

# The Swiss Economy's Resilience to Crisis and Its Lessons for Austria

*Switzerland and Austria, two small, open economies, have emerged fairly unscathed from the financial and economic crisis. Switzerland, above all, is notable for its relative stability. Domestic demand proved to be rather resilient, and in Switzerland, foreign trade performance also contributed to stability. At the same time, the important internationally oriented financial sector of both countries, a growth engine during good times, came to represent a risk factor during the crisis.*

*The key factors in explaining Switzerland's resilience to the crisis are the country's high degree of economic diversification and its specialization on/in products that are fairly robust to cyclical fluctuations. Like in Austria, a stable labor market and the absence of a real estate bubble preceding the crisis supported the economy. The stability of credit supply and the ultimately small impact of the financial crisis thanks to swift and decisive government action played an important role as well. Economic policymakers also made an important contribution to stability by reducing key interest rates, adopting economic stimulus packages, taking measures to stabilize the labor market and, above all, launching bank rescue packages to safeguard financial stability.*

*Preventing financial crises will be a great challenge for both countries in the coming years. In Switzerland, the too-big-to-fail aspect represents a major issue, considering that the total assets of the two biggest Swiss banks – UBS and Credit Suisse – each are a multiple of Swiss GDP.*

*JEL classification: E50, E60, O11*

*Keywords: Austria, Switzerland, financial market, financial and economic crisis*

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In times of a global financial and economic crisis, small economies with a comparatively large financial sector are especially exposed. The typically large degree of openness makes such economies very vulnerable to a decline in world trade. Furthermore, financial market turmoil jeopardizes small countries most.

But both Switzerland and Austria have weathered the financial and economic crisis fairly unscathed. The slump in growth during the crisis was less pronounced in both countries than in the euro area, and the recovery was comparably dynamic; this pattern was even more distinct in Switzerland. Domestic demand was relatively unaffected by the crisis, and in Switzerland,

foreign trade performance supported stability.

This study examines the structural, economic and monetary policy conditions that helped both countries cope with the crisis. Although both countries have pursued very different strategies – especially with regard to European integration – they (do) have factors in common that fed into their relative resilience to crisis.

This analysis, which focuses on Switzerland, benefits from the findings of a workshop the Oesterreichische Nationalbank (OeNB) held on the topic “Die Schweiz und Österreich – Zwei kleine Nachbarstaaten in und nach der Krise” (Switzerland and Austria – Two Small Neighboring Countries during

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Refereed by:  
Fritz Breuss, WIFO

and after the Crisis) on April 11, 2011. Experts on economics and monetary policy and researchers discussed the lessons learned from the recent crisis, using Switzerland as an example, and drew parallels to Austria. The annex contains the workshop program.

Both the authors of this study and the participants of the workshop identified the high degree of diversification in the Swiss economy and the specialization on products that are comparatively robust to cyclical fluctuations as important reasons for the country's resilience to the crisis. A stable labor market and the absence of a real estate bubble supported the economies of both Switzerland and Austria prior to the outbreak of the crisis. Stable credit supply and, in this connection, the ultimately small impact of the financial crisis thanks to swift and decisive government action played a key role as well.

Economic policymakers also made an important contribution to stability by reducing key interest rates, adopting economic stimulus packages, taking measures to stabilize the labor market and, above all, launching bank rescue packages to safeguard financial stability. The important, internationally oriented financial sector was a motor of growth in good times but represented a risk factor during the crisis. In Switzerland, the too-big-to-fail aspect represents/is a major issue, considering that the two biggest Swiss banks – UBS and Credit Suisse – have total assets that are a multiple of Swiss GDP. Preventing financial crises will be a great challenge for both countries in the coming years.

Section 1 of this study describes the different approaches that Switzerland and Austria have pursued in the past decades with regard to European inte-

gration. Section 2 describes the relatively favorable economic and economic policy conditions in both countries prior to the outbreak of the crisis. The economic and monetary policy measures taken to combat the crisis are explained in section 3. Section 4 concludes by identifying the challenges in store for the two countries.

## 1 Two Small, Open Economies in a European Framework<sup>2</sup>

Switzerland and Austria are small, open, and comparatively affluent economies (Breuss, 2011). Per capita GDP (measured in purchasing power parities) is noticeably higher in both countries (Switzerland: EUR 34,000, Austria: EUR 29,300) than the euro area average (EUR 25,600). Switzerland has strong economic ties to the EU in general and to Austria in particular (section 2.1). At 139%, Austria's degree of openness, as measured by the total of exports and imports in GDP, was clearly higher than that of Switzerland at 94%.

In 1960, both countries were founding members of the European Free Trade Association (EFTA). In the following decades, however, each country pursued a different strategy with regard to European integration. As a European integration trailblazer, as it were, Austria decided to pursue a policy of holding its exchange rate stable against the currencies of the main trading partners already in the 1970s, which in the long term proved to be a guarantee for price stability and a sound economic structure. In 1995, Austria drew the logical consequence of the successful hard currency policy it had pursued for years and joined the EU. In 1999, Austria was among the first countries to adopt the euro.

<sup>2</sup> This and the following sections are partly based on an OECD survey (2009a).

As part of the EU, Austria benefited directly from the ten-country enlargement in 2004 – some of these countries have since become key trading partners for Austria. This growth bonus for Austria based on participation in European integration becomes apparent in a direct comparison with Switzerland, paralleling the comparison of EU countries' growth with growth in Denmark (Koman and Wörgötter, 1994). Between 1995 and 2008, cumulative growth in Austria exceeded that in Switzerland by 8.6 percentage points. The stronger pace of growth in Austria in the past decades was, however, accompanied by greater volatility. The fluctuation of Swiss economic growth since the beginning of the 1990s was systematically below that of Austrian growth, and this tendency in fact became more pronounced once Austria had joined the EU. The recent crisis years also fit this pattern (chart 1).

When Austria adopted the euro, it relinquished its monetary policy autonomy. During the financial and economic crisis, Austria (therefore) benefited from the internal and external stability of the euro area. Thanks to the monetary policy of the Eurosystem, liquidity was ample at all times, ensuring

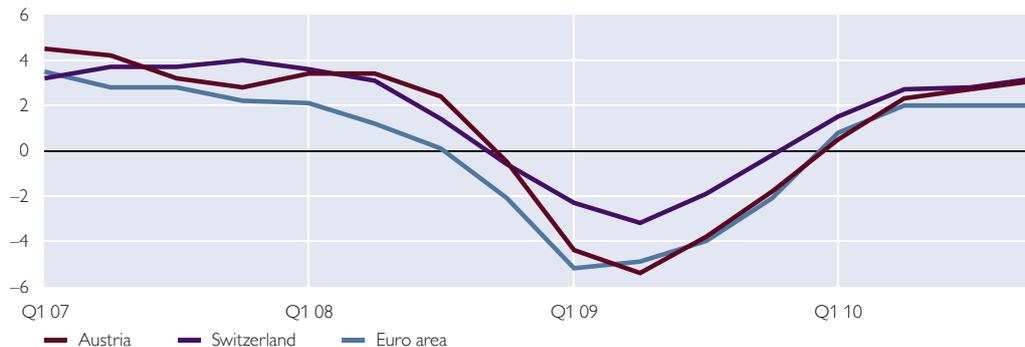
that financial markets would remain functional. In this respect, the euro proved to be a protective shield for the euro area countries.

