

BUFF/ED/22/65

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**Statement by Mr. Peter and Mr. Gindrat on Switzerland
Executive Board Meeting
June 10, 2022**

On behalf of our Swiss authorities, we thank staff for the insightful policy dialogue and the thorough analysis presented in the report. The consultations were appropriately broad in scope and covered the key topical policy challenges. In fact, the global and regional environment has remained highly volatile, necessitating flexible but prudent domestic policy responses. The Swiss economy has proved highly resilient, on account of very strong institutional and macroeconomic frameworks and the ability to mitigate external shocks in a timely manner. The authorities are in broad agreement with the staff's assessment and the thrust of their recommendations. These recommendations will usefully inform their macroeconomic policies under heightened uncertainty as well as further reform steps.

Overall Outlook

Our authorities broadly agree with staff on the outlook and risks. The Swiss economy continues to recover and is set to grow at a significantly above-average rate in 2022. The lifting of most pandemic restrictions bodes well for further recovery in the service sector. Strong employment growth testifies to a robust labor market. So far, the economic impact of the war in Ukraine has been modest. While trade with Russia and Ukraine fell on the back of the sanctions and reduced demand, the overall impact was minor, given the weak trade links. Against this background, staff's growth forecast for 2022 seems to be on the low side.

The main impact of the war on the Swiss economy has been on the price front. The sharp rise in commodity prices increased production costs and inflation, thereby also dampening real income and private consumption. As a result, inflation reached 2.9 percent in May. While the current situation could persist a little longer, the Swiss National Bank (SNB) shares staff's view that the recent increase in inflation above the price stability range is likely to be temporary.

On the exchange rate side, after an initial sharp appreciation towards the beginning of the war, the Swiss franc weakened again to below pre-war levels in nominal effective terms. Nonetheless, the risk of further safe-haven appreciation pressures remains high, should the war escalate and/or global uncertainty rise. While the direct effects of the war on Switzerland's open economy have so far been modest, its indirect effects are subject to high uncertainty and may be severe. Switzerland would be significantly affected if its key trading partners were to suffer a major economic downturn, possibly due to severe production shortfalls. At the same time, a worsening in the already-tight supply of raw materials could lead to a further rise in inflation globally. This would also increase the risk of inflation dynamics firming as a result of second-round effects. Finally, a renewed deterioration of the pandemic situation cannot be ruled out.

Monetary Policy

The authorities agree with staff that the accommodative monetary policy in 2021 and early 2022 has been appropriate. At the same time, the SNB has emphasized that its framework is robust and flexible to address challenges, and that it would not hesitate to react if inflation was to become more broadly based and persistent. If the SNB were to tighten, it could either raise its policy rate or sell foreign exchange or use a combination of both tools. The exact choice would depend on the circumstances if and when a tightening becomes necessary.

Fiscal Policy

The debt brake is the backbone of Swiss fiscal policy and has proved to be the key anchor for fiscal sustainability. Debt reduction in earlier years in adherence to the fiscal rule enabled Switzerland to tackle the Covid-19 crisis in excellent budgetary conditions. The flexibility of the rule has also allowed the federal authorities to act rapidly and with significant extraordinary spending to support the economy and households. The Federal Council has proposed to lengthen the amortization period of this extraordinary spending to 12 years, which, together with the use of SNB profit distributions and budget underspend, would smoothen the consolidation path required by the debt brake rule. A decision by parliament on an according bill is expected in 2022.

The challenges for fiscal policy remain high, also due to markedly risen spending demands. Expenditure pressures come from defense, the climate/energy transition, and to cover ageing-related costs. Despite low debt and ample fiscal space, reconciling these requests with the debt brake will not be straightforward since the Swiss constitution does not allow persistent deficits. The authorities agree that more mid-term planning for structurally higher expenditures is necessary to credibly comply with the debt brake. This is accommodated by the three-year financial plan that the Federal Council presents to Parliament annually with the annual budget. This financial plan allows to quickly identify negative structural balances and to propose remedial measures. In addition, at the beginning of each four-year legislative

period, the Federal Council presents its 10-year financial outlook. The 2023 outlook will serve to project and assess spending priorities and expected revenues through 2033.

External Sector Assessment

The authorities take good note of the IMF's external sector assessment. The estimated current account (CA) gap amounts to -0.9 percent of GDP. On this basis, staff assesses the Swiss franc to be overvalued by almost 2 percent. It should be emphasized that while the surplus increased notably compared to the previous year, this rebound is mainly due to the reversal of Covid-specific factors, as well as other global factors. In particular, as noted by staff, the increase in commodity prices has led to significantly higher merchanting income. Importantly, the CA increase has been driven neither by a change in Swiss policies and fundamentals, nor by the exchange rate. In view of these developments, the authorities would like to stress three points.

First, it is crucial that staff looks through the transitory global factors driving the Swiss CA surplus in their assessment. This is necessary to ensure consistent assessments over the years. More generally, the Swiss case illustrates that the methodology underlying these assessments would benefit from a deeper and more flexible consideration of temporary factors.

Second, the CA developments over the past two years highlight the limitations of the CA balance as an indicator to assess over- or undervaluation. Large CA fluctuations are often not associated with exchange rate movements. Conversely, large exchange rate movements may have a very limited impact on the CA balance in the short run. This is especially true in the case of Switzerland due to the composition of its CA surplus, which is dominated by industries that are rather insensitive to exchange rate movements.

