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May 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SWITZERLAND

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 2014 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on April 30, 2014, following discussions that ended on March 24, 2014, 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 15, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its April 30, 2014 consideration of the staff report that concluded the Article IV consultation with Switzerland.
- A **Statement by the Executive Director** for Switzerland.

The following documents have been or will be separately released.

Financial System Stability Assessment

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

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SWITZERLAND

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

April 15, 2014

KEY ISSUES

The Swiss economy has regained momentum, but inflation remains close to zero. There has been no new foreign exchange intervention, but past safe haven inflows have not yet reversed despite improved market confidence toward the euro area and tapering in the United States. Notwithstanding policy action, risks in the mortgage market remain elevated. The large systemic banks have continued to strengthen capital and restructure their business models, but the financial sector reform agenda is still incomplete.

Exchange Rate Policy: The exchange rate floor remains a necessary element of the monetary policy framework, as inflation is still close to the bottom of the range compatible with the Swiss National Bank's (SNB) definition of price stability and renewed exchange rate appreciation, as might arise from a new bout of safe haven inflows, would quickly bring back deflationary pressures.

The Mortgage Market: With monetary conditions remaining accommodative and housing prices growing faster than incomes, measures to curb mortgage demand especially from the more vulnerable households need to be strengthened.

The Banking Sector: Cooperation agreements with key foreign supervisors need to be reached to make the large banks resolvable. More resources are required for prudential bank supervision, and closer oversight and guidance to auditors performing supervisory audits are necessary. Deposit insurance should be brought in line with emerging international best practices.

Approved By
P. Gerson and M. Goodman

Discussions took place in Bern and Zurich on March 14–24. The staff team comprised Ms. Detragiache (head), Ms. Xiao, Mr. Abbas (all EUR), and Mr. Lundback (MCM). Mr. Enoch (MCM) joined the mission for the last three days to present the results of the FSAP. Messrs. Heller and Duperrut (OED) participated in the discussions.

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CONTEXT

1. **The Swiss economy has regained momentum, but monetary and exchange rate conditions have not normalized.** While growth is healthy and the pass-through from past appreciation has mostly run its course, inflation is still only barely positive. Though no foreign exchange market intervention has taken place since 2012, the currency has remained close to the floor imposed by the Swiss National Bank (SNB) in 2011 to contain deflationary pressures, notwithstanding improved market confidence toward the euro area and tapering in the United States. With the policy rate at zero and abundant excess liquidity, imbalances in the mortgage market continue to build though at a somewhat slower pace than last year.

2. **In the medium term, aspects of the current economic model will be questioned**. The role of Switzerland as a center for global wealth management is being challenged by the progressive erosion of bank secrecy. Under international pressure, the authorities need to reform parts of the current system of corporate taxation, which *de facto* give favorable tax treatment to income from foreign operations and have helped attract many multinational corporations. A recent popular vote approved curbs on immigration, putting in jeopardy the free movement of labor agreement and, possibly, broader cooperation agreements with the European Union (EU), by far Switzerland's largest trading partner. Lower immigration would also accelerate population aging.

3. **The large banking sector is resilient and considerable regulatory reforms have been implemented after the crisis**. The size and reach of the financial sector extend well beyond the Swiss borders, as the country is host to some of the largest and most globalized banks and insurance companies in the world. The 2014 FSAP Update finds that the position of the financial sector has improved markedly since the Global Financial Crisis, and recommends additional measures to strengthen the regulatory framework, prudential oversight, and the safety net to further improve the soundness and resilience of the system.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

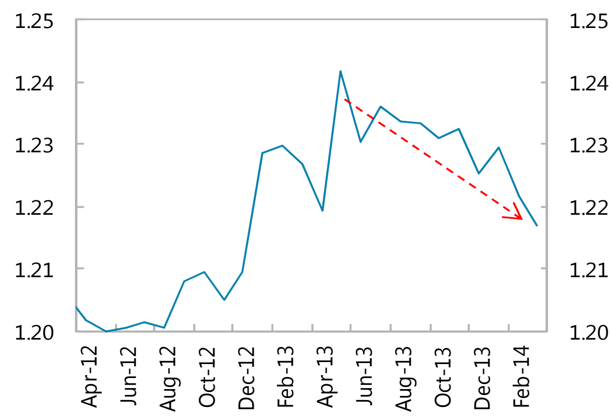
A. GDP Growth Has Accelerated and Inflation Is Still Close to Zero

4. **Driven by domestic demand, the economy grew briskly in 2013.** Output expanded at 2.0 percent in 2013, up from 1 percent in 2012 (Figure 1). Private consumption continued to grow steadily as wage increases and negative inflation raised real disposable income; construction saw a strong rebound, while an improving external environment turned the external sector's contribution to growth to positive. The lagged effects of the 2012 slowdown pushed the unemployment rate up to 3.2 percent, still low in international comparison. Labor supply was boosted by net immigration of some 1 percent of the population, the highest since 2008.

5. **After two years of deflation, price growth is hovering around zero.** As the pass-through from past exchange rate appreciation has abated, negative inflation from foreign goods and services has been offset by positive inflation from domestic goods and services. Inflation expectations (measured by consensus forecasts) have come down somewhat but are still well anchored in positive territory.

6. **A significant and sustained net reversal of safe haven capital inflows has not occurred, including because of intermittent waves of global financial turbulence.** The reduction in euro area tail risks, accompanied by nascent signs of a Europe-wide recovery, allowed the franc to trade in a 1.22–1.25 band relative to the euro during July 2012–April 2013, somewhat above the 1.2 floor. However, since then, global volatility surges around the announced and actual normalization of U.S. monetary policy, as well as recent EM turmoil and market jitters related to the political crisis in Ukraine, saw the franc appreciate against the euro and trade closer to the floor once again (Annex 1 and Figure 2). The SNB's balance sheet has remained elevated at around 80 percent of GDP, well above levels observed for other advanced economies with the exception of Hong Kong and Singapore.

CHF/EUR appreciation since April 2013

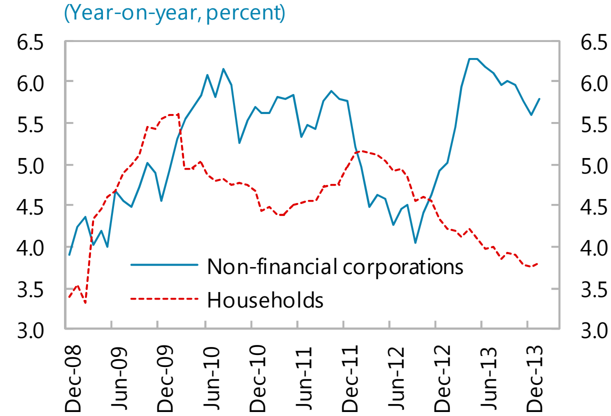


B. Pressures in the Housing Market Are Proving Difficult to Contain

7. **The banking sector is exhibiting divergent trends.** The balance sheets of the two large banks continue to shrink as the banks strive to meet new regulatory requirements. Meanwhile, domestically-oriented banks have grown substantially, fuelled by increases in real estate lending, and becoming increasingly exposed to a possible sharp price correction and higher interest rates. Overall, the banking sector appears well capitalized and profitable.

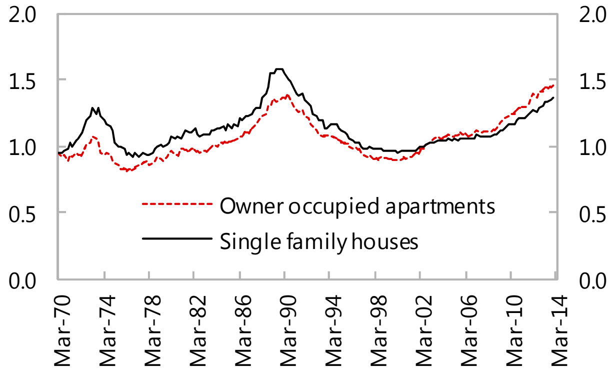
8. **Expansionary monetary policy and ample liquidity have pushed mortgage debt and real estate prices to historic heights.** Residential real estate prices have been growing faster than income, with prices of owner occupied apartments rising at 6 percent per year on average since 2008. In real terms, these prices are now above the peak reached in the early 1990s, which was followed by a sharp correction. In some areas such as Geneva, price growth has been substantially higher. In parallel, growth of about 5 percent per year since 2009 has

Mortages by Type of Borrower
(Year-on-year, percent)



Source: Swiss National Bank.

Real Residential Real Estate Prices
(Index)



Sources: Wuest&Partner, and IMF's International Financial Statistics.

brought mortgage debt above 140 percent of GDP at end-2013, a historic peak. The average mortgage maturity is relatively short (about 5 years), and mortgages are often rolled over at maturity. This exposes highly indebted households to potential interest rate hikes in the future. High mortgage growth in the buy-to-let sector is a source of concern. On the other hand, non-mortgage lending to corporations has remained subdued and there are no indications of stretched corporate balance sheets, with default rates and credit ratings stable.

C. The Fiscal Deficit and Debt Are Low

9. **Anchored in strong fiscal rules and discipline, the fiscal position is healthy.** The general government's budget was close to balance in 2013, as small deficits at the federal and cantonal level were offset by a surplus in the social security funds. The federal balance deteriorated somewhat relative to 2012 because of higher subsidies, grants, and social benefits, but deficits in cantons and municipalities were reduced from the previous year. Previous reforms to unemployment insurance and a VAT increase earmarked for invalidity pensions allowed the social security funds to remain in surplus.

10. **In 2014, the fiscal stance is expected to be broadly neutral.** The general government should record a small deficit largely reflecting the lack of a profit distribution from the SNB and one-off restructuring contributions towards cantonal pension funds. Going forward, cantonal finances will be under some pressure because of the continuing need to raise the funding ratio of cantonal pension funds and changes in the hospital financing scheme. In addition, the corporate tax reform which is envisaged to enter into force as of 2018 is likely to lead to a revenue loss for cantons (see below). To prepare for the potential revenue loss as part of the burden sharing agreement with cantons, the federal government plans to restrain spending and implement a consolidation package. All in all, the structural balance should remain close to zero beyond 2014, with deficits at the cantons and communes level offset by surpluses in the federal government and social security funds. The debt-to-GDP ratio should fall to 44 percent of GDP in 2017 (on a GFSM-basis). From a medium-term perspective, spending pressures will arise from population aging and peak at about 4 percent of GDP by 2055.

OUTLOOK AND RISKS

11. **The recovery is expected to be robust.** Looking ahead, in the baseline scenario recovering external demand and a stable exchange rate will provide impetus to exports and investment, while private consumption growth will moderate somewhat in line with modest real wage developments.

The economy should grow at 2.1 percent in 2014 and 2.2 percent in 2015, while inflation should continue to rise gradually and the output gap will progressively close.

12. **Risks to the outlook stem from spillovers from international developments, the domestic mortgage market, and the large financial sector.**[1] A strengthening in the global recovery would bring positive spillovers through higher external demand. Negative spillovers might arise if exit from UMP is disorderly and causes surges in global market volatility, leading to renewed safe haven inflows and forcing the SNB to intervene again. Protracted turmoil in emerging markets might also rekindle the attractiveness of Switzerland as a safe haven, as might a re-emergence of financial stress in the euro area because of significant policy slippages or adverse economic shocks.

13. **A domestic source of risk is the mortgage market, where imbalances have been building since 2007 though at a slower pace than in typical housing bubble episodes (Figure 3).** Domestically-oriented banks are especially vulnerable given their high and relatively undiversified exposure to domestic mortgages. Stress tests performed in the FSAP Update found these banks to be well capitalized under all scenarios, including a housing crash scenario. However, the analysis was limited by the lack of access to supervisory data on individual banks, and hence could not assess individual bank vulnerabilities.

14. **In addition, despite progress the two large banks remain highly leveraged and interconnected**. FSAP stress tests indicate that these banks comfortably exceed capital requirements under all adverse scenarios when applying the phase-in of Basel III rules, but under the most severe macroeconomic scenario capital ratios could fall below the 7 percent threshold under a fully implemented Basel III capital definition.[2] As the banks are globally interconnected, they are a potential source of outward spillovers and vulnerable to inward spillover from instability in global financial markets. The FSAP analysis finds that these risks are contained at the moment, and outward adverse spillovers measured as the contribution of the Swiss large banks to the vulnerability of other global banks have decreased significantly in recent months.[3] Possible financial-sovereign spillovers are also a concern given the large size of the financial sector relative to the economy. In addition, some cantonal banks have explicit funding guarantees and are large relative to the cantonal economy. Stress tests conducted as part of the FSAP indicate that existing capital buffers in the banking sector should be sufficient to absorb losses from severe macroeconomic shocks, suggesting limited fiscal contingent liabilities. The FSAP analysis also finds that contagion from banks to sovereign seems contained at present, owing to stronger capital buffers, fading concerns about tail events in the euro zone, and lower risk aversion among investors. Concerning the risk of illiquidity,

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[1] See Risk Assessment Matrix below for details.

[2] Under a fully implemented Basel III capital definition, breach of the CET1 ratio of 7 percent threshold would trigger the conversion of contingent capital and recovery measures according to the Swiss framework.

[3] See also Selected Issues Paper for the 2013 Article IV Consultation: “Outward Spillovers from Swiss G-SIBs in Times of Financial Stress.”

almost all banks satisfy the LCR requirement thanks in part to the unusually high amount of deposits at the central bank.

The authorities' view

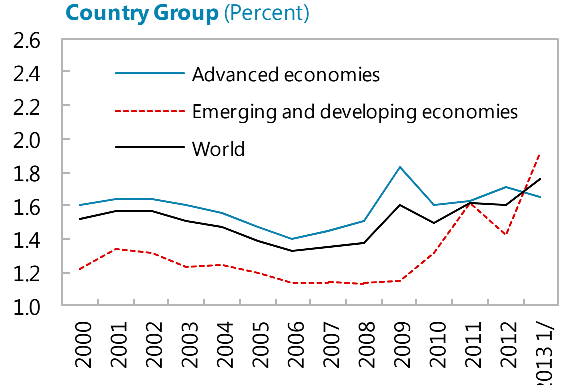
15. **The authorities were more sanguine than staff on the baseline scenario, but agreed about the main risk factors.** Growth forecasts were aligned for 2014, but a stronger acceleration was envisaged in 2015. The authorities agreed with staff that growth prospects are subject to considerable uncertainty in light of economic developments in the euro area and emerging markets against the backdrop of exit from the unconventional monetary policies in major advanced economies.

POLICY DISCUSSIONS

A. External Sector Assessment

16. **Overall, the Swiss current account surplus remained large in 2013, but its exact size will not be known until later in the year (Figure 4).** Preliminary estimates of the current account balance for 2013 indicate a surplus of 13 percent of GDP, a 3.4 percent of GDP increase over 2012. The goods balance improved slightly, consistent with a resumption of the post-crisis increase in Switzerland's share of the emerging and developing economies' market, but this was offset by softer services exports (including merchanting receipts). The bulk of the current account increase is accounted for by net investment income, which is highly volatile and subject to large downward revisions (averaging 5 percent of GDP over the last two years). To reflect likely downward revisions, staff estimates a current account surplus of around 9½ percent of GDP for 2013.

