INTERNATIONAL MONETARY FUND

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SWITZERLAND

May 2015

2015 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 2015 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 May 18, 2015, following discussions that ended on March 23, 2015, 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 May 4, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 18, 2015 consideration of the staff report that concluded the Article IV consultation with Switzerland.
- A **Statement by the Executive Director** for Switzerland.

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

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INTERNATIONAL MONETARY FUND

SWITZERLAND

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

May 4, 2015

KEY ISSUES

Switzerland has once again had to contend with capital flow volatility. Following the exit from the exchange rate floor in mid-January 2015 and the subsequent appreciation of the franc, the Swiss economy faces exchange rate overvaluation, slower near-term growth, and deflation. Both growth and inflation are expected to recover gradually over the medium term—to around 2 percent and 1 percent, respectively—as the economy adjusts to the shock. However, this relatively benign scenario is subject to important risks, most notably that operating in a low inflation environment may prove more difficult than assumed in the central scenario.

Monetary and fiscal policies can support faster adjustment and reduce risks. Further monetary easing via purchases of (mainly foreign) assets would help limit the near-term growth slowdown, reduce risks related to low inflation, and lessen franc overvaluation. Central bank communication should also be geared toward building an understanding of policy objectives and ensuring that inflation expectations do not become entrenched at low levels. Scope for fiscal policy to support aggregate demand is limited by Switzerland's fiscal rule and the small, open nature of Switzerland's economy. That said, fiscal policy can still support recovery by allowing automatic stabilizers to operate freely, as allowed under the rule. The rule's escape clause should be triggered in the event of a severe downturn to allow discretionary fiscal stimulus, as monetary policy would likely be overburdened in such a scenario.

The financial sector reform agenda should also be completed. The Swiss authorities have made important progress in this regard, and further steps are planned. Specific priorities, as laid out in last year's Financial Sector Assessment Program (FSAP) update, include raising the leverage ratios of the two large international banks, increasing public disclosure of information on risk weights, reforming FINMA's use of external auditors, overhauling deposit insurance, and containing housing- and mortgage-related risks.

Over the medium term, Switzerland faces a number of structural challenges; the authorities' ongoing efforts to address them are welcome and should continue. Priorities include adopting proposed pension reforms to ensure the sustainability of the system for future generations; completing ongoing reforms of corporate taxation and financial controls in ways that ensure full compliance with international initiatives aimed at limiting money laundering and cross-border tax evasion and avoidance; and reducing uncertainties related to future immigration policies and relations with the European Union.

Approved By
Mahmood Pradhan and Mary Goodman

Discussions took place in Bern and Zurich on March 13–23. The staff team comprised Messrs. Fletcher (head), Ishi, Mrkaic (all EUR), and Lundback (MCM). Ms. Denis and Ms. Jung (both EUR) supported the mission from headquarters. Messrs. Heller and Cavaliere (OED) participated in the discussions.

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MACROECONOMIC CONTEXT

Switzerland has once again had to contend with capital flow volatility. Following the exit from the exchange rate floor and the subsequent appreciation of the franc, the Swiss economy faces exchange rate overvaluation, slower near-term growth, and deflation. Both growth and inflation are expected to recover gradually over the medium term, to around 2 percent and 1 percent, respectively. However, this relatively benign scenario is subject to important risks, most notably that operating in a low inflation environment may prove more difficult than assumed in the central scenario.

A. Recent Developments

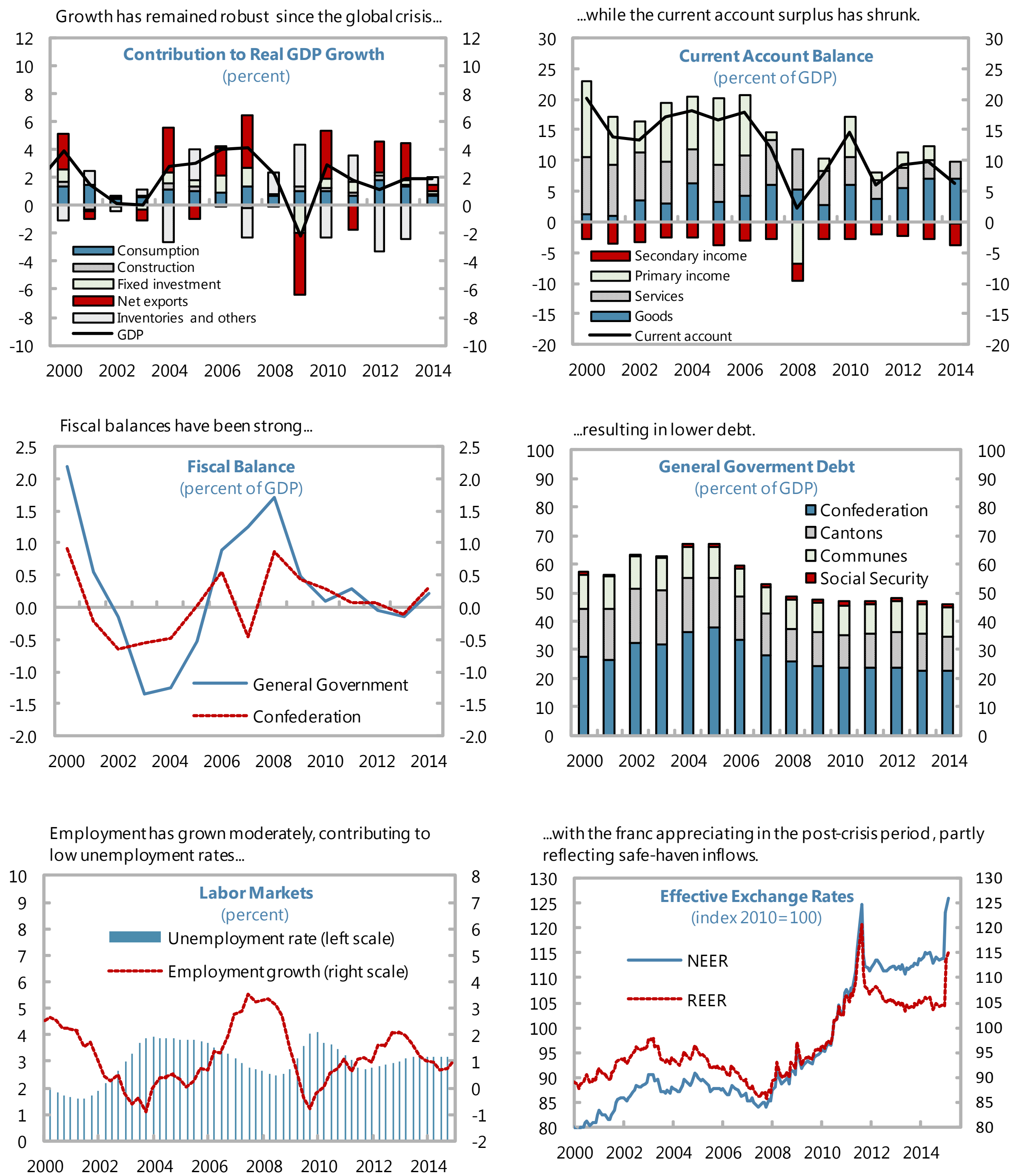
1. **The Swiss economy grew steadily in 2014**. Output expanded by 2.0 percent, driven by strong external demand and private consumption (Table 1, Figures 1–2). Solid growth narrowed the output gap to around -0.3 percent, with capacity utilization nearing its historic average. The unemployment rate stabilized at 3.2 percent.

2. **In 2015, the outlook shifted following the exit from the exchange rate floor**.

- The floor of 1.2 francs per euro, which had been in place since 2011, faced little pressure for most of 2013–14. However, in late 2014 the Swiss National Bank (SNB) started intervening heavily to defend the floor in response to increased capital inflows arising from a combination of events, including anticipation of the European Central Bank's quantitative easing program and geopolitical turmoil in Europe. In response, in December 2014 the SNB announced a cut in the interest rate on SNB deposits from zero to -0.25 percent (effective January 22, 2015), but significant interventions were still required to maintain the exchange rate floor.
- At the same time, the franc's depreciation against the dollar since mid-2014 had reduced the likelihood of franc overvaluation, raising risks that further intervention would ultimately result in losses on the SNB's balance sheet, which was approaching 90 percent of GDP. In addition, the SNB was concerned that, once the magnitude of its interventions became public, speculation about exit from the floor would mount, fueling a vicious cycle of rising inflows and a rapidly growing balance sheet.
- In this context, the SNB decided that the costs of maintaining the floor were no longer worth its benefits. The SNB thus exited from the floor on January 15, 2015. It also announced a cut in its effective policy rate from -0.25 percent to -0.75 percent (effective January 22, 2015). The policy rate applies on deposits at the SNB that exceed a high threshold (for domestic banks, the threshold is 20 times a bank's required reserves as of the reporting period ending November 19, 2014; minus (plus) any increase (decrease) in cash held). In this way, the effect of negative interest rates on bank profits is limited, while still creating incentives at the margin for agents to shift out of franc deposits and thereby depreciate the franc.
- Following significant intervention (purchases of roughly CHF 40 billion,[1] or 6 percent of GDP) during the subsequent two weeks, the franc has since hovered between 1.00 and 1.10 per euro, with limited intervention since end-January.

[1] Staff estimate based on weekly changes in SNB sight deposits.

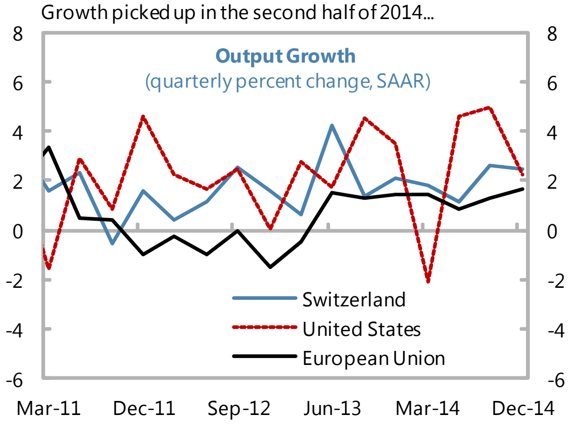
Figure 1. Switzerland: The Long View, 2000–15



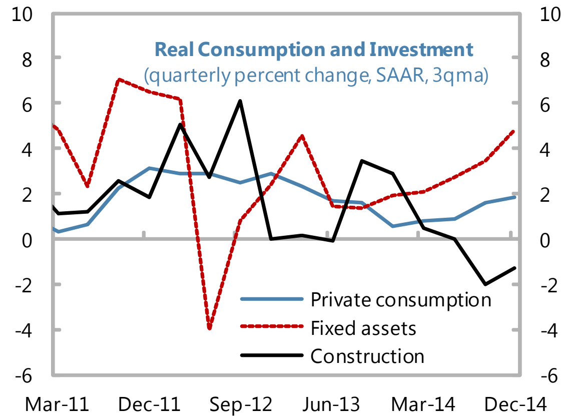
Sources: Haver Analytics; Information Notice System; State Secretariat for Economic Affairs; and Swiss National Bank.

Figure 2. Switzerland: Recent Economic Developments, 2011–14

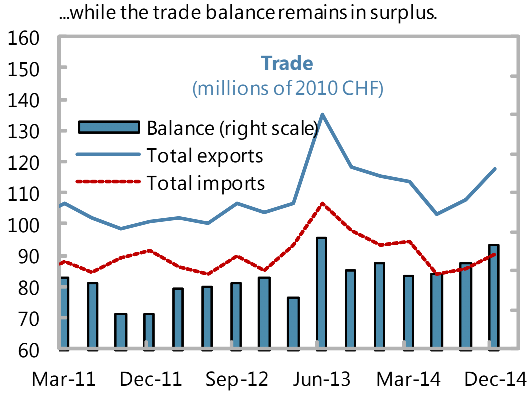
Growth picked up in the second half of 2014...



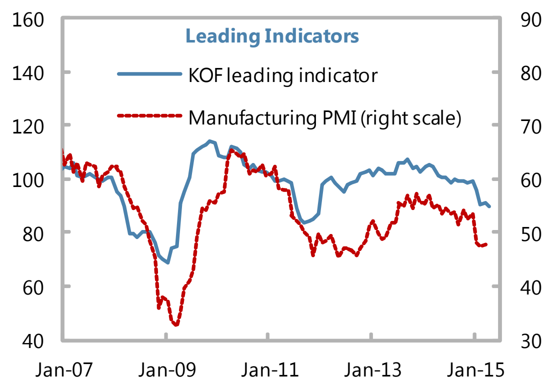
...mainly driven by consumption and investment in fixed assets...



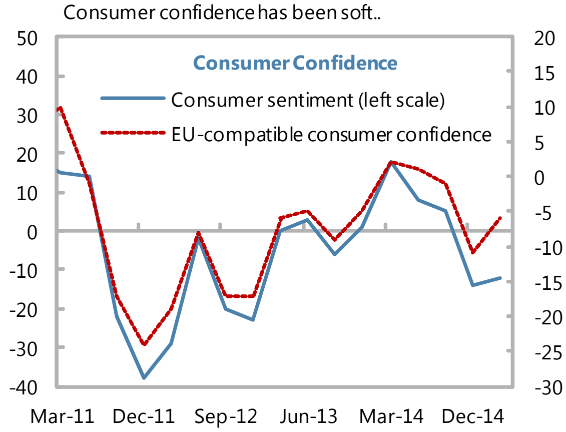
...while the trade balance remains in surplus.



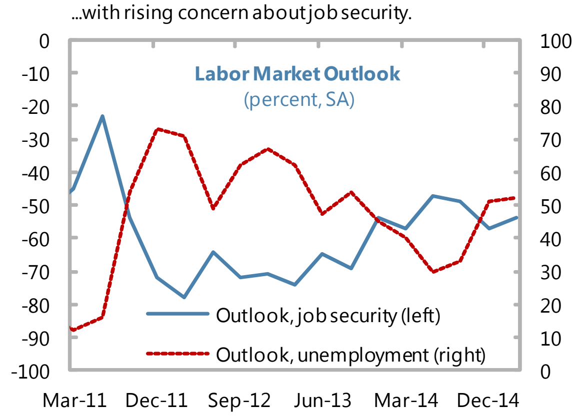
High-frequency indicators show weakening activity following the franc's appreciation.



Consumer confidence has been soft..



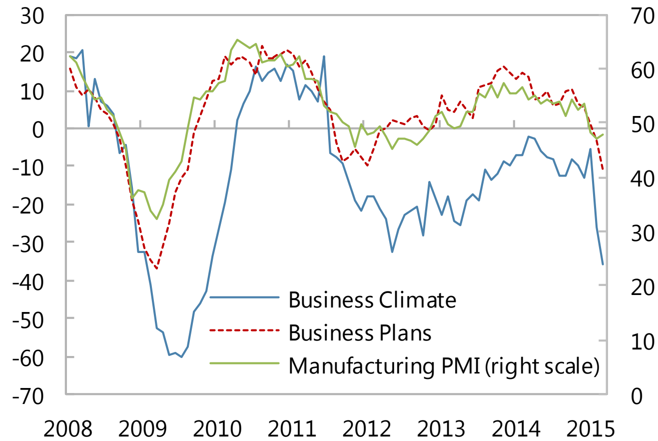
...with rising concern about job security.



Sources: Haver Analytics; Swiss Federal Statistical Office; Swiss Institute for Business Cycle Research; and Swiss National Bank.

3. **Following the appreciation, near-term growth indicators have weakened**. After exhibiting modest growth during 2012–14, KOF survey indexes of the current and future business climate have declined sharply following the exit from the exchange rate floor, as has manufacturing PMI. The current climate index has sunk to its lowest level since the 2009 recession.

Switzerland: KOF Business Survey Indices

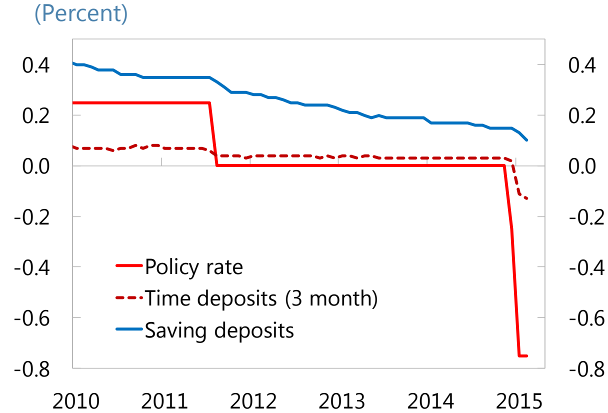


Source: Haver Analytics.

4. **Inflation has fallen deeper into negative territory**. The strong franc, together with lower oil prices, drove headline CPI inflation down to -0.9 percent in March 2015, with positive inflation for domestically produced goods (0.3 percent) being more than offset by sharply negative inflation for foreign goods (-4.3 percent). Measures of underlying inflationary pressures were similarly contained at end-March—core inflation was -0.2 percent, and unit labor cost growth remained muted near zero (Figure 3).

5. **The initial effects from negative interest rates and the exit from the exchange rate floor on the financial sector appear to have been fairly limited**. The stock market and stock prices for major banks have returned to levels similar to those before the immediate sharp drop following the exchange rate floor exit (Figures 4-5). Similarly, CDS spreads for the major banks have not moved much. However, it is too early to clearly see what the full effects will be. The large global banks foresee some fairly small negative effects, but are taking measures to adjust; some business segments will also benefit due to the increased FX market activity. The effect of negative interest rates on banks' profits is mitigated by the fact that (i) the rate applies only on deposits at the SNB over a high threshold (20 times reserves) and (ii) banks are passing on the negative rates to wholesale depositors. However, these effects vary across banks, such that some specific smaller banks may be more adversely affected.

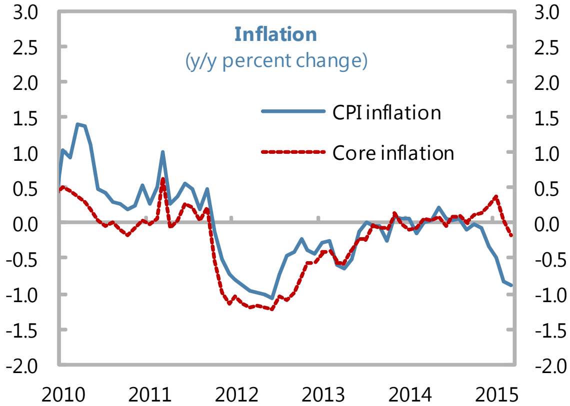
Switzerland: Retail Deposit Interest Rates
(Percent)



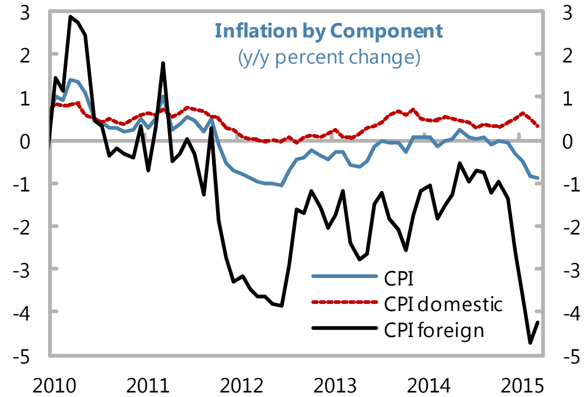
Source: Swiss National Bank.

Figure 3. Switzerland: Selected Monetary Indicators, 2010–14

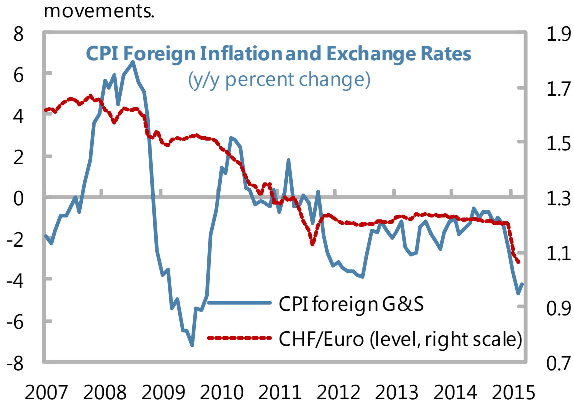
Inflation is falling sharply...



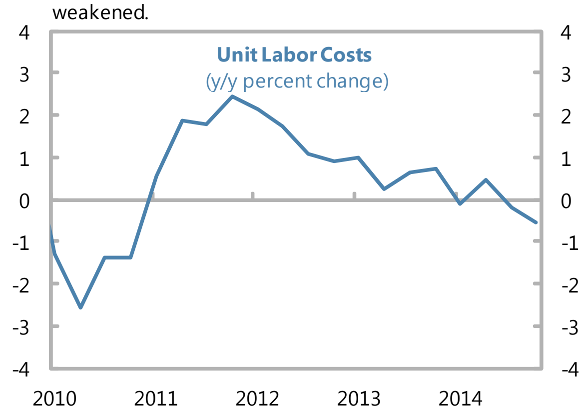
...as falling foreign CPI continues to put downward pressures on overall CPI.



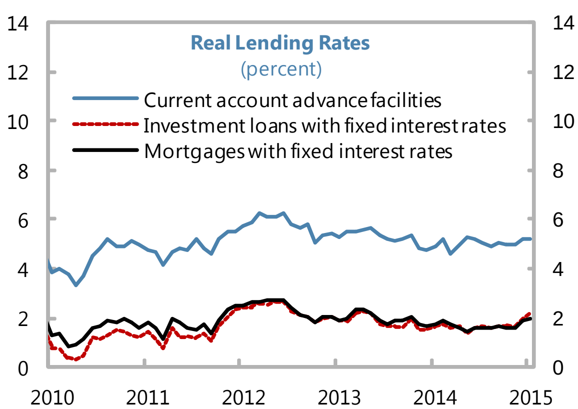
Foreign CPI has fallen along with exchange rate movements.



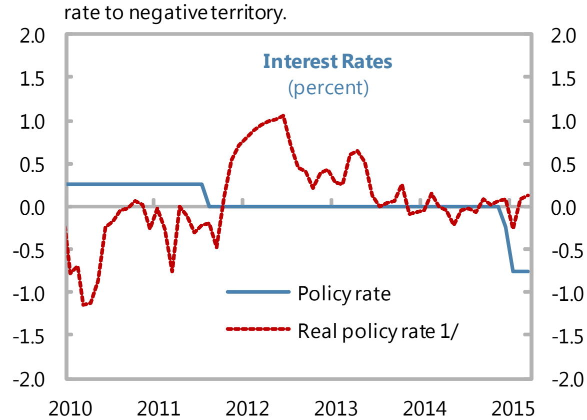
Meanwhile, domestic inflationary pressures have also weakened.



Real lending rates have edged up due to lower inflation.

