May 2009
IMF Country Report No. 09/164

Switzerland: 2009 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; 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 2009 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 9, 2009, 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 1, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 18, 2009, discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Switzerland.

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

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INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Consultation with Switzerland

Approved by Anne-Marie Gulde-Wolf and Martin Mühleisen

May 1, 2009

Executive Summary

- **Focus**. The report focuses on the impact of the global crisis, measures to manage the associated risks and vulnerabilities, and macro-financial linkages and spillovers.

- **Context**. Switzerland benefited from its strong macroeconomic, fiscal and external fundamentals going into the crisis. However, the large financial sector was affected at an early stage, and now the impact of the crisis on the real economy is being felt as well.

- **Outlook**. Staff expects a significant economic decline in 2009. Along with a sharp contraction in exports, investments are now being postponed. Consumption has held up well so far, but as unemployment rises household spending will lose momentum. Growth is expected to pick up in the course of 2010. Headline inflation is projected to be negative in 2009 and into 2010.

- **Monetary and exchange rate policy.** The Swiss National Bank has appropriately loosened monetary policy, bringing the policy rates almost to zero. Quantitative easing has been implemented with purchases of private sector paper and unsterilized foreign exchange intervention aimed at limiting undue appreciation of the Swiss franc.

- **Fiscal policy**. The impact of the crisis and two fiscal stimulus packages will result in a deficit, after years of surpluses. Further fiscal stimulus would be appropriate, but should not put at risk the sustainability of public finances at a time of significant contingent liabilities.

- **Financial sector policies.** Faced with severe financial sector pressures last autumn, the authorities responded with timely and broad stabilization measures, aimed at capital, assets, and liquidity. As the global downturn continues, risks remain in both banking and insurance/pensions, and additional support measures may be needed.

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I. The Context[1]

1. **Switzerland is affected by the global crisis through three important channels**. First, the decline in asset prices impacts the large Swiss banks and insurance companies directly through their balance sheets—the *stock effect*. Second, the turmoil will have longer-lasting implications for financial industry earnings—the *flow effect*. Third, the open Swiss economy will be affected by the crisis through the sharp downturn in growth prospects in key trading partners—the *trade effect*. As a result, after years of strong economic performance, the Swiss economy is now expected to shrink by 3 percent in 2009, before picking up again in the second half of 2010.

2. **The authorities' response to the financial turmoil in 2008 was comprehensive; the key issue looking forward will be whether more might be needed.** The authorities pushed for an early recapitalization of UBS, extended deposit insurance, negotiated new capital requirements and liquidity buffers for the large banks, and stepped up supervision. The SNB has been an active supplier of liquidity to the market, while the monetary policy stance has been relaxed aggressively. In addition, there has been a fiscal expansion. However, more may yet be needed if the turmoil continues; determining the optimal policy mix to address both possible further economic weakening and continuing financial sector vulnerabilities will be the key challenge for the authorities looking ahead.

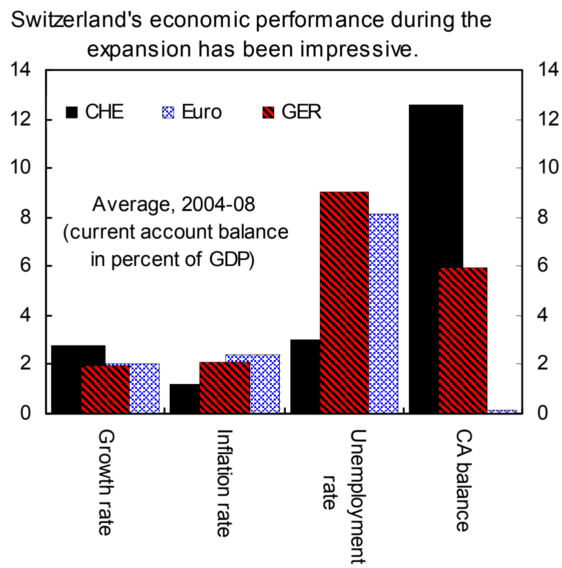
3. **Strong macro-financial linkages will drive policy choices.** Maintaining financial stability will be essential for ensuring macroeconomic stability and a return to growth in Switzerland—while also having positive spillovers to international financial stability. However, despite sound fundamentals, the limited size of the Swiss economy places a constraint on what the government can responsibly do to support the large financial sector. This puts a premium on tight regulation and effective supervision, and on coordination and cooperation between home and host country authorities. Potential problems will need to be addressed at an early stage, before large-scale rescue packages with major fiscal implications become unavoidable.

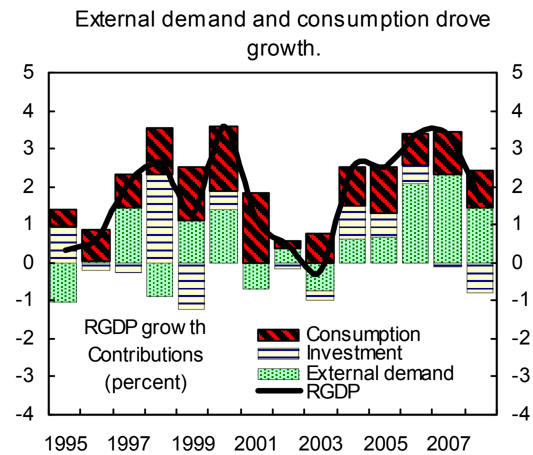
II. Recent Developments and Near-Term Outlook

4. **Switzerland's economic performance in recent years has been strong.** Real GDP growth averaged 3 percent from 2004 to 2007—significantly above potential (about 2 percent) and the euro-area average (2.3 percent)—while inflation remained muted (1 percent). Exports and financial service flows rose rapidly in line with a favorable external environment, allowing the 2006 current account surplus to peak at 14.5 percent of GDP. Investment was supported by strong corporate profitability and capacity utilization—at 87 percent—was well above its long-term average. Unemployment fell under 2½ percent,

[1] The staff team comprised Mr. Hilbers (head), Ms. Carare, Ms. Ohnsorge (all EUR), Mr. Jobst and Mr. Tower (both MCM), and visited Switzerland during February 26–March 9, 2009.

even as cross border working and immigration flows increased labor supply. A fiscal rule resulted in budgetary surpluses in 2006–07 of some 2 percent of GDP.





5. **The financial sector crisis, however, has hit Switzerland hard.** While UBS has been affected the most, both large banks have reported write-downs and losses, and underwent multiple capital injections, mostly via preference shares and convertible bonds. Job cuts have so far been mostly outside of Switzerland but are now also affecting domestic operations. In 2008, total revenues at the two big banks fell by 81 percent, while net new money flows into assets under management (AUM) dropped. Some institutions have suffered rating downgrades. Reflecting these losses, and the turmoil in global markets, the Swiss equity index fell by about 40 percent over last year. Investment and bank financial service income in the balance of payments—a key source of external income—declined by over 80 percent in 2008.

6. **The economy entered a recession in the second half of 2008.** Although the economy expanded by 1.6 percent in 2008, real GDP contracted by 0.2 percent in the second half of the year. Growth in exports slowed, falling from 9½ percent in 2007 to under 2½ percent in 2008, with a marked fall in the fourth quarter, as world trade collapsed. From the supply side, financial intermediation value added declined by about 7½ percent. Investment spending contracted since the second quarter, as firms scaled back plans given the deteriorating outlook. However, with labor markets robust, private consumption grew by a still healthy 1.7 percent, a rate not much lower than in 2007.

Switzerland: Financial Crisis - Write-downs, Capital Injections, and Job Losses 1/
(Billions of U.S. dollars unless noted otherwise, as of March 31, 2009)

	Write-downs 2/	Capital Injection	Job Cuts	In percent of workforce
Banking Sector				
UBS	50.6	33.9	11,000	13.2
Credit Suisse	15.6	11.8	7,420	15.4
Insurance Sector				
Swiss Re	6.4	2.6	134	1.1
Zurich Financial	2.9	...	1,100	1.9
Swiss Life	0.4	1.6	200	2.3
Total	75.9	49.9	19,854	9.1
Percent of global	6.7	4.8	6.9	...
Percent of Europe	19.5	12.6	19.7	...
Memorandum items				
Global	1,140.9	1,029.5	286,822	4.8
of which: Americas	716.9	563.7	180,657	8.1
of which: Europe	388.3	395.2	100,745	3.1
of which: Asia	35.9	70.6	5,420	0.7

Sources: Bloomberg; Bankscope; Moody's; The Banker; and IMF staff estimates.

1/ Since start of the crisis in June 2007 until March 2009.
2/ Writedowns and charges related to sub-prime and other assets.

7. **There was agreement that the slowdown will deepen (Figure 1).** At the time of the mission, staff expected Swiss GDP to contract by 2.3 percent in 2009, and hover around zero in 2010. Given a further deterioration in the indicators, the growth forecast has declined to -3.0 percent in 2009 and -0.3 percent in 2010 (Table 1). The government (SECO) forecast was somewhat more positive; the SNB estimated a contraction of between -2.5 and -3.0 percent in 2009. The slowdown will work its way mainly through reduced exports and investment. The authorities stressed that consumption is expected to still be relatively strong in the first half of 2009, and recede thereafter. Disposable income is the main determinant for consumption, and with relatively solid wage growth[2], it will take

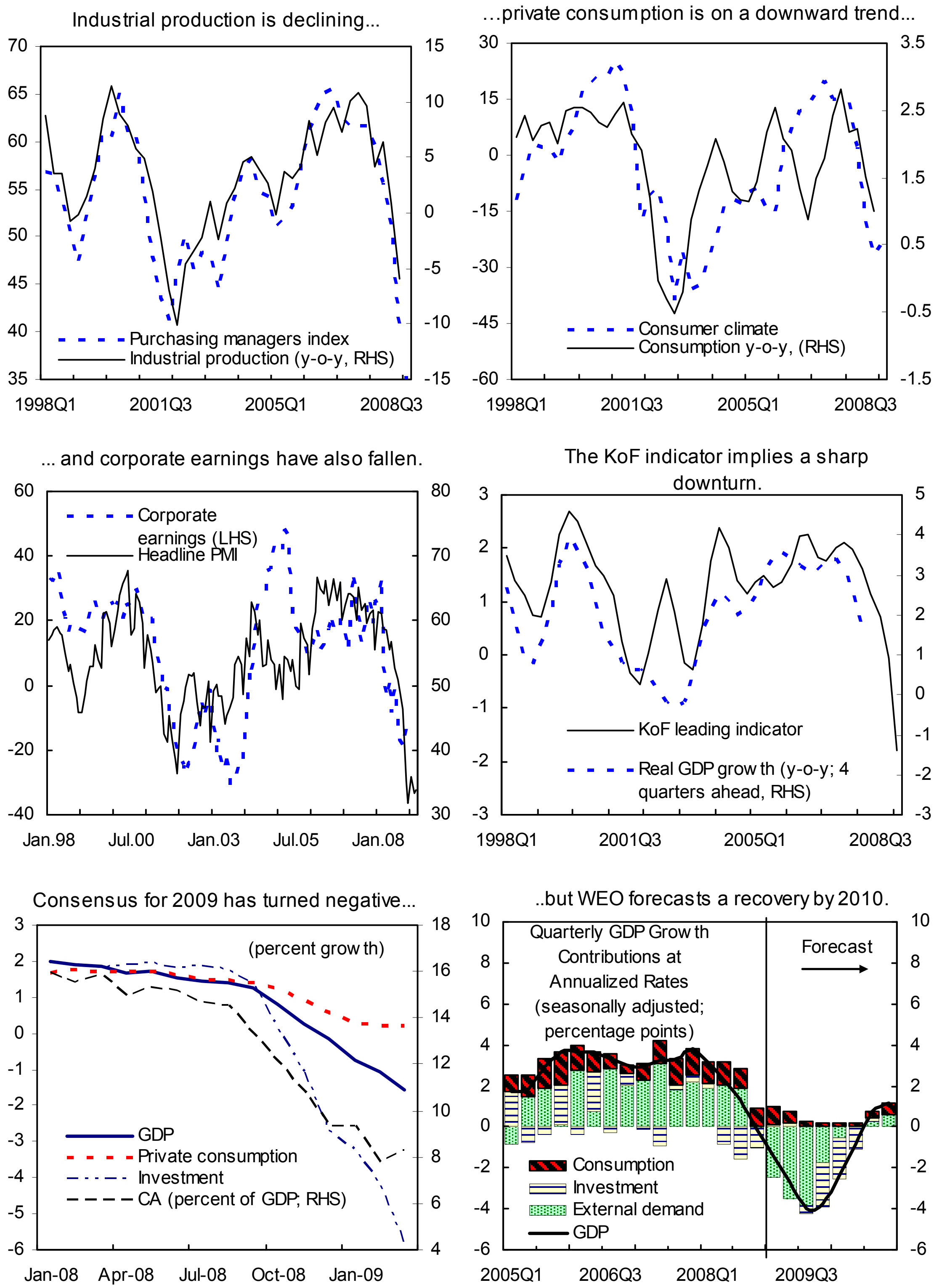
2009 Growth Forecasts
(Percent)

	IMF	SECO	KoF	Consensus 1/
RGDP	-3.0	-2.2	-2.4	-2.1
Private consumption	0.4	0.6	0.0	0.1
Investment 2/	-7.6	-10.0	-11.8	-7.2
Exports	-10.9	-8.1	-10.8	…
Imports	-8.0	-5.2	-8.3	…
Memorandum items:				
German 2009 growth	-5.6	-3.2	-3.0	-3.2
Swiss 2010 growth	-0.3	1.0	-0.3	0.3

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

[2] The UBS compensation survey indicates that 2009 nominal wage demands could reach 2½ percent.

Figure 1. Switzerland: Developments and Outlook, 1998-2010
(Year-on-year growth rates in percent, unless otherwise indicated)

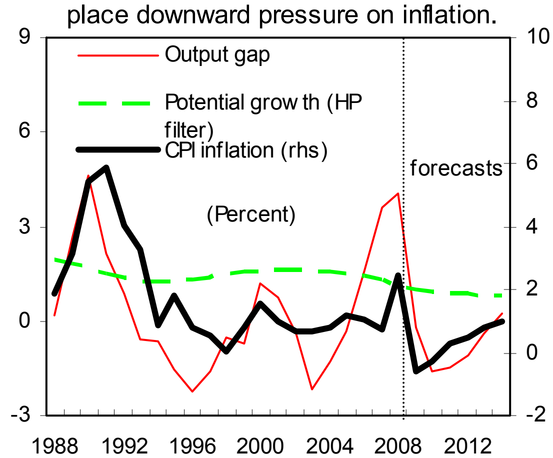


Sources: SNB; SECO; and IMF staff estimates.

a while until the sentiment is affected. However, weaker export growth and lower job prospects should impact employment with a lag and dent consumption growth afterwards.

8. **Headline inflation is set to decline rapidly and deflationary risks have increased (Figure 2).**[3] Inflation (y-o-y) peaked in July 2008 at 3.1 percent (the highest level in 15 years) on the back of higher fuel and clothing prices. As energy and food prices eased, headline inflation dropped to -0.4 percent in March. At the time of the mission, deflationary tendencies were not expected to persist, as core inflation remained above 1¼ percent. However, the rapid deterioration in the outlook has increased risks of deflationary expectations setting in. Inflation is now projected to reach -0.6 percent in 2009. The authorities have a similar (negative) inflation forecast for this year and noted the presence of deflationary risks.

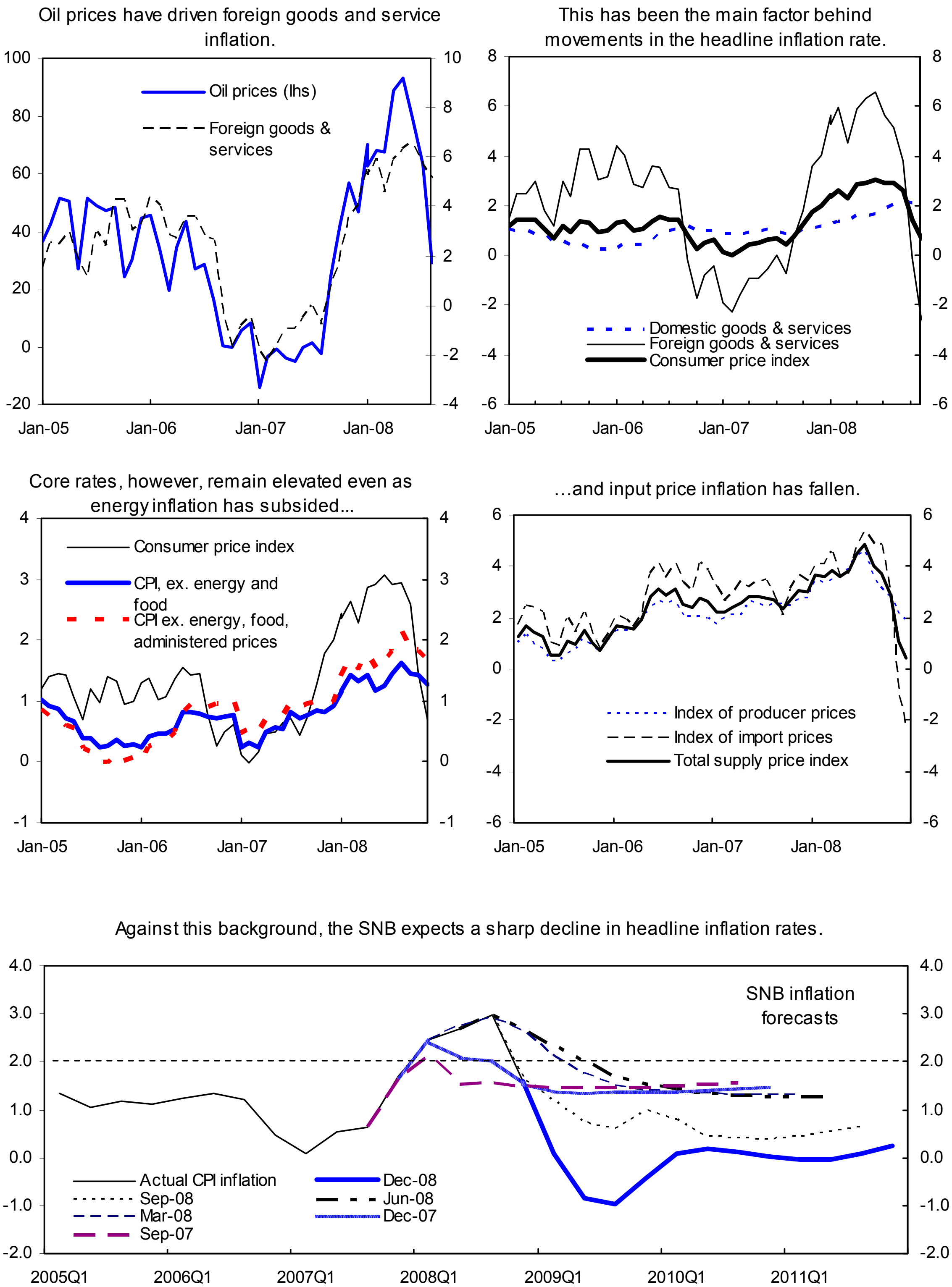
Growing slack in the economy should place downward pressure on inflation.