For decades, Switzerland has been pursuing what it refers to as a bilateral approach – it has concluded numerous agreements with EU Member States to govern bilateral political, economic and cultural relations. In May 1992, the Swiss government submitted an application for accession to the EU in Brussels. However, when a Swiss referendum vote at the end of 1992 rejected membership in the European Economic Area (EEA) by a very low margin, the Swiss government suspended EU membership negotiations. Instead, negotiations on a number of bilateral agreements were conducted and concluded in 1999 concerning the free movement of persons, agriculture, and air and road traffic. An additional set of agreements was concluded in 2007; among other things, it covers Switzerland's Schengen membership and anti-fraud cooperation with the EU. Upon enlargement of the EU in 2004, Switzerland extended the freedom of movement of persons to the new Member States and made a financial contribution to the EU's Cohesion Fund.

Chart 1

### Austria – Switzerland: Real GDP Growth

Change on the same quarter of the previous year in %

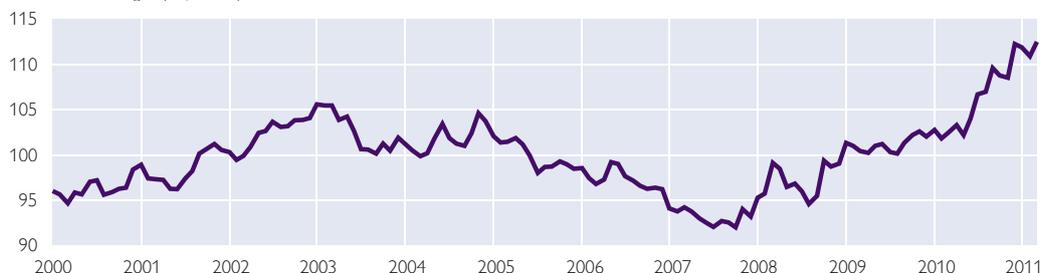


Source: Eurostat.

Chart 2

**Switzerland: Real Effective Exchange Rate**

CPI-based, broad group of trade partners



Source: ECB.

The country's growth potential has benefited from the agreement on the free movement of persons in recent years (Brunetti, 2011). The strong economic growth preceding the crisis was substantially bolstered by the growth of labor supply, which in turn resulted mainly from immigration<sup>3</sup> (OECD, 2007). Switzerland has succeeded in increasing the structural share of highly qualified skilled labor in recent decades (Pecoraro, 2006). This improvement of the migration structure drew not least on the country's rejection of the traditional immigrant worker model and the introduction of the freedom of movement between Switzerland and the EU (Haug, 2006). At the same time, the supply of foreign labor is traditionally procyclical in Switzerland, which dampens the rise in unemployment during economic downturns. However, this cyclicality has lessened, which may be partly explained by the agreement on the free movement of persons with the EU (OECD, 2007). While Swiss monetary policy is autonomous, exchange rate developments have noticeably restricted policymakers' room for maneuver in recent

years (section 3.1). The Swiss franc, traditionally reputed to be a safe haven among currencies in uncertain times, appreciated massively during the crisis. The real effective exchange rate of the Swiss franc rose by more than 20% from mid-2007 to end-2010 (chart 2).

Switzerland is likely to continue to pursue its bilateral approach in the near future. A survey conducted by ISO-PUBLIC in mid-2010 showed two-thirds of the Swiss population to reject EU membership, but 44% of respondents favored membership in the EEA.

## 2 Favorable Framework: Economic Structure, Labor Market, Fiscal Policy

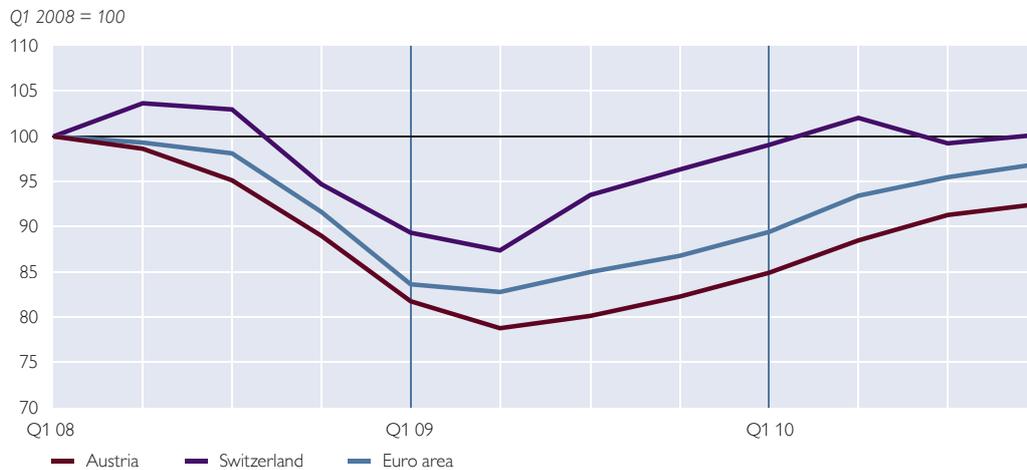
### 2.1 Sectoral Specialization Benefits Swiss but Weighs on Austrian Exports

Switzerland's sectoral and regional economic focus has supported the resilience of its foreign trade. Swiss exports slumped far less during the crisis than did euro area and indeed Austrian exports (chart 3). The contribution of net external demand to GDP was twice as high in Switzerland as in Austria during the crisis.

<sup>3</sup> This is particularly true of per capita economic growth, as most immigrants are working age and as labor force participation rates are high among immigrants.

Chart 3

### Development of Goods and Services Exports



Source: Eurostat.

The economic sectors in which Switzerland has taken global market leadership and which are considered to belong to the high-technology sector (chart 4) – above all the pharmaceutical industry and the manufacture of medical devices – were affected relatively little by the crisis. Whereas most manufacturing sectors in the industrialized countries suffered a severe slump in demand for exports in the course of 2009, prices and sales in the aforementioned sectors remained stable, which may be partly explained by the low cyclical nature of the generally state-run health care systems in the OECD countries.

The pharmaceutical industry's share of value added in the manufacturing industry is around 20% in Switzerland (euro area: 3½%; OECD, 2009a), and the pharmaceutical industry plus the manufacture of medical devices account for some 35% of Swiss exports. These demand effects have clearly more than offset the negative impact of the appreciation of the Swiss franc. In addition, exchange rate impacts on exports typically take effect with a pronounced

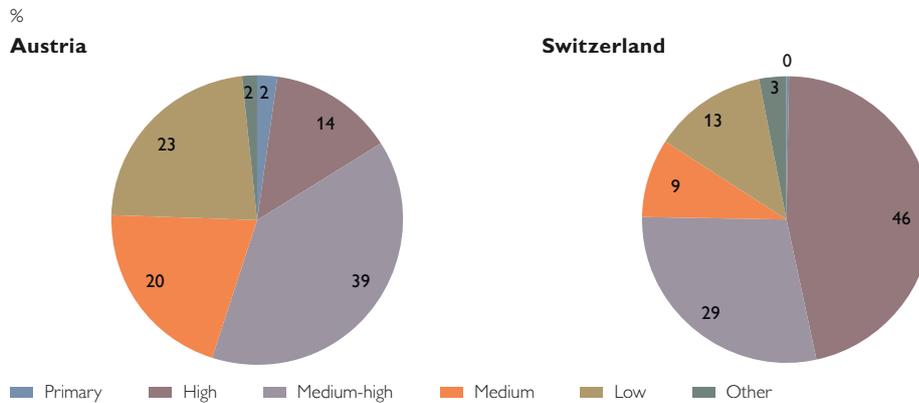
time lag. The high degree of representation of Swiss industry in leading-edge technology, frequently with patented products, may have strengthened manufacturers' pricing power and may thus have made them less susceptible to exchange rate fluctuations.