Share of Switzerland in Total Goods Imports by Country Group (Percent)



Source: Direction of Trade Statistics.
1/ Q1–3 2013.

17. **While the assessment remains difficult due to accounting and other anomalies, staff views the current account as broadly in line with fundamentals.** Model-based analysis suggests that a large the current account surplus is consistent with Switzerland's high per capita income, financial center structure, and demographics. In addition, no distortions that would result in excessive saving or insufficient investment are evident, and, as noted in past consultations, the surplus is somewhat larger than the norm, but this divergence can be accounted for by various anomalies that tend to overstate the surplus. For instance, merchant services, i.e. services by international commodity trading companies based in Switzerland, have become important over the last decade, contributing around 3 percent of GDP to the current account surplus in recent years, 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, which form a large component of Swiss current account receipts, should be attributed to foreign shareholders, rather than counted as domestic income. Third, cross-border shopping, i.e. direct purchases by households while abroad or mail/courier deliveries from abroad, may not be fully reflected in imports. Finally, Switzerland, like other low-tax financial centers that host large multinational corporations and their affiliates, is susceptible to attempts by those firms to minimize their taxes by booking profits in the country, which would result in inflated net exports. However, quantifying this factor is not possible for now.

18. **The franc still remains moderately over-valued, reflecting the legacy of the large real appreciation during 2008–11.** The assessment reflects the estimated 7 percent overvaluation according to the External Balance Assessment methodology, broadly unchanged since last year. The REER-ULC has appreciated by 2.6 percent since end-2012, and cumulatively by 1.3 percent since end-September 2011 (i.e. the first "post-floor" month). With negative inflation differentials vis-à-vis trading partners disappearing and the nominal exchange rate appreciating in line with the appreciation of the euro over the last 12 months, the over-valuation is no longer correcting itself. On the other hand, this moderate overvaluation is no longer having a significant negative effect on overall external sector performance. If safe haven flows reverse as the crisis effects wane, the real exchange rate overvaluation should reverse.

The authorities' view

19. **The authorities broadly concurred with staff's assessment of the current account and real exchange rate.** They agreed that movements in the Swiss current account—due to its special structure and the various anomalies affecting it—were difficult to interpret and compare with global norms, and did not necessarily mirror developments in the real exchange rate. They also noted that the current account statistics will change substantially with the adoption (in June 2014) of the BPM6 methodology. The authorities' stress that depending on the estimation methodology, the franc's overvaluation, which they saw as still burdensome for the export-oriented manufacturing sector, may be larger than the 7 percent IMF assessment.

B. Monetary and Exchange Rate Policies

20. **Domestic macroeconomic conditions do not call for a monetary tightening yet and the risk of resumption in safe haven inflows remains considerable.** Although both core and headline inflation turned slightly positive at end-2013, the recent inflation decline in other advanced economies and especially the euro area is exerting downward pressures on prices. Also, with the internationally open labor market stronger domestic activity may not result in wage and price pressures (though future curbs on immigration may change this in the medium term), while the money multiplier remains very low. On the other hand, sizable risks remain of renewed pressures on the franc through a return of safe haven inflows triggered by external events (see Para. 12). Without the floor, such pressures would translate in a sharp nominal appreciation and a return of deflation.

21. **The floor should remain in place for now to guard against deflationary risks.** Going forward, an appropriate strategy should balance the need to keep inflation expectations well anchored against the risk of an excessive tightening of monetary conditions through renewed exchange rate appreciation. Achieving this objective will require careful calibration of unconventional policy instruments.

- *In an upside scenario,* where the global recovery takes hold and confidence in the euro area solidifies, past safe haven flows would revert, potentially pushing the franc well above the floor. In this scenario, concerns about deflation would be muted, so there would be no need for a large depreciation to drive up inflation. A large depreciation would also be questionable from a multilateral perspective given the balanced external position. Thus, in this scenario the SNB should gradually reduce its holdings of foreign exchange reserves, supporting this strategy with clear communication to avoid market disruption and adverse outward spillovers. As the recovery takes hold, if inflation threatens to move above comfortable levels, then the SNB should raise the policy rate. This may become necessary even if the balance sheet has not returned to its pre-crisis level.

- *In a more challenging global environment,* where exit from UMP by major advanced countries is disorderly, downside risks to the euro area materialize, or the EM sell-off develops into a full-blown crisis, safe haven inflows may return and a premature exit from the floor would likely result in a sharp appreciation and renewed deflationary pressures. In this scenario, the SNB should keep the floor in place and consider imposing a negative interest rate on bank excess reserves to discourage inflows.

- Negative interest rates might also help address deflationary pressures that may arise from *adverse domestic shocks*. The impact of negative rates on the economy would need to be carefully monitored, and macroprudential measures may have to be reinforced to prevent an exacerbation of mortgage market imbalances.

22. **Risks from the large SNB balance sheet need to be mitigated.** These risks were recently underscored as the SNB announced a sizable valuation loss on gold holdings, triggering the first suspension of profit transfers to the Confederation and cantons in recent memory. While the build-up of risk provision was stepped up in 2011, it has not kept pace with the increase in the balance sheet. Going forward, provisioning should receive priority over transfers to the distribution reserve.[4]

The authorities' view

23. **The SNB continues to see the exchange rate floor as essential to guarding against the risk of deflation.** It noted the recent multiple downward revisions to its inflation forecast,

[4] For more details, see 2013 Selected Issues Paper, "SNB's Balance Sheet Risks and Policy Implications."

attributing them to weaker euro area inflation and a very protracted pass-through from past appreciation. The SNB agreed that negative interest rates on banks' excess reserves were a possible tool to be deployed if safe have inflows resumed on a significant scale. With regard to the management of its balance sheet and associated risks, the SNB viewed current profit distribution arrangements as sufficiently protective of its capital.

C. The Housing Market

24. **Despite measures taken by the authorities, risks in the mortgage and housing markets continue to build.** To address growing imbalances, in 2012 and 2013, the authorities tightened lending requirements and increased banks' capital buffers for mortgage risk (Box 1), but the effects appear to have been small so far. House price increases have slowed down somewhat, as prices for owner occupied apartments, which had grown by about 6 percent per year on average since 2008, grew at 4.3 percent (year-on-year) in the second half of 2013. However, limited cooling off effects can be seen in mortgage lending growth (where mortgages to buy-to-let companies accelerated in 2012–13), or in quantitative lending standards.

Box 1. Measures to Address Developments in the Housing and Mortgage Market

New minimum requirements drawn up by the Swiss Bankers Association recognized by FINMA, effective mid-2012:

- 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;
- Mortgages must be paid down to two thirds of the collateral value within a maximum of 20 years.

FINMA tightened rules for risk-weighting new and renewed mortgages for banks applying an internal ratings-based approach, effective 2013.

Federal Council measures, effective 2013:

- Mortgages that do not comply with the new minimum standards are allowed, but subject to a risk weight of 100 percent;
- 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.

On SNB's proposal, the Federal Council activated the Counter Cyclical Capital Buffer (CCB). The CCB applies to risk-weighted positions associated to residential property mortgages in Switzerland. The CCB was activated to a level of 1 percent CET1 capital by end–September, 2013 and raised to 2 percent in January 2014 (to be fulfilled by end-June, 2014).

25. **The measures taken to address developments in the mortgage and housing markets are welcome, but have been only partially successful.** The recent CCB hike was appropriate, but its impact may not be sufficient given the comfortable capitalization relative to prudential

requirements across the domestically oriented banking sector. In addition, existing self-regulation measures have not been very effective as quantitative lending surveys show no or limited reduction in debt-to-income ratios (DTIs) or loan-to-value ratios (LTVs). Although the household sector has substantial financial assets, data on the distribution of wealth and mortgage debt across households are not available, so there are concerns that vulnerable households may be taking on excessive debt.

26. **Direct regulatory measures targeting affordability and loan-to-value ratios should also be considered.** In an environment where interest rates are likely to remain very low, stronger measures targeting mortgage demand are needed. If agreement with the industry to tighten self-regulation (in particular, faster amortization and larger cash down payments) cannot be achieved, then it would be important to introduce direct regulation on maximum DTIs and LTVs.[5] Parallel measures to curb mortgages to income-producing real estate companies should also be put in place, while supervisors should continue to use Pillar II measures pro-actively to address concentration and interest rates risks. In addition, tax deductibility of mortgage interest should be reduced or eliminated.

The authorities' view

27. **The authorities agree that imbalances have continued to expand though they consider that the measures taken have had some calming effects.** Continued concerns were behind the recent decision to increase the CCB. The authorities also agreed on the need for further action targeting the demand side and informed that measures on affordability were under discussion, including with respect to the buy-to-let segment. If appropriately tight measures could not be implemented through self-regulation, direct regulation was an option. On the other hand, political support for a reform of the taxation of mortgage interest was seen as elusive.

D. Financial Stability and Oversight

The TBTF Banks and Cross-Border Resolution

28. **The two large banks continue to strengthen capitalization and restructure their business models, but the leverage ratios remains low compared to other large global banks.** In 2012, both banks stepped up their plans to build high-quality capital, and initiated strategic restructuring away from parts of investment banking to less capital-intensive wealth management. The banks are also revising their corporate structure, operations, and business lines to adapt to the still evolving new regulatory landscape, especially in the U.S. and the U.K., where they have important activities, and divergent approaches by regulators are an obstacle to the global management of liquidity and capital. At end-2013 both banks were already above the 10 percent

[5] There is cross-country evidence that DTI limits can be effective in curbing real estate and mortgage booms (e.g.; Lim, Columba, Costa, Kongsamut, Otani, Saiyid, Wezel, and Wu, 2011, "Macroprudential Policy: What Instruments and How to Use Them? Lessons from Country Experiences," IMF Working Paper No. 11-238; Igan and Kang, 2011. "Do Loan-to-Value and Debt-to-Income Limits Work? Evidence from Korea", IMF Working Paper No. 11-497; Kuttner, and Shim, 2013, "Can Non-Interest Rate Policies Stabilize Housing Markets? Evidence from a panel of 57 economies," BIS Working Papers No 433).

minimum CET1 capital ratio in the Swiss Too-Big-Too-Fail (TBTF) legislation to be met by 2019. The progress in increasing the leverage ratio, however, has been slower; both banks are below the fully-implemented Swiss minimum leverage ratio and lag behind most other large global banks based on other leverage measures (Figure 5). On the other hand, the liquidity position is strong, with the Basel III Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) exceeded at end-2013. Both banks were profitable in 2013, but potential costs from various legal risks (e.g. mortgage mis-selling and aiding tax evasion in the United States, illegal trading activity in LIBOR and foreign exchange markets) weighed on the results.

29. **Given the special risks posed by their size, the two large banks should rapidly bring their leverage ratio in line with that of other major international banks.** In light of the size of the two large banks relative to the economy, the authorities should ensure that minimum requirements in terms of leverage are more ambitious than minimum international standards both in terms of level and of the quality of capital. For the large banks, the current Swiss total capital leverage ratio minimum is above the envisaged 3 percent Basel. However, a substantial portion of the Swiss requirement can be held as CoCos, which are not necessarily Tier 1 capital. In addition, the ongoing examination by FINMA of how risk-weights in internal models differ from those under the standard approach is welcome, and model approval decisions should be reviewed in cases where such differences are large. In this context, FINMA should be commended for demanding higher risk weighted assets for operational risk from the two large banks.

30. **Making the TBTF resolution regime robust and workable cross-border should be a priority to ensure financial and economic stability.** Work should continue with the banks and key host authorities to finalize a viable strategy that would make the largest banks resolvable without government support. Reaching a cooperation agreement with the U.S. and U.K. authorities, the two key jurisdictions for the Swiss TBTF banks, would be a very welcome achievement.

The authorities' view

31. **The authorities emphasized that capital regulation will remain tighter than international standards.** On the regulatory leverage ratio, the authorities noted that Switzerland is ahead of the field as it already has a minimum leverage ratio in place. It was furthermore noted that as the Basel III definition of leverage is finalized, it will be ensured that the objective of having tougher rules than international minimum standards will be met. The authorities confirmed that they are actively working with, the U.K. and U.S. authorities on cross-border resolution under the "single point of entry" principle, with negotiations for a binding cooperation agreement planned to commence later this year.

Banking Supervision and Deposit Insurance

32. **Banking supervision, in particular of domestic banks, need to be further strengthened, including by shoring up resources.** The FSAP Update found a high level of compliance with Basel Core Principles and pointed to significant improvements in recent years. However, it also noted that FINMA operates with resources well below those of other supervisors. FINMA could usefully provide

more guidance to external auditors (which conduct most onsite banking supervision) as to what is needed, ensure greater harmonization across supervised entities, and complement the auditors' work with more "deep dives" on selected issues. Auditing firms should furthermore be periodically rotated (at least every five years) and not be paid by the supervised entities, but rather from a FINMA-administered fund. Increased resources for FINMA are needed so it can intensify its supervision of smaller and medium-sized domestically focused banks, particularly in light of risks from large exposures to the domestic mortgage market.

33. **The Swiss deposit insurance system needs substantial reform.** The FSAP Update indentified a number of weaknesses, and proposed several areas for improvement to bring the system in line with emerging international best practices, including greater transparency to depositors on coverage conditions, commitment to faster payouts, ex ante financing in a dedicated fund, and the fund to have powers to take action other than bank closure when there is a cheaper alternative.

The authorities' view

34. **The authorities believe that supervision is adequately funded and executed, and saw prospects for deposit insurance reform as limited.** FINMA stressed that the track record demonstrated that the currently applied risk-based approach to performing supervisory reviews with experienced and skilled staff had been successful. There was nonetheless agreement that domestically oriented banks deserved close attention, and in this context it was pointed out that Pillar II measures had been taken on an individual banks basis, including capital surcharges for institutions with higher interest rate or concentration risks. On deposit insurance, the authorities agreed that aspects of the current system could be improved, but pointed to a recent reform effort that failed to muster sufficient political consensus.

E. Medium-Term Prospects: Immigration, Population Aging, and International Initiatives on Corporate Tax Compliance and Bank Secrecy

35. **Despite opposition by the government and many business organizations, a popular vote recently approved the re-establishment of quotas on immigration**. The Federal Council now has three years to put in place a quota regime. The free movement of labor was part of a broader set of cooperation agreements reached with the EU in 1999, and contributed to the acceleration in Swiss economic growth in the 2000s (Annex 2). Immigrants account for a large share of the work force in many important sectors. Uncertainty as to the ability to recruit the needed personnel in the future may discourage new investment in these sectors. Additional uncertainty may arise as some other key cooperation agreements with the EU may be called into question. A rapid resolution of this uncertainty would be important to underpin the economic recovery. On the positive side, reduced immigration should take some pressure off the housing market.