9. **The precise impact of the financial crisis on potential output growth remains uncertain.** The authorities noted that potential output growth would be constrained over the next few years, but it was too early to quantify this. Given the financial sector's weight in value added and the importance of financial intermediation to growth, estimates of potential growth should decline. However, the permanence of recent labor migration and productivity gains—which could bolster the economy's resilience—were unknown. The authorities noted that under purely statistical methodologies potential growth would fall below 1.5 percent and that uncertainty surrounding potential output spilled over into uncertainty regarding output-gap/inflation dynamics.

[3] Switzerland has a relatively high "vulnerability to deflation" indicator and low inflation persistence given inflation shocks (IMF Staff Position Note, "Gauging Risks for Deflation", January 2009).

Figure 2. Switzerland: Inflation Developments, 2005-11
(Year-on-year growth rates, unless otherwise indicated)



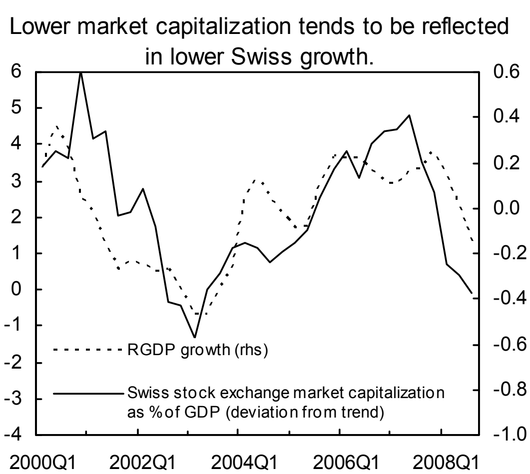
Sources: SNB; and IMF staff estimates.

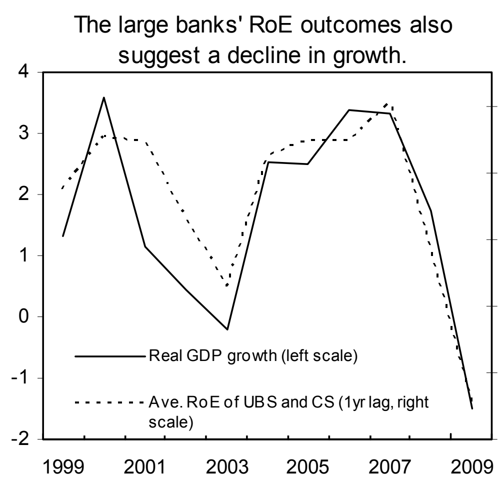
III. Macro-Financial Linkages and Risks

10. **Risks to the outlook are sizeable, on the downside, and depend on developments in global demand and financial markets**.

- **The baseline outlook incorporates a contraction in Switzerland similar to the one experienced by the euro zone.** Swiss real sector activity is correlated with euro area growth. The euro area is facing the prospect of a sizable and extended downturn which will spill over into Swiss export activity (63 percent of Swiss exports are to the European countries). However, as an open economy with a large financial sector, the probabilities of a larger contraction are non-trivial. Possible mitigating factors include the diversification of the Swiss economy, aggressive monetary policy relaxation, and the absence of a housing boom.

- **Swiss fortunes are aligned with the health of the global financial system (Box 1).** A fall in equity prices is associated with declines in financial service exports, and real growth. Returns on equity for the two large banks have been good predictors of the future direction of the economy. There is a risk to the outlook in case the problems at the two large banks continue—which will show up in a further reduction in investment income and financial service flows, and a deeper, more protracted recession. The financial crisis is affecting other parts of the Swiss financial system (e.g., insurance companies and pension funds) as well.



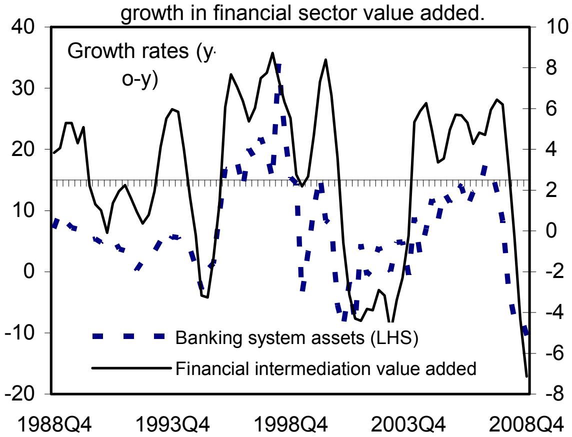


Box 1. Macro-Financial Linkages and Spillovers

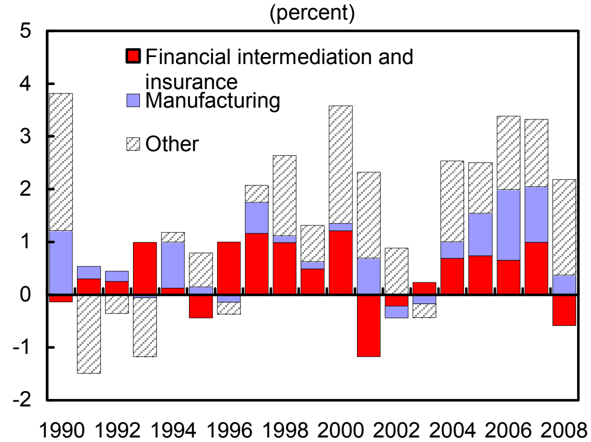
The financial sector accounts for a large share of economic activity. In 2008, financial intermediation accounted for about 9 percent of GDP (12 percent including insurance and pensions) and 5½ percent of employment. In terms of growth rates, financial intermediation directly contributed about 1 percentage point (pp) to Swiss real GDP growth (annually) between 2004 and 2007.

As the financial sector deleverages and shrinks, the amount of assets available to generate value added (VA) will decline. Growth in banking sector assets and financial sector VA is highly correlated (0.75). In 2008, the banking systems' total assets fell by 10.4 percent, while financial sector VA fell by 7.2 percent. Given the financial sector's overall weight in VA, the drop in banking assets placed *direct* downward pressure on growth of about 1.4 pp. At the same time, negative shocks to financial intermediation will also spill over onto the rest of the economy placing added *indirect* downward pressure on growth. A VAR regression using quarterly data for 1980-2008 suggests that a 1 percent contraction in the value added of financial intermediation reduces real GDP over the next 4-6 quarters by about ½ pp. Thus a 7.2 percent decline in financial intermediation could result in a 3.5 pp decline in real GDP growth (which encompasses both effects) within a year. This reduction in growth is in line with the staff's projected swing in Swiss growth rates (from +1.6 to -3.0 percent). Other real sector shocks (e.g., trade), which are not included here, are also expected to hit the economy.

Growth in financial sector assets underpins growth in financial sector value added.

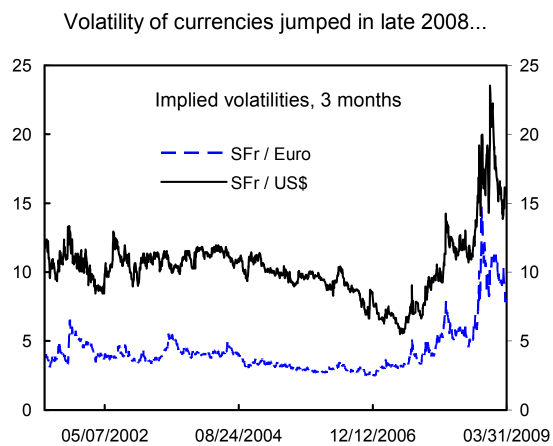


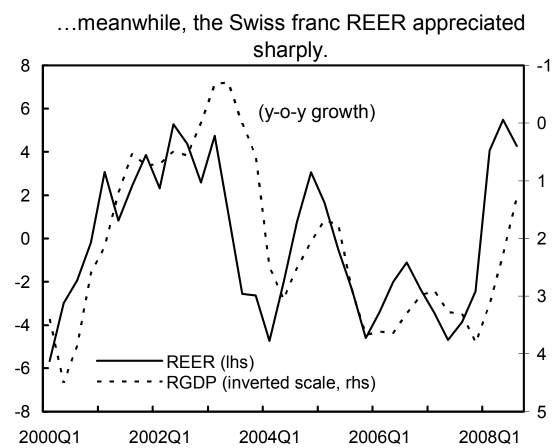
Contribution to Real GDP Growth, 1990-2008 (percent)



In addition to growth effects, financial sector balance sheet shocks also imply sizable contingent fiscal liabilities. The April 2009 GFSR indicated that Switzerland's financial system is systemically vulnerable to shocks emanating from other international financial centers.

11. **Increased equity market volatility has resulted in safe haven flows and upward pressure on the Swiss franc.** The Swiss franc plays a traditional role as a safe haven—appreciating in times of heightened uncertainty. With the decline in equity prices and return of risk aversion, real and nominal exchange rates became quite volatile. The franc appreciated by 8 percent against the euro in the span of a few months, reaching less than SFr 1.45 per euro at the end of October 2008, due in part to the unwinding of carry-trades. A marked reduction of interest rates pushed the rate above SFr 1.57 per euro by mid-December—which was reversed by early March as the rate declined to 1.47 leading up to the SNB policy meeting. There has been a clear link between exchange rate appreciation and economic growth in recent years.

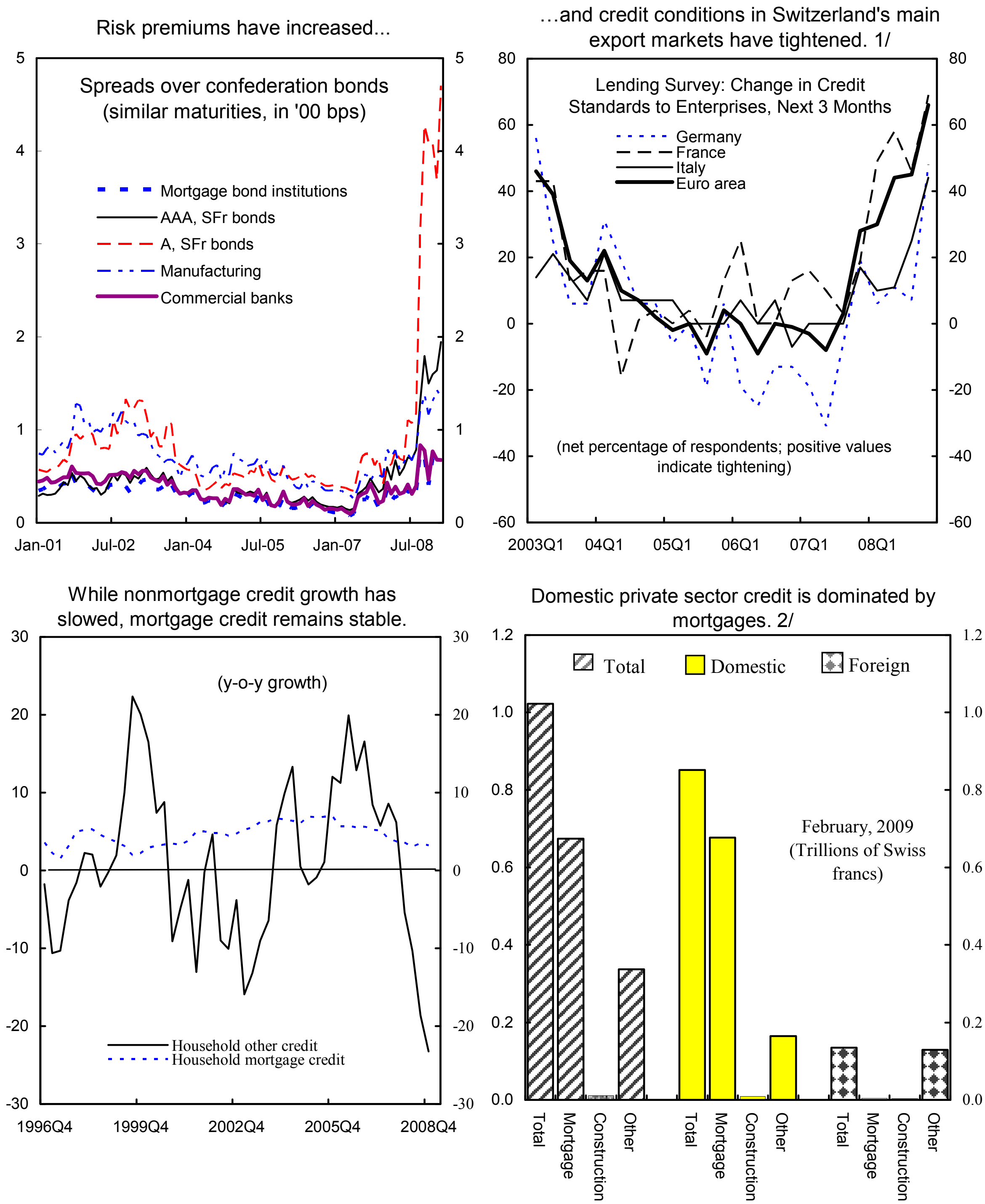




Source: Bloomberg; and Swiss National Bank.

12. **There is little evidence of a domestic credit crunch.** Private sector financing costs are rising and lending conditions are becoming stricter in trading partner economies (Figure 3). However, the SNB's survey of 20 major Swiss banks indicated that the vast majority had not tightened lending conditions. Given that the majority of Swiss private sector credit is in mortgages, the absence of a housing bubble, and a resurgent Pfandbrief (covered mortgage bond) market which has supported credit supply, Switzerland is expected to avoid a sharp contraction in domestic credit. The decline in domestic private sector credit growth (down 6 percentage points from its 2007 peak to 3.8 percent year-on-year in February) has stabilized. However, private household demand for credit, both mortgage and non-mortgage related, has slowed.

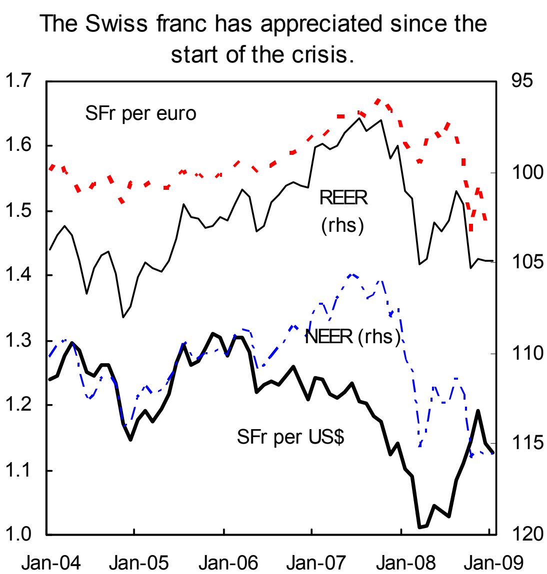
Figure 3. Switzerland: Developments in Credit

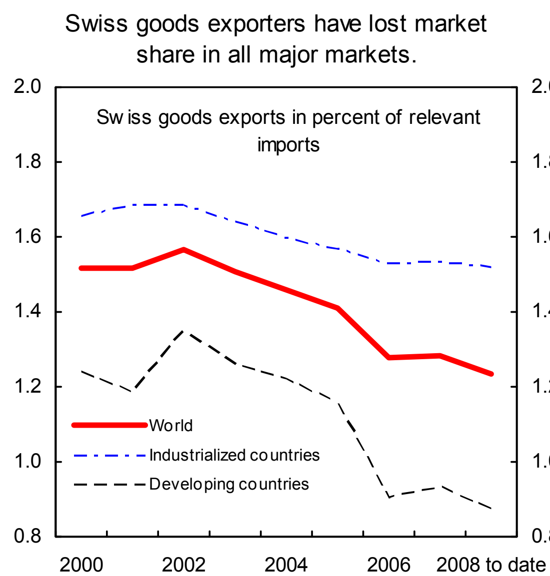


Sources: SNB Monthly Statistical Bulletin; SNB Bulletin of Banking Statistics; and IMF staff estimates.
1/ Reported as an indicator of broader European lending conditions in main export markets. An SNB survey started in early 2008 and only a few observations are available.
2/ Reported at *bank office level* (113 banks; at least SFr 280 million in lending); domestic credit by residence of borrower. Coverage does not include lending by Swiss banks outside of Switzerland.

IV. Assessment of External Stability

13. **Switzerland remains a competitive economy but export market shares have declined**. Switzerland's exports have expanded rapidly along with the cyclical up-tick in world trade. In many capital-intensive and luxury good areas, Swiss exporters were well placed to increase gross volumes as the world economy boomed. However, Switzerland's goods exports have lost market share in their major markets in recent years. Exports declined by 8 percent in real terms in 2008Q4 and by 14 percent in the first two months of 2009. While pharmaceuticals and chemicals—which make up about 1/3 of total exports—have remained relatively stable, demand for raw and semi-finished materials, and luxury goods has fallen sharply. At the same time, growth in labor productivity (GDP over hours worked) averaged about one percent from 2002–07, slightly under its historical norm of about 1.3 percent. Over the same period, average euro area and U.S. labor productivity rose by 1.1 and 1.8 percent, respectively.

