September 24, 2021
Approval: 10/1/21

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/51-2

11:40 a.m., June 17, 2019

2. Switzerland—2019 Article IV Consultation

Documents: SM/19/129 and Correction 1; and Supplement 1; and Supplement 1, Correction 1; and Supplement 1, Correction 2; SM/19/133; and Correction 1; and Correction 2; SM/19/134; and Correction 1; and Correction 2

Staff: Mathieu, MCM; van Elkan, EUR; Kaufman, SPR

Length: 1 hour, 8 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
D. Mahlinza (AE)	
M. Raghani (AF)	
G. Lopetegui (AG)	
	J. Shin (AP), Temporary
A. Tombini (BR)	
Z. Jin (CC)	
L. Villar (CE)	
L. Levonian (CO)	
R. Kaya (EC)	
	A. Castets (FF)
S. Meyer (GR)	
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
M. Kaizuka (JA)	
	C. Sassanpour (MD), Temporary
	W. Abdelati (MI), Temporary
	R. Doornbosch (NE)
	J. Sigurgeirsson (NO)
	L. Palei (RU)
M. Mouminah (SA)	
A. Mahasandana (ST)	
P. Inderbinen (SZ)	
S. Riach (UK)	
	A. Grohovsky (US), Temporary

G. Tsibouris, Acting Secretary
S. Maxwell, Summing Up Officer
D. Jiang, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: D. Nyberg. European Department: A. Apostolou, E. Detragiache, S. Maslova, S. Nowak, M. Segoviano Basurto, R. van Elkan. Fiscal Affairs Department: S. Hebous. Legal Department: Luca Ioana, J. Pampolina. Monetary and Capital Markets Department: A. Arda, S. Chen, M. Erbenova, C. Luttmer, P. Mathieu, J. Morsink,

J. Nolte, A. Pancorbo de Rato, L. Valderrama-Ferrando. Office of Executive Directors: Dominik Aleksander Skopiec. Strategy, Policy, and Review Department: M. Kaufman. Alternate Executive Director: R. Alkhareif (SA), B. Saraiva (BR). Senior Advisors to Executive Directors: F. Fuentes (BR), M.Gilliot (FF), P. Harvan (EC), G. Heim (SZ), K. Karjanlahti (NO). Advisors to Executive Directors: E. Boukpessi (AF), S. Buetzer (GR), X. Cai (CC), L. Cerami (IT), D. Fadhel (MI), R. Makhammadiev (SZ), A. Urbanowska (SZ), J. Montero (CE), A. Tola (SZ).

2. SWITZERLAND—2019 ARTICLE IV CONSULTATION

Mr. Inderbinen and Mr. Heim submitted the following statement:

On behalf of our Swiss authorities, we thank staff for their insightful reports, which provide a thorough analysis of macroeconomic developments and the financial sector. We broadly share staff's views on the challenges going forward, and appreciate their recommendations, many of which are in line with policies that are currently being implemented.

Outlook

The authorities broadly agree with staff on the outlook. Amid a weaker global economy, Swiss GDP growth lost momentum in the second half of 2018. Growth accelerated in Q1:2019, driven primarily by domestic demand and partly as a result of temporary factors. However, the authorities expect GDP to grow at a below-average rate in 2019. Leading indicators show weakening signs, primarily for the industrial sector, and the outlook remains subject to risks, especially related to the external environment. Spiraling protectionist tendencies could weigh on external demand, while global political uncertainty could affect investments. The Swiss franc could come under pressure as a safe haven asset, should global risks materialize. Domestically, imbalances in the residential real estate sector persist, with the risk of price corrections and related macroeconomic repercussions. On the upside, the domestic economy may grow more strongly than forecast on the back of the favorable situation in the labor market.

Policy Mix

The authorities consider the current policy mix to be appropriate. Fiscal policy has contributed to stabilizing the economy during the last decade. Over this period, education and research expenditure at the federal level has increased by around 44 percent, while expenditure on transport infrastructure rose by 38 percent. In 2016 and 2018, the authorities have set up two infrastructure funds, while also raising infrastructure expenditures. As a general point, the authorities are of the view that the policy mix should best depend on the nature of the economic issues and associated challenges that need addressing.

Fiscal Policy

Switzerland has a strong fiscal position, with general government debt at 40.5 percent of GDP, and all levels of government enjoying sound finances. The debt brake fiscal rule at the federal level aims for a structurally balanced budget. This cautious policy framework continues to serve the country well. Controlled expenditure growth has allowed for the creation of fiscal space within the budget, including through lower debt service, and its use for priority tasks (e.g. education and research). Moreover, the structural surpluses in federal finances since 2006 have allowed to reduce federal debt and to further strengthen the resilience of the economy. Along with strong and resilient institutions, the fiscal rule enables the financing of a well-developed welfare state, a top-level education system, and an extensive and interconnected public infrastructure. There is no lack of public investment in the authorities' view, and they are not convinced that an increase in public spending would sustainably boost growth.

In 2017, a group of experts reviewed the debt brake fiscal rule. Building on their recommendations, the Ministry of Finance conducted an in-depth analysis of the rule and monitored the development of budget underruns. Based on the results, the government decided in May 2019 not to adjust the fiscal rule, recognizing that current expenditures, investment and growth in priority areas can be financed through existing instruments. The government did, however, decide to simplify procedures for within-year supplementary budgets. This should reduce incentives for line ministries to maintain precautionary margins in spending execution, and allow the expenditure ceiling prescribed by the debt brake to be better utilized.

Monetary Policy

The authorities concur with staff that the current accommodative monetary policy remains appropriate. The Swiss franc is still highly valued and the recent appreciation of the Swiss franc against the euro has shown that the situation in the foreign exchange market remains fragile and that monetary conditions can change rapidly. Moreover, CPI inflation remains low and is expected to increase only gradually. Therefore, the negative interest rate on sight deposits and the SNB's willingness to intervene in the foreign exchange market as necessary remain essential. This keeps the attractiveness of Swiss franc investments low and eases pressure on the currency, in line with the mandate of the SNB to ensure price stability while taking due account of economic developments.

External Sector Assessment

The authorities welcome the careful analysis of the external sector, and in particular of the current account (CA). The two issues that are of particular interest in the Swiss case, i.e., measurement and demographics, are also relevant for many other members. Further work on these issues is warranted, including on the impact of intangible assets on the CA, and on how demographics and pension systems interact and effect savings. The external sector assessment, however, should not be limited to an analysis of the CA only. In order to facilitate a broader assessment, we encourage staff to pursue work on a better understanding of the apparent disconnect between the CA and the REER, as well as on the REER models of the EBA methodology.

Structural Issues

Major progress has been achieved in corporate income taxation (CIT) reform. Following the recent approval of the Federal Act on Tax Reform and AHV Financing (STAF) in a referendum, the new CIT framework will be effective starting from 2020. Corporate taxation will thus be compliant with international standards and will remain internationally competitive.

The authorities concur that pension reform is essential to maintain a sustainable and effective social safety net against the backdrop of an aging population and the low interest environment. The STAF package will generate the necessary additional financing for the first-pillar of the pension system, thus contributing to its sustainability. Given that the first pillar remains a reform priority, the government will submit a reform proposal (AHV 21) to parliament in 2019. Its objective is to secure the level of benefits and the financial sustainability of the first pillar. Key elements of the proposal include: (i) the unification of the retirement age at 65, (ii) additional earmarked revenue, and (iii) more flexibility in the retirement age, with incentives for working longer.

The authorities welcome staff's assessment of recent progress in the detection and repression of transnational corruption. They are well aware of the risks of transnational corruption, given the openness of the economy and the financial sector. The authorities are determined to tackle remaining issues to combat corruption effectively and in line with international best practices and standards. The voluntary assessment of its anti-bribery and AML/CFT frameworks under the 'forth element' of the Fund's Enhanced Engagement on Governance is consistent with Switzerland's long-standing support for the

Fund’s work on promoting good governance, as well as financial sector integrity, across the membership.

Financial Sector Policies

The authorities welcome the positive assessment of financial system stability. The results of the FSAP stress tests attest to the strong resilience of the financial sector. The authorities share staff’s assessment that financial institutions are well capitalized and could withstand severe macrofinancial shocks.

Important reforms have been implemented since the 2014 FSAP. These include the timely adoption of the Basel III framework; also, the ‘too-big-to-fail’ regime has been strengthened, with regulation for systemic banks that is more stringent than international standards. There has also been notable progress in strengthening financial sector supervision. Moreover, the regulatory framework for financial market infrastructures was further improved, particularly through the entry into force of the Federal Financial Market Infrastructure Act (FMIA) in January 2016. The adoption of Federal Financial Services Act (FinSA) and of the Federal Financial Institutions Act (FinIA), both of which will enter into force in 2020, will enhance client protection and supervision of asset management.

Regulatory reform continues. For example, in line with the principle of proportionality underlying the Swiss regulatory framework, FINMA is currently running a pilot for a small bank regime, to be implemented through a regulatory change effective as of January 2020. Moreover, a proposal for a resolution regime for insurance companies is currently in the parliamentary process and expected to enter into force in 2021. Under the ongoing review of legislation on insurance supervision, further key features of the Swiss Solvency Test (SST) will be more comprehensively enshrined in binding legislation, thus enhancing legal clarity and certainty.

The authorities are aware that the environment of persistently low yields entails risks and creates challenges to existing business models and profitability of financial firms over the medium term. They are closely monitoring developments and are continuously evaluating the need for additional regulatory and supervisory action.

In addition, the authorities will continue to monitor developments on the mortgage and real estate markets closely. Options for additional macroprudential measures and for strengthening existing measures to limit the build-up of risks and to strengthen the capacity to respond will be considered as needed. For any new macroprudential tools, decision making would be formalized and responsibilities and accountabilities clearly assigned, in line with the country's institutional framework of shared responsibility, collaboration, and respect for the mandates and independence of individual authorities.

The authorities welcome staff's recognition of the strength of financial sector supervision. FINMA's size and available resources are adequate to fulfil its mandate. FINMA's budgetary independence is clearly anchored in the law, and the level of resources can be adjusted flexibly. Moreover, an increase in resources is planned in the context of the supplementary tasks relating to independent asset managers, and FINMA regularly assesses the need for adjustments to its human resource allocation. Most recently, it increased resources in the fields of cyber risk, outsourcing, and fintech.

Important progress has been achieved in strengthening the financial safety net and crisis management arrangements. The authorities agree that further work is needed to finalize resolution plans and to improve resolvability of systematically important banks, in particular in the area of resolution funding. They also agree that this should not be restricted to global systemically important banks (G-SIBs), but also include other institutions, notably domestically-focused systemically important banks (D-SIBs). The strengthening of recovery and resolution planning for FMIs will be a priority for the medium term.

The authorities agree on the need for deposit insurance reform. Public consultation on a reform proposal was initiated in early March 2019. The reform would be a step forward, for instance by moving to a partially ex-ante funded system and introducing more stringent deadlines for pay-outs.

Switzerland welcomes innovation and embraces the opportunities of fintech. At the same time, the authorities are firmly committed to ensuring financial stability and integrity, as well as addressing potential risks. It is important to underline that financial market legislation and regulation applies to fintech entities and activities, in line with the principle of technology-neutrality. Notably, the AML/CFT regulations apply fully in the fintech area. The authorities have conducted an in-depth examination of legislation and regulation with a view to identify potential needs for amendments. A government report was published in December 2018 and, as a follow-up, legislative measures on several fronts are being prepared.

Mr. Tombini and Mr. Fuentes submitted the following statement:

We want to thank staff for the papers and Mr. Inderbinen and Mr. Heim for their helpful statement. Switzerland has maintained solid macroeconomic fundamentals and a strong policy framework, underpinned by high-quality human and physical capital. In 2018, the economy experienced a strong growth outturn driven primarily by buoyant private investment and robust external demand in a low inflation environment under expansionary monetary conditions. Unemployment continued to decline, while rising labor productivity kept unit labor cost checked and inflation remained subdued even in a tight labor market. Less favorable external conditions are weighing on exports and investment in 2019, moderating the pace of economic activity in the near term.

Monetary policy effectiveness may benefit from a more balanced policy mix. In a context of low growth and deflationary pressures, the Swiss National Bank (SNB) has maintained accommodative financial conditions since 2015, supported by a negative interest rate and episodic interventions in the FX market to prevent further appreciation of the franc. Against this background, authorities recognize the macroeconomic challenges associated with maintaining low interest rates for extended periods, particularly for the financial sector and the real estate market. While the implementation of unconventional monetary policy measures has been appropriate under the prevailing circumstances, we see merit in staff's recommendation of contemplating a rebalancing between monetary and fiscal policies, considering the limitations faced by SNB's ultra-loose monetary stance vis-à-vis the persistent overperformance of fiscal policy against the debt brake rule's structural-balance target.

Fiscal prudence continues to characterize Swiss public financial management. Switzerland has consistently run a modest budget surplus, with sizeable fiscal space and a low public gross debt anchored by an effective fiscal responsibility framework that balances the budget over the business cycle. In the near term, tax revenues are expected to decline, as authorities complete a corporate tax reform to maintain global competitiveness amid a changing international taxation landscape. Supplementing these reforms with higher value-added and environmentally related taxes would support fiscal sustainability and preserve fiscal space, as the aging population demand additional resources for the pension system and health services.

Switzerland's external position remains solid. The current account surplus continues to hover around 10 percent of GDP supported by strong exports and a rebound in investment income. The size and composition of the current account surplus are influenced by Switzerland's role as an international financial hub and by the savings of an aging population in the context of high pension contributions and rising longevity. That said, business sentiment indicators point to an underlying concern about the impact of international trade tensions and a disruptive Brexit on the external sector. In addition, risks emanating from the state of negotiations between Switzerland and the EU could affect export-oriented sectors in the near term.

We welcome progress in financial sector resilience, yet rising household debt warrant closer monitoring. Swiss financial institutions are well-capitalized, liquid and resilient to shocks, and operating under a strengthened supervision. Against this background, high household leverage stands out as a lingering vulnerability for financial stability as imbalances in the housing market deteriorated in 2018 in a context of rising mortgage lending and house prices. Consequently, we see merit in staff recommendation to implement new targeted macroprudential measures to curtail the further buildup of risk in the banking and real estate sectors, coupled with changes in the tax treatment of owner-occupied properties. In this vein, we commend FINMA actions to intensify its supervision of income-producing residential real estate and levied targeted capital surcharges on risky lending.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

The Swiss economy has generally performed well, although a temporary slowdown is expected in 2019. Inflation remains low and, while accommodative monetary policy is appropriate, financial sector risks need to be managed. Financial sector oversight has improved and reform measures have been taken since the last FSAP although vulnerabilities persist, particularly related to the real estate sector. We welcome the thorough assessment of the Swiss economy through the Article IV, the Selected Issues papers, and the FSSA and offer the following points for emphasis.

Given the Swiss current account surplus which remains substantial at 10.2 percent of GDP—including a 3.5 percent of GDP increase last year from 2017—we welcome the focus on the external sector in this report, including in two of the Selected Issues Papers. We appreciate the transparency in the adjustments to the EBA current account gap but question the size of the uncertainty band given these adjustments. If the income balance is typically revised downward would this not also revise downward staff's adjustments for measurement issues? Additionally, can staff explain their adjustment to the REER gap based on productivity if output per worker is already factored in?

We also echo staff's call for the authorities to enhance the transparency of exchange rate intervention, including publishing data on a more frequent basis.

Some rebalancing of the external sector could also come through use of Switzerland's substantial fiscal space. This is particularly true if increased spending went to dealing with high savings related to population aging, as the high level of household savings would seem to point to a need for improved public policies to help with population aging and retirement needs. We welcome staff's options in paragraph 25 for use of the surpluses. With negative borrowing costs, the authorities should also not be hesitant to undertake public investment. Under current conditions, estimated fiscal multipliers are sizeable and returns to such projects should clearly be positive. Such spending could also help boost potential growth.

We strongly concur with staff's recommendation to make the debt brake rule more symmetric, which would reduce the growth drag from the current asymmetry, allow for continued decline in debt ratios, and lift the extensive burden currently placed on monetary policy. The analysis of the fiscal and monetary trade-off is a good example of "integrated policy," which has received much attention recently at the Fund. In line with the idea of integrated policy, using fiscal policy to ease the burden on monetary policy could help reduce financial stability risks and the potential buildup of leverage attributable to loose financial conditions. Fiscal space could also be used to eliminate the PIT on imputed rental income and some deductibility of mortgage interest payments, further reducing financial vulnerabilities from the real estate sector.

Fundamentals in the Swiss financial sector are otherwise strong, and we welcome good capital buffers and regulation as identified in the FSSA, along with important progress made since the 2014 FSAP in the areas of too-big-to-fail, governance, resolution, FINMA, and financial market infrastructures. As staff note, risks particularly related to real estate have increased, and targeted macroprudential measures are needed, including the legal mandate to enhance the macroprudential framework. Furthermore, while we welcome that Switzerland participated in the fintech pilot in this FSAP, the lack of findings of a financial stability risk highlight the need for caution when approaching this issue in other FSAPs. We also encourage the authorities to implement FATF recommendations to strengthen financial institutions' obligation to report suspicious transactions. Apart from these recommendations, we welcome the focus and assessment of the supply-side of corruption in this report, and the authorities' recent efforts and improvements in implementing the OECD Anti-Bribery Convention.

Mr. Jin and Ms. Cai submitted the following statement:

We thank staff for the comprehensive reports and Messrs. Inderbinen and Heim for their helpful buff statement. The Swiss economy performed well in recent years while challenges stemming from the domestic and external sectors remain. We encourage the authorities to continue their prudent policies to bolster the economy's resilience and promote long-term growth. We broadly agree with staff's appraisal and would like to offer the following comments for emphasis.

We commend the authorities' sustained fiscal discipline which has yielded stable government debt and robust fiscal buffers. We tend to agree with the authorities that public spending might not be effective at addressing exchange rate shock. At the same time, we see merit in better utilizing fiscal space within the fiscal rule, especially to increase the public spending in preparing for future technological and demographic changes. We take positive note of the additional spending on growth-enhancing education and infrastructure. The authorities' decision to simplify procedures for within-year supplementary budgets to better utilize fiscal space under the expenditure ceiling is also a welcome step. We encourage the authorities to continue improving budget forecasting to reduce underspending and boost potential growth.

Monetary policy has been effective in supporting economic activity and inflation. We take note that in staff's perspective, monetary policy space is limited while moving somewhat further into negative interest rate territory remains feasible. Could staff shed light on to what extent the interest rate could be further decreased if needed? We see merit in having a holistic analysis on negative interest rate, including its macroprudential side effects and impacts on bank profitability, to offer the authorities a useful reference. Staff's comments are welcome. Besides, given that global financial risks are elevated and renewed safe-haven surges may occur in the event of severe risk-off episodes, we encourage the authorities to enhance the policy flexibility and ensure policies are clearly communicated.

More efforts are needed to strengthen the banking sector. It is encouraging to see that financial institutions are still well-capitalized and liquid. Meanwhile, the substantial exposure to the real estate market could potentially be a concern for financial stability, and the macroprudential policy which has only one mandated tool may constrain its capacity to address rising risks effectively. We take positive note of the planned introduction of higher risk weights for income-producing real estate and agree with staff that an expanded macroprudential framework with supply and demand tools is needed. The financial supervisor's heavy reliance on external auditors also raises concerns. We encourage the authorities to continue enhancing the Swiss Financial Market Supervisory Authority's (FINMA) governance and autonomy.

The aging population and automation pose challenges to Switzerland. We look forward to a successful pension reform, as well as other measures to unlock the economy's potential and raise competitiveness. The growing spending on education and vocational training has supported the upskilling of employment, which will help avoid wage polarization. More needs to be done to support elder workers should they be laid off, including further improving the social safety net.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Meyer and Mr. Buetzer submitted the following statement:

We thank staff for an insightful set of reports highlighting current challenges for the Swiss economy at large and offering further insights into the structure and features of the financial system. We also thank Mr. Inderbinen and Mr. Heim for their helpful buff statement. Switzerland enjoys strong fundamentals characterized by relatively stable growth, sound public finances and a competitive private sector. Yet, downside risks persist including from the potential fallout from a deterioration of the trade conflict and financial stability risks related to the low-for-long interest rate environment. We encourage the authorities to remain attentive to these challenges and build on their successful track record of sound and prudent policies.

While growth has been relatively stable on an aggregate basis it has been fairly subdued in per capita terms since the GFC. We would have appreciated a closer look at this metric, including at how it compares to peers, underlying factors, and impediments to a more vigorous growth performance on a per capita basis in the staff report. Staff comments would be welcome.

Switzerland has fared well with its debt brake framework. According to staff, the specific design features of the Swiss fiscal rules eventually have a certain tendency towards underspending. Hence, some targeted, technical refinement aiming at dis-incentivizing unwarranted budgetary underruns might have merits and we welcome the remedial measures to this end as alluded to by Mr. Inderbinen and Mr. Heim in their buff. However, this should not mask the fact that the very purpose of fiscal rules is to prevent deficit bias and the Swiss debt break rule is effectively delivering on this. Furthermore, the rule has apparently allowed for establishing sufficient financial envelopes compatible with public spending needs while also enhancing resilience to shocks. Materially expanding public spending at the current juncture might, as outlined by the authorities, result in spending inefficiencies. A well-functioning countercyclical fiscal function is provided through automatic stabilizers while buffers are available in the event of a severe shock. Moreover, staff advice for "higher public spending in 2019 when growth is predicted to be subdued" could well underestimate policy lags.

We agree with staff and the authorities that the monetary policy stance is appropriate, although the scope for further policy actions appears more limited than in the past. The SNB's two-pronged approach successfully has supported growth and stability while moderating pressures emanating from safe haven capital inflows that could rapidly resurge in case of sudden changes in monetary conditions. Accordingly, the monetary policy strategy should take due account of this susceptibility, while public spending is, as outlined by the authorities, not a suitable tool to address such shocks. At the same time, we concur with staff that FX interventions should not impede trend appreciation that is justified by fundamentals.

Continued vigilance towards financial stability risks is warranted. The search for yield in the low interest rate environment puts pressure on some financial market segments and the real estate sector, further exacerbated by high household leverage and signs of weakened lending standards. In addition, the financial sector's capacity to generate profits is impaired with potentially adverse effects on financial stability. In this context, a more pro-active and carefully calibrated macroprudential framework might be considered to meet the challenges and risks to financial stability. More specifically on house prices and household indebtedness, we would be interested in staff's assessment on current proposals under negotiation in Switzerland, especially regarding real estate taxation and their potential impact on alleviating pressures in the housing sector as well as on incentives for high household leverage (para. 31, 33).

The FSSA has put a spotlight on structural features of the financial sector. Size and complexity of the Swiss financial system require constant efforts to keep adequate regulatory and supervisory capacities. Priority should be given to strengthening the supervisory agency FINMA's autonomy and endow it with resources commensurate with the importance and centrality of the Swiss financial sector. Staff points to on-site inspections as being an area where capacity constraints are particularly felt. Could staff provide further details on the development of on-site inspections over the last years and to what extent FINMA had to rely on external auditors to conduct this task? Furthermore, does staff consider it feasible for FINMA to recruit the required number of on-site inspectors in due time?