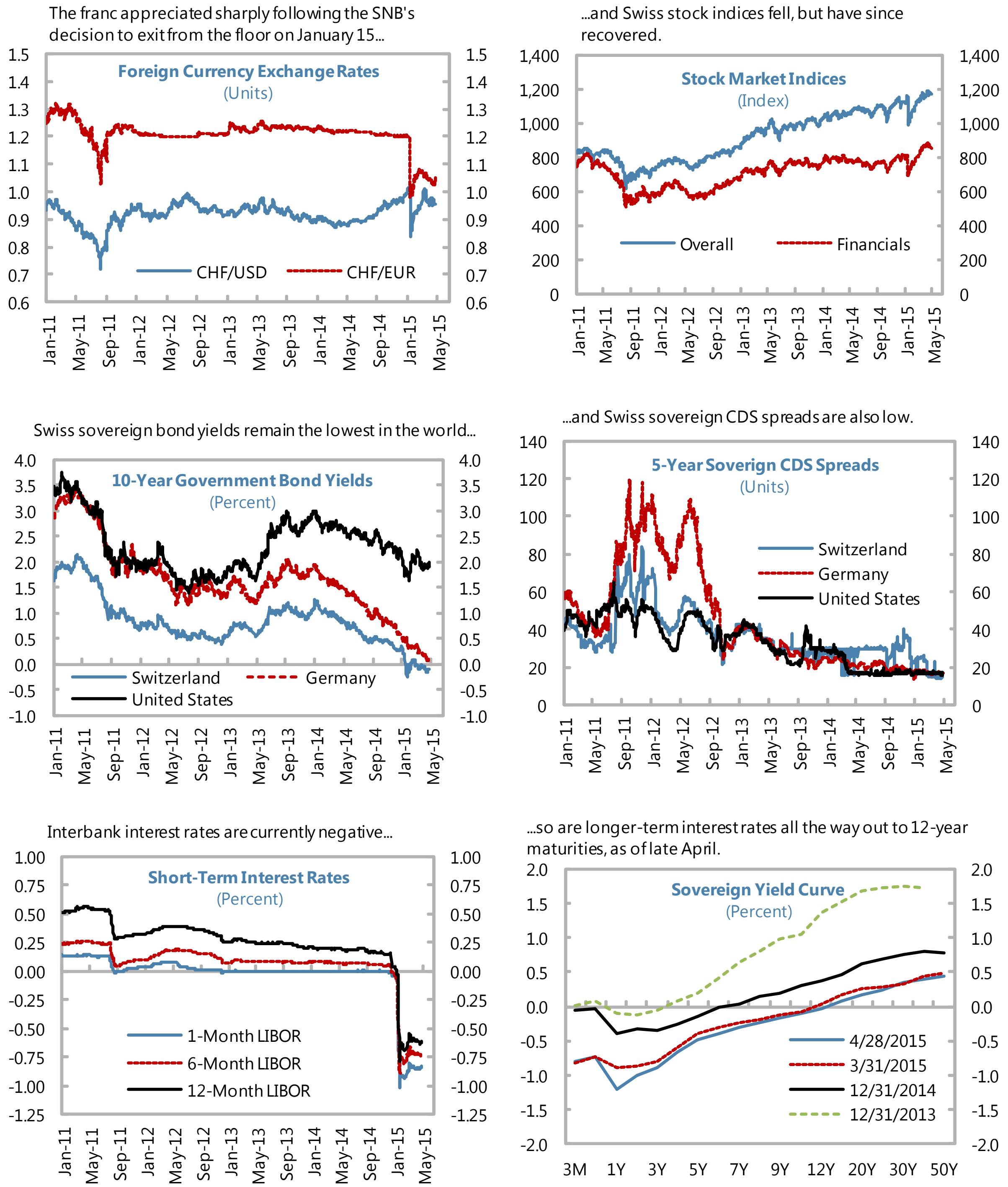


Against this backdrop, the SNB has cut the policy rate to negative territory.



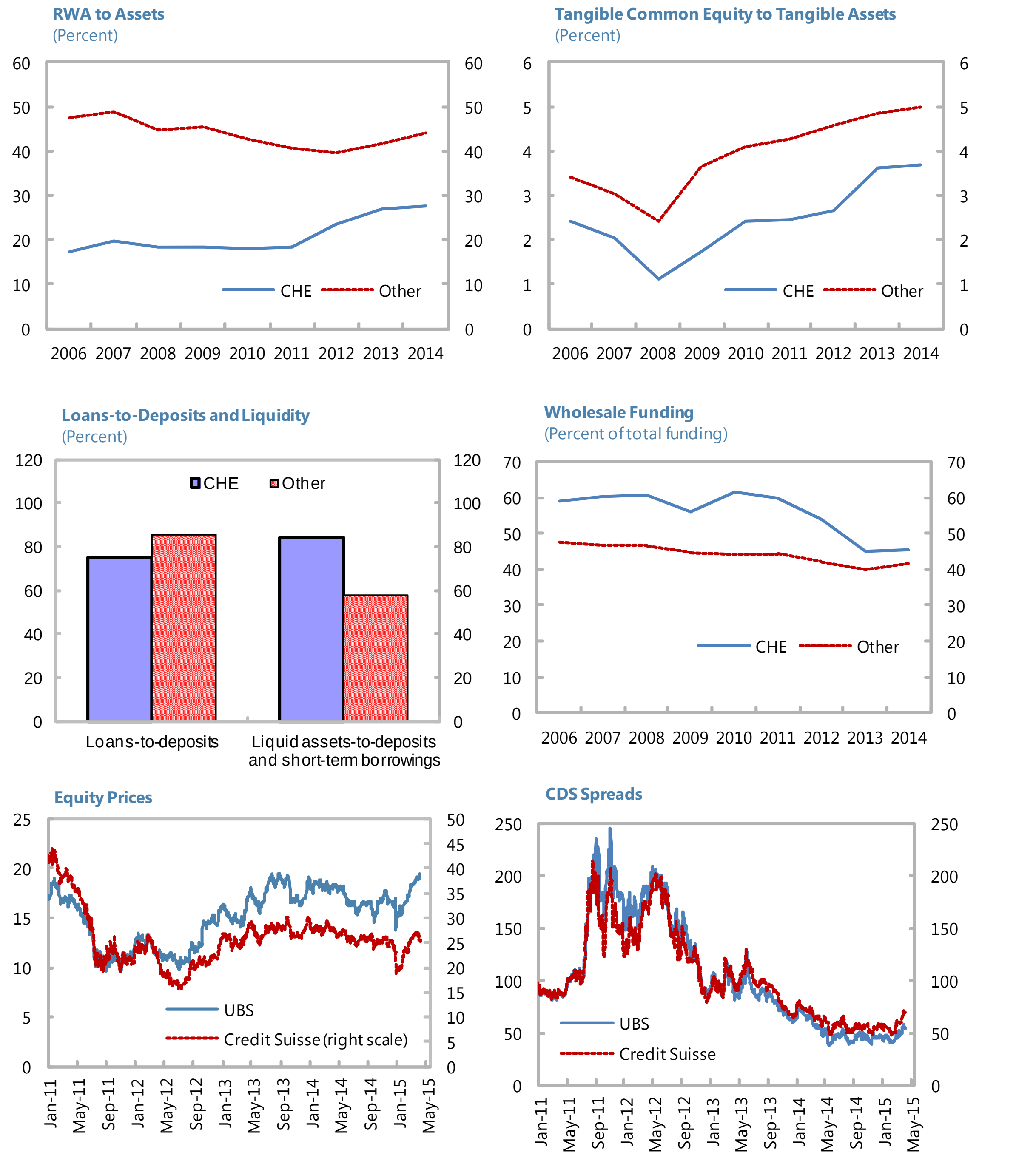
Sources: Haver Analytics; Swiss Federal Statistics Office; and Swiss National Bank.
1/ Nominal rate minus inflation.

Figure 4. Switzerland: Selected Financial Indicators, 2010–15



Sources: Bloomberg; and Datastream.

Figure 5. Switzerland: Indicators for Global Systemic Banks, 2006–15[1]



Sources: Bankscope; Bloomberg; and IMF staff calculations.
1/ Switzerland numbers are for Credit Suisse and UBS. "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, and Lloyds.

6. **The most affected parts of the financial sector are likely life insurers and private banks**.

- Life insurers have been under pressure due to a low-yield environment for several years now, forcing them to make significant adjustments. As a result, they actually recorded stronger positions, on average, in FINMA's latest Solvency Stress Test (based on end-2013 data) relative to two years earlier. Still, the recent drop in yields will create further challenges for life insurers, and the authorities should remain vigilant and support consolidation as needed.

- The same applies to private banks, which have significant revenue in foreign currency, but most of their costs in Swiss franc. Moreover, private banks were already facing pressure from international initiatives aimed at increasing transparency (e.g., the automatic exchange of tax information and AML/CFT-related initiatives). So far, the fallout on smaller Swiss private banks from the policy changes in 2015 appears to have been more limited than initially feared, but the situation must be continuously monitored.

7. **The appreciation of the franc also had outward spillovers**.

- Franc appreciation affected several economies in Eastern Europe with a sizeable stock of franc-denominated housing loans, notably Croatia and Poland, where such loans accounted for 6.3 and 7.7 percent of GDP, respectively. In general, the immediate macroeconomic impact of the franc's appreciation appears somewhat limited and is partly offset by lower franc interest rates; however, the Croatian government temporarily prevented pass-through to borrowers by fixing the applicable exchange rate at the pre-appreciation parity while a permanent solution is being negotiated between banks and borrowers. The contained effect is also partly due to actions by supervisors in some Eastern European countries to halt the provision of new franc-denominated mortgages in recent years and to manage related risks. Hungary mandated the conversion of all FX mortgages into domestic currency in November 2014.

- The exit from the exchange rate floor might also have modest effects on aggregate demand in other countries. In particular, the appreciation of the franc might increase external demand in trading partners, though such effects are likely to be modest given the relatively small size of the Swiss economy (only 0.5 percent of global GDP on a PPP basis). Any positive effects on aggregate demand in trading partners may also be at least partially mitigated by higher interest rates in these countries due to lessened SNB intervention to defend the floor.

B. External Assessment

8. **Switzerland has long run high current account surpluses**. Over the last 15 years, Switzerland's current account surplus has averaged around 10 percent of GDP (Table 2 and Figure 6). However, these surpluses are in some ways misleadingly high because they are driven by non-traditional flows, such as merchanting activities, commodity trading, financial and insurance services, and net FDI earnings (Annex 1), that are highly affected by the operations of large multinationals, financial firms, and wealthy foreigners for whom Switzerland is a desirable destination to centralize income and assets—reflecting Switzerland's economic stability and tax competitiveness, among other factors—but whose savings may not be fundamentally Swiss. For example, Swiss multinational

firms are often partly owned by foreigners through portfolio shares. Thus, a part of these companies' retained earnings really belong to foreign shareholders, generating an upward statistical bias to the current account of about 3 percent of GDP. Similarly, Switzerland, like other low-tax economies 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, thereby inflating net exports and net investment income, though such effects are difficult to quantify.

9. **Staff views Switzerland's external position as having been broadly in line with fundamentals in 2014, though this assessment is subject to high uncertainty**.

- The External Balance Assessment's (EBA) current account regression methodology suggests a current account norm for Switzerland of about 6¾ percent of GDP, reflecting Switzerland's financial center structure, demographics, and high per capita income. This norm is slightly below preliminary estimates of Switzerland's cyclically-adjusted current account surplus in 2014 (7½ percent of GDP), implying a slightly strong current account and slight undervaluation of the exchange rate.

- However, the EBA methodology does not fully take into account the special factors and anomalies in Switzerland's current account statistics discussed above. In addition, estimates of REER overvaluation in 2014 based on EBA methodologies (text table) suggest a moderate degree of *overvaluation*, not undervaluation. The lack of a trend in Switzerland's net international investment position (NIIP) to GDP ratio over the last 10 years (Table 2) also suggests that Switzerland's large current account surpluses do not result in explosive dynamics for the NIIP, whose large size is partly explained by the volatility of capital flows.[2]

Switzerland: EBA REER Analysis, 2014

Model	Overvaluation (percent)
Index	11.2
Level	12.6

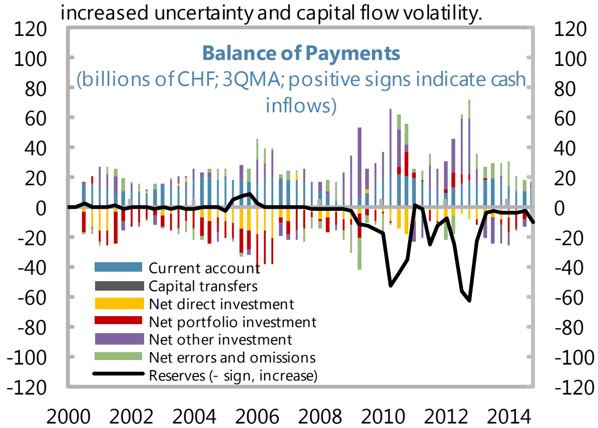
Source: Staff estimates.

- Adjusting for these considerations, staff assesses a current account gap for 2014 centered close to zero. However, the uncertainty band is wide, with the estimated gap ranging from -3½ percent of GDP to 2½ percent of GDP, reflecting the significant uncertainty introduced by the various idiosyncrasies of Switzerland's external statistics (Annex 1). Similarly, staff assesses the franc to have been broadly in line with fundamentals in 2014, with this assessment also subject to significant uncertainty.

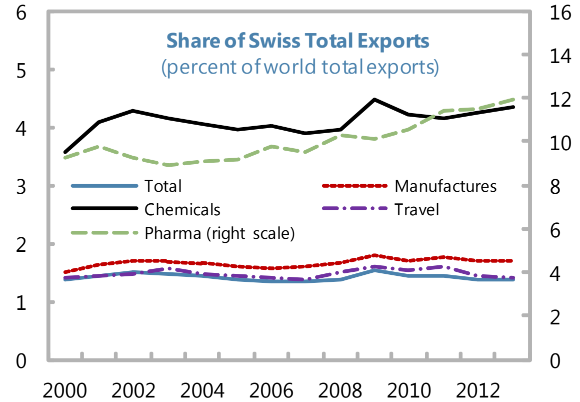
[2] The increase in Switzerland's NIIP is less than its current account surplus in part because of the statistical bias noted in paragraph 8. In particular, the retained earnings of Swiss multinational corporations boost Switzerland's current account, but not its NIIP because the foreign portfolio investment (FPI) claims of non-Swiss shareholders on the firm rise in value to reflect the retained earnings.

Figure 6. Switzerland: External Accounts and Exchange Rates, 2000–14

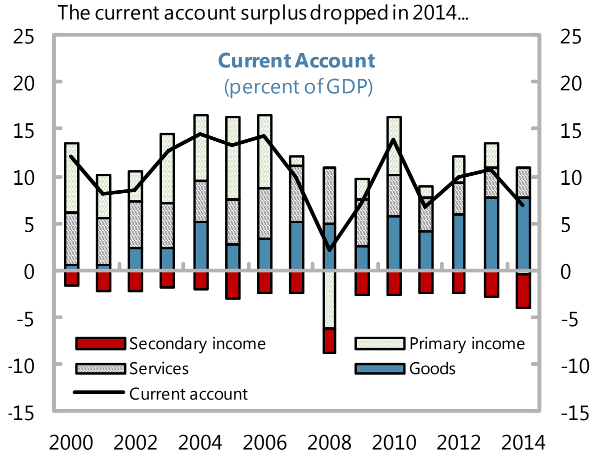
Reserves have increased sharply in periods of increased uncertainty and capital flow volatility.



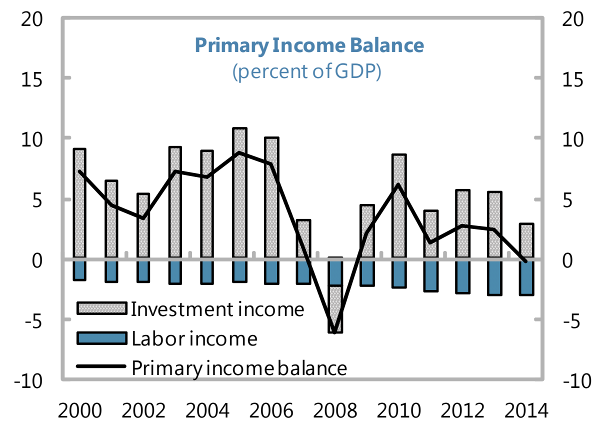
Despite the past appreciation, Swiss exporters have maintained competitiveness generally well.



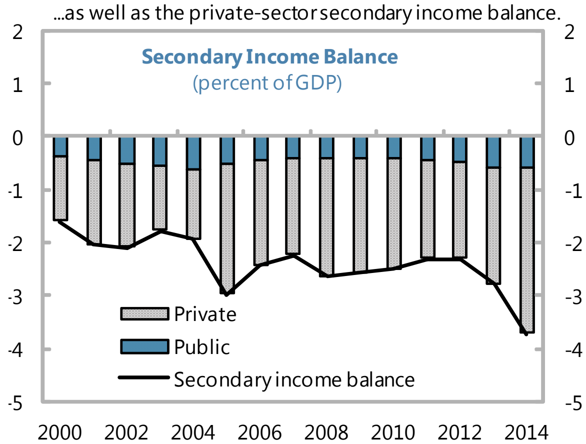
The current account surplus dropped in 2014...



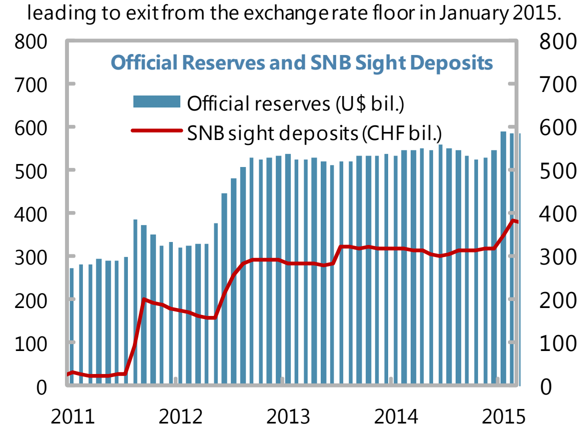
...due to a reduction in the investment income balance...



...as well as the private-sector secondary income balance.



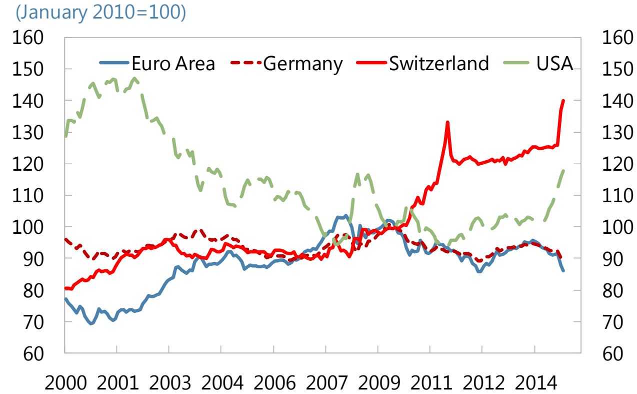
The SNB had to intervene heavily starting in late 2014, leading to exit from the exchange rate floor in January 2015.



Sources: Swiss National Bank; and Haver Analytics.

10. **The appreciation in early 2015 is likely to weaken the external position and to have left the franc overvalued**. As of April 2015, the REER has appreciated by about 10 percent relative to its average 2014 value. This appreciation is likely to reduce net exports due to lessened competiveness and has likely left the franc overvalued. This overvaluation partly reflects a policy gap of insufficiently easy monetary policy—simple Taylor rules suggest an optimal policy rate well below current levels—which in turn reflects various operational challenges associated with unconventional monetary policy (see monetary policy discussion in the next main section).

Real Effective Exchange Rates--Unit Labor Cost Basis
(January 2010=100)



Sources IMF International Financial Statistics.

C. Outlook and Risks

11. **The appreciated franc will weigh on growth during 2015–16, but the economy is expected to recover over the medium term**. Staff and consensus forecasts expect real GDP growth to slow to around ¾ percent and 1¼ percent in 2015 and 2016, respectively, mainly due to weaker net exports (Table 1). Unemployment is expected to rise only modestly (peaking at 3½ percent in 2015), as widespread use of short-time working arrangements in Switzerland lessens the adverse impact of weaker demand on unemployment. The output gap, almost closed at end-2014, is projected to widen in 2015. Over the medium term, this gap is expected to close and growth is expected to rise gradually as the economy adjusts to the shock and as increasing divergence between Switzerland's monetary policy stance and that of some other major advanced economies (due to a gradual increase in policy rates in the latter) helps ease appreciation pressure on the franc, supporting recovery of external demand.

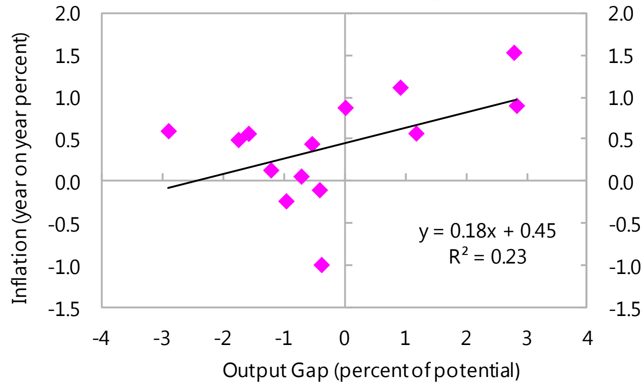
12. **Inflation is projected to trough in late 2015 before becoming slightly positive over the medium term**.

- Headline inflation is projected to fall near -1½ percent by late 2015, as the gradual pass-through from franc appreciation and lower commodity prices reaches peak effects. As these one-off effects dissipate, inflation is projected to gradually rise back into positive territory by early 2017.

- Assessing where exactly inflation will stabilize in the medium term is difficult, in part due to the lack of market-based measures of inflation expectations. However, if one assumes that real yields are similar to those in other safe havens (Germany, UK), then Switzerland's nominal government bond yields—which have recently set world-record lows (Figure 4)—imply that markets expect inflation to be roughly 1 percent 3–4 years from now.

- Similarly, an analysis of the recent relationship between core inflation and the output gap shows that the Phillips curve crosses the vertical axis at around ½ percent, implying that steady-state inflation expectations are anchored around that level.

Switzerland: Core Inflation and Output Gap
(Correlations between CPI(t) and output gap(t-1), 2000–14)



Source: IMF staff calculations.

- Taking both considerations into account and assuming unchanged monetary policy, staff project medium-term inflation in the range of ½–1 percent (Table 1), an outcome consistent with the SNB's definition of price stability of "less than 2 percent" inflation.

13. **However, this central scenario is subject to important risks** (see Annex 2 for further discussion of key risks).

- ***Risks related to low inflation***. One key risk is that operating in an environment of very low inflation may prove more challenging than assumed in the central scenario. In particular, low levels of inflation may make it difficult for monetary policy to reduce the real interest rate as needed to ensure full employment, given constraints on further significant reductions in nominal interest rates (i.e., "a liquidity trap"). Moreover, this risk may be higher than in previous periods due to the global drop in equilibrium real interest rates over the last decade. Such difficulties arising from low inflation may become especially acute if various risks to external demand (see below and Annex 1) are realized. Low equilibrium rates of inflation also imply low equilibrium nominal interest rates, posing challenges for some sectors such as defined-benefit pension plans and life insurers, and may make relative wage and price adjustments more difficult due to resistance to nominal wage and price cuts.

- ***Uncertainty about EU relations and immigration***. Last year's vote to move away from the free movement of labor with the EU has created substantial uncertainty about medium-term growth prospects, as such a move may reduce labor force growth, restrict firms' ability to recruit personnel, increase the fiscal challenges of population aging, and reduce Swiss firms' access to EU markets if existing cooperation agreements with the EU are revised. This uncertainty may also weigh on investment (see later section for further discussion of this issue).

- ***Global economic environment***. This risk goes in both directions. On one hand, downside surprises to global growth and further bouts of market risk aversion (e.g., due to a protracted period of turmoil in Greece or geopolitical events) could fuel franc appreciation and deflationary pressures and reduce growth. On the other hand, growth in Europe and other advanced economies could also surprise on the upside (e.g., due to a larger-than-expected boost from lower oil prices), supporting a more competitive franc, faster Swiss growth, and a quicker exit from deflation.

- ***Financial Sector***. The banking sector is highly globally interconnected; the largest banks (UBS and Credit Suisse) remain highly leveraged in comparison with most other global systemically important banks and still have large investment banking operations. Consequently, they could be a source of outward spillovers and remain vulnerable to inward spillovers from instability in global financial markets.

- ***Housing Market***. Though it has cooled recently, Switzerland's house prices have had a rapid run-up over the last decade, and mortgage debt is high as percent of GDP (see later section for more details). The economy could thus be vulnerable to a sharp decline in house prices, which would weaken household balance sheets and impede growth. Such a decline would also adversely affect the banking and insurance industries, with their large respective exposures to the mortgage market and real estate.

