selected Issues Paper "Outward Spillovers from the Swiss G-SIBs in Times of Financial Stress."

[8] Staff views the risk of a correction in the Swiss housing market as intermediate and its possible adverse impact on the economy as high.

contained under the baseline scenario, and noted that price declines have not spread to non traded goods or wages.

POLICY DISCUSSIONS

F. Monetary and Exchange Rate Policies

23. **The conditions to exit the floor, as laid out in the last consultation, are not met yet.** Both core and headline inflation are still negative, and economic activity is expected to remain below potential this year and the next. With the resumption of safe-haven inflows still a material risk, an exit from the floor, which could lead to sharp nominal appreciation, reinforce deflation, and put further strain on exporting and import-competing companies, would be premature.

24. **If confidence in global financial markets takes hold, the SNB should cautiously unwind past interventions, and it should exit the floor if a monetary tightening becomes necessary.** If there is a sustained portfolio reallocation away from safe haven assets, given the risks stemming from the large SNB balance sheet and provided other macroeconomic conditions remain close to the baseline scenario, the SNB should begin to gradually reduce its holdings of foreign exchange reserves rather than allow the exchange rate to move significantly above the floor. Once a recovery takes hold, if inflation threatens to move above comfortable levels, the SNB should return to a free float and raise the policy rate.[9]

25. **If safe haven inflows return, the SNB should consider imposing a negative interest rate on bank excess reserves.**[10] The Swiss government bill rates and some bond yields have been negative for some time, and the two large banks have recently imposed negative interest rates on large short-term institutional deposits in Swiss francs.[11] However, the interest rate on bank excess reserves at the SNB is currently zero. Imposing a negative rate in case of renewed pressures on the floor would reduce the attractiveness of CHF-denominated assets, discouraging inflows and reducing the need to intervene with additional reserves purchases. Negative interest rates have potential drawbacks, including possibly intensifying pressure in the mortgage market, but these are likely to be less relevant under the current circumstances in Switzerland than in other countries (Box 4).

26. **Further measures would be welcome to mitigate risks from the large SNB balance sheet.** While many central banks in advanced countries have expanded their asset holdings to pursue unconventional monetary policy, the SNB's balance sheet—at 85 percent of GDP—stands

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[9] An explicit "exit" may be unnecessary if capital flows revert and the exchange rate trades well above the floor.

[10] See Selected Issues Paper "Negative Policy Interest Rates: Should the SNB Consider Them?"

[11] The latter measure resulted in a rapid drawdown of such deposits, suggesting that negative interest rate can be effective.

out. Large losses, such as might occur if an exit from the floor was followed by an appreciation of the franc, would have adverse fiscal implications and could undermine the SNB's capital position.[12] While central banks can operate with negative equity and rebuild capital over time, there is a risk that they may become vulnerable to political pressures and see their independence undermined if their finances are weak. The SNB has taken steps to strengthen its capital by retaining more profits, but the effort has not kept up with the rapid expansion of the balance sheet. Thus, further risk-mitigating measures should be considered.[13]

Box 4. Negative Policy Interest Rates on Bank Excess Reserves: Should the SNB Consider Them?

With policy rates at or close to the zero lower bound in many countries, the challenge of managing capital inflows and the resulting pressures on the exchange rate has rendered negative interest rates a policy option worthy of discussion. In the case of Switzerland, the SNB could charge negative interest rates on bank reserves, or on bank reserves above the minimum requirement. This policy would be aimed at lowering wholesale market interest rates, thus discouraging capital inflows and relieving pressures on the exchange rate.

There are very few past cases in which negative interest rate were used to stem capital inflows. A recent example is Denmark, which introduced a negative policy interest rate in the summer of 2012 with a favorable experience so far.

Negative interest rates may raise special issues and even have drawbacks, particularly when countries want to use them to stimulate credit and economic activity. Negative central bank rates may not be transmitted to other interest rates, thus limiting their effects on economic conditions. In addition, they may impair the functioning of the interbank market and make money market mutual funds unprofitable as spreads become compressed and market turnover falls.

In the current conjuncture of Switzerland, these potential drawbacks are less relevant than in other countries. Activity in the interbank market is already very low, as all banks have excess liquidity. Money market mutual funds have a minor presence in Switzerland. Credit growth, particularly in the mortgage market, is strong. The impact of negative interest rates on mortgage rates depends on the pass-through.[1] If banks cannot pass through negative rates to depositors, they may increase lending interest rates. This would help curbing the growth of mortgage lending and housing prices. Thus, negative interest rates may help address the dilemma the SNB faces: low interest rates are necessary to defend the floor but fuel the housing and mortgage markets. They would also alleviate the need for the central bank to expand its balance sheet. On the other hand, if banks can pass through negative rates to depositors, lending rates would decline and pressures in the mortgage markets may intensify. However, pressures may be tempered if negative interest rates reduce capital inflows.

1/ See Selected Issues Paper "Negative Policy Interest Rates: Should the SNB Consider Them?"

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[12] The SNB capital was substantially weakened by a loss in 2010, when the bank intervened to defend the currency but then abandoned the effort.

[13] See Selected Issues Paper "SNB's Balance Sheet Risks and Policy Implications."

The authorities' view

27. **The authorities shared the mission's analysis, though considered the exchange rate as more significantly appreciated than staff.** They concurred that the conditions to exit the floor are not in place yet, including because they saw the Swiss franc as significantly overvalued and the impact on the economy particularly detrimental. They believed there was still substantial room for expanding the SNB balance sheet as investment opportunities had not yet been exhausted; and that provisions and profit transfer mechanisms currently in place were sufficient to protect the SNB capital in case of losses. They agreed that negative interest rates are a potentially useful tool, but were not committal as to which conditions may prompt their deployment. Finally, regarding the exit strategy, given the rates of return on their FX reserves, they believed they could easily absorb liquidity if needed via issuance of short-term bills and without exiting the floor.

G. The Housing Market

28. **The mission welcomed recent measures to contain vulnerabilities in the housing market and emphasized the need for vigilance.** Given growing risks, the set of prudential measures taken to tighten lending standards and conditions is prudent, and the decision to activate the CCB is welcome. However, at this early stage, little effects have been seen from these measures. Furthermore, the impact of the CCB may be limited given comfortable capital levels in domestically-oriented banks where mortgage lending is dominant. Therefore, the authorities should intensify supervision, strictly enforce the new minimum regulatory standards, and pro-actively use Pillar II measures to ensure prudent lending behavior. Implementing new prudential measures or tightening existing ones may be needed, and an increase of the CCB to its maximum of 2.5 percent should be an option.

29. **As the low interest rate environment is likely to persist, additional instruments may become necessary, including tax measures.** Introducing affordability ratios, such as a debt service-to-income ratio (DTI) in the macroprudential toolkit should also be reconsidered, as these instruments directly address concerns over stretched household balance sheets. In addition, this would be an appropriate time to phase out existing tax incentives that artificially inflate the mortgage market. Because mortgage interest payments are tax-deductible, many households carry much more mortgage debt than warranted. Phasing out the preferential tax treatment of mortgage interest, while lowering taxation of imputed rents, would remove a distortion from the economy and reduce risks in the mortgage market.

The authorities' view

30. **The authorities agreed that growing vulnerabilities in the mortgage market required a proactive approach.** They saw intense supervision and vigilant enforcement of regulations and standards as crucial in containing risks. An increase in the CCB later on was also seen as possible. The SNB agreed that LTV and DTI caps should be on the menu of options, but the decision was made last year by the Federal Council not to include them in the macroprudential toolkit. More generally, the authorities see DTI caps as potentially too limiting of private contractual freedom, and

prefer giving existing measures more time to have some impact before considering further steps. The likelihood that reforms of housing taxation would muster the necessary political support was seen as low, although such a reform would be timely and desirable.

H. Financial Sector Policies

31. **While in large banks capital ratios are improving substantially, more rapid progress on the leverage front would be prudent.** Total assets have declined and regulatory capital ratios have increased, but a sizable part of the adjustment has taken place through a reduction in RWAs. It is therefore important for banks and supervisors to increasingly focus on reducing leverage to shore up bank resiliency in case RWAs do not accurately reflect risks. The new minimum leverage ratio regulation will play an important role in this process. However, the phase-in period, ending in 2019, is relatively long, and some progress ahead of schedule would be prudent.

