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Assessment of Exchange Rate Developments

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Exchange Rates

The Views of Clients, the Market and Credit Suisse

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Editorial

Dear Reader,

Many export-oriented Swiss firms have faced major challenges as a result of the strong Swiss franc in recent years. However, thanks to long-standing Swiss attributes such as innovation, quality and adaptability, many clients have not only been able to overcome this crisis but have emerged from it stronger than ever.

A whole series of elections are being held in Europe this year and the global political events of recent months have thrown up some relatively unexpected events. The possible impact of political risks is difficult to forecast, however. In these uncertain times the Swiss franc is likely to remain strong for a while longer.

Credit Suisse is represented in every region of Switzerland with a team of FX specialists. This local presence enables us to have an intensive dialogue with companies on the exchange rate risks they face. In the course of our many discussions with clients, the growing uncertainty about the outlook for the Swiss franc against the euro, dollar and British pound is often a key issue. This prompted us to conduct a survey of Swiss companies' views on exchange rates. The results of the over 500 responses we received are set out in this brochure.

We hope that this will provide you with some interesting and useful insights for planning your foreign currency exposures.

Our mission is to be a competent and reliable partner for all your foreign exchange needs. We will always do our utmost to find the optimum solution for your individual situation.

We hope you enjoy reading this report.

Andreas Gerber
Head of SME Business Switzerland

Leif Woodtly
FX Sales Corporate & Institutional Clients

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Corporate Client Survey

SMEs Budgeting Cautiously

The roughly 500 small and medium-sized enterprises (SMEs) we surveyed expect a EUR/CHF exchange rate of 1.08 in 2017. The budgeted exchange rates are on the conservative side, particularly in the case of importers.

Over 500 corporate clients and their views on exchange rates

Around the turn of the year 2016/2017, Credit Suisse surveyed over 500 corporate clients on their expectations for exchange rates in 2017. Just over 40% of the participants in the survey have an export focus, while one third are primarily involved in importing. A quarter of the participating companies are involved in both the import and export business. This mirrors the structure of Swiss foreign trade fairly accurately: exports accounted for approximately 55% (CHF 210 billion) of total Swiss foreign trade volumes of CHF 384 billion in 2016.

Companies' exchange rate expectations differ (sometimes sharply)

The expectations and views of businesses about the future direction of exchange rates differ sharply (see left-hand chart). In the case of the euro this is not very surprising, as there are important elections and political decisions on the agenda in Europe over the coming weeks and months. After Brexit these could put Europe's cohesion to the test yet again and potentially impact on currency movements (see European Risk Barometer section, p.9). In spite of differing exchange rate expectations, the businesses do agree on one thing: a rate of 1.20 EUR/CHF – i.e. the EUR/CHF exchange rate cap abandoned by the SNB at the beginning of 2015 – is unlikely to be seen again in the near term. On average, the survey respondents expect an EUR/CHF exchange rate of just under 1.08 in 2017. The forecast for the US dollar in 2017 is CHF 1.02, while the British pound is forecast at CHF 1.25.

Firms use a cautious EUR/CHF rate for budgeting purposes

A rise in the franc is a particular risk for exporters, as their products become more expensive for foreign customers. The opposite naturally applies to importers, as their goods become more expensive if the Swiss franc depreciates. Consequently, importers generally budget more cautiously with a higher EUR/CHF rate (1.10) than exporters (1.07). A further indication of conservative planning is the difference between the EUR/CHF exchange rate businesses have budgeted for and their forecast. Particularly in the case of importers the average budgeted rate differs significantly from their exchange rate forecast of 1.07 (see right-hand chart).