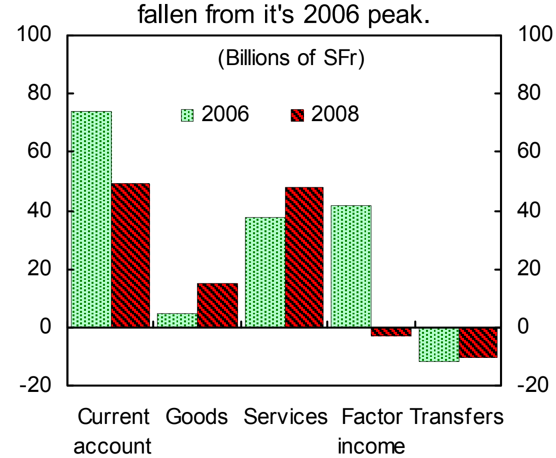




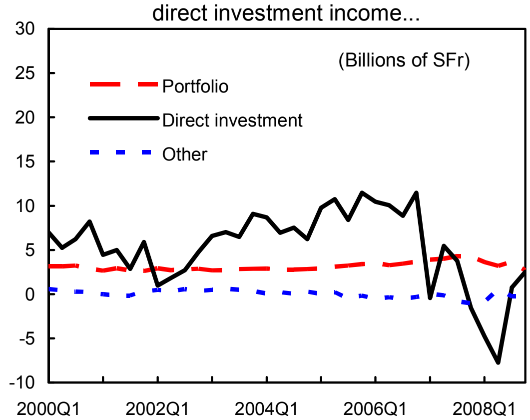
Sources: IMF, *Direction of Trade Statistics* and *WEO*.

14. **The current account has deteriorated but is expected to remain in surplus.**[4] The recent turbulence in financial markets and commodity price reversals have caused substantial adjustments in certain current account components. The most significant change is the shift in *net investment income*, which has fallen by 83 percent as banks' direct investment income is cut with subsidiaries reporting persistent losses. Given the size of the investment income component, the overall *current account* surplus has declined by 33 percent since 2006 and stood at 9.1 percent of GDP in 2008. Looking ahead, there was agreement that the surplus will remain under double digits over the next few years as financial sector activity declines, and investment banks restructure. WEO projections for the components of the current account reflect moderating commodity prices which will keep merchanting receipts low, and subdued bank commission and fee income will reduce financial service revenues. Investment income is not expected to quickly come back to 2004–07 levels given the uncertain outlook for investment banking.

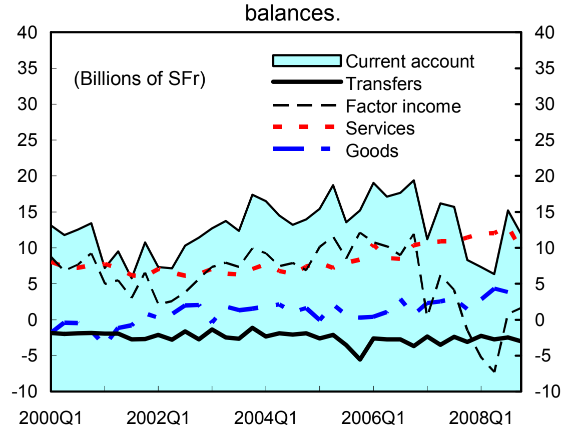
The current account surplus has fallen from it's 2006 peak.



Losses by banks' foreign subsidiaries have cut net direct investment income...



...and offset increases in goods and services balances.



Source: Swiss National Bank.

15. **CGER finds the exchange rate to be broadly in equilibrium, but a stronger-than-expected deterioration in the financial sector could imply overvaluation pressures going forward.** The *equilibrium exchange rate* approach in the current reference period suggests an overvaluation of about 1 percent, while the two current account based approaches

[4] As noted in previous staff reports, the accounting treatment of investment income overestimates the current account surplus by 4-5 percentage points of GDP.

(*macrobalance* and *external stability*) imply an undervaluation of about 1 and 9 percent, respectively (based on Fall 2008 CGER). On net, the average of the three methodologies suggests that the franc is broadly in equilibrium. Given sizable downside risks to the Swiss financial center and potential growth, a sharp decline in export market shares, as well as large contingent liabilities, a more pessimistic scenario may suggest that the exchange rate is on the strong side.

V. Financial Sector Issues

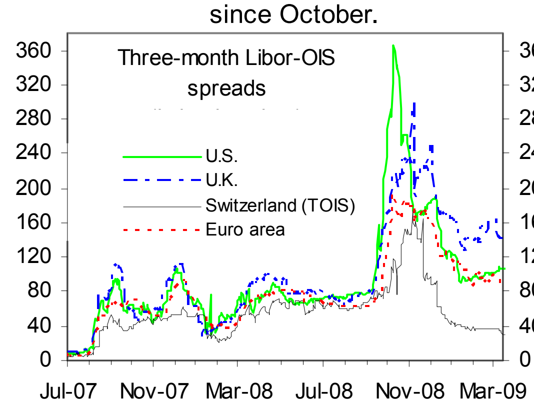
A. The Authorities' Response to the Crisis

16. **The authorities have moved proactively to reduce the impact of the crisis on the economy and to stabilize the financial system.** In hindsight (and in common with other countries), the authorities did not act forcefully enough to mitigate the buildup of risks to financial stability in the run-up to the crisis. However, since the start of the turmoil they have reacted swiftly. The SNB has actively cooperated with other central banks to ensure liquidity in the international interbank market. They pushed for recapitalization of the two large banks at an early stage and, when the crisis worsened in October 2008, introduced a plan to relieve pressures on UBS from bad assets without weakening its capital adequacy. They enhanced deposit insurance arrangements. Swiss regulators have also taken a lead in developing tighter financial sector regulation to help prevent crises in the future. The various measures have been coordinated to maximize the impact on fragile market confidence.

Interbank Liquidity

17. **In cooperation with other central banks, the SNB provided liquidity to calm interbank tensions.** Risk premiums in unsecured markets have remained volatile since the start of the financial turbulence. The SNB extended maturities on refinancing operations, starting in December 2007, and cooperated with the ECB in auctioning off U.S. dollar liquidity obtained via newly established swap lines with the U.S. Fed to ease dollar shortages. In late 2008, it offered Swiss francs through swap arrangements with the ECB and the National Bank of Poland, and in early 2009 with the National Bank of Hungary, to avoid tensions in the offshore Swiss franc market. Moreover, it has issued SNB bills in U.S. dollars to finance the Stabilization Fund (see below), and in Swiss francs to mop op excess liquidity from the domestically oriented banks.

Interbank tensions have declined since October.



Source: Bloomberg; IMF staff estimates.

Financial Sector Stabilization Package

18. **The stabilization initiative for UBS comprised both asset purchases and recapitalization (Appendix I).** The main measures were the transfer of $39 billion (equivalent to 8½ percent of GDP) of distressed assets to an SNB-sponsored special purpose vehicle and a capital injection of SFr 6 billion from the Swiss Confederation into UBS. Funds for the capital injection came from budgetary surpluses and did not require additional borrowing. The government's stake is in the form of mandatory convertible notes, which it hopes to sell before conversion. Credit Suisse did not participate in the asset purchasing plan but instead undertook a SFr 10 billion capital increase, placed with major global investors.

19. **The government made clear its readiness for further action if needed—and if private sector solutions proved insufficient.** At the same time as it announced the arrangements for UBS, the government indicated that it (and the SNB) would take further steps, if necessary, to safeguard financial stability. In particular, it would guarantee, as needed, new medium-term bank borrowings of Swiss banks in the capital market. No guarantees have so far been given. Further losses, including on banking book risks (which have not been addressed by the stabilization measures to date) may yet create a need for new intervention, including capital injections accompanied by shareholder dilution. However, the authorities would look for private sector solutions first. In this regard, the mission welcomed efforts to channel funds from the small banks, increasingly favored by depositors, to the larger banks through the covered bond market.

Financial Safety Net

20. **Switzerland has a developed bank resolution and insolvency framework.** The Swiss government reformed the law applying to insolvency of banks and securities dealers in line with the April 2008 FSF recommendations. The regulatory authority has extensive intervention powers and is itself the authority for initiating and overseeing insolvency proceedings. Until recently, the only need to use these arrangements was in respect of unauthorized firms, but in 2008 they were applied successfully to the small Swiss subsidiary of a foreign bank.

21. **The authorities have moved to strengthen deposit insurance, while initiating a fundamental review of the arrangements (Box 2).** The pre-crisis deposit insurance system factually could only protect smaller depositors at the small and medium-sized banks. Coverage was limited, overall covered payouts capped, financing *ex post*, and there could be delays in larger payouts. These arrangements risked being insufficient to maintain depositor confidence in case of problems. While coverage has now been extended, the mission noted that the system remains unfunded and still cannot fully cover large banks' deposits. The Federal Council has initiated a fundamental review of the system, due for completion later this year. The mission welcomed the review, noting the importance for countries with large banking systems of containing the contingent liabilities for government that can be created

by deposit insurance. In this context, the mission noted that a blanket guarantee for deposits, as given last year by governments in some major economies, would not have been credible in Switzerland, where deposits are about six times GDP.

Box 2. Deposit Insurance

On December 20, 2008, protected coverage was raised to SFr 100,000 per depositor from SFr 30,000 per depositor previously. In addition, the overall cap on the system-wide liabilities of the deposit insurance system was raised to SFr 6 billion from SFr 4 billion. The move followed increases in deposit insurance in other financial centers (a blanket guarantee for household deposits in Germany and Ireland in October 2008, and increases in limits in the U.S. and the U.K. in December 2008). The coverage of the insurance system is broad, comparable to that in the U.S. and the U.K., but the limit per depositor is less than that temporarily imposed in the U.S.

Comparison of Deposit Insurance Schemes

	Coverage	Limit	Cap on System-wide Deposit Insurance Liabilities	Amount of Preferential Deposits
Switzerland	All deposits held in accounts in the name of the bank client.	SFr 100,000 per depositor per bank. 1/	SFr 6 billion	SFr 353 billion (71 percent of GDP)
Germany	All household deposits	None. 2/	None.	EUR 1733 billion (69 percent of GDP)
U.K.	Customer deposits, insurance and home finance deposit, long-term insurance, and mandatory insurance accounts.	GBP 50,000 per person on deposits, GBP 48,000 on insurance and home finance, less for long-term insurance.	None.	Not available.
U.S.	All checking accounts, all deposit accounts except certain retirement accounts and excluding investment accounts in stocks, bonds, mutual funds.	Full coverage for checking accounts until end-2009, up to $250,000 for all other accounts until end-2009. 3/	None.	Not available.

Sources: National authorities.
1/ Increased on December 20, 2008 from SFr 30,000 previously.
2/ Announced but not legally implemented.
3/ Since October 14, 2008.

Regulation and Supervision

22. **The authorities have moved swiftly to enhance financial sector oversight and strengthen regulation (Appendix II, Box 3).** Supervisors intensified their oversight of major banks early in the crisis and have been extending this approach to insurance companies as they began to suffer from the economic downturn. Extensive regulatory reforms are being introduced, to take effect, where appropriate, when the crisis is over (to avoid reinforcing the downturn) but giving a clear signal now that regulation will be much more demanding in the future. The authorities noted that they will continue to balance participation in international regulatory work (e.g., FSF, Basel Committee) with a readiness to implement measures that they think appropriate to the Swiss financial sector. Similarly, they have been taking a stronger lead in international cooperation on the supervision of major groups, responding to

some limitations of previous arrangements with foreign supervisors that have been highlighted during the crisis.

Box 3. Key Elements of Regulatory Reform in Switzerland

Capital adequacy

- Basel II requirements to be strengthened in line with the Basel Committee's evolving standards;
- Increased capital buffers (under Pillar 2) above the Basel II minimum requirements for the two major banks, including a cyclical adjustment (by 2013);
- The introduction of a minimum leverage ratio, including a cyclical adjustment (by 2013);
- A redefinition of eligible capital.

Stress-testing

- FINMA is developing a "building block approach" to supplement the existing top down stress tests conducted by the SNB. Results will inform management discussions and can be input in capital adequacy decisions.

Liquidity

- New requirements are planned for the two large banks in 2009 and will be extended as appropriate to other banks.

Remuneration

- FINMA will issue guidance on remuneration practices.

Note: See Appendix II for details.

23. **The reform of capital requirements for the big banks is an important step with innovative elements.** In addition to increased capital under Basel II, for the large banks FINMA has introduced a minimum leverage ratio (core tier 1 capital as a percentage of assets excluding domestic lending) and provisions to vary the actual minimum required of banks to reflect economic conditions. The two banks have until 2013 to comply, with a longer deadline possible. By applying Basel II and leverage ratios together, with higher requirements in "good times", FINMA expects to address both the procyclicality of existing risk-based requirements and incentives created by leverage ratios for banks to increase risk assets and off-balance sheet business. The authorities noted that by defining "good times" by reference to profit cycles of individual banks, they have ensured that adjustments will be automatic and independent of judgmental estimates of the economic cycle.

24. **FINMA is also reforming its requirements in relation to stress-testing, bank liquidity, and remuneration.** In addition to the focus on capital, the reforms are addressing other weaknesses in regulation, in some cases extending work that was started before the financial crisis. For the stress test and liquidity requirements for banks, FINMA will apply the new approach initially to the major banks only, reflecting the significance of the shortcomings in these areas. But they will also be applied to other banks in due course,

depending on experience with the major banks. The authorities emphasized that planned FINMA guidance on remuneration, helpful in the context of controlling investment banking risks, will apply to all regulated entities.

25. **Overall, the reforms address key issues for the large Swiss banks but should be kept under review**. In particular, the reforms tackle pressing needs for improved liquidity standards and higher capital for investment banking. They respond well to the international reform agenda. The program needs to be kept under review in the light of further international work, for example on developing a macroprudential focus to regulation. While welcoming the new capital framework, the mission suggested that the exclusion of domestic lending from the leverage ratio calculation, while necessary in current economic circumstances, should be reconsidered in the future. The authorities noted they would do so, particularly if a minimum leverage ratio were introduced by the Basel Committee.

26. **Insurance regulation is also now being tested by the crisis.** While overall insurance sector exposure to US subprime and related risks is limited, regulators are having to respond to strains imposed by wider market falls, on life companies in particular. Major reforms since the sector's problems in 2001–03 have strengthened balance sheets and helped equip FINMA to manage the crisis. But the full benefits of the reforms, including those of the Swiss Solvency Test and the Swiss Quality Assessment, will be felt over coming years. In the meantime, the authorities have resorted to intensive monitoring of existing solvency standards and "tied assets" (those backing reserves). They are responding to solvency and liquidity pressures and have stepped up cooperation with foreign supervisors of major groups.

27. **The new integrated regulator FINMA is well-placed to strengthen supervision**. The Federal Office of Private Insurance (FOPI), the Swiss Federal Banking Commission (SFBC) and the Anti-Money Laundering Control Authority were merged on January 1, 2009 under a long-planned reform. The creation of FINMA has enhanced the capacity of regulators to implement changes resulting from the crisis and strengthened their hands in the supervision of the major banking and insurance groups. FINMA had a somewhat challenging start and a debate about its governance and staffing model was reopened. The authorities emphasized their commitment to strengthening governance as necessary.

28. **Additional resources will help to ensure the effectiveness of the new organization**. FINMA is a public law body, accountable to the Federal government but enjoying institutional and financial independence. In particular, it has appropriate flexibility to recruit staff with required skills. FINMA has 315 full-time staff at present (April 2009) and a budget in 2009 equivalent to $88 million. The authorities noted that FINMA will increase total resources to 355 full-time staff, while emphasizing the need for the appropriate level of skills and experience. The mission welcomed the planned strengthening of staffing

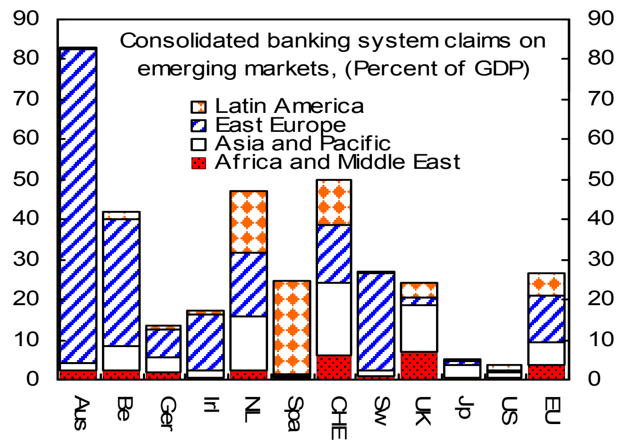
and noted that FINMA currently has somewhat light resources compared with those of other integrated regulators.[5]

B. Risks to Financial Stability

Balance Sheets and Income Statements

29. **The size and composition of the banks' balance sheets creates risks for the public sector.** The banking sector's total on-balance sheet assets (at the group level) alone exceeded SFr 4.7 trillion at end-2007 or over nine times the size of Swiss annual GDP.[6] Off-balance-sheet activities and emerging market exposure are also large. The rapid growth of the two big banks almost exclusively reflected the development of foreign business. For example, based on BIS data, as of the third quarter of 2008 Swiss banking exposure to emerging market countries was close to 50 percent of GDP—in Europe, second only to Austria. At end-2005, Swiss emerging market exposure had been only 28 percent of GDP.

Swiss banking system exposure to emerging markets is well diversified, but large.