Conversely, Austria has established itself squarely within the trans-European value added chain and has garnered success in exporting, in particular, products with medium-high-technology content. For one thing, this underlines the relatively important role of the automotive supply industry. When the world automobile sector slid into recession, Austria's export industry also took a heavy blow. Austria's service exports, by contrast, performed fairly robustly, but the country has only established itself in services with a low value added potential. 88% of service exports were in the areas transportation and travel.

The Austrian government's economic stimulus packages reflected the crisis-prone structure of Austrian industry. Automotive product suppliers, for instance, indirectly benefited from the

Chart 4

**Structural Breakdown of Goods Exports by Technology Intensity in 2009**



Source: OECD.

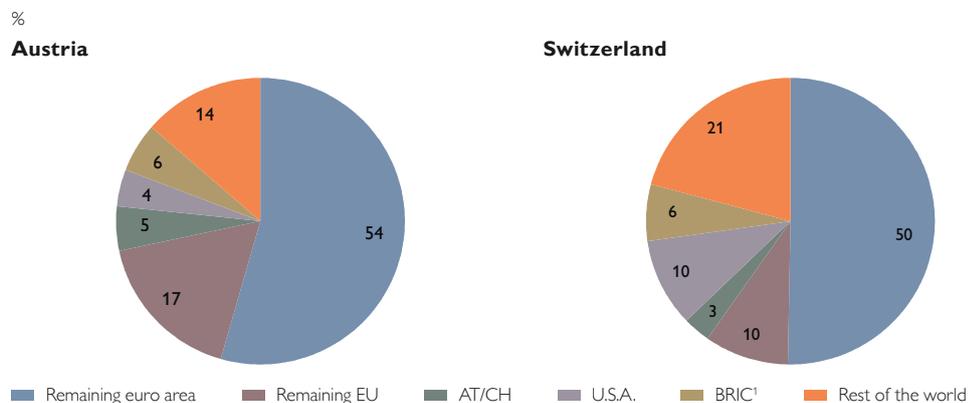
introduction of a car scrapping incentive that cost EUR 240 million overall (Breuss et al., 2009). Other EU Member States' car purchase incentive programs also buoyed Austria's automotive industry.

Switzerland's export industry also benefited from its regional diversification (chart 5): 50% of exports are to the euro area, but Switzerland also conducts a substantial share of foreign trade with emerging countries. These countries – above all China – experienced virtually no slackening of growth

during the crisis. According to an OECD analysis, Switzerland even out-ranks Germany on the list of European OECD member countries that are highly exposed to the Chinese market (Brézillon et al., 2010). By contrast, the lion's share of Austrian exports goes to other EU Member States (71%). Most recently, demand on the part of the Central, Eastern and South-eastern European (CESEE) countries and Germany powered Austrian export growth.

Chart 5

**Regional Breakdown of Export Demand in 2009**



Source: IMF.

<sup>1</sup> Brazil, Russia, India, China.

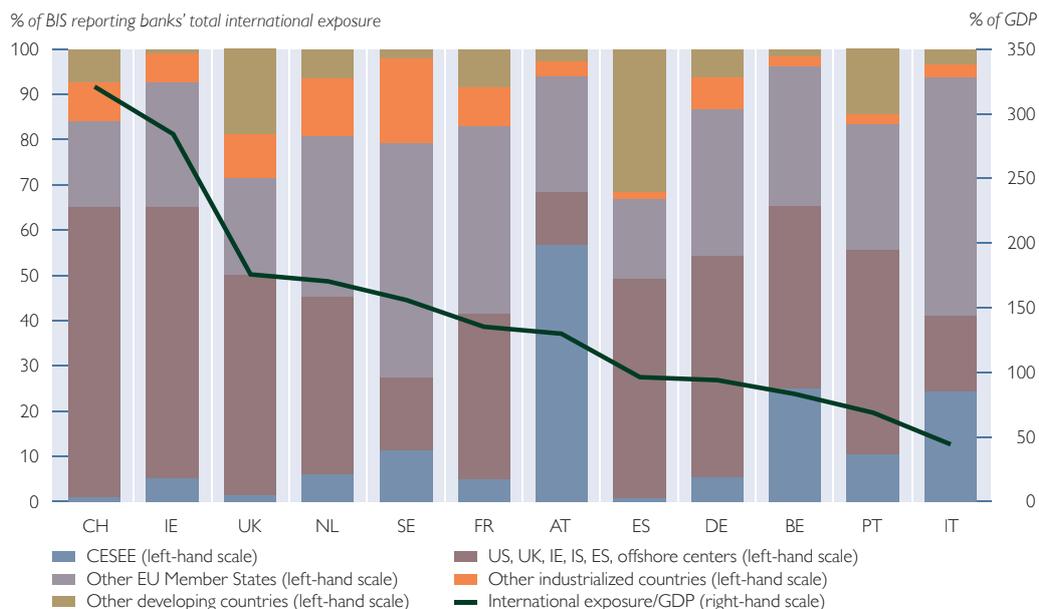
The financial market is a key economic factor especially in Switzerland, but also in Austria. Before the crisis, banks accounted for about 8½% of total Swiss value added, a larger percentage than in all other OECD countries (with the exception of Luxembourg).<sup>4</sup> Including the insurance business, the contribution of the financial sector to value added was 13%. By comparison, financial intermediation contributed roughly 4% or 5% to value added in Austria. While the Swiss financial market is dominated by the two global banks UBS and Credit Suisse, whose total assets amounted to seven times Swiss GDP in 2007 and still came to four times Swiss GDP in 2010, the Austrian financial market is rather fragmented and strongly exposed to the CESEE region (chart 6). Moreover, Austrian banks' total assets are much lower than those of their Swiss coun-

terparts. Whereas the financial market in Austria developed as a direct consequence of the European integration process, the Swiss financial center draws its eminent position from the historical importance of the Swiss franc as a safe haven currency – and from Swiss banking secrecy (Kugler, 2011).

As the Swiss financial market has specialized in asset management, fluctuations in the financial market do/did not have a strong negative impact on the economic cycle despite the market's size and global exposure (Schriber, 2007). Asset management business suffered above all from the decline in equity prices and sales, but was otherwise unaffected. Conversely, investment banking was seriously impacted by the financial crisis. The large Swiss banks were very heavily involved in investment banking and had to absorb substantial losses in securities trading for their

Chart 6

### Austrian Banks' International Exposure

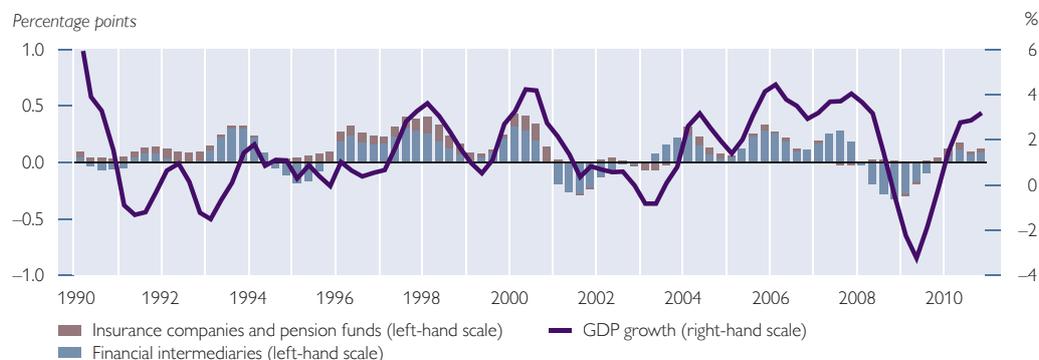


Source: BIS (Q3 2010), Eurostat.