36. **Slower immigration will increase the challenges of an aging population, and the new legislative pension reform proposal is welcome.** To tackle the long term fiscal challenge arising from population aging, the government unveiled the pension reform proposal "Pension

2020." The objective is to ensure sustainable financing of Pillar I and Pillar II pensions while maintaining current benefit levels. The main measures include: (i) harmonizing the reference retirement age for men and women at 65; (ii) facilitating a flexible transition to retirement from the age of 62 and cutting benefits for early retirement; (iii) introducing a sustainability rule for social security funds, which requires reversible automatic increases in contributions or cuts in benefit indexation in case measures proposed by the Federal Council to the Parliament fail to prevent the funding ratio from falling below 70 percent and deficits exceed 3 percent for two consecutive years. In addition, for Pillar II pensions the reform would reduce the minimum conversion rate from 6.8 percent to 6 percent and redefine the minimum interest rate at the end of each year when the achieved investment performance is known. A two percentage point increase in the VAT and higher social security contributions would finance the cost. Staff stressed that aligning male and female retirement age is appropriate, and placing the social security funds under a fiscal rule, as are most cantonal budgets and the federal budget, should reduce fiscal risks going forward.

37. **The tax treatment of corporate income on foreign activities is coming under international scrutiny.** Among several factors that make Switzerland attractive to multinational corporations is a favorable corporate income tax regime in many cantons, while bank secrecy has been an important factor for the wealth management sector. Responding to international pressures, the authorities are developing a strategy to reform special tax regimes that give more favorable tax treatment to income from foreign operations than income from domestic operations while maintaining Switzerland's attractiveness to international firms. The reform is envisaged to enter into force as of 2018.[6] Staff welcomed this plans and recommended that, in designing a new regime, the authorities take into account international efforts to counter base erosion and profit shifting in corporate taxation.

38. **In parallel, international initiatives to address tax evasion and money laundering are eroding bank secrecy.** This presents potential challenges to parts of the Swiss wealth management business and staff stressed the need to closely monitor this sector during the likely process of downsizing to avoid possible risks to financial stability. To protect the integrity of Switzerland as an international financial center, the authorities are also encouraged to forcefully implement the FATF and Global Forum standards in particular with respect to criminalization of tax crimes as predicate offences to money laundering, the transparency of legal persons, and due diligence requirements for politically exposed persons.

The authorities' view

39. **The authorities considered that it was early to assess the possible effects of the referendum on immigration, but were optimistic about succeeding with pension reform.** They agreed that uncertainty over the final outcome was not helpful to growth and noted that the Federal Council was moving forward speedily to develop possible strategies. On pension reform they

[6] See http://www.efd.admin.ch/themen/steuern/02720/index.html?lang=fr.

stressed the importance of reforming Pillar I and II together and noted that the parliamentary process was likely to be protracted, with enactment of the reform expected by 2020. On corporate income tax reform, they stressed their goal of maintaining international competitiveness, and informed that buffers were being built in the federal budget for possible burden sharing of the revenue losses with the cantons. On the wealth management sector, the authorities do not expect large adverse effects as competing financial centers will also adopt the new standards. The authorities also informed on progress in implementing international AML-CFT standards**.** A draft bill for implementing the revised 2012 Financial Action Task Force Recommendations (FATF) was approved by the upper house and should be taken up by the lower house later this year. An FATF Evaluation will start in the fall of 2014 and be finalized in 2016.

STAFF APPRAISAL

40. **The exchange rate floor continues to be a necessary element of the monetary policy framework.** Inflation is still close to the bottom of the range compatible with the SNB definition of price stability, and, renewed exchange rate appreciation, as might arise from a new bout of safe haven inflows, would quickly bring back deflationary pressures. Thus, monetary conditions need to remain expansionary and the exchange rate floor needs to remain in place. Negative interest rates on banks' excess reserves may need to be introduced in case of renewed strong pressures on the franc. The SNB balance sheet is likely to remain extended for a prolonged period with large fluctuations in mark-to-market profits, and provisions need to be strengthened to bring capital in line with risks.

41. **Stronger policies to curb the demand for mortgages are needed to reduce the risk of a sharp adjustment down the road**. The recent hike in the CCB is welcome, but its impact may not be sufficient as capital is not a constraint across the domestically oriented banking sector. More aggressive policies to discourage vulnerable households from taking on too much mortgage debt need to be put in place. To this end, existing self-regulation measures should be tightened, for example to speed up loan amortization. Parallel measures to curb mortgage growth in the buy-to-let segment should also be put in place. However, given the limited effect of self-regulation so far, stricter direct regulation may be necessary, including mandatory affordability caps and maximum loan-to value ratios. This would be an appropriate time to phase out tax incentives that encourage borrowing to finance home buying.

42. **A rapid resolution of uncertainty related to future immigration policy would be important to underpin the economic recovery**. The recent referendum to move away from the free movement of labor with the EU has increased uncertainty about medium-term economic prospects. Immigration has increased the labor force by about one percentage point per year since the free movement of labor accord with the EU came into force. Immigrants account for a large share of the work force in many important sectors. Uncertainty as to the ability to recruit the needed personnel in the future may discourage new investment in these sectors. Additional uncertainty may arise as some key cooperation agreements with the EU could be called into question.

43. **Slower immigration will increase the challenges of an aging population, and the new legislative pension reform proposal will help in meeting these challenges**. The proposal aims at placing first and second pillar pensions on a sustainable financial basis in light of population aging. Aligning the retirement age of women with that of men is appropriate, and placing the social security funds under a fiscal rule, as are most cantonal budgets and the federal budget, should reduce fiscal risks going forward.

44. **Plans to reform the corporate income tax to make it internationally acceptable are welcome**. Specifically, the authorities are seeking to eliminate the favorable tax treatment on income from foreign activities granted to corporations by cantons. This initiative is welcome and the authorities are encouraged to put in place a new regime taking into account international efforts to counter base erosion and profit shifting. The strategy to build buffers in the federal budget for possible burden sharing of the fiscal costs with the cantons should facilitate this reform.

45. **Continuing the financial sector reform agenda will strengthen the soundness and resilience of the financial system.** The latter is important for global financial stability given the prominent role of the Swiss banking and insurance sectors. In line with the FSAP update recommendations, the authorities are encouraged to:

- Press the large banks to continue efforts to rapidly bring their leverage ratios into line with those of other major international banks, ensure an ambitious minimum leverage ratio requirement, and improve transparency as regards risk weights.

- Continue discussions with international counterparts to reach agreement on measures to make the large banks resolvable without public sector support.

- Increase resources available to FINMA for banking supervision, in particular so it can extend its intensive supervision in the sector beyond the largest banks. Refine FINMA's use of external auditors for onsite supervision of the banks, including through periodic rotation of auditing firms, ensuring auditors are paid from a FINMA-managed bank-financed fund, and providing more guidance on their supervisory focus.

- Overhaul the deposit insurance scheme to bring it into line with emerging international best practices and the schemes being established in the region. This involves greater transparency to depositors on coverage conditions, commitment to faster payouts, ex ante financing in a dedicated fund, and the fund to have powers to take action other than bank closure when there is a cheaper alternative.

46. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Key FSAP Recommendations

Recommendation	Timing
Impose a leverage ratio on the banks that is tougher than international minima.	Short term
Remain alert to the build-up of risks in domestic real estate and mortgage markets. Fully enforce self-regulation, and consider further raising the CCB and introducing additional tools (e.g., debt-to-income (DTI) and loan-to-value (LTV) limits).	Short term
Reach agreement with partner supervisors as to the resolution of the country's G-SIFIs.	Medium term
Make available the full range of best practice resolution powers to handle any bank deemed systemic at the time.	Medium term
Overhaul the deposit insurance scheme: make its provisions more transparent; reform its governance; and build up dedicated ex ante funding with a back-up line of support. Make deposit insurance funds available to finance resolution measures on a least-cost basis.	Short term
Monitor closely the condition of the life insurance firms in advance of the prospective elimination of the palliative measures protecting the companies from the effects of low interest rates, and enhance public understanding of the SST.	Medium term
Issue guidance on the cantonal banks' governance, based on their best practice, including reducing political interconnectedness. Issue guidance on guarantees for cantonal banks, to enhance transparency and create a level playing field both across the cantonal banks and with the rest of the banking sector.	Short term
Ensure that the likely consolidation among the private banks in response to U.S. tax pressures proceeds smoothly.	Short term
Issue guidance to auditors to ensure consistency of supervision, and undertake more "deep dives" into particular areas of concern. Increase the intensity of onsite supervision, including of middle-sized and smaller banks.	Short term
Increase FINMA's resources so it can carry out its agenda for supervisory enhancement. The resource pool for highly qualified staff could be expanded.	Short to Medium term
Prioritize regulatory reform of securities markets, to bring arrangements up to international standards. Enhance focus on conduct of business supervision of banks and securities dealers.	Medium term
Pursue legislation to improve policyholder protection, enhance brokers' supervision, and increase the level of public disclosure.	Medium term
Bring FMIs into compliance with new international principles and establish crisis management arrangements between the authorities of FMIs.	Short term
Establish transparency in the financial sector as a core element of the Swiss "brand," in particular through heightening banks' disclosure requirements, including as regards capital weighting and providing data for adequate risk analysis.	Short term

Authorities' Response to Past IMF Policy Recommendations

IMF 2013 Article IV Recommendations	Authorities' Response
Monetary and Exchange Rate Policy I The exchange rate floor should remain in place for now.	Implemented.
Monetary and Exchange Rate Policy II Introduce negative interest rates on excess bank reserves in case of renewed appreciation pressures.	The authorities view negative interest rates as a possible policy tool to defend the floor.
Monetary and Exchange Rate Policy III More rapid growth in the SNB capital	The authorities consider the current approach sufficient.
Financial Sector Policy I Forceful monitoring and enforcement of the new minimum regulatory standards and a proactive use of supervisory discretion, 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.	The authorities have implemented the self-regulation, but believe that further tightening is needed and are discussing such measures. The CCB was increased from 1.0 to 2.0 percent, to be fulfilled by end-June 2014.
Financial Sector Policy II Phase out existing tax incentives for mortgage debt.	No action taken.
Financial Sector Policy III More rapid progress on the leverage front	The two big banks have made significant progress, but more is needed.
Financial Sector Policy IV Make further progress on cross-border bank resolvability	Progress is ongoing.
Fiscal Policy I Make rapid progress in tackling the cost of an aging population and apply automatic adjustors for pensions	The Pension 2020 proposals are in this direction.

Risk Assessment Matrix[7]

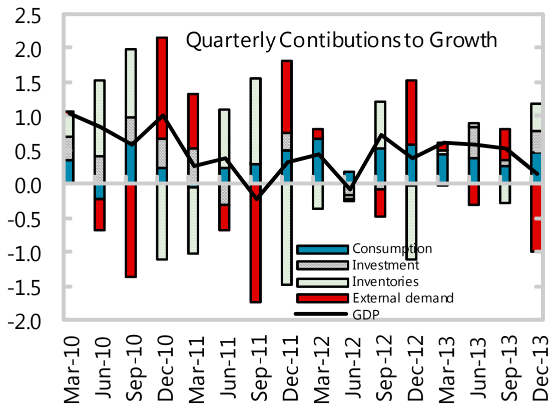
Switzerland	Overall Level of Concern	
Nature/Source of Main Threats and Possible Triggers	**Likelihood of severe realization of threat sometime in the next three years**	**Expected impact on financial stability if threat is realized**
Side-effects from global financial conditions: • Surges in global financial market volatility (related to UMP exit), leading to economic and fiscal stress, and constraints on country policy settings.	High Bouts of market volatility and higher-than-expected increases in long-term rates could occur as a result of advanced countries exiting from UMP.	Medium Disorderly unwinding of UMP might cause renewed safe haven inflows into Switzerland, forcing the SNB to intervene again to defend the floor. Pressures on the housing market may also intensify.
Protracted period of slower growth in advanced and emerging economies: • Advanced economies: larger than expected deleveraging or negative surprises on potential growth. • Emerging markets: earlier maturing of the cycle and incomplete structural reforms leading to prolonged slower growth.	High for Europe A protracted period of weak demand could take a toll on productive capacity across advanced economies. Medium for elsewhere Trend growth is lower as a result of weaker than expected productive capacity and human capital. Disappointing activity in emerging markets would bring about a reassessment that the cycle is more mature, amid quasi-fiscal activities more pervasive than in the baseline.	Low Europe is the main trading partner of Switzerland, a protracted period of slower European growth would dampen economic growth and possibly cause a recession.
Financial stress in the euro area re-emerges (triggered by stalled or incomplete delivery of Euro area policy commitments)	Medium Financial stress re-emerges and bank-sovereign links re-intensify as a result of stalled or incomplete delivery of policy commitments at the national or Euro area level (e.g. Banking Union), a negative assessment of the asset quality review combined with insufficient backstops, or adverse	Medium Given the close trade links, a re-emergence of the stress would slow economic growth. Safe haven capital inflows would resume, requiring intervention. Pressures on the housing market may also intensify. Direct financial sector direct exposure to

[7] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

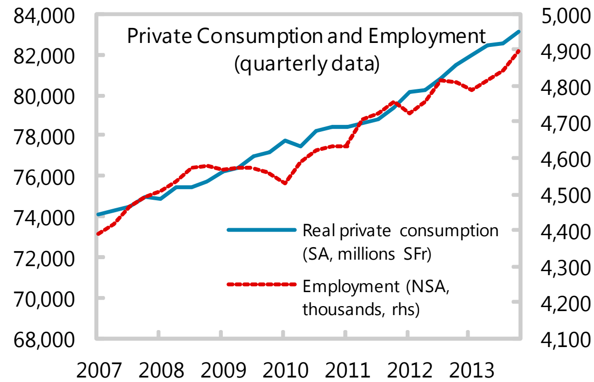
Switzerland	Overall Level of Concern	
	developments in some peripheral countries.	euro zone countries under market pressure is moderate. Indirect exposures could become problematic in a tail risk situation.
Sharp correction in the housing market.	Medium Low interest rates and ample liquidity continue to drive prices higher. A price correction is likely once interest rates return to normal levels.	Medium A sharp correction in housing prices would weaken household balance sheets and slow down growth. The banking and insurance industries, would both suffer, given their exposure to the mortgage market and real estate, respectively. Domestically-focused banks are particularly vulnerable, though they are well capitalized on average.
Bond market stress from a reassessment in sovereign risk	Medium • Japan: Abenomics falters, depressed domestic demand and deflation (short-term), leading to bond market stress (medium-term) Low • United States: protracted failure to agree on a credible plan to ensure fiscal sustainability (medium-term)	Medium Global asset managers may maintain or further shift asset allocations to safe havens, including Swiss-franc denominated assets. Safe haven flows would put the currency under pressure again and possibly re-exacerbate pressures in the housing market.
Risks to financial stability from incomplete regulatory reforms: delays, dilution of reform, or inconsistent approaches (medium-term)	Medium Remaining uncertainties about the design of future global regulatory landscape and slow progress in reaching agreements on effective crisis resolution mechanisms continue to pose risks.	Medium The banking sector is highly globally interconnected, and large banks are highly leveraged and have large wholesale funding positions. As such, they are a potential source of outward spillovers and vulnerable to inward spillover from instability in global financial markets.
Increasing geopolitical tensions surrounding Ukraine lead to disruptions in financial, trade and commodity markets	Medium Doubts about whether Ukraine will consistently make timely commercial and financial payments, both internally and externally; financial and trade disruptions; contagion; a further slowdown in Russia; and uncertainty all trigger a re-pricing of risks and heightened volatility in financial markets.	Medium The direct impact should be limited. However, contagion and heightened volatility in financial markets may trigger renewed safe haven flows.