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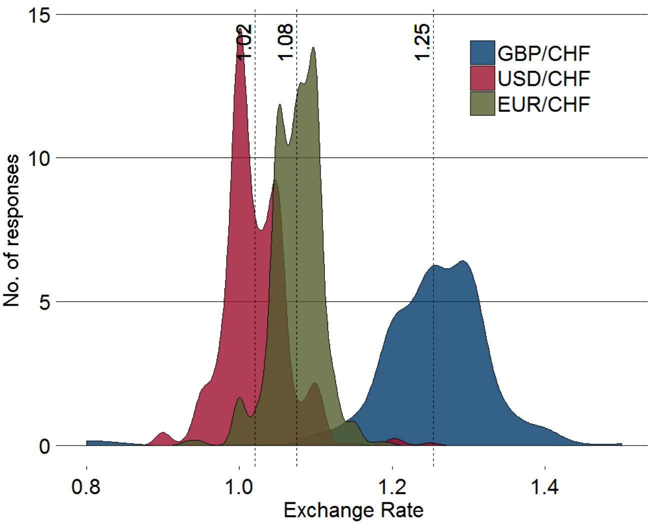
Exchange rate expectations widely dispersed

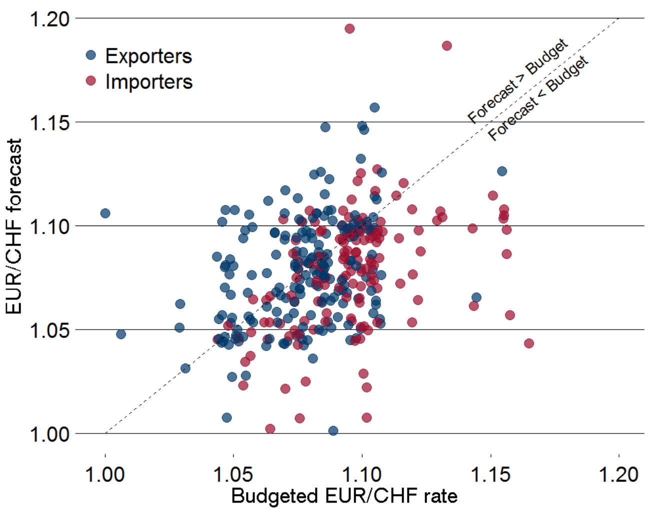
Exchange rate forecasts of surveyed SMEs for 2017; dotted line = average of all forecasts



Source: Credit Suisse SME Survey

Cautious EUR/CHF budgeting

EUR/CHF forecast and budgeted rate for 2017 for importers and exporters



Source: Credit Suisse SME Survey

Detailed Results of the SME Survey

Market Forecasts for 2017

Swiss businesses are not alone in their forecasts of exchange rates: according to Bloomberg Consensus, an average forecast of around 80 banks from around the world, exchange rates will average 1.07 (EUR/CHF), 1.03 (USD/CHF) and 1.25 (GBP/CHF) in 2017. The SME and market forecasts are all only around half a percent apart. The expectations of businesses and the market are therefore largely in line with each other.

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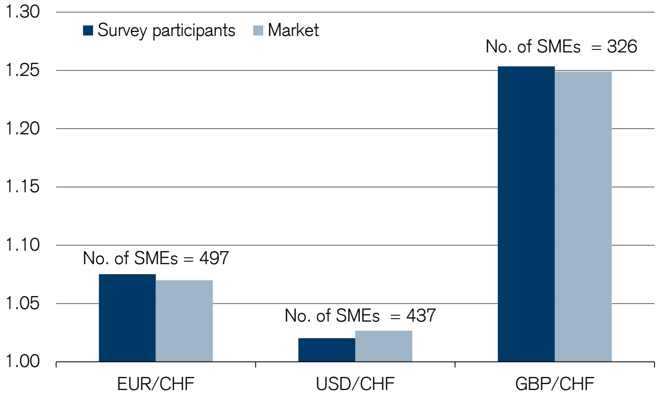
Corporate clients and the market in harmony

Exchange rate forecasts of the market and surveyed SMEs for 2017



Source: Bloomberg, Credit Suisse SME Survey

Hedging of Currency Risks

Swiss SMEs with a strong export and/or import focus and a large proportion of costs in Swiss francs (staff, real estate, etc.) have had to cope with large moves in exchange rates in recent years. These companies have in some cases suffered heavy margin losses. Given the current political uncertainties in Europe it is all the more surprising that well over a third of the companies surveyed do not hedge their currency risks. Only one in nine exporters protects themselves entirely by hedging. In the case of importers it is just over one in six.