<sup>4</sup> In 2010, this share declined to an average of approximately 6½% and 10½%.

Chart 7

**Switzerland: Financial Intermediaries' Contribution to Economic Growth**



Source: OECD.

own account (section 3.2). However, the banks conducted most of these activities outside of Switzerland. Even before the crisis, securities trading contributed only 15% to the Swiss banking sector's value added (Schriber, 2007). This explains why the negative contribution of financial intermediaries to value added was not much larger than in the previous period of turbulence around 2001, even though the most recent financial crisis was considerably more severe (chart 7).

**2.2 Debt Brake Expands Switzerland's Fiscal Policy Leeway**

Compared to the euro area average, Switzerland was in a comfortable fiscal policy position before the crisis hit.

In 2007, Switzerland's government debt ratio stood at only 46.5% of GDP (euro area: 66% of GDP). The country's rules-based fiscal policy contributed decisively to this low debt ratio. The Swiss constitution was amended in 2001 to provide for a debt brake for the federal budget<sup>5</sup>, calling for a federal

budget that was balanced over the course of the economic cycle and thus aiming for a reinforcement of the automatic stabilizers (Brunetti, 2011). Moreover, most of the Swiss cantons have imposed budget rules of their own. The declining debt ratio brought about by these measures affords Switzerland greater room for maneuver in times of crisis.<sup>6</sup> The cautious fiscal policy is likely to have strengthened the safe-haven effect for the Swiss franc and to have held financing costs in the private sector low, as the reduction of public debt bolstered the capital markets'

Table 1

**Fiscal Policy Indicators**

	Austria		Switzerland	
	Fiscal balance	Govern-ment debt	Fiscal balance	Govern-ment debt
	% of GDP			
2007	-0.9	60.7	1.7	46.5
2008	-0.9	63.8	2.3	44.3
2009	-4.1	69.6	1.2	42.2
2010	-4.6	72.3	-0.7	40.0

Source: European Commission, OECD.

<sup>5</sup> See e.g. Danninger (2002) and Federal Finance Administration (2004) for a description.

<sup>6</sup> Weber et al. (2008) present expenditure projections.

confidence in Swiss stability. Interest on long-term government debt remained favorable in Switzerland, also by comparison to Austria.<sup>7</sup> Prior to the crisis, Austria's public debt ratio stood at 60.7% of GDP, somewhat less than the euro area average.

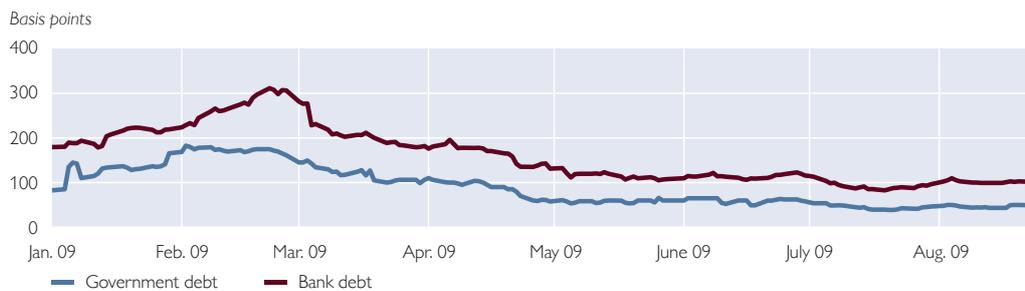
Despite the greater room for maneuver for Switzerland, far weaker fiscal policy measures were taken during the crisis than in Austria. The discretionary

deficit-reducing measures came to roughly 0.7% of GDP in 2009 (OECD, 2009a), less than in Austria (1.2% of GDP; OECD, 2009b). The related expenditures were mainly for projects already started, e.g. infrastructure development or research promotion projects, because the special combination of direct democracy and Swiss federalism can result in long delays in implementing new projects (Brunetti,

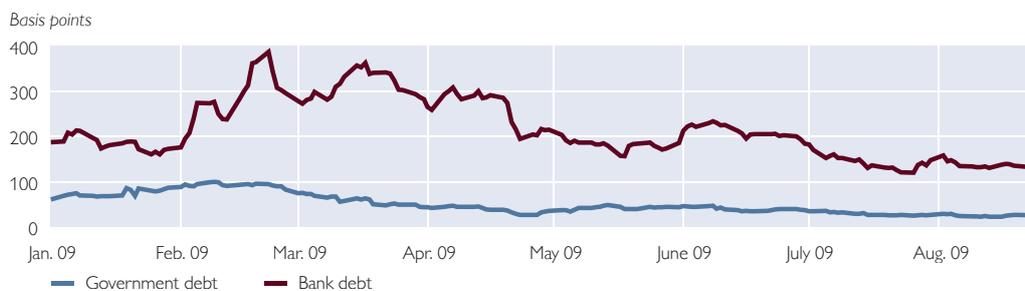
Chart 8

### CDS Prices for Government and Bank Debt

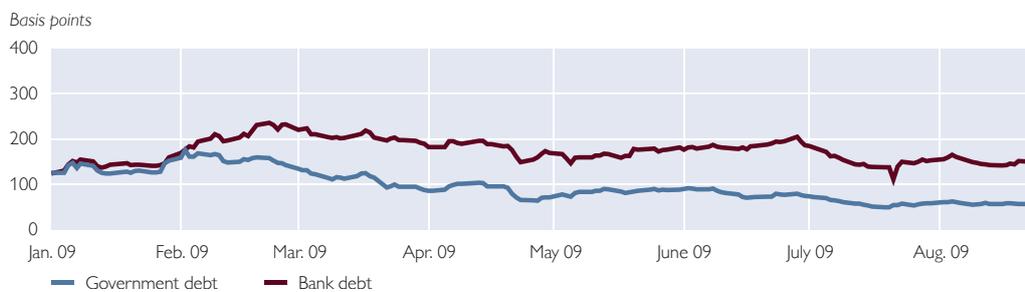
#### Switzerland



#### U.S.A.



#### United Kingdom



Source: Thomson Reuters.

<sup>7</sup> In March 2010, interest on ten-year Swiss government bonds was roughly 2% lower than on Austrian government bonds. At most half of this gap can be explained by the lower inflation target in Switzerland.

2011). At the same time, strong uncertainty about how long the crisis would last and how deep it would be led policymakers to adopt a gradual approach, under which discretionary measures that had already been adopted were taken stepwise and only after assessing whether they were still required.