32. **In this context, the mission emphasized the importance of ensuring that banks' internal risk models adequately capture relevant risks.** The two large Swiss banks are heavy users of internal risk models and have low ratios of RWA to total assets. Thus, the potential cost of deficiencies in internal models is high, and it must be ensured that banks do not change (or are not perceived as changing) models only to reduce capital charges without actual underlying adjustments in risks. Measures to enhance transparency to facilitate peer comparison of risk-weights might help reassure investors, while continued strict supervisory scrutiny of models backed up by action as necessary is also important. In this respect, the recent introduction by FINMA of bank-specific multipliers for new Swiss residential mortgages for banks using internal risk models is appropriate.

33. **The mission underscored the crucial role of cross-border cooperation for making the bank resolution framework effective.** TBTF legislation and the new ordinance on bank resolution are important steps forward but, as the Swiss G-SIFIs have large cross-border operations, more progress regarding international cooperation is necessary to make the framework workable for the large banks. Specifically, cooperation agreements with the supervisors in the U.S. and the U.K., where both banks have sizable operations, should usefully be put in place soon, and should be consistent with the Key Attributes of Effective Resolution Regimes for Financial Institutions of the Financial Stability Board. Rebates on capital requirement surcharges for measures taken by the banks to improve their global resolvability, envisaged under the TBTF legislation, and should be granted only when global resolvability is fully established.

The authorities' view

34. **The authorities agreed with the need to reduce leverage and closely supervise banks' internal risk models.** It was emphasized that the new Basel III leverage ratio will force banks to take action to reduce their balance sheet and act as an important back-stop for the potential drawbacks of internal risk models. They also noted that the more binding capital requirements for Swiss G-SIBs relative to the Basel III minima motivate banks to change asset composition. In addition, the authorities stressed that they closely monitor internal risk models and apply strict criteria for their

validation, and are actively engaged in the Basel Committee's efforts in this area. The SNB recommends that banks report RWA calculations using the standardized approach to enhance transparency. FINMA is currently evaluating options to enhance the transparency of the large banks' RWA calculations.

35. **The necessity of international cooperation for effective banking resolution is fully recognized by the Swiss authorities.** Work on a cooperation agreement with the U.S. and the U.K. on cross-border resolution is under way. More broadly, while they are fully engaged in ongoing initiatives, the authorities thought that progress at the international level was limited, and foresaw quite a lengthy process before a workable framework for cross-border resolution can be reached.

I. Fiscal Policies

36. **The "debt brake" rule continues to ensure prudent fiscal policy, though given the weak macroeconomic conjuncture there is no need to over perform it.** In 2013 and 2014, fiscal policy is expected to be somewhat tighter than what is needed to fulfill the fiscal rule. Staff observed that with the economy expected to operate below potential, inflation too low, conventional monetary policy instruments exhausted, and fiscal sustainability not in doubt, taking advantage of the room allowed by the fiscal rule would be warranted. This may also facilitate an early exit from the exchange rate floor. On the pension front, staff welcomed the Pension 2020 proposals as a first step toward a full-fledged pension reform proposal.

The authorities' view

37. **The authorities do not see a more expansionary fiscal stance as necessary.** Though they also expect a negative output gap in 2013–14, they remained skeptical about the usefulness of fiscal policy for cyclical stabilization beyond the operation of automatic stabilizers. They were also concerned that further government spending would mainly stimulate the nontraded sector, which is relatively healthy.

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38. **The exchange rate floor should remain in place for now.** Inflation is still well below comfortable levels, growth is modest, and the risk of resumption in "safe haven" capital flows remains significant. Once an economic recovery gets firmly under way, the SNB should exit the floor and return to a free float if inflation threatens to move above comfortable levels. Until then, sustained capital outflows should be used to cautiously unwind past currency interventions, while in case of renewed appreciation pressures the SNB should defend the floor, including by introducing negative interest rates on excess bank reserves as a temporary measure to discourage capital inflows.

39. **If balance sheet risks continue to increase, more rapid growth in the SNB capital would be advisable.** While the exchange rate floor policy played a key role in ensuring economic stability, it has expanded the SNB balance sheet to an unprecedented size. This exposes the bank's net

revenue to large fluctuations, and sizable losses could occur if an appreciation of the Swiss franc was to take place before foreign exchange interventions were unwound. The SNB capital is large and growing, reflecting in part reduced profit distribution to the Confederation and Cantons. However, there is a risk that losses may exceed buffers. In such circumstances, it will be important that the independence of the central bank not be put into question. Stepping up profit retention and capital building would be helpful in this regard.

40. **In current conditions, the fiscal stance could be more supportive of the expansionary monetary stance within the boundaries of the fiscal rule.** The "debt brake" rule has underpinned remarkable fiscal discipline and public debt is on a firm downward path. With conservative budget planning and execution, the federal government has consistently outperformed the rule. In 2013 and 2014, fiscal policy is set to be somewhat tighter than what is needed to fulfill the fiscal rule. With the economy expected to operate below potential, inflation too low, conventional monetary policy instruments exhausted, and fiscal sustainability not in doubt, a more supportive fiscal stance would be warranted.

41. **The recent measures to stem risks in the mortgage market are welcome.** With interest rates falling to new lows, mortgage debt has reached a historic peak, and housing prices are growing well above nominal GDP growth. While so far average prices are not accelerating as in typical bubble episodes, there is evidence of bubble-like dynamics in "hot spots." In 2012, the authorities appropriately moved to cool off the market with several measures. The recent activation by the Federal Council of the newly-created counter-cyclical capital buffer (CCB) is an important additional step.

42. **However, more interventions may become necessary as the low interest rate environment is likely to persist**. Forceful monitoring and enforcement of the new minimum regulatory standards and a proactive use of supervisory discretion to ensure prudent lending behavior will be important. If risks continue to build, the authorities should also stand ready to implement new measures or tighten existing ones, including raising the CCB to the maximum of 2.5 percent or introducing minimum affordability ratios.

43. **This would be an appropriate time to phase out existing tax incentives that artificially inflate the mortgage market.** Because mortgage interest payments are tax-deductible, many households carry much more mortgage debt than warranted. Phasing out the preferential tax treatment of mortgage interest, while at the same time phasing out taxation of imputed rents, would remove a distortion from the economy and reduce risks in the mortgage market.

44. **Switzerland's rapid progress in upgrading financial sector regulation and supervision both in banking and insurance is welcome.** The authorities have moved swiftly to address the gaps exposed by the financial crisis by implementing upgraded regulations for both banks and insurers in line with international initiatives. For example, in banking the Basel III capital and liquidity regulations for banks have been adopted, while in insurance the Swiss Solvency Test (SST) is in place. This reform momentum should continue.

45. **While in large banks capital ratios are improving substantially, more rapid progress on the leverage front would be prudent**. A sizable part of the adjustment to new capital regulations has taken place through a reduction in risk-weighted assets. In these circumstances, it is critical to ensure that banks' internal models to calculate risk-weighted assets capture relevant risks, and that banks do not resort (or are not perceived as resorting) to model changes only to reduce capital charges. Measures to enhance transparency to facilitate peer comparison of risk-weights could reassure investors, while continued strict supervisory scrutiny of models backed up by action as necessary is also important. In addition, as the new minimum leverage ratio regulation comes into force, banks will have to more forcefully reduce their balance sheet or build up capital. This regulation will ensure that overly optimistic risk-weighting does not undermine bank resiliency though the phase-in period is long.

46. **Despite significant steps forward in improving the bank resolution framework, further progress is needed along the cross-border dimension**. The introduction of the Bank Insolvency Ordinance and the banks' and authorities' work on resolution and recovery plans are welcome. Still, while the international work on global bank resolution continues, the goal of having a system in which large complex global banks can be resolved without threatening financial stability is yet to be reached both in Switzerland and abroad. Full-fledged cooperation agreements with key foreign supervisors establishing clear principles and procedures to ensure global resolvability is challenging, but we encourage the authorities to forcefully move forward in this direction. In the meantime, the high capital buffers envisaged under the Swiss TBTF legislation provide a key safeguard for taxpayers and financial stability and should remain fully in place.

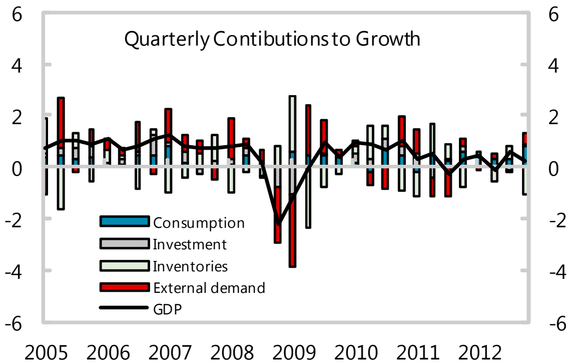
47. **It is recommended that the next Article IV consultation be held on the usual 12-month cycle**.