Third, given those limitations, using a wider set of indicators to assess a country's external sector position would support a more robust assessment. In this regard, we very much welcome the focus on the net international investment income position (NIIP) in the special issues paper. The most important takeaway is that cumulated CA surpluses over the years have not been associated with an increase in the NIIP. Instead, the NIIP has remained broadly stable. As staff notes, the gap between CA surpluses and effective NIIP accumulation has been driven not only by exchange rate losses stemming from the nominal appreciation of the Swiss franc, but also by measurement issues in the CA. Further work on the NIIP is certainly warranted. An important avenue would be to investigate how to systematically integrate the analysis of stocks into the EBA methodology.

Financial Sector Policies

The authorities have continued to strengthen regulation, enhance supervisory intensity, and have taken remedial action to address risk control failures. The regulatory and supervisory

framework has been adapted and enhanced to reflect new types of risks for financial intermediaries, including from climate change and cyber threats. With the decision to turn the National Cyber Security Centre (NCSC) into a federal office, the Federal Council has reinforced the institutional setup for cyber security. A more formalized cooperation between financial institutions and the authorities is being established through the newly founded Swiss Financial Sector Cybersecurity Centre (Swiss FS-CSC) association. Switzerland has been at the forefront in implementing a systematic and technology-neutral regulatory approach towards distributed ledger technology (DLT) and token-based financial services that leaves room for innovation. The authorities consider technological innovations also as a source of significant opportunities for the Swiss financial center. These can best unfold and grow on the basis of financial sector regulation that continues to be risk-based, transparent, and predictable.

The Basel III finalization package for banks is on track to be implemented in 2024 and, with regard to substance, in line with the standard. The proposal by the Federal Council to introduce a public liquidity backstop for systemically important banks under resolution will further enhance the credibility of large banks oversight and financial stability. Insurance legislation has been amended to, among other things, allow the restructuring of insolvent insurance companies, thereby better protecting existing contracts and avoiding bankruptcy.

Even with negative interest rates, banks' profitability has held up, also on account of expanded mortgage lending. On the downside, the authorities are aware that risks in the real estate and mortgage markets have risen, reflecting significant increases in property valuations, including of private homes. The reactivation of the sectoral counter-cyclical capital buffer (CCyB) will enhance the banking sector's ability to absorb losses and help maintain and strengthen banking sector resilience. The authorities consider these risks to be manageable, although time-lags add complexity. They agree that the possibilities for a further tightening of banks' self-regulation or an expansion of the legally mandated macroprudential toolkit may not be exhausted, should vulnerabilities in these markets develop further. Legally mandated self-regulation will remain the predominant approach to restrain high credit demand. In this respect, the mortgage stress test performed by staff is appreciated.

Switzerland continues to be committed to ensuring financial sector integrity and firmly implementing its latest revision of the AML/CFT legislation. New fintech/crypto service providers are already covered by the Swiss AML/CFT legislation. Staff's recommendations to remain vigilant and further enhance the framework to combat financial crime and bribery are well noted.

Switzerland has rapidly adopted all EU economic and financial sanctions imposed in relation to the war in Ukraine. The authorities are closely monitoring evolving international developments, continue to ensure the effectiveness of the Swiss sanctions regime, and are

actively engaging with international partners, in particular also regarding the enforcement of financial sanctions.

Structural Issues

The Swiss labor market coped well with the disruption caused by the pandemic. Use of short-term work compensation by companies was extensive and prevented larger scale layoffs. This being said, sectors have been affected very differently and targeted support to facilitate the transition into new jobs and (re-) training remain a priority. The authorities agree that further measures to enhance overall labor market participation would be beneficial, not least to provide relief for a tight labor market. Pension system reform has been high on the political agenda for some time. The government supports further reforms that will, in particular, enhance the financial sustainability of both the first and second pillars. Gradual advances should garner the broad-based political support necessary for securing confirmation by popular vote.

Switzerland remains one of the EU's closest partners. The Federal Council in February 2022 reiterated Switzerland's interest in maintaining and developing the bilateral approach with the EU. Exploratory discussions on a potential negotiation package are now taking place, and Switzerland remains committed to further develop constructively its important relationship with the EU.

Although Switzerland covers around 60 percent of its energy needs through hydropower, it remains reliant on other supply sources and is not shielded from the recent surge in energy prices. Energy security has rapidly emerged as a political priority. Pragmatic, mutually beneficial solutions are being pursued with neighboring countries to enhance resilience to potential energy shortages. The authorities are aware of the significant challenge of reconciling immediate and future energy needs with an ambitious climate strategy in order to achieve the 2050 net-zero greenhouse gas emissions target. They are preparing a revised CO2 law to replace the interim measures beyond 2024. It should be noted that Switzerland's carbon taxes are already among the highest globally.

The authorities are planning to mandate climate-related disclosures and transition plans based on TCFD starting in 2024. Their aim is to incentivize financial institutions to be more transparent on the compatibility of their commitments, targets, and portfolios with the Paris climate goals. Work is underway to finalize voluntary Swiss Climate Scores that reflect Switzerland's views with respect to best practice transparency on the Paris-alignment of financial products.