Overall, Switzerland even managed to cut its debt from 46.5% in 2007 to 40.0%<sup>8</sup> in 2010 – despite the peak of the crisis. Even during the crisis period, the budget closed with a surplus every year. In Austria, however, the deficit rose from 0.9% of GDP in 2007 and 2008 to 4.6% in 2010, and government debt augmented to 72.3% of GDP. It must be noted, though, that the downturn was more pronounced in Austria than in Switzerland. Expansionary fiscal policy played a crucial role in buffering the impact of the crisis and helped stabilize sectors sensitive to cyclical fluctuations, such as construction, and to prevent domestic demand from slumping even more.

However, it also became clear in the course of the crisis that – at least from market participants' perspective – government solvency risks were much more closely linked to the perceived solvency risks of the country's largest banks than was the case in other countries with important financial centers (chart 8). This can be explained by the much greater weight the total assets of the two largest banks, UBS and Credit Suisse, had relative to the size of the economy. Consequently, the highly positive perception of the Swiss government's creditworthiness also during the crisis hinged on the stabilization of UBS (section 3.2).

### **2.3 Short-Time Work Schemes Stabilize the Labor Market Given Favorable Initial Conditions**

Both Switzerland and Austria feature internationally very low unemployment rates. In fact, joblessness slipped to a low mark of just 2.5% (Switzerland) and 3.5% (Austria) compared to the euro area average of 7.2% in March 2008. By the end of 2009, it had risen by 1.6 percentage points in each country; since then, unemployment has been on the decline again. In the euro area, though, the jobless rate persisted at a level of 10% until the end of 2010. In both countries, the labor market thus supported consumer demand during the crisis and lessened pressure on government spending.

In addition to the favorable initial conditions, labor market policy contributed to the resilience of the labor market to crisis. Publicly funded short-time working schemes in Switzerland and in Austria played a considerable role in keeping unemployment from rising too strongly: In Switzerland, at times in 2009, 1.5% of the labor force was able to keep its jobs because of short-time working schemes (chart 9). Austria, too, had provisions allowing for short-time working even before the crisis; these schemes were expanded further at the height of the crisis in February 2009.<sup>9</sup>

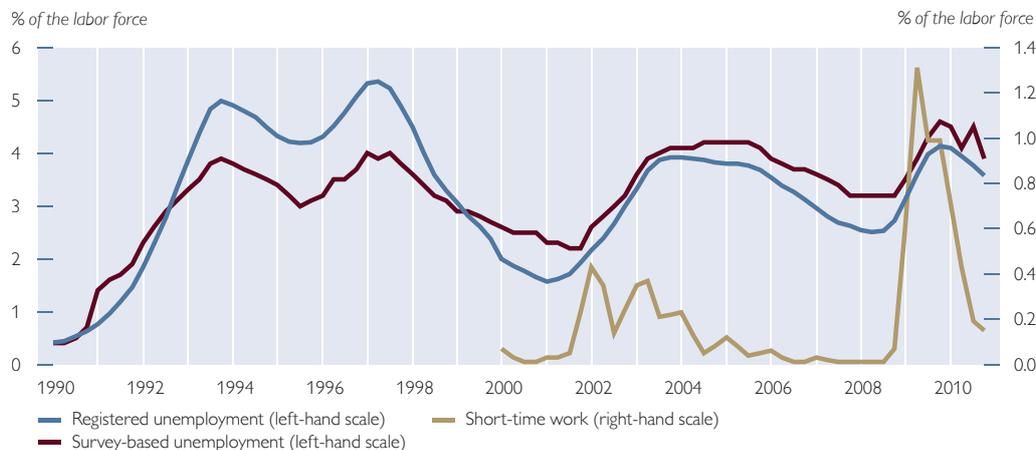
The smooth integration of young job seekers into the labor force via the established vocational training system made a major contribution to stabilizing the labor markets of both countries. The low share of young adults who are neither in training nor in the labor

<sup>8</sup> OECD estimate of May 2011.

<sup>9</sup> This included above all an increase in the maximum permissible reduction of working hours and an extension of the maximum period of applicability of short-time working from 12 months to 18 months.

Chart 9

### Switzerland: Unemployment and Short-Time Work



Source: OECD.

force confirms this assessment. But the vocational training system is not always immune to cyclical crises: Companies experiencing financial difficulties may cut back on investment in vocational training.<sup>10</sup> During the most recent crisis, though, Switzerland did not suffer any shortage of apprenticeship training positions, which may have to do with favorable financing conditions in firms, but also with demographic change and the resultant shrinking demand for training positions.

#### 2.4 The Swiss Real Estate Market Develops out of Sync with the Euro Area Market

The bursting of a housing price bubble in several euro area countries exacerbated the crisis substantially and massively endangered the stability of the banking system, but neither Switzerland nor Austria encountered such a procyclical factor. During the 1990s and at the beginning of the millennium, real estate prices remained largely stable and did not begin to rise

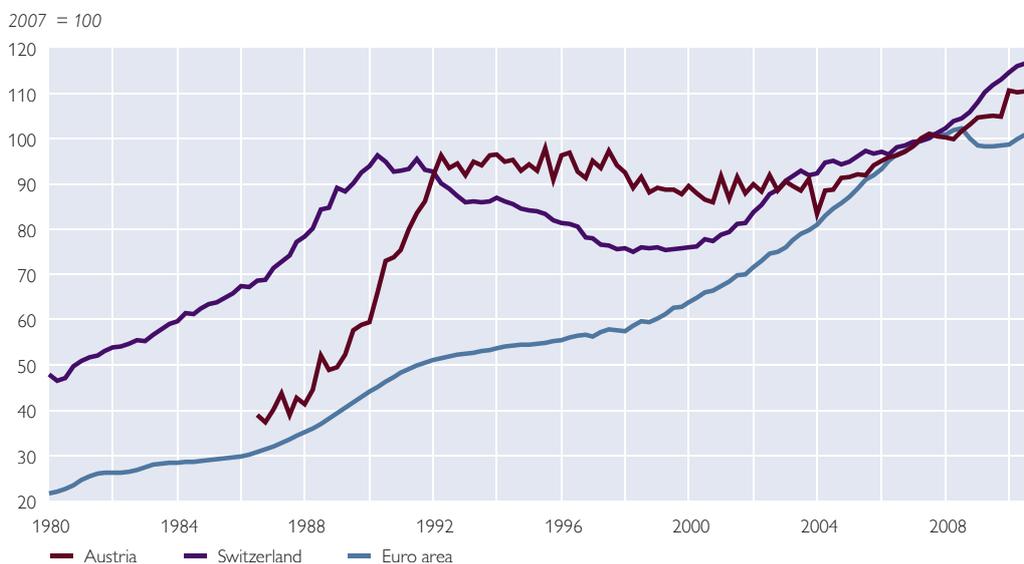
until more recently. In Switzerland, a housing price bubble had begun to develop as early as the mid-1980s, only to burst at the beginning of the 1990s, leading to a severe contraction of real estate prices (chart 10).

In the past few months, experts have increasingly sounded an alarm that a new real estate price bubble is building in Switzerland. In particular, the low key interest rates are helping create the conditions for such a bubble. However, Switzerland has always had high housing costs in an international comparison. One factor involved in these high costs is that each canton has its own construction standards, which undermines competition and raises construction costs (OECD, 2009a). One undesirable consequence of tax competition, moreover, is that local governments have an incentive to keep construction density low – to prefer single-family homes to apartment buildings – to attract a higher-income public. This, in turn, entails a lack of density in settlements close to urban areas and

<sup>10</sup> In fact, the supply of training positions in Switzerland is procyclical (Höckel et al., 2009).