Text Table 1. Authorities' Response to Past IMF Policy Recommendations

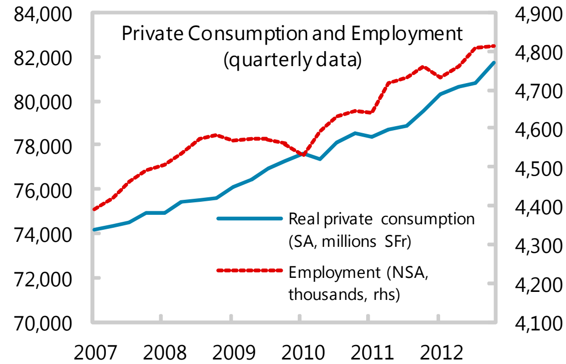
IMF 2012 Article IV Recommendations	Authorities' Response
Monetary and Exchange Rate Policy Return to a freely floating currency once economic conditions normalize.	The floor remains in place as macroeconomic conditions have not yet normalized.
Financial Sector Policy I Strengthen the preventive power of the macroprudential measures by adding minimum affordability ratios to the toolkit.	Minimum affordability ratios are not included in the macroprudential toolkit.
Financial Sector Policy II Reduce or eliminate the preferential tax treatment of mortgage debt service.	A tax reform has not been implemented yet.
Financial Sector Policy III Implement Basel III and TBTF capital requirements more rapidly	TBTF banks have stepped up plans to increase quantity and quality of capital or reduced their RWAs, though progress on leverage is slower.
Financial Sector Policy IV Make progress on bank resolvability	The new Bank Insolvency Ordinance was approved in 2012, and bank resolution and recovery plans are being formulated.
Financial Sector Policy V Broaden in-house supervisory capacity and reduce reliance on external auditors.	FINMA is committed to using external auditors, but wants to reduce the scope for the general regulatory audit.
Financial Sector Policy VI Strengthen the oversight of intra-group connections needs in the insurance sector	Group supervision is a priority for FINMA and steps have been taken to strengthen quality (including data quality, and refinement of analytical tools).
Fiscal Policy I Stand ready to support aggregate demand to the extent feasible under fiscal rules if the outlook deteriorates.	The authorities do not view countercyclical fiscal policy as useful under current circumstances.
Fiscal Policy II Make rapid progress in tackling the cost of an aging population and apply automatic adjustors ("fiscal rules") for pensions	The Pension 2020 proposals are in this direction.

Figure 1. Switzerland: Recent Economic Developments

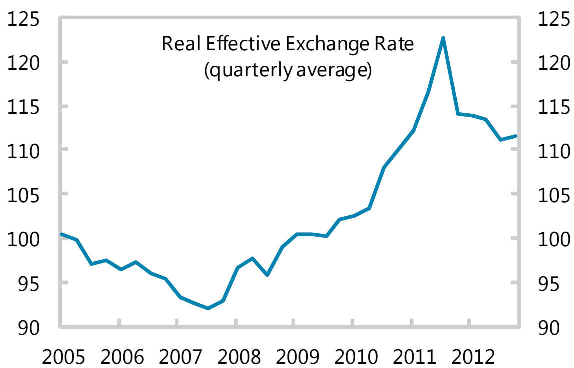
The rebound in economic activity is losing steam, driven by flagging external demand.



Employment and consumption have recovered.

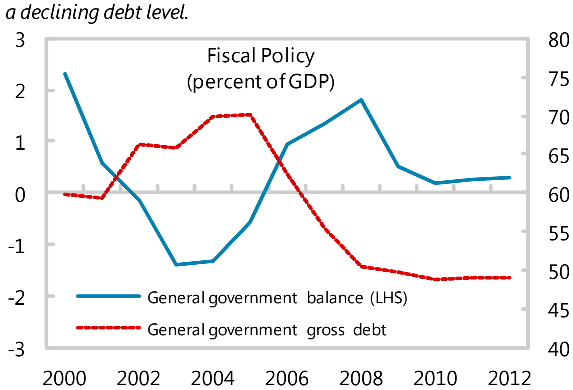


With the recent REER depreciation of the Swiss franc, ...

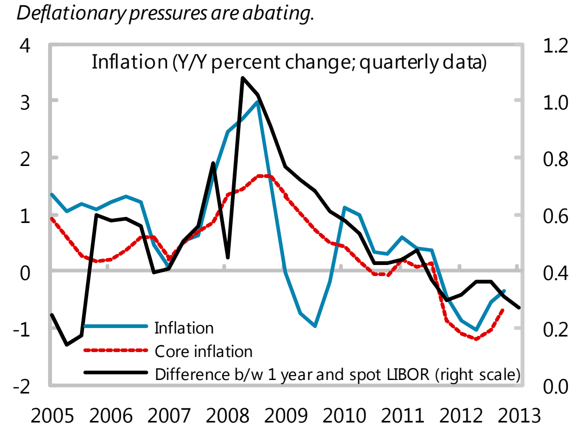


...exports stabilized but the PMI is weak.

The fiscal position remains strong with persistent surpluses and a declining debt level.

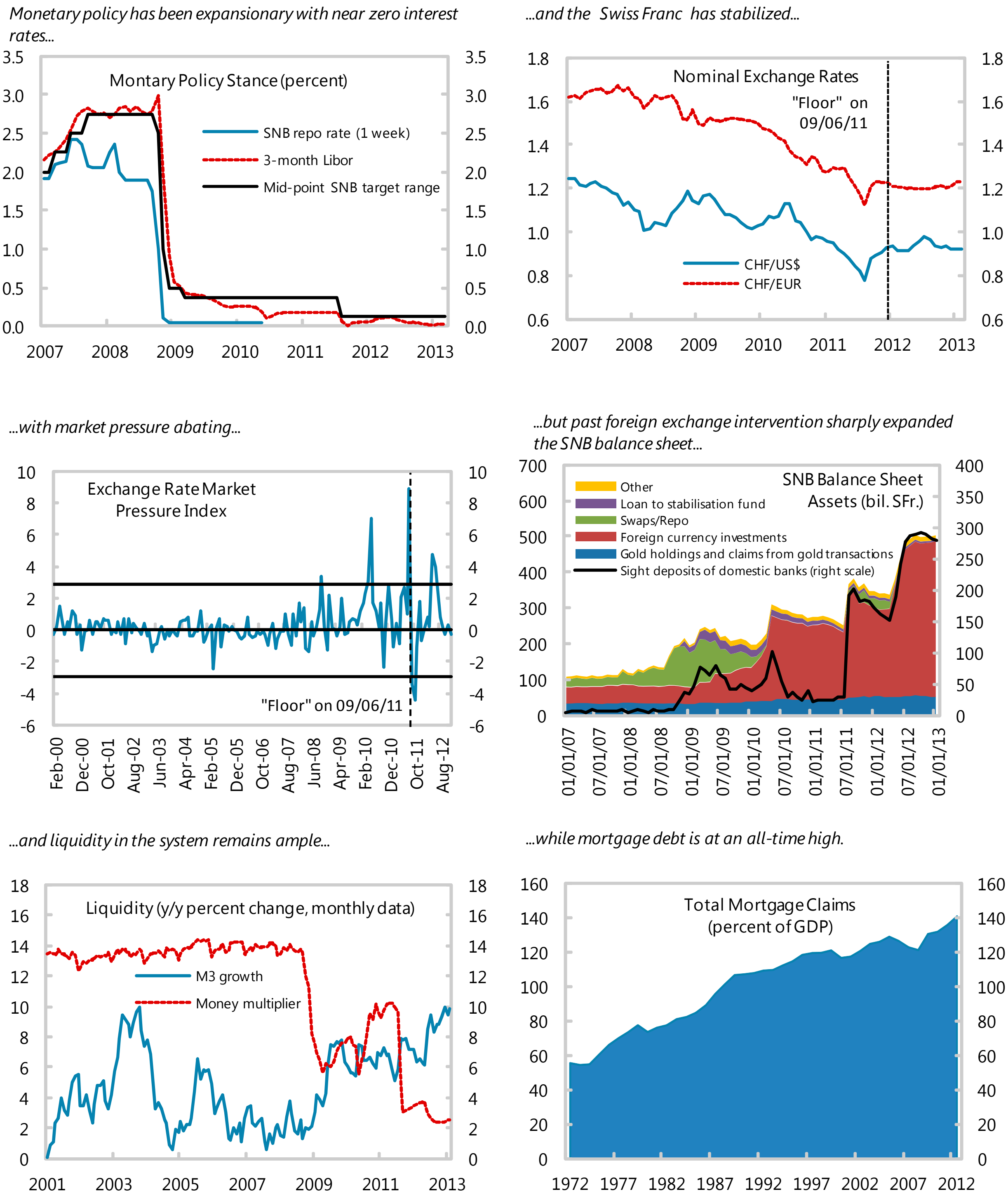


Deflationary pressures are abating.



