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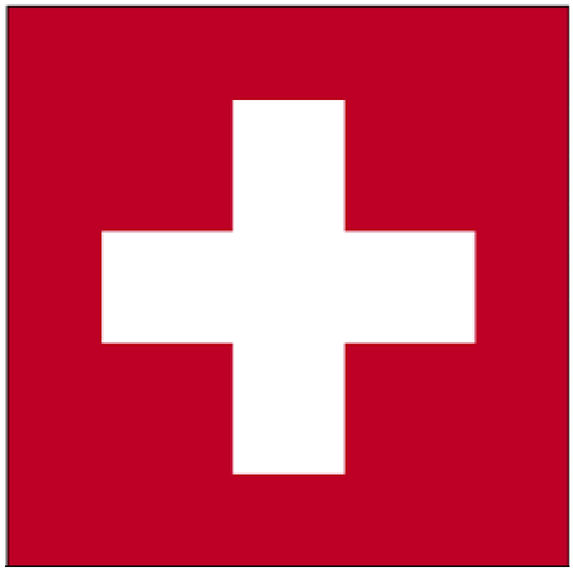
Country report

SWITZERLAND



Summary

The Swiss economy is on the path to recovery owing to expansionary monetary and fiscal policies combined with a quick rebound in world trade. That said, a further strengthening of the Swiss franc can pose significant challenges for exporters and monetary policymakers alike.

Things to watch:

External demand outlook

The strength of the Swiss franc

The evolution of the inflation rate

The recapitalisation of the banking sector (UBS and Credit Suisse in particular)

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Switzerland

National facts	
Type of government	Confederation
Capital	Bern
Surface area (thousand sq km)	41
Population (millions)	7.8
Main languages	German (63.7%)
	French (20.4%)
Main religions	Catholic (41.8%)
	Protestant (35.3%)
	Muslim (4.3%)
Head of State (president)	Micheline Calmy-Rey
Head of Government (prime-minister)	Micheline Calmy-Rey
Monetary unit	Franc (CHF)

Economy	2010	
Economic size	*bn USD*	*% world total*
Nominal GDP	528	0.85
Nominal GDP at PPP	340	0.46
Export value of goods and services	311	1.66
IMF quotum (in mln SDR)	3459	1.59
Economic structure	*2010*	*5-year av.*
Real GDP growth	2.7	2.0
Agriculture (% of GDP)	1	N/A
Industry (% of GDP)	28	N/A
Services (% of GDP)	71	N/A
Standards of living	*USD*	*% world av.*
Nominal GDP per head	67326	685
Nominal GDP per head at PPP	43331	371
Real GDP per head	52393	655

Social and governance indicators	rank / total
Human Development Index (rank)	13 / 169
Ease of doing business (rank)	27 / 183
Economic freedom index (rank)	5 / 179
Corruption perceptions index (rank)	8 / 178
Press freedom index (rank)	1 / 178
Gini index (income distribution)	33.7
Population below $1.25 per day (PPP)	N/A

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Germany	20	Germany	34
US	10	Italy	11
Italy	9	France	10
France	9	US	6
Main export products (%)			
Chemicals (% share)			39
Machinery, equipment and electronics (% share)			19
Precision instruments, watches, jewellery (% share)			18
Metals (% share)			6
Main import products (%)			
Chemicals (% share)			22
Machinery, equipment and electronics (% share)			18
Metals (% share)			8
Fuels (% share)			7
Openness of the economy			
Export value of G&S (% of GDP)			57
Import value of G&S (% of GDP)			50
Inward FDI (% of GDP)			5.6

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economy

The Swiss economy is on the path to recovery. Output and employment are already above pre-crisis levels. The economy was initially buoyed by the pickup in world trade, and then a strong increase in domestic demand growth from the middle of 2010. Of course, the three fiscal stimulus packages together with the (unconventional) monetary measures helped the country weather the economic fallout from the financial crisis. Households and corporations entered the recession with relatively strong balance sheets. Swiss households' gross debt-to-income ratios, traditionally high but more than matched by their large financial wealth, have remained stable in recent years. In contrast to most other European countries, the non-financial corporate net debt-to-income ratio declined prior to the crisis and has remained relatively low since.

Unfortunately, the pace of recovery will slow down this year and next. From 2011 onwards, fiscal stimulus measures will be replaced with consolidation measures. The austerity program foresees expenditure cuts of about 0.3% of GDP in both 2011 and 2012. The program is adequate to adhere to the budgetary rule which requires the structural federal government budget to be balanced. The external demand outlook remains uncertain as most advanced economies are carrying out fiscal consolidation measures to restore order to their public finances. So a weakening of foreign demand can have negative repercussions for the Swiss economy. What's more, a further strengthening of the Swiss franc (since mid-2007, the franc has appreciated by nearly 30% vis-à-vis its major trading partners) due mostly to safe haven effects can pose significant challenges for exporters. Although this is not our central scenario, we cannot exclude the possibility of a resurgence of turmoil in the eurozone to push the franc upwards. In that case, the central bank will face difficulty in heavily intervening in the FX markets given the mounting criticism it faced because of the CHF 32.7bn loss it incurred in 2010 because of its interventions in 2009-10; this as the franc continued to strengthen versus the currencies of its major trading partners. The appreciation of the franc in the future may pull inflation down, possibly into deflationary territory with the risk of low/negative inflation getting entrenched in expectations. Remember Switzerland's inflation is already one of the weakest amongst the advanced economies (CPI inflation was 0.2% y-o-y in Jan. 2011).