Chart 10

### Development of Housing Prices



Source: ECB.

thus a shortage of housing supply (OECD, 2009a). By contrast, Austria pursues an entirely different housing policy, namely of providing a large volume of social housing.

### 3 Monetary and Economic Policy Contributes to the Rapid Recovery of the Economy

#### 3.1 The Swiss National Bank Provides Strong and Targeted Support to the Financial Market and the Economy

Monetary policy helped significantly to stabilize the economy and the financial market during the crisis. The Swiss National Bank (SNB) participated in the coordinated massive easing of monetary policy alongside the Federal Reserve and the ECB. As monetary policy has a delayed effect, the joint action in 2008 represented an important stabilizing stimulus for the economy in 2009. But some of the effects were

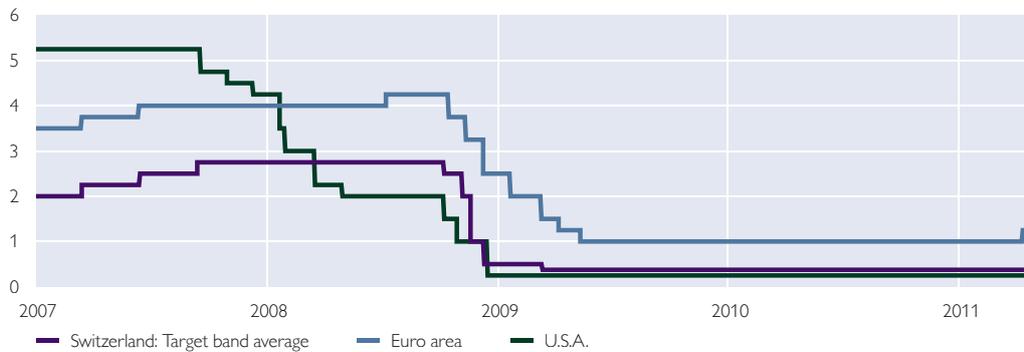
different in Switzerland: Like the ECB, the SNB reduced its key interest rate band as late as September 2008 (chart 11), but unlike interest rates in the euro area, short-term rates in Switzerland had stopped rising in the third quarter of 2007 and had also declined faster than in the euro area subsequently (chart 12).

The special nature of the Swiss monetary policy framework may have been partly responsible – the SNB sets an operational target range for the reference interest rate, namely the three-month LIBOR in Swiss francs. During the financial crisis, the spreads between interbank debt and “risk-free” credit spreads (e.g. central bank credit)<sup>11</sup> increased in high-income countries, which dampened the expansionary effects of monetary policy to a certain extent. These spreads were lower in Switzerland than in the U.S.A. or in the euro area. From the outset, the use

<sup>11</sup> This risk spread may be calculated as the difference between the LIBOR and the OIS (Overnight Indexed Swap) rate. The OIS reflects the expected risk-free overnight rate over the next three months.

Chart 11

### Key Interest Rates



Source: Thomson Reuters.

Note: Swiss target band until March 14, 2007: 1.5 to 2.5; until June 13, 2007: 1.75 to 2.75; until September 13, 2007: 2.0 to 3.0; until October 7, 2008: 2.25 to 3.25; until November 5, 2008: 2.0 to 3.0; until December 10, 2008: 0.5 to 1.5; until March 12, 2009: 0.0 to 1.0; from March 13, 2009: 0.0 to 0.75.

of the interbank rate as an operational target helped buffer factors that would result in a rise in this rate – such as increasing distrust among banks – by means of liquidity injections by the central bank. This approach dampens uncertainty about the future development of the interbank market, in turn reducing the risk premium on the interbank rate (OECD, 2009a).

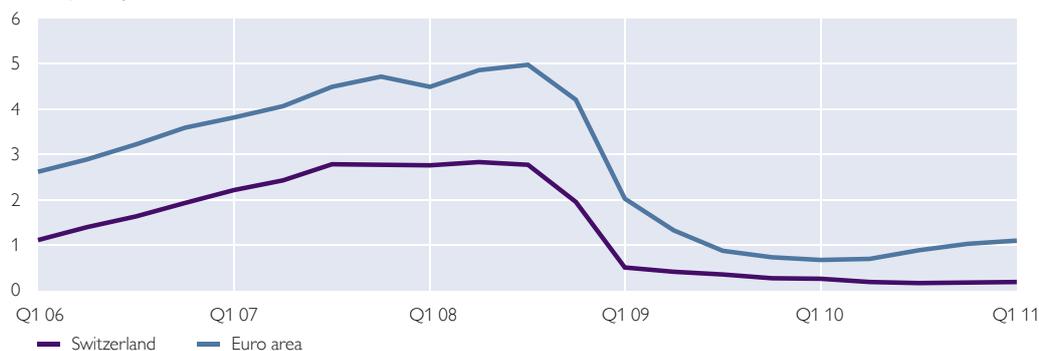
The euro area key interest rate was cut by a total of 325 basis points, whereas that of Switzerland was reduced by only 237 basis points. This gap may be partly

explained by the different nature of the two key interest rates. In Switzerland, the key interest rates included the risen risk premiums on interbank rates, but also reflect the country's lower pre-crisis interest rate level, giving the SNB somewhat less room for maneuver in cutting interest rates to close to zero. The Swiss definition of price stability is at the bottom of the lower initial level of interest rates: The SNB considers prices stable if inflation lies in a range of 0% to 2%. This target brought the inflation average in Switzerland over

Chart 12

### Three-Month LIBOR

Quarterly averages



Source: Thomson Reuters.

the last decade to approximately 1%. Conversely, the Eurosystem targets a rise in the HICP of below but close to 2%; and it has reached this target. Since the introduction of the euro, inflation has averaged about 2%.

Like other central banks, the SNB took other action in addition to lowering key interest rates to combat the crisis; it provided ample liquidity and purchased additional assets. This had become necessary not least because of the deflation risks which had arisen as a result of the massive appreciation of the Swiss franc in the course of the crisis. Whereas Austria's HICP growth rates were negative for only two months, Switzerland experienced deflation for eleven months in a row (chart 13).

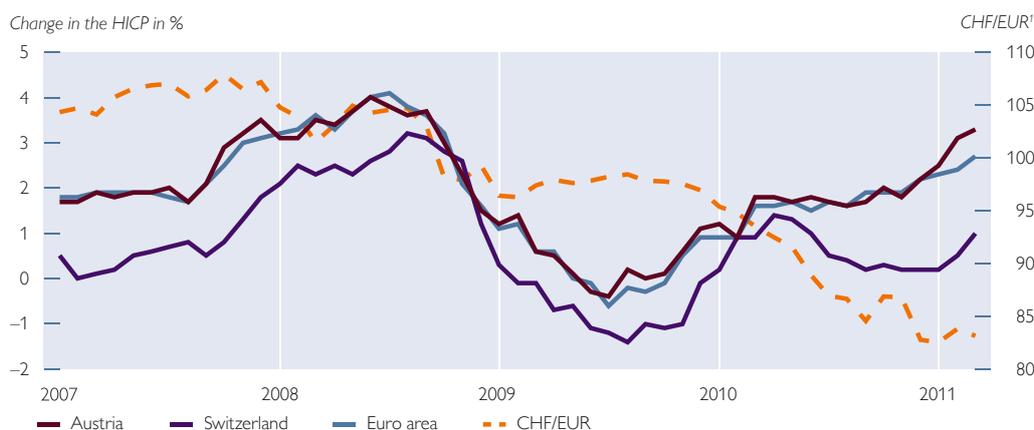
Compared to its Frankfurt and New York counterparts, the SNB was somewhat more restrictive in the choice of assets for purchase. The Swiss markets for asset-backed securities and corporate bonds are less developed than those of the euro area or the U.S.A.<sup>12</sup>

From March 2009, the SNB purchased foreign exchange to increase the monetary base. These purchases also served to put a lid on the appreciation of the Swiss currency and thereby to contain the risk of deflation. The purchases were not stopped until price stability had been securely reestablished.