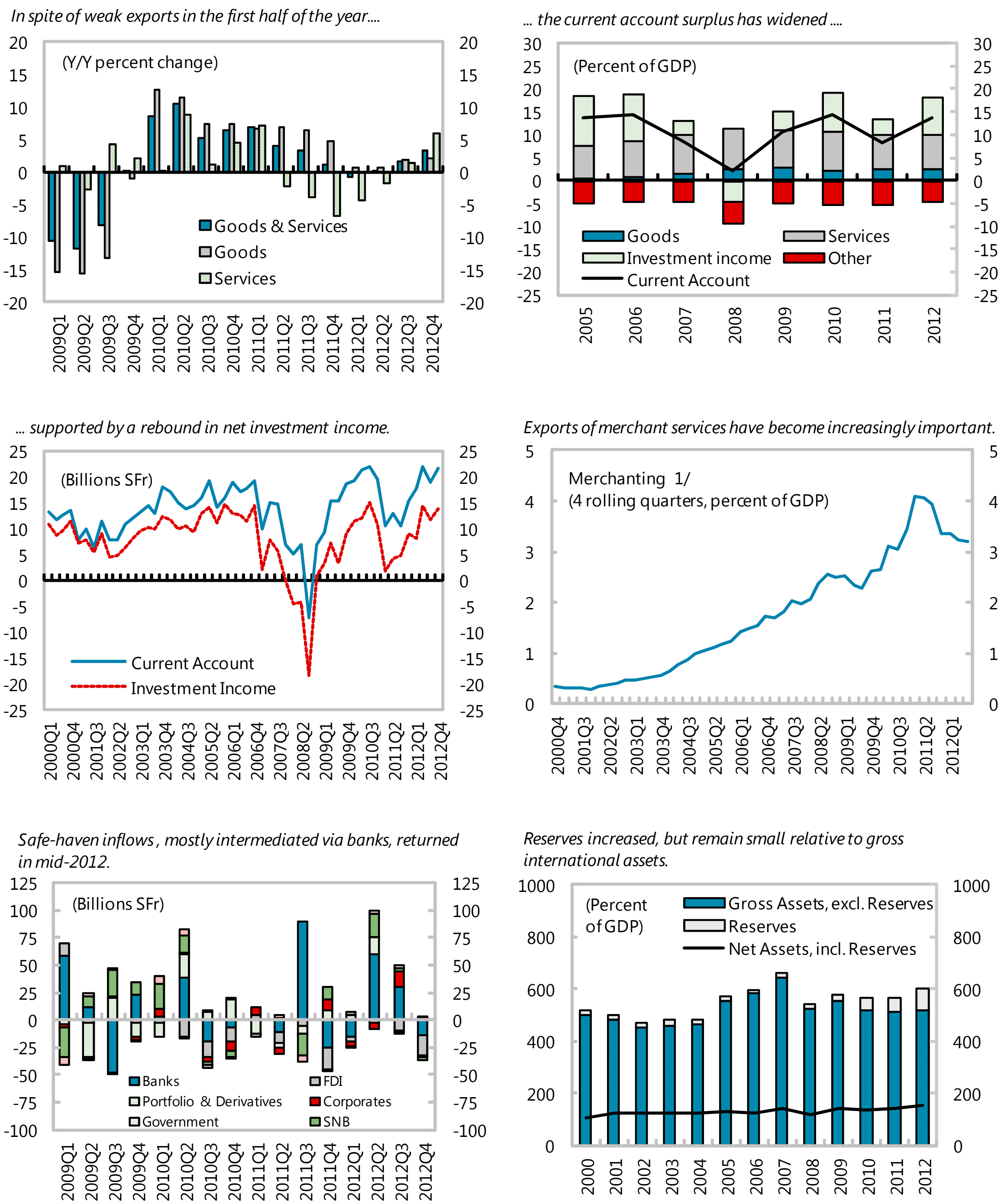
Sources: Haver Analytics; Swiss National Bank; and IMF estimates.

Figure 2. Switzerland: Monetary and Exchange Rate Policies



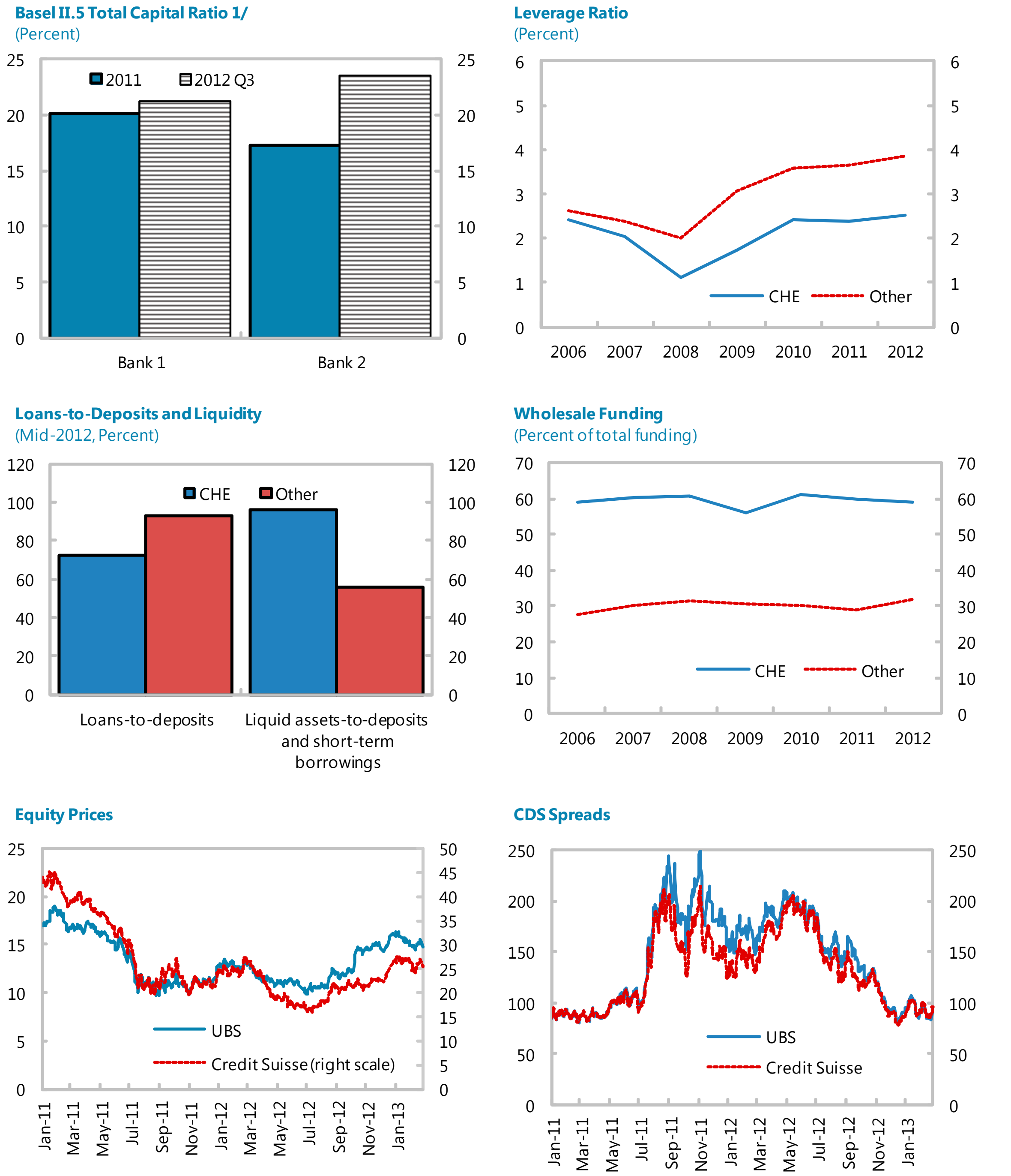
Sources: CFTC; Haver Analytics; Information Notice System; OECD; Swiss National Bank; and IMF staff estimates.