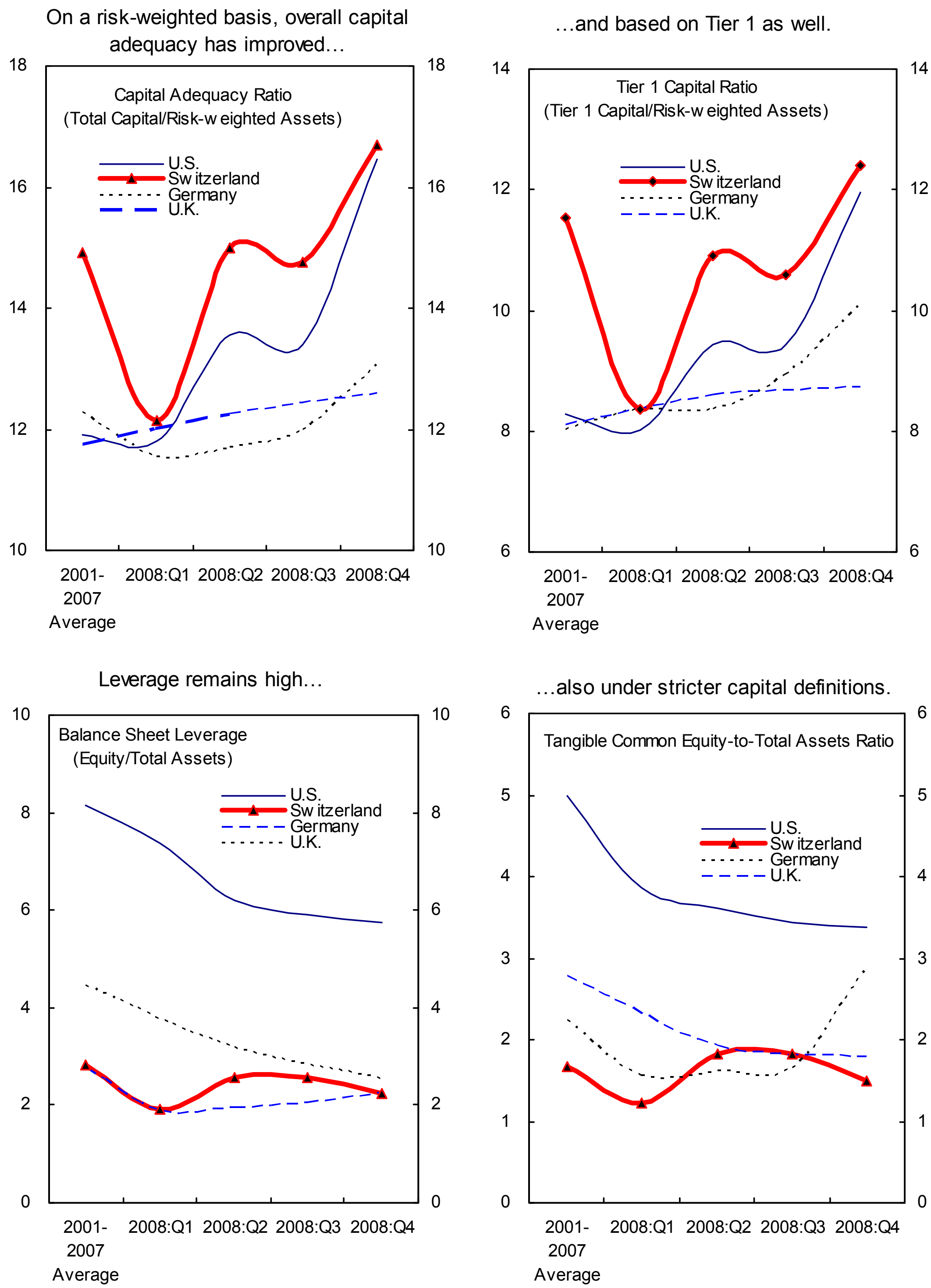
Source: BIS banking statistics, October 2008.

30. **The deleveraging process has been slow among the large banks (Figure 4).** Although the Swiss banking sector remains well-capitalized on a risk-weighted basis (Tier 1 capital ratio and capital adequacy ratio), low "permanence of capital" (in the form of tangible common equity) and still high balance sheet leverage have dented confidence in the ability of large Swiss banks to absorb further valuation losses. Despite a significant amount of noncore asset sales, basic leverage ratios have even reverted back to levels last seen in early 2008. Estimates could be higher depending if securities holdings were marked-to-market and how negative deferred tax liabilities are applied in the calculation of Tier I ratios.

[5] Based on the supervisory budgets of integrated financial sector supervisors in similar industrial countries, and using the size of assets under supervision and the degree of concentration of the sector as comparator metrics, the supervisory budget for Switzerland could be expected to fall within a range of $70-190 million. This tentative calculation abstracts from differences in responsibilities and operating procedures among supervisors.

[6] SNB 2008 Financial Stability Report.

Figure 4. Switzerland: Banking Sector - Capital Ratios 1/
(Percent)



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

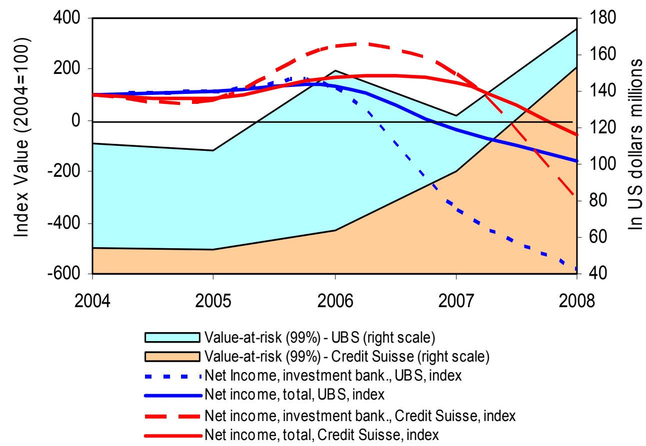
31. **Funding pressures for the large banks require close monitoring**. The funding market for bank-issued debt instruments remains depressed as banks strive to bolster their balance sheets and shore up their capital basis in anticipation of higher leverage ratios. Given that demand for bank term debt has largely disappeared, markets may demand some form of government guarantee—a contingency the authorities would consider, as announced in the October package of stabilization measures—to secure short-term financing of the two large banks. At the same time, the shift of deposits from the large to the smaller banks within the system, has added to liquidity concerns. At the time of the mission, the large banks felt that they had sufficient sources of short-term funding.

32. **Financial sector revenues will remain under pressure.** Investment banking revenues have declined sharply. At the same time, other key business areas, such as private banking, have been weakened. Net new money (from private banking and asset management) for the two large banks fell substantially in 2008 and outflows have continued in early 2009 for one institution. On March 13, Switzerland adopted the OECD standard on administrative assistance in fiscal matters, which will permit a fuller exchange of information with foreign tax authorities.[7] It is not possible, at this stage, to gauge the impact of the enhanced information exchange on Swiss banking.

Investment banking has underperformed while market risks have almost doubled ...

Large Swiss Banks: Net Income and Market Value-at-Risk

VaR, 2004-08



Sources: Financial statements (UBS, Credit Suisse); and IMF staff calculations.

Insurance and Pension Funds

33. **The insurance sector has suffered from the downturn in markets:**

- Most life companies reduced equity risk following the 2001–03 market falls but retained other significant market risk through corporate bonds and alternative investments that were not either matched by liabilities or fully hedged. Rising credit spreads, higher liquidity premiums, lower interest rates and increased market

[7] The authorities noted that bank information remains confidential and that to implement the exchange of information in individual cases on request, Switzerland will renegotiate double taxation agreements bilaterally (http://www.efd.admin.ch).

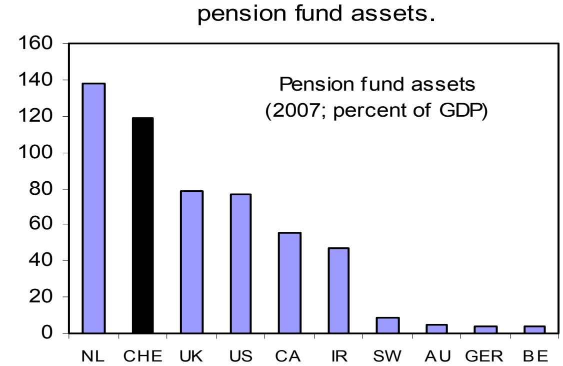
- volatility have combined to cause large, mostly unrealized losses in the second half of 2008, while increasing the cost of hedging.

- While non-life insurance is less affected, the reinsurance sector faces particular challenges. Non-life business globally is relatively unaffected by the crisis. However, a major reinsurance group is exposed to deteriorating credit conditions through some credit default swap contracts and other structured finance exposure acquired under a strategy to diversify from core business.

34. **Further market weakness could create serious stress at life insurance companies in particular, with implications also for pension funds.** The authorities noted that life insurers' liquidity is not now under pressure, giving them time to take strengthening measures, while solvency ratios still exceed the minimum at major firms. For most companies, the key pressures may arise from weaknesses in the business model exposed by the crisis (particularly the high capital drain and risk management challenges in guaranteed business). However, more severe pressures, even liquidity strains, are not impossible should there be a further market downturn. Given the high proportion of pension funds underwritten by insurers, there would be adverse impacts on the pensions sector were life insurance policyholder benefits to be put at risk.

35. **Occupational pension funds also face direct financial pressures from falling asset values.** A growing number of Pillar II pension funds, which had total assets of around SFr 630 billion at end-2007, have funding ratios of below 100 percent. Their average ratios are estimated to have fallen to around 95 percent from 112 percent at end-2007, comparable to the low point of 2002. Further market falls would require more measures to restore adequate funding ratios, for example through increased employee or employer contributions.

Switzerland has a sizable stock of pension fund assets.



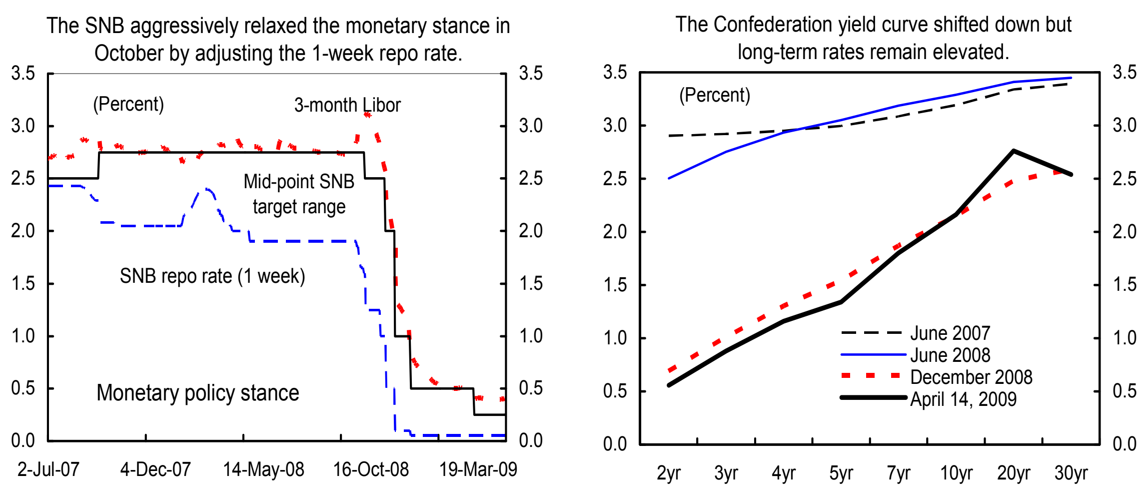
Source: OECD.

36. **The authorities are monitoring the impact of the crisis on these sectors and their wider implications.** The guarantees provided by the insurance and pension sectors are insulating Swiss policyholders and pension fund members from some of the direct wealth losses experienced in some other countries. But their capacity to absorb shocks is clearly limited. In this context, there is a particular need for pension fund supervisors (based in the cantons, but coordinated by a new confederation level body) to balance the needs both to restore funding ratios promptly and to avoid exacerbating the downturn through strong measures.

VI. Monetary and Exchange Rate Policies

37. **The SNB has used monetary policy to good effect in a difficult environment (Figure 5).**

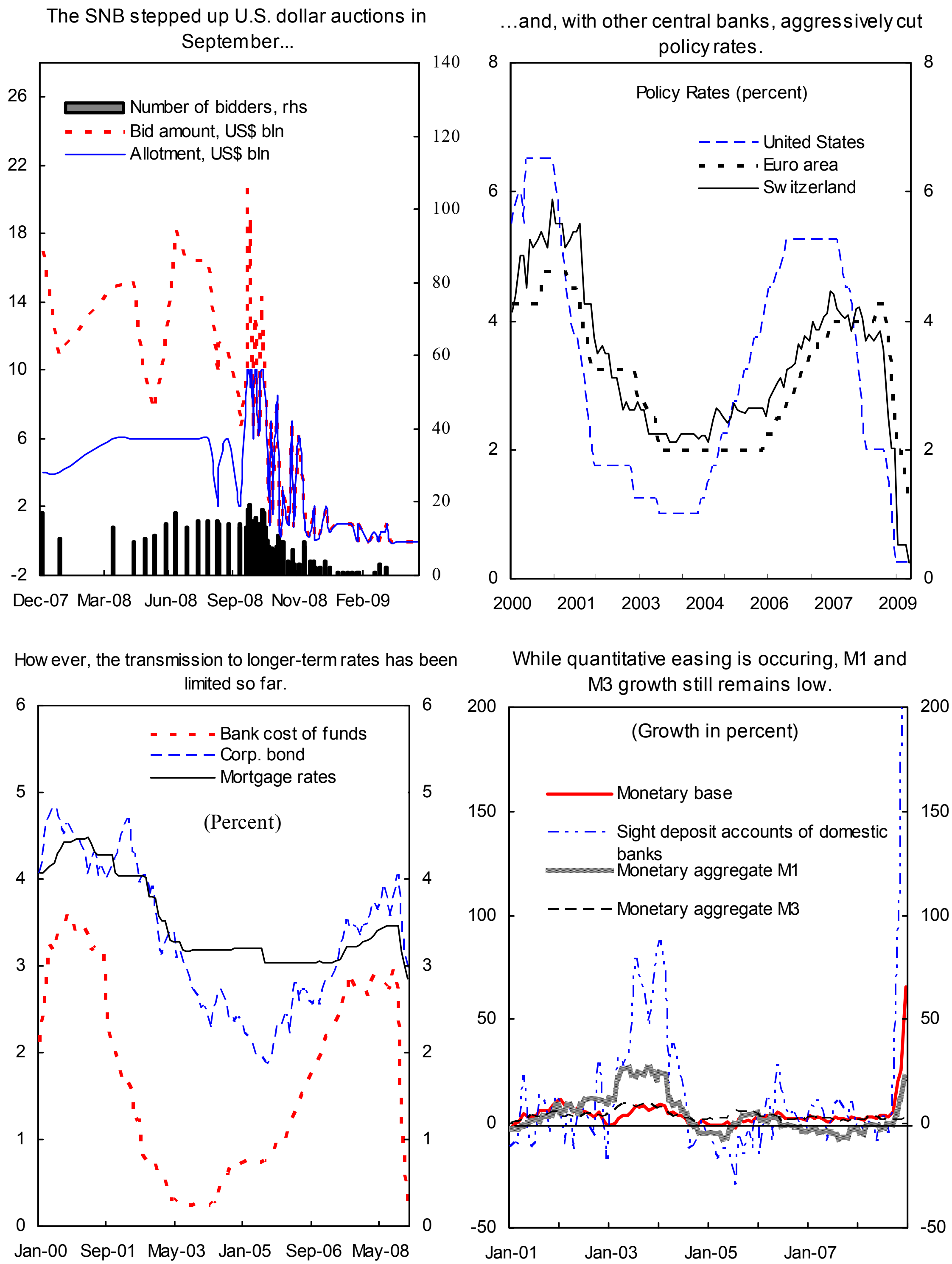
- The SNB kept the monetary stance unchanged in the first three quarters of 2008, offsetting higher risk premiums through lower repo rates. Infusions of SFr liquidity in interbank markets, use of longer-term repos, foreign exchange swaps, and new refinancing facilities lowered risk premiums and helped to ease appreciation pressures on the currency. Monetary and financial conditions continued to tighten nonetheless.



Source: Swiss National Bank.

- With the economic slowdown worsening, inflationary expectations rapidly falling and the currency appreciating, the SNB moved forcefully, relaxing the monetary policy stance by 225 basis points over a period of about two months at the end of 2008. With 1-week repo rates at 5 bps since September, the SNB had effectively moved to a zero interest rate policy at a relatively early stage. Longer-term rates, however, remained elevated.

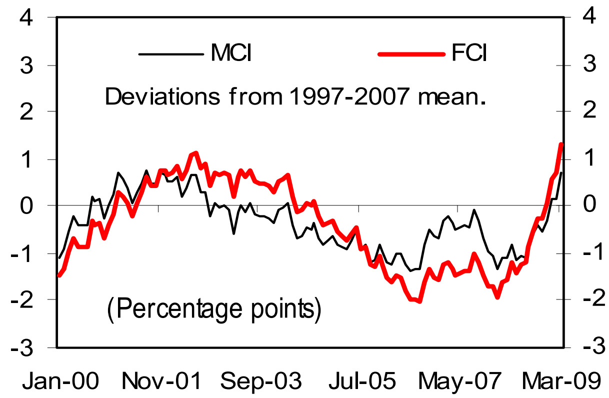
Figure 5. Switzerland: Monetary Developments



Sources: SNB Monthly Statistic Bulletin; and IMF staff estimates.

38. **At the time of the discussions, the SNB saw rapid Swiss franc appreciation as the main risk to the economy.** Despite a widening of interest rate differentials as the SNB cut policy rates, the Swiss franc had continued to appreciate against the euro on the back of safe haven flows. Currency volatility had also significantly increased. Given that anticipated reductions in euro-area rates would only exacerbate these tendencies, there was a concern that deflationary risks could accelerate uncontrollably in the middle of a severe recession. Waiting for a reversal in market sentiment could prove risky—and some insurance was felt to be necessary. Steering expectations, either by verbal intervention or "thinking aloud" to weaken the currency against the euro, or by a public recommitment to keep rates close to zero for a longer than expected period of time had worked during the last episode of deflationary risks in 2003. However, the SNB emphasized verbal intervention alone might prove insufficient in the current environment of risk aversion.

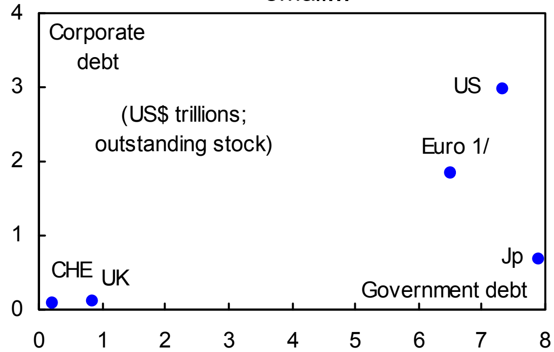
Monetary and financial conditions tightened despite interest rate cuts.



Source: Staff estimates, based on real exchange rates, interest rates, and equities.