When economic growth firmed in 2010, the SNB was faced with the difficulty that (like in some euro area countries) the interest rate level was too low to support robust domestic demand and thus gave the domestic real estate and mortgage market a strong impetus, but that an increase in key interest rates could fuel the rise in the Swiss franc even more and could thus weigh on activity in the export industry. Moreover, the strong Swiss currency kept inflation low. Given all these factors, the SNB was thus faced with finding the best moment to tighten monetary policy. At the beginning of April 2011, when the Eurosystem took the first step in reining in monetary growth by

Chart 13

### HICP and Nominal Exchange Rate



Source: Eurostat, BIS.

<sup>1</sup> Average for 2005 = 100.

<sup>12</sup> The volume of corporate bonds outstanding was less than 5% in Switzerland in September 2008; in the euro area, it was over 10%. The purchase of government bonds would have been an alternative, even if the Swiss market is smaller relative to GDP than that of the euro area or that of the U.S.A.

raising key interest rates by 25 basis points, Swiss key interest rates still hovered near zero.

### **3.2 Rescue of Large Swiss Bank UBS Prevents Systemic Financial Crisis**

With total assets of over 400% of Swiss GDP (2007), UBS is the largest bank in Switzerland. The financial crisis hit UBS hard – it had to write down USD 53 billion of its securities holdings until mid-2009 (OECD, 2009a), partly in connection with the U.S. subprime crisis. Since UBS was considered the world's best-capitalized bank before the crisis, its financial distress came as a surprise to some. The problem with this estimate, though, was rooted in the use of a risk-weighted approach for assets: UBS's assets comprised a hefty share of top-rated products that required only little capital cover. When the financial crisis unfolded, it turned out that the risk assessment of many of these products was off the mark.

While some other big banks operating internationally – above all in the U.S.A. – posted much larger losses than UBS in absolute terms and relative to the size of their total assets, UBS had to take writedowns that were very large measured in terms of the size of the Swiss economy as well as in terms of its equity, not least because UBS had such high leverage. Credit Suisse had to take smaller writedowns (OECD, 2009a). The other Swiss banks, which have a much smaller business volume and are concentrated on Swiss customers, did not have significant exposures in the subprime market.

The size of UBS's losses was met with great concern on the part of economic policymakers, who feared for the financial stability of the bank (Kugler, 2011). UBS may be oriented toward financial markets outside Switzerland, but the bank is nevertheless systemically important for the Swiss banking system; for example, it provides domestic and international payment services (Ambühl and Lewrick, 2010). Therefore, if it had not been possible to stabilize the bank, the consequences for the Swiss banking sector as a whole would have been dramatic.

The Swiss Federal Council and the SNB acted quickly in putting together a rescue package for UBS already in October 2008. The plan combined the advantages of transferring securities which had become illiquid into a central bank-run stabilization fund, with a government capital injection<sup>13</sup> (Wiedmer, 2011). At the outset, a volume of USD 54 billion (12% of GDP) of bad securities was slated to be taken over by the stabilization fund; ultimately, only USD 38 billion worth of securities were actually transferred. But this total was quite large compared to the size of the SNB's foreign reserve holdings. The SNB's loan to UBS to fund the asset transfer was financed largely by a swap agreement with the Federal Reserve System. Moreover, within the stabilization package, the Swiss Federal Council provided a capital injection of CHF 6 billion in the form of mandatory convertible notes. This total corresponded roughly to the envisaged maximum contribution by UBS to any losses of the stabilization fund. The residual risk of loss was borne

<sup>13</sup> From the perspective of stabilizing UBS, the transfer of toxic assets has the advantage of quelling uncertainty about the impact of any price changes on these securities on the bank's balance sheet. The capital injected allows the containment of moral hazard involved in state aid for stockholders of the bank. The moral hazard for the bank's debtors remains, however.

mainly by the SNB. In the meantime, sales have substantially reduced the volume of assets held by the stabilization fund, and so far, the public sector has not incurred any losses. In the meantime, the Swiss government has sold its mandatory convertible notes at a profit.

Whereas in Switzerland a systemically important financial institution had run into difficulties, in Austria, a handful of smaller banks experienced financial constraints because of their exposure to CESEE countries. In October 2008, the Austrian parliament adopted sweeping measures to ensure the sustainability of the domestic financial sector. As a confidence-building measure, deposits of natural persons were backed in full until end-2009. Since January 1, 2010, deposit insurance has been capped at EUR 100,000 per depositor and bank.<sup>14</sup> In addition, an option was created to strengthen banks' capital bases by providing state participation capital. A clearing bank was established to guarantee interbank credit, but recourse to its services was very low. Compared with the measures taken in other European countries, the Austrian bank support package was fairly generous, reflecting the firm resolve with which the Austrian government acted to maintain the stability of the Austrian financial center/market and to boost lending. Moreover, Austria actively championed the management of crisis-related problems in the CESEE countries with the Vienna Initiative, which helped stabilizing the Austrian banking sector.

Apart from the monetary policy measures taken, the rapid response of decision makers and the circumspect design of the bank rescue packages ensured that no credit shortage occurred in either Switzerland or Austria. In many OECD countries, a more restrictive lending policy dampened domestic demand,<sup>15</sup> either because borrowers' creditworthiness was assessed as being more unfavorable or because banks reduced their credit supply for solvency or liquidity reasons. Banks downsized balance sheets to absorb the impact of losses on capital ratios, in particular by cutting back on lending.<sup>16</sup>

In Switzerland, the total volume of loans granted by Swiss banks declined because foreign demand, which is important for large banks, contracted sharply and because banks scaled back external positions. The volume of lending in Switzerland continued to expand, though, and was in fact more robust than during the previous downturn in 2001 (chart 14). The rescue package put together by the Swiss government and the SNB succeeded in stabilizing UBS and thus the Swiss financial sector. Because the smaller Swiss banks do mainly domestic business, they did not require any consolidation. Moreover, they indirectly benefited from the inflow of funds from UBS customers, which they used to enlarge domestic credit supply (NZZ, 2009). As the crisis did not affect the real estate market, banks were not required to adjust their mortgage portfolios, either. Swiss companies' leverage is moderate in an international comparison, which contributed to the