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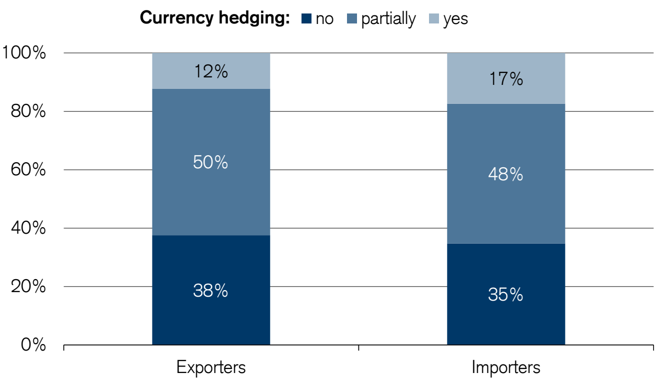
Currency risks are mostly borne by the businesses themselves

Proportion of surveyed SMEs who hedge currency risks (in percent)



Source: Credit Suisse SME Survey

Export Industry

Companies who hedge their currency risks have the advantage of being able to effectively budget with the exchange rates they expect. For example, in the export industry the average budgeted EUR/CHF rate of companies surveyed who have a hedging strategy is actually 0.8% above their exchange rate forecast. Companies without such hedging measures incorporate this risk into their budgeted rate, which in the case of the export industry is around 2.5% below the exchange rate these companies expect.

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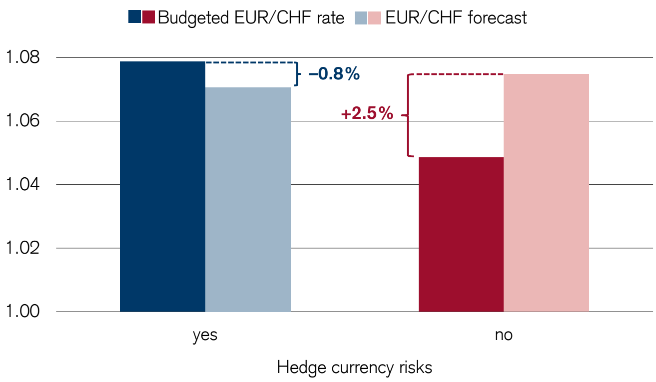
Non-hedging companies budget more conservatively

2017 EUR/CHF forecast and budgeted rate in the export industry



Source: Credit Suisse SME Survey

Credit Suisse Exchange Rate Forecasts

EUR Expected to Rise against CHF

We see EUR/CHF at 1.09 in 12 months' time. This positions the Credit Suisse forecast just marginally above that of SMEs and the market. The EUR should gain support from its undervaluation. In addition, a sustained rise in interest rates outside Switzerland should weaken safe haven demand. However, the lack of capital outflows from Switzerland limits the upside potential of the euro. Because political risks remain ever-present in Europe and the SNB is likely to tolerate moderate Swiss franc strength, we continue to regard protection against downside risks in the euro as advisable.

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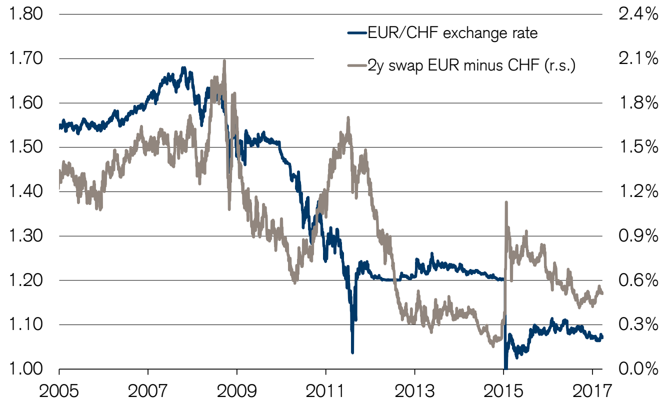
EUR interest rate differential remains low