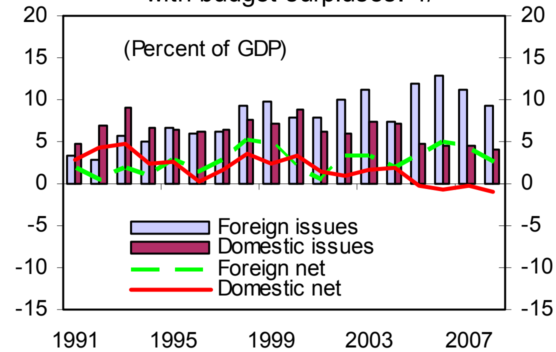
39. **However, options to counter an unwanted tightening of monetary and financial conditions are limited.** It was acknowledged that deflation risks, while increased, are still limited, credit is still available, and that the full effect of the already considerable monetary easing has yet to be realized. The authorities agreed that quantitative easing measures may not be overly effective, and entail increased risk to the SNB balance sheet. However, they emphasized the need to employ them, both to affect expectations and avoid the worse-case scenario of a deflationary spiral. With banks hoarding liquidity, a further sharp increase in the monetary base may not generate a subsequent rise in credit. Most short-term Swiss interest rates were already near zero. Direct bond purchases could be undertaken to lower longer-term interest rates, but Swiss debt markets are quite shallow, and an intervention could prove disruptive. In this context, direct foreign exchange intervention was seen by the SNB as the most effective monetary policy option.

Domestic debt markets are relatively small...



Source: BIS. Domestic debt in domestic currency (issued by nationals).
1/ Based on 12 euro area countries.

...and domestic bond issues have fallen with budget surpluses. 1/



Source: SNB Monthly Statistical Bulletin.
1/ Includes public and private issuers.

40. **At the mid-March meeting after the Article IV mission, the SNB announced measures—including currency intervention—to force a relaxation in monetary and financial conditions.**[8] The SNB noted that a sharp deterioration in the economic situation since last December and heightened deflationary risks over the next three years required decisive action. With the SNB forecasting -0.5 percent inflation for 2009 and zero inflation in the period 2010–11, the Libor target range was reduced by ¼ percentage point to between zero and 75 basis points. Moreover, the SNB will target the lower part of the band, as opposed to the usual middle point, a de facto easing of 25 basis points. Given unstable risk premiums that are hampering the transmission of monetary policy, the SNB decided to directly purchase private sector Swiss franc bonds. In order to counter an inappropriate tightening of monetary conditions, the SNB also announced it would buy euros on foreign exchange markets. This was the first foreign exchange intervention since 1995.[9]

VII. Public Finances

A. Fiscal Developments

41. **The fiscal position has improved significantly over the past four years (Figure 6).** The economic upswing and the consolidation since the introduction of the federal government debt brake rule have culminated in a general government surplus of 2.2 percent

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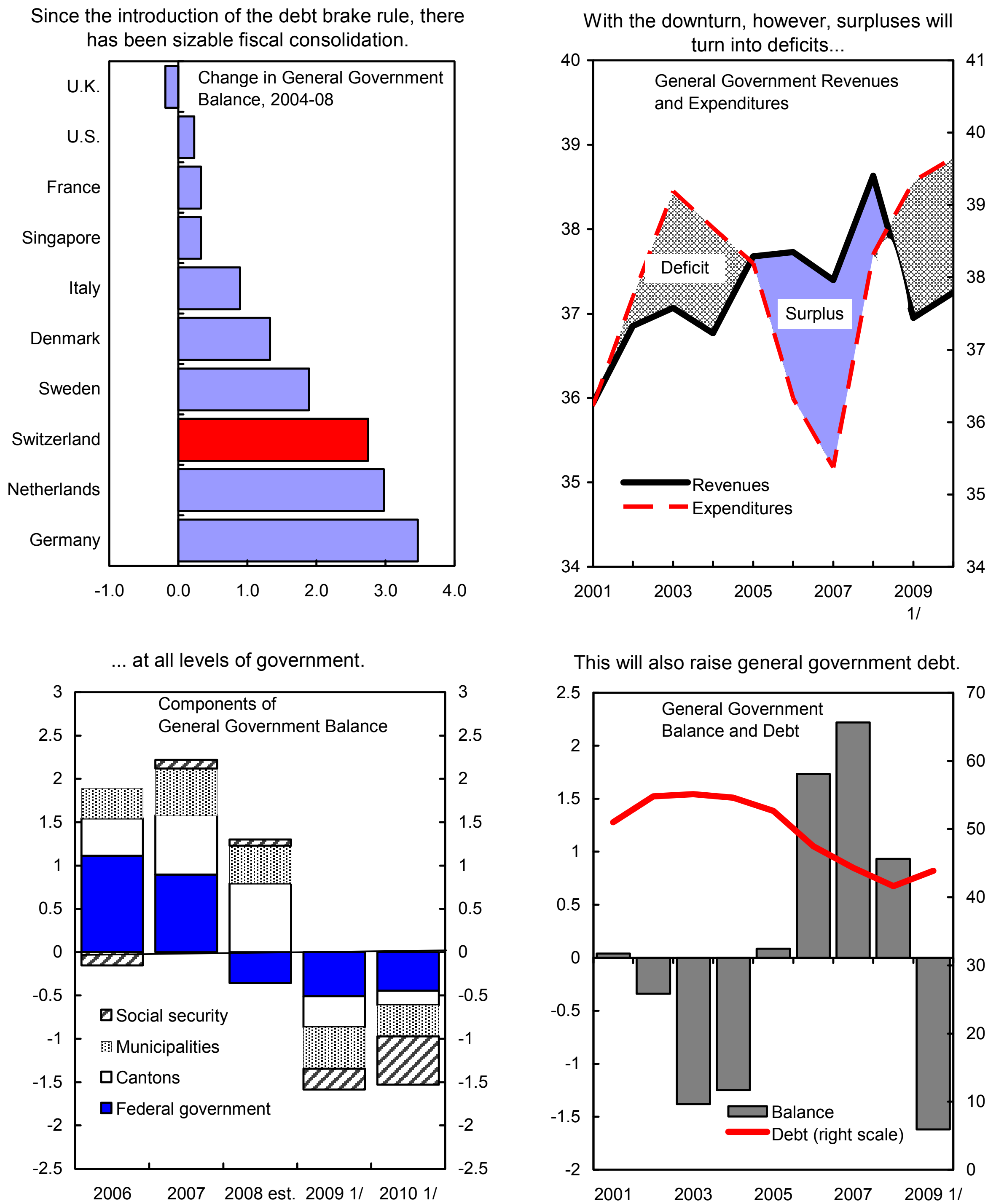
[8] The SNB has a mandate to ensure price stability, while taking economic developments into account. This objective encompasses the prevention of both deflation and inflation.

[9] The Swiss franc depreciated by about 4 percent against the euro (to SFr 1.54) on the day of the SNB announcement. Chairman Roth stated that the intervention did not represent a reversal of the SNB's traditional monetary policy strategy.

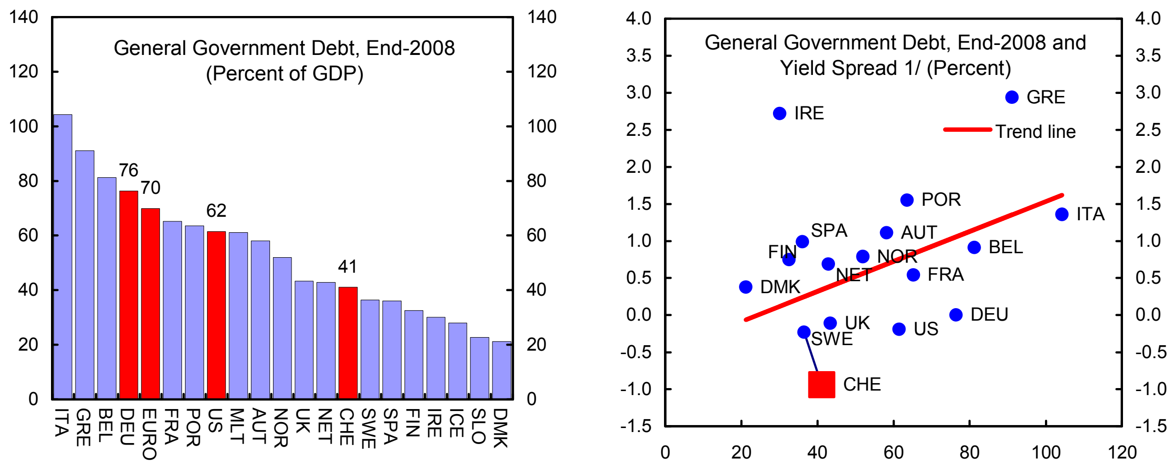
Figure 6. Switzerland: Fiscal Developments
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.
1/ Projection.

of GDP in 2007 (Tables 5 and 6). Despite the support for UBS in 2008, Switzerland's stock of debt at end-2008 remained about 30–35 percentage points of GDP below that of the Euro area average and Germany, and 20 percentage points below the U.S., as also reflected in relatively low financing costs. At end-2008, the *public sector* had a net international asset position of 21 percent of GDP, and 25 percent of GDP in the short-term.

General Government Debt and Yield Spreads



Sources: Haver Analytics; IMF *IFS*; and IMF staff estimates.
1/ Spread of local currency 10-year government bond yield over German 10-year government bond yield, as of March 16, 2009.

42. **In 2008, the fiscal stance was appropriately neutral.** The federal government's surplus swung into a deficit of 0.4 percent of GDP as UBS support and accounting adjustments were less than fully offset by early payments and lagged revenue effects linked to 2007's surprisingly strong economic growth. Continued surpluses at other levels of government, however, allowed the general government to record a surplus of 0.9 percent of GDP in 2008. Structural surpluses at both the general and federal government levels were broadly unchanged.

General Government Accounts
(Percent of GDP, unless otherwise specified)

	2007	2008 Est.	2009 Proj.	2010 Proj.
Real GDP growth (in percent)	3.3	1.6	-3.0	-0.3
Overall balance 1/	2.2	0.9	-1.6	-1.6
Revenues	37.4	38.6	37.0	37.3
Expenditures 1/	35.2	37.7	38.6	38.9
Cyclically adjusted balance 2/	1.0	-1.6	-1.5	-1.0
Structural balance 3/	0.7	0.6	-1.6	-1.2
Debt	44.3	41.6	43.8	45.0

1/ 2008 includes one-off expenditure of SFr 6 billion in support for UBS
2/ Excludes cyclical items but includes one-off items.
3/ Excludes cyclical and one-off items.

B. Fiscal Projections and Policy

43. **Planned stimulus measures—and full use of automatic stabilizers—will result in a general government deficit in 2009.** The federal government's plan to cancel some deferred corporate tax liabilities, to bring forward investment spending (which triggers cantonal cofinancing expenditures) as well as additional cantonal discretionary measures, will result in a fiscal stimulus of about 0.8 percent of GDP. Accelerated public investment plans account for about three-quarters of the stimulus measures at the federal government level, which amount to 0.3 percent of GDP including cantonal cofinancing. Cantonal stimulus measures, in contrast, include a substantial portion (about half) in tax cuts and rebates. Apart from unemployment insurance, the impact of automatic stabilizers would be relatively limited given the moderate size of government, and there was agreement that they should be allowed to play fully at all levels. Although the direct impact of crisis-related financial sector losses is limited, automatic stabilizers and planned fiscal stimulus measures will lead to a significant deterioration in government balances. Deficits are now expected for federal as well as cantonal, municipal, and social security budgets. At the general government level, a deficit of 1.6 percent of GDP is expected.

Elasticity of Selected Budget Items to Output Gap

	Switzerland	OECD average	Euro area average
Overall balance	0.37	0.44	0.48
Unemployment benefit	-0.19	-0.10	-0.11
Personal income tax	1.10	1.26	1.48

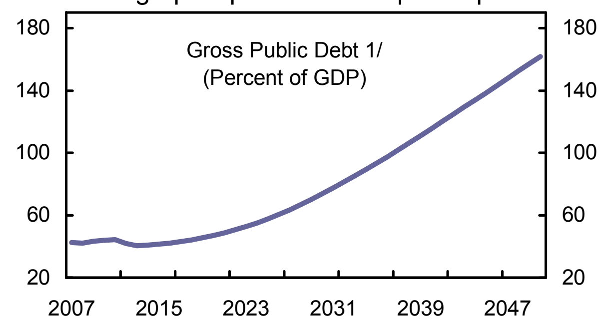
Source: OECD.

44. **The authorities will consider an additional stimulus for the 2010 budget.** At ¾ percent of GDP, current measures are smaller than those envisaged in other European countries. The mission argued that additional fiscal stimulus when part of a coordinated approach, could help dampen a negative confidence spiral. A package similar in size to the 2009 one would bring the average stimulus closer to the European average. The stimulus could target one-off payments to low-income households with high multipliers and be followed by more sustained, but slower, public investment. The authorities were open to a further stimulus but noted that there are limits to the effectiveness of fiscal expansion given Switzerland's open economy. New initiatives would require further coordination with cantonal governments—they undertake two-thirds of public investment and are the main distributors of social assistance—and would take time to implement. The measures would require use of the escape clause under the debt brake rule, which has just been extended to include extraordinary expenditures from 2010. Moreover, it was noted that personal and corporate income tax reforms are expected to widen structural deficits starting in 2011.

45. **Comprehensive reforms of entitlement programs, especially in pension and disability insurance, will be required to ensure long-term sustainability.** The *Long-Term Sustainability Report* estimated that a permanent fiscal consolidation of 1½ to 2 percent of GDP would be required to stabilize the stock of debt at its 2003 level. The *Assessment of the Tasks of Government* identifies areas which could yield further expenditure savings in the

short- to medium-term. These are being implemented beginning with the 2010 budget, but initial amounts are small. With the approval of a temporary VAT increase to finance deficits in disability insurance (subject to approval in a September referendum), parliament has requested a proposal for a comprehensive reform of the disability insurance system by end-2010. Parliamentary approval is pending for an increase in women's retirement age from 2014, after which more fundamental pension reform will be considered.

Without corrective measures, long-term demographic pressures will push up debt.



Sources: Ministry of Finance; and IMF staff projections.
1/ Projection assumes current revenue and expenditure patterns continue, and uses expected demographic parameters from the *Long-Term Sustainability Report.*

VIII. Staff Appraisal

46. **The global crisis will result in a significant decline in growth.** Strong trade and financial linkages underpinned above-average growth during the global upswing. These same linkages, however, expose Switzerland to the negative shocks that are now weighing heavily on global activity. Indeed, the economy entered a recession in the second half of 2008, as the financial crisis intensified and world trade fell sharply. Looking ahead, there are signs that the decline will accelerate—creating additional domestic and international risks given Switzerland's large international financial center—before positive growth is expected to return in the course of 2010.

47. **The size of the Swiss financial sector and its importance to the global economy call for a clear focus on ensuring financial stability.** Safeguarding stability is essential for a return to growth and will also contribute to restoring international financial stability. However, the size of the Swiss economy and limited public sector resources constrain the authorities' ability to support the financial sector without incurring unsustainable liabilities. At the same time, the scope for market-based support mechanisms, such as industry-funded deposit insurance schemes, is constrained by the high degree of concentration in the banking sector. All this calls for strong, effective regulation and supervision, with a particular focus on close monitoring of vulnerabilities, early identification of and response to risks, and contingency planning to deal with possible stresses.

48. **The authorities have taken a proactive approach in reducing the impact of the crisis on the economy—but more may be needed.** They have relaxed the policy mix, injected liquidity, and introduced measures to address risks to the stability of the banking system. The creation of the bank stabilization fund, enhancements to deposit insurance, new capital adequacy targets, and initiatives to channel funds to banks in need of liquidity have bolstered confidence in the financial system. However, uncertainty about future economic

and financial sector developments remains, and further policy action—including capital injections and government guarantees—may be required if the turmoil continues.

49. **Banks and other parts of the diverse Swiss financial sector will remain under increasing stress.** The two large banks continue to be highly leveraged despite a marked shedding of assets, continue to hold some amount of distressed assets, and the system as a whole is significantly exposed to creditors in emerging market countries. At the same time, earnings streams will remain under pressure as credit demand falters and revenues from private banking and wealth management business lines slow. Therefore, funding of banks continues to require close monitoring. Life insurance companies and pension funds operations are affected by lower asset prices. While many smaller and medium-sized banks have benefited from cash outflows from larger banks, strong liquidity at these firms also creates some risk of less prudent lending practices.

50. **The authorities are further developing the regulatory framework.** Last year they introduced an innovative reform of capital regulation for the large banks—applying both higher risk-based capital adequacy requirements that adjust to downturns in bank performance and a minimum leverage ratio—while acknowledging the need to avoid enhancing the current downturn by tightening capital and other rules too early. More stringent liquidity regulations to be introduced this year for the large banks respond to some weaknesses in international bank liquidity standards highlighted by the crisis. Switzerland has a developed bank resolution framework, but the recently extended deposit insurance regime should be put on a sounder footing to ensure adequate protection of depositors in case of failure, regardless of the size of bank. This requires, amongst other measures, the introduction of ex ante funding. The authorities are addressing these issues and will bring forward plans later in the year.

51. **The establishment of a new integrated supervisor (FINMA) provides a good opportunity to strengthen financial supervision.** An independent and well-resourced supervisory authority capable of responding effectively to the lessons of the financial crisis is essential to maintaining financial stability. FINMA should continue its progress in enhancing skills and resources, integrating sectoral regulatory approaches, and strengthening its forward-looking systemic surveillance. It needs to develop a strong supervisory style, in close cooperation with the SNB and foreign regulators. Continued intensive oversight of the large banks, including their foreign operations, is essential. With stresses spreading to other parts of the financial sector, there is also a need for close supervisory focus on the large (re)insurance sector and on medium-sized and small banks. With respect to the supervision of the smaller banks, this may require further development of the dual approach (with auditors) with increased on-site examination by FINMA staff and close attention to potential weaknesses in work delegated to auditors. In addition, there is a need to continue strengthening pension fund supervision (by cantons) in line with earlier recommendations.