We appreciate staff's work on the long-term challenges for the Swiss labor market posed by labor supply trends, automation, and the need to adapt social safety nets. Automation will continue shaping the structure of labor demand, thus exercising pressure on the affected workforce to adapt their skills and thereby preserve their employability. We would be interested if staff sees any shortcomings in the current skill matching mechanisms geared to the unemployed and/or those threatened by unemployment, considering that the authorities refer to efficiently functioning education and vocational training schemes (para 38)?

As regards Switzerland's current account balance, we take note of staff's comment that the EBA assessment is subject to especially-high uncertainty.

We welcome staff's work on anti-foreign bribery enforcement and AML/CFT issues in Switzerland as well as the authorities' actions aiming at enhancing compliance with international standards on taxation and transparency. We encourage tackling any detected shortcomings and full delivery on international standards and commitments in these areas.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for their detailed set of papers and Mr. Inderbinen and Mr. Heim for their candid buff statement, which attests to the constructive dialogue between staff and the authorities, despite some divergences on policy recommendations. We broadly agree with staff's analysis and recommendations and offer some comments for emphasis and clarification.

The outlook remains favorable, but downside risks prevail. Following a slowdown in the second half of 2018, Swiss economic growth is projected to return close to its potential in 2020 on account of a rebound in external demand and strong labor market conditions. However, the outlook is subject to external and domestic downside risks. On the external front, we note that staff include uncertainties regarding the framework agreement with the European Union, while the Risk Assessment Matrix specifically refers to possible delays in the adoption of the corporate tax reform and the removal of the EU-equivalence of the Swiss stock exchange, which is not mentioned in the Financial System Stability Assessment. What factors justify the inclusion of the risk of removal of the EU-equivalence of the Swiss stock exchange?

A more balanced macroeconomic policy mix would be beneficial. Monetary policy has been key to macroeconomic stabilization since the global financial crisis, as reflected in the very large size of the central bank's balance sheet and the deeply negative policy interest rate. While there is still monetary policy space in the event of a downturn, we agree with staff that it will be increasingly difficult to respond effectively and without heightening financial stability risks. On the other end, the fiscal position has been consistently above the balanced position mandated by the debt brake rule. While we agree with the authorities that monetary policy is better suited to respond to an exchange rate shock, we also note that the temporary economic slowdown appears only partly linked to external developments. We therefore continue to see merits in staff's recommendation to adopt a more balanced macroeconomic policy mix.

The fiscal framework has served the country well, but refinements are needed to avoid underspending. We take note that the fiscal overperformance has been driven not only by exceptional upswings in tax revenues, but also by recurrent underspending. We are pleased that the authorities are taking steps to avoid budget underruns, namely by simplifying the procedures for supplementary budgets. However, like staff, we think that correcting the asymmetric treatment of ex post overspending and underspending would be more effective for ensuring better utilization of spending targets. Furthermore, we agree with staff that although, as emphasized by the authorities, in Switzerland there is no obvious shortfall of public investment, the country could benefit from additional spending to address long-term challenges related to aging and slowing productivity.

Financial sector resilience has improved, but emerging risks should be promptly addressed. We welcome the broadly positive outcome of the stress tests conducted in the context of the Financial Sector Assessment Program (FSAP) and the strengthened regulatory and supervisory framework. Nonetheless, both the Article IV report and the Financial System Stability Assessment flag some weaknesses that should be promptly addressed. Rising risks and widespread exposures to the real estate sector require additional macroprudential supply and demand measures mandated by the supervisory authorities and complemented by the removal of tax preferences for real estate property. Legislative and regulatory initiatives to enable fintech activities are a welcome step toward legal certainty, financial development, and fair competition in the financial sector; however, new reporting requirements should be introduced to allow the authorities to monitor and mitigate potential risks to financial stability, integrity and consumer protection. Finally, we encourage the authorities to follow up on FSAP recommendations, most notably on strengthening the governance and autonomy of the Financial Market Supervisory Authority (FINMA) and enhancing the financial safety net including a well-designed reform of the Deposit Insurance Scheme.

We are pleased with the planned reform of corporate income taxation. We look forward to the full implementation of the corporate income tax reform, which will align the Swiss tax code with international standards and commitments under the OECD’s Base Erosion and Profit Shifting project. We also support the envisaged reform of the first pillar of the pension system and encourage the authorities to consider additional reforms to ensure the sustainability of the first and second pillars.

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for a set of insightful set of papers and Mr. Inderbinen and Mr. Heim for their helpful buff statement.

The Swiss economy has performed well. High productivity, low unemployment and a strong debt position attests to the authorities’ prudent economic management. Alongside, interest rates, inflation remains low and the current account surplus is large. A favorable economic situation in Europe, easing of trade tensions and greater certainty from Brexit are keys to sustaining the strong growth. Otherwise, Switzerland also faces demographic challenges, and vulnerabilities related to a globalized small open economy, imbalances in the real estate sector and the pressures of a safe haven currency. We broadly agree with the main findings of the staff report and would offer the following remarks for emphasis.

With a strong fiscal position, we appreciate the authorities’ views that the debt brake framework provides growth-enhancing and counter-cyclical support. Strict adherence to the debt-brake rule does place excessive caution in spending execution. The authorities are convinced that the present approach in fiscal policy as well as the policy mix are appropriate to deal with the investments related to infrastructure, education and more broadly for investing in Switzerland's future. So far this has served the country well and the review of the rule recommends a continuity with current expenditures, investment and growth in priority areas to be financed through existing instruments. Concerning the staff recommendations on the policy mix, we support the authorities' view that while Switzerland has fiscal space, usage of it depends on nature of the economic issues and associated challenges. Further, given the levels of surplus, the shift to a structurally-balanced fiscal position through an increase in the public spending to GDP ratio—including by the cantons has been recommended. Could staff offer more insight on the gaps which are needed to be addressed through this increase in fiscal spending and the risks that this may entail if the shift backfires?

With inflation persistently below target, we concur with staff on the need to keep monetary policy accommodative. At the same time, with the currency highly valued and the ultra-low interest rates, we wonder about the vulnerabilities accompanying a prolonged period of negative interest rates in the present conjuncture of tightening of financial conditions. We invite staff comments. We support staff recommendation for timely publication of foreign exchange intervention data. We appreciate staff's analysis of the external sector assessment, of the current account with high household savings being a major contributor. The buff has suggested further work, on how demographics and pension systems interact, and effect savings and that staff pursue work on a better understanding of the apparent disconnect between the CA and the REER, and the REER models of the EBA methodology. Staff comments on this are welcome.

To protect its strong international reputation, the authorities should continue to strengthen their supervision and oversight of the large and complex financial sector. Important reforms have been made since the 2014 FSAP, including efforts to support fintech developments. Financial sector supervision has been significantly strengthened. We welcome the findings of the 2019 FSAP and, like staff, see merit in addressing the key challenges, especially on several red flags that have emerged on the health of the Swiss real estate sector. On balance, we concur with staff assessment that the sustained low interest rates, tax policies spurring debt and enhancing house prices and related drivers for risky mortgages need macroprudential measures to rein in overheating trends. On strengthening the governance of FINMA, we see the value in a FINMA-led supervision with FINMA, rather than banks, contracting and paying audit firms directly for supervisory audits. Moving ahead, we would urge the authorities to address the recommendations of 2019 FSAP and through it the financial sector vulnerabilities.

Structural reforms to maintain Switzerland's competitiveness and appeal as a prime investment destination will need to address challenges related to an aging population and technological change. For this, staff has well advised actions for pensions, skilling, education and continued foreign worker movement. We positively note the efforts of the authorities in corporate income taxation and the detection and repression of transnational corruption. In parallel, the outstanding gaps in aligning legislation and practices to international standards, including on corporate taxation, anti-corruption and AML/CFT, should be swiftly implemented.

With these comments, we wish the authorities the best in their endeavors.

Mr. Sigurgeirsson and Ms. Karjanlahti submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Inderbinen and Mr. Heim for their informative buff-statement. The performance of the Swiss economy has been solid supported by strong fundamentals and credible policies. Despite the temporary slowdown in growth, the outlook remains positive. Risks, however, are tilted to the down side, with the open Swiss economy being subject to the risk of a deterioration in the external environment and the low interest rate environment has led to a building up of risks in the financial sector notably, in the mortgage and real-estate sectors. We broadly agree with staff's analysis and offer the following for emphasis.

Switzerland's debt break fiscal rule has yielded a strong fiscal position with low public debt, while, as indicated in the buff statement, enabled sufficient funding for the broad social services of a welfare state and maintained extensive infrastructure. We note the conservative implementation of the rule and the rationale of providing space for monetary policy. However, we sympathize with the authorities' assessment of the implementation of the fiscal rule, highlighting the concerns of inefficiencies that may arise if spending is increased without obvious gaps in public investment. In addition, the recent decision to simplify the procedures for within-year supplementary budgets, should address issues related to under executing expenditures. Naturally the fiscal rule by design needs to ensure a sufficient counter cyclical function. However, we would like to underscore that the main purpose of the fiscal rule is to prevent deficit bias and improve transparency and predictability of fiscal policy. Furthermore, it should be recognized that the consequences of deficit and tightening biases are not necessarily "symmetrical".

We agree with staff on the appropriateness of the current monetary policy stance. Monetary policy has effectively been able to manage pressures arising from large safe-haven flows, while allowing the exchange rate to move in line with fundamentals. While police space is stretched, the SNB does have room to further reduce the interest rates in case of deterioration in economic conditions or resume fx-interventions if renewed safe-haven pressures arise. However, the extended balance sheet of the SNB can create risks of its own. Moreover, mitigating the buildup of risks arising from the low-interest rate environment remains a priority.

The accumulating risks call for strengthening of the macroprudential framework.

Fast growth in private sector mortgages is a sign of possible risk accumulation and when combined with elevated residential property prices and rising vacancy rates this development becomes even more concerning. Households have large exposures to the real estate sector both directly and through their investment in insurance and pension funds. With the prospects of the low-interest rate environment continuing for a period of time broadening the macroprudential framework and tightening the stance is appropriate. We support staff's recommendation to upgrade the macroprudential tool kit to allow for binding demand side measures, such as DTI, LTV, and debt -service to income limits accompanied by a framework with sufficient incentives for implementation. Relying on banks' self-regulation seems to be a strategy that does not come without risk. Furthermore, tax incentives for debt financed real estate investments should be addressed.

Given the size and importance of the financial sector, improving the autonomy, governance, and accountability of FINMA will be important. This would help to preserve financial stability as well as maintain international competitiveness and credibility of the financial sector. As suggested by staff, FINMA would require increased resources and building enough capacity for data collection and analysis. In addition, we strongly agree with staff that to avoid situations of conflict of interest, FINMA should itself contract and pay for the supervisory audits for banks as well as increase its capacity to directly conduct more on-site inspections.

Continuing to comply with global standards in financial transparency and taxation remains a priority especially given the potential bribery risks in certain sectors and legal structures. We commend the authorities for making notable progress in addressing issues related to corruption and AML/CTF as well as aligning corporate taxation with international standards, without eroding competitiveness. To continue this work, we encourage the authorities to swiftly address the remaining deficiencies including approving the pending laws and efficiently implementing them.

Ms. Levonian and Mr. Hart submitted the following statement:

Staff's reports highlight that Switzerland's authorities have successfully navigated a challenging environment with sound macroeconomic policies. Still, as a small and very open economy, Switzerland remains vulnerable to shocks and external pressures. Monetary policy has been effective despite periodic challenges posed by the Swiss franc's safe-haven status, but more needs to be done to appropriately rebalance monetary and fiscal policy. Moreover, prolonged low interest rates among major central banks may fuel greater risk-taking in the search for higher yield, particularly in the domestic real estate sector.

We note that the authorities are committed to continue their prudent approach, as highlighted in Mr. Inderbinen's and Mr. Heim's helpful buff. There is also a need to proactively address key risks and imbalances. In this regard, we welcome the progress underway in corporate income tax reform and pension system reform. Since staff and the authorities broadly agree on the outlook and challenges, we will limit ourselves to a few comments.

We share staff's view that a shift towards a less conservative fiscal stance would be appropriate, but staff advice could better articulate the gaps that ought to be addressed. Switzerland has a strong fiscal position at all levels of government, negative borrowing rates, and is overly cautious in executing on its budget targets. Even taking a more neutral stance would be consistent with the debt brake. However, absent any evident infrastructure, education, or health gaps to address, we find staff's advice to focus on addressing longer-term challenges to be appropriate but vague.

The FSSA highlights Switzerland's financial sector resilience, but also makes clear that more can be done to strengthen financial supervision and proactively address the build-up of risks. We note that the authorities are well-aware of the risks to the housing sector, but their plans appear to be contingent on banks' self-regulatory response. We would encourage them to respond including through macroprudential measures and other steps to reduce household leverage. The authorities should also consider strengthening the financial regulator's autonomy, governance and accountability. The FSSA provides potential considerations in that regard.

We welcome Switzerland's voluntary inclusion of an assessment of its anti-bribery and AML/CFT regime in this AIV. Drawing on FATF and OECD peer assessments, the report notes the risks associated with being a global financial center and the home to large multinationals in sectors prone to bribery and corruption. Switzerland should aim for a high standard, and we welcome the good progress has been made on both fronts. We encourage the authorities to build on recent positive momentum to strengthen implementation and enforcement actions.

Mr. Heo, Mr. Shin and Ms. Park submitted the following statement:

We thank staff for an insightful report and Mr. Inderbinen and Mr. Heim for the informative buff statement. Skillful macroeconomic management has helped the Swiss economy weather large exchange rate shocks since the global financial crisis. We note staff's assessment that growth is expected to return to around a trend pace from 2020, with the output gap remaining closed and the current account stable. As a small open economy, Switzerland is vulnerable to external shocks, including the intensification of trade tensions and a disruptive Brexit. In this context, we agree that the key policy priorities include ensuring resilience to potential shocks, containing risks associated with the low interest rates and continuing to address challenges associated with population aging and technological change.

Article IV Staff Report

The current fiscal framework has served the authorities well – Switzerland has a strong fiscal position with low public debt and a well engrained culture of fiscal prudence. Nonetheless, given the tightening bias in the debt break rule identified by staff, we agree that there may be value in making changes to ensure the rule functions as it is intended to, providing an appropriate balance between maintaining fiscal discipline and providing sufficient space for growth enhancing spending. That said, we note that the authorities do not see a lack of public spending as an issue and question whether the proposed increase in public spending would sustainably boost growth. Staff comments are welcome. In this context, we wonder whether it may be more valuable to preserve fiscal space as a buffer to deal with significant adverse shocks should they materialize, in the current environment. If downside risks to activity were to materialize, it would make sense for fiscal policy to contribute more decisively to supporting growth, in the context of more limited monetary policy space.

The two-pronged monetary policy approach has been effective in managing exchange rate pressures, helping to prevent a prolonged growth slowdown and sustained deflation. We agree with staff that the current monetary policy stance remains appropriate, and welcome staff's assessment that there is some space to respond to a substantial deterioration in economic conditions. Similarly, we agree that FX intervention should be reserved for absorbing safe haven pressures that push the real exchange rate above its trend appreciation path. The risks associated with a continued period of low rates should be carefully monitored, and there may be a role for additional macroprudential measures to address an increase in risky lending for investment properties, discussed further below.

We note the assessment that the Swiss current account is broadly in line with fundamentals and desired policies – although subject to especially high uncertainty. Switzerland's role as a hub for multinational corporations and organizations complicates the measurement of macroeconomic activity and external sector developments. We appreciate staff's efforts to identify and correct for country specific factors and measurement issues where these are likely to be significant – particularly on retained earnings on portfolio equity – and reiterate the importance of doing this in an evenhanded and transparent way.

Finally, the Swiss economy has benefitted significantly from being an attractive destination for foreign investment and should continue to progress compliance with international standards. Recent progress in corporate income taxation reform is welcome. We agree with staff that the authorities should continue to align legislation and practices to international standards for corporate taxation, anti-corruption and AML/CFT.

Financial System Stability Assessment

We welcome the positive assessment of financial system stability in Switzerland. We note staff's finding that Swiss financial institutions are well capitalized and could withstand severe shocks under the adverse stress test scenarios. Nonetheless, the prolonged period of low interest rates has encouraged risk taking, notably in the residential investment property segment. We welcome the progress that has been made in strengthening financial sector supervision since the 2014 FSAP and broadly agree with the FSAP recommendations. Comments on a few specific aspects are below.

With imbalances in the real estate sector representing a key risk to financial stability, we welcome continued close monitoring of this area and agree that enhancing the macroprudential framework should be considered.

We share staff's concerns that relying on self-regulation by banks may be risky and agree that there would be value in expanding the macroprudential toolkit to include a range of demand- and supply-side tools. Given the potential distributional impacts of limits on loan-to-value (LTV) and debt-to-income (DTI) ratios, including the disproportionate impact on first-home buyers, the authorities may want to also consider more flexibility in the sectoral counter-cyclical capital buffer or limits on growth in lending to market segments where risks are elevated. Staff comments are welcome. In a context where responsibility for macroprudential oversight is shared, we agree that institutional arrangements for new tools should respect the mandates and independence of individual authorities.

The coverage of Switzerland's fintech sector as part of the FSAP is welcome. We note staff's assessment that the sector is not currently large enough to cause systemic risk but could pose contagion and reputational risks. This is an area where the need to support innovation should be carefully balanced against the need to protect financial stability and integrity. We agree that the authorities should continue to monitor this sector closely given rapid growth and innovation and ensure that regulators are sufficiently resourced to do this. We also tend to agree with staff that legislative changes should aim to ensure a level playing field between technologies.

Mr. Doornbosch and Mr. Tolici submitted the following statement:

We thank staff for the insightful papers and Mr. Inderbinen and Mr. Heim for an informative buff statement. Switzerland's economy continues to perform relatively well, due to a well-calibrated policy mix, including the two-pronged monetary policy, an exemplary fiscal policy and adequate macroprudential measures. The economy successfully absorbed large appreciation pressures, underpinned by strong external demand, and the accommodative monetary policy and policy normalization implemented by a number of major central banks. However, being a small open economy, economic growth depends for a large part on a favorable global environment. The downward risks to the outlook -originating from protectionist tendencies and safe haven capital flows related to political uncertainty- have become more prominent. Moreover, risks stemming from the real estate sector and aging population should be closely monitored by the authorities. We concur with staff's overall assessment and recommendations and offer some remarks for emphasis while asking for some clarifications.

The accommodative monetary policy has been effective in managing exchange rate pressures, supporting economic activity and avoiding deflation.

The two-pronged approach of negative interest rates on sight deposits placed at the central bank and unsterilized foreign exchange purchases helped restoring positive inflation and supporting economic growth in the context of the influx of safe-haven flows. The recent shift in the expected path of monetary policy of major advanced economies' central banks may put more pressure on the exchange rate of the Swiss franc. We support the SNB's stance for further monetary accommodation, if needed to secure price stability, but note that room for further easing is limited and should require tighter macroprudential measures to contain excessive risk taking in the real estate sector. To what extent should the SNB respond to renewed safe haven appreciation pressures? What instruments are at its disposal, taking into account the already relatively low policy rates maintained by the SNB and large balance sheet, relative to other major central banks?

The debt brake rule has served Switzerland's economy well, delivering debt reduction and economic stabilization. With regard to staff's view on making room for additional spending by implementing the debt brake rule less conservatively, we concur with the authorities' view that public expenditures should depend on an analysis of the social and/or economic benefit thereof. In this context, it should be noted that increased fiscal spending could introduce inefficiencies given Switzerland's lack of obvious public investment gaps.

While the Swiss financial sector is sound, increasing vulnerabilities in the real estate market requires close attention. We welcome the notable progress made by the authorities with strengthening the banking sector. As emphasized in the FSAP, the Swiss banking sector is well capitalized, profitable and could withstand severe macrofinancial shocks. While macroprudential measures implemented since the 2014 FSAP increased banking sector resilience, persistent low growth and low inflation in an environment of very low interest rates intensifies financial stability risks. We concur with staff that high household leverage in combination with house price increases due to investors looking for higher yields in low-yield economic circumstances presents a risk to financial stability. We are encouraged by the authorities' view in the report that new measures to curb imbalances in the real estate and mortgage markets are being prepared and amending the frameworks for regulation and supervision are under consideration. In this regard, we welcome strengthening the position of the financial supervisor FINMA. In addition to its prudential mandate, the FATF analysis puts further emphasis on the importance of a timely implementation of measures to address vulnerabilities identified with respect to corruption and international AML/CFT-scandals. To what extent does staff consider as appropriate a tightening of loan-to-value and/or loan-to-income standards to alleviate financial stability concerns stemming from the housing market? What other measures could be considered to curtail real estate speculation (investors' search for yield)?

We share the authorities' concerns regarding the external sector assessment. While staff evaluates that Switzerland's external position is broadly consistent with the fundamentals and desired policies based on the CA EBA model, the REER model indicates overvaluation of 11-17 percent (Table 7 p 41). As "Directors highlighted the importance of using … results from all EBA models" in the context of the ESR 2018, we believe that the Fund should better highlight the inherent uncertainty of the external sector assessment, particularly given the conflicting signals in Switzerland's case. Moreover, we hope that in the future the results of all the models will be presented in the main report.

Mr. Kaya, Mr. Benk and Mr. Harvan submitted the following statement:

We thank staff for the set of helpful reports and Messrs. Inderbinen and Heim for their informative buff statement. The Swiss economy continues to perform well and relies on sound fiscal and macroeconomic policies. Going forward, key policy challenges include reigning in real estate and mortgages markets, enhancing financial supervision and regulation, and addressing gaps in international commitments on corporate taxation and anti-corruption. We broadly concur with staff's assessment and recommendations.

Strong fundamentals, as well as sound macroeconomic and fiscal management ensured economic stability and steady output growth. Output is projected to remain close to its potential, while tightening labor market and limited spare economic capacity will push up inflation slightly. Fiscal policies have concentrated on reducing the stock of public debt in the context of an aging population and no investment gaps. We concur with staff that additional fiscal flexibility in the national debt brake might be useful in the context of discussed measures including tax system changes. Could staff comment on what the appropriate levels of public debt are for a smaller highly open economy like Switzerland? We welcome the information in the buff statement on the planned changes in the first pillar of the pension system and would appreciate staff's recommendations on changes to the effective retirement age in view of rising life expectancy.

We concur with staff and the authorities that the current accommodative monetary policy stance remains appropriate although policy space has been reduced. With inflation rate in line with the central bank's target range and output close to potential, we concur with the authorities that assignment of macroeconomic policies should reflect the source of economic weakness. The sizeable current account surplus has been largely stable as the flexible private sector and higher foreign-than-domestic inflation helped preserve competitiveness and restore profit margins. From a longer-term perspective, the CPI-based REER has continued to appreciate. With the Swiss franc a safe-haven currency, the policy interest rate in negative territory and a large SNB balance sheet, monetary policy is approaching its limits.