Figure 1. Switzerland: Recent Economic Developments

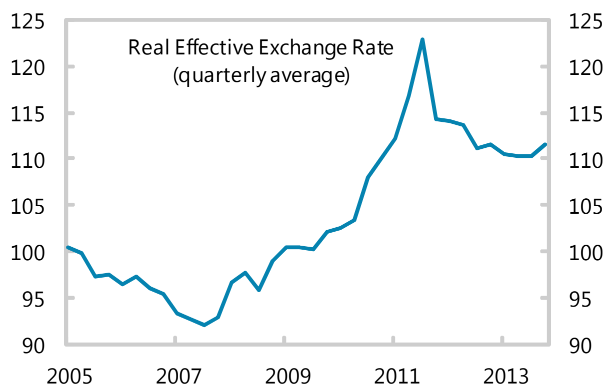
The economy has recovered in 2013 and the growth outlook is stable with growth around 2 percent (but almost 1 percent is population growth).



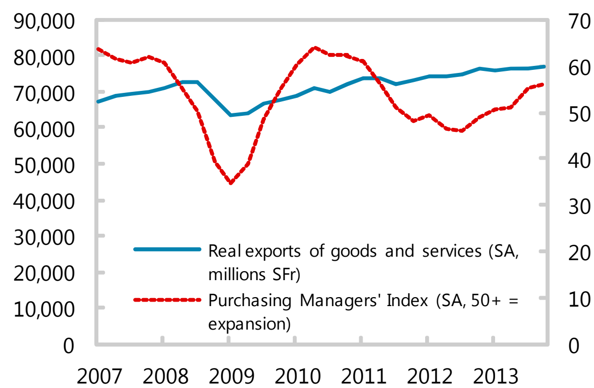
Employment and consumption have continued to rise.



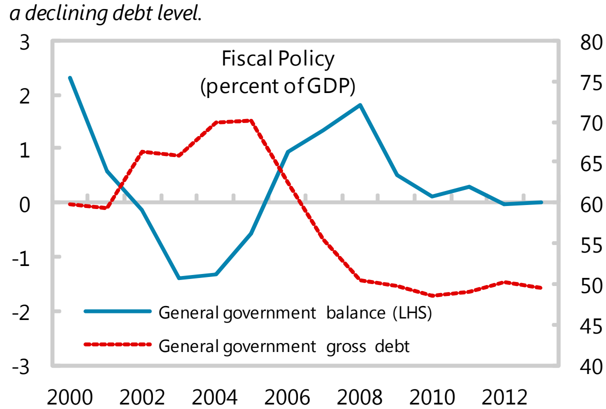
Despite the recent REER appreciation of the Swiss franc, ...



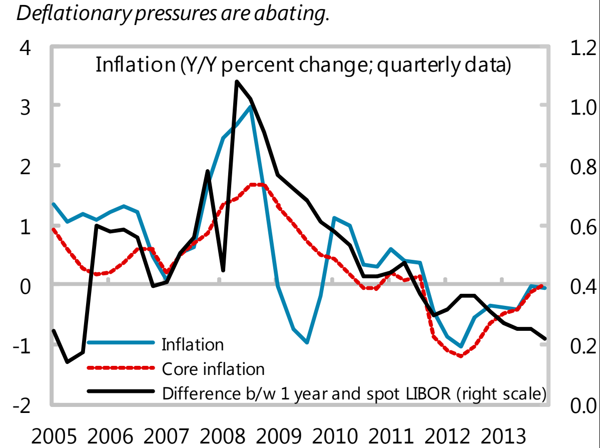
...both exports and PMI have increased.



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

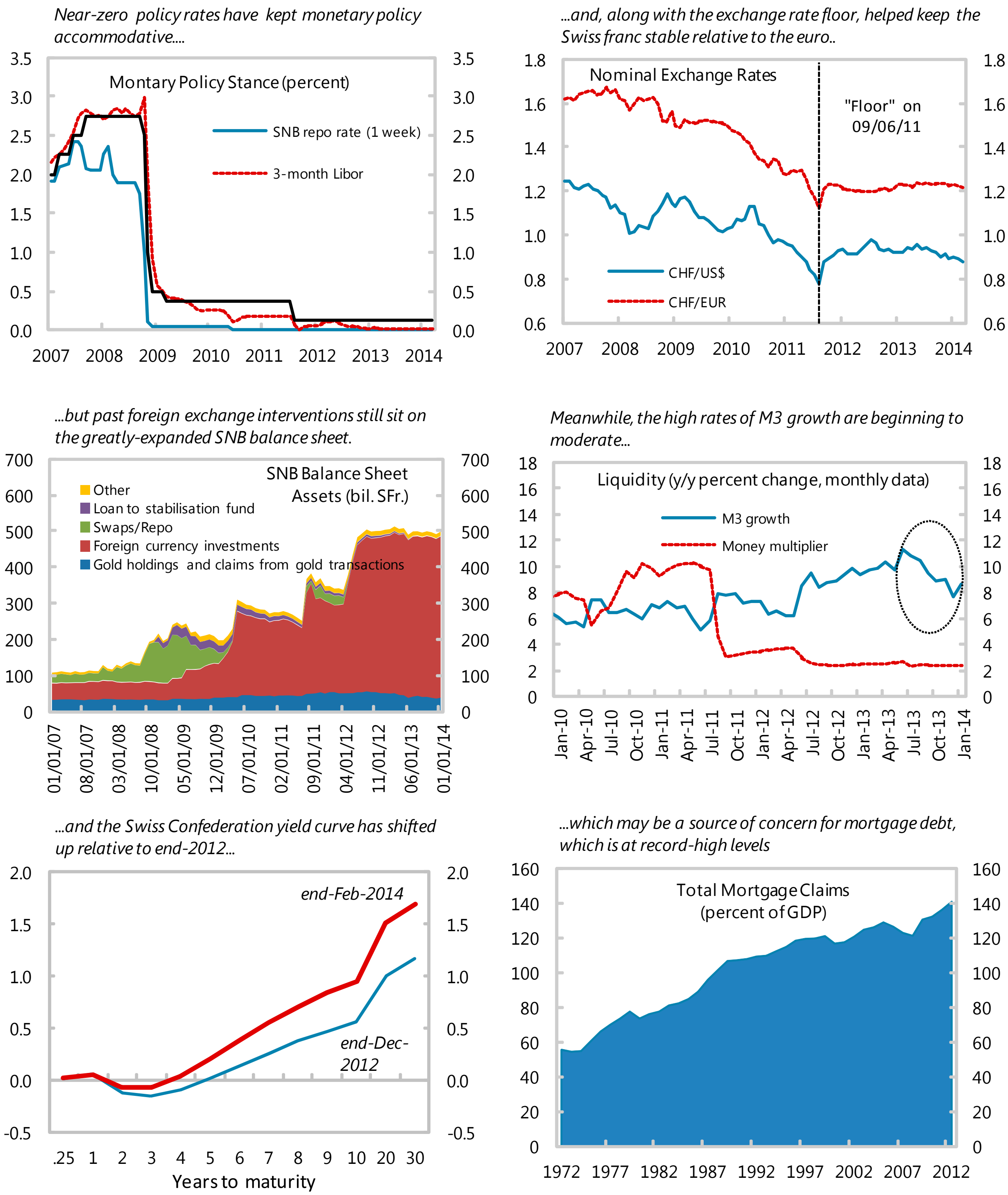


Deflationary pressures are abating.



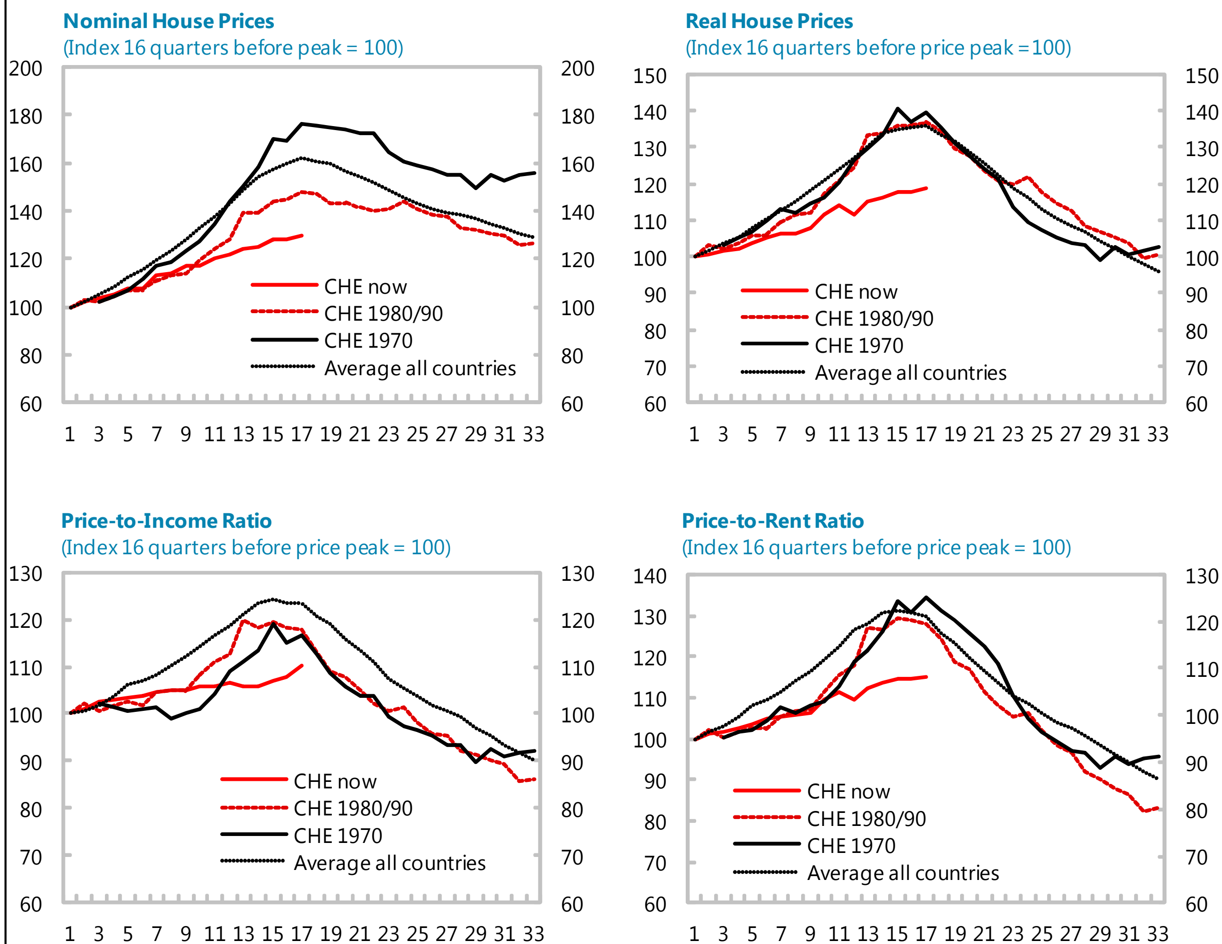
Sources: Haver Analytics; Swiss National Bank; and IMF estimates.

Figure 2. Switzerland: Monetary and Exchange Rate Policies



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

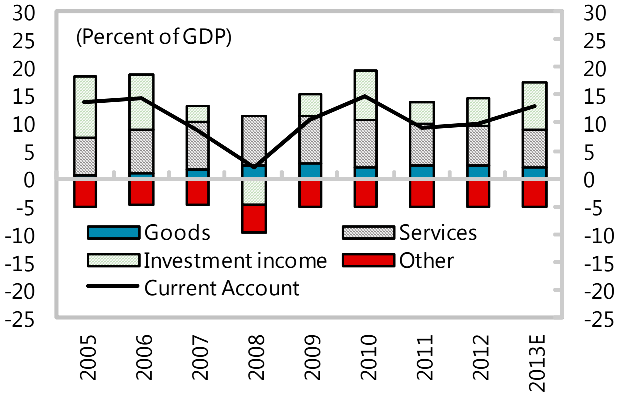
Figure 3. House Price Indicators During Boom and Bust Episodes in OECD Countries



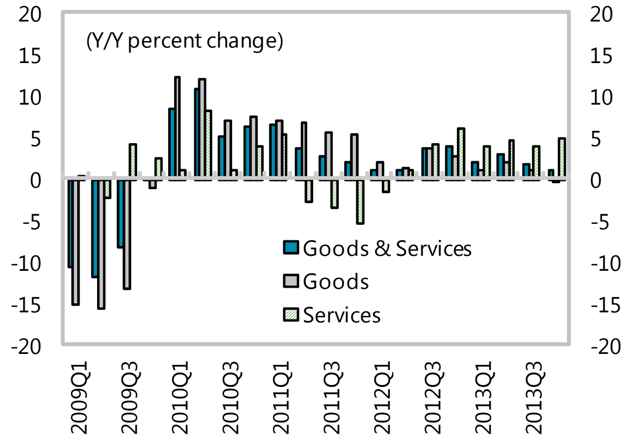
Sources: OECD; SFSO; Wuest&Partner; and IMF staff calculations.

Figure 4. Switzerland: External Account and Related Peculiarities

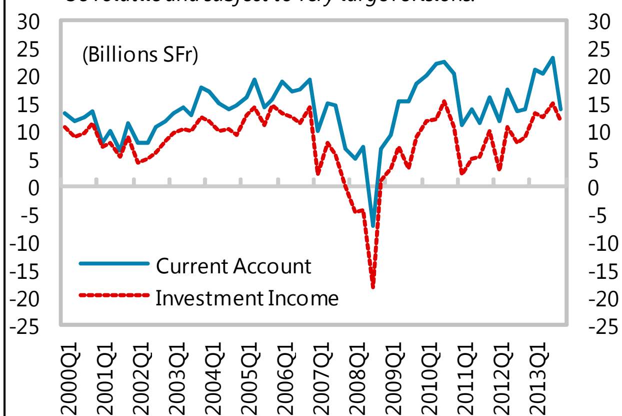
The preliminary current account estimates for 2013 imply a sharp increase over 2012...



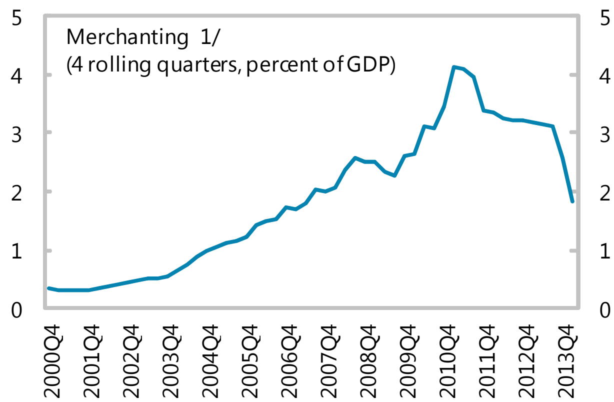
...reflecting moderate growth in exports....