52. **An additional temporary fiscal stimulus—that does not undermine long-term fiscal sustainability—is recommended.** A low stock of debt and previous surpluses

provided space for the announced discretionary spending measures of about ¾ percent of GDP in 2009. Full use of automatic stabilizers, and flexible application of debt brake rules, should also help to limit any procyclical tightening impulses. Looking ahead, the deteriorating outlook calls for some further stimulus in 2010, which could be similar in size to that of 2009. However, with bond markets becoming more sensitive to long-run sustainability concerns, as well as the need to preserve sufficient room for possible additional financial sector support, any new stimulus should be temporary in nature and well targeted. Long-term reforms of entitlement programs should remain on the authorities' agenda.

53. **Policy interest rates have been appropriately steered toward zero as growth prospects and inflationary expectations declined.** Rising risk premia and persistent currency appreciation due to safe-haven flows caused an undesirable tightening in monetary conditions. Given the sharp deterioration in the economy and increasing deflation concerns, there was a legitimate need to relax monetary conditions. The SNB's shift to a quantitative easing track in March—including intervention in currency markets to stem further appreciation pressures—reflects limited options to further influence monetary conditions. Unsterilized foreign exchange intervention within Switzerland's floating regime should be aimed at countering disruptive pressures, including those caused by safe haven flows. This would also provide some positive spillovers, including for Eastern European countries. Once the recovery commences, the SNB will need to exit quantitative easing, and reverse the build-up in monetary base to protect price stability.

54. **Switzerland's current account surplus reflects structural factors.** The surplus is mostly structural, reflecting the country's high per capita income, an aging population, and its position as an international financial centre. The writedowns of financial assets and decline in investment income flows will cause a reduction in the surplus in the near term. Some of this decline is structural, although it is too early to assess how much.

55. It is recommended that the next Article IV consultation be held on the standard 12 month cycle.

Table 1. Switzerland: Basic Data

Area and population			
Total area	41,293 square kilometers	GDP per capita (2007, in US$)	56,837
Total population (end-2007)	7.5 million	GNP per capita (2007, in US$)	57,876

	2006	2007	2008 1/	2009 1/	2010 1/	2011 1/
	(Percentage changes at constant prices, unless otherwise indicated)					
Demand and supply						
Total domestic demand	1.4	1.1	0.2	-0.5	1.2	0.6
Private consumption	1.6	2.1	1.7	0.4	0.6	1.0
Public consumption	-0.9	-1.1	0.0	2.5	-0.2	0.0
Gross fixed investment	4.9	5.7	-1.6	-7.6	0.5	1.1
Final domestic demand	2.0	2.6	0.7	-1.3	0.5	0.9
Inventory accumulation 2/	-0.6	-1.4	-0.4	0.7	0.6	-0.3
Foreign balance 2/	2.1	2.3	1.4	-2.5	-1.4	0.5
Exports of goods and nonfactor services	9.9	9.4	2.3	-10.9	0.0	6.2
Imports of goods and nonfactor services	6.5	5.9	-0.2	-8.0	3.2	6.2
GDP	3.4	3.3	1.6	-3.0	-0.3	1.0
Nominal GDP (billions of Swiss francs)	487.0	512.1	532.1	523.6	528.2	539.3
Employment and unemployment						
Employment (percent change)	0.9	1.0	1.1	-4.2	-1.8	-1.2
Unemployment rate (in percent)	3.0	2.5	2.7	3.9	4.6	4.2
Output gap (in percent of potential)	1.6	3.6	4.1	0.0	-1.3	-1.1
	(Percentage changes, unless otherwise indicated)					
Prices and incomes						
GDP deflator	1.7	1.8	2.2	1.4	1.2	1.1
Consumer price index	1.0	0.7	2.4	-0.6	-0.3	0.3
Nominal wage growth	1.6	1.8	3.3	0.3	0.9	2.3
Unit labor costs (total economy)	-0.8	-0.5	2.7	-1.0	-0.6	0.1
	(In percent of GDP)					
General government finances						
Revenue	37.7	37.4	38.6	37.0	37.3	37.2
Expenditure	36.0	35.2	37.7	38.6	38.9	38.6
Balance 3/	1.7	2.2	0.9	-1.6	-1.6	-1.4
Cyclically adjusted balance 4/	1.2	1.0	-1.6	-1.5	-1.0	-0.8
Structural balance 5/	0.5	0.7	0.6	-1.6	-1.2	-1.0
Gross debt	47.5	44.3	41.6	43.8	45.0	45.5
	(Percentage changes in annual averages)					
Monetary and credit data						
Broad money (M3)	2.4	2.1	3.2	...	...	...
Domestic credit	5.5	6.2	7.2	...	...	...
	(Period averages in percent)					
Interest rates						
Three-month rate	1.6	2.2	1.5	...	...	...
Yield on government bonds	2.5	2.9	2.5	...	...	...
	(In percent of GDP)					
Balance of payments						
Current account	14.5	10.1	9.1	7.6	8.1	8.9
Trade balance	1.0	1.8	2.7	1.7	1.6	1.6
Net investment income	10.4	4.3	1.9	1.9	2.3	2.8
Other	3.1	4.0	4.5	4.0	4.2	4.5
	(Levels)					
Exchange rates 6/						
Swiss francs per U.S. dollar (annual average)	1.25	1.20	1.08	1.16	...	...
Swiss francs per euro (annual average)	1.57	1.64	1.59	1.52	...	...
Nominal effective rate (avg., 1990=100)	108.4	106.1	112.4	118.3	...	...
Real effective rate (avg., 1990=100) 7/	101.7	98.0	103.1	108.4	...	...

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

1/ Fund staff estimates and projections unless otherwise noted.
2/ Change as percent of previous year's GDP.
3/ Including railway loans as expenditure.
4/ Excludes cyclical items only.
5/ Excludes cyclical and one-off items (about 2.1 percent of GDP in 2008).
6/ 2009 values as of April 14, 2009.
7/ Based on relative consumer prices.

Table 2. Switzerland: Balance of Payments, 2006–14 1/

	2006	2007	2008	2009	2010	2011	2012	2013	2014
			Projections						
	(In billions of Swiss francs, unless otherwise indicated)								
Current account	**71**	**52**	**48**	**40**	**43**	**48**	**54**	**62**	**69**
Trade balance	5	9	14	9	9	9	9	9	10
Exports	186	207	216	186	186	200	216	236	257
Imports	-181	-198	-202	-177	-177	-191	-207	-227	-248
Service balance	38	44	48	45	46	48	50	53	56
Net investment income	51	22	10	10	12	15	19	24	28
Net compensation of employees	-11	-12	-13	-14	-13	-13	-13	-13	-13
Net private transfers	-8	-8	-8	-8	-8	-8	-8	-8	-8
Net official transfers	-3	-3	-3	-3	-3	-3	-3	-3	-3
Private capital and financial account	**-71**	**-48**	**-45**	**-40**	**-43**	**-48**	**-54**	**-62**	**-69**
Net foreign direct investment	-56	0	-75	-18	-24	-27	-28	-28	-28
Net portfolio investment	-54	-23	-35	-29	-33	-40	-47	-54	-62
Net banking sector	24	6	61	7	14	18	20	20	20
Other 2/	16	-31	4	0	0	0	0	0	0
Official reserve flows	**0**	**-4**	**-3**	**0**	**0**	**0**	**0**	**0**	**0**
	(In percent of GDP, unless otherwise indicated)								
Current account	**14.5**	**10.1**	**9.1**	**7.6**	**8.1**	**8.9**	**9.9**	**10.9**	**12.0**
Trade balance	1.0	1.8	2.7	1.7	1.6	1.6	1.6	1.6	1.7
Exports	38.1	40.4	40.6	35.4	35.2	37.1	39.2	41.7	44.4
Imports	-37.1	-38.6	-37.9	-33.7	-33.5	-35.4	-37.6	-40.1	-42.7
Service balance	7.8	8.6	9.0	8.6	8.7	8.9	9.1	9.4	9.7
Net investment income	10.4	4.3	1.9	1.9	2.3	2.8	3.4	4.2	4.8
Net compensation of employees	-2.3	-2.4	-2.5	-2.6	-2.5	-2.4	-2.4	-2.3	-2.2
Net private transfers	-1.7	-1.5	-1.4	-1.5	-1.5	-1.4	-1.4	-1.4	-1.4
Net official transfers	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5
Private capital and financial account	**-14.5**	**-9.5**	**-8.4**	**-7.6**	**-8.1**	**-8.9**	**-9.9**	**-10.9**	**-12.0**
Net foreign direct investment	-11.6	-0.1	-14.0	-3.4	-4.4	-4.9	-5.0	-4.9	-4.7
Net portfolio investment	-11.0	-4.5	-6.6	-5.5	-6.3	-7.3	-8.5	-9.6	-10.7
Net banking sector	4.8	1.2	11.6	1.3	2.7	3.3	3.6	3.5	3.5
Other 2/	3.2	-6.0	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Official reserve flows	**-0.1**	**-0.8**	**-0.7**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Net IIP (in percent of GDP)	112	139	143	153	160	166	172	179	186
Official reserves									
(billions of U.S. dollars, end period)	38.1	42.7	…	…	…	…	…	…	…
Reserve cover (months of imports of GNFS)	2.7	2.6	...	...	...	...	...	...	...

Sources: IMF, World Economic Outlook database; and Swiss National Bank.
1/ Fund staff estimates and projections unless otherwise noted.
2/ Includes errors and omissions.

Table 3. Switzerland: Major Financial Institutions---Key Indicators, 2003–08

(Millions of Swiss francs, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008
Credit Suisse						
Total assets	962,164	1,089,485	1,339,052	1,255,956	1,360,680	1,170,350
Shareholders equity	34,692	36,273	42,118	43,586	43,199	32,302
Total operating income	26,322	27,033	30,489	38,603	39,735	12,095
Net income	4,999	5,628	5,850	11,327	7,754	-7,687
o/w fees and commissions	12,917	13,323	14,323	17,647	19,329	14,812
trading income	3,528	3,675	5,634	9,428	6,148	-9,880
RoA	0.52	0.52	0.44	0.90	0.57	-0.66
Gearing ratio 1/	27.73	30.04	31.79	28.82	31.50	36.23
RoE	14.41	15.52	13.89	25.99	17.95	-23.80
Tier 1 ratio (percent)	11.7	12.3	11.3	13.9	11.1	13.3
Number of employees	…	41,200	44,600	44,900	48,100	47,800
S&P long-term rating	AA-	AA-	AA-	AA-	AA-	A+
UBS						
Total assets	1,553,979	1,737,118	2,060,250	2,396,511	2,272,579	2,015,098
Shareholders equity	33,659	33,941	44,324	49,686	35,585	32,800
Total operating income	32,957	35,971	39,896	47,484	31,721	1,201
Net income	5,904	7,357	9,442	11,527	-5,247	-20,887
o/w fees and commissions	17,345	19,416	21,436	25,881	30,634	22,929
trading income	3,756	4,972	7,996	13,318	-8,353	-25,818
RoA	0.38	0.42	0.46	0.48	-0.23	-1.04
Gearing ratio 1/	46.17	51.18	46.48	48.23	63.86	61.44
RoE	17.54	21.68	21.30	23.20	-14.74	-63.68
Tier 1 ratio (percent)	12.0	11.9	12.9	11.9	8.8	11.0
Number of employees	65,879	67,407	69,569	78,140	83,560	77,783
S&P long-term rating	AA+	AA+	AA+	AA+	AA	A+
Swiss Re						
Total assets	169,698	184,440	221,299	291,300	307,287	224,789
Shareholders equity	18,511	19,177	24,393	30,884	31,867	19,167
Total operating income	36,430	36,093	38,012	40,771	42,874	23,407
Net income	1,702	2,475	2,304	4,560	4,162	-810
RoA	1.00	1.34	1.04	1.57	1.35	-0.36
Gearing ratio 1/	9.17	9.62	9.07	9.43	9.64	11.73
RoE	9.19	12.91	9.45	14.76	13.06	-3.40
Number of employees	7,886	8,359	8,882	9,586	10,891	11,560
S&P long-term rating	AA	AA	AA	AA-	AA-	A+
Zurich Financial Services 2/						
Total assets	317,642	350,887	339,612	374,781	389,344	307,316
Shareholders equity	18,934	20,515	22,426	25,587	28,804	20,713
Total operating income	57,208	61,214	67,186	65,002	55,163	30,314
Net income	2,009	2,466	3,214	4,620	5,626	4,860
RoA	0.63	0.70	0.95	1.23	1.44	1.58
Gearing ratio 1/	16.78	17.10	15.14	14.65	13.52	14.84
RoE	10.6	12.0	14.3	18.1	19.5	12.10
Number of employees	>50,000	>50,000	>55,000	>55,000	>60,000	58,220
S&P long-term rating	AA	AA	AA	AA-	AA-	AA-

Sources: Company reports; and IMF staff estimates.

1/ Total assets divided by shareholders equity.

2/ In millions of US$, unless otherwise indicated.

Table 4. Switzerland: SNB Balance Sheet
(Millions of Swiss francs; unless otherwise indicated)

	2005	2006	2007	2008
Assets				
Gold	25,483	31,228	34,776	30,862
Foreign currency reserves	45,584	45,400	50,586	47,429
IMF, international, and monetary assistance loans	1,828	1,102	961	1,296
Swiss franc repos	22,005	21,005	31,025	50,321
U.S. dollar repos	-	-	4,517	11,671
Swaps against Swiss francs				50,421
Money market, Swiss franc securities, other	6,789	6,077	5,062	22,324
Total assets	101,689	104,812	126,927	214,323
Liabilities				
Currency in circulation (banknotes)	37,195	38,134	44,259	49,161
Sight deposits	9,630	7,647	10,563	51,173
Repo, SNB bills & time liabilities	-	-	5,223	53,839
Foreign currency and other liabilities	159	99	1,200	1,700
Provisions and equity capital	54,705	58,931	65,682	58,449
Total liabilities	101,689	104,812	126,927	214,323
Memorandum items:				
NGDP (billions of Swiss francs)	463.1	487.0	512.1	532.1
Balance sheet, percent of NGDP	21.96	21.52	24.78	40.27
Banknotes, percent of total liabilities	36.58	36.38	34.87	22.94
Refinancing operations, percent of total assets	21.64	20.04	28.00	52.45
Provisions and equity capital, % of total assets	53.80	56.23	51.75	27.27

Sources: SNB; and IMF staff estimates.

Table 5. General Government Finances, 2007–11

(In billions of Swiss francs, unless otherwise specified)

	2007	2008	2009	2010	2011
	Estimates		Projections		
Federal Government 1/					
Revenues	58.7	64.2	57.9	59.2	59.1
Expenditures	54.2	66.0	60.4	61.4	62.7
Balance	4.6	-1.9	-2.5	-2.2	-3.6
Cantons					
Revenues	78.2	83.2	79.6	80.9	83.2
Expenditures	74.7	79.0	81.5	81.8	82.6
Balance	3.5	4.2	-1.9	-0.9	0.6
Municipalities					
Revenues	50.2	53.2	52.7	53.1	54.3
Expenditures	47.5	50.9	55.2	55.1	55.4
Balance	2.8	2.3	-2.6	-2.0	-1.1
Federal, cantonal, and municipal governments					
Revenues	157.4	170.9	159.5	162.7	165.6
Expenditures	146.5	166.3	166.4	167.9	169.7
Balance	10.9	4.6	-6.9	-5.1	-4.1
Social security					
Revenues	52.1	51.9	51.5	52.3	54.2
Expenditures	51.6	51.6	52.8	55.4	57.5
Balance	0.5	0.4	-1.3	-3.1	-3.3
General Government					
Revenues	191.5	205.6	193.8	197.1	200.8
Expenditures	180.2	200.6	202.0	205.3	208.2
Balance	11.4	5.0	-8.2	-8.2	-7.4
Gross debt					
Bund	121.0	121.7	125.4	130.7	137.6
Kantone	61.5	57.3	59.2	60.2	59.6
Gemeinden	44.6	42.3	44.9	46.9	48.0
Total	227.0	221.3	229.6	237.8	245.2
	(Percent of GDP)				
General Government					
Revenue	37.4	38.6	37.0	37.3	37.2
Expenditure	35.2	37.7	38.6	38.9	38.6
Balance	2.2	0.9	-1.6	-1.6	-1.4
Federal government	0.9	-0.4	-0.5	-0.4	-0.7
Cantons	0.7	0.8	-0.4	-0.2	0.1
Municipalities	0.5	0.4	-0.5	-0.4	-0.2
Social security	0.1	0.1	-0.2	-0.6	-0.6
Memorandum items:					
Structural balance 2/	0.7	0.6	-1.6	-1.2	-1.0
Gross debt	44.3	41.6	43.8	45.0	45.5

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

1/ Confederation and extra budgetary funds. Excludes transfers of proceeds from gold sales from confederation to social security fund (SwF 7 billion, or 1.3 percent of GDP).

2/ Computed as in OECD (2005). Excluding one-off items (1.1 percent of GDP in 2008).