We appreciate the FSSA which attests that Switzerland's financial sector is overall well-supervised. Many of the 2014 recommendations have been implemented and the authorities are in the process of further strengthening the supervisory regime. The buff statement notes that the Swiss regulatory framework is based on the principle of proportionality, which in our view, could have been better reflected in the Report. We also note with interest the Swiss pilot on a regime for small banks. We would appreciate if staff could follow-up on this pilot in forthcoming discussions on Switzerland, as this could be of value for the larger membership as most financial sectors are made up of small banks. The stress tests for both banks and insurance companies show that both are resilient to significant shocks. Asset management is growing also strongly in Switzerland. We wonder whether possible interconnections between asset management and banks/insurance companies or spillovers of financial stress can be sufficiently well captured to have a good understanding of systemic resilience. We fully support staff's recommendation to close data gaps also in this area. Since this recommendation has also been made in other jurisdictions, we wonder whether this warrants an international effort also to get a better understanding where risk is ultimately located. Staff's comments would be welcome.

The prolonged period of very low interest rates calls for beefing up the macroprudential policies framework to contain financial stability risks. Interest rates are near historical lows, with negative yields on government bonds with maturities up to 10 years. Mortgage bank lending is increasing rapidly to very high levels and showing signs of quality deterioration. We welcome the additional information in the buff statement on the resolution regime for insurance companies and efforts to strengthen client protection and supervision of asset management. The authorities are well-advised to implement the FSAP recommendations as summarized in Annex III. We concur with staff that reliance on legally-binding regulation may be preferable to self-regulation by banks. However, this regime seems to have worked thus far in Switzerland. Still, we agree with staff that more resources for FINMA are warranted in view of the increasing complexity of the financial sector, and the growth in new financial services and tools. Switzerland is at the forefront of Fintech. We agree with staff that integrity and conduct issues require special attention, but wonder whether regulation is the right tool to protect retail investors. Specific consumer protection may be more appropriate. Overall, we wonder whether regulatory gaps in Fintech can already be identified in view of the fast-evolving nature of Fintech.

To address challenges in the real estate and mortgages markets, we agree with staff on measures to contain house price volatility. Staff identifies issues in the tax treatment of owner-occupied property, lax amortization requirements, and low interest rates. Both the removal of taxation of imputed rent and mortgage interest deductibility should be considered. Did staff examine supply side constraints in the housing market?

Challenges remain in addressing some gaps in international standards. We welcome the recent approval of the new CIT framework that would comply with the OECD's Base Erosion and Profit Shifting project and initiatives by the EU, including by equalizing treatment of multinationals and other firms. We also commend the authorities' ongoing efforts to enhance the effectiveness of the AML/CFT framework through recent legislative proposals currently in parliament.

Ms. Mahasandana and Ms. Latu submitted the following statement:

We thank staff for the comprehensive reports and Messrs. Inderbinen and Heim for their helpful buff statement. Sound macroeconomic management has supported the commendable performance of the Swiss economy since the global financial crisis, with relatively favorable performance compared to other advanced economies. While the longstanding cross-country wage differential and ongoing inflow of foreign workers contribute to the robust growth in aggregate employment and rising productivity, inflation has remained subdued. Nevertheless, Switzerland faces several policy challenges as risks to the outlook are tilted to the downside from both the domestic and external sectors. This calls for continued prudent macroeconomic policies to bolster the economy's resilience, address longer-term challenges to growth, and support financial stability. We broadly share the thrust of staff's reports and offer the following remarks for emphasis.

We appreciate staff's discussion on shifting to a balanced fiscal position through higher public spending in 2019. In this context, we take due consideration of the authorities' clarification that the debt brake fiscal rule has provided growth-enhancing and counter-cyclical support. This is crucial to bolster growth particularly with the subdued near-term growth outlook. With the elevated downside risks to growth, we encourage close monitoring of the fiscal position and ensuring medium- to long-term challenges are also addressed. This includes accommodating growing demands for health care and other social spending in light of the aging population, and meeting additional outlays to upskill the population as a result of the changes in technology and nature of work.

The accommodative monetary policy stance remains appropriate. Despite the limited space for further easing, the current low interest rate environment can still be supportive of growth and help in mitigating safe-haven pressures, while inflation remains subdued. With the resulting rising risks to financial stability, we agree with staff that the macroprudential measures should be enhanced to restrain demand for high-risk mortgages on residential investment property. We welcome the authorities' commitment to pursue new measures to curtail imbalances in mortgage and real estate markets, including the intensified supervision of income-producing residential real estate and proposed changes to the Capital Adequacy Ordinance to raise the risk weights on residential investment mortgages. Are there any plans to revise the amortization requirements that have also contributed to the high household leverage? Foreign exchange intervention when needed to mitigate large safe-haven pressures is also supported to avoid excessive volatility in inflation and output.

We note the assessment of Switzerland's external position as broadly consistent with medium-term fundamentals. With the size and composition of the external accounts being influenced by Switzerland's role as a financial center and corporate hub, we also note that some factors especially relevant for Switzerland are not appropriately treated in the EBA model which has contributed to some unexplained residual. While we welcome the application of appropriate judgement in the use of the EBA model for this Article IV consultation, can staff comment on their work to better address unexplained residual and country-specific circumstances on an ongoing basis?

Strengthening financial sector resilience is crucial given the size and complexity of the Swiss financial system. While the financial system remains well capitalized and the banking system has ample liquidity, tackling the rising macrofinancial vulnerabilities from the low interest environment and high exposure to the real estate sector is needed. We welcome the authorities' efforts to strengthen financial supervision and support enhancing the authority and independence of the financial supervisory authority (FINMA) to commensurate with the very large and complex financial sector and institutions that it supervises. We encourage the authorities to proceed with the new Ordinance that is under consultation, to assist in better management of conflict of interest and objectivity concerns. This would allow the FINMA to effectively carry out its supervisory duties and foster financial sector resilience.

Taking decisive steps to implement the domestic reform agenda and improve compliance with international standards is important to bolster sustainable growth prospects. Preparing for population aging and automation and new arrangements is key to ensure sustainability of the strong employment and high productivity levels. We take positive note of the reforms to the pension system, which would be accompanied by the steadfast implementation of the new corporate income tax framework to maintain competitiveness while complying with international standards. We welcome the authorities' efforts to strengthen anti-foreign bribery enforcement and the implementation of the anti-corruption recommendations by the OECD Working Group. We also agree with progressing the ongoing efforts to strengthen the effectiveness of the AML/CFT framework and timely passage of the pending measures and their effective implementation. We encourage progress towards completing the negotiations of the agreement between Switzerland and the European Union to alleviate uncertainties for businesses and accessibility of exports to EU markets.

Mr. Raghani, Mr. N'Sonde and Mrs. Boukpessi submitted the following statement:

We thank staff for a set of comprehensive reports on Switzerland and Messrs. Inderbinen and Heim for the informative buff statement.

Switzerland's macroeconomic fundamentals continue to be strong. buffers are significant and the external position remains solid. We commend the authorities for their robust policy framework and prudent economic management. Growth reached 2½ percent in 2018 despite a slight slowdown in H2 and is expected to settle around 1½ percent over the medium-term. As a small open economy with a large financial sector and a safe-haven currency, Switzerland is vulnerable to global factors including trade tensions, increased protectionism, geopolitical risks and adverse developments in financial markets. Going forward, potential price corrections in the real estate and mortgage markets, delays in complying with international business standards and important demographic and technological changes are likely to weigh on the country's growth prospects.

Against this backdrop, it is essential that the authorities pursue an appropriate monetary-fiscal policy mix aimed at preserving macroeconomic stability while strengthening the economy's resilience and competitiveness. This entails enhancing the macro-prudential framework and advancing key structural reforms notably overhauling the corporate income tax (CIT) and pension system reforms to reinforce fiscal sustainability and buffers.

We broadly agree with the staff's appraisal and policy recommendations and wish to provide the following remarks for emphasis.

We commend the Swiss authorities for their strong commitment to fiscal prudence. The debt brake rule at the federal level has served the objective of fiscal and debt sustainability well, yielding comfortable fiscal buffers and helping reduce the general government debt and thus providing fiscal space to face an unanticipated economic slowdown. We agree with the authorities that the debt brake framework provides growth-enhancing and counter-cyclical support. However, we encourage them to consider a somewhat looser fiscal policy in the current environment of low inflation. Moving from a continued fiscal surplus to a balanced position would allow an increase in spending to notably face the long-term challenges related to population aging and evolving technology. We would appreciate staff's elaboration on the analyses and recommendations made by the Group of experts in 2017. Moreover, we welcome the measures highlighted in the buff statement aimed at better utilizing fiscal space under the fiscal rule by streamlining within-year underspending.

The Swiss National Bank (SNB)'s current accommodative monetary policy stance remains appropriate. The flexible dual approach of the SNB using an interest rate set at -0.75 percent and FX intervention, has been effective in steering up the economy through challenging times, allowing the Swiss franc to moderate its appreciation, supporting domestic demand and gradually rising the inflation rate in line with the SNB target range. We appreciate the focus in the Selected Issues paper on the Swiss franc and sympathize with the authorities' adequate approach with respect to the exchange rate policy.

We note the positive findings of the recent Financial Sector Stability Assessment (FSSA) and praise the authorities for the progress made in strengthening the banking sector resilience. Banks enjoy adequate capital and liquidity buffers underpinned by strong regulatory and supervisory frameworks. Nevertheless, high corporate and household leverage, and large exposure of banks to the property market pose some risks to financial stability in a context of a prolonged external and domestic low-yield environment. We support staff recommendation to further strengthen the macroprudential framework to lower the imbalances in mortgage and real estate markets and welcome the ongoing steps taken by the SNB, the financial supervisor (FINMA) and the Federal council in this regard. In addition, given the complexity and large size of the Swiss financial system, it will be critical to continue enhancing the frameworks for supervision and regulation, including the conduct of banks' supervisory audits as well as developing tools to cope with challenges posed by fintech and cyber threats.

We encourage the authorities to build on the advances made in structural reforms, particularly the corporate taxation and pension reform and to further buttress governance. We note the recent approval of the referendum on CIT and pension systems and look forward to their swift completion and implementation. We also welcome the authorities' continuing efforts to implement key recommendations of the FATF, further promote transparency in financial institutions, and address the remaining deficiencies in the AML/CFT framework. In addition, we highly value the authorities' strong involvement, at the international level, in the fight against corruption.

With these remarks, we wish the authorities of Switzerland continued success.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written set of papers and Messrs. Inderbinen and Heim for their helpful buff statement.

Strong fundamentals and skillful macroeconomic management have contributed to the good performance of the highly-open and globally-integrated Swiss economy over the past decade. In 2019, growth is expected to continue, albeit at a below-average pace, in a low unemployment environment and with inflation returning to the mid-point of the SNB's band by 2020. Fiscal policy continues to outperform the structural-balance objective, the external current account surplus remains close to double digits, the already-moderate public debt is declining further, and reserves are more than adequate. The financial soundness indicators are robust. While growth is expected to recover to its potential from next year, risks to the outlook are skewed to the downside, including from rising global trade protectionism and persistent imbalances in the domestic mortgage and real estate markets. The authorities should therefore rebalance the macroeconomic policy mix, further strengthen financial sector resilience, and accelerate structural reform implementation. We concur with the thrust of the staff appraisal.

In a subdued growth environment, substantial fiscal space even relative to the debt brake rule, argues for a looser fiscal policy. This will also create room for additional healthcare and other social outlays associated with population aging and technological change, and reduce overdependence on monetary policy. Consideration should be given to reducing systematic underestimation of structural revenue and under-execution of the budget. We learn from Messrs. Inderbinen and Heim that, contrary to staff recommendation to let the fiscal rule's ex-post provision operate symmetrically to allow spending to catch up the following year, the authorities have opted to simplify procedures for within-year supplementary budgets to incentivize better utilization of expenditure ceilings by line ministries. Staff may wish to elaborate. We see merit in using surpluses to compensate cantons for any revenue shortfalls from CIT reform, avoiding allocation of surpluses to various distortionary tax expenditures, and eliminating mortgage interest tax deductibility together with abolishing PIT on imputed rental income.

The two-pronged monetary policy, involving interest rates and FX interventions, has been effective in avoiding deflation and supporting growth. The current expansionary stance remains appropriate, given the output gap, below-target inflation, and sustained safe-haven appreciation pressures on the Swiss franc. We agree that while the monetary policy is stretched, there is still room to modestly reduce the policy rate and resume FX purchases, if needed, to achieve the inflation objective and counter excessive appreciation pressures. However, given that a more negative rate risks "runs to cash" by the public and "search for yield" by banks, we welcome adoption of a tiered remuneration structure and setting a high threshold to protect retail depositors from negative rates and insulate banks' profitability. We find merit in regular and timely publication of FX intervention data and take positive note of SNB's weekly dissemination of such data.

The oversized and complex financial sector is well-capitalized and liquid, with low NPLs. Important reforms made over the past five years have enhanced the system's resilience to severe adverse shocks, as corroborated by stress tests conducted under the recent FSAP. However, widespread financial, corporate, and household exposure to growing imbalances in residential investment properties—in a sustained low interest rate environment—pose risks and warrant expanding the macroprudential toolkit and tightening the existing generous amortization requirements. Regulation and supervision should be strengthened by clarifying FINMA's mandate and enhancing its authority, autonomy, and resources. Work should also continue to further upgrade financial safety nets and crisis management frameworks, including by improving banks' recovery and resolvability and thoroughly reforming the deposit insurance agency in line with international norms.

Ongoing structural reforms remain key to preserve Switzerland's status as a valued destination for foreign investment and boost productivity and potential growth. More-dated skills of an aging workforce exposed to high risk of automation call for continued upgrading of human capital, openness to skilled foreign labor, and increasing compatibility of social safety nets to new and more varied work arrangements. CIT reform to maintain competitiveness and comply with international standards, and pension reform to ensure long-run sustainability, should proceed expeditiously. We welcome strengthened anti-foreign bribery enforcement and continued efforts to enhance the effectiveness of the AML/CFT framework, including in the fintech area.

Mr. Geadah and Ms. Abdelati submitted the following statement:

We thank staff for the insightful reports and Mr. Inderbinen and Mr. Heim for the helpful buff statement. Switzerland continues to perform well and to be well managed in the face of challenges from its currency's safe haven status, and its prospects remain favorable. Like other countries, it is susceptible to an intensification of trade disruptions. The external position is strong, and broadly in line with fundamentals, as outlined in the report. We agree with staff that low-for-longer interest rates that could affect the real estate market, or lack of clarity on long-term relations with the EU, could unsettle the business climate; both require close attention.

Staff draws attention to an imbalance between fiscal and monetary policies and recommends that it be redressed. The accommodative monetary policy has been well-managed so far and remains appropriate, and the authorities believe there is still some space for further easing, and the side effects can be mitigated. However, we see merit in staff's advice to make use of fiscal space to address long term structural challenges, especially given the moderate and declining public debt and current negative borrowing costs. Higher spending in 2019 would also help to boost growth.

At the same time, we appreciate the authorities' view that Switzerland does not have obvious public investment gaps, and that automatic stabilization is already provided through generous unemployment benefits, subsidies for mandatory health contributions, and growth enhancing education spending.

We note that a group of experts recommended not to change the debt brake rule in 2017, and that if any changes were to be made, it would be to lower taxes. However, staff cautioned that lowering taxes further could encourage risky mortgages and further exacerbate rising residential property process. On this issue, we see merit in the staff's call for making more use of the automatic stabilizing objective of the debt brake rule (without changing the rule), including through avoiding overly-conservative forecasts. Were the authorities open to this advice?

With the buildup of risk due to sustained low interest rates, there is a need to further increase bank resilience. We agree with staff that new measures are needed to restrain demand for high risk mortgages, and that the toolkit for mandated risk mitigation measures should be expanded. Switzerland's large financial sector and its central role call for commensurate oversight and regulation, including to safeguard against reputational risks. We underscore the need for FINMA to have greater autonomy, including with respect to hiring audit firms. Rapid technological changes call for adequate upgrading of regulations to protect integrity and stability of the system.

Switzerland's high-quality education and investment in innovation has been a hallmark of its export-based economic success. It will be important to maintain this by continuing to review any gaps in the social safety nets consistent with new work arrangements. It will also be important to prepare for population aging by continuing pension reforms to ensure sustainability.

Mr. Kaizuka and Mr. Minoura submitted the following statement:

We thank staff for their comprehensive reports and Mr. Inderbinen and Mr. Heim for their informative statement. We welcome that the Swiss economy has outperformed compared to other advanced economies since the global financial crisis, notwithstanding periodic safe-haven pressures. However, several challenges still remain, including high mortgage debt and property prices, limited space of monetary policy and population aging. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Monetary Policy

While the current accommodative monetary policy stance is appropriate given the subdued inflation and safe-haven pressures, limited space for further easing calls for a more prominent role of fiscal policy. Whereas space remains for a modest reduction in the policy rate, further easing could risk search-for-yield by banks and increase financial vulnerabilities. Against this background, macroprudential policies and further utilization of fiscal policy gain the importance. At the same time, we encourage staff to continue monitoring closely the effects of the negative interest rate on bank profitability.

Fiscal Policy

We commend Switzerland for maintaining a sound fiscal position. Having said so, negative borrowing costs and sustained fiscal surpluses indicate substantial fiscal space, which could be utilized to alleviate pressure on monetary policy. Given the fact that fiscal policy has consistently overperformed the debt brake (DB) rule's structural-balance objective and imposed a sustained drag on output, shift from a sustained structural fiscal surplus to a balanced position consistent with the DB rule is warranted. We note of the staff's view that a less-conservative implementation of the DB rule would make room for additional spending, including health care and other social spending. On the other hand, the authorities comment that a group of experts recommend to lower taxes, rather than to raise spending, if any changes were made. Could staff elaborate more on the differences of the views and their background? We agree that improving the procedures for assessing the output gap and forecasting revenue would reduce systematic underestimation of structural revenue and encourage the authorities' efforts on this front.

Financial Sector Policy

We welcome the finding in Financial System Stability Assessment (FSSA) that Swiss financial institutions are well capitalized and could withstand the severe shocks under the adverse stress test scenarios. On the other hand, sustained low interest rates and high real estate exposure are creating risks, including the buildup of risk in residential investment mortgages and the high household leverage. Therefore, we concur with the authorities and staff that new targeted macroprudential measures are needed. Those could include both supply and demand side tools, such as higher risks weights for income-producing real estate or tightening of LTV limits. Regarding this point, we take note of staff's comment that the authorities have no legal mandate for such demand-side measures, and appreciate staff's elaboration on it. At the same time, tax policies that encourage high household leverage need to be removed to avoid further incentivizing debt and boosting house prices.

We commend the Swiss authorities that supervision has been strengthened over the past decade. However, given the very large and complex financial sector and institutions of Switzerland, upgrading of regulatory and supervisory frameworks and capacities need to be continued. We agree with staff that FINMA could manage conflict of interest and objectivity concerns better by directly contracting and paying audit firms for supervisory audits of banks. Strengthening the governance and autonomy of FINMA and upholding its authority are also indispensable. We also expect the authorities' continued efforts on filling the data gap. Could staff elaborate more on the existing data gap?

Structural Issues

We welcome that recent approval of the referendum allows for the implementation in 2020 of the new corporate income tax (CIT) framework that abolishes preferential tax regimes in compliance with the OECD's Base Erosion and Profit Shifting project and initiatives by the EU. Steady implementation of CIT reform remains key to align with international standard. Regarding the pension reform, while the referendum also modestly increases funding for the first-pillar, given the remaining shortfalls of current revenue, further pension reforms are needed going forward. We also commend the authorities' ongoing efforts to enhance the effectiveness of the AML/CFT framework and encourage timely implementation of these initiatives.

Mr. Mahlinza and Mr. Ismail submitted the following statement:

We thank staff for the informative set of papers and Mr. Inderbinen and Mr. Heim for their insightful buff statement.

The Swiss economy remains strong, supported by sound macroeconomic policies, buoyant net exports and investment, and robust economic fundamentals, including strong fiscal and debt positions. Notwithstanding, the second half of 2018 saw a temporary slowdown due to weaker global trade, a drought and some bottlenecks in the German auto sector. Medium term prospects remain broadly favorable although, the outlook is susceptible to downside risks stemming from a potential escalation of trade tensions, renewed safe-haven pressures, vulnerabilities in the real estate market, and uncertainty around long-term relations with the EU. We broadly agree with staff analysis and policy recommendations and provide the following comments for emphasis.

The fiscal position remains strong and the public debt to GDP ratio continues to decline, underpinned by the debt brake (DB) rule. We take note of staff's concern that fiscal policy remains underutilized and that the current environment provides a good opportunity to shift to a structurally-balanced fiscal position through a step increase in the public spending to GDP ratio. In this respect, a less conservative DB rule would help prepare the economy for the technological change and aging pressures as well as reducing the burden on monetary policy. Nevertheless, the authorities do not see the need to change the DB rule and consider that the DB framework provides sufficient growth-enhancing and counter cyclical support to stimulate the economy and address potential cyclical downturns. Staff comments on the adequacy of the framework to provide a stimulus are welcome.

The current accommodative monetary policy stance is appropriate given the subdued inflation. In this context, we welcome the tiering of the negative policy rate and high thresholds that have helped protect banks' profitability and retail depositors from negative rates. These efforts have been well supported by foreign exchange interventions which have helped alleviate safe-haven pressures on the franc. Furthermore, these interventions have contributed to the expansion of the SNB's balance sheet as well as the rapid build-up of reserves. While the large reserves held by the SNB contribute to financial stability, we wonder whether there are risks associated with the large SNB balance sheet and how these risks could be addressed. Staff comments are welcome.

Although the financial sector remains broadly resilient to severe shocks, risks posed by high exposure to real estate require vigilance. To this end, we concur that the authorities should tighten macroprudential policy to restrain elevated demand for high-risk mortgages fueled by the search for higher yields in the low interest environment. That said, we wonder, if and to what extent, FX interventions by SNB could have stimulated excessive credit to mortgages. Staff comments are welcome. Further, we agree that the authorities should complement self-regulation by banks with a framework that enhances expectations to act while reducing tax incentives that encourage high-risk household leverage. At the same time, strengthening FINMA's autonomy and supervisory capacity would be important to preserve financial stability and protect the strong international reputation of the Swiss financial system.

The free movement of labor has enhanced the elasticity of labor supply while higher spending on education and vocational training has helped improve productivity growth and reduced vulnerability to automation. Going forward, we urge the authorities to strengthen social safety nets and eliminate disincentives for employing older workers. Finally, we welcome the authorities' efforts in implementing the OECD Anti-Bribery Convention and commitment to implement the main FATF recommendations. We believe that these efforts will go a long way towards addressing corruption and related money laundering as well as eliminating illicit financial flows, which is a major concern for the African region.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their very interesting set of documents including the comprehensive and detailed assessment of the financial sector. We also thank Mr Inderbinen and Mr. Heim for their informative buff statement. We broadly share staff's assessment and wish to add the following remarks for emphasis.

Outlook and risks

Growth in 2018 has been well-above trend against the backdrop of depreciation of the franc in mid-2018 which boosted exports. Output growth is expected to slow this year and return to a lower level consistent with the limited spare economic capacity, a more subdued external demand and the lesser proceeds from licensing and broadcast rights generated by internal sporting events. Risks to growth are both external and domestic. Export performances could be affected by greater protectionism and a no-deal Brexit while uncertainty around the negotiations with the EU to adopt a new framework agreement.