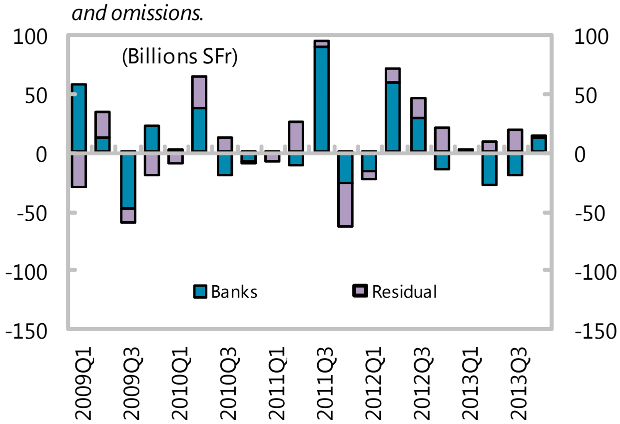
...but mainly high net investment income, which tends to be volatile and subject to very large revisions.



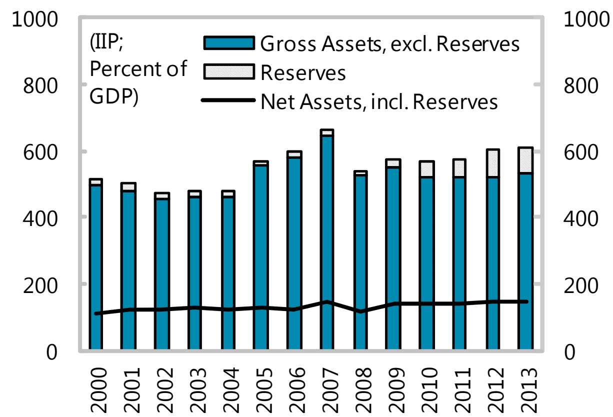
Merchanting exports softened, but still remain above levels prevailing during the pre-crisis period.



There were some tentative signs of net bank lending outflows but their BoP impact was offset by large errors and omissions.

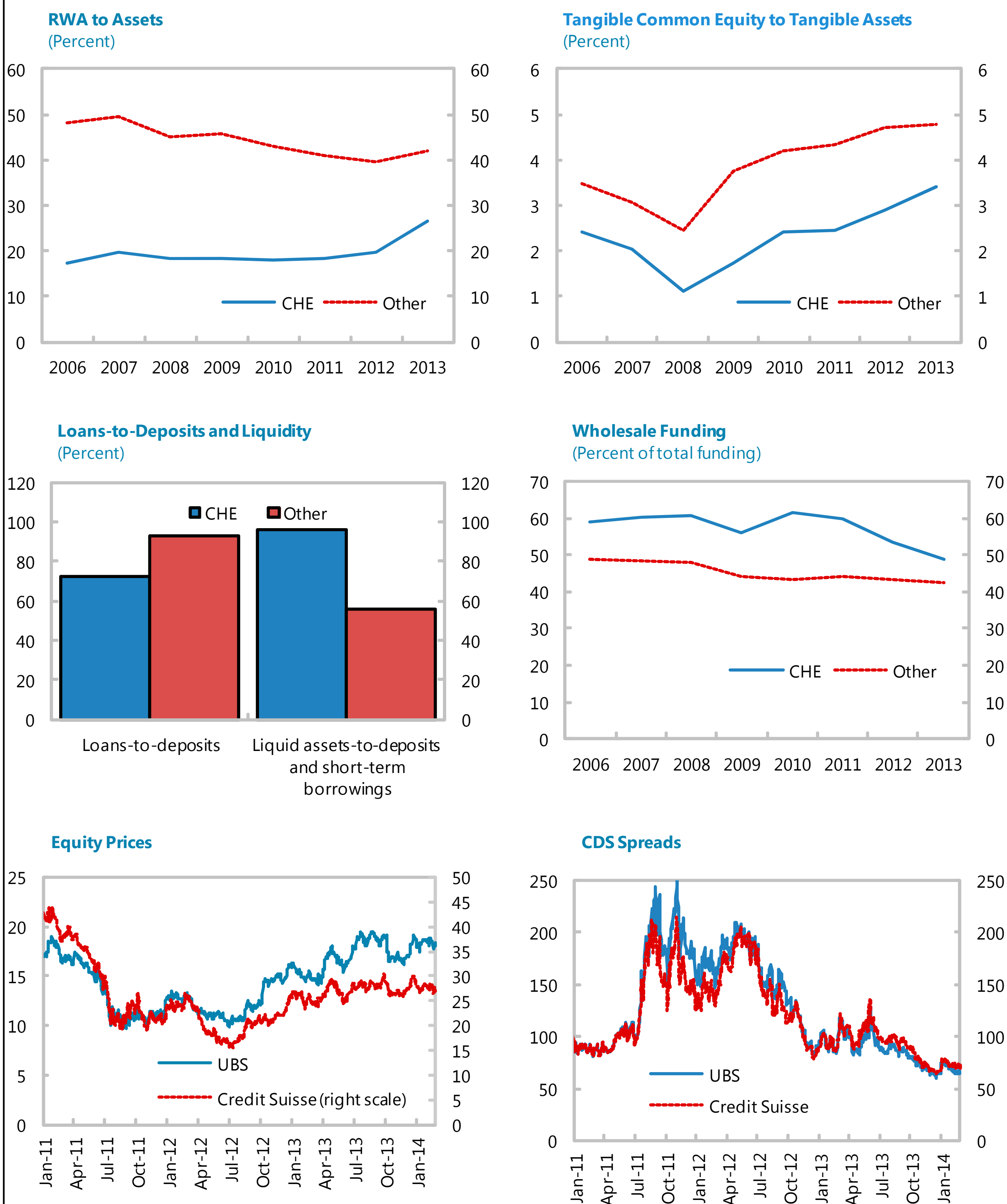


Overall, there was no significant net pressure on reserves.



Sources: Haver Analytics; IMF's *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

Figure 5. Switzerland: Systemic Bank Indicators*



Sources: Bankscope; Bloomberg; and IMF staff calculations.

*/ "Other" includes Citigroup, Deutsche Bank, HSBC, JP Morgan Chase, Barclays, BNP, Bank of America, New York Mellon, Goldman Sachs, Mitsubishi, Morgan Stanley, Royal Bank of Scotland, Bank of China, BBVA, BPCE, Crédit Agricole, ING, Mizuho, Nordea, Santander, Société Générale, Standard Chartered, State Street, Sumitomo, UniCredit, Wells Fargo, Commerzbank, Dexia, Lloyds.

Table 1. Switzerland: Selected Economic Indicators, 2010–15

	2010	2011	2012	2013	2014	2015
				Projections		
Real GDP (percent change)	3.0	1.8	1.0	2.0	2.1	2.2
Total domestic demand	2.7	1.8	1.2	1.8	1.7	1.6
Final domestic demand	2.2	1.9	1.9	2.2	2.1	1.9
Private consumption	1.7	1.1	2.4	2.3	1.8	1.8
Public consumption	0.2	1.2	3.2	3.0	1.7	0.9
Gross fixed investment	4.8	4.6	-0.3	1.7	3.0	2.7
Inventory accumulation 1/	0.5	-0.1	-0.6	-0.4	-0.4	-0.3
Foreign balance 1/	0.5	0.2	0.0	0.4	0.6	0.8
Nominal GDP (billions of Swiss francs)	572.7	585.1	591.9	603.2	621.7	641.3
Savings and investment (percent of GDP)						
Gross national saving	35.0	30.2	30.6	30.7	31.2	31.3
Gross domestic investment	20.3	21.3	21.0	21.1	21.3	21.5
Current account balance	14.8	9.0	9.6	9.6	9.9	9.8
Prices and incomes (percent change)						
GDP deflator	0.3	0.4	0.1	0.0	0.9	0.9
Consumer price index	0.7	0.2	-0.7	-0.2	0.2	0.5
Nominal wage growth	0.8	1.0	0.8	0.7	0.8	1.0
Unit labor costs (total economy)	-2.3	2.1	1.5	-0.3	-0.3	0.1
Employment and slack measures						
Unemployment rate (in percent)	3.5	2.8	2.9	3.2	3.2	3.0
Output gap (in percent of potential)	-0.5	-0.4	-1.2	-1.0	-0.7	-0.2
Capacity utilization	81.1	84.3	81.5	80.8	...	...
Potential output growth	1.6	1.7	1.8	1.8	1.8	1.8
General government finances (percent of GDP)						
Revenue	32.9	33.5	33.1	33.3	32.8	33.0
Expenditure	32.8	33.2	33.2	33.3	33.0	32.6
Balance	0.1	0.3	0.0	0.0	-0.2	0.4
Cyclically adjusted ordinary balance	0.3	0.5	0.4	0.4	0.1	0.5
Gross debt 2/	48.5	49.1	50.1	49.4	48.1	47.3
Monetary and credit (percent change, averages)						
Broad money (M3)	6.4	6.9	8.0	9.7	...	...
Domestic credit, non-financial	2.1	3.7	5.3	3.9	...	...
Three-month SFr LIBOR	0.2	0.1	0.1	0.0	...	...
Yield on government bonds (7-year)	1.3	1.2	0.4	0.6	...	...
Exchange rates (levels)						
Swiss francs per U.S. dollar (annual average)	1.0	0.9	0.9	0.9	...	...
Swiss francs per euro (annual average)	1.4	1.2	1.2	1.2	...	...
Nominal effective rate (avg., 2005=100)	128.0	137.7	137.8	140.1	...	...
Real effective rate (avg., 2005=100) 3/	110.1	114.2	111.6	112.0	...	...

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

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, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
						Projections		
	(In billions of Swiss francs, unless otherwise indicated)							
Current account	**12**	**58**	**84**	**52**	**57**	**58**	**62**	**63**
Goods balance	15	16	13	14	16	16	20	25
Exports	217	188	204	209	212	213	218	229
Imports	202	172	191	194	197	197	198	204
Service balance	50	46	49	44	41	41	42	43
Net investment income	-26	23	50	22	30	30	29	26
Net compensation of employees	-13	-14	-15	-17	-18	-18	-18	-18
Net private transfers	-11	-10	-9	-8	-8	-8	-9	-9
Net official transfers	-3	-3	-3	-4	-4	-4	-4	-4
Private capital and financial account	**-12**	**-25**	**-116**	**-48**	**-101**	**-58**	**-62**	**-63**
Capital transfers	-4	-4	-5	-8	-2	-10	-11	-12
Financial account	-8	-21	-112	-40	-99	-48	-51	-51
Net foreign direct investment	-33	3	-55	-19	-33	-70	-70	-70
Net portfolio investment	-39	-32	31	-17	13	73	69	68
Net other investment 1/	67	55	50	39	95	-51	-50	-49
o/w net banking sector	63	43	14	49	58	-51	-50	-49
Official reserve flows	-4	-47	-138	-43	-175	0	0	0
Net errors and omissions	**0**	**-33**	**32**	**-4**	**44**	**0**	**0**	**0**
	(In percent of GDP, unless otherwise indicated)							
Current account	**2.1**	**10.5**	**14.8**	**9.0**	**9.6**	**9.6**	**9.9**	**9.8**
Goods balance	2.7	3.0	2.3	2.5	2.6	2.6	3.2	3.8
Exports	38.2	34.0	35.6	35.7	35.9	35.3	35.1	35.7
Imports	35.6	31.0	33.3	33.2	33.3	32.7	31.9	31.8
Service balance	8.8	8.3	8.5	7.5	7.0	6.9	6.8	6.7
Net investment income	-4.6	4.1	8.7	3.8	5.1	5.0	4.7	4.0
Net compensation of employees	-2.3	-2.5	-2.6	-2.9	-3.0	-2.9	-2.8	-2.8
Net private transfers	-1.9	-1.8	-1.6	-1.4	-1.4	-1.4	-1.4	-1.4
Net official transfers	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Private capital and financial account	**-2.1**	**-4.6**	**-20.3**	**-8.2**	**-17.1**	**-9.6**	**-9.9**	**-9.8**
Capital transfers	-0.7	-0.7	-0.8	-1.4	-0.3	-1.7	-1.8	-1.9
Financial account	-1.4	-3.9	-19.5	-6.8	-16.7	-7.9	-8.2	-8.0
Net foreign direct investment	-5.7	0.5	-9.5	-3.2	-5.5	-11.6	-11.3	-10.9
Net portfolio investment	-6.8	-5.8	5.4	-2.9	2.2	12.1	11.1	10.5
Net other investment 1/	11.9	9.9	8.7	6.6	16.0	-8.5	-8.0	-7.6
o/w net banking sector	11.1	7.8	2.4	8.4	9.7	-8.5	-8.0	-7.6
Official reserve flows	-0.7	-8.4	-24.1	-7.3	-29.5	0.0	0.0	0.0
Net errors and omissions	**0.0**	**-6.0**	**5.6**	**-0.7**	**7.4**	**0.0**	**0.0**	**0.0**
Memorandum items:								
Net IIP (in percent of GDP)	115.6	141.4	139.3	143.3	148.3	153.4	157.0	160.2
Official reserves								
(billions of U.S. dollars, end-period)	68.8	135.9	260.0	334.2	526.1	533.9	…	…
Reserve cover (months of imports of GNFS)	3.9	7.7	12.9	15.6	23.5	23.4	…	…

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

1/ Includes derivatives and structured products.