Authorities' views

14. **The authorities broadly agreed with staff's assessment of macroeconomic developments and risks**. They agreed that the franc was now overvalued. They also agreed that the sharp appreciation of the franc has depressed growth prospects in the short run and presents a challenge for the export sector, especially in those industries where the market power of Swiss firms is limited. On the low-inflation environment, they noted that domestic inflation was still positive and viewed the current deflation as a transitory phenomenon, driven by lower energy prices and currency appreciation, and projected inflation to move back into positive territory over the medium term. On spillovers to Eastern Europe from the franc's appreciation, the SNB noted that the authorities in Eastern Europe had been aware of risks related to franc-denominated mortgages for some time.

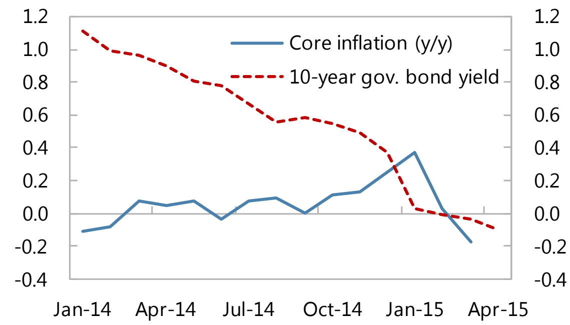
MACROECONOMIC POLICIES: SUPPORTING SUSTAINABLE GROWTH

Further monetary easing via purchases of (mainly foreign) assets and strong communication of the SNB's objective to boost inflation over the medium term could help lessen the near-term growth slowdown, reduce risks of entrenching low inflation, and limit franc overvaluation. Scope for fiscal policy to support aggregate demand is limited by Switzerland's fiscal rule and the small, open nature of its economy. That said, fiscal automatic stabilizers should be allowed to operate freely, as allowed under the rule, and the rule's escape clause should be triggered in the event of a severe downturn to allow discretionary fiscal stimulus. Pension and corporate tax reforms are key priorities for fiscal structural reforms.

A. Monetary and Exchange Rate Policies

15. **Further monetary easing would support economic adjustment and reduce risks**. The output gap is expected to widen in the near term, and the negative rates for both core inflation and 10-year bond yields suggest significant risks of a protracted period of low inflation. In this context, monetary easing would helpfully limit the growth slowdown, reduce risks of inflation expectations becoming anchored at low levels, and lessen exchange rate overvaluation.

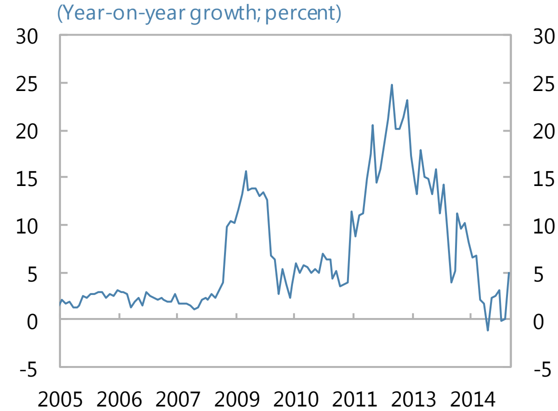
Switzerland: Core Inflation and Bond Yields
(percent)



Source: Haver Analytics.

16. **However, with the policy rate already at -0.75 percent, room for further conventional easing appears limited**. The policy rate should remain at its current negative level for now, as this helps ease franc appreciation pressures and encourages domestic consumption and investment. However, additional deep policy rate cuts could risk adverse nonlinear effects, such as increased cash hoarding. This in turn could reduce financial intermediation and weaken monetary transmission mechanisms. In this regard, the SNB has appropriately intensified the monitoring of depositors' behavior. So far there are few signs of significant cash hoarding.

Switzerland: Currency in Circulation
(Year-on-year growth; percent)



Sources: Haver Analytics; IFS; and Swiss National Bank.

17. **Monetary easing could instead be achieved via a pre-announced program of asset purchases**.

- Purchases of foreign assets could help directly address deflationary pressures arising from the overvalued exchange rate. The amount of foreign-asset purchases could be preannounced (e.g., *X* billion per month, to be continued until further notice) and adjusted as necessary to achieve inflation objectives. Compared to the previous approach of setting the exchange rate floor, fixing the *quantity* of foreign-asset purchases would not unduly suppress exchange rate volatility, thereby reducing the risk of a "one-way bet" in the market. Fixing the quantity also avoids an unlimited commitment of the SNB's balance sheet. Compared to the current approach of ad hoc interventions, pre-announced interventions might help signal monetary dovishness, thereby raising inflation expectations, spurring franc depreciation, and further supporting higher inflation.

- Purchases of domestic assets could also be considered. However, the scope for such purchases is more limited, given that domestic yields are already very low (yields are negative out to 12-

year maturities as of late April) and given the limited supply of domestic assets. In particular, the outstanding stock of federal government bonds is only 12 percent of GDP.

18. **The SNB could also further enhance communication and the articulation of its monetary policy framework**. The SNB's decision to abandon the floor has created some uncertainty about its monetary policy framework going forward. The SNB could therefore helpfully elaborate on its medium-term monetary policy objectives. More specifically, it may be useful to indicate a preference for moving inflation back near the upper end of the target range (i.e., closer to 2 percent) over the medium term, given the benefits to re-anchoring inflation expectations at higher levels to avoid the complications of operating monetary policy at low levels of inflation.

19. **The SNB's capital buffers should be kept in line with risks**. The SNB's balance sheet is likely to remain large for a prolonged period, with large fluctuations in mark-to-market profits (Table 3). Although a central bank's main objective is to achieve price stability, not maximize profits, the SNB could nonetheless encounter reputational problems if it incurred a large capital deficiency. To reduce related risks to the SNB's operations and independence, the SNB should continue to prioritize provisioning over transfers to its distribution reserve and maintain a prudent profit distribution policy.

Authorities' views

20. **The SNB agreed with much of staff's analysis, but preferred to see how the outlook develops before taking further monetary policy action**. The SNB agreed that monetary conditions were too tight, the franc was overvalued, and preannounced purchases of foreign assets was one option for further monetary easing. However, the SNB wanted to allow more time to see how the outlook develops in both Switzerland and elsewhere in Europe before taking further monetary policy action. On the communication strategy, the SNB did not see a strong case for announcing a preference for moving inflation back near the upper end of the target range (i.e., closer to 2 percent) over the medium term. The SNB considers inflation in the range of 0–1 percent to be consistent with its monetary policy framework and, therefore, does not share staff's risk assessment.

B. Fiscal Policy

21. **Switzerland's fiscal rule has helped it maintain low deficits and debt**. In place since 2003, Switzerland's "debt brake" rule requires that the federal government budget be in structural balance ex ante and that any ex post overruns be made up by running structural surpluses in subsequent years. Parliament can temporarily suspend the debt-brake rule in cases of "exceptional financial requirements" (e.g., war, severe recession) by a simple majority vote in both houses, but this option has rarely been invoked. The federal rule and similar rules for cantons have helped keep the budget in balance and helped limit general government gross debt to 46 percent of GDP at end-2014 (Tables 4–5, Annex 3).

22. **The mission recommended continued compliance with the rule in the central scenario**. Suspending the rule in response to the mild growth slowdown envisaged in the central scenario would set a precedent that could undermine the rule's ability to restrict fiscal irresponsibility over

the longer run. In addition, exchange rate overvaluation suggests that relying more heavily on monetary, rather than fiscal, easing to boost demand should lead to better external balance. Fiscal multipliers may also be small in Switzerland given its openness.

23. **However, fiscal policy should do what it can to support demand**. In the central scenario, fiscal automatic stabilizers should be allowed to operate fully, as allowed by the rule. The authorities should also avoid budgeting overperformance against the rule in 2016, as this would add an unnecessary contractionary impulse. If a deep or prolonged recession materializes, discretionary fiscal easing should be employed to support growth and inflation and avoid overburdening monetary policy. Such easing could be achieved by temporarily suspending the rule under established procedures.

24. **Pension reforms will help address longer-term fiscal challenges**. Population aging is projected to substantially increase fiscal costs related to pensions over the longer run. To help address this challenge, the government has submitted a comprehensive reform proposal to parliament. The reform includes measures to equalize retirement ages for men and women and to reduce the rate at which pension savings are converted into pension annuities by reducing this conversion rate from 6.8 to 6.0 percent per annum. In addition, the government has proposed to increase VAT rates by 2 percentage points by 2029 to ensure more stable funding for the pension system. Such reforms will help ensure the sustainability of the social safety net and its continued availability for future generations. In relation to the second pillar, staff recommended reducing the minimum guaranteed return on invested assets, as such returns have become more difficult to achieve in the low interest-rate environment (Box 1).

25. **Switzerland has prepared a comprehensive corporate tax reform (Corporate Tax Reform III)**. Switzerland has faced international pressure in recent years to reduce the favorable tax treatment provided to multinational corporations in many cantons. In this context, the authorities have developed a corporate tax reform, expected to be submitted to parliament this summer and implemented by 2019, that intends to reform special tax regimes that give more favorable treatment to income from foreign operations than income from domestic operations. As this will in some cases result in a net revenue loss, the federal government has proposed to provide fiscal support to cantons to assist the reform—the current estimate of the needed transfer is approximately ¼ percent of GDP. Staff welcomed efforts to reduce distortions in the corporate tax code and encouraged the authorities to finalize the reform in ways that are consistent with ongoing international initiatives to counter base erosion and profit shifting.

Authorities' views

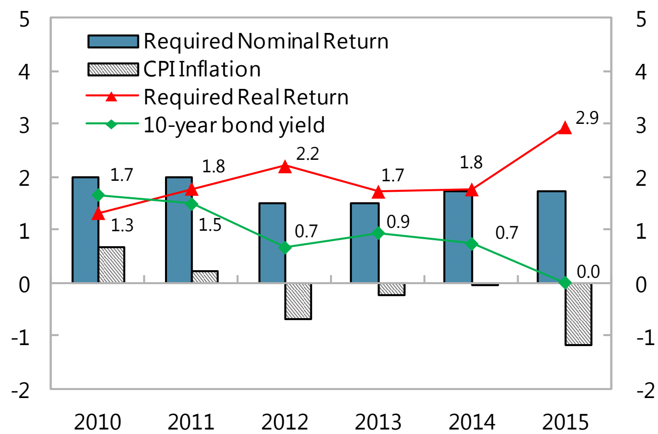
26. **The authorities emphasized the value of the fiscal rule and the importance of pension and corporate taxation reforms**. The authorities agreed that automatic fiscal stabilizers should operate freely and saw no need for discretionary fiscal stimulus, including because the expected growth slowdown was expected to be limited. The authorities also indicated that they did not expect budgetary overperformance to occur either this year or next. They instead emphasized the importance of structural fiscal reforms, especially those related to pensions and corporate taxation. On the minimum guaranteed rate of return, the authorities noted that it is reviewed each year on a regular schedule and the next review will be undertaken in the autumn of 2015.

Box 1. Guaranteed Rate of Return in Swiss Pension Funds

The Swiss pension system consists of three pillars. The first pillar is universal old age, survivors, and disability insurance. Currently, the age of retirement is 65 years for men and 64 years for women. It is a pay-as-you-go system, financed by contributions from employees and employers (both pay 4.2 percent of the employee's income). The second pillar consists of fully funded, occupation-based pension plans. These are compulsory for employees and financed by both employees and employers. Contributions depend on the rules of the individual pension fund, but the contribution of the employer must be at least as large as the contribution of the employee. The third pillar includes private voluntary pension schemes.

Guaranteed nominal rate of return. Swiss pension funds that operate in the second pillar are required to provide their members with a guaranteed rate of return on members' invested assets. The rate of return is not constant and is determined administratively each year. During 2003–09, the average nominal required rate broadly matched the average yield on 10-year Swiss government bonds. However, after 2010, the required rate has not declined in line with declines in headline inflation, resulting in a large increase in required real returns. In 2015, the real guaranteed return stands around 3 percent—by far the highest in the last decade.

Swiss Pension Funds: Required Return



Sources: Credit Suisse; and IMF staff calculations.

Consequences of the high required rate of return. A too-high guaranteed rate of return risks the insolvency of pension funds and may also encourage them to take excessive risks. It could also lead to refunding, in which both employers and employees are required to pay additional funds and/or pension benefits are reduced to restore solvency.

Policy advice. In the short run, consideration should be given to lowering the nominal guaranteed rate of return when it next comes up for review later this year to bring it more into line with market yields. Eventually, consideration could also be given to linking the nominal guaranteed rate of return more closely and automatically to market-based measures of achievable returns.

COMPLETING FINANCIAL SECTOR REFORM

The financial sector reform agenda, as laid out in last year's FSAP, should also be completed. Priorities include raising the leverage ratios of the two large international banks to safer levels, increasing public disclosure of information on risk weights, reforming FINMA's use of external auditors, overhauling deposit insurance, and ensuring that risks related to housing and mortgage markets are contained.

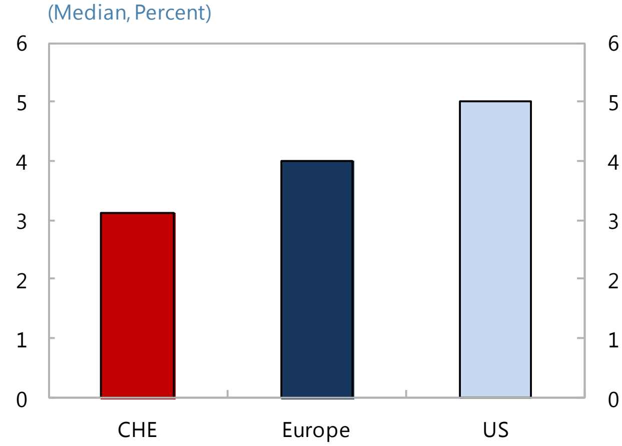
A. The Big Banks

27. **Switzerland's two global systemically important banks (G-SIBs) have continued their strategic adjustments, and their balance sheets appear strong by many metrics.** Both banks have met the 10 percent minimum CET1 capital ratio required under Swiss Too-Big-To-Fail legislation well in advance of the 2019 deadline and are in line with or comfortably above the average ratio for other G-SIBs. Both banks are above the Liquidity Coverage Ratio minimum of 100 percent, effective in 2015 in Switzerland, and had, based on a not-yet-final methodology, estimated Net Stable Funding Ratios above 100 percent as of spring 2014. The NSFR is not yet part of Swiss regulation but planned to be introduced in 2016. Both banks have remained profitable in 2014, though substantial provisions for litigation and regulatory issues (e.g., those related to foreign-exchange market manipulation, U.S. and other cross-border tax matters, and legacy issues related to the sale of residential mortgage-backed securities and U.S. mortgage crisis fines and penalties) weighed on the results.

28. **However, there are still important areas for further improvement, as identified by last year's FSAP (Annex 4)**.

- These banks' leverage ratios are above current regulatory minima. However, their ratios remain low by international standards (Table 6, Figure 5, and text chart). Given the risks to the Swiss economy posed by the large size of these banks, the authorities should tighten minimum leverage ratio requirements for G-SIBs to ensure that they are more ambitious than international minima and that the quality of capital is aligned with or more demanding than international standards.[3] In addition, the authorities should encourage the large banks to further strengthen their capitalization, including multi-year plans to increase their leverage ratios, and promote conservative dividend policies to bolster the capital base.[4]

G-SIB Basel III Tier 1 Leverage Ratios, 2014Q4
(Median, Percent)



Sources: Bank Reports; and IMF staff calculations.

[3] The current Swiss Too-Big-To-Fail framework was to a large extent formulated before many of details of Basel III had been worked out; consequently, some capital definitions are not aligned.

[4] Dividend plans compared to earnings per share are fairly high for the Swiss G-SIBs compared to other G-SIBs, although part of the dividends will be scrip dividends (dividends paid in shares, which does not deplete capital).

- The authorities should also vigilantly challenge risk weights from internal ratings-based models and increase banks' disclosure requirements regarding capital-weights to enhance transparency and bolster understanding of, and credibility in, banks' soundness and business strategies.

- Continued action is needed to improve the resolvability of the G-SIBs through strengthened cross-border coordination and further restructuring. Given the global reach of these banks, reaching agreements with partner supervisors is critical. While both banks have made structural changes, including by organizing through holding companies, and have updated their global recovery and resolution plans in 2014 to improve their resolvability, this process needs to continue to further improve resolvability.

- The authorities must also continue to proactively address operational risks by intense supervision of risk management practices and provisioning, to avoid and mitigate effects from negative surprises related to, for example, trading activities and investigations of tax evasion or money laundering.

29. **Encouragingly, the authorities are moving to address these concerns**.

- One important element is the follow-up to recommendations related to Too-Big-To-Fail (TBTF) in the December 2014 report of the "Group of Experts on the Further Development of the Financial Market Strategy," or the "Brunetti Report".[5] Recommendations included recalibration of capital requirements and adjustments to capital quality, and the Federal Council has instructed the Federal Department of Finance (FDF) to formulate concrete legislative proposals in this area. The details are yet to be worked out, but it is generally expected that that requirements on capital ratios, including leverage, will be set high, and that capital quality will be adjusted to be at least as stringent as international standards.

- The authorities are adopting international standards related to increased disclosure regarding risk weights and are involved in international initiatives to strengthen standards further. This is welcome, but in the possible absence of significant progress internationally, the Swiss authorities should stand ready to take the lead and heighten disclosure requirements.

- Regarding resolution, the authorities are cooperating with foreign supervisors and expect to conclude cooperation agreements on crisis management with the Crisis Management Group members for the Swiss G-SIBs. This would be an important step, but the details remain to be seen and assessed.

[5] "Group of Experts on the Further Development of the Financial Market Strategy—Final Report" https://www.news.admin.ch/message/index.html?lang=en&msg-id=55545

Authorities' views

30. **The authorities generally agreed with staff's assessment and recommendations, but stressed caveats on several issues**. Support appeared broad among the authorities for raising the leverage ratio to more ambitious levels and for increasing public disclosure requirements for risk weights in internal risk models. FINMA also emphasized that it is closely monitoring the calculation of risk weights and has taken action when shortcomings have been observed, including by introducing multipliers and a moratorium on capital-reducing model changes. FINMA agreed with the need for banks to continue building capital, but cautioned that an overly conservative dividend policy might hinder banks' ability to attract equity capital. On resolvability, the authorities fully recognize that the work to make the G-SIBs resolvable is not finished, but stressed that progress in recent years has been substantial. On conduct risks, FINMA explained that related supervision and enforcement efforts are being stepped up, which in combination with large investments in these banks to control these risks could help reduce adverse events going forward.

B. Broader FSAP Recommendations

31. **Switzerland continues to take measures to strengthen its financial sector more generally, including with respect to key FSAP update recommendations (Annex 4)**. Such efforts are important not only for Switzerland, but also to promote global financial stability, given the prominent role of the Swiss banking and insurance sectors. Still, the FSAP update was concluded only a year ago, and many of the reforms are work in progress. Thus, continued efforts are needed to further strengthen the post-crisis transition to a safer financial sector.

32. **The authorities are therefore encouraged to complete the financial sector reform agenda, as laid out in last year's FSAP update**. The TBTF policies (discussed above) and policies to contain the potential build-up of risks in the domestic real estate and mortgage markets (discussed below) are important policy areas in this regard. Other priority measures going forward include the following.

- ***Continue to refine FINMA's use of external auditors***. FINMA has taken regulatory measures to strengthen its guidance to external auditors. This is encouraging, and implementation must be forceful to validate the work of the auditors and ensure supervisory harmonization across entities. FINMA also reports that it has intensified its direct supervisory activities, including on-site inspections, and resources will be redirected to further strengthen these supervisory activities. However, more resources for FINMA may still be needed, as pointed out by the FSAP and for which there are no plans. The use of external auditors could also be strengthened by paying auditors from a FINMA-managed, bank-financed fund rather than by the bank that is being audited to avoid conflicts of interest, and by periodically rotating auditing firms.

- ***Overhaul deposit insurance***. The governance of the deposit insurance scheme should be reformed to make it more independent by substantially limiting the influence of the banking industry in its board. Dedicated ex ante funding with a back-up line of support should also be built up to strengthen access to funds and confidence in case of bank failures. The Brunetti

Report has encouraging recommendations in this direction, and the authorities should take steps to reform the scheme accordingly. In addition, deposit insurance funds should be made available to finance resolution measures on a least-cost basis.

Authorities' views

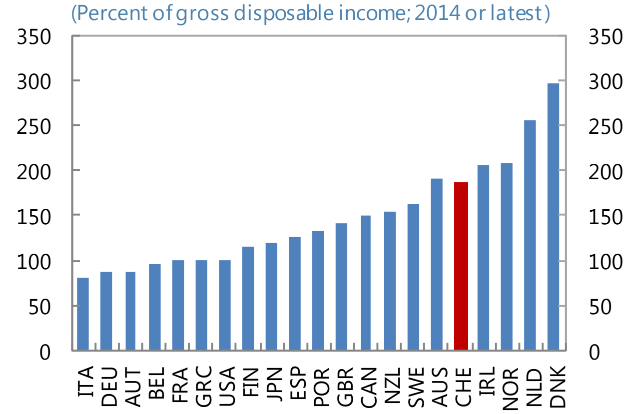
33. **The authorities emphasized that they are taking many steps for financial sector reform and that many of the FSAP update recommendations would be implemented**. Regarding banking supervision, FINMA explained that they are working hard to further strengthen the management of the use of external auditors. They do not see a need for a substantial increase in the overall resource envelope unless new statutory tasks are assigned to FINMA. Rather, further reallocation within FINMA would be sufficient. FINMA agreed that reforming how external auditors are being paid to reduce conflicts of interest could be helpful, but was more skeptical about the benefit from mandatory rotation of auditors, as it is an oligopoly market with few firms available. On deposit insurance, the Federal Council has taken note of the Brunetti Report and will decide on how to proceed with the expert group's recommendations at a later date.

C. Housing Market

34. **The Swiss authorities have undertaken various prudential measures over the last three years aimed at reducing housing-related risks**. Swiss household debt (mainly mortgages) is high by international standards, and mortgage debt has been rising steadily since 2008, in tandem with a buoyant housing market (Figure 7). To reduce related financial stability risks, the authorities have undertaken a number of prudential measures, including strengthened bank "self-regulation" standards approved by FINMA, effective September 2014 (Box 2).

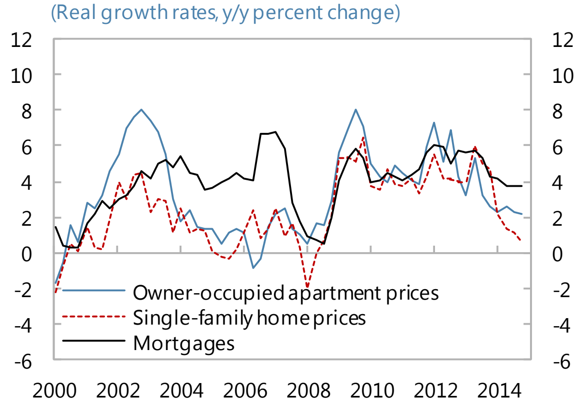
35. **These measures appear to have had some effect, as housing and mortgage markets show some signs of cooling**. The growth rate of residential real estate prices has eased both for owner-occupied apartments and single family houses, including in areas, such as Lake Geneva, that previously saw rapid house price growth (Figure 7). Mortgage growth has also decelerated, although this effect is less pronounced (text chart). Similarly, price-to-rent and price-to-income

Household Debt
(Percent of gross disposable income; 2014 or latest)



Source: Haver Analytics.

Switzerland: House Price and Mortgage Growth
(Real growth rates, y/y percent change)



Sources: Haver Analytics; and Swiss National Bank.

ratios have started to stabilize (Figure 7). The percent of new mortgages for owner-occupied real estate with loan-to-value ratios exceeding 80 percent have also been on a declining trend. As the authorities have taken a range of measures to address the risk of a build-up of imbalances in the housing and mortgage markets, it is difficult to clearly disentangle which have been the most effective. However, the consensus view among the authorities and banks was that the required down payment from the borrower's own funds (not funded by using pension savings) has perhaps been the most important measure.