We thank staff for the interesting chapter of the Selected Issues Paper on cross-border wage gaps which raises some questions. Swiss wages are higher than in neighboring regions but nominal wage growth has almost halved since the Great Financial Crisis. However, what the ECM's results do not suggest is that lower inflation expectations may also partially account for the behavior of nominal wages. Staff's comments would be welcome. Moreover, it could also have been interesting to try to assess the impact of automation, digitalization and outsourcing on this down-trend.

External sector assessment

On a long-term perspective, we agree that the trend appreciation of the REER has been consistent with the high current account and private capital and financial account surpluses. Those persistent surpluses are due to a strong home bias in savings and appetite for Swiss franc investments. According to the EBA methodology, the CA gap is assessed to be in the “broadly consistent” range in 2018 including however outside-the-model adjustments to consider measurements biases (valuation losses due to inflation and retained earnings accounting). As mentioned in the report, domestic policy gaps (-1,0 percentage points of the CA gap) consist of excessive private sector credit (-1,3) and fiscal underspending (0,4). Foreign exchange interventions (FXI), which have occurred until last year, albeit for modest amounts, may also play a role on the current account balance. While FXI are included in the EBA model, they are only used in relation with capital controls. Accordingly, we are wondering to what extent letting the FXI variable impact the current account in the model would be consistent in the case of Switzerland even in the absence of capital controls?

On reserves accumulation, we thank staff for the very interesting chapter of the Selected Issues Paper and the monetary authorities for having agreed to disclose the composition of their reserve portfolio. The equity investment strategy of the SNB has been one the unexpected consequences of the sustained low interest rates which has depressed the returns on Central Banks foreign exchange reserves. It thus reflects a tactical portfolio allocation of external assets. While the SNB is a passive investor, its holdings of equity positions in US companies is significant albeit the latter display a high market capitalization. More generally, we are wondering how staff assesses the trade-offs between this type of tactical portfolio allocation of external assets and the Central Banks’ responsibilities for preserving their independence, financial stability and liquidity risk management. Furthermore, the private sector is net long in foreign currency, which is consistent with the slight depreciation of the Swiss franc against the US dollar and the Euro since 2015 despite the existence of some foreign currency liquidity mismatches. Depending on the composition of portfolio investment liabilities and the volatility of currency options which are not mentioned in the document, we would be interested in staff’s point of view on the potential causal connection between accumulation of reserves and private sector’ risk taking in the case of Switzerland.

Policy mix

In line with our past statements, we strongly encourage the authorities to rebalance their policy mix towards increased public spending ahead of technological changes and aging population. Switzerland’s special safe haven status has implied steering carefully monetary policy in order to reduce appreciation pressures, avoid deflation and support the economy, an ability for which the SNB has been successful in. Tiering negative policy rate and unsterilized foreign exchange intervention have proven to be useful in this context. The ultra-loose monetary stance, the highly-valued Swiss franc and the still ECB accommodative policy raise however the question of the existing space for monetary policy to avoid the risk of a Japan-like deflation scenario in a context of low inflation forecasts. Against this background, monetary policy should not be overburdened and continue to be directed at maintaining inflation target with foreign currency intervention reserved for addressing large exchange market pressures.

The rebalancing in domestic and external demand’s contribution to GDP growth should be eased in line with a greater and more flexible use of fiscal space under the Debt Brake rule. This would allow to foster growth-enhancing spending and preparedness for demographic transition. The rule’s ex post provision to operate symmetrically should be allowed to reduce systematic under-execution of the budget while forecasting procedures of output gap and structural revenue could be softened. This is, in our view, could be done without being detrimental to the country’s safe haven status given the existing substantial fiscal space. The latter should not only be used to cushion downside risks materialization but also to tackle structural issues such as tax system challenges and the increase in the dependency ratio.

On the tax system, we salute the implementation next year of the CIT framework ending cantonal preferential tax regimes in compliance with the OECD’s BEPS project and EU initiative to make multinationals tax treatment even among.

Pension scheme should also be adjusted in line with structural changes of the economy including automation and increase in foreign highly skilled workers. We agree with staff’s recommendations that equalize male and female retirement ages and raise them over time seem appropriate to face ageing challenges while helping preserve the pension system financial substantiality.

Structural policies

We encourage the authorities to maintain their efforts to strengthen the anti-foreign bribery enforcements in line with the OECD Working Group on Bribery in International Business Transactions’ recommendations. Given the weight of the financial sector assets, including insurance and pension fund assets in the swiss economy, shortcomings to the AML-CFT regime should be urgently addresses. In this regard, we would like to know if staff has an idea on the timing of the entry into force of the pending laws related to the new sanctions' regime for breaches of the notification requirements for beneficial owners and to the conversion of bearer shares in non-listed companies into nominal shares.

Financial System Stability Assessment

The swiss financial system is large, well-capitalized and benefits from ample liquidity of the banking sector and good profitability of the insurance sector, but further measures are needed to address rising macrofinancial risks. While we share staff's overall risk assessment which concludes on the remaining vulnerability of the financial system to a variety of cyclical and structural shocks, we think that the report rightly underscores domestic banks' high exposure to real estate markets and the significant impact a sharp reversal of historically high house prices would have not only on heightened credit risks, asset impairment, default events but also on non-banking financial industry exposed to real estate. Given the rising risks associated to loan affordability, prices' hike, tax deductibility of mortgage interest payments and more generally to mortgage default risk sensitivity to interest rate shocks, strengthening the macroprudential framework appears as a priority. We fully agree with staff that the toolkit should be expanded with binding supply and demand-side instruments but also to non-banking financial institutions and the responsibilities of each supervisory agency in this respect clarified.

Risk management in the banking sector deserves close attention. Given the large recourse to external auditors, there is a great need to ensure the independence of the audits carried out and improve the effectiveness of the supervisory audit system under the FINMA. Governance issues should be addressed to prevent conflict of interest risks from materializing. While a post-stress leverage ratio could help compensate for the banks' underestimation of risk exposures in their internal models, increasing the consistency and the granularity of supervisory reporting and enlarging the SNB's stress testing exercise to major private banks would be consistent complements. More generally, we strongly encourage the authorities to finalize the implementation of 2014 FSAP recommendations including enforcement of self-regulation related to domestic real estate and mortgage markets, transparency in the financial sector and the increase in FINMA's resources to carry out its agenda for supervisory enhancement.

Other key aspects of financial sector regulation and supervision should likewise be addressed. Internal governance and crisis management arrangements should be improved to ensure that the Financial Market Infrastructures (FMI) have strong internal governance and continuity of services in case of extreme scenarios. More resources should be dedicated to FMIs by FINMA to facilitate progress in these areas, especially in resolution planning. Given its importance in the swiss economy (160 percent of GDP at end-2017) and the high concentration of risks, the fund investment industry warrants heightened monitoring. Giving FINMA more power to impose administrative fines should go along with a more active enforcement policy and a more comprehensive disclosure of individual enforcement actions to earn credibility. While not a systemic risk at this stage, we concur with staff's recommendation that reputation and contagion risk stemming from crypto-related activities should not be discarded. Further legislative and regulatory steps should be taken to set clear and transparent eligibility standards for the blockchain and DLT activities, maintain a level playing field among bank and nonbank entities, improve investor protection and ensure operational safety and stability.

Finally, we encourage the authorities to address the remaining key deficiencies of the AML-CFT framework including reporting obligation, proportionality of sanctions and enhanced international cooperation.

Mr. Villar and Mr. Montero submitted the following statement:

We thank staff for its comprehensive set of reports and Mr. Inderbinen and Mr. Heim for their helpful buff statement. We broadly agree with the thrust of the staff report but would like to offer a few comments and qualifications.

The Swiss economy has performed quite well during the period after the global financial crisis supported by strong fundamentals and skillful macroeconomic management. The fiscal and public debt positions are strong, and the external surplus remains persistently large. At the same time, inflation and interest rates remain at very low levels—with negative yields on government bonds with maturities of up to 10 years. Going forward, growth is expected to converge towards potential, though risks are tilted to the downside. Additionally, the economy will face several challenges associated with growing imbalances in the real estate and mortgage markets, persistent subdued inflation with limited conventional monetary space, and population ageing.

Regarding downside risks, we believe that the uncertainties around the framework agreement between Switzerland and the EU are downplayed. The rejection by the Federal Council of the agreed text last week could have a series of negative consequences, such as on access to some EU markets and the loss of stock market equivalence, which would impact business confidence and investment. Staff's comments are welcome.

We acknowledge the difficulty in assessing Switzerland's external position due to its role as financial center, corporate hub and safe haven. We welcome staff's comprehensive analysis, which is consistent with the revised EBA methodology. However, we have some reservations on the assessment that the Swiss external position in 2018 was broadly consistent with fundamentals and desirable policies. Firstly, the current account surplus is supported by a large goods and services trade surplus (11.2 percent of GDP), which hints at a possible REER undervaluation. Moreover, the adjustment for mismeasurement in the income account was almost 1 pp larger than in last year's ESR. Could staff provide more details on this? Secondly, Switzerland presents a large and sustained creditor position (NIIP of 128 percent of GDP), which can be destabilizing for the Swiss economy and for the rest of the world. In this context, we concur with staff and with Mr. Meyer and Mr. Buetzer's statement that FX interventions should not impede trend appreciation that is justified by fundamentals.

Like staff, we believe that a symmetrical operation of the debt brake rule, avoiding a bias towards underspending, would help relieve pressures off monetary policy in a context of persistently low inflation, support domestic demand, and help correct the excessive external surplus. We also share staff's view that current proposals to allocate fiscal surpluses to various tax deductions should be managed with caution to avoid distortionary effects.

We note that high cross-border wage gaps have persisted over time, which might hint at the existence of labor market distortions. The staff's analysis on this topic suggests that this gap is entirely explained by fundamentals, but we would call for a more prudent appraisal as this conclusion is based on aggregate data and may require a more detailed microeconomic approach. Staff's comments are welcome.

We welcome the comprehensive and insightful analysis of the FSAP report, which is rich in substantial recommendations that deserve a careful monitoring going forward, given the globally systemic nature of the Swiss financial sector. We share staff's view that sustained low interest rates and high real estate exposure are creating risks. The combination of elevated residential property prices, high leverage and rising vacancy rates create a cocktail that increases the likelihood of a price correction. Given the extensive exposure to real estate —by households, NFCs, banks, pension funds, insurance companies—any shock to property prices could spill over the whole economy, with significant financial stability and economic costs. We thus very much welcome the fact that FSAP's stress tests find financial institutions to be well-capitalized and liquid before severe shocks, although some banks would breach their capital buffer under a very adverse scenario, while others are vulnerable to USD liquidity shocks or to stressed wholesale scenarios. Additionally, it is encouraging that the insurance sector remains resilient in the stress tests.

Despite this resilience, we concur with staff on the need for new targeted macroprudential measures. Although we feel reassured by Mr. Inderbinen and Mr. Heim's statement that additional macroprudential measures will be considered as needed, relying on banks' self-regulation on demand-side measures is subject to concerns about timeliness and stringency. Thus, we support a broadening of the toolkit for mandated demand and capital-based macroprudential measures, along with an accountability framework specifying expectations to act to prevent inaction biases, along the lines of best international practices.

The systemic nature of the Swiss financial system calls for regular upgrading of regulatory and supervisory systems. Strengthening the autonomy and governance of FINMA is critical for addressing conflicts of interest and objectivity concerns—derived from the fact that banks contract and pay the supervisory auditors—and, thus, preserving financial stability. Important progress has been achieved in the areas of financial sector safety nets and crisis management arrangements, but more work is needed to improve banks' recovery and resolvability, as acknowledged by both staff and the authorities. We take positive note of staff's recommendation to thoroughly reform the deposit insurance system (DIS) by creating a public and fully-funded deposit insurance agency—on which there is an ongoing public consultation. How does staff assess the current proposal on the DIS being prepared by the authorities?

The Swiss authorities are at the global forefront for promoting blockchain and DLT. This must be done cautiously to prevent distorting the playing field, which may misallocate resources and create financial integrity concerns, as highlighted by the FSAP report.

We welcome the recent approval of the referendum that allows for the implementation of the new CIT framework abolishing preferential tax regimes in compliance with the OECD's BEPS and EU initiatives. We are also pleased by the progress made in anti-foreign bribery enforcement and in the

AML/CFT framework. We call for expeditious implementation of all required changes in these three areas and to continue efforts to close remaining gaps.

Mr. Mouminah, Mr. Alkhareif and Mr. Rouai submitted the following statement:

We thank staff for the well-written set of reports, including the Financial System Stability Assessment (FSSA), and Mr. Inderbinen and Mr. Heim for their insightful buff statement. We broadly concur with the staff appraisal and would limit our remarks to a few issues for emphasis.

Developments in Switzerland continues to be positive. Indeed, we note with satisfaction that the Swiss economy has performed well since the global financial crisis. Although risks to the outlook are tilted to the downside, Switzerland will continue to benefit from the strong fundamentals of its economy and from the authorities' skillful macroeconomic management.

The policy mix has been supportive and seems broadly appropriate. Staff notes that in an environment of subdued growth and more-limited monetary policy space, Switzerland would benefit from a shift from a sustained structural surplus to a balanced fiscal position through higher public spending in the new areas of technology and emerging workplace trends and to address the challenge of population aging. Here, we take positive note of substantial increase in spending in education and infrastructure in recent years. At the same time, we note that under-execution of expenditure continues to explain the overperformance of the debt brake (DB) rule. In this context, we are encouraged to note in the buff statement that the authorities have decided to simplify procedures, which are expected to facilitate utilization of the expenditure ceiling prescribed by the DB rule.

We welcome the FSAP's findings and policy recommendations. We are reassured by the conclusion that Swiss institutions are well capitalized and could withstand the severe shock under the adverse stress test scenario. We take positive note that several reforms have been implemented since the 2014 FSAP, including the timely adoption of the Basel III framework. We encourage the authorities to take into consideration staff's recommendation to expand the macroprudential toolkit to mitigate the further buildup of risk in the banking and real estate sectors. We also support further efforts to strengthen financial sector regulation and supervision with a special focus on upgrading the authority of the Swiss Financial Market Supervisory Authority (FINMA) to ensure that it is adequate to the very large and complex financial sector and institutions that it supervise.

The coverage of Fintech and Crypto-Assets in the FSSA is timely. We take positive note of the emphasis placed on innovation, including in the area of fintech, without compromising financial stability and integrity. As changes in this area are rapid, the authorities should carefully look at all options before adapting their legal framework to safeguard financial stability and integrity and address potential risks. Here, we welcome the indication in the buff statement that the authorities are firmly commited to ensuring financial stability.

Finally, the authorities are encouraged to continue their focus to close the remaining gaps regarding international commitments and standards. In this context, we welcome the authorities' efforts to promote good governance as well as financial sector integrity.

With these remarks, we wish the authorities continued success.

Mr. Mozhin and Mr. Palei submitted the following statement:

We thank staff for a set of insightful papers on the Swiss economy and Mr. Inderbinen and Mr. Heim for highlighting the authorities' position on key issues raised by staff. We recognize some differences in views on the authorities' fiscal stance, public investments, and the overall fiscal framework. While the authorities are fully aware of the risks stemming from the real estate sector, they seem to prefer a more gradual approach to developing and applying the macroprudential toolkit. The FSSA contains rich analysis of the existing and emerging challenges in a systemically important for the global economy financial center. We are pleased to note that the authorities and staff view the FSAP as a useful contribution to the ongoing national and international debates.

In a recent IEO report Switzerland was featured among the main case studies of unconventional monetary policies. Facing the shocks from the waves of the global financial crisis, the monetary authorities had to rely on negative interest rates, intensified their purchases of the Swiss franc-denominated assets, and eventually introduced the exchange rate floor. Given the current state of the global economy and the developments in Switzerland's key trading partners, it is a good time to revisit the effectiveness of the monetary and exchange rate policy tool box at the disposal of the Swiss National Bank. The lessons from Switzerland could also contribute to the Fund's newly invigorated attention to the interaction of monetary policies, exchange rates, macroprudential tools, and various capital account measures. Overall, we agree with the authorities and staff that their policy actions have been and remain successful in maintaining a stable inflation rate and reducing volatility of the output, while in many respects strengthening financial stability.

We note that, due to large-scale foreign exchange interventions, the current level of reserves is close to 120 percent of GDP. However, even in the chapter of the SIP, staff did not refer to the country's position evaluated against the standard metrics of the reserves' adequacy, including the ARA metric. We appreciate the references to the need for a safe access to additional foreign exchange liquidity even in advanced economies, including Sweden, Israel, the Czech Republic and Poland. We agree that the lack of resources available through the IMF and the lingering uncertainty in availability of swaps between the central banks put many economies at risk. At the same time, we would ask staff to elaborate on the role of the swaps. Do staff think that the scale of the swap arrangements is small? Or, maybe, access to these resources could be impaired for some reasons? (Also, as a side matter, is it the intention of the Fund to finally reassign the former FCL-user Poland from the group of EME to the group of advanced economies or staff will correct the text?). In addition to the above, we would be interested in comparisons between the indicators of adequacy of foreign exchange reserves in Switzerland and in other small open economies, including the financial centers.

We note that reserves management in Switzerland has some similarities with that in the Czech Republic, as part of the reserves is invested in stocks and other higher risk financial instruments. From this point of view, this type of reserves management already demonstrates many features of a possible sovereign wealth fund. According to staff, the debates about the costs and benefits of formally creating such a fund are not new to the Swiss authorities. We would welcome additional information on these debates and would be interested in staff's opinion on this matter. For example, one could see that creating a sovereign wealth fund from the part of foreign exchange reserves could have important implications for the authorities' fiscal framework. In many economies institutional arrangements exist to allocate to such funds extra foreign exchange reserves, fiscal surpluses, or a part of revenues from natural resources.

Mr. Lopetegui and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the report, Selected Issues paper (SIP), and the Financial System Stability Assessment (FSSA) and Mr. Inderbinen and Mr. Heim for their comprehensive buff statement. We found the "Swiss franc –

living in a multipolar world" paper very useful, to get an overview into why the franc's behavior shifted significantly during the past decade.

Switzerland enjoys an enviable socioeconomic position, robust institutions, and strong policy framework. It is no wonder the Swiss franc has a reputation as a safe haven in times of world uncertainty. The policy framework has helped the buildup of significant fiscal and external buffers while the economy is characterized for its important presence in global financial and trade markets. Against a background of growth deceleration this year, the outlook is subject to risks related to the external environment, including increasing trade tensions and changing global financial conditions, and possible appreciation of the Swiss franc should global risks materialize. Imbalances in the real estate sector persist and are a source of domestic risk.

A strong fiscal position gives ample space for policy action if the economy requires a boost. According to the report, structural surpluses from 2006 to 2018 accumulated to around 6 percent of GDP. The staff argues that a conservative implementation of the Debt Break (DB) rule ends up imposing a drag on output, whereas less conservative implementation of DB will help the long-term performance of the economy. On this, we would highlight that the economy appears to be at full employment, and the authorities are expressing some concerns regarding higher spending. Moreover, a recent review of the DB rule, led the government not to adjust the rule, since envisaged spending needs can be financed with existing instruments, as noted in the BUFF statement. A group of experts suggested that if adjustments were to be made, taxes could be lowered instead. We would appreciate staff's reflections on the pros and cons of these three policy options at the current juncture, namely using fiscal space to increase spending, reducing taxes or saving the fiscal space for a significant downturn.

The challenges faced by the Swiss National Bank (SNB) authorities to stabilize the currency given its implication on domestic trade and the global financial system are not simple. Since the exit from the 1.2 francs per euro exchange rate floor in early 2015, the domestic currency continued its appreciation trend against major currencies. The undeniable effect of monetary policies by the major central banks has led the SNB to use a two-pronged approach to deal with massive capital inflows in past years. Interest rate setting in negative territories at -0.75 percent, plus massive non-sterilized foreign exchange intervention, has allowed the franc to moderate its appreciation. What is somewhat notable is that the appreciation trend has not resulted in a deterioration of the trade balance, perhaps signaling that productivity growth in tradable sectors has remained robust. Staff's comments are welcome. We would also appreciate staff's elaboration on the apparent difference of views with monetary authorities, regarding the available room for monetary policy accommodation.

We found the FSSA timely to encourage the authorities to enhance the regulation and supervision of the financial system and contain risks. We welcome the results of stress tests, which point to the resilience of financial institutions in the face of possible shocks. Still, we agree with staff that macroprudential policies should be used to reduce risks in real estate, exacerbated in an environment of low interest rates. Tax policy should contribute to reduce incentives towards high indebtedness and property demand. We encourage the authorities to reflect on staff's advice to strengthen the Swiss Financial Market Supervisory Authority (FINMA).

We also encourage the authorities to move expeditiously in addressing weaknesses regarding anti-corruption and AML/CFT.

With these comments, we wish the people of Switzerland every success in their future endeavors.

The Acting Chair (Mr. Furusawa) made the following statement:

The Swiss economy has performed well in recent years, and the prospects are favorable with moderate growth and subdued inflation. Directors have acknowledged some external and internal challenges to the outlook and encourage the authorities to take steps to ensure an appropriate mix of macroeconomic policies to enhance financial stability and boost potential growth.

Mr. Inderbinen made the following statement:

We are grateful to colleagues for the interest in Switzerland they expressed in their gray statements and also to the staff for the many answers that they have provided for this meeting.

I would like to provide some context on a few new developments for the benefit of the discussion. First, on corporate tax reform, we take good note of the comments made by many Directors on the outcome of the popular vote earlier this year on the reform package. Last Friday, the government passed the ordinance for the entry into force of the full reform package on January 1, 2020. As a detail of domestic procedure, if any of the cantons would not implement the corporate reform package in its mandatory provisions, federal law would apply from January 1 next year.

Second, there have been quite some comments in the gray statements on possible measures to alleviate financial stability concerns in the housing market, and as noted in our buff statement, the authorities are monitoring developments in the mortgage and real estate markets closely. I would just like to elaborate a little bit with respect to what we had in the buff statement and state that the Swiss Financial Market Supervisory Authority (FINMA) has already intensified supervision in this area and has levied targeted capital surcharges. The government for its part is preparing an adaptation of the Capital Adequacy Ordinance to increase risk rates for residential investment mortgages in line with the revised Basel III standardized approach. Public consultation on a proposal will end in July this year. In parallel, discussions are being finalized with banks on tightening of self-regulation, which if appropriate, would be recognized by FINMA as a binding regulatory standard for all institutions.

There was some interest by Mr. Kaya and others on asset management, and the staff does elaborate on the links between the asset management industry and the banking sector in the written responses and also touch on the data issues that are involved, and I would just like to complement this by stating that FINMA, the supervisor, has increased intensity of supervision of the industry and continues to expand its data-based supervision.

Finally, a last point on the Libra project, which has hit the headlines in some quarters, I would like to state that the authorities are in contact with the social network company in question on this, and the supervisory authorities will determine what is required in terms of licensing if and when a formal application is made.