Table 6. Switzerland: Federal Government Finances, 2007–12

	2007	2008	2009	2010	2011	2012
	(Billions of Swiss francs)					
Revenue 1/	58.7	64.2	57.9	59.2	59.1	59.8
Current revenue	57.7	63.6	57.4	58.0	58.2	59.7
Taxes	53.3	58.8	52.8	53.3	53.4	54.6
Direct taxes	22.6	26.9	22.2	21.4	21.4	21.9
Indirect taxes 2/	30.7	31.8	30.7	31.9	32.1	32.7
Nontax revenue	4.4	4.9	4.6	4.7	4.7	5.1
Capital revenue 1/	1.0	0.5	0.5	1.2	1.0	0.1
Expenditure 1/ 3/	54.2	66.0	60.4	61.4	62.7	64.2
Current expenditure	47.7	52.6	52.2	53.8	54.9	56.4
Wages and salaries	4.5	4.3	4.8	4.9	4.9	4.9
Goods and services	4.0	4.8	4.8	4.8	4.8	4.4
Interest payments	4.0	4.0	3.9	4.6	5.4	6.2
Transfers	35.2	39.4	38.6	39.6	39.8	40.9
Capital expenditure 1/	6.5	13.4	8.2	7.6	7.8	7.8
Overall balance	4.6	-1.9	-2.5	-2.2	-3.6	-4.4
	(Percent of GDP)					
Revenue	11.5	12.1	11.1	11.2	11.0	10.8
Current revenue	11.3	12.0	11.0	11.0	10.8	10.8
Taxes	10.4	11.0	10.1	10.1	9.9	9.9
Direct taxes	4.4	5.1	4.2	4.0	4.0	4.0
Indirect taxes 2/	6.0	6.0	5.9	6.0	5.9	5.9
Nontax revenue	0.9	0.9	0.9	0.9	0.9	0.9
Capital revenue	0.2	0.1	0.1	0.2	0.2	0.0
Expenditure 3/	10.6	12.4	11.5	11.6	11.6	11.6
Current expenditure	9.3	9.9	10.0	10.2	10.2	10.2
Wages and salaries	0.9	0.8	0.9	0.9	0.9	0.9
Goods and services	0.8	0.9	0.9	0.9	0.9	0.8
Interest payments	0.8	0.8	0.8	0.9	1.0	1.1
Transfers	6.9	7.4	7.4	7.5	7.4	7.4
Capital expenditure	1.3	2.5	1.6	1.4	1.4	1.4
Overall balance	0.9	-0.4	-0.5	-0.4	-0.7	-0.8
Memorandum items:						
Structural fiscal balance 4/	0.3	0.6	-0.5	-0.3	-0.5	-0.7
Gross debt	23.6	22.9	23.5	23.7	23.9	24.1

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

1/ Includes the balance of the Confederation and extrabudgetary funds (Public Transport Fund, ETH, Infrastructure Fund, Federal Pension Fund).
2/ Excludes VAT increase planned for 2010 since it has not yet been approved.
3/ 2008 total expenditures include extraordinary spending. Exclude transfers of proceeds from gold sales from confederation to social security fund.
4/ Excludes cyclical and one-off items (about 1.4 percent of GDP) in 2008.

Table 7. Switzerland's International Investment Position, 2003–08
(in millions of Swiss francs, unless otherwise indicated; total at year's end)

	2003	2004	2005	2006	2007	2008
Foreign assets	**2,189,987**	**2,259,767**	**2,772,036**	**3,068,062**	**3,636,196**	**3,107,662**
Direct investment 1/	422,244	453,307	567,752	683,307	740,472	770,849
Portfolio investment	816,257	860,284	958,336	1,072,345	1,190,815	938,412
Other assets	865,439	861,908	1,170,154	1,233,742	1,619,880	1,319,514
Reserve assets	86,047	84,462	75,794	78,668	85,029	78,887
Foreign liabilities	**1,657,579**	**1,724,029**	**2,204,280**	**2,523,108**	**2,921,900**	**2,452,086**
Direct investment 1/	200,666	223,694	223,636	323,310	379,894	397,881
Portfolio investment	556,790	589,478	788,126	930,140	902,077	625,363
Other liabilities	900,123	911,782	1,192,518	1,269,658	1,639,929	1,428,842
Net investment position	**532,408**	**535,738**	**567,756**	**544,954**	**714,296**	**655,576**
Direct investment 1/	221,578	229,613	344,116	359,997	360,578	372,968
Portfolio investment	259,466	270,806	170,210	142,205	288,738	938,412
Other assets and liabilities	-34,684	-49,874	-22,364	-35,916	-20,049	-109,328
Reserve assets 2/	86,047	84,462	75,794	78,668	85,029	78,887
Memorandum items: 3/						
Foreign assets	500	501	599	630	710	584
Foreign liabilities	379	382	476	518	571	461
Net investment position	122	119	123	112	139	123

Source: April 2009 SNB Monthly Bulletin.
1/ Expansion of reporting population in 2004.
2/ In 2005, distribution to Confederation and cantons of proceeds from gold sales.
3/ In percent of GDP.

Table 8. Switzerland: Financial Soundness Indicators

	2003	2004	2005	2006	2007	2008
Banks						
Capital adequacy						
Regulatory capital as percent of risk-weighted assets 1/	12.4	12.6	12.4	13.4	12.1	14.8
Regulatory Tier I capital to risk-weighted assets 1/	13.5	13.3	13.0	13.4	11.6	12.3
Non-performing loans net of provisions as percent of capital 2/	-0.5	-1.2	-1.0	-1.0	-0.9	1.3
Asset quality and exposure						
Non-performing loans as percent of gross loans	1.3	0.9	0.5	0.3	0.3	0.5
Sectoral distribution of bank credit to the private sector (percent) 3/						
Households	63.7	65.2	66.6	68.5	71.5	65.4
Agriculture and food industry	1.3	1.3	1.2	1.4	1.4	1.3
Industry and manufacturing	4.1	3.7	3.4	3.0	3.4	3.0
Construction	2.2	2.1	1.9	1.7	1.8	1.6
Retail	4.1	3.7	3.6	3.1	3.3	3.1
Hotels and restaurants / Hospitality sector	1.5	1.4	1.3	1.2	1.2	1.1
Transport and communications	1.1	1.1	1.1	1.0	1.1	0.9
Other financial activities	2.2	2.2	2.4	3.1	5.2	7.0
Insurance sector	0.5	0.5	0.4	0.4	0.4	0.8
Commercial real estate, IT, R&T	12.3	12.2	12.1	11.0	5.9	11.0
Public administration (excluding social security)	3.3	3.1	2.6	2.4	1.1	1.8
Education	0.2	0.2	0.2	0.2	0.2	0.2
Healthcare and social services	1.3	1.3	1.3	1.1	1.1	1.0
Other collective and personal services	1.5	1.5	1.5	1.3	1.7	1.2
Other 3/	0.5	0.5	0.5	0.6	0.6	0.6
Earnings and profitability						
Gross profits as percent of average assets (ROAA)	0.7	0.8	0.9	0.9	0.7	0.3
Gross profits as percent of average equity capital (ROAE)	11.7	14.3	18.0	17.7	15.4	5.4
Net interest income as percent of gross income	40.2	36.4	30.9	27.4	28.1	36.3
Non-interest expenses as percent of gross income	63.5	62.7	59.2	63.0	70.4	85.5
Liquidity						
Liquid assets as percent of total assets	26.7	24.5	24.7	25.2	27.1	29.2
Liquid assets as percent of short-term liabilities	63.7	59.6	59.4	60.4	63.9	67.1
Net long position in foreign exchange as a percentage of tier I capital 1/	30.1	15.5	30.6	21.9	13.7	-16.1

Source: Swiss National Bank.
1/ The 2007 and 2008 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%.
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.

Table 9. Switzerland: Structure of the Financial System

	2003	2004	2005	2006	2007	2008
			(Number of institutions)			
Banks	342	338	337	331	330	324
Cantonal banks	24	24	24	24	24	24
Large banks	3	3	2	2	2	2
Regional and savings banks	83	83	79	78	76	76
Raiffeisen banks	1	1	1	1	1	1
Other banks	190	188	189	183	183	178
Trading banks 1/	9	8	7	7	7	…
Stock exchange banks	55	53	56	52	48	48
Other banks 1/	4	4	4	4	6	9
Foreign controlled banks	122	123	122	120	122	121
Branches of foreign banks	26	25	28	29	30	29
Private bankers	15	14	14	14	14	14
Insurance companies - Life 2/	24	24	24	24	24	…
Insurance companies - General 2/	124	124	124	124	90	…
Pension funds 2/	…	2,935	2,770	2,669	2,543	…
Concentration						
Banks 3/	63	66	67	72	71	65
			(In billions of Swiss francs)			
Assets						
Banks	2,237	2,491	2,846	3,194	3,458	3,080
Cantonal banks	311	314	327	343	357	389
Large banks	1,409	1,644	1,910	2,198	2,341	1,885
Regional and savings banks	81	81	84	86	85	90
Raiffeisen banks	102	106	108	114	123	132
Other banks	302	314	382	410	488	519
Trading banks 1/	42	43	45	46	47	…
Stock exchange banks	83	86	106	122	145	131
Other banks 1/	3	4	3	4	7	56
Foreign controlled banks	174	182	228	239	288	332
Branches of foreign banks	16	15	17	23	34	24
Private bankers	17	17	17	19	30	41
Insurance companies - Life 2/	311	303	298	281	287	…
Insurance companies - General 2/	530	536	567	569	594	…
Pension funds 2/	…	484	543	583	605	…
Deposits						
Banks	974	1,044	1,211	1,374	1,519	1,395
Cantonal banks	169	180	186	192	200	234
Large banks	526	577	700	834	913	722
Regional and savings banks	50	51	54	54	53	55
Raiffeisen banks	65	71	73	75	80	86
Other banks	149	153	185	206	252	274
Trading banks 1/	26	27	28	29	29	…
Stock exchange banks	49	47	61	66	83	85
Other banks 1/	2	2	3	2	3	35
Foreign-controlled banks	72	76	93	108	137	154
Branches of foreign banks	2	2	2	2	7	4
Private banks	13	11	11	11	13	20

Source: Swiss National Bank.

1/ Trading banks reclassified in 2008 as stock exchange or other banking institutions.
2/ Data for 2008 not yet available.
3/ Share in percent of three largest banks in total assets of the sector.

Appendix I. The SNB Stabilization Fund

The authorities undertook a stabilization initiative for UBS through distressed asset purchases and a capital injection (Table A). On October 16, 2008, the Swiss Confederation announced that it will strengthen the UBS capital base by subscribing to mandatory convertible notes to the amount of SFr 6 billion, while the SNB created an SPV entity that would absorb problem assets ("bad bank" model). The SPV is funded by a first loss position taken by UBS, which is assumed to cover 10 percent of the SPV asset portfolio, and by a $35 billion non-recourse SNB loan—collateralized by the assets of the fund. The capital injection from the government came from the structural surplus, while the SNB initially procured the funds required for the transfer of the illiquid assets into the SPV from the U.S. Federal Reserve by means of a U.S. dollar – Swiss franc swap.

Owing in particular to amendments made to international accounting standards since the announcement of the stabilization measure, the transfer of assets has been reduced from its original level of approximately $60 billion to approximately $39 billion. The SNB and UBS agreed that certain categories of assets (structured products backed by student loans and assets that have been wrapped by monoline insurers) are to be withheld from the StabFund. The decision to retain the structured products on student loans reflected changes to IFRS accounting standards (IAS39) in October 2008 that made it possible for UBS to reclassify these assets (from "held for trading" to "loans and receivables"). The re-classification resulted in cost savings from accepting a low impairment charge (in lieu of the 10% equity contribution and possibly an additional write-off at the transfer price agreed by the SNB). The impact on UBS in the short term is similar to that of the StabFund in that further pressures on net income from mark-to-market losses have been avoided. By not transferring these assets, UBS remains exposed to possible impairment of the assets.

Assets have been transferred at prices set by an independent valuation process. In two steps, the SNB StabFund acquired assets from UBS in the equivalent amount of about $39 billion. Asset prices were determined by the SNB based on a valuation conducted by third-party valuation experts. The assets purchased were primarily U.S. and European residential and commercial mortgage-backed securities as well as other asset-backed securities.

Capital injections of financial institutions have been administered through a wide range of capital and subordinated debt instruments.

Table A. Global Banking: Overview of Selected Bank Recapitalization Measures

Investor category							
State	UK banks (RBS, HBOS & Lloyds £9bn) French banks (6 banks, €12bn)	US banks	Commerz-bank[4] €8.2bn	ING €10bn Aegon €3bn	KBC €3.5bn	**UBS** SFr 6bn	UK banks (RBS, HBOS & Lloyds £28bn) Dexia €6.4bn and Fortis €11.2bn
Private equity[1]	**Credit Suisse** SFr 5.5bn	Barclays[2] £3bn			Unicredit €3bn	**Credit Suisse** SFr 1.7bn Barclays[3] £2.8bn	Credit Suisse SFr 3.2bn
Capital Instrument	Non-cumulative hybrid	Hybrid warrants	Non-convertible hybrid[5]	Convertible hybrid (issuer)	Convertible hybrid (investor)	Mandatory convertible hybrid (within short time)	Straight equity
Regulatory classification	Lower Tier 1 capital		Core Tier 1 capital				

Degree of existing shareholder dilution[6] →

Notes: 1/ sovereign wealth funds, existing/new investors; 2/ issuance in conjunction with £3bn warrants. Any proportion exceeding the 15 percent limit of (innovative) Tier 1 hybrid capital instruments is classified as Upper Tier 2 capital; 3/ only classified as core Tier 1 capital and ranking as ordinary equity upon conversion in June 2009; 4/ includes some capped participation on redemption; 5/ convertible hybrid securities represent a form of subordinated debt that obligates the holder to accept common or perpetual preferred stock in lieu of cash for repayment of principal; 6/ increasing pure equity features, generally rating agency treatment

Sources: Dealogic, Datastream, Bloomberg, Reuters, Barclays Capital, ING.

Appendix II: Regulatory Reform in Switzerland

The financial services regulator FINMA, in collaboration with the SNB, is undertaking extensive reforms to its regulatory framework to respond to the lessons of the financial crisis. The main elements are as follows.

Capital adequacy

Basel II, including the Pillar 3 disclosure requirements, has been implemented for all Swiss banks. Six groups use the Internal Ratings-Based approach for credit risk and two the Advanced Measurement Approach for operational risk. Under Pillar 2, all banks are required to hold capital at least 20 percent above the Basel II 8 percent minimum ratio (the "Swiss finish"). The reforms will provide for:

- Changes in the calculation of the Basel II ratio in line with Basel Committee standards. The emphasis on revised requirements for trading book risks will make the impact particularly strong for the major Swiss banks because of the continuing significance of their investment banking business.
- Increased capital buffers (under pillar 2) above the Basel II minimum requirements for the two major banks: starting on 1 January 2013, they will have to meet a minimum ratio (capital as a percentage of risk-weighted assets) of 12 percent—but higher "in good times" (see below).
- The introduction, also from 1 January 2013 and just for the two major banks, of a minimum leverage ratio: they will have to hold capital as a percentage of (unweighted) assets of 3 percent at group level and 4 percent at bank level – and higher "in good times"; the ratio calculation excludes domestic lending (except interbank) and selected assets used in central bank repos, and allows use of Swiss GAAP measures of positive replacement value on derivatives that recognize a higher degree of netting than IFRS.
- Variations to address the procyclicality of existing requirements: the Basel II minimum will rise to as much as 16 percent of risk-weighted assets in good times and the minimum leverage ratio will also be significantly higher. "Good times" are defined as periods of at least two years in which a bank generates profits of at least the normal level for the industry.
- A redefinition of eligible capital (for both Basel II and leverage measures) to anticipate changes planned by the European Union in the revised Capital Requirements Directive.

Stress-testing

- FINMA is developing a "building block approach" to supplement the existing top down stress tests coordinated by the SNB. Large banks are required to submit sensitivity analyses for their main risk clusters which FINMA uses to assess the impact of its scenarios.
- FINMA will use the results to inform risk management discussions with the banks (especially vulnerability to future shocks) and possibly as an input into capital

adequacy decisions. The two banks submitted initial results in relation to June 2008 data, the analysis of which will help FINMA refine the approach.

Liquidity

- New requirements are planned to be introduced for the two large banks in 2009 and extended as appropriate to other banks. Banks will have to demonstrate their ability to withstand a liquidity crisis on the basis of scenarios defined by the regulator. The details are under development. They will capture bank specific and market wide stresses.

Remuneration

- FINMA will issue guidance later this year on remuneration practices. This will be applicable to all regulated financial companies and will address risks in all areas of business, not only investment banking. It will draw on FINMA's experience in approving 2008 UBS bonus allocations, a FINMA task under the stabilization package.

INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2009 Consultation with Switzerland

(In consultation with other Departments)

May 1, 2009

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Appendices

Appendix I. Switzerland: Fund Relations

(As of March 31, 2009)

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

		SDR Million	% Quota
II.	**General Resources Account:**	SDR Million	% Quota
	Quota	3,458.50	100.00
	Fund holdings of currency	2,992.18	86.52
	Reserve position in Fund	466.36	13.48
III.	**SDR Department:**	SDR Million	% Allocation
	Holdings	175.41	N/A
IV.	**Outstanding Purchases and Loans:**	None	
V.	**Financial Arrangements:**	None	
VI.	**Projected Obligations to Fund:**	None	

VII. **Exchange Rate Arrangement:**

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

On April 2, 2009, Switzerland notified the IMF of the exchange restrictions that have been imposed against certain countries, individuals, and entities, in accordance with relevant UN Security Council resolutions and EU regulations.

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

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

VIII. **Article IV Consultation:**

Switzerland is on the standard 12-month Article IV consultation cycle. The 2009 mission visited Bern and Zürich during February 26 to March 9, 2009 and held discussions with President and Finance Minister Merz, Chairman Roth of the Governing Board of the Swiss National Bank (SNB), and other senior officials. Outreach activities included discussions with members of parliament, NGOs, the private sector, and think-tanks. Messrs. Moser (Executive Director) and Weber (Advisor) attended some of the meetings.

The mission comprised P. Hilbers (Head), A. Carare, F. Ohnsorge (all EUR), A. Jobst and I. Tower (both MCM).

In agreement with the authorities, the mission focused on core surveillance issues. No background papers have been produced.

The mission held a joint press conference on the concluding statement. The authorities have agreed to the publication of the staff report.

IX.	**Technical Assistance:**	None
X.	**Resident Representatives:**	None
XI.	**Other**	FSAP Update, November 2006

Appendix II. Switzerland: Statistical Issues

Switzerland's economic and financial statistics are adequate for surveillance purposes. Switzerland generally publishes timely economic statistics and posts most of the data and the underlying documentation on the internet. In June 1996, Switzerland subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are currently posted on the Dissemination Standards Bulletin Board. Switzerland is in full observance of SDDS requirements, and it is availing itself of the SDDS's flexibility options on dissemination of production index data (for periodicity and timeliness) and of wages and earnings data (for periodicity). However, a number of statistical gaps and deficiencies remain, mainly reflecting a lack of resources and the limited authority of the Federal Statistical Office (BfS) to request information:

- reliable general government finance statistics appear with considerable lags, mainly due to delays in compiling fiscal accounts at the level of cantons and communes;

- pension statistics are published with a long lag;

- GDP by industry appears with a considerable lag.