Box 2. Measures to Reduce Housing- and Mortgage-Related Risks

Revised minimum requirements for mortgages, drawn up by the Swiss Bankers Association and approved by FINMA, effective mid-2012:

- Mortgages must entail a down payment of at least 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 lending value of the mortgage 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.

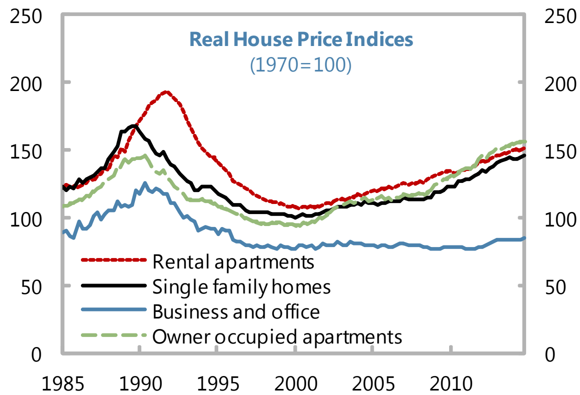
On the SNB’s proposal, the Federal Council activated the countercyclical capital buffer (CCB). The CCB applies to risk-weighted positions associated to residential property mortgages in Switzerland. The CCB was activated to a level of 1 percent (to be met in the form of CET1) capital by end–September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

Amended minimum standards for mortgage financing issued by the Swiss Bankers Association and approved by FINMA, effective September 1, 2014:

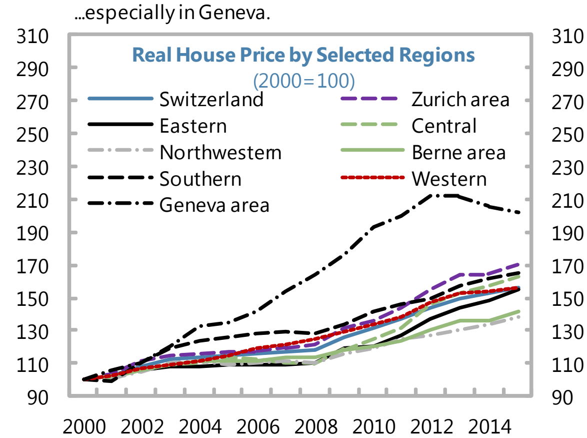
- The amortization period for repayment down to two-thirds of the lending value of the mortgage was shortened from 20 years to 15 years. Moreover, the loan must now be repaid in regular tranches of an equal amount from the start.
- Stricter use of second incomes when assessing financial sustainability.
- For future lending, real estate values must now be based on the market value or the purchase price, whichever is lower.

Figure 7. Switzerland: Housing Markets, 1980–2014

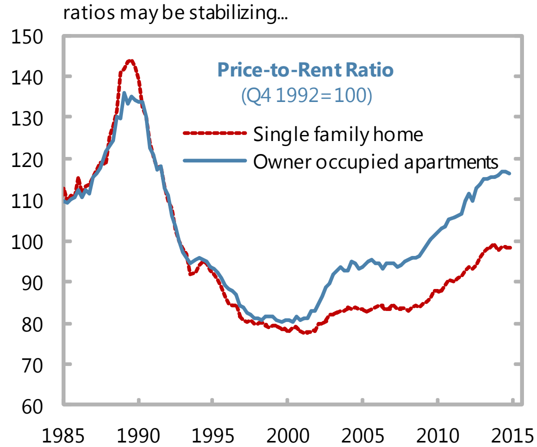
Real house prices have risen steadily over the last decade...



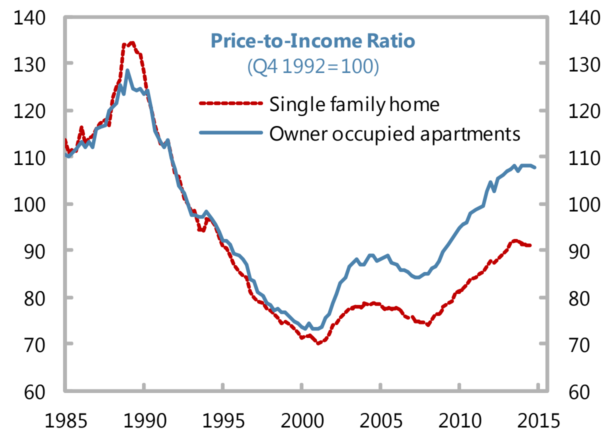
...especially in Geneva.



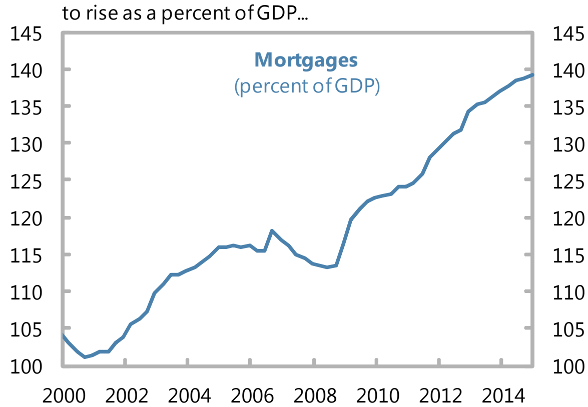
However, there are tenative signs that price-to rent ratios may be stabilizing...



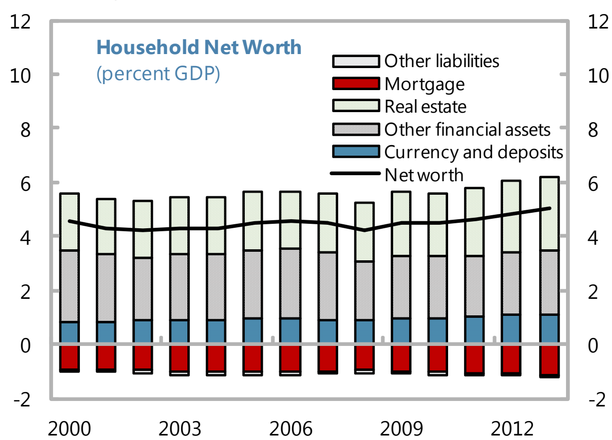
...as are price-to-income ratios.



Nonetheless, households' mortgage debt continues to rise as a percent of GDP...



...though their net worth is 5 times GDP.



Sources: State Secretariat for Economic Affairs; Swiss National Bank; IMF Global House Price Index; and Haver Analytics.

36. **However, the cooling of mortgage-related risks is still tentative and partial**. Mortgage debt is high and still rising as a percent of GDP, and loan-to-income ratios on new mortgages have not yet declined. It is thus important to continue monitoring housing and mortgage-related risks closely and to fully enforce existing regulations and minimum standards, especially given recent interest rate cuts for SNB sight deposits, which could re-ignite mortgage demand. If risks are not reduced or re-accelerate, tighter and more binding prudential measures, such as explicit limits on the percent of new mortgages that can exceed a given debt-service-to-income and/or debt-to-income ratio should be adopted. Likewise, efforts to address concentration and interest-rate risks, as identified by the SNB in its most recent Financial Stability Report, may need to be stepped up via Pillar 2 measures, including, if necessary, additional capital charges.

Authorities' views

37. **The authorities believe their measures have had some effect, but are still concerned, as imbalances are still large and have not fallen substantially**. Consequently, they agree that further policy action may be warranted, in particular to target affordability and the income-producing real estate sector. However, they also emphasized that the effects of measures are lagged, as can be seen from the experience in recent years, and it is therefore appropriate to let the measures announced in mid-2014 work through the system first. The SNB, furthermore, explained that, if imbalances appear set to increase further, an upward adjustment of the CCB could be proposed. FINMA also emphasized that they carefully analyze interest rate and concentration risks of banks and that they in several instances have taken action to reduce risks in individual institutions.

STRUCTURAL ISSUES

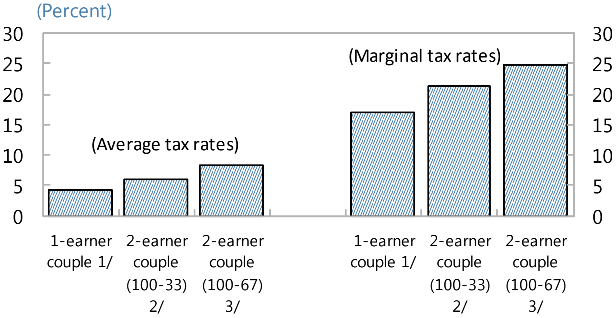
38. **A referendum in February 2014 obliges the government to set unspecified limits on immigration from the EU by 2017**. Tight limits could hurt Switzerland's growth potential by restricting the availability of highly-skilled foreign labor. Limits on immigration are also incompatible with agreements with the EU, which would have the right to respond by terminating Swiss-EU bilateral agreements. Such actions would severely constrain Swiss companies' access to EU markets, which account for over half of Switzerland's exports and three-quarters of its imports. A constructive resolution to this uncertainty would help underpin near-term economic recovery and support long-term growth.

39. **Switzerland continues progress toward implementation of international standards for AML/CFT and the transparency and exchange of information on tax matters**. In December 2014, parliament approved a bill aimed at implementing the 2012 Financial Action Task Force (FATF) Recommendations. The FATF is now in the process of assessing these measures, and it will be important for the Swiss authorities to ensure full compliance, particularly with regard to transparency of legal persons and arrangements, tax crimes, and politically exposed persons. In January 2015, the Federal Council embarked on consultations on the ratification of the Multilateral Convention and on the legal framework for the implementation of the reporting standard on automatic exchange of information. The parliamentary process in this regard is expected to begin in

mid-2015, possibly followed by a referendum, with the relevant laws expected to be in place by 2017. Staff welcomes this progress and encourages the authorities to forcefully implement the FATF and Global Forum standards in order to protect the integrity of Switzerland as an international financial center.

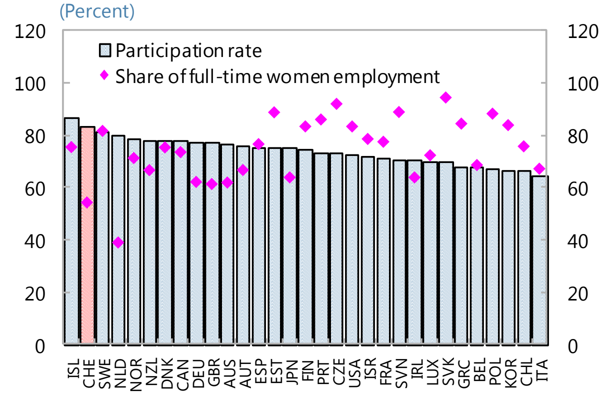
40. **Structural reforms should continue to ensure long-run sustainable growth**. OECD and World Bank *Doing Business* reports indicate scope for further improvement in areas such as facilitating full-time labor participation of women (e.g., reducing child care costs and marginal tax rates on second earners) and improving access and equity in education, both of which could help boost growth.

Switzerland: Income Tax Rates, 2013
(Percent)



Source: OECD Taxing Wages database.
1/ One-earner married couple at 100% of average earnings, 2 children.
2/ Two-earner married couple, one at 100% of average earnings and the other at 33%, 2 children.
3/ Two-earner married couple, one at 100% of average earnings and the other at 67%, 2 children.

Women Labor Participation And Full-time Employment
(Percent)



Source: OECD Labor Force Statistics.

Authorities' views

41. **The authorities broadly shared staff's views on structural issues**. The authorities agreed that uncertainty over the immigration reform and EU relationships would not encourage investor sentiments. The policy goal is to preserve bilateral agreements with the EU, while building a sustainable immigration policy that would contribute to balanced growth. The implementation of OECD and FATF recommendations is underway, and the authorities are committed to launching automatic exchange of information with partner states starting in 2018. The authorities also agreed with staff's view that there remains scope to enhance women's full-time labor participation.

STAFF APPRAISAL

42. **Economic growth in Switzerland is likely to slow in the near term while inflation becomes more negative**. Switzerland's economy has performed relatively well in the aftermath of the global financial crisis. However, exchange rate appreciation in early 2015 has likely left the Swiss franc overvalued and weakened the near-term outlook. In particular, GDP growth is expected to ease to around ¾ percent in 2015, mainly due to weaker net exports. The strong franc, together with lower oil prices, is also likely to drive inflation down to well past -1 percent by late 2015.

43. **Over the medium term, the economy is expected to recover gradually, but uncertainty around this central scenario is wide**. As the economy adjusts to the exchange rate appreciation, growth is projected to rise gradually back to around 2 percent over the medium term while inflation increases to around 1 percent. However, this scenario is subject to important risks, including risks related to very low inflation, uncertainty about EU relations and immigration, global and regional economic developments, the effects of ongoing changes in the international financial regulatory landscape, and the potential for price reversals in the housing market.

44. **Further monetary easing would support adjustment and reduce risks**. Easing would help limit the near-term growth slowdown and lessen exchange rate overvaluation. Boosting inflation closer to 2 percent over the medium term would also reduce risks associated with operating in a low-inflation environment.

45. **Monetary easing could perhaps be achieved via a program of pre-announced asset purchases**. Such purchases could consist of foreign-currency assets—and perhaps some domestic assets, though scope for this is more limited—with the pace of purchases adjusted as necessary in response to developments. In addition, the policy rate should be maintained at its current negative level for now, as this has been helpful in reducing franc appreciation and deflationary pressures. Central bank communication should also be geared toward building an understanding of policy objectives and ensuring that inflation expectations do not become entrenched at low levels. In particular, it may be useful to indicate a preference for moving inflation back near the upper end of the target range (i.e., closer to 2 percent) over the medium term. The SNB should also prioritize provisioning over transfers to its distribution reserve to ensure that its capital remains in line with risks.

46. **Fiscal policy can also support recovery**. In the central scenario, automatic stabilizers should be allowed to operate fully, as allowed under Switzerland's debt-brake rule, which has served Switzerland well. Overperformance against the rule should also be avoided, as this would add an unnecessary contractionary impulse. If the economic slowdown is significantly more severe or protracted than envisaged, discretionary fiscal stimulus could also be employed by triggering the rule's temporary escape clause to help boost growth and inflation and avoid overburdening monetary policy.

47. **Pension reforms will help address longer-term fiscal challenges**. Population aging is projected to substantially increase fiscal costs related to pensions and healthcare over the longer run. The government's pension reform proposals will help address this challenge and help ensure the sustainability of the social safety net and its continued availability for future generations.

48. **Continued structural reforms will help support medium-term growth potential**. A top priority in this regard is to achieve a constructive resolution to the uncertainty about EU relations and immigration. Efforts to reform corporate taxation and implement AML/CFT reforms and automatic exchange of tax information are welcome and should be pursued in ways that are fully consistent with international standards, thereby ensuring the integrity of Switzerland as an international financial center and avoiding adverse effects on growth from potential international

countermeasures. Reforms to boost full-time female labor force participation, such as lowering marginal tax rates on second incomes, could also boost potential growth over the medium term.

49. **Continuing the financial sector reform agenda will strengthen the system's soundness and resilience**. Important progress has been made over the last year, including measures to tighten lending standards for mortgages, which appear to have supported some reduction in mortgage-related risks. However, additional financial sector reforms can be undertaken to further strengthen financial sector regulation and supervision. In this regard, the authorities' plans to adopt further measures along the lines of those recommended in the Brunetti Report are encouraging. In this context and in line with FSAP update recommendations, the authorities are encouraged to:

- Continue to monitor closely financial stability risks related to Switzerland's housing market and its high levels of mortgage debt. If risks do not decline, consider tighter and more binding prudential measures, such as explicit limits on the percent of new mortgages that can exceed a given debt-service-to-income or debt-to-income ratio.

- Press the largest banks to continue rapidly bringing their leverage ratios into line with other large international banks and raise minimum leverage ratio requirements to more ambitious levels.

- Continue to refine FINMA's use of external auditors, including by periodically rotating auditing firms; providing more guidance on their supervisory focus; paying auditors from a FINMA-managed, bank-financed fund rather than by the bank that is being audited to avoid conflicts of interest; and intensifying FINMA's own onsite inspections, including by increasing the number of deep dives.

- Increase banks' disclosure requirements regarding capital-weights to enhance transparency and bolster understanding of, and credibility in, banks' soundness and business strategies.

- Continue to monitor closely the possible effects on the financial sector of the recent exchange rate appreciation and low interest-rate environment. The second factor is particularly important for life insurers and defined-benefit pension plans. To ensure the sustainability of the latter, the minimum guaranteed rate of return that applies to some plans and that is established by the government should be reduced to bring it into line with market rates.

- Overhaul the deposit insurance scheme to bring it into line with emerging international best practices, including by building up dedicated ex-ante funding with a back-up credit line from the authorities, reforming the scheme's governance so that a majority of board members are independent of the banking industry, and allowing the scheme to finance resolution measures.

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

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

Table 1. Switzerland: Selected Economic Indicators, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Staff estimate	Staff projections			
Real GDP (percent change)	2.9	1.9	1.1	1.9	2.0	0.8	1.2	1.5	1.9
Total domestic demand	-0.6	4.2	-1.2	-0.8	1.7	2.5	1.8	1.4	1.8
Final domestic demand	2.1	1.9	2.7	2.0	1.2	2.0	1.5	1.6	1.7
Private consumption	1.6	0.9	2.8	2.2	1.0	2.5	2.0	1.8	1.8
Public consumption	0.2	2.1	2.9	1.4	1.1	1.8	1.2	1.2	1.2
Gross fixed investment	4.2	4.4	2.5	1.8	1.8	1.0	0.5	1.4	1.8
Inventory accumulation 1/	-2.4	2.1	-3.5	-2.5	0.4	0.4	0.2	-0.2	0.1
Foreign balance 1/	3.4	-1.9	2.2	2.7	0.5	-1.4	-0.4	0.2	0.3
Nominal GDP (billions of Swiss francs)	605.6	618.5	624.4	635.7	651.8	648.2	651.1	662.1	678.3
Savings and investment (percent of GDP)									
Gross national saving	38.0	33.8	34.1	33.2	30.5	28.6	28.5	28.3	28.5
Gross domestic investment	24.0	27.0	24.2	22.5	23.6	22.8	22.9	22.8	22.8
Current account balance	14.0	6.8	9.9	10.7	7.0	5.8	5.6	5.5	5.7
Prices and incomes (percent change)									
GDP deflator	0.2	0.2	-0.2	-0.1	0.5	-1.4	-0.8	0.2	0.5
Consumer price index (period average)	0.7	0.2	-0.7	-0.2	0.0	-1.1	-0.4	0.4	0.8
Consumer price index (end of period)	0.5	-0.7	-0.4	0.1	-0.3	-1.4	0.3	0.5	1.0
Nominal hourly earnings	0.8	1.0	0.8	0.8	0.8	0.1	0.5	1.0	2.0
Unit labor costs (total economy)	-2.2	2.0	1.5	-1.1	-1.2	-0.7	-0.7	-0.5	0.1
Employment and slack measures									
Unemployment rate (in percent)	3.5	2.8	2.9	3.2	3.2	3.4	3.6	3.4	3.3
Output gap (in percent of potential)	-0.4	-0.4	-1.0	-0.7	-0.2	-0.9	-0.9	-0.8	-0.2
Capacity utilization	81.1	84.3	81.5	80.7	82.0	...	...	...	...
Potential output growth	2.0	1.9	1.7	1.7	1.5	1.5	1.3	1.3	1.4
General government finances (percent of GDP)									
Revenue	31.1	31.7	31.3	31.3	31.3	31.3	31.3	31.3	31.3
Expenditure	31.0	31.4	31.4	31.5	31.1	31.6	31.6	31.5	31.4
Balance	0.1	0.3	-0.1	-0.1	0.2	-0.3	-0.3	-0.2	-0.1
Cyclically adjusted balance	0.2	0.4	0.2	0.1	0.3	0.0	0.0	0.0	0.0
Gross debt 2/	47.1	47.1	48.2	47.0	46.1	46.1	45.6	44.6	43.5
Monetary and credit (percent change, average)									
Broad money (M3)	7.0	7.2	9.8	7.7	3.3	...	...	...	...
Domestic credit, non-financial	2.1	3.7	5.3	3.9	2.7	...	...	...	...
Three-month SFr LIBOR	0.2	0.1	0.1	0.0	0.0	...	...	...	...
Yield on government bonds (7-year)	1.3	1.2	0.4	0.6	0.4	...	...	...	...
Exchange rates (levels)									
Swiss francs per U.S. dollar (annual average)	1.0	0.9	0.9	0.9	0.9	...	...	...	...
Swiss francs per euro (annual average)	1.4	1.2	1.2	1.2	1.2	...	...	...	...
Nominal effective rate (avg., 2000=100)	128.6	144.8	144.2	145.3	148.9	...	...	...	...
Real effective rate (avg., 2000=100) 3/	109.8	118.0	114.0	114.0	116.0	...	...	...	...

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. Calculated as the sum of Federal, Cantonal, Municipal and Social security gross debts.

3/ Based on relative consumer prices.

Table 2. Switzerland: Balance of Payments, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
						Staff projections			
	(In billions of Swiss francs, unless otherwise indicated)								
Current account	**85**	**42**	**62**	**68**	**45**	**37**	**37**	**37**	**39**
Goods balance	36	26	37	50	51	48	45	44	45
Exports	288	307	312	346	300	291	296	307	322
Imports	252	281	274	297	250	243	251	263	277
Service balance	27	22	21	20	20	20	19	19	20
Net primary income	37	8	17	16	-2	-6	-1	-2	-1
Net secondary income	-15	-14	-14	-18	-24	-25	-26	-25	-25
Private capital and financial account	**106**	**13**	**84**	**98**	**44**	**37**	**36**	**36**	**38**
Capital transfers	-5	-8	-2	1	-1	0	0	0	0
Financial account	110	22	86	98	45	37	36	36	38
Net foreign direct investment	59	18	26	30	28	29	29	29	29
Net portfolio investment	-33	13	-17	16	-1	8	4	6	5
Net financial derivatives	0	0	-1	-1	-1	-1	-1	-1	-1
Net other investment	-54	-51	-96	39	9	-8	0	3	6
Change in reserves	138	43	175	13	9	10	5	0	0
Net errors and omissions	**30**	**-12**	**26**	**29**	**0**	**0**	**0**	**0**	**0**
	(In percent of GDP, unless otherwise indicated)								
Current account	**14.0**	**6.8**	**9.9**	**10.7**	**7.0**	**5.8**	**5.6**	**5.5**	**5.7**
Goods balance	5.9	4.2	6.0	7.8	7.8	7.4	6.8	6.7	6.6
Exports	47.6	49.6	49.9	54.5	46.1	44.9	45.4	46.4	47.5
Imports	41.7	45.4	43.9	46.7	38.3	37.5	38.6	39.7	40.8
Service balance	4.4	3.6	3.4	3.1	3.1	3.1	3.0	2.9	2.9
Net primary income	6.2	1.3	2.8	2.5	-0.3	-0.9	-0.2	-0.3	-0.1
Net secondary income	-2.5	-2.3	-2.3	-2.8	-3.7	-3.9	-3.9	-3.8	-3.7
Private capital and financial account	**17.4**	**2.1**	**13.4**	**15.5**	**6.7**	**5.8**	**5.5**	**5.5**	**5.6**
Capital transfers	-0.8	-1.4	-0.4	0.1	-0.1	0.0	-0.1	0.0	0.0
Financial account	18.2	3.5	13.8	15.3	6.8	5.8	5.6	5.5	5.6
Net foreign direct investment	9.7	2.8	4.1	4.8	4.3	4.5	4.4	4.4	4.2
Net portfolio investment	-5.4	2.1	-2.7	2.5	-0.1	1.2	0.5	0.8	0.7
Net financial derivatives	0.0	-0.1	-0.2	-0.1	-0.2	-0.1	-0.2	-0.2	-0.2
Net other investment	-8.9	-8.2	-15.3	6.2	1.4	-1.3	0.0	0.4	0.9
Change in reserves	22.8	6.9	28.0	2.0	1.4	1.5	0.8	0.0	0.0
Net errors and omissions	**5.0**	**-1.9**	**4.2**	**4.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Net IIP (in percent of GDP)	134.0	138.9	132.9	117.7	121.6	128.1	133.1	136.3	138.7
Official reserves									
(billions of U.S. dollars, end-period)	240.1	295.1	439.5	542.5	509.7	…	…	…	…
Reserve cover (in months of imports)	8.6	9.3	13.7	15.3	16.2	…	…	…	…

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

Table 3. Switzerland: SNB Balance Sheet, 2009–14

(Millions of Swiss francs; unless otherwise indicated)

	2009	2010	2011	2012	2013	2014
Assets						
Gold	38,186	43,988	49,380	50,772	35,565	39,630
Foreign currency reserves	94,680	203,810	257,504	432,209	443,275	510,062
IMF, international, and monetary assistance loans	5,905	4,971	4,923	4,528	4,538	4,627
Swiss franc repos	36,208	…	18,468	…	…	…
U.S. dollar repos	…	…	371	…	…	…
Swaps against Swiss francs	2,672	…	…	…	…	…
Money market, Swiss franc securities, other	29,614	17,187	15,434	11,925	7,004	6,883
Total assets	207,264	269,955	346,079	499,434	490,382	561,202
Liabilities						
Currency in circulation (banknotes)	49,966	51,498	55,729	61,801	65,766	67,596
Sight deposits	57,102	48,917	216,701	369,732	363,910	387,666
Repo, SNB bills and time liabilities	27,473	121,052	15,086	…	…	…
Foreign currency and other liabilities	6,820	5,897	5,441	9,825	12,682	19,635
Provisions and equity capital	65,902	42,591	53,123	58,075	48,023	86,305
Total liabilities	207,264	269,955	346,079	499,434	490,382	561,202
Memorandum items:						
Nominal GDP (billions of Swiss francs)	587	606	619	624	636	652
Balance sheet, percent of GDP	35.3	44.6	56.0	80.0	77.1	86.1
Banknotes, percent of total liabilities	24.1	19.1	16.1	12.4	13.4	12.0
Refinancing operations, percent of total assets	18.8	…	5.4	…	…	…
Provisions and equity capital, percent of total assets	31.8	15.8	15.3	11.6	9.8	15.4
Monetary base 1/	89,156	74,185	231,954	350,965	380,523	384,920

Sources: Swiss National Bank; and IMF staff estimates.