More broadly, as we state in our buff statement, the authorities are aware of the opportunities and the risks of fintech, and they are committed to ensuring financial stability and integrity as well as addressing any potential risks.

The staff representative from the European Department (Ms. Van Elkan) made the following statement:[1]

> We provided written responses to nearly all the Directors' questions, so I would just like to make a few remarks on the policy mix and the respective roles of monetary and fiscal policy.
>
> Many Directors noted that the choice of policies should depend on the nature of the economic challenge. That is certainly true, but it excludes another important consideration, which is how much policy space exists. During the past decades, Switzerland has been buffeted by safe haven appreciation surges that imposed downward pressure on imported inflation. Since exiting the exchange rate floor in 2015, intervention has been used effectively to lean against these safe haven surges, and since 2016, imported inflation has averaged around 0.8 percent. Meanwhile, domestically sourced inflation has been more stable but much lower, averaging only about a quarter of a percent. Of course, the Swiss National Bank's (SNB) mandate is for overall price stability, but differentiating between domestic and imported inflation highlights where the challenge is coming from.
>
> Intervention is effective for responding to fast-moving safe-haven pressures. On the other hand, the policy interest rate, which has a longer transmission lag, is best suited for addressing low-frequency, more persistent deviations from price stability.
>
> The policy rate is approaching the effective lower bound, and intervention is also facing limits given the very large size of the SNB's balance sheet. By contrast, the authorities characterize the fiscal policy framework as cautious and see the need to build further fiscal space. They see no gaps in public investment and are concerned that raising spending may not increase growth but create inefficiencies. We are proposing that they run a balanced structural position by raising spending. In terms of where to spend, we identify compensating cantons for any residual revenue shortfalls from the corporate income tax reform. Revenue uncertainty from the reform is quite high, and if losses are larger than expected, cantons may need to lower spending to comply with their own debt brake rules.
>
> We also identify the need for additional spending to support future growth. Drawing on the findings of the OECD, we would advise first to

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

increase public subsidies for preschool where attendance at only 3 percent is the lowest in the OECD due to very high out-of-pocket costs.

Second, there is a need to produce more homegrown high skilled workers rather than relying on immigrants educated abroad. A little more than 40 percent of students graduate high school with qualifications that can feed into an academic tertiary education, which is also one of the lowest in the OECD. The more common alternative of employer-based vocational training tends to provide skills for specific jobs but leaves workers less able to adapt to future changes in work, including digitalization, and more susceptible to unemployment later in life.

Meanwhile, tertiary education is largely a cantonal obligation, and fiscal constraints at some of the more populace cantons are curtailing their spending. Fragmentation across different fiscal jurisdictions is also seen as constraining public resources for lifelong learning, and participation is especially low among those with less initial education, although these are the very workers who would benefit the most.

Third, children from immigrant backgrounds, including those born to immigrants in Switzerland, tend to underperform their Swiss non-immigrant counterparts on high school proficiency tests; and the OECD concludes that increasing educational spending on these children promises above-average returns.

Turning to the policy mix, fiscal policy can assist monetary policy in supporting inflation and activity. This applies when responding to safe haven pressures and when addressing persistently low inflation, including for factors mainly from domestic sources. Very low interest rates create search for yield and boost asset prices. They may also encourage additional saving to protect retirement income and to finance a down payment on a house, thereby compressing domestic demand. These significant side effects of monetary policy should be weighed against any potential inefficiencies that might be associated with fiscal spending.

If financial stability risks were to materialize, the macroeconomic costs could be high. In fact, the origin of Switzerland's debt brake rule was to address ballooning public debt around the turn of the century that occurred following the housing price correction in the previous decade and which caused persistent weakness in tax revenue, not higher spending. A better policy mix today, along with tighter macroprudential policies, could reduce the likelihood that a similar situation would reoccur. The authorities' intention to more fully spend the approved budget allocation, as noted in their buff statement, is therefore welcome. In addition, systematic errors in forecasting structural revenues should be avoided.

The staff representative from the Monetary and Capital Markets Department (Mr. Mathieu) made the following statement:

We have issued to the Executive Board eight Financial Sector Stability Program (FSAP) technical notes in conjunction with the Financial System Stability Assessment (FSSA). They have not appeared on IMF Connect , but they were issued last Friday, and I invite Directors to take knowledge of the detailed analysis contained therein that supports the FSSA report.

Mr. Palei made the following statement:

Before I make my intervention, I would like to ask the staff about the written responses to technical questions. In the introduction to the written questions, the staff said that broader policy questions in the area of the global financial safety net (GFSN) will be addressed in the staff's oral intervention, but I have not heard anything on this topic, because we in our gray statement have asked about the adequacy of foreign exchange reserves and the swaps arrangement. I do not know if that is what was meant by the staff, but I would like to understand when the staff plans to make this oral intervention.

The staff representative from the Strategy, Policy, and Review Department (Mr. Kaufman), in response to questions and comments from Executive Directors, made the following statement:

Maybe I can say a few things on the question about the global financial safety net. The GFSN has expanded since the global financial crisis, but some of the layers remain untested. Some of the elements that had been transformed in the structure of the GFSN relate to bilateral swap lines and new regional financing arrangements (RFAs) and increase complexity. A multi-layered structure of the GFSN remains a challenge, and we have recognized that the effectiveness of many of its layers and of their interaction during crisis times remains untested. It remains to be seen how some significant aspects of the GFSN will react in times of crisis.

The Fund has done work on some areas, and the Board endorsed a framework for collaboration with RFAs in 2017, which has been guiding staff's work, in particular deepening collaboration including on joint test runs with some of these RFAs.

Mr. Palei made the following statement:

Those were not the answers we were looking for. We asked about the level of foreign exchange reserves in Switzerland and their adequacy for financial stability in particular. We understand that the current level of foreign exchange reserves is a byproduct of the monetary policy which was constrained during the crisis. But here we are today; the ceiling was abolished several years ago, and Switzerland has foreign exchange reserves at 120 percent of GDP. The question is whether this level is excessive or not. I think it is an actual question, and we have tried to answer it in most of the country discussions.

One chapter in the selected issues paper is devoted to foreign exchange reserves, but it does not contain the adequacy metrics we are used to. It does mention several other advanced economies that did experience a shortage of foreign exchange, and they had to make special arrangements to gain this access to foreign exchange, and they also concluded that higher foreign exchange would be beneficial for them. The countries mentioned in the selected issues paper were Sweden, Israel, and Poland, among others. When you look at the level of foreign exchange reserves in these countries, it is not even comparable to what Switzerland has. I have a back-of-the-envelope calculation, but it is like 15, 20, 25 percent of GDP but not 120 percent of GDP.

I also think that some of the concerns expressed by the staff in the written responses, like technical issues related to the balance sheet of the central bank, are not the most important ones. The fact is that foreign exchange reserves are very large, and the question is how to use them in an optimal fashion. We raised the possibility of creating a sovereign wealth fund. Other countries did it with their excess foreign exchange reserves. There is nothing very innovative about it. It is a straightforward approach. If Switzerland needs 20 percent of GDP in foreign exchange reserves in a liquid form, that is fine, but then there is an additional 100 percent of GDP which could be allocated to the sovereign wealth fund. This amount of resources can provide annually 3 or 4 percent of GDP in additional income to the authorities. It could be transferred to the Ministry of Finance, or other arrangements could be made. This is a valid question, and I hope the staff will comment on this a bit more. It is also related to the recommendations with respect to fiscal policy in Switzerland. If they have this extra 3 percent of GDP annually in additional income, then maybe they need to think even harder about decreasing the tax burden, and that is the authorities' preference, or what staff said about increase in expenditures.

Mr. Meyer made the following statement:

We agree that Switzerland enjoys strong fundamentals, sound public finances, and a very competitive private sector, but as in almost all cases, risks persist, especially regarding any fallout from a deterioration of the trade conflict and financial stability risks related to the low-for-long interest rate environment, especially considering the size and complexity of the financial sector in Switzerland. It is against this background that we encourage the authorities to remain attentive to these challenges and build on the successful track record of sound and prudent policies.

On substance, we believe that this debt brake framework has served Switzerland well and should basically not be changed. The Swiss fiscal rules have successfully prevented a deficit bias while allowing for sufficient financial envelopes that are compatible with public spending needs. At the same time, we see merit in more technical refinements and disincentivizing unwarranted budgetary underruns and welcome the remedial measures to this end, as alluded to by Mr. Inderbinen and Mr. Heim in their buff.

Lastly, I wanted to note a broader policy issue. We noted that Ms. Pollard and Mr. Grohovsky state in their gray statement that, "The analysis of the fiscal and monetary tradeoff is a good example of 'integrated policy', which has received much attention recently at the Fund." However, I wanted to highlight that to our knowledge the Integrated Policy Framework (IPF) makes references to exchange rate policy, monetary policy, macroprudential policy, but this does not include fiscal policy. Perhaps the Strategy, Policy, and Review Department (SPR) wants to comment. It would be good to include fiscal policy when developing that framework. We would be interested to hear one sentence from SPR on that. With this, I wish the authorities all the best.

Mr. Castets made the following statement:

We issued a detailed gray statement, so I will try to concentrate my remarks on a few points. The first one is to commend the authorities for the persistently strong performance of the economy of Switzerland, and while we agree that they may be subject to external risks mainly related to worsening trade tensions and to a no-agreement Brexit, I think we can all agree on the very strong fundamentals of the Swiss economy.

On the External Balance Assessment (EBA) methodology, we asked a written question. I would like to be sure that we understood the staff's answer. Once again, we are facing a specific case where there has been some specific adjustments made to account for the measurement biases, and we thank the staff for the detailed answer to our technical question, but still, the historical evidence shows that fiscal policy, through fiscal surpluses and foreign exchange interventions, and through reserves accumulation frequently impact current account balances, because the current account must balance out at the global level, and factors that increase surpluses in some countries must increase deficits in other countries. That is a well established fact. Reserve accumulation has an especially large negative effect on the current account balance of reserve-issuing countries, mainly the United States and the euro area.

Our point is that the P star (P*) for foreign exchange intervention maybe should not be set at zero to account for these imbalances in the case of countries that accumulate a very high level of reserves such as Switzerland, and we would appreciate if you could share your views on that aspect with us.

We also would like to reiterate the importance of rebalancing the policy mix considering that monetary policy space is shrinking in the context of the zero lower bound environment. As duly pointed out in the report, we think there is ample fiscal space for fiscal policy to be more active, less stringent on spending, and less conservative on output gap estimations, and we fully share the staff's recommendation to adapt the debt brake since the approach that is taken so far has proved to be asymmetric in its impact.

It is particularly important in the context of rapid population aging but also technical changes since there is a case to be proactive and to anticipate on the impact on the economy in the context where staff last year and in its review identified a Swiss proposal on productivity. It is a question that interested us and many Board members, so we would encourage the staff to keep digging into this issue.

Finally, on the FSSA, we encourage the supervisory authorities to strengthen the macroprudential framework and their control over the way risk exposures in the banking sector are evaluated and reported. As suggested in the report, the SNB should include major private banks in the stress testing framework, and we also find the staff's recommendation on risks stemming from crypto-related activities to be very consistent and fully aligned with the discussion we just had this morning on fintech.

Mr. Sigurgeirsson made the following statement:

The Swiss economy benefits from strong fundamentals. The fiscal position is solid, and the SNB has weathered the pressure from safe-haven flows remarkably well, managing volatility and inflation while maintaining competitiveness. We have issued a comprehensive gray statement, but I would like to highlight just a few points here.

First, we would like to reiterate our support for the authorities' view with respect to the fiscal rule. The debt brake rule has thus far supported the financing of a comprehensive welfare state while building up significant buffers. Furthermore, as pointed out by Mr. Inderbinen in his buff statement, without obvious investment, the growth boost of increased spending is questionable.

Second, we are reassured by the FSSA assessment on the strength and resilience of Swiss financial institutions. Nevertheless, given the size and complexity and interconnectedness of the Swiss financial system, the lack of breadth and strength in financial supervision remains a significant risk going forward.

We have had cases, very sad cases, of large financial sectors that are insufficiently supervised. Thus, we welcome the effort of strengthening the autonomy, governance, and accountability of FINMA and moving away from practices creating possible conflict of interest.

Third, the low interest rate environment and accumulating risks in the mortgage and real estate sectors call for swift expansion of macroprudential tools both with supply- and demand-side measures. These should be combined with an effective implementation framework and proper enforcement mechanisms reducing the reliance on banks' self-regulation, something that my constituency has some bad history with.

Lastly, it has been an interesting discussion by Mr. Palei and others on the exchange reserves. Usually we are faced with countries having too little, and the chapter on reserves was helpful but it was just descriptive. There were no policy recommendations. I would be interested to hear from the staff some color on what the ideas are. You mentioned rearranging the furniture a little bit and moving some of it to the government's balance sheet. They are a wealth fund, and they run into problems there with equity. I think I have heard the idea being floated about the Swiss bank issuing bonds themselves to increase the market or the number of investors.

Ms. Mahasandana made the following statement:

We thank the staff for the reports and response to our technical questions and Mr. Inderbinen for his buff statement. We commend the authorities of Switzerland for the sound macroeconomic policy management over years, which has yielded strong fundamentals, and we welcome their commitment to continued prudence, particularly in the view of risks to the outlook emanating from the broad domestic and external sectors. We have some brief remarks to offer for emphasis.

First, on the EBA model, we echo other Directors' gray statements in appreciating the staff's effort in acknowledging the high uncertainty in connection with the assessment, and the transparency in applying judgment for country-specific factors and measurements. We acknowledge that the model may already have some residuals, and that residuals should at best be kept at minimum. We note the staff's response to our questions that the lack of data as well as lack of sufficient time and country coverage prevent the inclusion of this important factor in the EBA model, which could explain the large unexplained residuals. At the same time, we welcome and support the staff's work that is underway to construct a large structural data set to better facilitate the EBA, as well as growing efforts to better understand the current account balance and to this end, country-specific factors. This would help enhance the quality of the EBA results over time.

Second, with regard to the staff's recommendation for the policy mix, we appreciate the analysis of the tradeoff and complementarities of the fiscal and monetary policy and, in turn, the implications for financial stability. This has underscored the significance of ongoing discussions on the appropriate policy mix in the context of the IPF, especially with regard to the point that Mr. Meyer mentioned about inclusion of fiscal policy in the IPF discussions.

In relation to the consultations on hand, this also reflects the difference in view on the appropriate policy mix between the staff and authorities, as well as Directors, particularly on fiscal policy. In this regard, we take positive note of the authorities' track record and prudent fiscal policy performance and agree that finding the right policy mix should best depend on country-specific issues and economic challenges that need addressing. To this end, we encourage the authorities to continue to be vigilant in monitoring the fiscal position to ensure that appropriate spending within the fiscal rules is undertaken to address key risks to the economy, including aging population and changes in technology.

Mr. Grohovsky made the following statement:

We issued a gray statement, so we just want to make a few points. First, we want to emphasize our support for the staff's recommendations to make the debt brake rule more symmetric, and we also welcome the detail in the staff's responses to technical questions and this morning on the social investment needs that could boost productivity. That level of detail is helpful to have in the report and they made a fairly compelling case for some increased public spending.

We also wanted to welcome the focus on the holistic policy mix that was in the report, and as Mr. Meyer said this morning, and he is completely correct, the IPF has not been mentioning fiscal policy as much. But we are in complete agreement with him that fiscal policy would be a good element to look at and a good thing to bring into that discussion, and that came up in the Independent Evaluation Office's (IEO) discussion on unconventional monetary policy as well, so we would like to see a bit more of that incorporated into these IPF discussions.

Second, going to a point that Mr. Castets commented on, we read with interest the response to the question that they asked on exchange rate intervention in the EBA model. We understand why P star (P*) for intervention should be set to zero, but in our view, Switzerland's intervention has had an effect on the real effective exchange rate (REER) and the current account balance, notably during the time when the SNB set a floor on the exchange rate, and intervention was unsterilized, and we think there are several recent studies of the Swiss experience that concur with this, so we welcome the staff's comment on that as well.

We also welcome the details in the staff responses to questions on the EU-Swiss negotiations, and seeing progress in this area is important for Switzerland. We also welcome that Switzerland should be in compliance with the base erosion and profit shifting (BEPS) initiative in 2020, which we think is a good development.

Finally, on the FSAP, it is interesting, and we welcome the progress that Switzerland has made since their previous FSAP. One thing we noted was that this was one of the first fintech pilots. The findings were that it was not a financial stability risk, and we note as well that there are not international standards on this, so we would urge some caution on approaching fintech in future FSAPs, particularly given how resource-intensive the FSAP is. There are many ways that we can do knowledge sharing and learn more about fintech developments in a country than just having an FSAP, and Mr. Inderbinen noted in this morning's meeting that this is an issue that needs to be macrocritical if it is included in surveillance. I do not know if he had this specific example in mind, but we certainly did, and that it is just something that needs to be proportionate to all the other elements that go into an FSAP.

Mr. Kaizuka made the following statement:

I would like to congratulate the Swiss authorities for the strong economic performance compared with the other advanced countries since the global financial crisis. I have to emphasize that Japan is also facing common challenges, including rapid population aging, surplus savings, and periodic safe-haven pressures, and the interest rate being in the negative territory for an extended period of time and also the necessity to enhance productivity. Reading through the Article IV report for Switzerland, we can learn many things for the future policy direction of my country, so I thank the staff for this paper.

My gray statement was quite silent on the external sector assessment, so I will make some supplementary comment on the external sector assessment of Switzerland. First, I echo to Mr. Inderbinen's call for further work on how the demographics and the pension system interact and affect savings. It is encouraging to see the answer to the question raised by Mr. Gokarn and the staff is quite committed to continue the work on how the demographics of the pension system will affect the savings and the current account balances. I look forward to the further discussion on this. I am not quite sure whether the staff is ready to make some recommendation when we have External Sector Report (ESR) discussion coming next month.

On the external sector assessment, I take note of the relatively large adjustment, there is a 4.4 percent of GDP gap between the norm and the actual current account surplus, and out of the 4.4 percent, 3.5 percent has adjusted taking into consideration the Swiss country-specific factors. It is fine if it is a very rational thing. But what struck my interest is that did include the estimated retained earnings in the portfolio equity investment, and I realize the Swiss are now engaging in abolishing the preferential tax treatment in line with the OECD BEPS Action 5, and also there is some repatriation happening, responding to the U.S. tax reform. Taking into consideration those reasons, the large portion of the adjustment will be necessary in the future consideration.

Mr. Raghani made the following statement:

We commend the authorities for their policies, which led to the good performance of the Swiss economy since the global financial crisis. We encourage them to consider implementing sound policies and reforms to enhance resilience of the economy, notably by safeguarding financial stability and containing risks from the real estate sector, as well as promoting long-term growth.

We have issued a gray statement, and I would like to make a point for emphasis related to fintech. Like Mr. Mouminah, and Mr. Heo, we appreciate the coverage of Switzerland's fintech sector in the FSSA. This is quite timely, as evidenced by this morning's earlier discussion. We encourage the authorities to continue monitoring this sector closely, given its rapid growth and evolving changes while ensuring financial stability and integrity. We welcome Mr. Inderbinen's comment on this matter.

With these remarks, we wish the authorities all success in their policy and reform endeavors.

Mr. Mouminah made the following statement:

We issued a gray statement, so I will be brief and focus my remarks on two issues, namely the policy mix and the FSSA.

First, I believe that the current policy mix has been supportive and seemed broadly appropriate. The staff has underscored that Switzerland would benefit from moving toward a more balanced fiscal position through higher public spending. In this context, I take positive note of the substantial increase in spending on education and infrastructure in recent years, as highlighted by Mr. Inderbinen in his buff statement. Also, I welcome the authorities' efforts to simplify the procedures which are expected to facilitate utilization of expenditure ceiling.

On the FSSA, I am reassured by the conclusion that the Swiss institutions are well capitalized and could withstand the severe shock under the adverse stress tests scenario. I also commend the Swiss authorities for the important reforms that have been implemented since the 2014 FSAP, including the timely adoption of the Basel III framework. I also welcome the authorities' focus on fintech and their determination to further strengthen financial stability and integrity, a point raised by Mr. Raghani earlier.

Finally, I encourage the authorities to continue to focus on closing the remaining gaps regarding international commitments and standards. In this context, it is encouraging to note the authorities' efforts to promote financial sector integrity and good governance. With these remarks, I wish the Swiss authorities continued success.

The staff representative from the European Department (Ms. Van Elkan), in response to further questions and comments from Executive Directors, made the following additional statement:

The questions broadly fell under two categories, the debt brake rule, and also reserves and the external sector assessment. Let me first address the debt brake rule issue. I hear calls to make the debt brake operate more symmetrically but a preference to do so through technical operational refinements rather than modifying the rule, which we are perfectly happy with, although if the rule were to be symmetric, it would also impact behavior as well. There is a tendency to err on the side of caution partly because the punitive sanctions apply only in one direction, but nonetheless, we are perfectly happy with technical refinements as well, which is also why we are proposing that the estimates of structural revenue and output gaps be more neutral as opposed to always erring on the side of caution.

On the reserves and the external sector assessment, in terms of the adequacy of reserves, the Fund's Assessing Reserve Adequacy (ARA) metric does not apply to advanced countries per se, so this does not give a very good guidance, but we do note some of the elements that go into this metric—import coverage and coverage of external liabilities for the economy as a whole—and in particular, because Switzerland is a financial center, it does have very high short-term liabilities related to banks—reserves cover somewhere between 80 to 120 percent of those short-term external liabilities. We are not arguing by any means that there is a need for more precautionary reserves for this purpose. The first line of defense is for banks to self-insure, and this is also what the FSAP was looking at when they were doing their liquidity stress tests. Since the global financial crisis, there have been the liquidity requirements by currency as well, so the onus is primarily on the banks to do this, but the central bank is there as a backstop.

In terms of what the implication is for the optimal level of reserves and whether this would impact the P star (P*), it is worthwhile noting that divesting reserves would imply a tighter monetary policy, and this would lead to an appreciation of the real exchange rate. We observed that the current account itself is not terribly responsive to the real exchange rate, but nonetheless, some important sectors of the economy, and these are those which also tend to be more labor intensive, are still vulnerable to real exchange rate changes.

I would also note that there is another point about creating a sovereign wealth fund. Already some of SNB's profits are transferred every year to the cantons to support their spending. This is based on an agreement reached every five years between the SNB and the owners of the bank, which are, in fact, the cantons. There is the balancing between building up the capital of the SNB, which was depleted at the time of the crisis— it needed to intervene in the financial sector—and meeting the spending needs of the cantons. This profit-sharing arrangement is up for discussion next year or the year after, so given that the SNB has a stronger capital position, maybe there is some flexibility to move in that direction, increasing transfers to the cantons.

Going back to the P star (P*), this would be a decision not just for Switzerland. This has implications for a number of countries across the membership where the P star (P*) is set to zero, so it would require consideration from a broader perspective.

In terms of demographics and savings, we noted in our written responses that work is ongoing on this front, and it is quite possible that different pension schemes can affect savings. The most obvious way to think about this is if the mandatory contribution rate is higher than what would be the voluntary counterfactual rate, but there are also issues related to how much risk is pooled by having these schemes as well.

