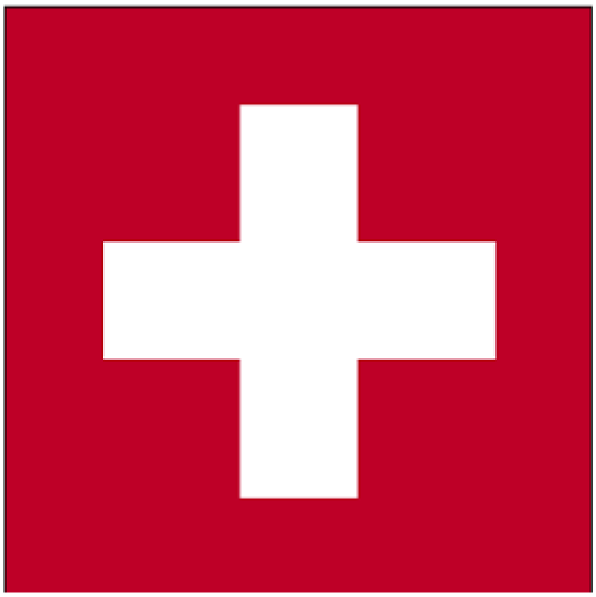
Country report **SWITZERLAND**



Summary

Switzerland's economic recovery has been robust thus far but the coming quarters can prove more challenging amid weaker external demand. Thankfully, the country has ample fiscal space to battle any significant economic slowdown. On the monetary policy front, we expect the central bank to maintain the peg with the euro until deflationary risks abate. The Swiss banking sector has stabilised but remains vulnerable to a stricter regulatory environment. Moreover, the rapid increase in house prices, especially in some 'hot spots', is posing a long-term risk to financial stability. And given the very large size of the Swiss banking system, any unexpected large-scale capitalisation could significantly weaken the government's strong balance sheet. But since we expect the regulators to take corrective measures to cool the property market, we deem the risk of another banking crisis limited.

Things to watch:

- Strength of economic growth in major trading partners
- Deflationary pressures
- Regulatory measures that intend to strengthen the banking system

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Switzerland

National facts	
Type of government	Confederation
Capital	Bern
Surface area (thousand sq km)	41
Population (millions)	7.9
Main languages	German (63.7%)
	French (20.4%)
Main religions	Catholic (41.8%)
	Protestant (35.3%)
	Muslim (4.3%)
Head of State (president)	Eveline Widmer-Schlumpf
Head of Government (prime-minist	Eveline Widmer-Schlumpf
Monetary unit	Franc (CHF)

Social and governance indicators	rank / total
Human Development Index (rank)	11 / 187
Ease of Doing Business Index (rank)	26 / 183
Index of Economic Freedom (rank)	5 / 179
Corruption Perceptions Index (rank)	8 / 183
Press Freedom Index (rank)	8 / 178
Gini index (income distribution)	33.682
Population below $1.25 per day (PPP)	n.a.

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	636	0.92
Nominal GDP at PPP	377	0.48
Export value of goods and services	409	1.87
IMF quotum (in mln SDR)	3459	1.59
Economic structure	*2011*	*5-year av.*
Real GDP growth	1.9	2.0
Agriculture (% of GDP)	n.a.	n.a.
Industry (% of GDP)	28	28
Services (% of GDP)	n.a.	n.a.
Standards of living	*USD*	*% world av.*
Nominal GDP per head	80178	744
Nominal GDP per head at PPP	47523	385
Real GDP per head	52855	650

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	20	Germany	34
US	11	Italy	11
Italy	8	France	9
France	8	US	6

Main export products (%)	
Chemicals (% share)	39
Machinery, equipment and electronics (% sh	19
Precision instruments, watches, jewellery (%	19
Metals (% share)	7
Main import products (%)	
Chemicals (% share)	22
Machinery, equipment and electronics (% sh	18
Metals (% share)	11
Fuels (% share)	10
Openness of the economy 2011	
Export value of G&S (% of GDP)	64
Import value of G&S (% of GDP)	53
Inward FDI (% of GDP)	1.6