1/ Currency in circulation and sight deposits of domestic banks.

Table 4. Switzerland: General Government Finances, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Staff estimate	Staff projections			
	(In billions of Swiss francs, unless otherwise specified)								
General government									
Revenue	189	196	196	199	204	203	204	207	212
Expenditure	188	194	196	200	203	205	206	209	213
Net lending/net borrowing	1	2	0	-1	1	-2	-2	-1	0
Confederation (Federal government) 1/									
Revenue	61	63	62	63	64	63	64	65	66
Expenditure	59	63	62	64	61	65	65	66	68
Net lending/net borrowing	2	1	0	-1	2	-2	-1	-1	-2
Cantons									
Revenue	76	78	79	80	82	82	82	83	85
Expenditure	75	80	81	82	85	83	83	84	85
Net lending/net borrowing	1	-1	-3	-2	-3	-1	-1	-1	0
Communes/municipalities									
Revenue	42	43	43	44	45	45	45	46	47
Expenditure	43	43	44	44	45	45	45	45	46
Net lending/net borrowing	-1	0	-1	0	0	0	0	1	1
Social security 2/									
Revenue	53	58	59	60	61	61	61	62	64
Expenditure	55	55	56	58	58	60	61	62	63
Net lending / net borrowing	-2	3	3	2	3	1	0	0	1
General government gross debt 3/	285	291	301	299	300	299	297	296	295
Confederation (Federal government) 1/	145	148	150	146	148	147	145	144	142
Cantons	69	72	78	80	77	76	75	75	75
Communes/municipalities	63	65	66	68	67	67	67	68	69
Social security 2/	8	6	7	5	8	9	9	9	10
	(In percent of GDP)								
General government operations									
Revenue	31.1	31.7	31.3	31.3	31.3	31.3	31.3	31.3	31.3
Expenditure	31.0	31.4	31.4	31.5	31.1	31.6	31.6	31.5	31.4
Net lending/net borrowing	0.1	0.3	-0.1	-0.1	0.2	-0.3	-0.3	-0.2	-0.1
Confederation (Federal government) 1/	0.3	0.1	0.1	-0.1	0.3	-0.2	-0.2	-0.2	-0.3
Cantons	0.2	-0.2	-0.4	-0.3	-0.5	-0.1	-0.1	-0.1	0.0
Communes/municipalities	-0.1	0.0	-0.2	-0.1	-0.1	0.0	0.0	0.1	0.1
Social security	-0.3	0.5	0.5	0.3	0.4	0.2	0.0	0.0	0.1
General government gross debt 3/	47.1	47.1	48.2	47.0	46.1	46.1	45.6	44.6	43.5
Confederation (Federal government) 1/	23.9	24.0	24.1	23.0	22.8	22.6	22.3	21.7	20.9
Cantons	11.4	11.6	12.5	12.6	11.8	11.7	11.5	11.3	11.0
Communes/municipalities	10.4	10.5	10.6	10.7	10.3	10.4	10.4	10.3	10.1
Social security 2/	1.3	1.0	1.1	0.8	1.2	1.4	1.4	1.4	1.5
Memorandum items:									
Nominal GDP (billions of francs)	606	619	624	636	652	648	651	662	678
Output gap (percent)	-0.4	-0.4	-1.0	-0.7	-0.2	-0.9	-0.9	-0.8	-0.2
General Government cyclically adjusted balance	0.2	0.4	0.2	0.1	0.3	0.0	0.0	0.0	0.0

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

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

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

3/ Data are unconsolidated.

Table 5. Switzerland: General Government Operations, 2003–12

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	(In billions of Swiss francs, unless otherwise specified)									
Revenue	161.1	164.7	171.1	179.7	187.7	187.5	186.8	188.7	196.0	195.5
Taxes	94.5	97.7	102.2	108.3	114.6	122.6	121.1	122.4	126.1	126.2
Taxes on income, profits, and capital gains	55.1	56.7	60.5	64.7	69.4	74.9	74.3	73.8	77.2	76.3
Taxes on goods and services	28.1	29.1	30.3	31.5	32.4	29.6	28.8	30.5	31.2	32.8
Taxes on property	10.3	10.8	10.5	11.0	11.8	11.8	11.8	11.9	11.7	11.0
Taxes on international trade and transactions	1.1	1.1	1.0	1.0	1.0	6.2	6.2	6.2	6.1	6.1
Social contributions	32.7	31.9	32.4	33.5	35.1	36.9	38.1	38.3	40.9	41.8
Grants	0.1	0.1	0.1	0.1	-1.4	0.1	0.2	0.2	0.2	0.2
Other revenue	33.8	35.0	36.3	37.8	39.3	28.0	27.3	27.9	28.8	27.3
Of which: property income	8.3	8.4	9.1	9.5	9.7	9.3	8.9	9.0	9.4	7.7
Expenditure	167.4	170.7	173.9	174.9	180.5	177.3	184.0	188.0	194.2	195.8
Expense	164.6	168.5	172.3	173.7	179.1	177.1	182.6	186.6	193.0	195.3
Compensation of employees	47.7	48.4	49.2	49.9	51.2	41.0	43.1	44.1	45.3	46.1
Purchases/use of goods and services	22.6	22.9	23.5	23.8	24.4	21.8	22.5	21.6	23.2	23.7
Interest expense	6.9	6.6	6.9	7.2	6.9	6.5	5.7	5.5	5.4	5.1
Social benefits	55.2	56.6	58.4	58.6	59.6	60.3	64.3	66.4	66.1	67.6
Expense n.e.c.	32.3	33.9	34.3	34.2	37.0	47.6	47.0	48.9	53.0	52.9
Net acquisition of nonfinancial assets	2.8	2.2	1.6	1.3	1.4	0.2	1.4	1.4	1.2	0.5
Net operating balance	-3.5	-3.8	-1.2	6.0	8.6	10.5	4.2	2.1	3.0	0.2
Net lending/borrowing	-6.4	-6.1	-2.7	4.8	7.2	10.2	2.8	0.6	1.8	-0.3
Net acquisition of financial assets	...	...	...	...	...	...	14.5	-19.3	12.9	21.1
Net incurrence of liabilities	...	...	...	...	...	...	11.7	-19.9	11.1	21.4
	(In percent of GDP)									
Revenue	34.0	33.7	33.7	33.4	32.7	31.4	31.8	31.2	31.7	31.3
Taxes	19.9	20.0	20.1	20.1	20.0	20.5	20.6	20.2	20.4	20.2
Taxes on income, profits, and capital gains	11.6	11.6	11.9	12.0	12.1	12.6	12.7	12.2	12.5	12.2
Taxes on goods and services	5.9	6.0	6.0	5.9	5.7	5.0	4.9	5.0	5.0	5.2
Taxes on property	2.2	2.2	2.1	2.0	2.1	2.0	2.0	2.0	1.9	1.8
Taxes on international trade and transactions	0.2	0.2	0.2	0.2	0.2	1.0	1.1	1.0	1.0	1.0
Social contributions	6.9	6.5	6.4	6.2	6.1	6.2	6.5	6.3	6.6	6.7
Other revenue	7.1	7.2	7.2	7.0	6.9	4.7	4.7	4.6	4.7	4.4
Expenditure	35.3	34.9	34.3	32.5	31.5	29.7	31.3	31.1	31.4	31.4
Expense	34.7	34.5	34.0	32.3	31.2	29.7	31.1	30.8	31.2	31.3
Compensation of employees	10.0	9.9	9.7	9.3	8.9	6.9	7.3	7.3	7.3	7.4
Purchases/use of goods and services	4.8	4.7	4.6	4.4	4.3	3.7	3.8	3.6	3.7	3.8
Interest expense	1.4	1.4	1.4	1.3	1.2	1.1	1.0	0.9	0.9	0.8
Social benefits	11.6	11.6	11.5	10.9	10.4	10.1	10.9	11.0	10.7	10.8
Expense n.e.c.	6.8	6.9	6.8	6.4	6.5	8.0	8.0	8.1	8.6	8.5
Net acquisition of nonfinancial assets	0.6	0.5	0.3	0.2	0.2	0.0	0.2	0.2	0.2	0.1
Net operating balance	-0.7	-0.8	-0.2	1.1	1.5	1.8	0.7	0.3	0.5	0.0
Net lending/borrowing	-1.3	-1.2	-0.5	0.9	1.3	1.7	0.5	0.1	0.3	-0.1
Net acquisition of financial assets	...	...	...	...	...	...	2.5	-3.2	2.1	3.4
Net incurrence of liabilities	...	...	...	...	...	...	2.0	-3.3	1.8	3.4

Source: Federal Ministry of Finance.

Table 6. Switzerland: Financial Soundness Indicators, 2007–14

	2007	2008	2009	2010	2011	2012	2013	Jun-14
Banks								
Capital adequacy								
Regulatory capital as percent of risk-weighted assets 1/	12.2 *	15 *	17.5	17.1	16.6	16.9	17.5	16.6
Regulatory Tier I capital to risk-weighted assets 1/	11.5 *	12.5 *	14.9	15.4	15.4	15.7	16.4	14.6
Non-performing loans net of provisions as percent of tier I capital 2/	6.3	6.4	7.0	6.0	5.4	5.0	4.7	3.9
Asset quality and exposure								
Non-performing loans as percent of gross loans	0.8	0.9	1.1	0.9	0.8	0.8	0.8	0.7
Sectoral distribution of bank credit to the private sector (percent) 3/								
Households	66.2	65.5	67.1	68.3	68.8	68.4	68.0	68.0
Agriculture and food industry	1.6	1.5	1.3	1.3	1.2	1.2	1.2	1.2
Industry and manufacturing	3.1	3.0	2.9	3.0	2.9	2.7	2.4	2.3
Construction	1.6	1.6	1.6	1.6	1.7	1.6	1.6	1.6
Retail	3.1	3.0	3.1	3.2	3.1	3.0	2.8	2.8
Hotels and restaurants / Hospitality sector	1.1	1.1	1.1	1.1	1.1	1.0	0.9	0.9
Transport and communications	0.9	0.9	0.9	0.9	0.7	0.8	0.8	0.8
Other financial activities	0.0	0.0	0.4	0.5	0.5	0.6	0.8	0.7
Insurance sector	0.3	0.8	0.5	0.6	0.4	0.6	0.6	0.5
Commercial real estate, IT, R&T	10.9	11.0	11.3	12.1	12.4	12.8	13.3	13.6
Public administration (excluding social security)	2.1	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Education	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Healthcare and social services	1.0	1.0	1.0	1.1	1.1	1.2	1.3	1.2
Other collective and personal services	1.5	1.2	1.0	1.0	1.0	0.9	0.9	0.9
Other 4/	6.4	7.4	7.6	5.3	5.0	5.0	5.3	5.5
Earnings and profitability								
Gross profits as percent of average assets (ROAA)	0.7	0.3	0.5	0.7	0.7	0.6	0.7	0.6
Gross profits as percent of average equity capital (ROAE)	13.7	4.8	7.2	10.4	9.8	9.1	9.3	7.6
Net interest income as percent of gross income	28.1	36.3	30.4	27.9	31.1	31.6	32.3	36.0
Non-interest expenses as percent of gross income	70.4	85.4	80.1	73.3	72.0	73.7	71.6	73.6
Liquidity								
Liquid assets as percent of total assets	14.0	16.3	14.2	10.3	15.5	17.0	12.5	12.1
Liquid assets as percent of short-term liabilities	32.8	37.2	32.9	23.3	33.9	35.4	47.4	47.6
Net long position in foreign exchange as a percentage of tier I capital	12.9	-13.0	-20.6	-36.7	-56.9	-44.5	-41.0	-37.2

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/ As percent of total credit to the private sector.

4/ 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%.

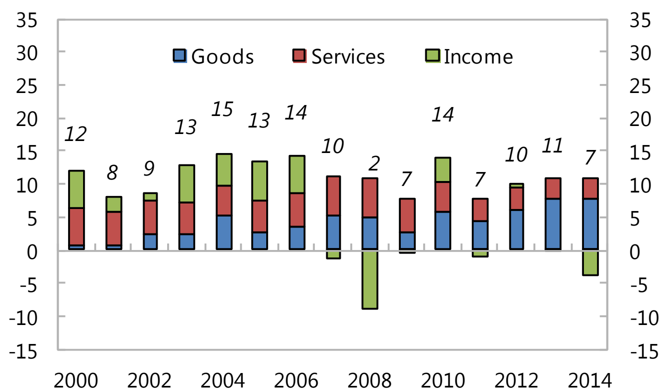
Annex I. Switzerland: External Sector Assessment[1]

Much of Switzerland's current account surplus is accounted for by nontraditional factors, such as merchanting profits, net exports of financial/insurance services, and a statistical bias due to the treatment of retained earnings of multinationals with large foreign ownership. These factors reflect Switzerland's role as a global hub for commodity trading, wealth management, and multinational corporations (MNCs), which in turn boosts reported Swiss income and savings, even though some of this saving may not be fundamentally Swiss. In addition, the SNB reported significant earnings on its large foreign exchange reserves built up in response to post-crisis safe-haven inflows. Stripping away these nontraditional factors reveals a much more modest "underlying" current account balance that is consistent with evidence on the overvaluation of the Swiss franc. The sharp decline in the current account in 2014 (linked to a decline in net income from abroad) highlights the importance of adjusting for these nontraditional factors for purposes of Swiss external assessments.

A. Stylized Facts about the Swiss Current Account

1. **At 9.2 percent of GDP in 2012–14, Switzerland's current account surplus appears high by international standards, but not by its own**. As can be seen, the Swiss current account surplus averaged just over 10 percent of GDP during 2000–14 and reached or exceeded 14 percent of GDP in 2004, 2006, and 2010.

Swiss Current Account Balance and Major Components
(Percent of GDP)



Source: Haver Analytics.

2. **The structure of the Swiss current account is complex, with "nontraditional" items accounting for a large fraction of the surplus (Annex Table 1)**.

- The statistical treatment of retained earnings of MNCs with substantial foreign ownership generates an upward bias in the current account. In particular, under balance of payments accounting rules, all retained earnings of Swiss MNCs are reported as net FDI income for Switzerland, even if foreign shareholders have a claim on those earnings. Because Swiss MNCs distribute less of their earnings to their foreign shareholders than foreign MNCs distribute to their Swiss shareholders, this biases the Swiss current account upwards. In Switzerland, the bias is estimated at approximately 3 percent of GDP in 2014. The attraction of Switzerland as a base for MNCs also partly explains Switzerland's high NIIP (Annex Figure 1) .
- The 2012–14 *goods balance* of +7.2 percent of GDP mostly reflects net exports of goods under merchanting, i.e. profit made on goods bought and sold offshore by Swiss merchanting firms.

[1] Prepared by S. Ali Abbas (SPR), S. Denis (EUR), and M. Mrkaic (EUR).

- The 2012–14 *services balance* of +3.2 percent of GDP was more than fully accounted for by financial and insurance services, reflecting Switzerland's role as one of the world's leading wealth management centers.

- Although the 2012–14 *income balance* was -1.3 percent of GDP, it masks large positive net investment earnings of 4¾ percent of GDP, which are offset by even larger negative labor and secondary income balances. Much of large positive net investment earnings are due to the statistical bias explained in the first bullet above.

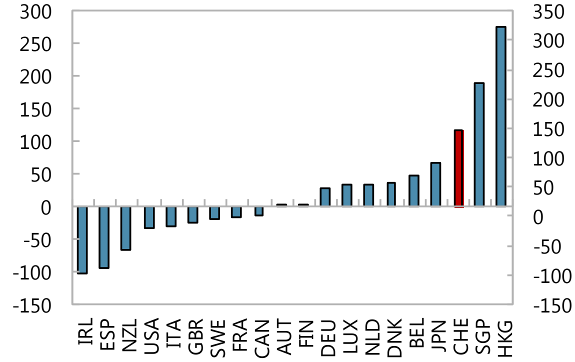
3. **This complexity sets apart the Swiss current account from those of many other major economies with large surpluses**. Factors such as merchanting, financial and insurance services, net FDI earnings, and income on FX reserves only play a marginal role in the current account dynamics of other major economies with large surpluses, e.g. Germany (Annex Figure 2). The same factors seem to play a larger role in some smaller economies that—like Switzerland—offer competitive tax regimes and host important financial centers.

4. **The Swiss current account exhibits large volatility that is largely unrelated to movements in the real exchange rate and global demand**. The standard deviation of the Swiss surplus, computed over the last decade, is 4 percentage points of GDP, one of the highest among advanced economies (Annex Figure 3). Some of this volatility comes from fluctuations in net exports of nonmonetary gold and merchanting (which are strongly correlated with international gold and commodity price movements), and some from financial and insurance services (which respond strongly to global financial shocks). As shown in Annex Table 1, most of the volatility comes from net investment income, in particular net FDI receipts. The latter, which are an outcome of the complex activities of MNCs based out of Switzerland (and motivated sometimes by tax optimization objectives), are difficult to estimate, with official revisions between first estimates and final accounts averaging 3 percentage points of GDP in the last four years. An example of the current account's high volatility is the decline in its surplus from 10.7 percent of GDP in 2013 to 7.0 percent of GDP in 2014, which can be accounted for by the nontraditional factors. The decline in the current account balance occurred despite a stable REER and relatively stable domestic and foreign demand.

5. **The association between the Swiss REER and the current account surplus is mild**. Movements in the exchange rate are likely to have some effects on export/import volumes of some traditional goods and on cross-border trade. Consequently, the appreciation in 2015 is likely to adversely affect near-term growth, as noted in the main text. However, the dominance of nontraditional items in the current account and their volatility mean that the year-to-year relationship between the REER and the current account is mild, as the nontraditional items dominating the Swiss current account are unlikely to be highly exchange-rate sensitive. In addition, even many of the "traditional" items in the trade balances may be less exchange rate-sensitive in Switzerland than in other economies due to tax optimization strategies contaminating intra-MNC cross-border trade. Annex Figure 4 confirms the mild association between movements in the Swiss REER (CPI basis) in a given year and current account-to-GDP changes in the following year.

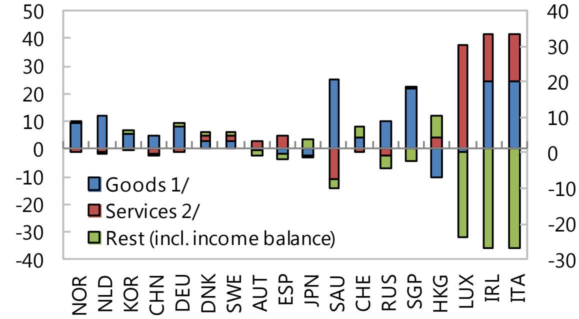
Annex 1. Figures

Figure 1. Net IIP Stocks
(Percent of GDP in 2014)



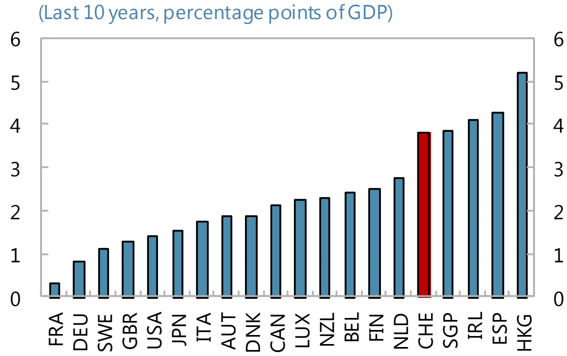
Source: Haver Analytics.

Figure 2. Structure of Largest Current Account Surpluses
(Percent of GDP in 2014)



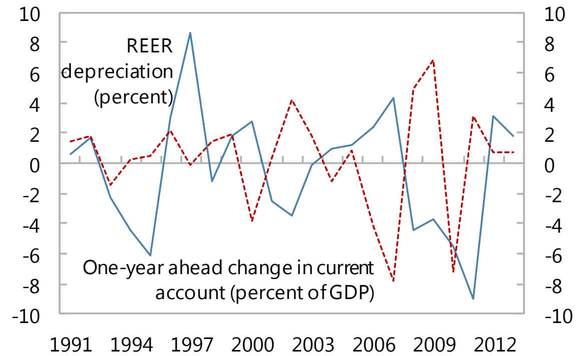
Sources: Haver Analytics; WEO; IMF staff calculations.
1/ Excluding nonmonetary gold and merchanting.
2/ Excluding finance, insurance and license fees.

Figure 3. Standard Deviation of Current Account
(Last 10 years, percentage points of GDP)



Sources: Haver Analytics; WEO; and IMF staff calculations.

Figure 4. Correlation between REER depreciation *(t)* and Change in CAB/GDP *(t+1)* is not strong



Source: IMF staff calculations.

B. Assessment of the Swiss Current Account and Real Exchange Rate

6. **Staff views Switzerland's external position as having been broadly in line with fundamentals in 2014, though this assessment is subject to high uncertainty**. This judgment reflects a balance of a number of factors, including the EBA current account norm estimates, EBA REER overvaluation estimates, and special Swiss-specific factors, as elaborated upon in the main text (paragraphs 8–10), this previous section of this annex, and the draft country page for the 2015 External Sustainability Report (see below). Consistent with this view, staff assesses the franc to have been broadly in line with fundamentals in 2014, with this assessment also subject to significant uncertainty.