In terms of how the EBA adjustment might be impacted by the corporate income tax reform, this is reflecting both the Swiss corporate income tax reform and the international tax reforms, so there was an impact in the external accounts in 2018 as a result of the U.S. tax reform. This led to large gross flows but very little change in net positions, either in the current account, the income account, the financial account, or in the net international position. However, going forward, this is a question and is also linked to what the revenue impact of the reform will be for the fiscal sector as well. It could be that the current account income flows might be smaller in the future, as would corporate income tax revenue for the cantons.

Mr. Palei made the following statement:

I have a question that is not related to the discussion on Switzerland, but we did ask it in our gray statement. I did not want to contaminate a good discussion on the policies in Switzerland and the recent developments. But I do not know whether it was a Freudian slip or something else, but the staff referred to Poland as an advanced economy in the report, and in the past, our office argued in favor of such an approach. Mr. Panek and, if I recall correctly, Mr. Trabinski as well, mentioned that Poland could be an advanced economy. But the Fund considers it as an emerging market economy. Maybe it is a question for SPR. Are there any rules for references to any countries as is it an emerging market economy or an advanced economy, or do country teams have complete freedom in applying their judgment? Maybe this team thinks Poland is an advanced economy and that it is less advanced. Are there any guidelines, any rules, and also how does the Transparency Policy apply in this particular case? Is it possible to change the wording for staff, or are there some other rules guiding this situation?

The staff representative from the Strategy, Policy, and Review Department (Mr. Kaufman), in response to further questions and comments from Executive Directors, made the following additional statement:

The World Economic Outlook (WEO) has some classification of countries, and that is what we usually use. I can check the case of Poland. In terms of transparency, if this is a factual mistake, we have to go back to transparency theme, and we can discuss that. These appear in the selected issues paper, not in the staff report, so we will have to look into how we can make that amendment, but we need to discuss that with the Transparency Policy team.

There was another question on the role of fiscal policy in IPF, and that is a very fair question, and we got quite good feedback during the Spring Meetings on the need to explicitly consider fiscal policy in the context of the IPF, and the teams working on the three legs of the IPF are now in the process of seeing how they can adjust their approach. I cannot speak to the extent and how they are going to do it, but that was important feedback we got during the Spring Meetings on the IPF workstream.

Mr. Palei made the following statement:

I thank staff for the reply. I am a little disappointed that you have not looked into it since we did have this question in our gray statement, but I would appreciate if you would get back to us and maybe send a copy of your response to other offices, because it is an interesting while albeit very technical matter.

Mr. Inderbinen made the following concluding statement:

I thank Directors for their thoughtful gray statements and also for their contributions to the discussion this afternoon. I would like to state that the Swiss authorities very much appreciate the dialogue with staff, and the high appreciation is fully compatible with the fact that the agreement does not necessarily extend to all of their policy recommendations.

I would like to make a few points on some of the issues that have come up in the discussion and in the gray statements. First, on fiscal policy and the policy mix, as noted, the fiscal position remains firmly anchored in the debt brake rule, which was adopted in the early 2000s after a decade of rapidly growing debt levels. The rule is widely seen as a success in Switzerland and an example of good practice, and this was acknowledged in many of the gray statements, including by Mr. Meyer, Mr. Gokarn, Mr. Sigurgeirsson, and in some of the comments this afternoon.

As indicated in our buff statement and as discussed earlier, the government has decided to make recent improvements in a targeted and technical sense to the rule, and the simplified procedures within the supplementary budget should reduce the incentives for ministries to over-budget and should contribute to expenditures ceilings being utilized more fully in line with the rule.

I should state that suggestions for increased expenditure, including those made by the staff in their written answers and reiterated earlier, would need to be assessed against the principle of subsidiarity that governs all levels of government in the country, and also with a social preference to limit the overall size of government.

Turning to monetary policy, the authorities agree with the staff that the current accommodative stance remains appropriate. At the current juncture, the negative interest rate on sight deposits and the willingness of the SNB to intervene in foreign exchange markets as necessary remains essential. The two-pronged strategy is aimed at ensuring price stability.

We would also like to note that foreign exchange interventions are published in an easily accessible manner in the SNB’s annual report, and interventions can also be deduced quite precisely from the weekly publication of data on sight deposits at the SNB.

Moving on to the external sector assessment, we would like to highlight again the importance of taking into account country-specific factors. The staff has elaborated on the adjustments and revisions associated with the measurement issues, and I would like to offer one comment on the demographics, pensions, and savings. High household savings can be traced back to a significant extent to contributions to the capitalized and compulsory second- pillar system of the pension system. This second pillar accounts for 6 percent of household savings, which is high across international comparison. This also reflects that over the next few decades, the share of retirees in Switzerland is projected to increase significantly.

On the financial sector, we welcome the positive assessment of financial sector stability, and we take good note of the encouragement in many of the gray statements to take action on the FSAP recommendations, including on possible additions to the macroprudential toolbox, the governance issues related to audit supervision, and crisis management. As noted at the outset, measures are in train to mitigate the stability risks that are associated with mortgage market risks and the real estate sector.

Last but not least, on governance, Switzerland has participated in this Article IV cycle in the voluntary assessment of its anti-bribery and AML/CFT frameworks under the so-called fourth element of the Fund’s enhanced engagement on governance. The authorities welcome the staff’s assessment of the framework’s effectiveness and the detection and repression of transnational corruption, and we would also encourage other members that have yet to commit to voluntary assessments to do so.

In closing, I would like to express our gratitude to Ms. van Elkan and Mr. Mathieu and their respective teams for the excellent work on the Article IV consultation and the FSAP. We thought the reports were very well-crafted and clear on the respective views of the staff and the authorities, and the three selected issues papers have added considerable background information to some of the critical aspects.

The Acting Chair (Mr. Furusawa) noted that Switzerland is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the Swiss authorities for the economy's good performance since the global financial crisis. Directors considered that prospects are favorable, with moderate growth and subdued inflation, although intensification of international trade tensions, renewed safe-haven pressures, and imbalances in the domestic real estate market weigh on the outlook.

Directors praised the authorities' overall management of the macroeconomy, although many Directors saw scope to rebalance the policy mix. Very accommodative monetary policy has helped deter safe-haven pressures and reverse earlier deflation, but has also encouraged search for yield by the financial sector. Directors concurred that the current accommodative monetary stance should be maintained. While limited room remains to further ease monetary policy if needed to secure price stability, many considered a more prominent role for fiscal policy in view of the substantial fiscal space. A few Directors, however, emphasized that public spending would not be effective at addressing exchange rate shocks. Directors agreed that any reduction in the policy interest rate would also reinforce the need to tighten macroprudential policies. Foreign exchange intervention should be reserved for addressing large exchange market pressures, provided the trend appreciation is allowed.

Directors welcomed the reduction in public debt achieved under the fiscal debt break rule, while recognizing that the current framework has served the country well. Many Directors recommended moving to a balanced structural position in light of the low level of public debt and favorable debt dynamics, including through refinements to avoid underspending. Doing so would allow room for addressing long-term challenges such as technological change and population aging, and compensating any revenue shortfalls from corporate tax reform. A few other Directors underscored that the primary purpose of the debt break rule is to avoid a deficit bias and ensure the predictability of fiscal policy.

Directors welcomed the FSAP's findings and endorsed its main recommendations. They supported expanding the macroprudential toolkit to encompass additional mandated instruments, accompanied by a framework with enhanced expectations to act. Directors also recommended strengthening the governance, autonomy, and resources of the financial sector supervisor and recommended allowing it to directly contract and pay for outsourced supervisory audits. They encouraged further reinforcement of the financial safety net and crisis management arrangements, including improving banks' recovery and resolvability and establishing an effective public deposit insurance agency. To contain risks in the real estate sector brought by low interest rates, Directors called for introducing new measures to restrain demand for high-risk mortgages, together with tighter amortization requirements and removal of tax incentives that encourage high household leverage. Directors welcomed the authorities’ actions to strengthen anti-foreign bribery enforcement and looked forward to continued progress in enhancing the anti-corruption and AML/CFT regimes.

Directors recommended continuing to prepare for population aging, increased automation and new work arrangements. They welcomed the recent approval of the referendum on corporate income taxation and pension systems as important and encouraged prompt implementation of these reforms. They also encouraged maintaining the high-quality of education and investment in innovation and reviewing social safety nets to ensure they are compatible with new work arrangements.

It is expected that the next Article IV consultation with Switzerland will be held on the standard 12-month cycle.

APPROVAL: October 1, 2021

CEDA OGADA
Secretary

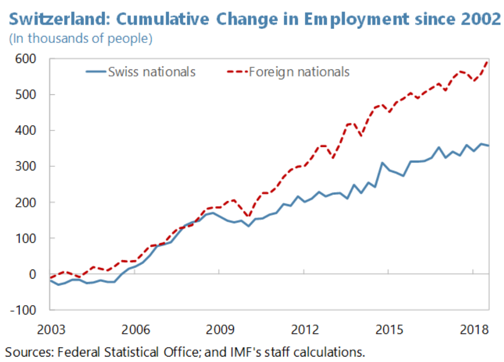
Annex

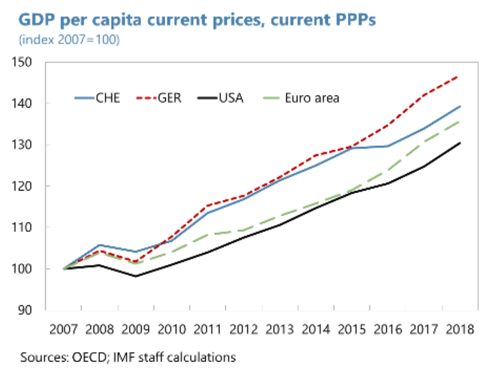
The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Real Sector

1. ***While growth has been relatively stable on an aggregate basis it has been fairly subdued in per capita terms since the GFC. We would have appreciated a closer look at this metric, including at how it compares to peers, underlying factors, and impediments to a more vigorous growth performance on a per capita basis in the staff report. Staff comments would be welcome.***

- Switzerland's cumulative economic growth compares favorably with other advanced economies. A considerable part of this growth was due to an increase in employment. Part of this increase came from employment of Swiss nationals, with a larger part from an increase in employment of foreign nationals. This latter group also added to the Swiss population. Adjusting for the change in population, Switzerland's per capita growth in real income has been slower than in several other advanced economies.





- Nonetheless, Swiss labor productivity—which is invariant to the nationality of employed workers—remains relatively high, which has supported high and rising wages (see accompanying SIP).
- Moreover, measured in terms of purchasing power, Swiss incomes have risen quite strongly on a per capita basis since the GFC. This reflects both the increase in real output per person, and the increase in purchasing power that has come from the real appreciation of the franc.

- Real GDP growth has benefited from growth in world demand. Real Swiss exports have risen in line with trading partners' real import demand, despite the strong real appreciation. On the other hand, domestic demand has lagged overall GDP growth.

2. ***On the external front, we note that staff include uncertainties regarding the framework agreement with the European Union, while the Risk Assessment Matrix specifically refers to possible delays in the adoption of the corporate tax reform and the removal of the EU-equivalence of the Swiss stock exchange, which is not mentioned in the Financial System Stability Assessment. What factors justify the inclusion of the risk of removal of the EU-equivalence of the Swiss stock exchange?***

3. ***Regarding downside risks, we believe that the uncertainties around the framework agreement between Switzerland and the EU are downplayed. The rejection by the Federal Council of the agreed text last week could have a series of negative consequences, such as on access to some EU markets and the loss of stock market equivalence, which would impact business confidence and investment. Staff's comments are welcome.***

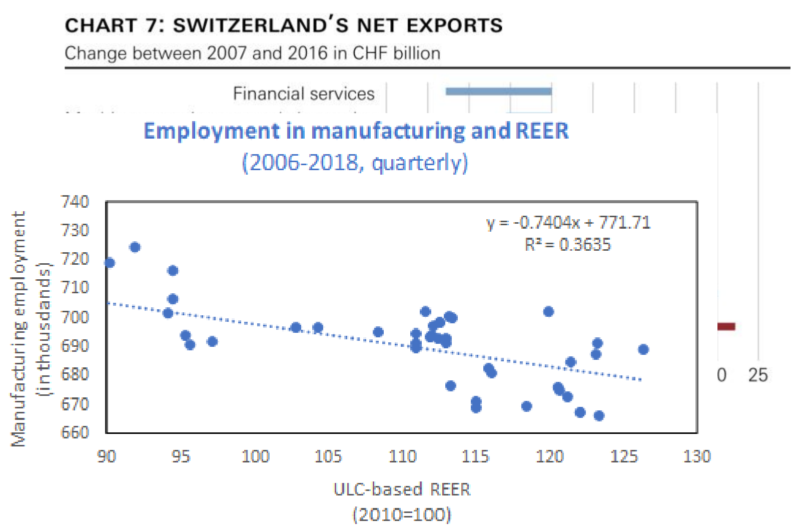
- Switzerland and the EU enjoy strong mutual benefits from their close economic integration and cooperation. Maintaining Switzerland's access to EU markets, which absorbs more than half of Swiss exports and are the source for three-quarters of its imports, is essential. Relations are currently governed by a network of 120 bilateral treaties. A proposal to replace this network with an institutional framework agreement has been under discussion for several years. Last week the Swiss Federal Council announced that the draft institutional agreement between Switzerland and the EU was broadly positive, but requested several clarifications.
- Lack of agreement on the new framework could result in EU-based investors being unable to directly access the Swiss stock exchange owing to the non-extension of equivalence status under the EU's MiFID II (new markets in financial instruments directive). The capitalization of the Swiss equity market is the fourth largest in Europe, and EU-registered entities account for about one-third of trading.
- Approval on May 19, 2019 of the referendum on corporate tax and first pillar pension funding allows for abolishing from 2020 preferential tax regimes that no longer

conform with international standards. Switzerland would therefore be in compliance with the OECD's Base Erosion and Profit Shifting project and initiatives by the EU at that time.

- Bullet 3 of the FSSA RAM (Appendix II) also notes "Unsatisfactory conclusion of ongoing discussions on the Swiss-EU framework agreement … " as a risk. Removal of the stock exchange equivalency is part of that EU-Swiss risk.

4. ***What is somewhat notable is that the appreciation trend has not resulted in a deterioration of the trade balance, perhaps signaling that productivity growth in tradable sectors has remained robust. Staff's comments are welcome.***

- The Swiss trade balance has important components that are less affected by movements in the REER. In particular, pharmaceutical and merchanting sectors have dominated the trade balance in recent years (as discussed in SNB President Jordan's speech). The trade surpluses for these two industries have increased irrespective the movements in the exchange rates. Strong performance of the pharmaceutical industry benefitted from the growing global demand for healthcare products. Merchanting was boosted by the growing importance of Switzerland as a hub for global commodity trade. Another sector less elastic to REER movements is luxury goods, which is also developed in Switzerland.
- The performance of these above-mentioned sectors contrasts with some other industries, which were hurt by the REER appreciation.



- The REER appreciation have had an adverse impact on employment in the exchange-sensitive sectors, in particular, in manufacturing.

Monetary Policy

5. ***Could staff shed light on to what extent the interest rate could be further decreased if needed?***

- The extent to which interest rates could be further reduced is not known with certainty, although scope to lower rates can be increased through mitigating policies.
- Cash storage costs and the inconvenience of and security concerns about holding large amounts of cash are important considerations. At sufficiently negative interest rates, the public may decide to convert deposits into cash, which erodes banks' funding base and pose risks to financial stability, while also hampering the transmission of monetary policy. Considerations regarding the extent to which the interest rate could be further reduced includes a search for yield by the financial sector, which could intensify financial stability risks, and the risk banks face in replacing deposits with alternative sources of financing.
- The SNB can reduce incentives for converting deposits into cash and risks posed by the search for yield by introducing further tiering of bank deposits at the SNB, or by remunerating banks' currently zero-yielding reserves at a modestly positive rate, while keeping unchanged the threshold and remuneration rate subject to the negative interest rate policy. In addition, tighter macroprudential policies would help to limit risks to financial stability.

6. ***We see merit in having a holistic analysis on negative interest rate, including its macroprudential side effects and impacts on bank profitability, to offer the authorities a useful reference. Staff's comments are welcome.***

- If needed, moving further into negative interest rate territory remains feasible but it risks a search for yield by the financial sector and could affect banking profitability (see 2018 SIP on how banks have adjusted to negative interest rates). Since the introduction of the negative interest rate policy, domestically-focused banks have managed to preserve their return on assets due to an expansion in mortgage lending, while the burden of negative interest rates has been limited due to large exemption thresholds of bank deposits at the SNB; and lower credit losses, value adjustments and provisions, and greater cost efficiency.
- Reducing interest rates further, however, would strengthen the need for tighter macroprudential measures to contain excessive risk-taking in the real estate sector. Moreover, measures to restrain demand for high-risk mortgages and tightening existing generous amortization requirements would help to avoid excessive risk taking.

7. ***To what extent should the SNB respond to renewed safe haven appreciation pressures? What instruments are at its disposal, taking into account the already relatively low policy rates maintained by the SNB and large balance sheet, relative to other major central banks?***

- The SNB should lean against large appreciation surges through FX intervention that would otherwise push the real exchange rate well-above its trend appreciation path and cause excessive volatility in inflation and output, provided that the trend appreciation is maintained. Given the now more-limited monetary policy space but substantial fiscal space, fiscal policy should also contribute to supporting inflation and growth.

- By contrast, a change in interest rates is best suited for responding to persistent weakness in inflation and activity.

8. ***While the large reserves held by the SNB contribute to financial stability, we wonder whether there are risks associated with the large SNB balance sheet and how these risks could be addressed. Staff comments are welcome.***

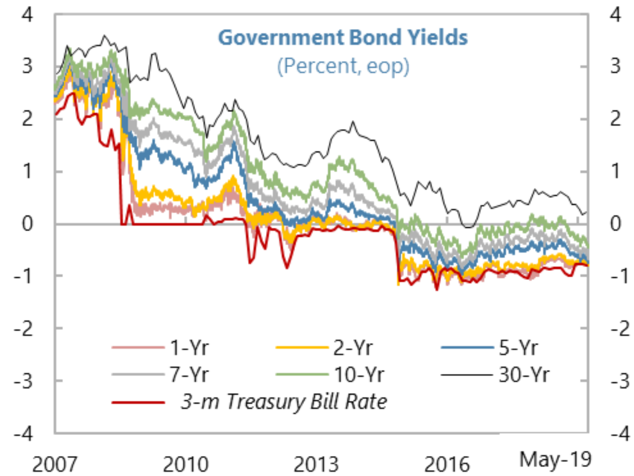
9. ***While the SNB is a passive investor, its holdings of equity positions in US companies is significant albeit the latter display a high market capitalization. More generally, we are wondering how staff assesses the trade-offs between this type of tactical portfolio allocation of external assets and the Central Banks' responsibilities for preserving their independence, financial stability and liquidity risk management.***

- The SNB's monetary policy objective takes primacy over foreign exchange reserve management in order to avoid conflicting objectives. Investment policy guidelines dictate how reserves are managed, and focus on security, liquidity and return on investment. Diversification across asset classes helps to limit risk, however risks associated with the Swiss franc cannot be mitigated as this would intrude on monetary policy.
- To preserve its independence, the SNB pursues a passive rather than tactical investment strategy. The SNB's Governing Board sets the broad investment principles and strategy, while the SNB's Asset Management unit implements the strategy, and its Risk Management unit monitors implementation. The SNB seeks to avoid disrupting the markets in which it participates, preferring deep markets, which mitigate liquidity risks, and adjusting gradually to its desired portfolio to avoid financial stability risks. The SNB does not invest in major banks. The SNB's reserve portfolio comprises mainly of highly-rated sovereign bonds, which are safe and liquid.
- A large balance does however expose the SNB to valuation losses. To safeguard its equity position, and ultimately its independence, the SNB allocates provisions for currency reserves of a minimum of eight percent per year to build up capital. Provisions total 11 percent of GDP, and the SNB's equity capital was around 16 percent of GDP at end-2018. A large balance sheet may also attract proposals on how it might be deployed, which could also impinge on independence.

10. ***That said, we wonder, if and to what extent, FX interventions by SNB could have stimulated excessive credit to mortgages. Staff comments are welcome.***

- Mortgage credit has been fueled by the environment of low interest rates, both globally and in Switzerland. A high domestic saving rate and the franc's status as a safe haven currency also fuel demand for Swiss assets, raising their price. While the

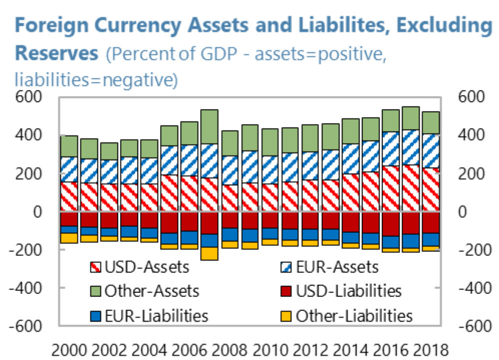
SNB's policy rate has remained unchanged since early 2015, the interest rate on 10-year Swiss government bonds recently declined to -0.45 percent—close to their lowest ever level—in response to renewed regional and global concerns.



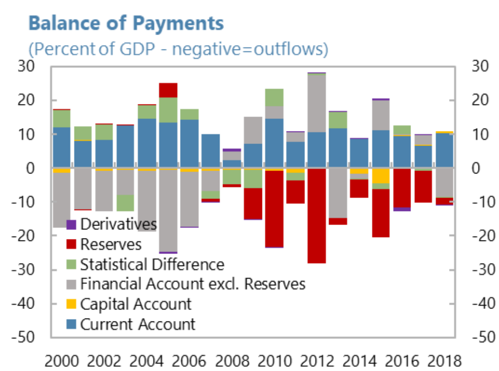
- The SNB has purchased foreign reserves and expanded its balance sheet to support inflation and growth mainly during periods of inflow surges that otherwise would have appreciated the franc even more sharply than occurred. If it had not intervened, one might even expect that the additional demand for Swiss assets would have further pushed down Swiss interest rates (see related 2018 SIP) and stoked demand for investment property and mortgage credit.

11. ***Depending on the composition of portfolio investment liabilities and the volatility of currency options which are not mentioned in the document, we would be interested in staff's point of view on the potential causal connection between accumulation of reserves and private sector' risk taking in the case of Switzerland.***

- Before the crisis, private sector financial net outflows broadly counterbalanced the current account surplus, neutralizing the effect on the balance of payments. From the start of the crisis and until 2018, private net outflows largely dried up, and there were inflows in several years.[2] High savings have persisted but with a preference for domestic assets to avoid valuation losses on unhedged foreign-currency assets (or the cost of hedging) in the context of the higher post-crisis risk of appreciation given the franc's safe-haven status. As a result, intervention by the SNB supplanted private sector financial outflows. More recently, decreased volatility of the franc coincided



Sources: SNB; and IMF staff calculations.



Sources: SNB; and IMF staff calculations.