Table 3. Switzerland: General Government Finances, 2010–15

	2009	2010	2011	2012	2013	2014	2015
					Projections		
	(In billions of Swiss francs, unless otherwise specified)						
Federal Government 1/							
Revenues	60.6	61.2	63.5	62.1	63.5	64.7	67.6
Expenditures	58.1	59.3	63.0	61.7	64.2	64.5	66.7
Balance	2.5	1.8	0.5	0.4	-0.7	0.2	1.0
Cantons							
Revenues	75.2	76.4	78.3	78.8	81.0	82.2	85.7
Expenditures	72.9	75.1	79.7	81.5	81.7	84.9	86.7
Balance	2.2	1.3	-1.4	-2.7	-0.7	-2.8	-1.0
Municipalities							
Revenues	41.7	42.0	43.0	43.6	44.6	45.4	46.6
Expenditures	42.5	42.7	43.3	44.4	45.1	45.8	46.7
Balance	-0.8	-0.7	-0.3	-0.8	-0.5	-0.5	-0.2
Social security 2/							
Revenues	52.7	53.1	57.9	58.6	59.5	60.8	61.9
Expenditures	53.9	54.9	55.0	55.7	57.6	59.0	59.4
Balance	-1.2	-1.7	2.9	2.9	1.9	1.9	2.5
General Government							
Revenues	186.8	188.7	196.0	196.2	201.1	204.0	211.6
Expenditures	184.0	188.0	194.2	196.3	201.0	205.2	209.3
Balance	2.8	0.6	1.8	-0.1	0.0	-1.2	2.3
Gross debt							
Federal Government	143.0	145.1	148.3	150.3	150.4	148.9	150.6
Cantons	69.9	69.2	73.0	77.7	79.0	80.3	81.4
Communes	61.9	63.1	65.5	67.0	67.9	68.9	69.8
General government	275.6	277.9	287.2	296.7	298.2	299.1	303.2
	(In percent of GDP)						
General Government							
Revenue	33.7	32.9	33.5	33.1	33.3	32.8	33.0
Expenditure	33.2	32.8	33.2	33.2	33.3	33.0	32.6
Balance	0.5	0.1	0.3	0.0	0.0	-0.2	0.4
Federal government	0.4	0.3	0.1	0.1	-0.1	0.0	0.1
Cantons	0.4	0.2	-0.2	-0.5	-0.1	-0.4	-0.2
Municipalities	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	0.0
Social security	-0.2	-0.3	0.5	0.5	0.3	0.3	0.4
Memorandum items:							
Structural balance	1.2	0.3	0.5	0.6	0.4	0.3	0.3
Gross debt							
Federal government	25.8	25.3	25.4	25.4	24.9	24.0	23.5
Cantons	12.6	12.1	12.5	13.1	13.1	12.9	12.7
Communes	11.2	11.0	11.2	11.3	11.3	11.1	10.9
General government	49.7	48.5	49.1	50.1	49.4	48.1	47.3

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)

	2010	2011	2012	2013
Assets				
Gold	43,988	49,380	50,772	35,565
Foreign currency reserves	203,810	257,504	432,209	443,275
IMF, international, and monetary assistance loans	4,971	4,923	4,528	4,538
Swiss franc repos	...	18,468	...	...
U.S. dollar repos	...	371	...	...
Swaps against Swiss francs	...	...	...	...
Money market, Swiss franc securities, other	17,187	15,434	11,925	7,004
Total assets	269,955	346,079	499,434	490,382
Liabilities				
Currency in circulation (banknotes)	51,498	55,729	61,801	65,766
Sight deposits	48,917	216,701	369,732	363,910
Repo, SNB bills and time liabilities	121,052	15,086	...	...
Foreign currency and other liabilities	5,897	5,441	9,825	12,682
Provisions and equity capital	42,591	53,123	58,075	48,023
Total liabilities	269,955	346,079	499,434	490,382
Memorandum items:				
Nominal GDP (billions of Swiss francs)	573	585	592	603
Balance sheet, percent of GDP	47.1	59.1	84.4	81.3
Banknotes, percent of total liabilities	19.1	16.1	12.4	13.4
Refinancing operations, percent of total assets	...	5.4	...	...
Provisions and equity capital, percent of total assets	6.4	4.5	2.4	1.4
Monetary base 1/	74,185	231,954	350,965	380,523

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	2013
Banks							
Capital adequacy							
Regulatory capital as percent of risk-weighted assets 1/	12.1 *	14.76 *	17.9	17.3	16.7	16.94	16.45 Jun
Regulatory Tier I capital to risk-weighted assets 1/	11.6 *	12.29 *	15.2	15.6	15.5	15.75	15.14 Jun
Non-performing loans net of provisions as percent of tier I capital 2,3/	-0.9	6.5	6.9	5.4	4.8	4.35	**
Asset quality and exposure							
Non-performing loans as percent of gross loans 3/	0.3	0.9	1.0	0.9	0.8	0.77	**
Sectoral distribution of bank credit to the private sector (percent) 4/							
Households	71.5	65.4	67.1	68.3	68.8	65.6	65.7
Agriculture and food industry	1.4	1.3	1.3	1.3	1.2	0.9	0.9
Industry and manufacturing	3.4	3.0	3.0	3.0	2.9	3.0	2.7
Construction	1.8	1.6	1.6	1.6	1.7	1.7	1.7
Retail	3.3	3.1	3.1	3.2	3.1	3.3	2.7
Hotels and restaurants / Hospitality sector	1.2	1.1	1.1	1.1	1.1	1.0	1
Transport and communications	1.1	0.9	0.9	0.9	0.7	0.8	0.8
Other financial activities	5.2	7.0	0.4	0.5	0.5	0.7	0.9
Insurance sector	0.4	0.8	0.5	0.6	0.4	0.7	0.7
Commercial real estate, IT, R&T	5.9	11.0	11.4	12.0	12.4	13.9	14.5
Public administration (excluding social security)	1.1	1.8	0.0	0.0	0.0	0.0	0
Education	0.2	0.2	0.1	0.1	0.1	0.2	0.2
Healthcare and social services	1.1	1.0	1.0	1.1	1.1	1.3	1.3
Other collective and personal services	1.7	1.2	1.0	1.0	1.0	1.0	0.9
Other 5/	0.6	0.6	7.6	5.3	5.0	5.7	6.1
Earnings and profitability							
Gross profits as percent of average assets (ROAA)	0.7	0.3	0.5	0.7	0.7	0.6	0.8 Jun
Gross profits as percent of average equity capital (ROAE)	15.4	5.4	14.5	21.0	19.7	18.4	24.2 Jun
Net interest income as percent of gross income	28.1	36.3	30.4	27.9	31.1	31.6	30.4 Jun
Non-interest expenses as percent of gross income	70.4	85.5	80.1	73.3	72.0	73.7	69.2 Jun
Liquidity							
Liquid assets as percent of total assets	27.1	29.2	27.7	23.5	26.6	26.7	28.3 Jun
Liquid assets as percent of short-term liabilities	63.9	67.1	64.3	53.8	58.8	55.8	58.9 Jun
Net long position in foreign exchange as a percentage of tier I capital	13.7 *	-16.1 *	-23.2	-41.1	-61.2	-47.6	-55.9 Jun

Source: Swiss National Bank.
1/ Based on parent company consolidation. This consolidation basis equals the CBDI approach defined in FSI compilation guide plus foreign bank branches operating in Switzerland, and minus overseas deposit-taking subsidiaries.
2/ Until 2004, general loan-loss provisions were made; as of 2005, specific loan-loss provisions have been carried out.
3/ From 2008 onwards broader criteria pursuant to national accounting regulations (FINMA-RS 08/2 Art. 228b) has been applied for defining non-performing loans.
4/ As percent of total credit to the private sector.
5/ 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%.
** Not yet available.

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	186.8	188.7
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	27.9
Expenditure	174.9	180.5	177.6	184.0	188.0
Expense	173.7	179.1	177.4	182.6	186.6
Compensation of employees	49.9	51.2	41.0	43.1	44.1
Purchases/use of goods and services	23.8	24.4	21.8	22.5	21.6
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	37.0	47.6	47.0	48.9
Net acquisition of nonfinancial assets	1.3	1.4	0.2	1.4	1.4
Net operating balance	6.0	8.6	10.5	4.2	2.1
Net lending /borrowing	4.8	7.2	10.2	2.8	0.6
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	32.9
Taxes	21.3	21.2	21.6	21.8	21.4
Taxes on income, profits, and capital gains	12.7	12.8	13.2	13.4	12.9
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	4.9
Expenditure	34.4	33.4	31.3	33.2	32.8
Expense	34.2	33.1	31.2	32.9	32.6
Compensation of employees	9.8	9.5	7.2	7.8	7.7
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	6.8	8.4	8.5	8.5
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	0.1
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.

Table 7. Switzerland Federal Government Debt Sustainability Analysis (DSA)-Baseline Scenario

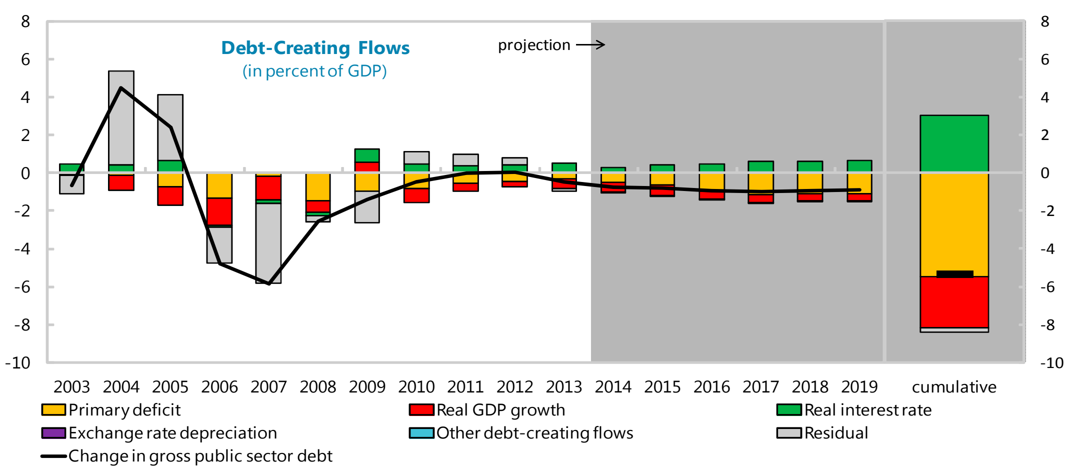
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of April 01, 2014		
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019	Sovereign Spreads		
Nominal gross public debt	31.2	25.4	24.9	24.2	23.3	22.4	21.4	20.5	19.6	EMBIG (bp) 3/		-70
Public gross financing needs	3.3	3.2	3.4	3.0	0.7	1.3	0.5	0.6	0.4	5Y CDS (bp)		25
Real GDP growth (in percent)	2.0	1.0	2.0	2.1	2.2	2.0	2.0	1.8	1.8	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	1.1	0.1	0.0	0.9	0.9	0.9	0.9	1.0	1.0	Moody's	Aaa	Aaa
Nominal GDP growth (in percent)	3.1	1.2	1.9	3.1	3.1	2.9	2.9	2.8	2.8	S&Ps	AAA	AAA
Effective interest rate (in percent) [4/]	2.1	1.8	2.0	2.1	2.6	3.1	3.8	3.9	4.2	Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing
Change in gross public sector debt	-1.0	0.0	-0.5	-0.8	-0.8	-1.0	-1.0	-0.9	-0.9	-5.3	primary
Identified debt-creating flows	-1.0	-0.3	-0.3	-0.7	-0.8	-0.9	-1.0	-0.9	-0.8	-5.1	balance [9/]
Primary deficit	-0.7	-0.5	-0.3	-0.5	-0.7	-0.9	-1.1	-1.1	-1.1	-5.5	0.3
Primary (noninterest) revenue and gra	10.7	10.4	10.5	10.4	10.5	10.7	10.8	10.8	10.8	63.9	
Primary (noninterest) expenditure	10.0	10.0	10.2	9.9	9.8	9.7	9.6	9.6	9.6	58.4	
Automatic debt dynamics [5/]	-0.3	0.2	0.0	-0.2	-0.1	0.0	0.2	0.2	0.3	0.4	
Interest rate/growth differential [6/]	-0.3	0.2	0.0	-0.2	-0.1	0.0	0.2	0.2	0.3	0.4	
Of which: real interest rate	0.3	0.4	0.5	0.3	0.4	0.5	0.6	0.6	0.6	3.0	
Of which: real GDP growth	-0.6	-0.3	-0.5	-0.5	-0.5	-0.5	-0.4	-0.4	-0.3	-2.7	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (1) (e.g., drawdown of	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.1	0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

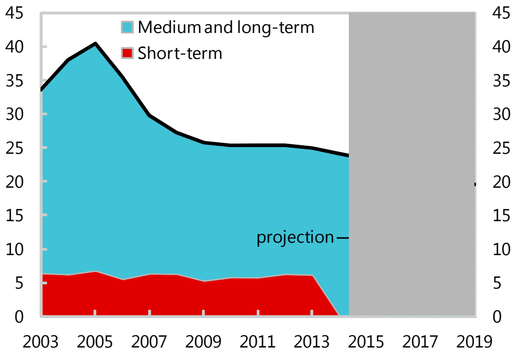
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 8. Switzerland Federal Government DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

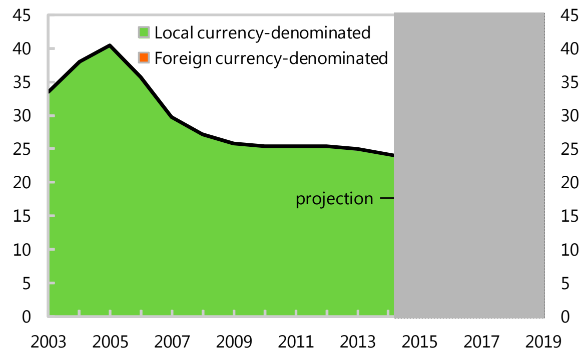
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

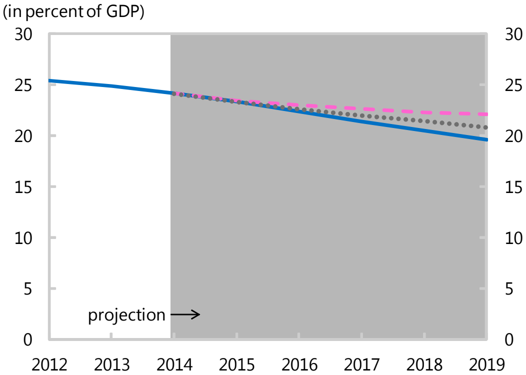


Alternative Scenarios

Baseline Historical Constant Primary Balance

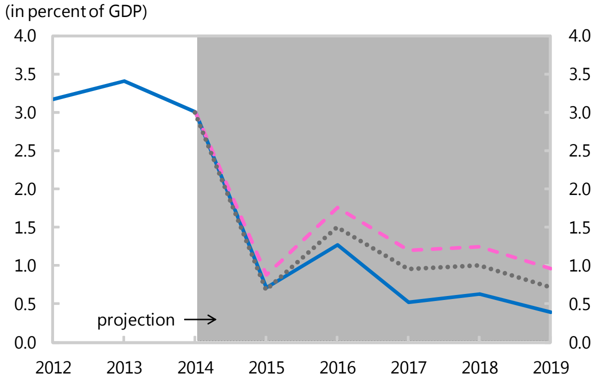
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.1	2.2	2.0	2.0	1.8	1.8
Inflation	0.9	0.9	0.9	0.9	1.0	1.0
Primary Balance	0.5	0.7	0.9	1.1	1.1	1.1
Effective interest rate	2.1	2.6	3.1	3.8	3.9	4.2
Constant Primary Balance Scenario						
Real GDP growth	2.1	2.2	2.0	2.0	1.8	1.8
Inflation	0.9	0.9	0.9	0.9	1.0	1.0
Primary Balance	0.5	0.5	0.5	0.5	0.5	0.5
Effective interest rate	2.1	2.6	3.1	3.7	3.9	4.1

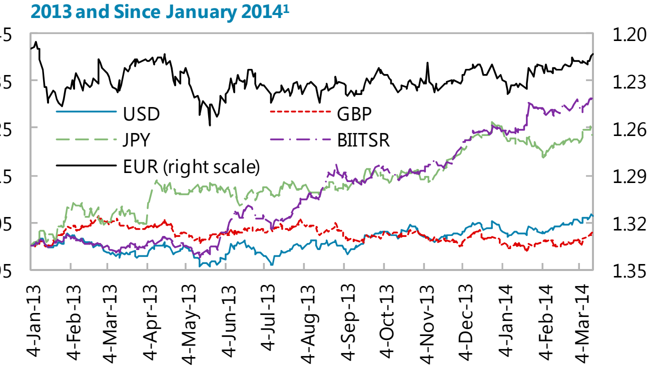
Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.1	2.1	2.1	2.1	2.1	2.1
Inflation	0.9	0.9	0.9	0.9	1.0	1.0
Primary Balance	0.5	0.7	0.7	0.7	0.7	0.7
Effective interest rate	2.1	2.6	3.0	3.7	3.7	3.9

Source: IMF staff.