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

Economy

Swiss economic performance continues to surprise on the upside. Economic growth came in at 1.9% y-o-y in 2011. Domestic demand was boosted by investment, notably in construction due to low interest rates. Financial services output recovered, although at a slower pace than in previous expansions. Substantial employment growth has continued to lower unemployment. Of course, activity slowed down in the second half of the year owing to slower global demand and formidable exchange rate pressures. What was particularly surprising was that the economy did not contract in the fourth quarter of last year like most of the eurozone countries (Finland, France and Slovakia were obvious exceptions). Going forward, growth is expected to remain weak in the first part of 2012 and regain some momentum thereafter. This is based on our projection of a slight pickup in global demand in 12H2. In any case, slower growth in Switzerland's major trading partners will continue to curb output growth throughout this year and next.

On a positive note, prudent budgetary policies have resulted in strong public finances. The government budget surplus was 0.8% on average between 2008 and 2011 (the budget balance never entered the red in any single year since 2007). The favorable debt metrics have provided ample room for the government to stand ready to support the still fragile economic recovery. In our view, available leeway under the 'debt brake' rule (requiring a balanced budget over the economic cycle) should be used to prop up aggregate demand if the envisaged recovery stalls in the course of the year. This means automatic stabilizers must be allowed to operate in full if growth falters, and even the option of discretionary fiscal stimulus should remain on the table in case the economy proves significantly weaker than anticipated. That said, from a longer-term perspective, a conservative fiscal policy is appropriate in view of potential fiscal risks related to the financial sector (6x Swiss GDP) and an aging population. Regarding the latter, we support the IMF's proposal for a specific fiscal rule that automatically links the retirement age and/or pension benefits to life expectancy. Such a rule would certainly reduce the need for repeated and often difficult reform discussions while ensuring the country's long-term fiscal sustainability.

On the monetary policy front, we deem the introduction of the exchange rate floor (set at 1.20 CHF/EUR) by the Swiss National Bank (SNB) on September 6, 2011 as an appropriate policy response given the risk of a sharp contraction of net exports. With the economy showing signs of cooling, inflation dipping into the negative territory, and capital inflows surging amid safe haven effects, the risk was that sizable appreciation of the Swiss franc would push the country towards a recession and entrenched deflation. Unfortunately, conventional policy measures were exhausted given that the central bank rate was stuck at the zero bound. Quantitative easing would not have helped much either because of the small size of the domestic bond market. The SNB exchange rate commitment to peg the franc to the euro weakened the currency on a trade-weighted basis and thus helped shore up the economy. The nominal effective exchange rate (NEER) dropped by 20% between August 2011 and February 2012, after rising by a whopping 50% since the beginning of last year. Indeed, once risks of deflation abate, we would expect the central bank to return to a freely floating currency.

Banking Sector

The Swiss banking sector has stabilised but remains vulnerable. The financial industry will face challenges meeting the new, more stringent regulatory environment. The Swiss regulators are taking tough measures to minimise systemic risks. Recently, the so-called 'too big to fail' law came into effect. It establishes the Basel III principles with a 'Swiss Finish', which requires the two largest banks, UBS and Credit Suisse, to meet much stricter capital requirements (total capital ratios of 19% compared to 10.5% under Basel III). Banks are expected to fully comply with this requirement by the end of 2018. Close to half of the required capital can consist of contingent convertible bonds (CoCos) and the remainder being common equity. The conversion of CoCos into paid-in capital will be triggered when the regulatory accounting value of common equity relative to risk-weighted assets drops below predefined thresholds.

The too big to fail law also foresees requiring the banks to develop contingent procedures to enable them to keep systemically important activities afloat in case of capital shortfalls. However, these requirements have yet to be spelled out. With a smaller chance of bank insolvency and mechanisms of a bondholder bail-in in place, the potential need for the sovereign to step in to support the financial sector is reduced. Naturally, Swiss regulators must make sure that only a small share of CoCos are sitting on the balance sheets of the other domestic financial institutions. Otherwise the whole exercise will turn out to be futile.