Figure 3. Switzerland: External Accounts



Sources: Haver Analytics; IMF Balance of Payments Statistics; and IMF staff calculations.
1/ Merchanting is defined as the purchase of goods by a resident (of the compiling economy) from a nonresident combined with the subsequent resale of the same goods to another nonresident without the goods being present in the compiling economy (BPM6, Section 10.41).

Figure 4. Switzerland: Systemic Indicators



Sources: Bankscope; Bloomberg; and IMF staff calculations.
1/ 2012 third quarter reports.

Table 1. Switzerland: Selected Economic Indicators, 2010–14

	2010	2011	2012	2013	2014
				Projections	
Real GDP (percent change)	3.0	1.9	1.0	1.3	1.8
Total domestic demand	2.3	1.9	1.5	1.4	1.9
Final domestic demand	2.2	2.0	1.8	1.8	1.8
Private consumption	1.6	1.2	2.5	2.0	1.9
Public consumption	0.7	2.0	0.7	1.3	1.1
Gross fixed investment	4.8	4.0	0.3	1.5	2.0
Inventory accumulation 1/	0.1	-0.1	-0.2	-0.3	0.0
Foreign balance 1/	0.9	0.2	-0.4	0.0	0.1
Nominal GDP (billions of Swiss francs)	574.3	586.8	593.0	602.4	617.4
Savings and investment (percent of GDP)					
Gross national saving	34.2	29.1	34.1	34.5	34.6
Gross domestic investment	20.0	20.8	20.6	21.4	21.8
Current account balance	14.3	8.4	13.6	13.1	12.8
Prices and incomes (percent change)					
GDP deflator	0.5	0.2	0.1	0.3	0.7
Consumer price index	0.7	0.2	-0.7	-0.2	0.2
Nominal wage growth	0.8	1.0	1.0	0.5	0.6
Unit labor costs (total economy)	-3.0	1.8	1.8	-0.8	-1.2
Employment and slack measures					
Unemployment rate (in percent)	3.5	2.8	2.9	3.2	3.2
Output gap (in percent of potential)	0.3	0.6	-0.1	-0.5	-0.6
Capacity utilization	81.1	84.3	81.5	…	…
Potential output growth	1.7	1.7	1.7	1.7	1.7
General government finances (percent of GDP)					
Revenue	32.8	33.4	33.0	33.2	33.2
Expenditure	32.7	33.1	32.7	33.0	32.7
Balance	0.2	0.3	0.3	0.2	0.5
Cyclically adjusted ordinary balance	0.1	0.1	0.3	0.4	0.6
Gross debt 2/	48.8	49.0	49.1	48.3	46.7
Monetary and credit (percent change, averages)					
Broad money (M3)	7.0	7.2	9.9	…	…
Domestic credit, non-financial	2.1	3.7	5.3	…	…
Three-month SFr LIBOR	0.2	0.1	0.0	…	…
Yield on government bonds (7-year)	1.3	1.2	0.4	…	…
Exchange rates (levels)					
Swiss francs per U.S. dollar (annual average)	1.0	0.9	0.9	…	…
Swiss francs per euro (annual average)	1.4	1.2	1.2	…	…
Nominal effective rate (avg., 2005=100)	113.1	127.3	127.1	…	…
Real effective rate (avg., 2005=100) 3/	107.5	118.0	114.3	…	…

Sources: Haver Analytics; IMF's Information Notice System; Swiss National Bank; and IMF Staff estima

1/ Contribution to growth.

2/ Reflects new GFSM 2001 methodology, which values debt at market prices.

3/ Based on relative consumer prices.

Table 2. Switzerland: Balance of Payments, 2010–14

	2010	2011	2012	2013	2014
				Projections	
	(In billions of Swiss francs, unless otherwise indicated)				
Current account	**82**	**49**	**80**	**79**	**79**
Goods balance	13	14	17	14	15
Exports	204	209	213	215	222
Imports	-191	-194	-196	-201	-207
Service balance	49	46	43	39	40
Net investment income	49	20	48	56	56
Net compensation of employees	-17	-19	-18	-19	-19
Net private transfers	-13	-12	-9	-12	-12
Net official transfers	0	0	0	0	0
Private capital and financial account	**-110**	**-44**	**-105**	**-79**	**-79**
Capital transfers	-5	-1	-1	-10	-11
Financial account	-105	-43	-104	-69	-68
Net foreign direct investment	-49	-32	-38	-8	-8
Net portfolio investment	31	-17	14	-2	-3
Net other investment 1/	50	48	95	-59	-57
o/w net banking sector	14	49	58	-59	-57
Official reserve flows	-138	-43	-175	0	0
Net errors and omissions	**28**	**-5**	**25**	**0**	**0**
	(In percent of GDP, unless otherwise indicated)				
Current account	**14.3**	**8.4**	**13.6**	**13.1**	**12.8**
Goods balance	2.3	2.5	2.9	2.4	2.4
Exports	35.5	35.6	35.9	35.7	36.0
Imports	-33.2	-33.1	-33.1	-33.3	-33.5
Service balance	8.5	7.8	7.2	6.5	6.4
Net investment income	8.6	3.3	8.1	9.2	9.0
Net compensation of employees	-2.9	-3.2	-3.0	-3.1	-3.1
Net private transfers	-2.2	-2.0	-1.5	-2.0	-2.0
Net official transfers	0.0	0.0	0.0	0.0	0.0
Private capital and financial account	**-19.2**	**-7.5**	**-17.7**	**-13.1**	**-12.8**
Capital transfers	-0.8	-0.2	-0.2	-1.7	-1.8
Financial account	-18.4	-7.3	-17.5	-11.5	-11.1
Net foreign direct investment	-8.5	-5.4	-6.4	-1.3	-1.3
Net portfolio investment	5.4	-2.9	2.3	-0.4	-0.5
Net other investment 1/	8.7	8.2	16.1	-9.7	-9.3
o/w net banking sector	2.4	8.4	9.8	-9.7	-9.3
Official reserve flows	-24.0	-7.3	-29.4	0.0	0.0
Net errors and omissions	**4.9**	**-0.9**	**4.2**	**0.0**	**0.0**
Memorandum items:					
Net IIP (in percent of GDP)	137.2	140.8	151.3	172.0	178.9
Official reserves 2/					
(billions of U.S. dollars, end-period)	271	332	531	…	…
Reserve cover (months of imports of GNFS) 2/	14.2	17.0	26.5	…	…

Sources: Haver Analytics; Swiss National Bank; and IMF staff estimates.
1/ Includes derivatives and structured products.
2/ Official reserves for 2011 are as of end-December 2011.

Table 3. Switzerland: General Government Finances, 2010–14

	2009	2010	2011	2012	2013	2014
				Projections		
	(In billions of Swiss francs, unless otherwise specified)					
Federal Government 1/						
Revenues	60.6	61.2	63.5	61.8	63.5	65.0
Expenditures	58.1	59.4	63.0	62.0	63.8	64.7
Balance	2.5	1.8	0.5	-0.3	-0.3	0.3
Cantons						
Revenues	75.1	76.3	78.2	78.9	81.1	83.8
Expenditures	72.8	74.7	79.5	79.4	80.5	82.5
Balance	2.3	1.6	-1.4	-0.5	0.7	1.3
Municipalities						
Revenues	41.7	42.0	43.0	43.3	44.3	45.3
Expenditures	42.5	42.7	43.5	44.2	44.9	45.6
Balance	-0.8	-0.7	-0.4	-0.8	-0.6	-0.3
Social security 2/						
Revenues	52.7	53.1	57.9	59.2	60.1	61.1
Expenditures	53.9	54.9	55.0	55.9	58.6	59.5
Balance	-1.2	-1.7	2.9	3.2	1.5	1.6
General Government						
Revenues	186.7	188.6	195.8	195.6	199.9	205.0
Expenditures	183.9	187.6	194.2	193.9	198.6	202.1
Balance	2.8	1.0	1.6	1.7	1.2	2.9
Gross debt						
Federal Government	143.0377726	145.1	148.8	152.0	153.0	152.0
Cantons	70.9	70.5	72.9	72.7	71.5	69.8
Communes	61.3	64.0	65.5	65.6	65.7	65.7
General government	276.0	280.1	287.5	291.1	290.9	288.2
	(In percent of GDP)					
General Government						
Revenue	33.7	32.8	33.4	33.0	33.2	33.2
Expenditure	33.2	32.7	33.1	32.7	33.0	32.7
Balance	0.5	0.2	0.3	0.3	0.2	0.5
Federal government	0.4	0.3	0.1	0.0	-0.1	0.0
Cantons	0.4	0.3	-0.2	-0.1	0.1	0.2
Municipalities	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Social security	-0.2	-0.3	0.5	0.5	0.2	0.3
Memorandum items:						
Structural balance	0.9	0.1	0.1	0.3	0.4	0.6
Gross debt						
Federal government	25.8	25.3	25.4	25.6	25.4	24.6
Cantons	12.8	12.3	12.4	12.3	11.9	11.3
Communes	11.1	11.1	11.2	11.1	10.9	10.6
General government	49.8	48.8	49.0	49.1	48.3	46.7

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

1/ Includes the balance of the Confederation and extrabudgetary funds (Fund for Large Railway Projects, ETH Domain, Infrastructure Fund, Swiss Alcohol Board, Swiss Federal Institute for Vocational Education and Training, Swiss National Museum, Pro Helvetia, Swiss National Science Foundation, Switzerland Tourism).