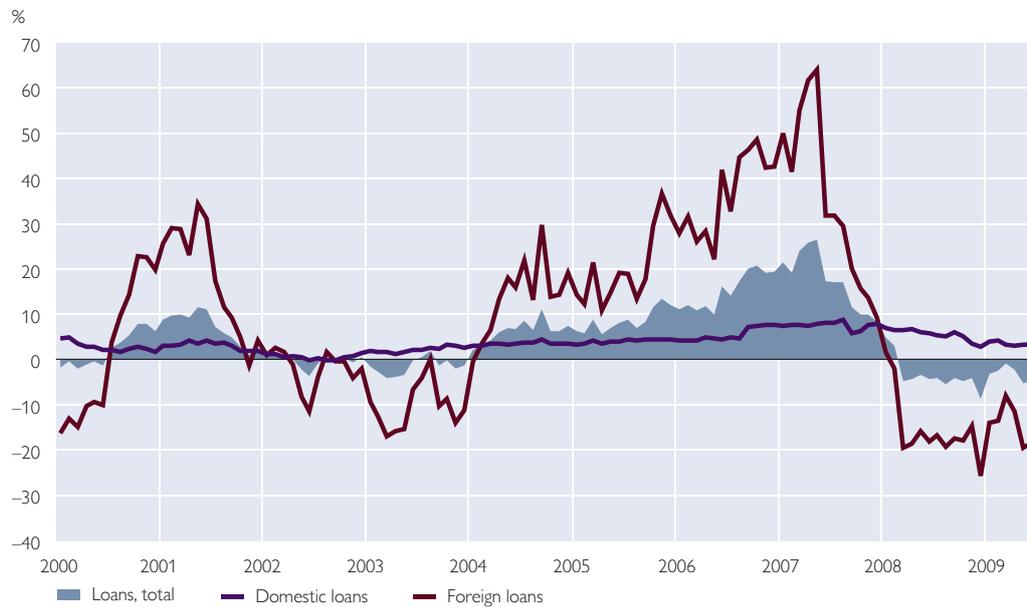
<sup>14</sup> For more details, see OeNB (2009). Switzerland also extended its deposit insurance coverage, but retained fairly stringent upper limits.

<sup>15</sup> Many banks, e.g. in the U.S.A. and in the euro area, introduced tighter lending conditions especially in 2008 (OECD, 2008).

<sup>16</sup> More restrictive lending could also have a negative impact on export financing. In fact, a pronounced share of the slump in foreign trade in 2008 and 2009 can be traced to more restrictive lending (OECD, 2008).

Chart 14

### Switzerland: Loan Growth



Source: SNB, Monthly Statistical Bulletin.

stability of their creditworthiness. Low corporate taxes in Switzerland reduce companies' tax incentive for substantial debt financing.<sup>17</sup> The robust labor market and sound government finances also fostered private and public borrowers' creditworthiness (section 2).<sup>18</sup>

#### 4 Summary and the Lessons of the Swiss Experience

Switzerland and to a lesser extent Austria demonstrated resilience during the crisis and experienced a fast recovery. Labor market stability and the absence of a housing bubble before the crisis contributed decisively to both countries' development. Above all in Switzerland, the economy's specialization on/in products that are relatively robust to cyclical fluctuations also played an important role. In both countries, cuts in key interest rates, economic stimulus

packages and labor market policy measures made a crucial contribution to stabilizing consumer demand and shoring up business confidence. Another factor which played an important role is that both countries succeeded in stabilizing the banking sector without unduly burdening government budgets. As the financial and economic crisis wore on, the moderate government and private sector debt level came to play a stabilizing role as well.

The strategies that kept Switzerland on an above-average growth path cannot simply be transposed to Austria, however. Austria would do well to improve its export structure by moving to higher-quality production. Increasing research and development expenditure and more investment in education could promote such a shift. As Austria is strongly integrated into overall Euro-

<sup>17</sup> However, Swiss stockholders have to pay taxes on dividends at regular income tax rates, though not in all cases. By contrast, retained earnings benefit from the fact that value gains are generally not subject to taxation.

<sup>18</sup> Then again, household gross debt is high by international standards.

pean manufacturing structures, such improvement strategies are more contingent on developments in Austria's main export partner countries than is the case in Switzerland. European integration also prevents Austria from pursuing an independent immigration policy of the Swiss type that focuses only on highly qualified migrants. Switzerland benefited most from growing in-migration from EU countries; such effects are hard to achieve in Austria. Switzerland leads by example above all in the development of public finance: Of course, Switzerland is generally the richer economy, but there is no doubt that Austria's public expenditure and tax structures have a great reform potential.

Despite its relatively successful position, Switzerland will face a number of economic policy challenges in the next few years.

As a case in point, it will be especially crucial to take preventive regulatory action against risk emanating from the too-big-to-fail Swiss banks. In this vein, the Swiss banking authorities already tightened existing capital and liquidity standards for banks and introduced a ratio of capital to total non-risk-adjusted assets for large banks (OECD, 2009a). Furthermore, the Swiss government proposed a set of measures to parliament that provides for additional capital requirements for the large banks. These capital requirements are to be calculated based on a given bank's total assets and its systemic importance, but long transition periods are envisaged. Also, the large banks will

have to present plans on how to sequester and run systemically important business areas from other operational units if the latter are distressed (Wiedmer, 2011). In addition, it might be worth considering drawing up a set of "macroprudential" regulatory instruments in Switzerland suited to rapidly identifying and defusing stability risks that arise as a result of undesirable systemic developments. At present, cautious observation of real estate price developments is in order.

What is more, trend productivity growth in Switzerland was weak in the past few years both compared to Austria and compared to other OECD countries. Hence, the aggregate level of productivity remained low despite the high/great weight of research-intensive and highly productive sectors in Swiss GDP in an international comparison, mainly because of the development of services not suited to international trade. The relatively high level of prices for goods produced and services rendered in Switzerland by comparison to other high-income countries (e.g. Austria) notwithstanding lower taxes results from weaker productivity in these sectors (OECD, 2007; OECD, 2009a).

Keeping step with the many decisions and reforms in the EU to preserve Switzerland's tried and true "bilateral approach" represents an additional challenge. However, as many agreements with Switzerland are in the EU's interest as well – such as the exchange of financial information – both parties are likely to wish to continue the negotiation of bilateral agreements.

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## Annex

Program of the OeNB workshop of April 11, 2011 “Schweiz und Österreich – Zwei kleine Nachbarstaaten in und nach der Krise” (Switzerland and Austria – Two Small Neighboring Countries during and after the Crisis)

9:00 a.m. **Switzerland and Austria –**

**Resilience to Crisis thanks to Structural Strengths**

Chair:

*Doris Ritzberger-Grünwald*

Head, Foreign Research Division, Oesterreichische Nationalbank (OeNB)

*Aymo Brunetti*

Head, Economic Policy Directorate,

State Secretariat for Economic Affairs (SECO), Bern

*Andrés Fuentes*

Economics Department, Organisation for Economic  
Co-operation and Development (OECD)

Discussant:

*Fritz Breuss*

Austrian Institute of Economic Research (WIFO)

11:00 a.m. **A Small Country and the Financial Market:**

**Source of Growth and Risk?**

Chair:

*Peter Mooslechner*

Director of the OeNB's Economic Analysis and

Research Department, Oesterreichische Nationalbank (OeNB)

*Thomas Wiedmer*

Alternate Member of the Governing Board,

Swiss National Bank (SNB), Bern

*Peter Kugler*

Professor, University of Basel

Discussant:

*Philip Reading*

Director, Financial Stability and Bank Inspections Department,  
Oesterreichische Nationalbank (OeNB)