Another risk to the sector arises from Switzerland's housing market. According to the IMF, the risk of a real estate bubble has increased. As monetary conditions loosened following the financial crisis, housing price growth accelerated (rose by around 20% in the period 08Q1-11Q4). In the assessment of the SNB, house prices exceed 'fundamental' valuations only in some local areas so far (e.g. Geneva and Zurich). However, since monetary conditions are unlikely to be tightened for some time, the risk that a nationwide bubble may form is intensifying. And this would pose serious risks to Switzerland's financial stability. To this end, macroprudential instruments should be imposed, such as time-variant counter-cyclical capital buffers or temporary measures to slow excessive lending growth (e.g. limits to loan-to-income ratios). This is because a continued rise in house prices at the current pace would be credit negative in the medium-term.

Switzerland

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	3.6	2.1	-1.9	2.7	1.9	0.2	0.7
Consumer prices (average % change pa)	0.7	2.4	-0.5	0.7	0.2	-0.8	0.3
Current account balance (% of GDP)	9.3	1.1	7.4	14.0	14.1	11.5	10.6
Economic growth							
GDP (% real change pa)	3.6	2.1	-1.9	2.7	1.9	0.2	0.7
Gross fixed investment (% real change pa)	5.1	0.5	-4.9	7.5	3.9	1.5	1.5
Private consumption (real % change pa)	2.3	1.4	1.4	1.7	1.0	0.3	0.3
Government consumption (% real change pa)	0.3	2.7	3.3	0.8	1.7	1.0	0.3
Exports of G&S (% real change pa)	9.6	3.1	-8.6	8.4	3.4	0.9	2.5
Imports of G&S (% real change pa)	6.1	0.3	-5.5	7.3	1.9	0.1	2.7
Economic policy							
Budget balance (% of GDP)	1.7	0.6	2.0	0.5	0.9	-0.3	-0.3
Public debt (% of GDP)	43	41	39	38	36	36	36
Money market interest rate (%)	2.5	2.6	0.4	0.2	0.1	0.0	0.1
M2 growth (% change pa)	3	4	8	6	14	8	5
Consumer prices (average % change pa)	0.7	2.4	-0.5	0.7	0.2	-0.8	0.3
Exchange rate LCU to USD (average)	1.2	1.1	1.1	1.0	0.9	0.9	1.0
Recorded unemployment (%)	2.8	2.6	3.7	3.9	3.1	3.3	3.6
Balance of payments (mln USD)							
Current account balance	40349	5686	36453	74015	89900	68500	61500
Trade balance	13234	13482	1426	12291	19800	16800	17200
Export value of goods	200491	241163	206119	258521	312500	297400	293900
Import value of goods	187260	227680	204690	246230	292600	280600	276600
Services balance	34186	41928	38169	44020	50700	36700	32800
Income balance	2426	-36904	8932	29967	31200	26400	22200
Transfer balance	-9498	-12821	-12075	-12263	-11900	-11400	-10700
Net direct investment flows	-18591	-27583	1088	-43828	-28060	-13050	-15140
External position (mln USD)							
International investment position	691510	617900	724890	801700	n.a.	n.a.	n.a.
Total assets	3183330	2886740	3072830	3315190	n.a.	n.a.	n.a.
Total liabilities	2491820	2268840	2347940	2513490	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	3.0	2.7	0.3	2.3	3.1	2.8	3.0
Current account balance (% of GDP)	9.3	1.1	7.4	14.0	14.1	11.5	10.6
Inward FDI (% of GDP)	7.7	3.2	6.0	4.1	1.6	4.0	4.4
International investment position (% of GDP)	159.3	122.8	147.3	151.9	n.a.	n.a.	n.a.

Source: EIU