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

Table 4. Switzerland: SNB Balance Sheet

(Millions of Swiss francs; unless otherwise indicated)

	2008	2009	2010	2011	2012
Assets					
Gold	30,862	38,186	43,988	49,380	50,772
Foreign currency reserves	47,429	94,680	203,810	257,504	432,209
IMF, international, and monetary assistance loans	571	5,905	4,971	4,923	4,528
Swiss franc repos	50,321	36,208	...	18,468	...
U.S. dollar repos	11,671	...	...	371	...
Swaps against Swiss francs	50,421	2,672	...	...	...
Money market, Swiss franc securities, other	23,049	29,614	17,187	15,434	11,925
Total assets	214,323	207,264	269,955	346,079	499,434
Liabilities					
Currency in circulation (banknotes)	49,161	49,966	51,498	55,729	61,801
Sight deposits	51,173	57,102	48,917	216,701	369,732
Repo, SNB bills and time liabilities	53,839	27,473	121,052	15,086	…
Foreign currency and other liabilities	1,700	6,820	5,897	5,441	9,825
Provisions and equity capital	58,449	65,902	42,591	53,123	58,075
Total liabilities	214,323	207,264	269,955	346,079	499,434
Memorandum items:					
Nominal GDP (billions of Swiss francs)	568	554	574	587	593
Balance sheet, percent of GDP	37.7	37.4	47.0	59.0	84.2
Banknotes, percent of total liabilities	22.9	24.1	19.1	16.1	12.4
Refinancing operations, percent of total assets	52.5	18.8	…	5.4	…
Provisions and equity capital, percent of total assets	10.8	14.3	6.4	4.5	2.4
Monetary base 1/	49,562	99,087	90,208	137,728	284,303

Sources: Swiss National Bank; and IMF staff estimates.
1/ Currency in circulation and sight deposits of domestic banks.

Table 5 Switzerland: Financial Soundness Indicators

	2007	2008	2009	2010	2011	2012
Banks						
Capital adequacy						
Regulatory capital as percent of risk-weighted assets	12.1 *	14.76 *	17.9	17.3	16.7	16.9
Regulatory Tier I capital to risk-weighted assets	11.6 *	12.29 *	15.2	15.6	15.52	15.7
Non-performing loans net of provisions as percent of tier I capital	-0.9	1.3	0.3	5.4	4.8	...
Asset quality and exposure						
Non-performing loans as percent of gross loans	0.3	0.5	0.5	0.9	0.8	...
Sectoral distribution of bank credit to the private sector (percent) 2/						
Households	71.5	65.4	67.1	68.3	68.8	65.6
Agriculture and food industry	1.4	1.3	1.3	1.3	1.2	0.9
Industry and manufacturing	3.4	3.0	3.0	3.0	2.9	3.0
Construction	1.8	1.6	1.6	1.6	1.7	1.7
Retail	3.3	3.1	3.1	3.2	3.1	3.3
Hotels and restaurants / Hospitality sector	1.2	1.1	1.1	1.1	1.1	1.0
Transport and communications	1.1	0.9	0.9	0.9	0.7	0.8
Other financial activities	5.2	7.0	0.4	0.4	0.5	0.7
Insurance sector	0.4	0.8	0.5	0.5	0.4	0.7
Commercial real estate, IT, R&T	5.9	11.0	11.4	11.4	12.4	13.9
Public administration (excluding social security)	1.1	1.8	0.0	0.0	0.0	0.0
Education	0.2	0.2	0.1	0.1	0.1	0.2
Healthcare and social services	1.1	1.0	1.0	1.1	1.1	1.3
Other collective and personal services	1.7	1.2	1.0	1.0	1.0	1.0
Other 3/	0.6	0.6	7.6	7.6	5.0	5.7
Earnings and profitability 3/						
Gross profits as percent of average assets (ROAA)	0.7	0.3	0.5	0.7	0.7	0.7
Gross profits as percent of average equity capital (ROAE)	15.4	5.4	14.5	21.0	19.6	11.3
Net interest income as percent of gross income	28.1	36.3	30.4	27.9	30.9	30.9
Non-interest expenses as percent of gross income	70.4	85.5	80.1	73.3	72.1	69.8
Liquidity 3/						
Liquid assets as percent of total assets	27.1	29.2	27.7	23.5	26.8	27.6
Liquid assets as percent of short-term liabilities	63.9	67.1	64.3	53.8	58.7	60.3
Net long position in foreign exchange as a percentage of tier I ca|	13.7 *	-16.1 *	-23.2	-41.1	-60.6	-61.3

Source: Swiss National Bank.

1/ Until 2004, general loan-loss provisions were made; as of 2005, specific loan-loss provisions have been carried out.

2/ As percent of total credit to the private sector.

3/ Mining and extraction, production and distribution of electricity, natural gas and water, financial intermediation, social security, ex-territorial bodies and organizations, other.

* These ratios were calculated from numbers that originate from the Basle I as well as from the Basle II approach. Therefore, interpretation must be done carefully since they can vary within +/- 10%.

** Data for 2012 are as of June 2012.

Table 6. Switzerland: General Government Operations, 2006–10

	2006	2007	2008	2009	2010
	In billions of Swiss francs, unless otherwise specified				
Revenue	179.7	187.7	187.8	186.7	188.6
Taxes	108.3	114.6	122.6	121.1	122.4
Taxes on income, profits, and capital gains	64.7	69.4	74.9	74.3	73.8
Taxes on goods and services	31.5	32.4	29.6	28.8	30.5
Taxes on int. trade and transactions	1.0	1.0	6.2	6.2	6.2
Other taxes	11.0	11.8	11.8	11.8	11.9
Social contributions	33.5	35.1	37.1	38.1	38.3
Grants	0.1	-1.4	0.1	0.2	0.2
Other revenue	37.8	39.3	28.0	27.3	27.8
Expenditure	174.9	180.5	177.6	183.9	187.6
Expense	173.7	179.1	177.3	182.5	186.1
Compensation of employees	49.9	52.2	42.7	43.3	44.5
Purchases/use of goods and services	23.8	24.4	21.8	22.5	22.0
Interest	7.2	6.9	6.5	5.7	5.5
Social benefits	58.6	59.6	60.5	64.3	66.4
Expense n.e.c.	34.2	36.0	45.8	46.7	47.7
Net acquisition of nonfinancial assets	1.3	1.4	0.2	1.4	1.5
Net operating balance	6.0	8.6	10.5	4.2	2.5
Net lending /borrowing	4.8	7.2	10.3	2.8	1.0
Net acquisition of financial assets	6.1	26.0	20.9	8.0	2.8
Net incurrence of liabilities	1.0	18.4	10.2	5.1	1.8
	(In percent of GDP)				
Revenue	35.4	34.7	33.1	33.7	32.8
Taxes	21.3	21.2	21.6	21.8	21.3
Taxes on income, profits, and capital gains	12.7	12.8	13.2	13.4	12.8
Taxes on goods and services	6.2	6.0	5.2	5.2	5.3
Taxes on int. trade and transactions	0.2	0.2	1.1	1.1	1.1
Other taxes	2.2	2.2	2.1	2.1	2.1
Social contributions	6.6	6.5	6.5	6.9	6.7
Other revenue	7.4	7.3	4.9	4.9	4.8
Expenditure	34.4	33.4	31.3	33.2	32.7
Expense	34.2	33.1	31.2	32.9	32.4
Compensation of employees	9.8	9.7	7.5	7.8	7.8
Purchases/use of goods and services	4.7	4.5	3.8	4.1	3.8
Interest	1.4	1.3	1.1	1.0	1.0
Social benefits	11.5	11.0	10.7	11.6	11.6
Other expense	6.7	6.7	8.1	8.4	8.3
Net acquisition of nonfinancial assets	0.2	0.3	0.0	0.3	0.3
Gross operating balance	1.2	1.6	1.8	0.8	0.4
Net lending /borrowing	0.9	1.3	1.8	0.5	0.2
Net acquisition of financial assets	1.2	4.8	3.7	1.4	0.5
Net incurrence of liabilities	0.2	3.4	1.8	0.9	0.3

Source: Federal Ministry of Finance.