7. **The appreciation in early 2015 is likely to weaken the external position and to have left the franc overvalued**. As of April 2015, the REER has appreciated by about 10 percent relative to its average 2014 value. This appreciation is likely to reduce net exports due to lessened competiveness and has likely left the franc overvalued. This overvaluation partly reflects a policy gap of insufficiently easy monetary policy—simple Taylor rules suggest an optimal policy rate well below

current levels—which in turn reflects various operational challenges associated with unconventional monetary policy (see monetary policy discussion in main text).

8. **Further insights for the Swiss external sector assessment can be obtained by stripping nontraditional components from the Swiss surplus and focusing on an "underlying" measure of the current account**. Note that we are adopting a slightly different approach here than used in the EBA, in that the EBA assumes that all economies' current accounts are comparable, while making a 2½ percent of GDP adjustment for three financial center economies. This approach is somewhat unsatisfactory, given that, in the Swiss case, net exports of merchanting and finance/insurance services alone add up to 7 percent of GDP in 2014. In our approach, therefore, we adjust the Swiss current account for nontraditional items in a consistent manner over time, producing three definitions of "core current account" (bottom 3 rows of Annex Table 1):

- The *narrow* definition sums the (i) goods balance *less* merchanting and nonmonetary gold net exports; (ii) services balance *less* finance and insurance services and patents/license fees; and (iii) income balance *less* all net investment income. As can be seen, during 2000-14 this balance averaged -1.4 percent of GDP, with a low volatility of 1.2 percentage points of GDP.

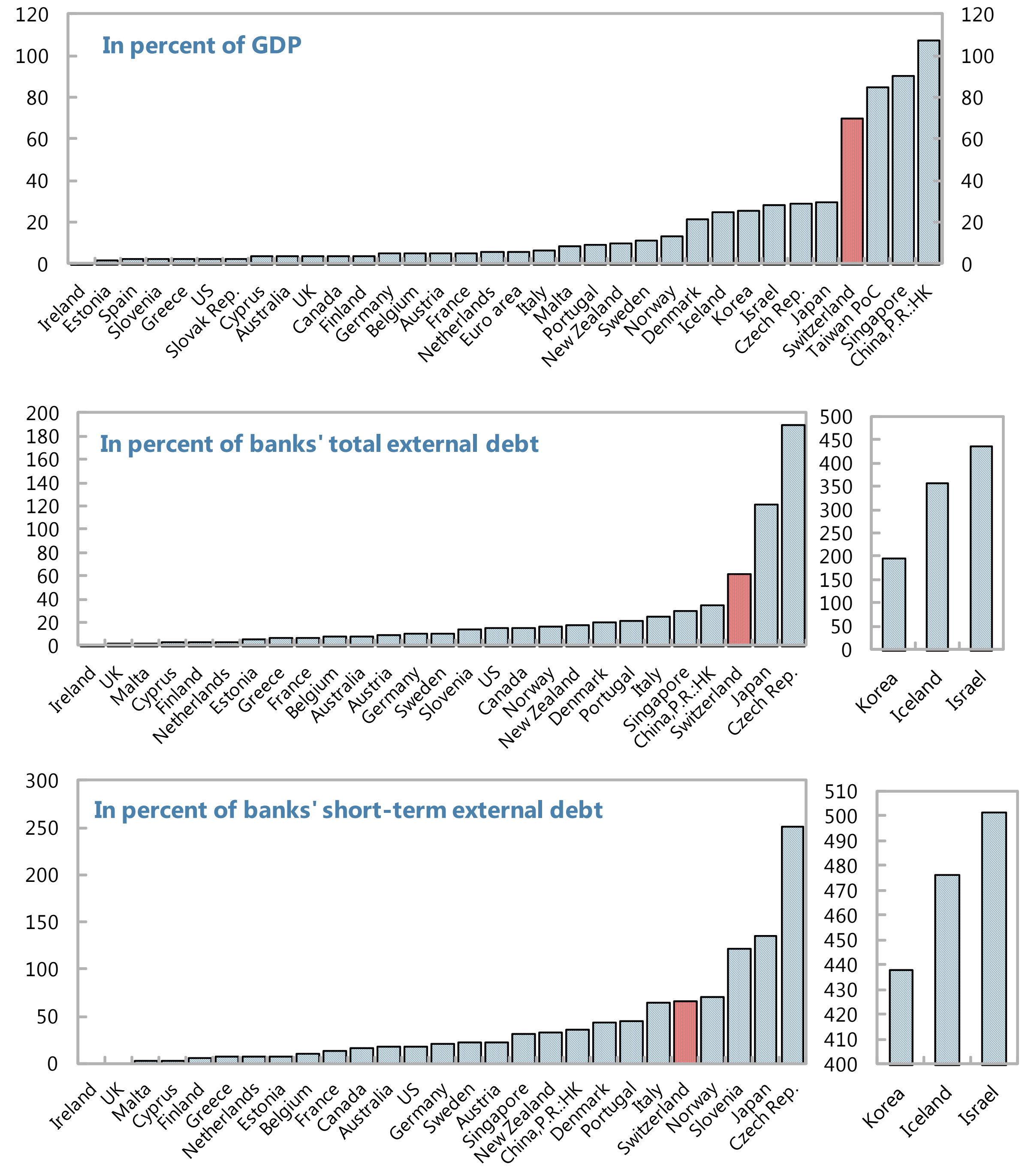
- The *medium* definition adds to the narrow definition the excluded services net exports (finance, insurance, and patent/license fees), as it could be argued that this income accrues to Swiss residents as remuneration for providing services that the Swiss economy has built a comparative advantage in over a period of decades. This balance averaged 3.9 percent of GDP over 2000–14, with a volatility of 1.8 percentage points of GDP.

- The *broad* definition adds to the medium definition one-half of *X*, where *X* is net investment income excluding income earned on the SNB's foreign exchange reserves. This definition treats half of the foreign assets owned by Swiss corporate and individual citizens as reliably Swiss, with the other half seen as representing decisions by globally mobile firms and individuals to invest their wealth via Switzerland for security and stability, tax optimization, or other reasons. This balance averaged 6.5 percent of GDP over 2000–14, with a volatility of 2.6 percentage points of GDP.

9. **These smaller and relatively stable "core balances" lend further support to the overvaluation of the REER**. The sizes of the core surpluses are small; in fact, the cleanest measure ("narrow" definition) shows an average *deficit* of 1.4 percent of GDP over 2000–14 and a consistent widening of this deficit since 2008 (cumulatively 4.2 percentage points of GDP). The medium and broad definitions of the core surplus also undershoot the estimated EBA norm.

10. **Switzerland's central bank reserves are large by most metrics, but partly reflect the high volatility of its capital flows**. As a percent of GDP, Switzerland's reserves are some of the highest among advanced economies, but similar to those of other financial centers (Hong Kong SAR, Singapore). However, relative to bank debt, Switzerland's reserves are not as high as in some other small, open economies.

Advanced Economies: Foreign Exchange Reserves, End-2014[1]



Sources: IMF World Economic Outlook database; and World Bank/IMF/BIS External Debt database.
1/ For several countries, the data are for end-2013.

Annex Table 1. The Structure of the Swiss Current Account Balance (2000–14)

Percent of GDP	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Avg. (2000-14)	Std. dev. (2000-14)	Avg. (2000-02)	Avg. (2012-14)	Avg(2012-14) *minus* Avg(2000-02)	2014 *minus* 2011
Headline current accountbalance:	12.0	8.2	8.6	12.7	14.5	13.4	14.2	10.0	2.2	7.1	14.0	6.8	9.9	10.7	7.0	10.1	3.5	9.6	9.2	-0.4	0.2
Goods and services balance	6.3	5.7	7.4	7.3	9.6	7.6	8.7	11.2	11.0	7.6	10.3	7.8	9.4	11.0	11.0	8.8	1.8	6.4	10.5	4.0	3.2
Goods balance	0.7	0.7	2.4	2.4	5.2	2.8	3.5	5.2	5.0	2.7	5.9	4.2	6.0	7.8	7.8	4.2	2.2	1.3	7.2	6.0	3.6
Goods_ex-gold&merchanting	-0.6	-0.3	1.6	1.4	2.0	1.2	1.6	2.5	3.0	2.9	2.6	2.9	3.2	2.9	3.9	2.1	1.3	0.2	3.4	3.1	1.0
Goods_nonmonetary gold	0.9	0.6	0.2	0.2	1.9	-0.1	-0.4	0.1	-1.3	-3.6	-1.3	-3.2	-1.5	1.2	0.0	-0.4	1.5	0.6	-0.1	-0.6	3.2
Goods_merchanting	0.4	0.4	0.6	0.7	1.3	1.6	2.3	2.6	3.3	3.4	4.6	4.5	4.3	3.7	3.9	2.5	1.6	0.5	3.9	3.5	-0.6
Services balance	5.6	5.0	5.0	4.9	4.4	4.8	5.2	6.0	5.9	4.9	4.4	3.6	3.4	3.1	3.1	4.6	0.9	5.2	3.2	-1.9	-0.4
Services_ex-FIL	-0.6	-0.4	-0.6	-0.6	-1.1	-1.1	-0.8	-0.5	0.1	-0.3	-0.3	-0.6	-0.8	-1.1	-0.8	-0.6	0.3	-0.5	-0.9	-0.4	-0.3
Services_finance & insurance (FI)	5.7	4.8	4.8	4.9	4.9	5.1	5.3	5.9	5.1	4.3	3.8	3.4	3.5	3.5	3.4	4.6	0.9	5.1	3.5	-1.7	0.0
Services_patents & license fees (L)	0.5	0.6	0.7	0.6	0.7	0.8	0.7	0.6	0.8	0.9	0.9	0.7	0.7	0.7	0.6	0.7	0.1	0.6	0.7	0.1	-0.1
Income balance	5.7	2.5	1.2	5.4	4.9	5.8	5.5	-1.2	-8.8	-0.5	3.7	-1.0	0.5	-0.3	-4.0	1.3	4.2	3.1	-1.3	-4.4	-3.0
Primary income balance	7.3	4.5	3.3	7.2	6.8	8.8	7.9	1.0	-6.2	2.1	6.2	1.3	2.8	2.5	-0.3	3.7	3.9	5.0	1.7	-3.4	-1.6
Labor income	-1.8	-1.9	-2.0	-2.0	-2.1	-2.0	-2.1	-2.2	-2.2	-2.3	-2.5	-2.7	-2.9	-3.0	-3.1	-2.3	0.4	-1.9	-3.0	-1.1	-0.4
Investment income	9.1	6.5	5.3	9.2	8.9	10.8	10.0	3.2	-3.9	4.4	8.7	4.0	5.7	5.5	2.8	6.0	3.8	6.9	4.7	-2.3	-1.2
Inv income_ex-FX	*8.5*	*5.9*	*4.8*	*8.8*	*8.4*	*10.4*	*9.7*	*2.9*	*-4.3*	*3.9*	*7.8*	*3.0*	*4.6*	*4.2*	*1.4*	*5.3*	*3.8*	*6.4*	*3.4*	*-3.0*	*-1.7*
Inv income_FDI	5.8	3.9	2.2	6.1	6.0	8.0	7.2	0.2	-6.5	2.2	6.3	1.5	3.4	3.6	1.5	3.4	3.6	4.0	2.8	-1.2	-0.1
Inv income_FPI	2.7	2.3	2.4	2.4	2.3	2.5	2.6	2.9	2.4	2.2	2.0	1.5	1.4	0.6	0.1	2.0	0.8	2.5	0.7	-1.8	-1.4
Inv income_Other	0.0	-0.3	0.2	0.3	0.1	-0.1	-0.2	-0.2	-0.1	-0.4	-0.4	0.0	-0.2	0.0	-0.2	-0.1	0.2	0.0	-0.1	-0.1	-0.2
Inv income_reserves (FX)	0.6	0.6	0.5	0.5	0.5	0.4	0.3	0.3	0.3	0.5	0.8	1.0	1.1	1.3	1.5	0.7	0.4	0.5	1.3	0.8	0.5
Secondary income balance	-1.6	-2.0	-2.1	-1.8	-1.9	-3.0	-2.4	-2.2	-2.6	-2.6	-2.5	-2.3	-2.3	-2.8	-3.7	-2.4	0.5	-1.9	-2.9	-1.0	-1.4
Public	-0.4	-0.4	-0.5	-0.5	-0.6	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.5	-0.5	-0.6	-0.6	-0.5	0.1	-0.5	-0.6	-0.1	-0.1
Private	-1.2	-1.6	-1.5	-1.2	-1.3	-2.4	-2.0	-1.8	-2.2	-2.1	-2.1	-1.8	-1.8	-2.2	-3.1	-1.9	0.5	-1.4	-2.4	-0.9	-1.3
Underlying current account balance:																					
Narrow = blue cells only	-1.9	-2.7	-0.5	-0.3	-0.7	-2.4	-1.3	0.2	0.5	-0.5	-1.1	-1.2	-1.5	-3.4	-3.9	-1.4	1.3	-1.7	-2.9	-1.3	-2.7
Medium = blue + FIL services	4.3	2.7	5.1	5.1	4.8	3.4	4.8	6.8	6.4	4.7	3.6	3.0	2.7	0.9	0.1	3.9	1.8	4.0	1.2	-2.8	-2.9
Broad = blue + 0.5*(FIL services + Inv. income ex-reserves)	8.6	5.7	7.5	9.5	9.0	8.6	9.6	8.2	4.2	6.6	7.5	4.5	5.0	3.0	0.8	6.6	2.6	7.2	2.9	-4.3	-3.7

Sources: SNB; Haver Analytics; and Fund staff calculations.

	Switzerland: Draft Page for the 2015 External Sustainability Report	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Switzerland is a financial center with a positive NIIP of about 120 percent of GDP and large gross foreign asset and liability positions of 624 and 504 percent of GDP, respectively. The NIIP to GDP ratio has been volatile with no significant trend over the last 10 years, despite large current account surpluses. The ratio is projected to rise moderately in the medium term as recent exchange rate appreciation contributes to a wider output gap and significant inflation undershooting, both of which will temporarily depress nominal GDP growth. Over the longer run, the ratio is expected to stabilize and then decline modestly. **Assessment**. Switzerland's large gross liabilities and the volatility of its capital flows present risks, but these are mitigated by Switzerland's large net asset position and foreign reserves.	**Overall Assessment**: *In 2014, the underlying external position was broadly consistent with medium-term fundamentals and desirable policy settings.* This assessment takes into account measurement anomalies in the Swiss balance of payments. *After the significant REER appreciation in early 2015, the external position will likely weaken.* **Potential policy responses**: Monetary easing, perhaps via a schedule of FX purchases (given limited options for other methods of monetary easing), would help limit the near-term growth slowdown, reduce risks of inflation expectations becoming anchored at low levels, and lessen franc overvaluation.
Current account	**Background**. Switzerland has a moderate to large CA surplus, dominated by net investment income and goods balance. Preliminary estimates from the authorities indicate a surplus of 7 percent of GDP in 2014, down from 11 percent in 2013, reflecting mainly a decline in primary income. Correcting for net foreign ownership of FDI retained earnings and other factors (e.g., merchanting exports) that have a tangential relation to the real Swiss economy would further reduce the "true" CA surplus.[1/] **Assessment**. The EBA CA regression approach estimates a CA gap of around 0.7 percent of GDP, reflecting a cyclically-adjusted current account surplus of 7.5 percent of GDP and an EBA CA regression-estimated norm of 6.8 percent of GDP. However, Switzerland's current account surplus is misleadingly high because it is driven by non-traditional flows—such as merchanting activities, commodity trading, financial and insurance services, and net FDI earnings—that are highly affected by the operations of large multinationals, financial firms, and wealthy foreigners, whose savings may not be fundamentally Swiss. The CA assessment is subject to unusually high uncertainty, given these anomalies, the high volatility of income flows, and the potential for large revisions to the preliminary 2014 CA estimate. Taking these considerations into account, staff assesses a CA gap for 2014 ranging from -3.5 to 2.5 percent of GDP. The CA gap is expected to become more negative in the near term due to REER appreciation so in far in 2015, which will adversely affect competiveness.	
Real exchange rate	**Background**. The REER (CPI basis) appreciated by 26 percent from 2007 to 2011. In September 2011, the SNB established a floor of 1.20 for the CHF/EUR exchange rate, and the REER depreciated by 4 percent during 2011–14. The SNB exited from the floor on January 15, 2015. As of April 2015, the REER has appreciated by about 10 percent from its average 2014 level. **Assessment**. The EBA REER index and level regression-based estimates suggest that the average REER in 2014 was overvalued by 11 and 13 percent, respectively, relative to its fundamentals and desirable policy settings. Taking into consideration these estimates, the somewhat smaller estimates implied by staff's CA assessment, and staff's broader analysis, staff assesses that the franc was broadly in line with fundamentals in 2014 (overvalued by 0–10 percent). Overvaluation likely increased in 2015 due to the appreciation so far this year.	
Capital and financial accounts: **flows and policy measures**	**Background**. Significant net outward FDI (mostly reinvested earnings) has been a consistent feature of the financial account in recent years, although bank lending flows have become critical since the crisis. The SNB absorbed very large safe-haven inflows (intermediated by the banking system) during 2009–12 through reserve accumulation. **Assessment**. Safe-haven capital inflows may return in the event of a re-emergence of euro area stress, an intensification of emerging market turmoil (including due to a disorderly UMP exit by major central banks), or political risks.	

	Switzerland (continued)
FX intervention and reserves level	**Background**. The SNB accumulated foreign exchange reserves of about 70 percent of GDP during 2009–14 in various rounds of intervention, including to defend the CHF/EUR floor. At end-2014 the SNB's balance sheet was approaching 90 percent of GDP. The SNB exited from the floor on January 15, 2015. The franc has since floated between 1.00–1.10 CHF/EUR, with the SNB intervening occasionally (mainly in the immediate aftermath of the exit from the floor). **Assessment**. Reserves are large relative to GDP but more moderate relative to external liabilities. Substantial reserves are explained in part by the volatility of capital flows. In recent years, interventions have been monetary policy operations aimed at avoiding persistent inflation undershooting and given the limited supply of domestic assets available for purchase. Interventions have also helped limit exchange rate overvaluation.
Technical Background Notes	1/ Swiss multinational 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. See T. Mancini-Griffoli and N. Stoffels, "Adjusting the Current Account to Better Capture Wealth Accumulation," mimeo, SNB, August 2012. See also the discussion elsewhere in this annex.

Annex II. Switzerland: Risk Assessment Matrix[1]

Source of Risks	Relative Likelihood	Expected impact	Policy Response
Globally Originated Risks from the G-RAM			
1. A surge in financial volatility, as investors move to safe-haven assets	**High**	**High** Potential triggers could include market displacement from asynchronous policy normalization, a reassessment of fundamentals, and commodity price volatility. Demand for safe-haven assets would rise, leading to sharp appreciation pressures on Swiss franc assets. The franc appreciation adds to deflation and hurts Swiss competitiveness and growth.	Further ease monetary policy via additional FX purchases. Consider temporarily suspending the fiscal rule to allow deeper fiscal easing if downturn is sustained and/or deep.
2. Protracted period of slower growth in advanced and EM economies	**High**	**High** Europe is Switzerland's main trading partner. A protracted period of slower European growth would dampen economic growth.	Same as 1 above.
3. Heightened risk of geopolitical fragmentation in Russia/Ukraine and the Middle East	**Medium**	**High** The direct impact should be limited. However, contagion and heightened volatility in financial markets may trigger renewed safe-haven flows.	Same as 1 above.
Globally Originated Risks not in the G-RAM			
4. Upside surprises to demand (external or domestic), inflation, and/or franc depreciation	**Medium**	**Medium** Higher-than-expected growth in major trading partners or increased global risk appetite could boost franc depreciation, inflation, and growth.	Scale back monetary easing relative to baseline recommendations.
5. Growing changes in the international regulatory landscape and increased enforcement actions against banks	**Medium**	**Medium** Switzerland's attraction as a financial center may diminish, affecting financial sector assets, growth, employment, and public finances.	Compliance and effective implementation of relevant international standards, including those issued by the FATF.

[1] 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 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 between 30 and 50 percent). 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.

Source of Risks	Relative Likelihood	Expected impact	Policy Response
Domestically Originated Risks			
6. A surge in house prices and mortgage borrowings, which eventually collapses	**Medium**	**High** Households' balance sheets would be hit hard, and domestic demand would be reduced. The financial sector would suffer through both direct and indirect effects.	Keep tightening supervision and macroprudential policies during the upswing. Loosen macro policies following the bust.
7. Weaker economic relationships with EU	**Medium**	**Medium** Re-introducing immigration quotas could restrict access to skilled workers and EU markets, weakening long-run growth.	Secure a constructive resolution to uncertainties related to EU relations and immigration.

Annex III. Switzerland: Debt Sustainability Analysis

Summary: Public debt sustainability risks remain subdued due to the strict implementation of fiscal rules and the low stock of public debt.[1]

Baseline Scenario: The two main assumptions underlying the baseline scenario are a gradual but steady recovery of economic growth and the continued adherence to federal and sub-federal fiscal rules. Under the baseline scenario, public debt is projected to decline from 46 percent of GDP in 2015 to 41 percent of GDP in 2020. Gross financing needs are expected to remain around 10 percent of GDP during the medium term.

Stress Tests: The main risk to debt dynamics is a negative growth shock. Other risks—for example, an adverse interest rate shock or a shock to financing needs—affect the public debt trajectory only to a minor extent.

- **Real GDP growth shock**. Real GDP growth rates are assumed to be one standard deviation (1.8 percent) below the baseline during 2015–16. Under this scenario, the debt-to GDP ratio approaches 48 percent in 2017 (3 percentage points higher than the baseline).

- **Primary balance shock**. The primary balance in 2015–16 is hit by a negative shock of 0.4 percent of GDP. This shock results in a debt-to-GDP ratio that is only slightly above the baseline during 2015–20.

- **Real interest rate shock**. The nominal interest rate increases by 200 basis points during 2015–20. The debt-to-GDP ratio increases only marginally in 2016 and continues declining afterwards.

- **Real exchange rate shock**. This scenario assumes that the nominal CHF/USD exchange rate increases by 14 percent in 2016 relative to its 2015 level. As with other non-growth related shocks, the impact of this shock on the trajectory of public debt is minor.

- **Combined shock**. A simultaneous combination of the previous three shocks would result in an increasing debt-to-GDP ratio that approached 48 percent in 2017 (approximately 3 percentage points higher than the baseline). However, after 2017, the debt would start declining on a trajectory that is parallel to the one under the baseline scenario.

[1] For the purpose of this analysis, the general government includes the federal government, cantonal governments, municipal governments, and the social security fund.