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

From July 2006, the SNB conducts the monthly survey on the cost of borrowing. Data on financial flows and non-financial assets was published in 2007. In conjunction with the SNB's centennial, **long-run historical time series** covering monetary aggregates, capital markets, and the SNB balance sheet have been published. At the end of 2007, the SNB introduced a new monthly survey on **interest rates** for various banking products. Under the agreement with SFBC on reciprocal exchange of data, the SNB has since 2007, been collecting the new capital adequacy statement information, in accordance with Basel II. Since 2007, the SNB has conducted surveys of Liechtenstein-based companies when preparing its international investment position. In order to gain information on the effects of the financial crisis on domestic bank lending, the SNB has been collecting **qualitative** data on the lending policies of about 20 banks since the first quarter of 2008. The results of the survey complement the quantitative data obtained from existing statistics. This supplementary quarterly survey is only temporary and not published.

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

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

The Federal Finance Administration has started preparations for **revamping fiscal statistics** with the adoption of the *Government Finance Statistics Manual 2001*, the reform of the accounting standards for cantons and communes (*Harmonisiertes Rechnungslegungsmodell der Kantone HRM2*) and the introduction of full accrual budgeting and accounting at the level of the federal government (*Neues Rechnungsmodell Bund NAM*) along the lines of the International Public Sector Accounting Standards (IPSAS). Figures according to the new accounting standards have been produced for the federal government (*NAM*) 2007 and for some cantons (*HRM2*) for 2009. Figures according to GFSM2001 may be reported beginning in 2009. A ROSC mission on fiscal transparency took place during January 16–29, 2009.

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

Switzerland participated in the **Coordinated Compilation Exercise for Financial Soundness Indicators (FSIs).** Data and metadata on a benchmark set of indicators of the soundness of the financial system (for year-end 2005) has been posted on the IMF website.

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

Table of Common Indicators Required for Surveillance
(As of April 29, 2009)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Apr 09	Apr 09	D and M	M and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar 09	Apr 09	M	M	M
Reserve/Base Money	Mar 09	Apr 09	M	M	M
Broad Money	Mar 09	Apr 09	M	M	M
Central Bank Balance Sheet	Mar 09	Apr 09	M	M	M
Consolidated Balance Sheet of the Banking System	Mar 09	Apr 09	M	M	M
Interest Rates[2]	Mar 09	Apr 09	D and M	M and M	D and M
Consumer Price Index	Mar 09	Apr 09	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4]	2007	Sep 08	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government[3]	Feb 09	Mar 09	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4/08	Mar 09	Q	Q	Q
External Current Account Balance	Q4/08	Apr 09	Q	Q	Q
Exports and Imports of Goods and Services	Feb 09	Apr 09	M	M	M
GDP/GNP	Q4/08	Mar 09	Q	Q	Q
Gross External Debt	2008	Mar 09	Q	Q	Q

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
May 26, 2009

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

IMF Executive Board Concludes 2009 Article IV Consultation with Switzerland

On May 18, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

Switzerland's recent economic performance has been strong. From 2004 to 2007 real GDP growth remained above potential—and the euro area average—while inflation was muted. Exports and financial service flows rose rapidly in line with a favorable external environment, and unemployment fell to 2½ percent, even as cross border workers and immigration flows increased labor supply. A fiscal rule resulted in budgetary surpluses in 2006–07 of some 2 percent of GDP.

Global credit strains, however, have had an impact on the financial sector. Financial sector writedowns have been substantial, requiring sizeable capital injections and staff cuts. While deleveraging at financial institutions is ongoing, domestic lending has remained on a steady pace. The absence of a housing and credit bubble, in particular, has helped to support credit growth.

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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. 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.

The economy entered a recession in the second half of 2008. Growth in exports slowed, falling from 9½ percent in 2007 to 2¼ percent in 2008, with a marked fall in the fourth quarter, as world trade collapsed. From the supply side, financial intermediation value added declined by about 7 percent. Investment spending contracted since the second quarter, as firms scaled back plans given the deteriorating outlook. However, with labor markets robust, private consumption grew by a still healthy 1.7 percent, a rate not much lower than in 2007. Leading indicators, however, suggest the downturn will deepen. Economic growth is expected to decline from 1.6 percent in 2008 to -3.0 percent in 2009 as the worsening external environment takes its toll on exports and financial sector inflows, and lower employment will gradually weaken consumption.

Headline inflation averaged 2.4 percent in 2008, while core inflation was about 1½ percent. CPI inflation declined sharply in late 2008 due to fuel and food price decreases and is expected to remain negative in the near-term, given base effects and a weak global environment. For 2009, inflation is projected to average -0.6 percent, with negative inflation continuing into 2010. Flat real wage growth helped to support competitiveness, but export market shares have fallen.

With inflationary expectations declining rapidly, and the currency appreciating due to safe haven effects, the SNB aggressively relaxed the monetary stance. The SNB's target range for the 3-month Libor has been decreased by 250 basis points since October and now stands at 0 to 0.75 percent. To counter an unwanted tightening of monetary and financial conditions, the SNB implemented quantitative easing measures in March, including foreign exchange intervention to limit upward pressure on the Swiss franc.

The fiscal stance was neutral in 2008. The general government recorded a surplus of about 1 percent, as continued surpluses at lower levels of government offset a small federal deficit. Debt to GDP ratios have fallen below 42 percent but aging-related expenditures are expected to reverse this trend in the medium-term. A fiscal impulse and full use of automatic stabilizers are expected to push the general government balance into deficit in 2009.

Executive Board Assessment

Executive Directors welcomed Switzerland's strong growth performance over the last few years, but noted that the global financial crisis and collapse in world trade had pushed the Swiss economy into a recession in the second half of 2008. Given Switzerland's openness and the size of its financial sector, the economy is projected to experience a significant contraction in the near-term, with sizable downside risks to the outlook.

Against this background, Directors observed that the key policy priority is to maintain domestic financial stability, which would contribute also to international financial stability given Switzerland's strong international linkages. They commended the authorities for their proactive and effective response to date to limit the fallout from the financial turbulence. In particular, Directors welcomed the relaxation of macroeconomic policies, creation of the bank stabilization fund, enhancements to deposit insurance, and introduction of innovative capital requirements, including a minimum leverage ratio. They also praised the authorities for their active cooperation with other central banks, including in Eastern Europe, to ensure liquidity to the international interbank market.

Looking ahead, Directors noted that persistent financial sector turmoil may require further policy actions. They therefore welcomed the authorities' commitment to take prompt action if needed and their preparation of contingent policy strategies. With regard to the financial sector, Directors stressed that strong and effective regulation and supervision will remain key, with a particular focus on monitoring of potential vulnerabilities—such as earnings of the large banks and related funding pressures—and on early response to risks. Directors welcomed the increased capital requirements for large banks and the authorities' recognition of the need to avoid exacerbating the downturn by tightening these rules too soon. Some Directors felt that government guarantees could be helpful to ensure funding of systemically important institutions. Directors considered that the deposit insurance scheme, while improved, should be put on a sounder footing through the introduction of ex ante funding.

Directors observed that the creation of a new integrated supervisor (FINMA) provides a good opportunity to strengthen financial supervision. To this end, FINMA should make further progress in enhancing resources, integrating sectoral regulatory approaches, and strengthening forward-looking systemic surveillance. Continued intensive oversight of large banks as well as close supervision of the large (re)insurance sector will also be essential. Other important actions will be increased on-site examination by FINMA staff and strengthened pension fund supervision undertaken by the cantons. Directors welcomed the adoption by Switzerland of the OECD standard on administrative matters, which will permit a fuller exchange of information with foreign tax authorities.

Executive Directors supported the authorities' relaxation of monetary policy as growth prospects and inflationary expectations have declined. Most Directors considered that the recent shift to quantitative easing—including intervention in currency markets to stem further appreciation pressures—was appropriate, and reflected limited options to further influence monetary conditions and counter deflation risks. Directors welcomed the authorities' commitment to a timely and orderly exit from quantitative easing once recovery commences, and their intention to reverse the build-up in the monetary base to protect price stability. Careful communication of policy intentions by the authorities will remain important.

Directors commended Switzerland's strong fiscal performance in recent years, which has provided room for the welcome fiscal stimulus in the 2009 budget and the full use of automatic stabilizers. Many Directors considered that a further stimulus package in 2010 would be appropriate given the severity of the current downturn and the available fiscal space. Many other Directors, however, supported the authorities' intention to consider further stimulus in 2010 should prospects deteriorate further, and underlined the need to preserve fiscal space for possible additional financial sector support given the significant uncertainty surrounding global financial developments. All Directors agreed, however, that long-term fiscal sustainability requires that any new stimulus be temporary and targeted, and that long-term reforms of entitlement programs remain firmly on the authorities' agenda.

While noting that Switzerland's large external current account surplus largely reflects structural factors, Directors recognized that writedowns of financial assets and a decline in investment flows will likely cause a reduction in the surplus in the near-term. Taking into account these considerations, Directors agreed with the staff assessment that the exchange rate appears broadly in line with fundamentals.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2009 Article IV Consultation with Switzerland is also available.

Switzerland: Selected Economic Indicators

	2005	2006	2007	2008 1/	2009 1/
Real economy					
Real GDP (percentage changes)	2.5	3.4	3.3	1.6	-3.0
Real total domestic demand (percentage changes)	1.9	1.4	1.1	0.2	-0.5
CPI (year average)	1.2	1.0	0.7	2.4	-0.6
Unemployment rate (in percent of labor force)	3.4	3.0	2.5	2.7	3.9
Gross national saving (percent of GDP)	35.2	36.7	32.3	30.8	28.0
Gross national investment (percent of GDP)	21.6	22.2	22.2	21.7	20.4
Public finances (percent of GDP)					
Federal government balance	0.1	1.1	0.9	-0.4	-0.5
General government balance 2/	0.1	1.7	2.2	0.9	-1.6
Gross public debt	52.7	47.5	44.3	41.6	43.8
Balance of payments					
Trade balance (in percent of GDP)	0.6	1.0	1.8	2.7	1.7
Current account (in percent of GDP)	13.6	14.5	10.1	9.1	7.6
Official reserves (end of year, US$ billion) 3/	36.3	38.1	42.7	…	…
Money and interest rates					
Domestic credit (annual average)	4.0	5.5	6.2	7.2	…
M3 (annual average)	4.2	2.4	2.1	3.2	…
Three-month Libor rate (in percent)	1.5	1.6	2.2	1.5	…
Government bond yield (in percent)	2.1	2.5	2.9	2.5	…
Exchange rate					
Exchange rate regime				Free float	
Present rate (May 1, 2009)				SwF 1.13 per US$1	
Nominal effective exchange rate (1990=100)	109.8	108.4	106.1	112.4	…
Real effective exchange rate (1990=100) 4/	104.0	101.7	98.0	103.1	…

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

1/ Staff estimates and projections.
2/ Including Confederation, cantons, communes, and social security.
3/ Excluding gold.
4/ Based on consumer prices.

Statement by Thomas Moser, Executive Director for Switzerland
May 18, 2009

1. On behalf of the Swiss authorities, I would like to thank the staff for a very thorough report, their thoughtful and well-balanced analysis, and the candid policy recommendations. We consider this a very good standard for Fund Article IV reports, both in terms of quality and detail. It also sets an example of how financial sector issues should be incorporated in Article IV reports.

2. The Swiss authorities broadly share the staff's assessment and specific policy advice. They welcome the positive assessment of their response to the financial market turmoil to date. Looking forward, in most areas - and in particularly in the area of financial sector stability, - my authorities have developed wide-ranging policy strategies that should only be implemented if the economic situation deteriorates further, or when private sector solutions are lacking. At this stage, my authorities do not see a need for additional policy measures.

3. Following strong performance in recent years, driven not only by external demand but also by private consumption, external shocks pushed the Swiss economy into recession in the second half of 2008. Given its openness and the importance of the financial sector, the Swiss economy will experience a significant contraction. However, there are mitigating factors. Credit developments have continued to develop favorably through February, and since there has been no housing bubble in Switzerland, the construction sector – supported by favorable mortgage rates and rising real housing prices – still experiences a very satisfactory degree of capacity utilization.

Monetary policy

4. Given the size of the shock and the traditionally low level of inflation in Switzerland, deflationary risks are clearly present. The Swiss National Bank (SNB) expects headline inflation to remain in negative territory throughout 2009, and to average around -0.5 percent over the year. As regards 2010, inflation should hover around 0 percent. It might even be slightly positive, but the uncertainties remain very large at this stage.

5. My authorities fully share the staff's description and appraisal of Swiss monetary policy. In particular, the report adequately describes the constraints and reasons for the recent shift to unconventional measures. The SNB has early and aggressively relaxed the monetary policy stance. Given the low interest-rate level in Switzerland, the SNB reached the zero-interest-rate floor earlier than other central banks. In mid-March, when a further expansion of monetary policy became necessary, the SNB took three additional measures: increasing the

number of longer-term repo transactions, purchasing Swiss franc bonds issued by private sector borrowers, and buying foreign currency on the open market. The SNB has also stepped up the provision of Swiss-franc liquidity outside of Switzerland. Foreign banks are allowed to participate in the SNB's repo transactions since 1999, but since the end of last year the SNB is also providing Swiss-franc liquidity via swap lines to the ECB and the National Bank of Poland, and since this year to the Hungarian central bank and to the Fed.

6. The decision to purchase foreign currency on the foreign exchange market was taken in order to prevent a further appreciation of the Swiss franc, which would have defeated the SNB's efforts to counter deflation risks. The aim was not to reinforce artificially the competitiveness of the Swiss economy but to limit undue appreciation of the Swiss franc. This decision must be understood against the backdrop of the very limited options available. Interest rates were effectively at zero, and interest rate differentials with other currencies were widening.

7. The Swiss authorities are aware of the necessity of an orderly and timely exit of the current exceptional monetary policy stance in order to reduce liquidity and maintain price stability in the future. The SNB has the necessary instruments at its disposal, including the recently introduced SNB bills. My authorities are also conscious of the fact that the exit will have to occur before unemployment ceases to increase, which will require a particular communication effort.

Maintaining financial sector stability

8. My authorities broadly share the staff's view on financial sector issues and welcome the positive assessment of the measures they have undertaken to support the stability of the financial system. They are aware of the uncertainties in financial markets and the real economy lying ahead. In the past, they have communicated effectively and proved that they are ready to act swiftly if needed. Structures and instruments for additional support are in place and are constantly being optimized.

9. As a general point, the Swiss authorities attach considerable importance to the costs of public interventions both in terms of fiscal costs and market distortions, and prefer private sector solutions whenever possible. The only banking sector intervention so far has been the one to support UBS, with a transfer of US$38.7 billion of distressed assets to an SNB-sponsored special purpose vehicle, and a capital injection of SFr 6 billion from the Swiss Confederation. No government guarantees of bank debt or of bank borrowing have been granted, and there is no apparent need for such measures so far.

10. Exposure of Swiss banks to emerging markets, mentioned in paragraphs 29 and 49 of the staff report, are not a significant concern of my authorities. Exposure is not significantly

higher than for other small advanced countries, and it is more diversified, with a higher exposure to the Asia/Pacific region, where growth rates are still positive.

11. My Swiss authorities fully agree with the importance of international cooperation, and they are well aware of the systemic importance of the two large Swiss banks and the two largest Swiss (re)insurers. Both the SNB and FINMA have been actively involved with their respective foreign counterparts in the exchange of information and the coordination of policy responses. Switzerland is also actively contributing to the multilateral efforts and international initiatives in the relevant international fora.

12. The key regulatory reforms are well described in the staff report. The requirement for Swiss banks to hold capital well above international standards will continue, and the capital buffers for the two large banks will be increased even further, including a cyclical adjustment, while a minimum leverage ratio will have to be observed. Also, FINMA introduced a regular, mandated stress testing exercise with the two large banks to supplement the existing top down stress tests conducted by the SNB. Previously initiated initiatives to address the immediate and long-term risks in the insurance sector were further advanced (Swiss Solvency Test; quality assessment of governance, risk management, and internal controls). For FINMA, the benefits of being an integrated supervisory agency are becoming evident.

Fiscal policy

13. Despite the economic slowdown in 2008 and measures to stabilize the financial sector, the general government continued to register a surplus for the fourth consecutive year. The surplus of 0.9 percent of GDP stemmed mainly from cantons and municipalities, whereas at the federal level, expenditures increased significantly in 2008 because of budgeted extraordinary spending, as well as the support for UBS. However, a large part of the increase was compensated by the much better than expected revenue performance. The strong fiscal performance across all levels of government in the past years has led to a sharp decline in public debt levels, with gross public debt currently at 41.5 percent of GDP. Uncertainties regarding the outlook for 2009 and 2010 are significant. For 2009, my authorities currently project a general government deficit of 0.9 percent of GDP, which is lower than the staff's projection.

14. Against the backdrop of strong fiscal performance at all levels of government during recent years, Switzerland can allow the full use of its automatic stabilizers. This, together with the discretionary measures adopted at the federal and cantonal level for 2009, will provide a combined stimulus of around 1.4 percent of GDP. Staff's estimate is lower, which partly reflects the definition of stimulus measures. On this issue, my authorities underscore the need for caution with cross-country comparisons. In particular, my authorities are not persuaded by the assessment of the size of the Swiss automatic stabilizers used in the staff

report, which depends largely on the definition of measures to be included, on methodological uncertainties and on country-specific conditions, such as the lag of automatic stabilizers. In any case, the economic impact of automatic stabilizers corresponds to a large extent to IMF fiscal policy advice, i.e., the effects are temporary, they kick in when economic activity is low, and they benefit mostly households whose buying power is at risk.

15. The federal authorities have taken a phased approach in providing additional fiscal stimulus to the economy, with the scope of the measures depending on the expected depth of the economic downturn. The measures were carefully selected to ensure a timely, targeted, and temporary effect. As noted by staff, the authorities will consider an additional stimulus in 2010, should the outlook deteriorate further. This decision must be considered carefully, since this would require that the escape clause under the fiscal rule (the “debt brake”) be invoked.

16. In judging the appropriateness of the fiscal stimulus, my authorities carefully weigh the effectiveness of the measures. An important element in their considerations is not to compromise the positive effects of the recent fiscal consolidation efforts. The authorities consider that an adequate balance has been achieved in strengthening confidence through timely actions without weakening confidence by taking on excessive future liabilities. As regards the latter, my authorities fully share the staff’s view that comprehensive reforms of entitlement programs will be key to ensure long-term fiscal sustainability. The efforts under the Assessment of the Tasks of Government will be stepped up as soon as the economic recovery is on solid grounds.