[2] In addition to the change in direction of private financial flows, the type of private financial flows shifted, with fewer related to FDI and portfolio investment, and more of "other investment," including currency and deposits.

with a resumption in mid-2017 of private financial outflows that restored the pre-GFC balance of payments pattern. Private sector foreign currency-denominated assets have also risen.

12. ***From this point of view, this type of reserves management already demonstrates many features of a possible sovereign wealth fund. According to staff, the debates about the costs and benefits of formally creating such a fund are not new to the Swiss authorities. We would welcome additional information on these debates and would be interested in staff's opinion on this matter.***

- The SNB's stock of reserves is a by-product of its constrained monetary policy. The SNB purchased foreign reserves and expanded its balance sheet to support inflation and growth in response to safe haven inflow surges and once the policy interest rate had been reduced close to zero. The balance sheet counterpart to these reserve assets is primarily central bank monetary base (a short-term liability, mainly to banks).
- A sovereign wealth fund is a depository for wealth or profit, usually constituted from sales of natural resources or windfall tax revenue and, as such, assets are not offset by liabilities (instead, by equity). By contrast, transferring the SNB's reserves out of its balance sheet would require the simultaneous transfer of liabilities or create an equity shortfall that would need to be plugged. Alternatively, the government could choose to purchase the reserves from the SNB, and in return issue government debt to the SNB, but is constrained by its DB rule. Even if government securities were issued in exchange for reserves, they may not have a similar liquidity structure as the reserves they replaced. Another issue is that just as reserves were accumulated for monetary policy reasons, in the future there may be a need to divest reserves if demand for the franc were to decline.

13. ***We would also appreciate staff's elaboration on the apparent difference of views with monetary authorities, regarding the available room for monetary policy accommodation.***

- Views on monetary policy between staff and the authorities are closely aligned. Both agree that the current expansionary monetary policy remains appropriate, and that some--albeit limited--policy space exists to respond to a substantial deterioration in economic conditions, whether it be safe haven inflow surges or a sustained weakening of inflation and growth. In addition, both concur that, as a complement to monetary policy, macroprudential policies should be tightened to contain excessive risk-taking in the real estate sector.

Fiscal Issues

14. ***Further, given the levels of surplus, the shift to a structurally-balanced fiscal position through an increase in the public spending to GDP ratio—including by the cantons has been recommended. Could staff offer more insight on the gaps which***

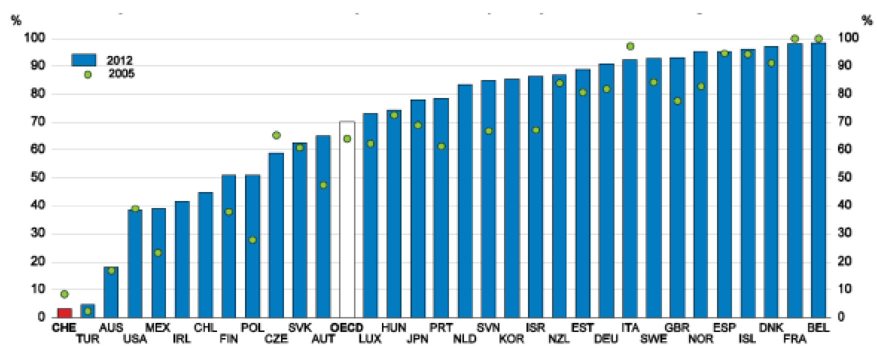
are needed to be addressed through this increase in fiscal spending and the risks that this may entail if the shift backfires?

15. ***That said, we note that the authorities do not see a lack of public spending as an issue and question whether the proposed increase in public spending would sustainably boost growth. Staff comments are welcome.***

- By international comparison, Switzerland scores highly on physical and digital infrastructure. However, there is scope for further investment in social infrastructure in order to foster a more productive domestic workforce:

○ Increasing spending on early childhood education and daycare, especially for children from immigrant families (and more generally children with disadvantaged socio-economic backgrounds). According to the 2016 OECD Paper on Raising Public Spending Efficiency in Switzerland, "Across OECD countries, enrolment of children at age three in pre-primary education has increased from 64 percent on average in 2005 to 70 percent in 2012. But in Switzerland, despite recent progress, childcare places are still in short supply, and only 3 percent of children aged three are enrolled in pre-primary education, the lowest rate in the OECD" (Figure below). Increasing spending on affordable childcare would also reduce disincentives for women to return to the labor force while enhancing future human capital.

Figure: Enrolment rates in early childhood and primary education at the age of three



Source: OECD, Education at a Glance 2014 database.

○ Improving the education outcomes of children of immigrants, who lag their Swiss counterparts, should be a priority given Switzerland's shortage of skilled workers. Based on the OECD's Economic Survey of Switzerland (2017), the children of immigrants in Switzerland lag significantly in science performance relative to non-immigrant students (a performance gap in PISA educational scores of 63, compared with an OECD average of 44). More generally, youth in Switzerland with immigrant backgrounds significantly underperform according to PISA, where the average score of immigrant students is 464, compared to 527 for non-immigrant students. Moreover, the underperformance persists across generations in Switzerland as first and second- generation immigrants have similar average scores.

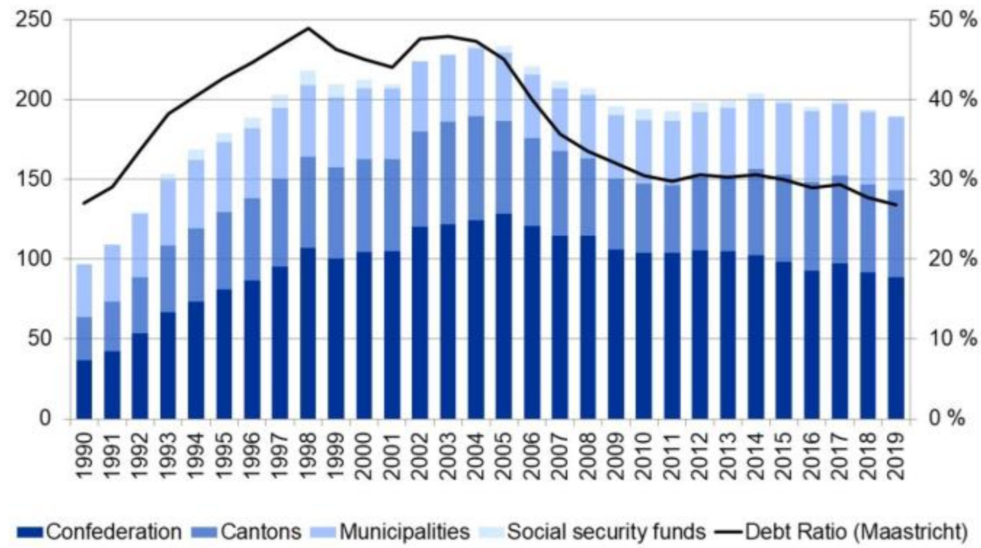
- ○ Addressing the high dropout rate at some universities for example by improving educational preparedness at high school and increasing resources for study-and-career guidance counselling for high school students.
- ○ Supporting cantonal investments in key priority projects in health and education. For example, one large canton identified investments in the Technical University and higher education institutions as key priorities, but its cantonal fiscal rule is precluding undertaking this investment.

- Pro-growth spending today would prove partially self-financing over the medium-term. Overall, the payoff from additional spending in the areas identified above is likely to far exceed risks. In view of the very strong fiscal position, ample scope would still remain to provide sizable discretionary stimulus if needed to address a sharp slowdown in activity.

16. ***Could staff comment on what the appropriate levels of public debt are for a smaller highly open economy like Switzerland?***

- General government debt Switzerland peaked at close to 50 percent of GDP in the late 1990s, and has been declining since the early 2000s, reaching 27 percent of GDP in 2018 according to the Maastricht definition (see the Figure below). The GFS definition indicates a higher level of public debt and a smaller decrease in the debt ratio as it includes mark-to-market valuation changes, including as a result of declining interest rates on sovereign bonds (and hence higher prices). In contrast, the Maastricht definition captures only the government's payment obligations.
- Switzerland's level of public debt is relatively low by comparison with other OECD countries, as illustrated on page 10 of the staff report. According to staff's debt sustainability analysis, debt is also sustainable and expected to decline to 32 percent of GDP by 2024 (and around 20 percent of GDP on a Maastricht definition). Gross debt would continue to decrease relative to GDP if government spending were to increase marginally, as recommended by staff. In addition, using a common cross-country methodology, staff assesses that Switzerland has "substantial" fiscal space.

Figure: Maastricht debt 1990–2019, in CHF bn (left axis) and in percent of GDP for the general government (right axis)



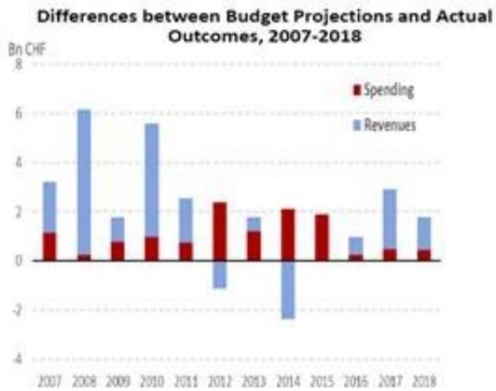
17. ***We learn from Messrs. Inderbinen and Heim that, contrary to staff recommendation to let the fiscal rule's ex-post provision operate symmetrically to allow spending to catch up the following year, the authorities have opted to simplify procedures for within-year supplementary budgets to incentivize better utilization of expenditure ceilings by line ministries. Staff may wish to elaborate.***

18. ***On this issue, we see merit in the staff's call for making more use of the automatic stabilizing objective of the debt brake rule (without changing the rule), including through avoiding overly-conservative forecasts. Were the authorities open to this advice?***

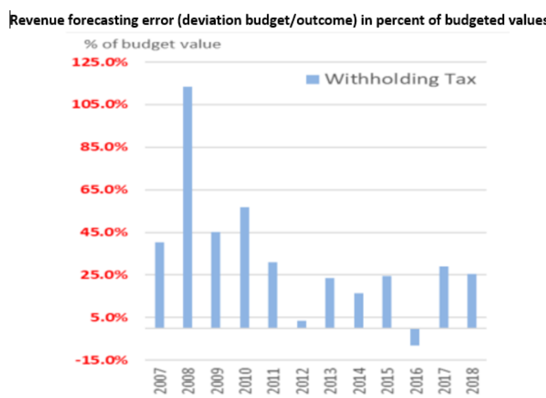
19. ***Nevertheless, the authorities do not see the need to change the DB rule and consider that the DB framework provides sufficient growth-enhancing and counter cyclical support to stimulate the economy and address potential cyclical downturns. Staff comments on the adequacy of the framework to provide a stimulus are welcome.***

- The conceptual framework underpinning Switzerland's DB rule is rightly recognized as well designed for providing countercyclical support to the economy through the operation of automatic revenue stabilizers, while also gradually lowering the debt to GDP ratio. As written in the Federal Constitution, expenditures should balance expected receipts after accounting for the cyclical position of the economy. (An exceptional access clause allows to increase the spending ceiling during extraordinary circumstances.) In the event of spending overruns, an offsetting reduction in future spending is required. This requirement operates asymmetrically, with no requirement to make up in the future any past underspending.

- Implementation of the rule indicates a further tightening bias. According to the authorities, since 2007, the fiscal outturn at the federal level has exceeded the projected level, with the exception of 2014. (Other levels of government also run surpluses.) Overperformance reflects both spending underruns and stronger than forecast revenue. Average overperformance amounts to about 0.5 percent of GDP per year.



- Relative to structural balance, maintaining a structural surplus during periods of weak growth imply a further drag on activity and place a greater burden on monetary policy to support the economy and deliver price stability.



- The revenue forecasting error is particularly high, and rather systematic, in the case of withholding taxes as indicated in the chart below that presents the deviation of actual withholding tax revenues from budget projections (expressed in percent of the budget value, whereby a positive figure indicates that revenues have been underestimated. The part of revenue that is attributed to structural factors (and hence can be spent) also tends to be underestimated owing to assumptions of too-strong cyclical conditions.
- The authorities' proposal in their buff statement to more fully execute the approved spending ceiling within the given fiscal year is fully in line with staff's recommendations. This should be complemented with improved procedures for estimating the output gap and forecasting structural revenue, thereby allowing spending to better match structural revenue. This additional room for spending under the DB rule could be used to further compensate cantons for CIT revenue loss, and/or to prepare for technological change and population aging.
- A second-best alternative would be to allow the rule's ex post provision to operate symmetrically, thereby permitting previous fiscal overperformance to be spent the subsequent year.

20.

Moving from a continued fiscal surplus to a balanced position would allow an increase in spending to notably face the long-term challenges related to population aging and evolving technology. We would appreciate staff's elaboration on the analyses and recommendations made by the Group of experts in 2017.

21. ***We note of the staff's view that a less-conservative implementation of the DB rule would make room for additional spending, including health care and other social spending. On the other hand, the authorities comment that a group of experts recommend to lower taxes, rather than to raise spending, if any changes were made. Could staff elaborate more on the differences of the views and their background?***

22. ***We would appreciate staff's reflections on the pros and cons of these three policy options at the current juncture, namely using fiscal space to increase spending, reducing taxes or saving the fiscal space for a significant downturn.***

- In mid 2017, a group of experts considered whether budget (i.e., spending) underruns should continue to be used to reduce debt. They expected budget underruns to decrease in the next few years owing to a new expenditure management model and the normalization of interest rates and inflation trends. They suggested expanding the debt brake if the budget underruns remained "sustainable and considerable" in the coming years. The group was skeptical about the alternative of raising expenditure, and interpreted the budget underruns as a sign that the tax burden is higher than it needed to be, and therefore was more in favor of a tax cut than an increase in expenditure.
- According to the authorities, the administrative reforms in connection with the New Management Model for the federal government increased flexibility in budget implementation by allowing more broadly-defined budgets. The goal of the reform was to introduce performance-based budgeting rather than to reduce underspending. According to the authorities, underutilization of budgeted funds remained unchanged in 2017 but lower in 2018. The fact that spending has begun to move closer to budgeted amounts is welcome and an appropriate use of the space under the DB rule.
- With public debt already moderate, staff sees no need to continue to run sustained structural fiscal surpluses. Staff also recommends raising spending rather than lowering taxes to make room for additional spending to compensate cantons in case of any remaining revenue loss from CIT reform (so that cantons are not forced to cut their own spending), and to provide resources for additional social and educational spending. Current proposals by the authorities to instead "spend" the surplus by providing tax expenditures would have the effect of making the tax system more distortionary and more regressive.

Financial Stability

23. ***More specifically on house prices and household indebtedness, we would be interested in staff's assessment on current proposals under negotiation in Switzerland, especially regarding real estate taxation and their potential impact on***

alleviating pressures in the housing sector as well as on incentives for high household leverage (para. 31, 33).

- Current tax treatment of housing, whereby mortgage interest payments and maintenance costs are tax deductible gives homeowners an incentive to maintain large unamortized mortgages while investing their savings in third-pillar pension funds or other assets which are tax-privileged (in particular, assets which generate tax-exempted capital gains). This creates incentives for holding elevated gross debt. Swiss household's gross debt in relation to disposable income is among the highest across OECD countries, mainly due to mortgage debt. Simultaneously reducing households' gross debt and gross financial assets would lower their direct and indirect exposure to real estate on both sides of their balance sheet.
- The authorities recognize that tax incentives on residential property encourage the accumulation of mortgage debt. An advisory board recommended implementing changes to residential property taxation as a priority.
- To ensure tax neutrality of housing, the tax deductibility of mortgage interest payments should be accompanied by removal of taxation on imputed rental income.
- Parliament is currently discussing eliminating taxation of imputed rent but with only partial removal of mortgage interest deductibility, with possible exemptions for first-time home buyers. However, eliminating the tax payment while still allowing the tax deduction would incentivize further increases in indebtedness and further raise house prices, which is contrary to the objective of the reform.

24. ***At the same time, with the currency highly valued and the ultra-low interest rates, we wonder about the vulnerabilities accompanying a prolonged period of negative interest rates in the present conjuncture of tightening of financial conditions. We invite staff comments.***

- Global financial conditions have loosened during 2019. This suggests that monetary policy in Switzerland is likely to remain accommodative, and that Switzerland could face safe haven inflows. Private sector credit relative to GDP has risen strongly since the global financial crisis and exceeds its long-term trend. As a result, financial stability risks could intensify, especially in residential real estate, at a time when vacancy rates are increasing.

25. ***To what extent does staff consider as appropriate a tightening of loan-to-value and/or loan-to-income standards to alleviate financial stability concerns stemming from the housing market? What other measures could be considered to curtail real estate speculation (investors' search for yield)?***

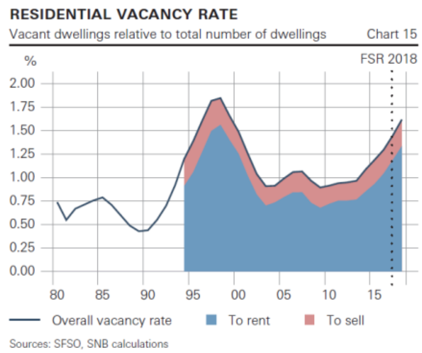
26. ***Are there any plans to revise the amortization requirements that have also contributed to the high household leverage?***

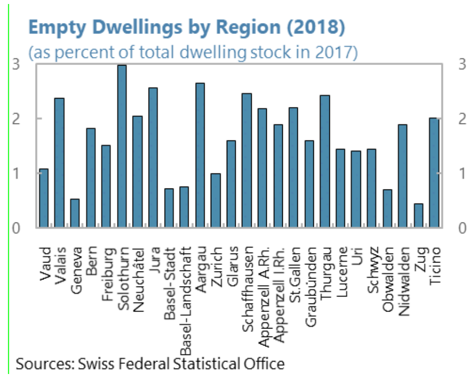
- Based on an SNB survey of mortgage borrowing, newer-vintage mortgages are more risky, with nearly half exceeding indicative loan-to-income affordability thresholds and also carrying high loan-to-value ratios (2019 and 2018 SNB Financial Stability Reports). Therefore, tightening loan-to-value and/or loan-to-income standards would help to reduce borrowers' eligibility for these risky loans, thereby limiting the build up of risk in the housing and credit markets. Demand side measures (e.g., LTV and amortization requirements) would be appropriate to address risks associated with affordability concerns. With banks already having adequate levels of capital and able to generate new capital when issuing loans, supply-side capital based measures may be less effective at the current juncture.

- The Swiss Bankers Association (SBA) is considering a revision to the self-regulation guidelines that would reduce the LTV ratio and shorten the amortization period for new loans financing residential investment property. If the SBA's tighter self-regulation measures are approved by FINMA, they would become a binding regulatory standard. Also, the Federal Council has proposed to raise the capital requirement on high-LTV loans for residential investment property. This would involve increasing the risk weights for loan tranches exceeding two-thirds of the residential investment property's value.
- In its 2019 Financial Stability Report (June 2019), the SNB calls for targeted measures for residential investment property lending, and supports the Federal Council's proposal to increase risk weights for high-LTV loans financing residential investment property, and the SBA's readiness to consider reducing the LTV ratio and shortening amortization periods for new loans for residential investment property. It notes that either revision of the guidelines or the regulatory amendment should be adopted by end year.

27. ***Did staff examine supply side constraints in the housing market?***

- Supply constraints in the housing market vary by region (see SR ¶28 and ¶52). At the country-wide level, the share of empty dwellings has risen in the past few years, and is approaching rates last seen around the time of the late-1990s housing crisis. While in large cities vacancies and new construction rates are low, in other regions the increase and high level of vacant dwellings indicates an oversupply of housing. In the residential investment property segment, the further rise in the number of vacant dwellings suggests that brisk construction of rental apartments has led to an over-supply. Banks' current lending practices in the residential investment property segment are particularly risky as a growing share of new mortgage loans in this segment have been used to finance properties in regions with high vacancy rates.





Financial System Stability Assessment (FSSA)

28. ***Could staff provide further details on the development of on-site inspections over the last years and to what extent FINMA had to rely on external auditors to conduct this task? Furthermore, does staff consider it feasible for FINMA to recruit the required number of on-site inspectors in due time?***

- FINMA has been increasing on-site supervision in line with the previous FSAP recommendations. As noted in the technical note on banking supervision (SM/19/154; 6/14/2019), during 2014–17, FINMA's direct on-site work increased by about 44 percent. FINMA estimates that its annual on-site work amounts to 15 FTEs, while about 300 FTEs were used by external supervisory auditors for on-site supervisory work. The FSAP believes that there remains scope for improving the overall effectiveness of FINMA's approach to on-site supervision by rebalancing the responsibilities of FINMA staff and supervisory auditors. The supervisory audits can be streamlined without compromising overall supervisory effectiveness and FINMA's current reforms on auditing provide sound ground for further improvements.
- In January 2019, FINMA adopted a new approach that will refocus the on-site supervisory audits and further increase FINMA's own inspections. The reform targets a 30 percent reduction in supervisory expenses and staff recommends that the savings be used to increase FINMA resources for its direct bank supervision, including on-site inspections. Under the reform, FINMA will also provide more explicit and formal direction to the supervisory auditors.
- FINMA has a tradition of recruiting expert staff from outside Switzerland, particularly from neighboring jurisdictions to broaden the pool of available skills. Importantly, FINMA's human-resources policies show positive results in lowering the high staff turnover for bank supervision noted by the previous FSAP.

29. ***Therefore, we concur with the authorities and staff that new targeted macroprudential measures are needed. Those could include both supply and demand side tools, such as higher risks weights for income-producing real estate or***

tightening of LTV limits. Regarding this point, we take note of staff's comment that the authorities have no legal mandate for such demand-side measures, and appreciate staff's elaboration on it.

- The authorities confirmed to the FSAP team that the Federal Council has the legal authority to create new macroprudential tools. However, so far, the authorities have chosen not to create new legally binding tools for demand-side measures. On the demand side, self-regulation requires agreement with the Swiss Bankers Association, which may impact timeliness and stringency. Once agreement is reached, FINMA formally recognizes the limits as binding.

30. ***We also expect the authorities' continued efforts on filling the data gap. Could staff elaborate more on the existing data gap?***

- The FSAP has noted a lack of granularity in important data on the asset management and fund industry. The SNB collects quarterly data from domestic regulated asset managers and funds. However, the data is not granular enough to analyze several important risks, notably on aspects of credit quality, liquidity and liabilities. Additionally, reporting does not cover foreign funds managed by Swiss regulated entities or distributed to Swiss investors. The large number of small independent asset managers are to come under the regulatory perimeter from 2020. Better data on concentration risk is also needed, in particular on derivative exposures between the largest banks and their investment funds within the groups.
- In the stress testing context, increasing data granularity in supervisory returns would allow the SNB to leverage, to a greater extent, banks' regular supervisory reporting into their stress testing framework. Better data is needed on nonbanks and pension fund investment activities, with more granular information on real estate and mortgage LTV and DTI ratios, and income calculations. Enhanced cooperation among regulators is needed to monitor risks from the pension sector.
- More reliable data on the size of regulated entities' indirect exposures to crypto assets is critical to drawing clear conclusions on systemic risk. FINMA data on direct exposures of crypto assets held by banks shows that these exposures were less than CHF 200 million at the beginning of 2019. Anecdotal evidence obtained by staff from crypto-related and financial entities also suggests that there is little sign of systemic risk. However, certain banks and other regulated entities may also have indirect exposure to crypto assets.