Switzerland: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

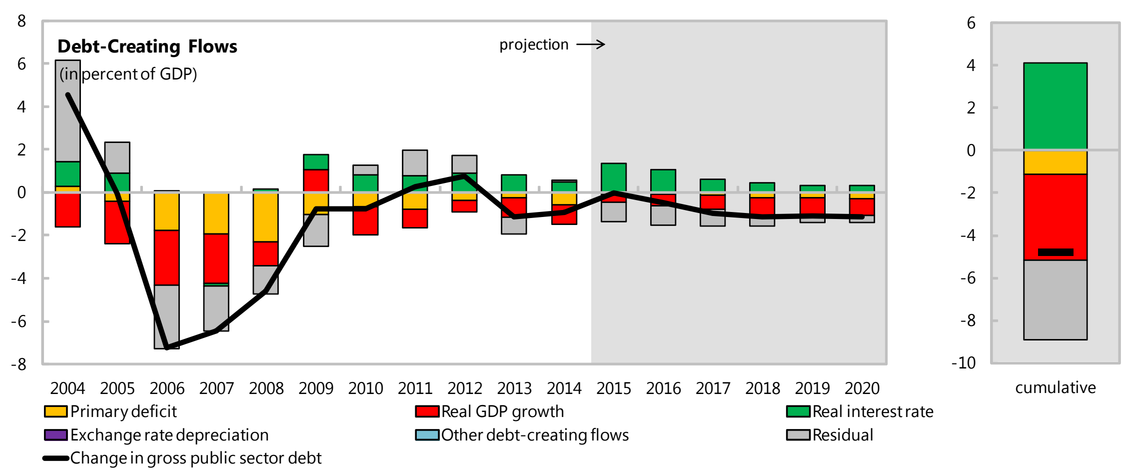
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	54.0	47.0	46.1	46.1	45.6	44.6	43.5	42.4	41.3
Public gross financing needs	1.4	1.7	1.3	11.0	12.5	11.7	10.9	10.2	9.9
Public debt (in percent of potential GDP)	54.1	46.7	46.0	45.7	45.2	44.3	43.4	42.4	41.3
Real GDP growth (in percent)	2.2	1.9	2.0	0.8	1.2	1.5	1.9	1.9	1.9
Inflation (GDP deflator, in percent)	0.9	-0.1	0.5	-1.4	-0.8	0.2	0.5	0.8	0.8
Nominal GDP growth (in percent)	3.1	1.8	2.5	-0.6	0.4	1.7	2.5	2.7	2.8
Effective interest rate (in percent) [4/]	2.0	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6

As of April 15, 2015		
Sovereign Spreads		
Bond Spread (bp) 3/		-25
5Y CDS (bp)		15
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AAA	AAA
Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.6	-1.1	-0.9	0.0	-0.5	-1.0	-1.1	-1.1	-1.1	-4.8	
Identified debt-creating flows	-1.7	-0.4	-1.0	0.9	0.4	-0.2	-0.7	-0.7	-0.8	-1.1	
Primary deficit	-1.0	-0.2	-0.6	-0.1	-0.1	-0.1	-0.3	-0.3	-0.3	-1.1	-0.5
Primary (noninterest) revenue and grants	31.9	31.0	31.0	31.0	31.0	31.0	31.0	31.0	31.0	185.8	
Primary (noninterest) expenditure	30.9	30.7	30.4	30.9	30.9	30.8	30.7	30.7	30.7	184.6	
Automatic debt dynamics [5/]	-0.7	-0.1	-0.4	1.0	0.5	-0.1	-0.4	-0.5	-0.5	0.1	
Interest rate/growth differential [6/]	-0.7	-0.1	-0.4	1.0	0.5	-0.1	-0.4	-0.5	-0.5	0.1	
Of which: real interest rate	0.6	0.8	0.5	1.4	1.1	0.6	0.4	0.3	0.3	4.1	
Of which: real GDP growth	-1.3	-0.9	-0.9	-0.4	-0.6	-0.7	-0.8	-0.8	-0.8	-4.0	
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	
Residual, including asset changes [8/]	0.1	-0.8	0.1	-0.9	-0.9	-0.8	-0.5	-0.4	-0.4	-3.7	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds (bp).

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 = effective nominal 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).

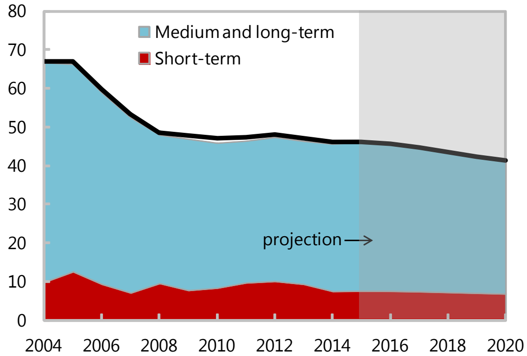
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

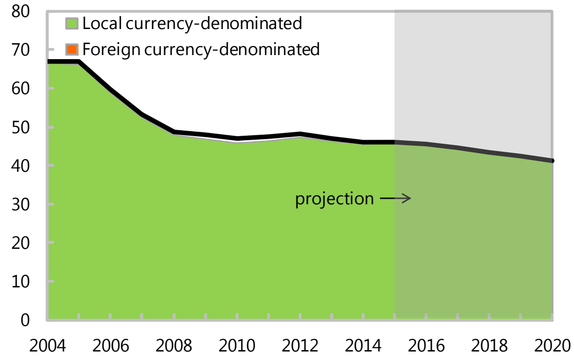
Switzerland: Public DSA – Alternative Scenario

Composition of Public Debt

By Maturity
(in percent of GDP)



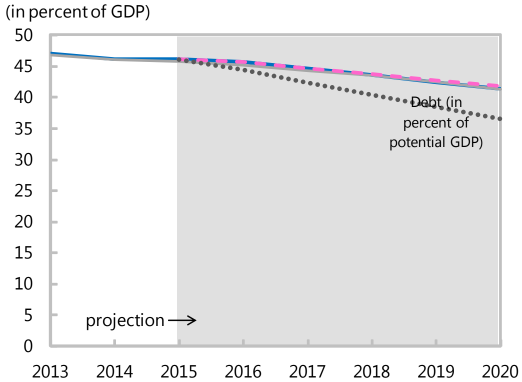
By Currency
(in percent of GDP)



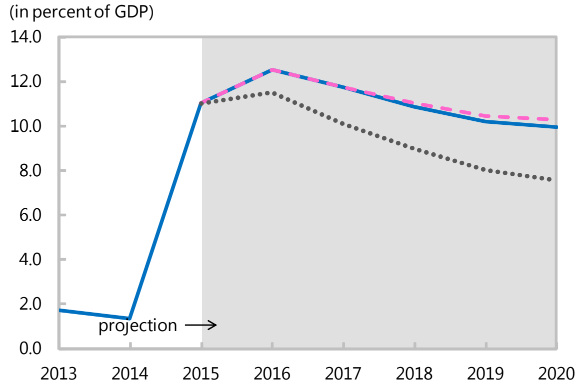
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt 1/
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.8	1.2	1.5	1.9	1.9	1.9
Inflation	-1.4	-0.8	0.2	0.5	0.8	0.8
Primary Balance	0.1	0.1	0.1	0.3	0.3	0.3
Effective interest rate	1.6	1.6	1.6	1.6	1.6	1.6
Constant Primary Balance Scenario						
Real GDP growth	0.8	1.2	1.5	1.9	1.9	1.9
Inflation	-1.4	-0.8	0.2	0.5	0.8	0.8
Primary Balance	0.1	0.1	0.1	0.1	0.1	0.1
Effective interest rate	1.6	1.6	1.6	1.6	1.6	1.6

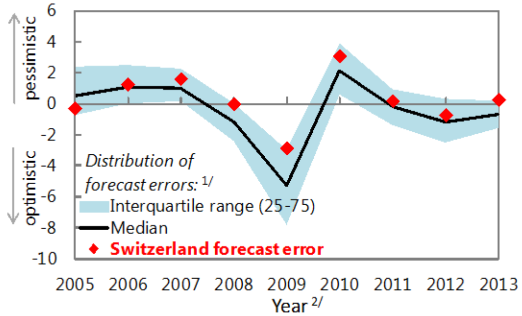
Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.8	2.1	2.1	2.1	2.1	2.1
Inflation	-1.4	-0.8	0.2	0.5	0.8	0.8
Primary Balance	0.1	1.0	1.0	1.0	1.0	1.0
Effective interest rate	1.6	1.6	1.5	1.5	1.5	1.5

Source: IMF staff.

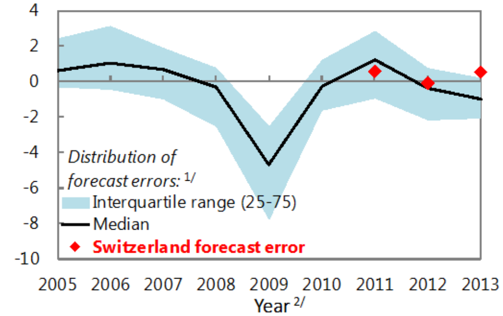
Switzerland: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

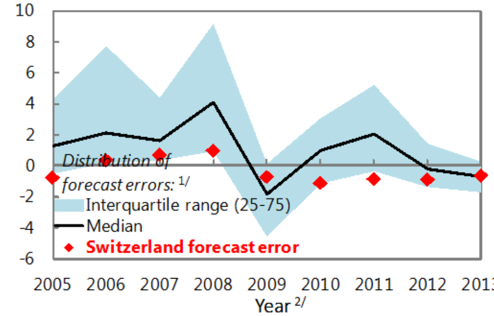
Real GDP Growth
(in percent, actual-projection)
Switzerland median forecast error, 2005-2013: **0.17**
Has a percentile rank of: **62%**



Primary Balance
(in percent of GDP, actual-projection)
Switzerland median forecast error, 2005-2013: **0.53**
Has a percentile rank of: **75%**

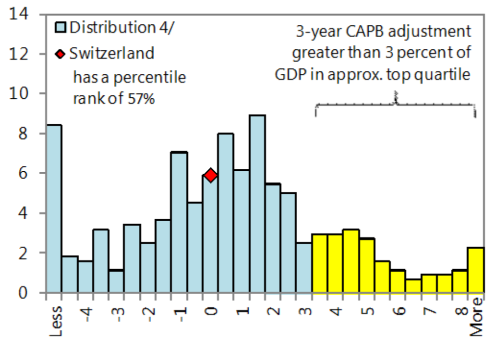


Inflation (Deflator)
(in percent, actual-projection)
Switzerland median forecast error, 2005-2013: **-0.72**
Has a percentile rank of: **9%**

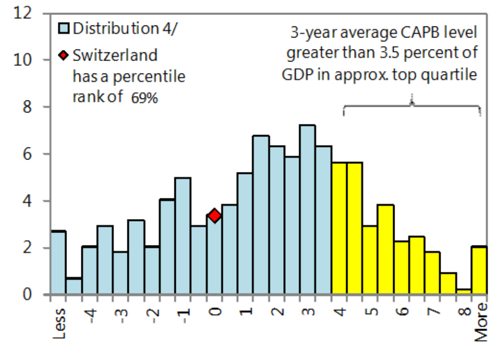


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

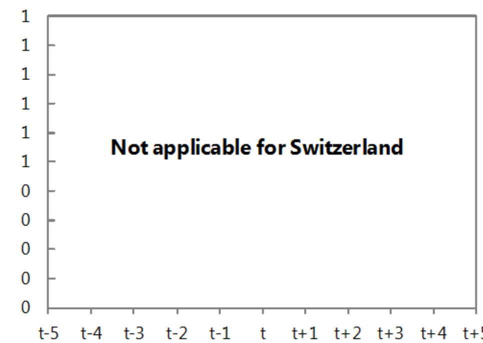


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

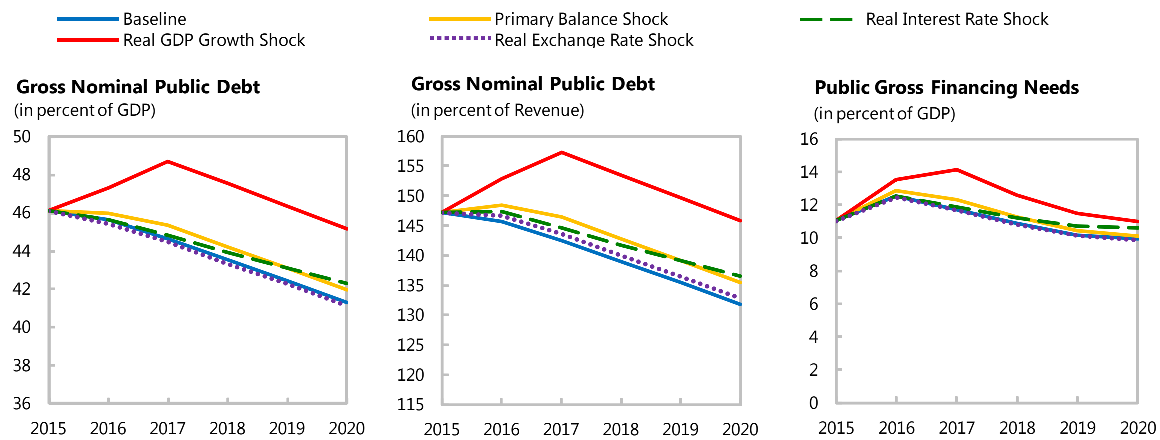
Real GDP growth
(in percent)



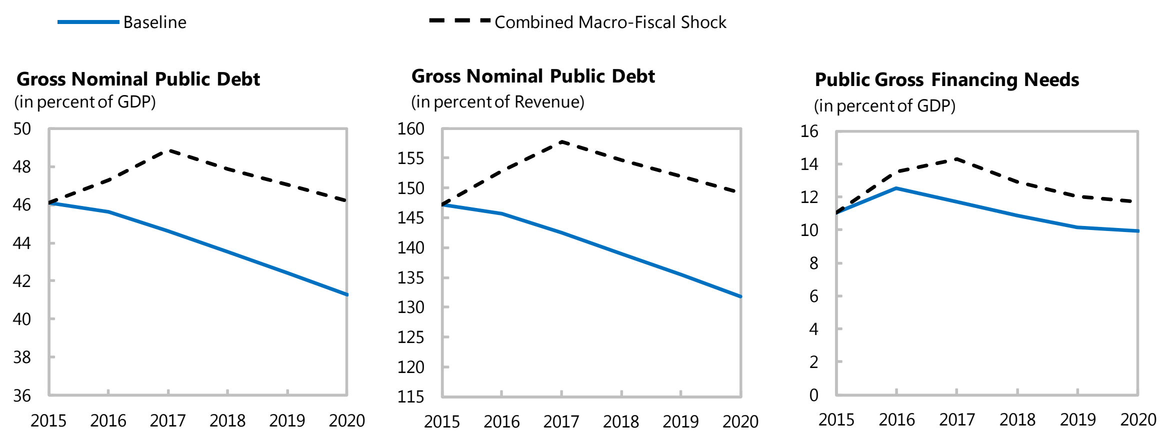
Source: IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Switzerland, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Switzerland: Public DSA – Stress Test

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	0.8	1.2	1.5	1.9	1.9	1.9
Inflation	-1.4	-0.8	0.2	0.5	0.8	0.8
Primary balance	0.1	-0.3	-0.2	0.3	0.3	0.3
Effective interest rate	1.6	1.6	1.6	1.6	1.6	1.6
Real Interest Rate Shock						
Real GDP growth	0.8	1.2	1.5	1.9	1.9	1.9
Inflation	-1.4	-0.8	0.2	0.5	0.8	0.8
Primary balance	0.1	0.1	0.1	0.3	0.3	0.3
Effective interest rate	1.6	1.6	1.9	2.1	2.2	2.4
Combined Shock						
Real GDP growth	0.8	-0.6	-0.3	1.9	1.9	1.9
Inflation	-1.4	-1.2	-0.3	0.5	0.8	0.8
Primary balance	0.1	-0.6	-1.3	0.3	0.3	0.3
Effective interest rate	1.6	1.6	1.9	2.1	2.2	2.4

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	0.8	-0.6	-0.3	1.9	1.9	1.9
Inflation	-1.4	-1.2	-0.3	0.5	0.8	0.8
Primary balance	0.1	-0.6	-1.3	0.3	0.3	0.3
Effective interest rate	1.6	1.6	1.6	1.6	1.6	1.6
Real Exchange Rate Shock						
Real GDP growth	0.8	1.2	1.5	1.9	1.9	1.9
Inflation	-1.4	-0.3	0.2	0.5	0.8	0.8
Primary balance	0.1	0.1	0.1	0.3	0.3	0.3
Effective interest rate	1.6	1.6	1.6	1.6	1.6	1.6

Source: IMF staff.

Switzerland: Public DSA – Risk Assessment

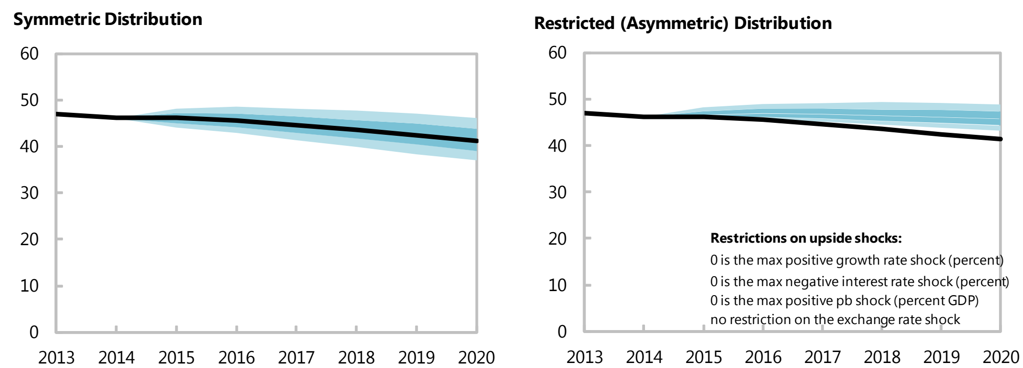
Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

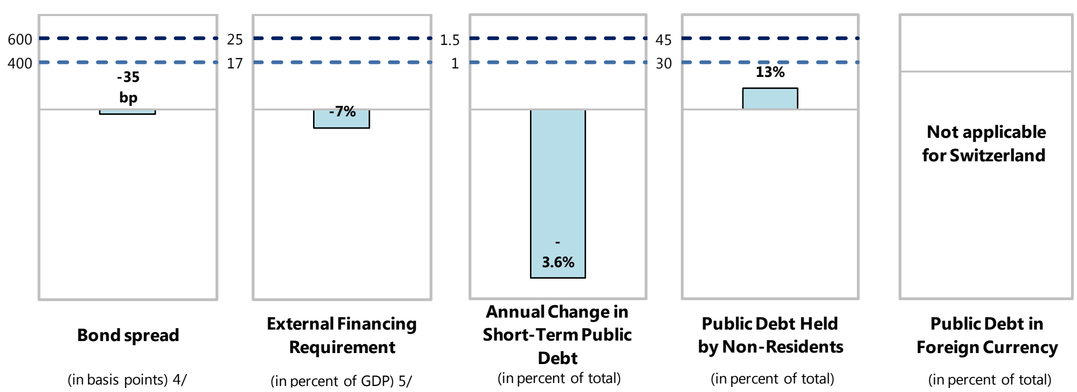
Baseline   Percentiles: 10th-25th   25th-75th   75th-90th



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)

Switzerland   Lower early warning   Upper early warning



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds (bp), an average over the last 3 months, 15-Jan-15 through 15-Apr-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex IV. Switzerland: FSAP Update—Status of Key Recommendations

Recommendation	Actions taken by the authorities
Short term	
Impose a leverage ratio on banks that is tougher than international minima.	In December, 2014, the final report of the "Group of Experts on the Further Development of the Financial Market Strategy," appointed by the Federal Council and led by Professor Aymo Brunetti, was released. It has recommendations for modifying the current Swiss Too-Big-To-Fail framework, including that Switzerland should be among the leading countries in terms of going-concern capital requirements based on both risk-weighted requirements and the leverage ratio. In February 2015, the Federal Council expressed its support for the recommendations and has instructed the FDF to submit proposals for necessary legal adjustments by end-2015.
Remain alert to the build-up of risks in domestic real estate and mortgage markets. Fully enforce self-regulation, and consider further raising the countercyclical capital buffer and introducing additional tools (e.g., debt-to-income (DTI) and loan-to-value (LTV) limits).	FINMA and the SNB closely monitor real estate and mortgage market developments and are still concerned about imbalances, notwithstanding a slowdown in both real-estate price and mortgage growth. The authorities are enforcing self-regulations and have taken the following new measures, implemented since September 2014: stricter (i) amortization requirements; (ii) use of second incomes for financial sustainability evaluation; and (iii) valuation of properties for mortgages. There are currently no plans to introduce new macroprudential tools.
Bring Financial Market Infrastructures (FMIs) into compliance with new international principles and establish crisis management arrangements between the authorities of FMIs.	The CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs) have been transferred into national law for central counterparties, payment systems and central securities depositories as well as securities settlement systems by revising the requirements for such FMIs in the National Bank Ordinance (NBO). For trade repositories, the international principles will be transferred into national law in the new Financial Market Infrastructures Act, which is currently in Parliament and is expected to enter into force at the earliest at the beginning of 2016. Crisis management will also be strengthened as the new Financial Market Infrastructure Act is completed and implemented by the Financial Market Infrastructure Ordinance. FINMA and the SNB intend to identify and implement the arrangements needed to ensure effective coordination and cooperation between the authorities and with FMIs for FMI-specific crisis scenarios.
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.	A FINMA circular (2008/22) is being revised to reflect the revised pillar 3 disclosure requirements. This circular has previously been updated to comply with Basel Committee on Banking Supervision requirements regarding: a) composition of capital disclosure, b) leverage ratio framework and disclosure; and c) liquidity coverage ratio disclosure standards. The two Swiss big banks have increased transparency related to model-based RWA in line with the recommendations of the Enhanced Disclosure Task Force (a private sector initiative). For example, both institutions

	recently started to disclose changes in their RWA, broken down by cause, including reductions attributable to model adjustments. There is no information for the period between 2009 and 2012, during which large decreases in the big banks' RWA occurred. In addition, Swiss accounting rules for banks were revised in 2014, providing the authorities with the opportunity to require more information, especially in the notes to the financial statements.
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.	On December 5, 2014, the Federal Council took due note of the final Brunetti Report, which includes several recommendations largely in keeping with the FSAP recommendations, including transparency, governance reform in line with international standards, shorter payout period (20 to 7 working days), and ex ante funding. The Federal Council will decide on how to proceed with the expert group's recommendations at a later date. There is no proposal to make deposit insurance funds available to finance resolution measures on a least-cost basis, however.
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.	A full revision of the primary reference for governance issues (FINMA Circular 2008/24 "Supervision and Internal Control—Banks") is planned for 2015, with particular focus on the latest international developments in this area. More concise formulation of qualification criteria for board members and a bank's risk governance framework will also be considered. FINMA reports that governance issues are given considerable weight in its ongoing supervision of big and middle-sized banks, including cantonal banks. Qualification and composition of the supreme governing body as a whole are periodically challenged at the regular supervisory dialogue with the banks. All the cantonal banks, except one, now have a majority of independent board members as set out in FINMA Circular 08/24. No explicit guidance on guarantees for cantonal banks is planned or likely to occur in the near future.
Ensure that the likely consolidation among the private banks in response to U.S. tax pressures proceeds smoothly.	In 2014, the consolidation process for private banks continued. Five private banks ceased their business and were released from FINMA's supervision. One private bank was merged with another firm. One private bank was liquidated and another one is still in the process of liquidation. These transactions proceeded smoothly, except in one case unrelated to U.S. tax pressures. So far, the extent of problems in smaller Swiss private banks appears to have been more limited than feared.
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.	In 2013, FINMA established Circular 2013/3 focusing on prudential audits performed by external auditors. This text is being implemented and supplemented by templates and instructions concerning risk analysis, audit strategy and form and content of long-form audit reports. FINMA has furthermore decided to issue detailed guidance describing how to audit each regulatory audit field. The circular provides the possibility to mandate experts or audit firms that are not in charge of the ordinary audit to investigate a special field, and FINMA uses this option. FINMA has intensified its direct supervisory activities over recent years, in particular through internal analytical work and on-site inspections. FINMA is currently examining the possibility to redirect some resources in order to

	further strengthen these supervisory activities. The Federal Council adopted a report on December 20, 2014, which concludes that there is no fundamental need for institutional reform. However, it identified certain areas for improvement, including (i) FINMA to further develop their own monitoring activities, notably by enhancing their analytical work and increased on-site inspections; (ii) FINMA to ensure that institutions with comparable activities and risks are supervised consistently; (iii) FINMA to use their human resources according to the importance of the individual areas of supervision. The Federal Council will decide on how to proceed with the expert group's recommendations at a later date.
Short to medium 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.	There are no plans to increase FINMA's resources, as the authorities do not share the view that additional resources are needed.
Medium term	
Reach agreement with partner supervisors as to the resolution of the country's G-SIFIs.	FINMA reports that it has reached a consensus on the resolution strategy of its G-SIBs with the Crisis Management Group (CMG) of both G-SIBs and is currently concluding cooperation agreements on crisis management of the Swiss G-SIBs between the CMG members. Detailed implementation of the agreements still needs to be defined and agreed upon.
Make available the full range of best practice resolution powers to handle any bank deemed systemic at the time.	No changes made to directly address the FSAP recommendation. The authorities plan to amend the banking act to provide a statutory basis for FINMA bail-in powers and grant it resolution powers for holding companies and non-operational entities.
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 Swiss Solvency Test.	Life insurers are monitored closely. For 2014, FINMA expects that the effects of the palliative measures have been smaller compared to previous years. FINMA engages in the exchange of information on Swiss Solvency Test-related topics with regulators and supervisors in other jurisdictions (e.g., EIOPA, BaFin). In addition, FINMA representatives give presentations about the Swiss Solvency Test, both in Switzerland and abroad.
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.	The Federal Council has taken note of the results of the consultation on the Financial Services Act (FinSA) and the Financial Institutions Act (FinIA) and instructed the FDF to carry out various adjustments. The aim is to upgrade the quality of the services provided by Swiss financial institutions and to improve client protection, while at the same time, bring regulations in line with international standards and equivalent to EU regulation. The FinSA, inter alia, governs financial institutions' relationship with their clients with regard to the most important financial products, and harmonizes the associated code of conduct. The FinIA brings together various existing laws on the supervision of financial institutions that operate an asset management business in any form in a new piece of legislation. The new Financial Market Infrastructure Act, currently in parliament,

	governs the organization and operation of financial market infrastructure. The provisions that are currently dispersed in various federal acts will be combined in a single law aligned with market developments and international requirements.
Pursue legislation to improve policyholder protection, enhance brokers' supervision, and increase the level of public disclosure.	In March 2015, a revision of the Insurance Supervisory Ordinance went into force. This includes improvements of policyholder protection, increased public disclosure of insurance companies, and the supervision of insurance brokers. Policyholder protection is intended to be enhanced by: (i) applying the Swiss Solvency Test also to reinsurance captives and (ii) increasing the qualitative requirements, such as additional requirements on organization and corporate governance. In particular, insurers are required to have independent risk management and compliance functions. In addition, the Own Risk and Solvency Assessment (ORSA) has been assembled in a dedicated section. Parts of these requirements existed until now as a collection of individual items. For liquidity of insurers, existing qualitative requirements are complemented with quantitative requirements, which FINMA has been tasked to further specify. Public reporting requirements of insurers are increased by requiring insurers to publicly report on their activities, profits, risk management, risk profile, methods for technical provisions, capital management, and solvability. This obligation will be synchronized with the application of the public disclosure requirements in the European Union. FINMA is to further elaborate the specifications. The supervision of insurance brokers is enhanced by the obligation to report to FINMA items from criminal records, if they are related to certain criminal actions.