SWITZERLAND

April 23, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(Data as of March 29, 2013)

Membership Status:

Joined 5/29/92; Switzerland has accepted the obligations of Article VIII, Sections 2, 3, and 4; and maintains a 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 September 25, 2012, 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.

General Resources Account

	SDR Million	Percent Quota
Quota	3,458.50	100.00
Fund holdings of currency	2,748.39	79.47
Reserve position in Fund	710.14	20.53
New arrangement to borrow	1,344.50	

SDR Department

	SDR Millions	Percent Allocation
Net cumulative allocations	3,288.04	100.00
Holdings	3,048.30	92.71

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund[1]:

			Forthcoming		
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.23	0.30	0.30	0.30	0.30
Total	0.23	0.30	0.30	0.30	0.30

[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.

Exchange Rate Arrangement:

The de jure exchange rate arrangement is free floating; the exchange rate of the Swiss franc is determined by market forces in the foreign exchange market. However, the Swiss National Bank (SNB) reserves the right to intervene in the foreign exchange market. All settlements are made at free market rates. On September 6, 2011, the SNB set a minimum exchange rate of CHF 1.20 per euro to stop the appreciation of the franc and committed to defending the limit by buying foreign currency in unlimited quantities. The SNB publishes information regarding its foreign exchange transactions in its annual accountability report. In 2012, to combat the massive overvaluation of the Swiss franc and to enforce the minimum exchange rate, the SNB purchased foreign currency to a value of approximately CHF 188 billion. The purchases were made with a wide range of counterparties in Switzerland and abroad. Effective September 6, 2011, the de facto exchange rate arrangement is other managed.

Technical Assistance: None

Resident Representatives: None

Other: FSAP Update, November 2006

STATISTICAL ISSUES

1. **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 (FSO) 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:

2. **In 2012, the SNB launched the completely revised survey on external trade in services to close important gaps and fulfill the requirements of the bilateral agreement on statistics between Switzerland and the EU in the area of BoP statistics.** The new survey provides a country breakdown and covers all important components of the external trade in services. The number of enterprises required to provide data to the SNB was significantly increased (from around 500 to around 2000), contributing to a vastly better coverage, notably on the import side of the external trade. The SNB will start publishing data based on the new survey in 2014. The projects with a view to closing gaps in the direct investment BoP statistics also made good progress in 2012. The first survey based on the revised concept is scheduled for 2014. Starting in the first quarter of 2013, CPIS data will be available on a quarterly instead of a yearly basis. Work has started on revising the surveys on payment transactions, notably taking into account recent developments in the area of cashless payment transactions. A gap analysis will be undertaken in 2013 in the context of a possible adherence of Switzerland to the SDDS plus standard.

3. **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.

4. Switzerland has continued to provide data on Financial Soundness Indicators (FSIs) and participated in the 2009 Coordinated Direct Investment Survey. The data and metadata for both these initiatives have been posted on the IMF website.

5. The FSO initiated various projects in 2012 to improve core business statistics. The new database was used in the June 2012 revision of National accounts figures. FSO also developed a new methodology to produce first estimates of GDP by canton, with first results disseminated in December 2012. In 2013, the FSO will prepare the introduction of the 2008 version of the System of National Accounts (SNA 2008). First results will be disseminated in September 2014 in line with the timetable set by the European Union. It will also produce new business census results for the first time since 2008 and will be based on administrative data for the first time.

Table of Common Indicators Required for Surveillance
(As of April 9, 2013)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Apr 13	Apr 13	D and M	M and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar 13	Apr 13	M	M	M
Reserve/Base Money	Mar 13	Apr 13	M	M	M
Broad Money	Mar 13	Apr 13	M	M	M
Central Bank Balance Sheet	Mar 13	Apr 13	M	M	M
Consolidated Balance Sheet of the Banking System	Mar 13	Apr 13	M	M	M
Interest Rates[2]	Mar 13	Apr 13	D and M	M and M	D and M
Consumer Price Index	Mar 13	Apr 13	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4]	2011	Apr 13	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government[3]	Feb 13	Mar 13	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4/12	Mar 13	Q	Q	Q
External Current Account Balance	Q4/12	Apr 13	Q	Q	Q
Net International Investment Position	Q4/12	Apr 13	Q	Q	Q
Exports and Imports of Goods and Services	Feb 13	Apr 13	M	M	M
GDP/GNP	Q4/12	Mar 13	Q	Q	Q
Gross External Debt	2012	Mar 13	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)

Public Information Notice (PIN) No. 13/56
FOR IMMEDIATE RELEASE
May 21, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation with Switzerland

On May 8, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

With the exchange rate floor in place for over a year, the Swiss economy has been relatively stable, though GDP growth decelerated, and inflation remains negative. While overall export growth is weak, the external position remains comfortable reflecting high investment income and strong export performance in some sectors. The economy is expected to regain momentum only gradually, in line with a baseline scenario of subdued global recovery.

Managing the new exchange rate regime has required large foreign exchange interventions. When safe haven pressures resumed in mid-2012, the Swiss National Bank (SNB) intervened heavily to defend the floor. As a result, its foreign exchange reserves increased by over 65 percent and its balance sheet reached 85 percent of GDP, the largest among major central banks. The expansion in reserves was largely matched by an increase in bank sight deposits (excess reserves) at the SNB.

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Historically, low interest rate and abundant liquidity are fueling the housing and mortgage market. Mortgage lending has grown at about 5 percent per year since 2009, and mortgage debt recently reached over 140 percent of GDP, high in both international and historical comparisons. The authorities have taken several measures to contain risks, including prudential measures to tighten lending standards and conditions, and the recent activation of the countercyclical capital buffer.-

The financial sector is restructuring to adapt to the more stringent regulatory environment, while the banking resolution framework has been reformed. Basel III capital requirements were introduced at the beginning of this year and the Swiss "Too-Big-To-Fail" legislation requires large banks to hold additional buffers. Despite high regulatory capital ratios, the leverage of the two big banks is high compared with other global banks and improved only modestly, as the new minimum regulatory leverage ratio is gradually being phased in and does not bind yet. A new Banking Insolvency Ordinance went into effect in 2012 while cross-border resolution remains to be addressed.

The fiscal position is healthy and government debt low, with a broadly neutral stance projected for 2013. The "debt brake" rule has underpinned remarkable fiscal discipline and public debt is on a firm downward path. However, there are long-term challenges from population aging, which a recently published "Pensions 2020" reform program aims to address.

Executive Board Assessment

Executive Directors noted that, notwithstanding Switzerland's stable economy and strong policy frameworks, risks stemming mostly from the euro area crisis and vulnerabilities in the domestic financial sector clouded the near-term outlook. Accordingly, they encouraged the authorities to remain vigilant and persist in their steadfast pursuit of pragmatic and forward-looking policies.

Directors agreed that the exchange rate floor has helped safeguard macroeconomic stability in turbulent times. They shared the view that it should remain in place for now, given low inflation, subdued growth, and the threat of further capital inflows. While recognizing the need for caution in implementing unconventional measures, many Directors encouraged the authorities to consider introducing negative interest rates on excess bank reserves if appreciation pressures reappear. The authorities should also take full advantage of any capital outflows to unwind past currency interventions. More broadly, Directors noted that the exchange rate floor policy has expanded the SNB's balance sheet to an unprecedented size and encouraged the authorities to step up profit retention and capital building.

Directors commended the authorities for their prudent fiscal policy underpinned by the debt-brake rule. Many Directors agreed with the authorities that, barring a deterioration of the outlook for domestic demand, only automatic stabilizers should provide countercyclical fiscal support. Some Directors, however, considered that the current expansionary monetary stance could be usefully complemented by some fiscal support within the boundaries of the debt-brake rule.

Directors welcomed the steps taken to contain risks in the mortgage and real estate markets, including the activation of counter-cyclical capital buffers. They nonetheless counseled the authorities to lay the groundwork for additional policy actions, including tax reforms and affordability limits, if vulnerabilities in these markets do not abate.