Annex 1. Surges in Global Financial Volatility and the Swiss Franc[1]

1. **Switzerland's attraction as a safe haven was re-affirmed during recent bouts of global financial turbulence.** The heightened market volatility following the May 22, 2013 Fed "taper talk" saw the franc strengthen against major EM currencies, the euro, and the U.S. dollar. The latter outcome suggests that volatility-induced safe haven inflows dominated any portfolio re-allocation away from Switzerland which may have occurred due to a higher yield differential vis-à-vis the United States. After a brief respite from positive news about the euro area, safe haven inflows resumed in January 2014 on renewed market concerns about EM resilience. These inflows have been further reinforced by the crisis in Ukraine.

Franc Appreciation Against Major Currencies After May 22, 2013 and Since January 2014[1]



Source: IMF's Internatinal Financial Statistics.
[1]Index = 100 on Jan 4, 2013; for CHF/EUR, actual exchange rate shown on inverted right scale; upward trend shows franc appreciation; BIITSR is average index for currencies of BR, ID, IN, TU, ZA, RU.

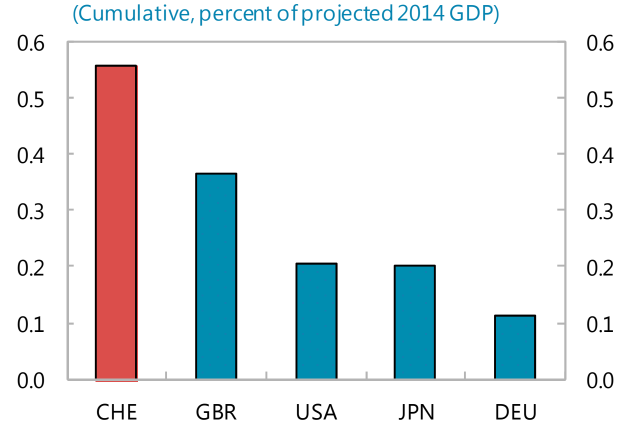
10-year Sovereign Yields
(basis points)

	CHE	Avg.	DEU	USA	JPN	GBR
Peak Δ after May 22 taper talk	29	32	*30*	*49*	*-2*	*50*
Δ since start of 2014	-30	-32	*-41*	*-33*	*-10*	*-44*
Level as on March 14, 2014	94	190	*151*	*266*	*64*	*280*

Source: Haver

2. **Although small relative to 2009–12 levels, the recent inflows indicate Switzerland's particular vulnerability to major shifts in global risk sentiment.** The franc has appreciated against other safe haven currencies since end-2013. At the same time, Switzerland has received the largest of global mutual fund inflows as a percent of GDP. A materially stronger franc would threaten to push down Swiss inflation, already close to zero and the lowest among peers. The fact that Swiss long-term yields have again sunk below

Global Mutual Fund Inflows Since end-2013
(Cumulative, percent of projected 2014 GDP)



Source: EPFR Global.

[1] Prepared by S. Ali Abbas and Yingbin Xiao (EUR), Keiko Honjo and Dirk Muir (RES).

1 percent, means even less space for (conventional) monetary accommodation to guard against deflation/recession risks.

3. **Simulations from staff's G20MOD[2] illustrate that absent an exchange rate floor Switzerland could slip into deflation/recession in an adverse global scenario.** The simulations consider a scenario of disorderly unwinding of UMP, coupled with geo-political tensions in Europe, resulting in a 100 basis point increase in the sovereign risk premia of stressed euro area economies and EMs over 2014–17. The associated safe haven inflows appreciate the franc by an average of 5 percent against the euro (and in real effective terms) during 2014–15, unwinding by 2018. With the policy rate bound at zero, the simulations show Swiss inflation falling below zero in 2014–15 and output losses peaking at 1.6 percent in 2015 (relative to staff baseline). The Swiss outcomes turn out to be worse than for the euro area and the United States, as those two areas avoid deflation. These results help underscore the pivotal role of the exchange rate floor in the Swiss monetary framework, as a necessary buffer against another major currency appreciation-deflation-recession cycle.

G20MOD Simulations Results for Scenario with EM/EA Stress and Safe Haven Inflows into Switzerland Under a Fully Flexible Exchange Rate

	Real GDP (percent deviation from baseline)			Headline inflation (percent point deviation from baseline)			*Memo:* Swiss REER (percent deviation from baseline)
	Switzerland	Euro Area	United States	Switzerland	Euro Area	United States	
2014	-0.60	-0.13	-0.03	-0.48	-0.10	-0.02	4.96
2015	-1.51	-0.80	-0.16	-0.60	-0.40	-0.10	5.61
2016	-1.60	-1.12	-0.09	-0.43	-0.52	-0.08	3.43
2017	-1.04	-0.99	0.01	-0.32	-0.53	0.00	1.18
2018	-0.11	-0.64	0.05	-0.05	-0.45	0.05	-2.25

Source: Staff estimates based on the G20MOD of the IMF Research Department.

[2] G20MOD is a module of the IMF's Flexible System of Global Models (FSGM).

Annex 2. A New Approach to Immigration?[1]

1. **A recent popular initiative, approved by a narrow majority through a referendum, calls for new restrictions on immigration.** The vote reflected public concerns about the pressure placed by high rates of immigration on transport, infrastructure, the housing market, education services, and local employment.

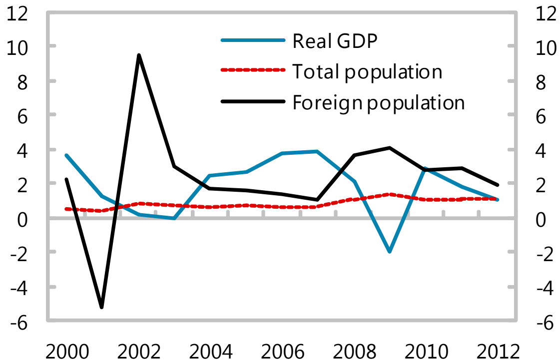
2. **Switzerland has experienced a new immigration wave since the enactment of the Free Movement of Persons Treaty (FMP) with the EU/EFTA in June 2002 gradually led to the full liberalization of immigration from these countries.** During 2002–12, total population growth was 0.94 percent per year and net immigration contributed 0.88 percentage points to the total. The share of foreign born inhabitants in total population increased from 20 percent in 2001 to 25 percent in 2012, one of the highest among OECD countries. The share of foreign born in the labor force was 29 percent in 2012. In 2002–12, EU citizens accounted for 60 percent of net immigration, while there was virtually no net immigration from the EU in the previous decade, with Germany the most represented country. About a third of the foreign-born population is highly educated, a higher proportion than the native population.

3. **The recent popular vote creates uncertainty to medium-term economic prospects. Highly skilled immigrant workers are important for sectors such as finance, pharmaceuticals, and health care, while lower-skilled ones play an important role in construction.** Immigration restrictions may hamper recruitment, which may in turn affect investment and location decisions by firms. In addition, slower immigration would cause old-age dependency to rise, with adverse effects on the social security funds. Lower long-term growth would also lead to less favorable public debt dynamics. A recent OECD study assesses the fiscal benefits of immigration in Switzerland at about 2 percent of GDP, among the highest in the OECD countries.

4. **Finally, the FMP is part of a bundle of seven bilateral agreements with the EU covering free movement of goods and services as well as agriculture and public procurement.** These treaties may be called into questions by the EU and may need to be renegotiated, creating uncertainty for a numbers of economic activities.

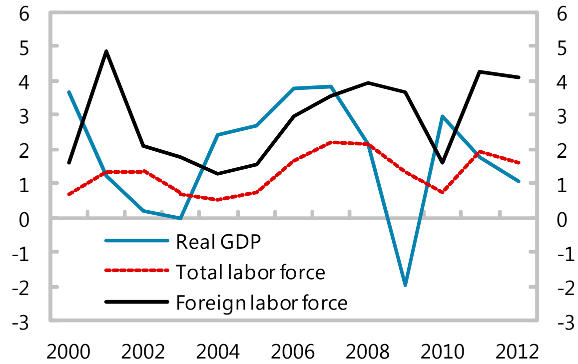
[1] Prepared by Yingbin Xiao and S. Ali Abbas.

Real GDP Growth and Population Growth
(Percent change)



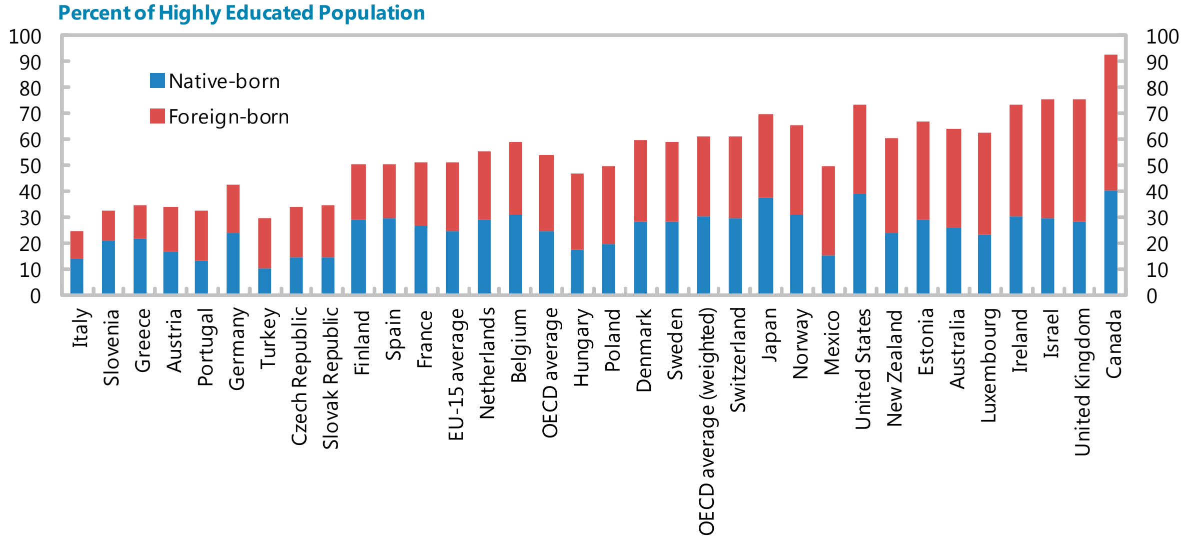
Sources: Eurostat; and Haver Analytics.

Real GDP Growth and Labor Force Growth
(Percent change)



Source: Haver Analytics.

Percent of Highly Educated Population



Sources: US Current Population Survey; other non-European countries, Finland and the United Kingdom: Database on Immigrants in OECD Countries (DIOC) 2005-06; other European countries: European Union Labour Force Survey (Eurostat).

INTERNATIONAL MONETARY FUND

SWITZERLAND

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 15, 2014

Prepared By | **European Department**

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FUND RELATIONS

(Data as of February 28, 2014)

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 October 04, 2013, 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	3,206.67	97.72
Reserve position in Fund	251.83	7.28
New arrangement to borrow	1,383.37	

SDR Department

	SDR Millions	Percent Allocation
Net cumulative allocations	3,288.04	100.00
Holdings	3,132.77	95.28

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund[1]:

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.16	0.20	0.20	0.20	0.20
Total	0.16	0.20	0.20	0.20	0.20

[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 2013, the SNB' commitment to defending the minimum exchange rate remained unchanged. After a short period of volatility, the Swiss franc has followed an appreciating trend within a 2 percent band against the euro since end-May, 2013. Therefore, the de facto exchange rate has been reclassified to a crawl-like arrangement from other managed, effective May 29, 2013.

Technical Assistance: None

Resident Representatives: None

Other: FSAP Update, December 2013

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). The Swiss Federal Council has come out in favor of Switzerland participating in the IMF's new, extended statistical standard SDDS Plus. Implementing the requirements of SDDS Plus in Switzerland—a task in which an interagency working group(SIF, SNB, FSO, FFA, FSIO, SECO, and FINMA) is to play an active role—will take several years. 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. Progress has been made in the area of balance of payments (BOP) statistics. In 2013, the content-related revision of surveys in connection with financial flows (investment BOP) was completed. Reporting institutions will submit data according to the new concept for the first time for 2014 Q3. The new surveys aim, among other things, to meet the requirements of the bilateral statistical agreement between Switzerland and the EU. This means in particular that more details on the breakdown of financial flows by country will be collected. To date, the presentation of Switzerland's BOP has been based on the fifth edition of the IMF's Balance of Payments Manual (BPM5). In 2013, preparatory work was undertaken to place the publication of the BOP on the methodological basis of the sixth edition (BPM6) as of 2014 Q1. The SNB will reclassify the old data series in line with BPM6 when publishing the BOP data for 2014 Q1, in order to ensure that new and old data are comparable and that long data series are available.

3. 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. In addition, reporting banks submitted data for the revised locational banking statistics and consolidated banking statistics surveys for the first time in 2013. Both surveys are conducted in collaboration with the BIS. Also in 2013, the SNB began to transmit FSB Data Gaps Initiative related data to the central data hub specially set up for this initiative and hosted by the BIS. In the field of statistics on cashless payment transactions, the various surveys are currently being thoroughly revised. The prime aim of the revision is to enable a full reflection of the technological innovations of the past few years in the area of cashless payment transactions. Reporting institutions are obliged to submit the revised surveys for the first time as of December 31, 2014 (reference date).

4. The FSO has taken various steps in 2013 to improve core business statistics. In November 2013, new business census results were published for the first time since 2008, based mainly on administrative data. As expected, the new approach led to a significant extension of the statistical universe and enabled the FSO to take into account small business units which were below the thresholds in the census in the past. The FSO also initiated the revision of the job statistics in order to integrate the new universe in the survey. The FSO plans to publish results according to the 2008 version of the System of National Accounts (SNA 2008) in September 2014. The timeliness of dissemination of national accounts data will improve sequentially and data on the sequence of accounts should be disseminated at t+10 beginning in 2016.

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)

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No.14/XX
FOR IMMEDIATE RELEASE
May XX, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Switzerland

On April 30, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Switzerland as well as the country's 2014 Financial System Stability Assessment (FSSA).

The growth of the Swiss economy has gathered pace, but inflation nevertheless remains close to zero. The recovery is expected to continue and inflation should rise gradually while the output gap will progressively close. The fiscal position is healthy, with a broadly neutral stance projected for 2014, and government debt is low.

There has been no new foreign exchange intervention to support the exchange rate floor, but past safe haven inflows have not yet reversed and the balance sheet of the Swiss National Bank (SNB) remains large. Despite improved market confidence toward the euro area and tapering in the United States, the exchange rate has remained close to the floor. For 2013, the SNB reported a large valuation loss on gold holdings, triggering the first suspension of profit transfers to the Confederation and cantons in recent memory.