Annex V. Switzerland: Authorities' Response to Past IMF Policy Recommendations

IMF 2014 Article IV Recommendations	Authorities' Response
Monetary and Exchange Rate Policies	
Monetary conditions should remain expansionary and the exchange rate floor should remain in place.	The SNB has maintained an expansionary monetary policy stance with the policy rate reduced to -0.75 percent. However, in early 2015, the SNB had to intervene heavily to maintain the exchange rate floor against the euro. At the same time, depreciation against the dollar reduced the likelihood of franc overvaluation. In this context, the SNB judged that the franc needed more flexibility and that, with this change in conditions, the costs of maintaining the floor were no longer worth the benefits, resulting in an exit from the floor on January 15, 2015.
Negative interest rates on banks' excess reserves may need to be introduced in case of renewed strong pressures on the franc.	Implemented.
Provisions need to be strengthened to bring SNB capital in line with risks.	The SNB built up provisions for currency reserves in 2014.
Housing Market Policies	
• Discourage vulnerable households from taking on too much mortgage debt. • Existing self-regulation measures should be tightened, for example to speed up loan amortization. • Curb mortgage growth in the buy-to let segment. • Stricter direct regulation may be necessary, including mandatory affordability caps and maximum loan-to value ratios. • Phase out tax incentives that encourage borrowing to finance home buying.	The authorities are enforcing self-regulations and have taken new measures, implemented since September 2014: (i) stricter amortization requirements; (ii) stricter use of second income for financial sustainability evaluation; and (iii) stricter valuation requirements for residential real estate. There are currently no immediate plans to introduce new macroprudential tools, though the authorities are continuously assessing whether further action is needed.
Structural and Fiscal Policies	
Address the challenges of an aging population.	The government submitted the Pension 2020 reform package to the parliament.
A rapid resolution of uncertainty related to future immigration policy.	In progress.

Financial Sector Policies	
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.	The Federal Council expressed its support for the recommendations of the Brunetti Report, which includes that Switzerland should be among the leading countries in terms of going-concern capital requirements based on both risk-weighted requirements and the leverage ratio, and instructed the FDF to submit proposals for necessary legal adjustments by end-2015. The authorities are adopting international standards related to increased disclosure of risk weights and involved in international initiatives to strengthen standards further.
Continue discussions with international counterparts to reach agreement on measures to make the large banks resolvable without public sector support.	FINMA reports that it has reached a consensus on the resolution strategy of its G-SIBs with the Crisis Management Group (CMG) of both G-SIBs and is currently concluding cooperation agreements on crisis management of the Swiss G-SIBs between the CMG members.
Increase resources available to FINMA for banking supervision, in particular so it can extend its intensive supervision in the sector beyond the largest banks.	FINMA reports that it has intensified its direct supervisory activities, including on-site inspections, and resources will be redirected to further strengthen these supervisory activities. They do not see a need for substantially increased resources.
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.	In 2013, FINMA established Circular 2013/3 focusing on prudential audits performed by external auditors. This text is being implemented and supplemented by templates and instructions concerning risk analysis, audit strategy, and form and content of long-form audit reports. FINMA has furthermore decided to issue detailed guidance describing how to audit each regulatory audit field.
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.	The Federal Council took note of the recommendations of the Brunetti Report on this issue, which includes several recommendations largely in keeping with the FSAP recommendations, including transparency, governance reform in line with international standards, shorter payout period, and ex ante funding. The Federal Council will decide on how to proceed with the recommendations at a later date. There is no proposal to make deposit insurance funds available to finance resolution measures on a least-cost basis.

INTERNATIONAL MONETARY FUND

SWITZERLAND

May 4, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By **European Department**

CONTENTS

FUND RELATIONS

(As of April 20, 2015)

Membership Status: Joined May 29, 1992; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	3,458.50	100.00
Fund holdings of currency	3,345.34	96.73
Reserve position in Fund	113.22	3.27
New arrangement to borrow	1,110.93	

SDR Department

	SDR Millions	Percent Allocation
Net cumulative allocations	3,288.04	100.00
Holdings	3,006.39	91.43

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund:[1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

			Forthcoming		
	2015	2016	2017	2018	2019
Principal					
Charges/Interest	0.12	0.16	0.16	0.16	0.16
Total	0.12	0.16	0.16	0.16	0.16

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, and all settlements are made at free market rates. On January 15, 2015, the SNB ended the exchange rate floor of CHF 1.20 per euro, and the franc has since been floating. However, the SNB may intervene in the foreign exchange market. The SNB publishes information regarding its foreign exchange transactions in its annual accountability report. The 2014 IMF Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) classifies the de facto exchange rate regime as a crawl-like arrangement. This

[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.

classification does not take into account the exit from the exchange rate floor in January 2015; the implications of this move for the de facto classification will be assessed in the context of the 2015 AREAR.

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 April 30, 2014, 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.

Latest Article IV Consultation: The last Article IV consultation was concluded on April 30, 2014, with the staff report published on May 28, 2014. Switzerland is on the standard 12-month consultation cycle.

Technical Assistance: None

Resident Representatives: None

Financial System Stability Assessment Update and ROSCs:

- A Financial System Stability Assessment Update was conducted in 2013–14, and the report was issued on May 28, 2014.
- Reports on the Observance of Standards and Codes (Basel core principles, IAIS core principles, and IOSCO objectives and principles) were conducted in 2013–14, and the report was issued on May 28, 2014.

STATISTICAL ISSUES

Switzerland's economic and financial statistics are adequate for surveillance purposes. Switzerland 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 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) plays an active role—will take several years. 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. More specifically:

- general government finance statistics are finalized 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 are published with a considerable lag.

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

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 have reported 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. Since 2014, the BOP and international investment position data have been published based on the sixth edition of the IMF's Balance of Payments Manual (BPM6). To ensure that new and old data are comparable and to ensure that data users have long data series at their disposal, the SNB formally reclassified the old data series in line with BPM6.

Switzerland has continued to provide data on Financial Soundness Indicators (FSIs) and participated in the 2009 Coordinated Direct Investment Survey. The data and metadata have been posted on the IMF website. Both the SNB and FINMA have continued to transmit FSB Data Gaps related data to the central data hub hosted by the BIS and have continued their preparatory work for phase 3 of the project. In the area of cashless payment transactions, the various surveys have been thoroughly revised. The prime aim of the revision was to enable a full reflection of the technological innovations of the past few years in the area of cashless payment transactions. Reporting institutions have reported data according to the revised surveys for the first time as of December 31, 2014 (reference date).

The FSO has taken various steps in 2014 to improve core business statistics. In September 2014, national accounts results were published for the first time according to the 2008 version of the System of National Accounts (SNA 2008). This enabled users to have internationally comparable data with a timing that was tightly coordinated with Switzerland's European partners. Given the importance of R&D in Switzerland, the impact was quite high in terms of GDP level, but moderate in terms of dynamics. For 2015, the FSO plans to publish new data on jobs, which will be in line with the concepts of the business census introduced in the last quarter of 2012. In addition, a project was initiated to produce prices on real estate transactions. First results are expected in 2017 and will assist monitoring of the housing market.

Table of Common Indicators Required for Surveillance (As of April 31, 2015)					
	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Same day	Same day	D and M	M and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb 15	Mar 15	M	M	M
Reserve/Base Money	Mar 15	Apr 15	M	M	M
Broad Money	Mar 15	Apr 15	M	M	M
Central Bank Balance Sheet	Mar 15	Apr 15	M	M	M
Consolidated Balance Sheet of the Banking System	Feb 15	Apr 15	M	M	M
Interest Rates[2]	Same day	Same day	D and M	M and M	D and M
Consumer Price Index	Mar 15	Apr 15	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4]	2012	Feb 15	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government[3]	Feb 15	Mar 15	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4/14	Feb 15	Q	Q	Q
External Current Account Balance	Q4/14	Mar 15	Q	Q	Q
Net International Investment Position	Q4/14	Mar 15	Q	Q	Q
Exports and Imports of Goods and Services	Feb 15	Mar 15	M	M	M
GDP/GNP	Q4/14	Mar 15	Q	Q	Q
Gross External Debt	Q4/14	Mar 15	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. 15/239
FOR IMMEDIATE RELEASE
May 27, 2015

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

IMF Executive Board Concludes 2015 Article IV Consultation with Switzerland

On May 18, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Switzerland.

Switzerland's economy has performed relatively well in the aftermath of the global financial crisis, with growth reaching 2 percent in 2014. However, the economic environment became more complicated in late 2014, as increased capital inflows forced the Swiss National Bank (SNB) to start intervening heavily to defend its exchange rate floor of 1.20 francs per euro. The SNB eventually exited the floor on January 15, 2015, while also cutting its policy rate (the interest rate on deposits at the SNB exceeding 20 times required reserves) to -0.75 percent. Following these moves, the exchange rate appreciated substantially before stabilizing at around 1.05 francs per euro.

In the near term, economic growth in Switzerland is likely to slow, as the strong franc, which is now likely overvalued, reduces net exports. Consistent with this view, leading economic indicators have declined so far in 2015. For the full year, GDP growth is projected to slow to about 0.75 percent and to about 1.25 percent in 2016. This growth slowdown is expected to increase unemployment, but only modestly, in part due to the cushioning effects of short-time work arrangements. Inflation, which is already very low at -1.1 percent as of April 2015, is expected to fall further in 2015, as the effects from exchange rate appreciation and the recent decline in oil prices continue to pass through into final prices.

Over the medium term, the economy is expected to recover gradually. As the economy adjusts to the exchange rate appreciation, growth is projected to rise gradually back to around 2 percent over the medium term while inflation increases to around 1 percent. Switzerland's fiscal rules are expected to keep the structural fiscal deficit near zero and government debt low.

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[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.

However, this central scenario is subject to important risks. One key risk is that very low levels of inflation may complicate the operation of monetary policy by making it more difficult to reduce real interest rates as necessary in response to shocks. Indeed, yields on 10-year government bonds are negative and the lowest in the world, indicating significant risks of a protracted period of very low inflation and sluggish growth. Other important risks include uncertainty about future immigration policy and its effects on EU relations, global and regional economic developments, the effects of ongoing changes in the international financial regulatory landscape, and the potential for price reversals in the housing market, which has been buoyant in recent years.

To help address risks and medium-term challenges, the authorities have recently undertaken or proposed a numbers of reforms. These include various financial sector reforms (e.g., adoption of tighter lending standards for mortgages), proposed reforms to bolster the sustainability of the pension system, and proposed reforms of corporate taxation and financial controls to help comply with international initiatives aimed at limiting money laundering and cross-border tax evasion and avoidance.

Executive Board Assessment[2]

Executive Directors commended Switzerland's continued strong economic fundamentals underpinned by sound policy management. Directors noted, however, that following the exit from the exchange rate floor earlier this year and the subsequent appreciation of the franc, the economy faces currency overvaluation and weakened near-term growth and low inflation prospects.

Directors agreed that further monetary easing would support growth and reduce exchange rate overvaluation. In addition, they noted that moving inflation closer to the upper end of the target range over the medium term could mitigate risks associated with low inflation. However, a number of Directors considered that controlling inflation to this extent may not be feasible for the small and open Swiss economy.

Given the limited room for conventional monetary easing, Directors saw need to explore various options. In this regard a pre-announced program for asset purchases could be an option, although many Directors were not convinced about the effectiveness of such a program at this juncture. Looking ahead, Directors agreed that the policy rate should be maintained at its current level for now, as this has been helpful in reducing deflationary pressures. More broadly, they encouraged the central bank to further enhance communication of its monetary policy framework and to

[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 summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

continue to prioritize provisioning over transfers to its distribution reserve to ensure that its capital remains in line with risks.

Directors commended Switzerland's fiscal rule which has helped maintain low deficits and debt. They concurred that for fiscal policy to support growth, automatic stabilizers should be allowed to operate fully, as permitted under Switzerland's debt-brake rule, while avoiding budgeting over-performance against the rule. Directors generally agreed that in the event of a severe or protracted recession, discretionary fiscal stimulus could be employed by triggering the rule's temporary escape clause to help boost growth and inflation and avoid overburdening monetary policy.

Directors welcomed the progress made in financial sector reforms and encouraged further action in line with the Brunetti Report and the FSAP update. They highlighted the need to closely monitor financial stability risks in the housing market and adopt further prudential measures as needed. These could include raising minimum leverage ratio requirements of the two large international banks and improving their resolvability, increasing banks' disclosure of information of risk weights, further refining FINMA's use of external auditors, and overhauling deposit insurance. Directors also called for continued monitoring of the effects of the low-interest rate environment, especially for life insurers and defined-benefit pension plans.

Directors underscored the need to sustain structural reforms to support medium-term growth and address challenges. In this regard, they called for action to reduce uncertainty related to future immigration policy and its effect on relations with the European Union. Directors looked forward to the timely completion of the corporate tax reforms and financial controls, consistent with international initiatives aimed at limiting money laundering and cross-border tax evasion and avoidance. Reforms to boost full-time female labor force participation, such as lowering marginal tax rates on second incomes, could also enhance potential growth. Directors welcomed the proposed pension reforms, which would help ensure the sustainability of the social safety net and its continued availability for future generations.

Switzerland: Selected Economic Indicators, 2012–16

	2012	2013	2014	2015	2016
Real GDP (percent change)	1.1	1.9	2.0	0.8	1.2
Total domestic demand	-1.2	-0.8	1.7	2.5	1.8
Final domestic demand	2.7	2.0	1.2	2.0	1.5
Private consumption	2.8	2.2	1.0	2.5	2.0
Public consumption	2.9	1.4	1.1	1.8	1.2
Gross fixed investment	2.5	1.8	1.8	1.0	0.5
Inventory accumulation 1/	-3.5	-2.5	0.4	0.4	0.2
Foreign balance 1/	2.2	2.7	0.5	-1.4	-0.4
Nominal GDP (billions of Swiss francs)	624.4	635.7	651.8	648.2	651.1
Savings and investment (percent of GDP)					
Gross national saving	34.1	33.2	30.5	28.6	28.5
Gross domestic investment	24.2	22.5	23.6	22.8	22.9
Current account balance	9.9	10.7	7.0	5.8	5.6
Prices (percent change)					
GDP deflator	-0.2	-0.1	0.5	-1.4	-0.8
Consumer price index (period average)	-0.7	-0.2	0.0	-1.1	-0.4
Consumer price index (end of period)	-0.4	0.1	-0.3	-1.4	0.3
General government finances (percent of GDP)					
Revenue	31.3	31.3	31.3	31.3	31.3
Expenditure	31.4	31.5	31.1	31.6	31.6
Balance	-0.1	-0.1	0.2	-0.3	-0.3
Cyclically adjusted balance	0.2	0.1	0.3	0.0	0.0
Gross debt 2/	48.2	47.0	46.1	46.1	45.6
Employment and slack measures					
Unemployment rate (percent)	2.9	3.2	3.2	3.4	3.6
Output gap (percent of potential GDP)	-1.0	-0.7	-0.2	-0.9	-0.9
Capacity utilization	81.5	80.7	82.0	...	...
Potential output growth	1.7	1.7	1.5	1.5	1.3
Exchange rates (levels)					
Swiss francs per USD (annual average)	0.9	0.9	0.9	...	...
Swiss francs per euro (annual average)	1.2	1.2	1.2	...	...
Real effective rate (avg., 2000=100) 3/	114.0	114.0	116.0	...	...

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

1/ Contribution to growth.

2/ Unconsolidated and reflects GFSM 2001 methodology, which values debt at market prices.

3/ Based on relative consumer prices.

Statement by Messers. Daniel Heller, Executive Director for Switzerland, and Marco Cavaliere, Senior Advisor to the Executive Director
May 18, 2015

General

On behalf of the Swiss authorities, we would like to thank staff for presenting a helpful report and for their candid policy recommendations. The report includes a thorough and insightful analysis of the macroeconomic situation. Moreover, it adds considerable value to the domestic policy discussions in Switzerland. In most aspects, we share staff's opinion on the challenges going forward.

Outlook

Staff's outlook for the Swiss economy is well in line with our authorities' latest forecast, which was done in March 2015. We are slightly more optimistic than the Fund regarding growth prospects for 2016, as our forecast relies on a firming recovery in export sectors. We fully share staff's risk assessment.

Monetary and exchange rate policy

The Swiss National Bank (SNB) shares staff's view that monetary conditions are too tight, given the overvaluation of the Swiss Franc. The SNB will therefore remain active in the foreign exchange market, as necessary, in order to influence monetary conditions. Regarding a preannounced program of foreign purchases, this might be one of the policy options. However, the effectiveness of such a policy should not be overestimated. As the recent experience suggests, the quantity of foreign assets to be purchased would presumably need to be fairly high to have a meaningful effect on the exchange rate. Moreover, this would expand the balance sheet at a pace that might limit the flexibility of monetary policy in the future. As it regards moving inflation back near the upper end of the target range (i.e., closer to 2 percent) over the medium term, the SNB's view is that it is not possible, in a small open economy like Switzerland, to fine-tune inflation to such an extent. Announcing a narrow target would suggest that the SNB has better control of inflation than it actually does.

Fiscal policy

We agree with staff that both the debt brake rule at the federal level as well as the different fiscal rules at the cantonal level have largely contributed to the success of fiscal policy in recent years. According to our latest estimates, the general government should record a small deficit amounting to 0.1 percent of GDP in 2014. This nearly balanced result, which was reached in an increasingly difficult environment, underscores the decisive efforts at all government levels to keep fiscal policy on a sustainable path. In moving forward, we remain committed to the fiscal strategy of (i) complying with the requirements of the debt brake rule in the short and medium-term and (ii) maintaining expenditure growth at a sustainable level. At the same time, we are aware that economic indicators for Switzerland have recently worsened, pointing to a slowdown in growth. We share staff's opinion that in this situation allowing automatic stabilizers to operate freely is the best way forward. Discretionary stabilization measures should remain an option only in case of a severe recession.

External assessment
We welcome the very helpful analysis of the factors underlying Switzerland's large current account surplus. As rightly noted by staff, several special factors, such as (i) the treatment of retained earnings of multinational corporations, (ii) merchanting activities, and (iii) financial services, are important to understand the level and movement of the Swiss current account. It should be also noted that merchanting activities are not the only key driver of the goods balance surplus. In fact, the pharmaceutical and chemical export industry, which is not mentioned in the report, makes an even larger contribution, by accounting for more than 40 percent of total exports in goods.

Pension reform
We welcome staff's recommendation to go forward with the comprehensive pension reform package prepared by the government. We also take note of the recommendation to reduce the minimum guaranteed interest rate on invested assets for second pillar pension funds. In this regard, we would like to note that our authorities review this minimum interest rate every year and acts, on the recommendation of a commission of external experts, to ensure an adequate level of objectivity, reliability, and transparency. The criteria considered include, among others, movements in equities, bonds, and real estate. Thus, the average yield of 10-year Swiss government bonds is not the key reference for setting the aforementioned minimum interest rate, as the staff's report might suggest. The last review of the rate in October 2014 did not give grounds for a rate reduction. In fact, while the yield on Swiss government bonds remained low, other asset classes including real estate posted good performances. The next review will take place in autumn 2015.

Financial sector policies
We generally agree with staff's assessment and recommendations on Swiss financial sector policies. We would like to provide comments in these three key areas.

Large banks
We welcome staff's support for the recommendations in the "Brunetti Report," especially regarding the need to raise leverage ratio requirements for large banks to levels that are internationally leading. We agree that while these banks are well capitalized relative to peers in terms of risk weighted capital ratios, their leverage ratios are below the average of other major banks. We also share staff's view that improvements in risk weighted assets (RWA) transparency are needed. To address these and other issues, a working group led by the Federal Department of Finance is reviewing the Too-Big-To-Fail framework and will make concrete proposals by end-2015, taking into account the finalization of an international standard on Total Loss-Absorbing Capacity (TLAC) for global systemic banks. This group has a mandate, in particular, to recalibrate risk weighted and leverage ratio requirements so that they are internationally leading and to review the method of calculating RWA and propose adjustments, if necessary. Finally, we share staff's view that, while the large banks have announced important steps to adapt their legal structure, continued action, including at international level, is needed to further improve their resolvability.

Housing and mortgage sector
We share staff's assessment that, despite a partial slowing of dynamics in the housing and mortgage sectors, risks remain high. Various prudential measures have been undertaken

between 2012 and 2014 to address these risks. While the measures appear to have had some positive effect, large imbalances remain. As noted in the report, measures implemented recently require more time to take full effect. Our authorities will continue to (i) closely monitor developments in the housing and mortgage markets and (ii) reassess on a regular basis the need for an adjustment to the countercyclical capital buffer. Moreover, they agree that further policy action may be warranted, in particular, to target affordability and the income-producing real estate sector.

FINMA's supervisory approach

Regarding staff's recommendation to improve the system of external audit firms used for regulatory audits, we understand that directly mandating audit firms and paying them through a FINMA-managed and bank-financed fund may reduce conflicts of interests. Switching to such a system would, however, require legislative changes. Furthermore, effective measures are already in place to ensure FINMA's control over the work conducted by audit firms and to prevent banks from influencing their auditors. Our authorities are also of the opinion that periodic rotation of audit firms, as recommended by staff, would not be an effective measure to enhance the Swiss supervisory approach, owing to the oligopolistic structure of the audit market. Finally, after a recent significant expansion in staffing, FINMA considers its current resource to be adequate.