Directors commended the authorities for the timely implementation of Basel III regulations, the "too-big-to-fail" legislation, and the reform of the bank resolution framework. Noting that systemically important banks with global reach have improved their capital ratios in part through a reduction in risk-weighted assets, they urged the authorities to monitor the capitalization and restructuring plans of these banks to ensure that leverage is quickly brought in line with peers. Directors also welcomed the significant steps in improving the bank resolution framework, but stressed the importance of addressing the cross-border dimension to fully ensure global resolvability.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2013 Article IV Consultation with Switzerland is also available.

Switzerland: Selected Economic Indicators

Population (end-2009): 7.7 million
Per capita GDP ($): 65,592
Quota (current; millions SDRs / % of total): 3,458.5 / 100%
Literacy rate: 99 (both male and female)
Main products and exports: watches, machinery, chemical and pharmaceutical products
Key export markets: Germany (19%), Euro area (48%), United States (10%)

	2012	2013	2014 Proj.
Output			
Real GDP growth (%)	1.0	1.3	1.8
Employment and unemployment			
Unemployment (%)	2.9	3.2	3.2
Prices			
Inflation	-0.7	-0.2	0.2
General government finances			
Revenue (% GDP)	33.3	33.7	34.0
Expenditure (% GDP)	33.0	33.5	33.6
Fiscal balance (% GDP)	0.3	0.2	0.5
Public debt (% GDP)	49.1	48.3	46.7
Monetary and credit			
Broad money (% change)	9.9	...	...
Credit to the private sector (% change)	5.3	...	...
3-month Treasury bill interest rate (%)	0.0	...	...
Balance of payments			
Current account (% GDP)	13.6	13.1	12.8
FDI (% GDP)	-6.4	-1.3	-1.3
Reserves (months imports)	24.0	...	...
External debt (% GDP)	...	...	...
Exchange rates 4/			
REER (% change)	-3.1	...	...

Sources: IMF's Information Notice System; Swiss National Bank; Swiss Institute for Business Cycle Research; and IMF staff projections.

Statement by Rene Weber, Executive Director for Switzerland and Marcel Peter, Senior Advisor to Executive Director
May 3, 2013

On behalf of our Swiss authorities, we thank staff for once more submitting a thorough and candid staff report, which provides an objective analysis of the macroeconomic situation and helpful conclusions for policies. Staff's policy recommendations add considerable value to the domestic policy discussions in Switzerland. We share staff's opinion on the challenges going forward in most aspects.

Outlook

The staff's latest scenario for the Swiss economy broadly corresponds to our own and those of most other forecasters. The recession in the euro area has weighed on GDP growth and GDP per capita actually stagnated in 2012. Traditional export industries, such as machinery and metals, have particularly suffered from weak external demand and the strong Swiss franc. In contrast, more domestically-oriented parts of the economy have continued to do well, supported by a robust labor market and continued immigration. Due to steady immigration during the past six years, our estimate of potential output is higher than the staff's and, consequently, our estimate for the output gap for 2011-13 is more negative.

The growth outlook remains highly uncertain and dependent on external developments. Like the staff, our main scenario projects a gradual improvement of the Swiss economy in 2013 and a return to growth above potential in 2014. The key underlying assumption is that the euro area manages to progressively overcome its debt crisis, which seems not yet assured. While confidence indicators in Europe have deteriorated again and remain substantially below their long-term average, domestic survey data has also been weak recently. The Swiss economy will thus likely remain fragile in the short term.

Rising imbalances in the Swiss housing market currently constitute the main domestic risk. Against the backdrop of historically low interest rates, mortgage debt relative to GDP reached a high level, while price-to-rent and price-to-income ratios are rising and affordability ratios are falling. As a result, sudden changes in either economic fundamentals or market sentiment would have a significant impact on the housing market.

Monetary and exchange rate policy

In line with staff, the Swiss National Bank (SNB) continues to view the exchange rate floor as essential for containing the risk of deflationary pressures taking hold in Switzerland. An exit is currently premature, as the Swiss franc continues to be overvalued, and both inflation and the output gap are negative. Moreover, the risk of renewed safe haven pressures on the exchange rate continues to be elevated. The floor will remain in place as long as warranted by the outlook for inflation and growth. This being said, the SNB agrees with staff's assessment that a return to a freely floating exchange rate regime is desirable, once economic conditions normalize.

We would like to stress that the SNB will enforce the floor with utmost determination. It continues to stand ready to undertake unlimited interventions to this end if necessary. In addition, the SNB does not exclude taking further measures, if the economic outlook and the risk of deflation so require. In this regard, the SNB duly notes the staff's recommendation to consider imposing negative interest rates on banks' reserves held with the SNB in case of renewed pressures on the exchange rate.

The report pays special attention to the fact that defending the floor has resulted in an important accumulation of foreign exchange reserves by the SNB. As the SNB has noted repeatedly, it is prepared if necessary to buy foreign currency in unlimited quantities in order to enforce the minimum exchange rate. The defense of the floor takes precedence over other considerations in connection with the accumulation and investment of its foreign exchange reserves. The SNB does currently not plan to unwind or limit its foreign exchange reserve accumulation.

Fiscal policy

Although the recession in the euro area affected Switzerland in 2012, the finances of the federal government remain healthy. The same is true for public finances overall: the general government balance should remain positive in 2012, with an expected small surplus of 0.3 percent of GDP.

At the federal level, the well-established debt brake rule has made a significant contribution to maintaining a sound fiscal position, both before and after the crisis. That said, the federal government's leeway as regards fiscal policy will be limited in the future, as evidenced by declining budget surpluses and structural balances since 2008. At the same time, the possibility of persistently weak growth in the euro area and the repercussions of potential tax reforms are looming large for the fiscal position. Against this backdrop, the federal government is keen to preserve some degree of flexibility in fiscal policy. For this reason, it put together the *2014 Consolidation and Task Evaluation Package*, which provides for savings of about CHF 700 million per year compared to the current financial plan 2014-2016.

As regards discretionary fiscal policy to support aggregate demand, the position of the authorities remains unchanged. In the current macroeconomic environment, fiscal policy is hardly the right instrument to support the export oriented sectors of the economy. Moreover, domestic demand—the major beneficiary of potential fiscal stimulus measures—has been one of the main pillars of growth throughout the crisis. Domestic-oriented sectors like construction as well as public- and private-sector services have been supported by continued immigration and low interest rates and are expected to expand further in the coming years. A more expansionary fiscal policy would mainly further boost the domestic sectors (in particular construction), thereby exacerbating already existing risks.

We firmly believe that automatic stabilizers should play the main countercyclical role. These stabilizers were strengthened through the introduction of the debt brake framework. If the economic outlook were to deteriorate to such an extent that domestic demand was negatively affected, discretionary fiscal stimulus would, of course, be considered, with the debt brake rule allowing for the necessary flexibility.

Financial sector policies

The authorities concur with the staff's assessment of the main challenges to ensure financial stability, namely the need to (i) reduce leverage of the large banks and to closely supervise their internal risk models; (ii) advance the issue of effective resolvability of banks, particularly at the international level; and (iii) continue to address the risks in the domestic housing and mortgage markets given historically low interest rates and abundant liquidity.

As staff notes, measures have been taken to address these challenges. To increase the banks' resilience and stem potential risks for financial stability from imbalances in the Swiss housing and mortgage markets, the authorities chose to activate the sectoral countercyclical capital buffer for bank residential mortgage loans in February 2013. They continue to monitor housing and mortgage market developments closely and are committed to take further measures aimed at reducing risks to financial stability, if needed.

The recent implementation of the comprehensive SIFI/TBTF-framework, together with the fully implemented Basel III framework, will address risks by requiring the large banks to further strengthen their capitalization. Higher capital requirements will also motivate banks to further adjust their asset composition, thereby reducing risks in their balance sheets. Internal risk models are being closely monitored by FINMA, with validation subject to strict criteria. While the large Swiss banks are rather well capitalized relative to peers in terms of regulatory capital, the authorities agree with the staff's conclusion that leverage ratios still need to be improved.

The authorities share the staff's view that international cooperation is essential for effective bank resolution. Switzerland is fully engaged in ongoing regulatory efforts, both at the national level and in the corresponding work of the FSB. After comprehensive recent revisions, Switzerland has an advanced resolution framework in line with the FSB's *Key Attributes.* Work on cooperation agreements with the U.S. and the U.K. on cross-border resolution is under way. The authorities stress the necessity to advance the issue of G-SIB resolution at the international level and, in particular, to extend the mandates of resolution authorities with a view to improving cross-border coordination of measures.

Finally, Switzerland will undertake an FSAP in the second half of this year, the outcome of which will be submitted for the Board's consideration together with the staff report for the 2014 Article IV consultation.