31. ***We take positive note of staff's recommendation to thoroughly reform the deposit insurance system (DIS) by creating a public and fully-funded deposit insurance agency—on which there is an ongoing public consultation. How does staff assess the current proposal on the DIS being prepared by the authorities?***

- As discussed in the technical note on Financial Safety Net and Crisis Management Arrangements (SM/19/152; 6/13/2019), while the reforms under consideration would be an improvement, they would not fully align the Swiss DIS with the IADI Core

Principles (CPs) and international best practice. As currently proposed, the deposit insurance fund (DIF) would not be ex-ante fully funded and remain without any cash component as banks would only pledge assets. The DIS would maintain a cap on banks' overall DIF contribution, while the CPs see target levels as minimums. The payout period could take considerably longer than the seven business days prescribed by the CPs and depositors would still lack a legal claim against the DIS to be reimbursed when their bank fails. The deposit insurance agency's (DIA) mandate and governance would remain unchanged—it would lack the critical functions that the CPs assign to the DIA (including the power to reimburse insured depositors) and it would not be able to fund resolution measures. It's private-sector nature and board composition with active bankers would continue to prevent it from becoming a full member of national crisis management arrangements as required by the CPs.

32. ***Given the potential distributional impacts of limits on loan to- value (LTV) and debt-to-income (DTI) ratios, including the disproportionate impact on first-home buyers, the authorities may want to also consider more flexibility in the sectoral counter-cyclical capital buffer or limits on growth in lending to market segments where risks are elevated. Staff comments are welcome.***

- The FSAP recommends that the 2.5 percent ceiling of the sectoral CCyB should be raised and its credit-growth trigger removed or broadened A range of macroprudential sectoral tools that target specific credit categories, including sectoral capital requirements, loan-to-value (LTV), and debt-service-to-income (DSTI) ratios, can address financial stability risks in a targeted manner. While more targeted measures, for instance LTV and DSTI ratios that distinguish first time buyers and investors or by region, may be more efficient in promoting financial stability, they often require more information and can be more difficult to monitor and enforce.

33. ***We wonder whether possible interconnections between asset management and banks/insurance companies or spillovers of financial stress can be sufficiently well captured to have a good understanding of systemic resilience. We fully support staff's recommendation to close data gaps also in this area. Since this recommendation has also been made in other jurisdictions, we wonder whether this warrants an international effort also to get a better understanding where risk is ultimately located. Staff's comments would be welcome.***

- Direct exposures of Swiss banks to asset management institutions is limited, in aggregate amounting to 2.5 percent of total assets. Direct exposures from securities financing transactions and derivative instruments are also limited. However, over one-third of Swiss banks' operating income is generated by fees and commissions, of which securities trading and investment banking accounting for over three quarters. The share of portfolio management and advisory fees commissions ranges between 30 percent and 75 percent for the G-SIBs and private banks, respectively. Reputational risk is also a potential stress conduit. Among the 12 banks covered in the FSAP stress tests, assets under discretionary management are equivalent to 65 percent of total balance sheet assets.

- As regards an international effort, an initiative on data gaps is in place. Since 2009, at the request of the G20 Finance Ministers and Central Bank Governors, the IMF (STA and MCM) and FSB IMF lead the Data Gaps Initiative (DGI) to support enhanced policy analysis of emerging risks and close the data gaps identified following the global financial crisis. Switzerland participates in this initiative that also aims to improve data on NBFIs, including life and non-life insurance companies, pension funds and investment funds. In September 2015, the G20 concluded the first phase (DGI-1) and endorsed the launch of the second phase (DGI-2). DGI-2 recommendations are clustered under three main headings: (i) monitoring risk in the financial sector; (ii) vulnerabilities, interconnections and spillovers; and (iii) data sharing and communication of official statistics. Further, the European Systemic Risk Board recently published recommendations addressing systemic risks related to liquidity mismatches and the use of leverage in investment funds, taking into account ongoing international and European initiatives on macroprudential policy in this area. As part of this effort, it is seeking to enhance further the data infrastructure to assess systemic risk that can arise in, or be propagated by, the investment funds sector.

External Balance Assessment

34. ***If the income balance is typically revised downward would this not also revise downward staff's adjustments for measurement issues? Additionally, can staff explain their adjustment to the REER gap based on productivity if output per worker is already factored in?***

- The balance of payments data is produced with a 3 month lag relative to the observation period. Information on the income account relies on data from private sector balance sheets. However, large corporates' financial statements are finalized only once they have been approved by their auditors. This may take six months or more and can lead to revisions in the income account, especially related to FDI. In the interim, the income balance is based on preliminary estimates. Later revisions may also occur as additional data becomes available to resolve errors and omissions and to reflect expanded survey coverage of entities and asset classes.
- The adjustments for measurement issues in the EBA are related to retained earnings on portfolio equity investment and to valuation losses on fixed income securities owing to expected inflation. To ensure comparability across countries, these adjustments are based on cross-country datasets as discussed in the Board paper 2018 External Sector Report: Tackling Global Imbalances amid Rising Trade Tensions. In order to limit year-to-year volatility, the adjustors are based on 5-year moving averages.
- The EBA in year t is based on the preliminary current account for year t-1. Hence, subsequent revisions to the current account do not affect the external sector

assessment. In addition, because the adjustors are based on separate cross-country data that is lagged and averaged across time, the adjustors are not affected by the current account revisions.

- The REER models use the ratio of PPP GDP to working age population relative to the average of Germany, Japan, and the U.S., demeaned (as discussed in the latest vintage of the External Balance Assessment EBA Methodology). For Switzerland, the contribution of this variable is quite small, particularly, for the level REER regression.
- Bear in mind that time series regression based on demeaned variables may experience difficulties with capturing structural breaks or changes in trends, as it is based on the assumption of mean reversion. This could be pertinent to Switzerland which is likely to be experiencing a secular trend in productivity, especially in knowledge-based sectors, given that it is at the technology frontier in many fields.

35. ***The buff has suggested further work, on how demographics and pension systems interact, and effect savings and that staff pursue work on a better understanding of the apparent disconnect between the CA and the REER, and the REER models of the EBA methodology. Staff comments on this are welcome.***

- On demographics and pension system: The latest EBA refinements introduced a demographics specification that allows for both formal transfer schemes, such as a PAYG pension system, and informal transfers to affect savings. This is done by linking the generosity of those transfer systems to the future old-age dependency ratio. The future old-age dependency ratio proxies for the relative size of the tax base from which payments are financed. This specification is used to overcome data limitations regarding the generosity of intergenerational transfer systems. As in previous specifications of the EBA framework, the view is that mandatory savings need not necessarily affect savings (and thus the current account) because households can offset mandatory programs by adjusting voluntary private savings. The effect of the design of pension systems on savings and the current account is a continuing and active area of study.
- On CA/REER relationship: While the EBA models, in general, suggest that countries with current account balances higher (lower)-than-warranted by fundamentals and desirable policies tend to have undervalued (overvalued) exchange rates, they sometimes give conflicting signals. The latter can reflect rapid exchange rate movements that are temporary or not yet fully reflected in the current account, rigidities related to the FX regime or, like in the case of Switzerland, measurement issues that may affect the results of one model (CA) but not others (REER). In general, more weight is given the CA model as it is more intuitive and stable. Yet, since no single model can capture all the characteristics of the external sector, Staff assessments necessarily rely on judgment by considering (potentially) omitted country-specific factors, as well as complementary tools such as the methodology to estimate measurement biases.

36. ***While we welcome the application of appropriate judgement in the use of the EBA model for this Article IV consultation, can staff comment on their work to better address unexplained residual and country-specific circumstances on an ongoing basis?***

- EBA models, like all models, are unlikely to have a perfect fit and residuals can be due to numerous factors. Some of the residuals are known to relate to measurement issues and structural features, and staff has been developing (including as part of last year's EBA refinements) complementary tools to assess the role of these factors to better ascertain whether residual reflect excess imbalances or features not fully captured by the model. Yet, because data are limited in many cases, these factors can only be explored outside of the EBA model for now. For example:
    - Measurement issues are analyzed outside of the EBA by estimating CA biases, but data limitation prevent a broader adjustment within the EBA model.
    - The structural complementary tool considers variables that were found to have an impact on the current account balance (both theoretically and empirically), but lack of sufficient time and country coverage prevent including these aspects in the into the EBA models. Going forward, the construction of a large structural dataset (extending time and country coverage) should lay the ground to include some of these structural variables directly into the EBA models.
    - In addition, Staff is continuously working to improve our understanding of CA balances, e.g. through work on corporate saving, which will enable to enrich our complementary tools and/or EBA models over time.

37. ***While FXI are included in the EBA model, they are only used in relation with capital controls. Accordingly, we are wondering to what extent letting the FXI variable impact the current account in the model would be consistent in the case of Switzerland even in the absence of capital controls?***

- The vast literature on foreign exchange intervention indicates that these policy instrument should have a meaningful effect on exchange rates and current accounts when domestic and foreign currency instruments are imperfect substitutes. Restrictions to capital flows are the most prominent and observable form of imperfect substitutability between domestic and foreign assets. Thus, the EBA specification takes the interaction between FXI and capital controls into account. There may be other relevant forms or causes of imperfect substitutability, but they are in general difficult to measure. That said, it is important to stress that the modelling of FXI in EBA is mostly aimed at trying to identify the sources of excess imbalances, but it has no major consequence for the estimation of the overall gap of a given country, since the P* for FXI is set to zero in most cases (including Switzerland) and, thus, the CA norm is unaffected by FXI.

38. ***Moreover, the adjustment for mismeasurement in the income account was almost 1 pp larger than in last year's ESR. Could staff provide more details on this?***

- Staff estimates of mismeasurement was 3 percent of GDP last year (including 1.1 percent due to the portfolio equity retained earnings bias, and 1.9 percent due to the inflation bias; cf. 2018 ESR, Technical Supplement Box 1). Data updates led to some upward revision of both the portfolio equity retained earnings bias (to 1.3 percent) and inflation bias (to 2.2 percent). It should be noted that the estimates of measurement biases can be volatile in some cases, as they can be affected by the operations of large multinational companies.

Structural Issues

39. ***We would like to know if staff has an idea on the timing of the entry into force of the pending laws related to the new sanctions' regime for breaches of the notification requirements for beneficial owners and to the conversion of bearer shares in non-listed companies into nominal shares.***

- Parliament will be considering these draft laws this year. Given the necessary deliberations on these legislative measures, it is difficult to assess when the Parliamentary discussions will be concluded and whether the laws will be passed.

40. ***We would be interested if staff sees any shortcomings in the current skill matching mechanisms geared to the unemployed and/or those threatened by unemployment, considering that the authorities refer to efficiently functioning education and vocational training schemes (para 38)?***

- Switzerland's vocational education and training (VET) system has been successful in supporting workers' incomes through rising productivity. Switzerland's long-established apprenticeship system combines classroom and workplace learning, and is widely viewed as having ensured a pool of highly-skilled workers for Swiss companies (Financial Times, 2017).
- Nonetheless, in an environment of rapid technological change, vocational training organized by firms may have limitations. This is because firms have incentives to provide training that primarily benefits the firms. As a result, there might be a tendency toward current-job-specific knowledge that may depreciate rapidly in the context of automation. In such an environment, a greater premium may be had on more general, broad-based knowledge that is portable across jobs and adaptable to changing technologies. According to Rafael Lalive and Daniel Oesch of the University of Lausanne (in Credit Suisse, 2019, "AI and the Future of Work"), most studies suggest that the degree of automation is negatively correlated with the level of training in a given profession. Low-skilled occupations would therefore be more exposed to technological change than occupations requiring a high level of training. More specifically for Switzerland, a recent analysis suggests that VET graduates are more threatened by automation than university graduates. While 65 percent of the

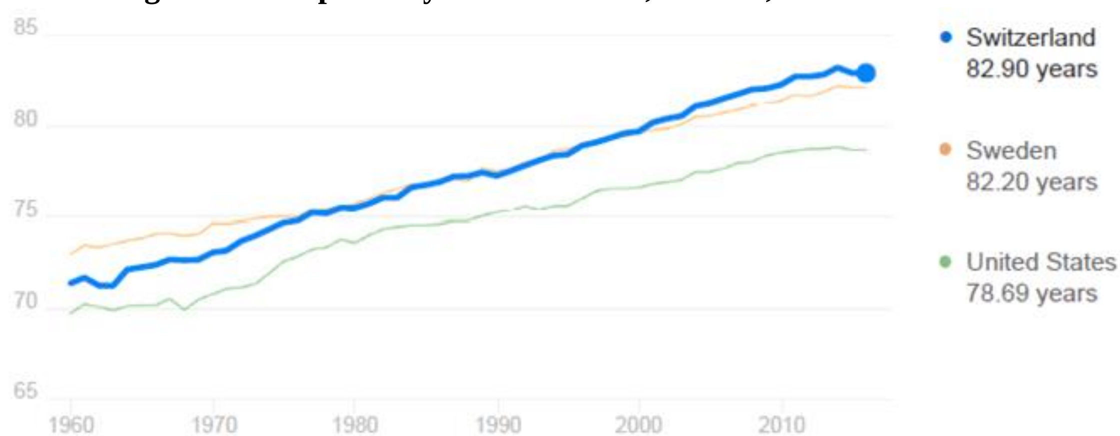
jobs held by the former would be threatened, this is only the case for 25 percent of the jobs held by university graduates.

- Another consideration is that reduced tenure of employment with an individual firm (either due to more flexible labor markets or less long-term employment contracts) tends to discourage fungible vocational training, as the benefits would tend to accrue to a more-mobile worker than to the firm providing the training. (OECD, 2008, "Costs and Benefits in Vocational Education and Training," by Kathrin Hoeckel)
- Moving forward, workers that acquire skills and capabilities required by advanced technologies can benefit from automation and digitalization. Acemoglu and Restrepo (Project Syndicate, 2019) argue that the future of work and the workforce will depend on the balance between *labor replacing technologies*—automation that replaces workers—and *labor reinstating technologies*, that generate new tasks at which humans have a comparative advantage. Thus, investing in training that prepares workers to perform these new tasks is critical.

41. ***We welcome the information in the buff statement on the planned changes in the first pillar of the pension system and would appreciate staff's recommendations on changes to the effective retirement age in view of rising life expectancy.***

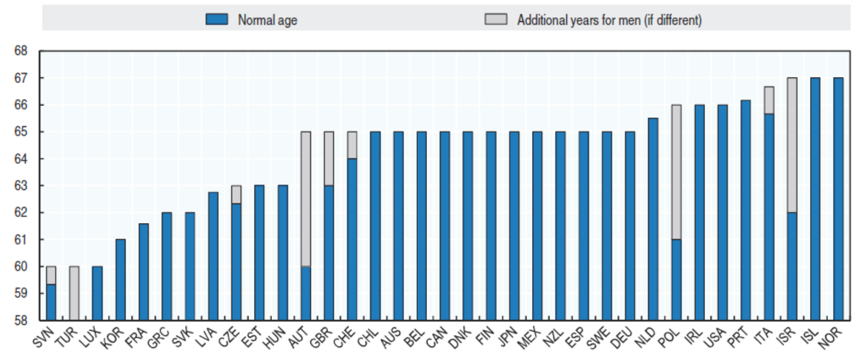
- Life expectancy in Switzerland has been steadily increasing over the course of past decades, reaching 82.9 years in 2016 (see the Figure below). Life expectancy compares favorably with most other advanced countries.

Figure: Life expectancy in Switzerland, Sweden, and the United States



- However, the retirement age in Switzerland is around the average for OECD countries.

3.8. Current retirement age in 2016 for a person who entered the labour force at age 20

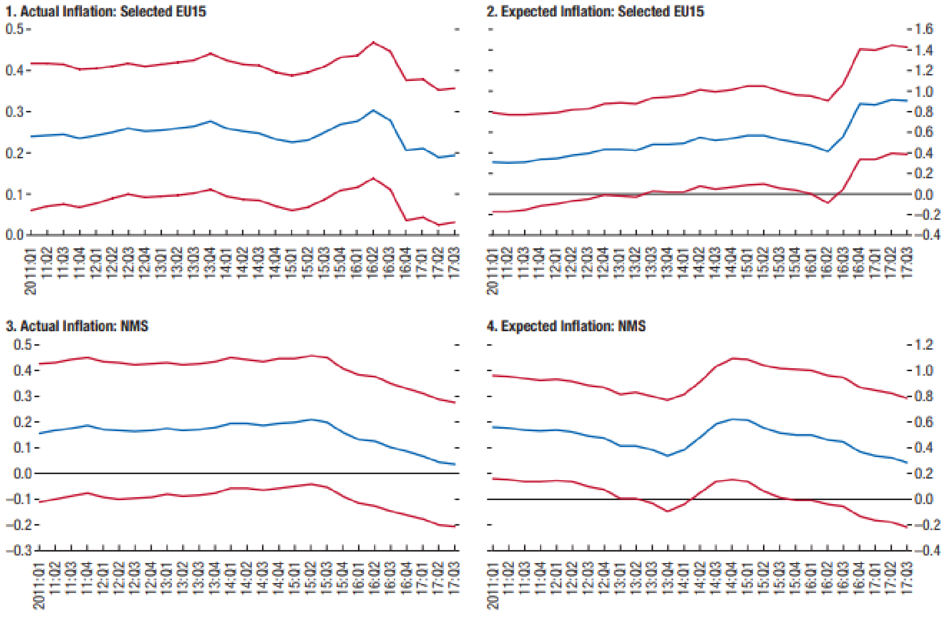


- Increasing the retirement age to take account for past increases in life expectancy by working additional years would constitute an important element of a reform that supports a comfortable lifestyle in retirement. Staff recommends initially equalizing male and female retirement ages, and then raising them gradually over time.

42. ***Swiss wages are higher than in neighboring regions but nominal wage growth has almost halved since the Great Financial Crisis. However, what the ECM's results do not suggest is that lower inflation expectations may also partially account for the behavior of nominal wages. Staff's comments would be welcome. Moreover, it could also have been interesting to try to assess the impact of automation, digitalization and outsourcing on this down-trend.***

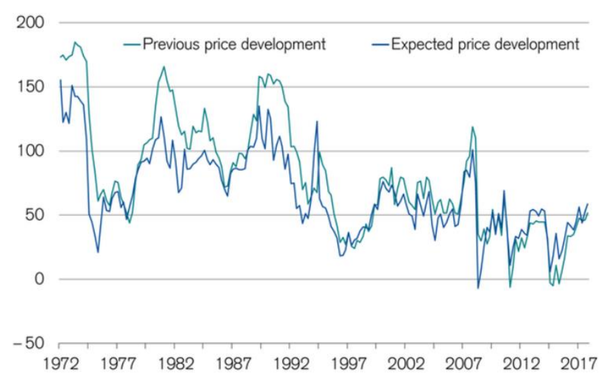
- Staff research finds that the bulk of the wage slowdown in advanced economies can be accounted for by reductions in both inflation and inflation expectations (Chapter 2 of the May 2018 EUR REO). However, in the euro area, wage setting has become notably more forward-looking over time, while wage adjustment in response to actual inflation has declined modestly in recent years. Rolling regression estimates of wage Phillips curve, which control for both actual and expected inflation, show an increase in the coefficient on expected inflation and a decrease in the coefficient on the actual inflation.

Figure 2.26. Rolling Estimates of Coefficient before Actual and Expected Inflation



Source: IMF staff calculations.
Note: The blue lines denote the point estimates, and the red lines denote the 95 percent confidence bands. The time period on the horizontal axis denotes the end of each 15-year rolling window. EU15 = long-standing EU members; NMS = newer EU members.

- There are some signs of a de-anchoring of inflation expectations in the euro area in recent years. The rolling regression estimates indicate that inflation expectations have become somewhat more sensitive to movements in actual inflation. Overall, the results support the view that low inflation since the global financial crisis contributed to some de-anchoring of inflation expectations in the euro area similar to Lyziak and Paloviita (2017). In Switzerland (which was not included in the EUR REO analysis), survey data also suggest that consumers' expectation of future inflation are closely related to past price developments. The analysis in the accompanying *Selected Issues Paper* also shows that inflation matters for short-term dynamics of Swiss wages (Table 1), with a 1 percentage point increase in inflation raising wages by up to 0.9 percentage points in the following year.



Inflation expectations are deeply entrenched

Survey-based assessment of consumers, index

Source: State Secretariat for Economic Affairs (SECO), Credit Suisse

- Automation and digitalization affect wage developments. However, the extent to which such changes impact wages over the long term is difficult to assess. For instance, although automation and digitalization increase the pressure on certain workplaces and thus on wages, general wage levels rise concurrently since new jobs in high-wage fields are created (Credit Suisse, 2018).

- According to Rafael Lalive and Daniel Oesch of the University of Lausanne (in Credit Suisse, 2019, "AI and the Future of Work"), computers and robots will only be used where they lead to productivity gains and, consequently, additional income. These productivity gains can benefit three groups of stakeholders: (1) the workforce whose productivity has increased in the form of wage increases; (2) business owners who benefit from an increase in their profits; or (3) consumers who benefit from lower prices. In practice, productivity gains tend to benefit all three groups to some extent. These three groups will then use their increased income to acquire more goods and services, which should in turn lead to employment growth.
- At the same time, technology in the form of machines, robots, or digital assistants competes with intermediate-skills workers for repetitive, but cognitively demanding work of, for instance, office clerks (automatic teller machines). Fewer workers with intermediate skills are needed to execute tasks of intermediate complexity, and these workers then compete with both low-skilled and high-skilled workers for low- and high-complexity tasks. Intermediate-level jobs will fare less well, with lower employment and lower wages. According to this line of reasoning, technology would lead to a hollowing out of the middle class, a phenomenon called polarization.

43. ***The staff's analysis on this topic suggests that this gap is entirely explained by fundamentals, but we would call for a more prudent appraisal as this conclusion is based on aggregate data and may require a more detailed microeconomic approach. Staff's comments are welcome.***

- Based on available country-level data, staff's analysis finds that cross-border differences in the pace of nominal wage growth reflect differences in labor productivity growth, corporate profit gaps, and large, persistent foreign exchange rate shocks. Moreover, these gaps persist despite the opening of the Swiss labor market to EU workers, thereby removing an important potential labor market distortion.
- Lack of comparable cross-country micro-level data prevents a more disaggregated analysis of wage gaps. However, several micro-level studies focusing on Swiss-only wages arrive at similar conclusions as our analysis. For example, a recent KOF study (A. Beerli, J. Ruffner, M. Siegenthaler, and G. Peri, 2018) finds that the opening the Swiss labor market to European cross-border workers had a positive impact on Swiss salaries. The researchers found that wages earned by well-qualified Swiss employees in border regions grew faster than those in non-border regions despite greater immigration inflows of similarly well-qualified foreign workers. Since most of the jobs created were high-skilled, average wages in Switzerland responded positively to opening the labor market to foreign workers. This finding is in line with staff's conclusions in the SIP, based on country-level data.