Expansionary monetary policy and ample liquidity have contributed to push real estate prices and mortgage debt to historic heights, with prices of owner occupied apartments rising by 6 percent per year on average since 2008. Mortgage lending has grown by about 5 percent per year since 2009, and mortgage debt recently reached an all-time high of over 140 percent of GDP. The authorities have taken several measures to contain risks, including raising the countercyclical capital buffer and adopting prudential measures to tighten lending standards and conditions.

The financial sector has continued to restructure to adapt to the more stringent regulatory environment. The 2014 FSAP Update finds that the position of the financial sector has

[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.

improved markedly since the Global Financial Crisis, but gaps remain in the regulatory framework, prudential oversight, and safety net.

The current economic model faces some medium-term challenges. International initiatives to address tax evasion and money laundering are eroding bank secrecy. The tax treatment of corporate income on foreign activities is coming under international scrutiny. A recent popular vote approved curbs on immigration, which has been an important contributing factor to the acceleration in Swiss economic growth in the 2000s.

Executive Board Assessment[2]

Executive Directors noted that the Swiss economy has regained momentum and growth is healthy, but monetary and exchange rate conditions have not yet normalized, and risks relating to deflation, the domestic housing market, and spillovers from external developments remain. In the medium term, some aspects of the current economic model might be challenged.

Directors noted that domestic macroeconomic conditions do not call for a monetary tightening yet and that the risk of a resumption of safe haven inflows remains considerable. They generally agreed that the exchange rate floor remains necessary to guard against deflationary risks. Directors underscored that an appropriate strategy going forward should seek to keep inflation expectations well anchored while avoiding an excessive tightening of monetary conditions. When conditions permit, a return to a flexible exchange rate would be desirable.

While recognizing the need for caution in calibrating unconventional policy instruments, Directors recommended contemplating alternative measures. In particular they encouraged the authorities to consider introducing negative interest rates on excess bank reserves in case of deflationary pressures resulting from appreciation. However, it would be important to carefully monitor their economic impact and reinforce macroprudential measures as needed. In an upside scenario, the authorities should also gradually reduce their holdings of foreign exchange reserves. More broadly, Directors noted that the Swiss National Bank's (SNB) balance sheet would likely remain extended for a prolonged period, and encouraged the authorities to step up SNB's provisions.

Directors welcomed the steps taken to contain risks in the mortgage and real estate markets, including the increase in counter-cyclical capital buffers. They advised the authorities to continue to monitor price developments in the housing sector, and to lay the groundwork for stronger policy actions to curb the demand for mortgages, potentially including tax reforms, and direct regulatory measures targeting affordability and loan-to-value ratios.

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[2] 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.

Directors welcomed the implementation of considerable regulatory reforms. Noting remaining gaps, they encouraged the authorities to follow up on the FSAP update recommendations. In particular, they advised the authorities to encourage the large banks to achieve leverage ratios tighter than international standards. Directors also underscored the need to reach cooperation agreements with key foreign supervisors to make the large banks resolvable. They generally called for reforms to the deposit insurance system, including to make it more transparent and universal across all banks. In general, they also considered it important to increase resources for prudential bank supervision, provide closer oversight and guidance to auditors performing supervisory audits, and seek to improve the governance of the cantonal banks.

In light of the recent popular vote, Directors agreed that a rapid resolution of uncertainty related to future immigration policy will be important to support economic recovery. They welcomed the new legislative pension reform proposal as well as plans to reform aspects of the corporate income tax. On the latter, Directors encouraged putting in place a new regime taking into account international efforts to counter base erosion and profit shifting.

Switzerland: Selected Economic Indicators, 2010–15

	2010	2011	2012	2013	2014	2015
				Projections		
Real GDP (percent change)	3.0	1.8	1.0	2.0	2.1	2.2
Total domestic demand	2.7	1.8	1.2	1.8	1.7	1.6
Final domestic demand	2.2	1.9	1.9	2.2	2.1	1.9
Private consumption	1.7	1.1	2.4	2.3	1.8	1.8
Public consumption	0.2	1.2	3.2	3.0	1.7	0.9
Gross fixed investment	4.8	4.6	-0.3	1.7	3.0	2.7
Inventory accumulation 1/	0.5	-0.1	-0.6	-0.4	-0.4	-0.3
Foreign balance 1/	0.5	0.2	0.0	0.4	0.6	0.8
Nominal GDP (billions of Swiss francs)	572.7	585.1	591.9	603.2	621.7	641.3
Savings and investment (percent of GDP)						
Gross national saving	35.0	30.2	30.6	30.7	31.2	31.3
Gross domestic investment	20.3	21.3	21.0	21.1	21.3	21.5
Current account balance	14.8	9.0	9.6	9.6	9.9	9.8
Prices and incomes (percent change)						
GDP deflator	0.3	0.4	0.1	0.0	0.9	0.9
Consumer price index	0.7	0.2	-0.7	-0.2	0.2	0.5
Nominal wage growth	0.8	1.0	0.8	0.7	0.8	1.0
Unit labor costs (total economy)	-2.3	2.1	1.5	-0.3	-0.3	0.1
Employment and slack measures						
Unemployment rate (in percent)	3.5	2.8	2.9	3.2	3.2	3.0
Output gap (in percent of potential)	-0.5	-0.4	-1.2	-1.0	-0.7	-0.2
Capacity utilization	81.1	84.3	81.5	80.8	…	…
Potential output growth	1.6	1.7	1.8	1.8	1.8	1.8
General government finances (percent of GDP)						
Revenue	32.9	33.5	33.1	33.3	32.8	33.0
Expenditure	32.8	33.2	33.2	33.3	33.0	32.6
Balance	0.1	0.3	0.0	0.0	-0.2	0.4
Cyclically adjusted ordinary balance	0.3	0.5	0.4	0.4	0.1	0.5
Gross debt 2/	48.5	49.1	50.1	49.4	48.1	47.3
Monetary and credit (percent change, averages)						
Broad money (M3)	6.4	6.9	8.0	9.7	…	…
Domestic credit, non-financial	2.1	3.7	5.3	3.9	…	…
Three-month SFr LIBOR	0.2	0.1	0.1	0.0	…	…
Yield on government bonds (7-year)	1.3	1.2	0.4	0.6	…	…
Exchange rates (levels)						
Swiss francs per U.S. dollar (annual average)	1.0	0.9	0.9	0.9	…	…
Swiss francs per euro (annual average)	1.4	1.2	1.2	1.2	…	…
Nominal effective rate (avg., 2005=100)	128.0	137.7	137.8	140.1	…	…
Real effective rate (avg., 2005=100) 3/	110.1	114.2	111.6	112.0	…	…

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

1/ Contribution to growth.

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

3/ Based on relative consumer prices.

Statement by Daniel Heller, Executive Director of Switzerland, and Jérôme Duperrut, Senior Advisor to the Executive Director
April 30, 2014

General

On behalf of the Swiss authorities, we would like to thank staff for their reports, which provide a thorough analysis of macroeconomic developments and the financial sector. In many aspects, we share staff's views on the challenges going forward. We would like to extend our appreciation to staff for their policy recommendations, which add significant value to policy discussions in Switzerland. While many of these recommendations are in line with policies that are already being implemented in Switzerland, others, in particular those linked to the FSSA, deviate to a varying extent from the views of our authorities.

Outlook

The Fund's outlook for the Swiss economy is broadly in line with our authorities' forecasts. The Swiss economy continued to grow robustly in 2013. This growth was mainly driven by domestic sectors such as construction, investment and household consumption. High immigration and low interest rates were the key factors for the strong domestic demand. The export sector, which previously suffered from a weak external environment, is showing signs of recovery. Our slightly higher forecast for growth in 2015 is close to staff's and reflects the considerable uncertainties around future external developments. We also share staff's assessment of the risks faced by the Swiss economy, especially those associated with the imbalances in the housing and mortgage markets.

Monetary and exchange rate policy

The SNB fully shares staff's view that monetary conditions need to remain expansionary and that the exchange rate floor needs to remain in place. Even though the SNB has not had to buy foreign currency to enforce the floor for more than a year, the floor remains necessary to avoid an undesirable tightening of monetary conditions. The Swiss franc continues to be overvalued, the policy rate (3M-Libor) is at the zero lower bound, and inflation – having been negative for two years – is just returning to zero. Renewed exchange rate appreciation due to safe haven inflows would quickly bring back deflationary pressures. The SNB also concurs with staff that in such a scenario, negative interest rates on bank excess reserves would be an option.

As the SNB has stressed several times, if necessary, it is prepared to buy foreign currency in unlimited quantities in order to enforce the minimum exchange rate. This takes precedence over any other considerations regarding the accumulation and investment of its foreign exchange reserves. The SNB currently has no plans to unwind or limit its foreign exchange reserve accumulation. While staff refers to the risks arising from the large balance sheet of the SNB, the SNB has stepped up provisioning to strengthen its balance sheet, as also noted by staff.

Fiscal policy

Overall, fiscal policy remains on solid ground in Switzerland. The general government is expected to record a small budget surplus in 2013 (0.3 percent of GDP), as the small deficit of the Confederation and the sub-central entities is compensated for by a surplus in the social security funds. In 2014, the general government balance is expected to turn slightly negative (-0.2 percent of GDP), mainly due to a lack of profit distributions from the SNB and further one-off restructuring contributions towards cantonal pension funds. However, fiscal indicators are expected to improve considerably in the years thereafter, with general government recording solid surpluses. Accordingly, the general government debt should fall further to 44 percent of GDP in 2017.

Financial sector policies

We welcome staff's positive assessment of financial system stability and the observance of standards and codes in Switzerland. We appreciate staff's recognition of Switzerland's considerable progress in implementing the 2007 FSAP recommendations, the timely adoption of the Basel III framework, the swift introduction of measures addressing the too-big-to-fail problem, stricter liquidity requirements, a countercyclical capital buffer and focused measures addressing a potential overheating in the Swiss residential real estate market. We also take good note of the high overall compliance with the Basel Core Principles (BCPs) and Insurance Core Principles (ICPs). The positive results of the stress testing exercises confirm the resilience of the Swiss financial sector. Moreover, we appreciate that staff acknowledge the progress Switzerland has made in addressing the recommendations from the last IOSCO assessment and support the current reforms in the area of securities regulation. This being said, we would like to comment in greater detail on some important aspects of the key FSAP recommendations.

FINMA's supervisory effectiveness and resources
We welcome staff's recognition of the strength of the Swiss supervisory approach including the institutional setup of the Swiss Financial Market Supervisory Authority (FINMA) as an integrated supervisory authority. We also appreciate staff's conclusion that employing external resources from audit firms is a reasonable and valid supervisory approach, in particular given the global operations of large Swiss banks and the limited availability of highly-specialized supervision experts in Switzerland. It is further acknowledged by staff that FINMA has successfully put in place important enhancements to its own supervisory processes and practices, especially with regard to big banks. Finally, we value staff's

assessment regarding the appropriateness, also in terms of resources, of Swiss G-SIB home-supervision.

Effective supervision carried out by FINMA has contributed to the increased robustness and resilience of the Swiss financial sector, as recognized by staff. We are not of the opinion that there are "significant weaknesses in supervision". We would like to remind that since 2008 no important Swiss bank has had difficulties, multiple institutions have left the market without affecting creditors or clients, and the Swiss deposit insurance has not dispensed funds over this period. We do not believe that staff's recommendation to improve the process towards mandating external audit firms is a sufficient justification to conclude that there are significant weaknesses in supervison, in particular given the assessors' general acknowledgement of this supervisory approach. We also would like to stress that the wording "significant weaknesses" is not consistent with staff's careful and more constructive assessment in the Report on the Observance of Standards and Codes on the same issue.

Our authorities think that FINMA resources are appropriate to fulfill its mandate. They remain of the opinion that staff's assessment grade for the relevant BCP is not justified, especially as staff came to the conclusion that this issue is only valid for a very limited area - the supervision of small and medium sized banks. With BCP 2 primarily geared towards the process of obtaining and allocating resources in order to avoid political pressure which could undermine supervisory independence, our authorities' views is that FINMA's budgetary independence is clearly anchored in the law, as acknowledged in the FSSA. FINMA's current level of resources can thus be adjusted flexibly. Furthermore, the narrow focus on FINMA's internal resources available for bank supervision completely omits the important contribution of external audit firms to successful supervision. Accounting for these firms, Switzerland's resources allocated to bank supervision are well within the range of comparable jurisdictions.

Capital requirements and leverage ratio on banks

Switzerland has introduced a leverage ratio for large banks in addition to risk-weighted capital requirements well ahead of the envisaged Basel standard and a comprehensive "too-big-to-fail" (TBTF) regime which is explicitly based on parallel requirements, including capital, leverage, liquidity and resolution measures. Our authorities therefore disagree with staff's statement that "early focus on regulatory bank capital has not been matched by equal focus on other measures of bank strength, particularly the leverage ratio". However, we agree with staff's view that the two large Swiss banks need to further improve their leverage ratios.

Mortgage and housing markets

Our authorities are well aware of the risks associated with developments in the mortgage and housing markets. In order to address these risks, measures have already been taken in 2012 and 2013. These measures include (i) the activation of the countercyclical capital buffer with a focus on residential property mortgages, (ii) prudential measures taken by FINMA, (iii) a revision of self-regulation guidelines for mortgage lending, and (iv) the Federal Council's decision to increase the countercyclical capital buffer requirements, effective in June 2014. Our authorities will continue to monitor developments in the mortgage and housing markets closely, and will reassess the need for an adjustment to the CCB on a regular basis. Moreover, given the potential overheating of the Swiss mortgage market, discussions are currently taking place about the design and implementation of further measures directly targeting the banks' risk-taking.

Resolution regime and use of deposit insurance funds
The current Swiss TBTF-regime does not include an ex-ante funded resolution scheme. This reflects a deliberate policy decision to avoid wrong incentives and moral hazard. Instead, Swiss banks are required to issue a minimum amount of contingent convertible debt which is the functional equivalent of an internalized, institution-specific resolution fund. Our authorities are not convinced by staff's key recommendation to make deposit insurance funds available to finance resolution measures.

Swiss Solvency Test for insurers
Our authorities appreciate the support expressed by staff for various areas of improvement in the regulation and supervision of insurers, including with regard to group supervision and the Swiss Solvency Test (SST). The latter was introduced in 2010 and is a fully risk-based, market consistent solvency regime for insurers, considerably ahead of other comparable international instruments. Since staff raised certain concerns regarding the SST adjustments permitted in 2013 to accommodate the persistent low interest environment and the late introduction of the Solvency II framework in the European Union, it is important to note that these measures are transparent, temporary (they are due to expire at the end of 2015), carefully designed and targeted to avoid wrong incentives, and apply only to existing business. Further, they are intended for and have been used primarily by life insurers who have been hit the most from the low interest rate environment and an uneven international playing field.

Financial Markets Infrastructure regulation
Full implementation of the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMIs) by the systemically important financial market infrastructures in Switzerland is a top priority for our authorities. Substantial progress has been achieved and financial market infrastructures are expected to be compliant with most requirements by Summer 2014. The staff highlights some of the challenges in implementing the PFMIs, including an environment focused on efficiency and subject to competition. It should be noted that the situation in Switzerland is similar to many other countries with regard to these challenges.