The good news is that Switzerland's sufficient fiscal space owing to favourable debt metrics allows the government to respond to negative economic shocks. Switzerland's public finances were in good shape going into the financial crisis, thanks to windfall gains from the central bank's gold sales, the balanced-budget rule and the moderate discretionary easing. In 2010, the public debt-to-GDP ratio was 39.5% while the budget deficit was 0.4% of GDP. Monetary space of the conventional type, however, has been fully exhausted by the near-zero policy rate effective since 2009.

Banking Sector

Switzerland's AAA sovereign rating reflects the expectation that there will not be any further sizeable fallout from the financial crisis in the banking sector. Given the very large size of the Swiss banking system, with assets of more than 6x Swiss GDP (which among highly rated sovereigns is only surpassed by Luxembourg), any unexpected large-scale recapitalisation could lead to a significant surge in the public debt-to-GDP ratio.

According to the IMF, the performance of the banking sector has improved thanks in part to the favourable economy and accommodative monetary conditions. Swiss banks have largely written down their losses, shed some CHF 1½trn in assets from mid-2007 to end-2009, de-risked their balance sheets, and strengthened their funding and capital positions. What's more, banks have reported higher profitability, better asset quality, and stronger capital and liquidity buffers in 2010.

That said, large banks remain relatively more leveraged and dependent on wholesale funding than smaller banks, and have large cross-border exposures. Moreover, UBS and Credit Suisse would be particularly affected by the exclusion of hybrid capital and deferred tax assets from the definition of Core Tier 1, the likely new benchmark for core capital according to basel III. Last year, the IMF stated that only 64% of the current capital of UBS and CS qualifies for the Core Tier 1 definition according to new proposals. Note that the Swiss regulators have imposed a minimum 10% Core Tier 1 ratio for UBS and CS, as opposed to the 7% that will be the norm in other countries from 2019 onward.

Another risk to the sector arises from the increased external pressures on the Swiss financial services industry. As governments in other countries seek to cut their budget deficits, it is highly likely that their fight against tax evasion will intensify. While the Swiss authorities have agreed to further international cooperation in tax affairs, the country's bank secrecy laws are likely to remain under close scrutiny. This might lead to an outflow of funding from the sector in the coming years.

Finally, the IMF believes that the risks for other banks are more concentrated in mortgage lending given the evidence of declining lending standards in the housing market since the crisis. While overall housing prices have not accelerated so far as in a typical real estate bubble, preventive action is warranted, according to the IMF, to address both financial stability and social concerns.

Switzerland

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	3.6	3.6	1.9	-1.9	2.7	1.8	1.3
Consumer prices (average % change pa)	1.1	0.7	2.4	-0.5	0.7	1.1	1.2
Current account balance (% of GDP)	14.2	9.3	1.3	7.9	10.0	7.8	7.2
Economic growth							
GDP (% real change pa)	3.6	3.6	1.9	-1.9	2.7	1.8	1.3
Gross fixed investment (% real change pa)	4.7	5.1	0.5	-4.9	3.6	1.8	1.5
Private consumption (real % change pa)	1.6	2.3	1.3	1.0	1.7	1.2	1.2
Government consumption (% real change pa)	0.3	0.3	1.7	1.6	0.0	0.3	-0.3
Exports of G&S (% real change pa)	10.3	9.6	3.3	-8.7	7.7	1.2	2.2
Imports of G&S (% real change pa)	6.5	6.1	0.3	-5.4	7.2	2.0	2.2
Economic policy							
Budget balance (% of GDP)	1.7	2.2	0.9	-0.2	-0.3	-0.5	-0.3
Public debt (% of GDP)	47	44	41	41	40	39	39
Money market interest rate (%)	1.5	2.5	2.6	0.4	0.2	0.4	0.7
M2 growth (% change pa)	5	3	3	8	10	2	2
Consumer prices (average % change pa)	1.1	0.7	2.4	-0.5	0.7	1.1	1.2
Exchange rate LCU to USD (average)	1.3	1.2	1.1	1.1	1.0	1.1	1.1
Recorded unemployment (%)	3.3	2.8	2.6	3.7	3.9	3.4	3.6
Balance of payments (mln USD)							
Current account balance	55701	40379	6468	38972	53000	41300	37200
Trade balance	5008	13234	13482	1391	1400	-200	-2800
Export value of goods	167221	200491	241163	206119	229900	231100	229200
Import value of goods	162210	187260	227680	204730	228500	231200	232000
Services balance	28055	34118	41347	34971	41700	40900	37800
Income balance	31988	2544	-35686	14922	22500	12900	13300
Transfer balance	-9350	-9517	-12675	-12312	-12700	-12300	-11100
Net direct investment flows	-31563	-18591	-37563	-6021	-34490	-15130	-13420
Change in international reserves	6859	10874	-1298	61180	N/A	N/A	N/A
External position (mln USD)							
Total foreign exchange reserves	38094	44474	45061	98199	N/A	N/A	N/A
International investment position	521630	691460	629080	736360	N/A	N/A	N/A
Total assets	2490020	3183280	2897190	3082840	N/A	N/A	N/A
Total liabilities	1968390	2491820	2268110	2346480	N/A	N/A	N/A
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	1.3	3.0	2.7	0.3	0.3	0.0	-0.5
Current account balance (% of GDP)	14.2	9.3	1.3	7.9	10.0	7.8	7.2
Inward FDI (% of GDP)	11.5	7.7	3.2	5.6	1.4	2.4	2.6
International investment position (% of GDP)	133.3	159.3	125.2	149.7	N/A	N/A	N/A

Source: EIU