EUR/CHF and two-year swap (right scale)



Source: Bloomberg, Credit Suisse, last data point:20.03.2017

USD Should Continue to Strengthen

We expect the USD/CHF exchange rate at 1.09 in 12 months' time. Our outlook for the US dollar against the Swiss franc is significantly more positive than the views of SMEs and the market. Strong US macro data and the continued tightening of US monetary policy will support the US dollar in our view. At the current stage of the cycle where the interest rate differentials vis-à-vis the Swiss franc have reached a critical level, further rate hikes by the US Federal Reserve are generally favorable for the US dollar, particularly since there is no limit on dollar strength from the valuation side.

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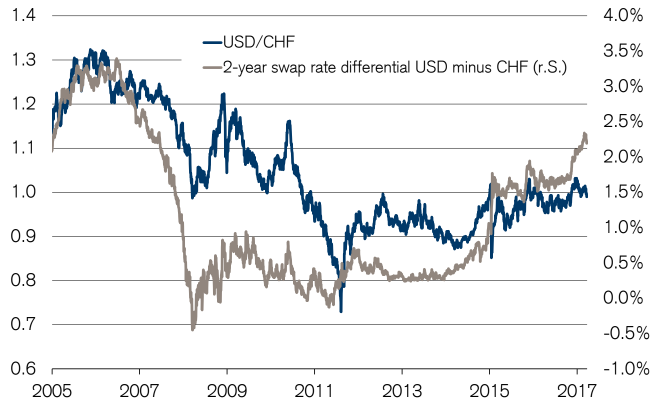
Interest rate differential widens in favor of the USD

USD/CHF and two-year swap rate differential



Source: Bloomberg, Credit Suisse, last data point:24.03.2017

GBP Expected to Rise against CHF

We are positive on the pound due to its very low valuation. In our view a "hard" Brexit is priced in, and the risk of further weakness is limited assuming the UK data is not much weaker than expected or the Bank of England shifts to a looser policy stance. If the market begins to view the prospects for Brexit more positively, we see potential for a recovery, especially against the franc, as the pound is the most undervalued currency against the Swiss franc. We expect a GBP/CHF exchange rate of 1.42 in 12 months' time.

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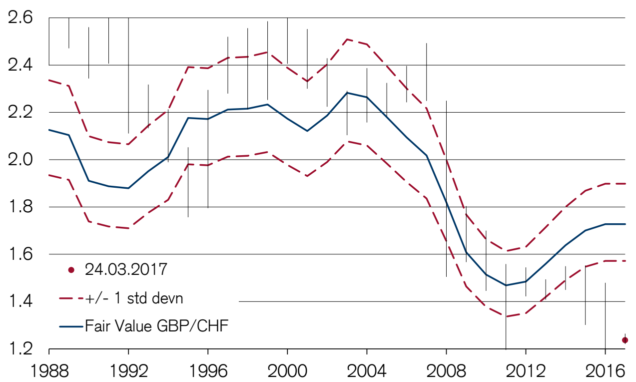
GBP especially undervalued against the CHF

Fair Value GBP/CHF



Source: Bloomberg, Credit Suisse, last data point:24.03.2017

Global Environment

Broadening Upturn in Global Growth

The improvement in the global economy is continuing, and we expect higher growth in 2017 than last year. Inflation is projected to overshoot a little in the first quarter of 2017 and only fall modestly thereafter.

Robust US economy paves the way for further Fed hikes

Although the new US administration has announced very few concrete details on its fiscal policy agenda since it took office, the economic data has remained robust since the beginning of the year. The sentiment indicators for businesses and consumers remain at very high levels. At the same time, inflation has picked up gradually. The US Federal Reserve (Fed) has already responded by raising interest rates in March and signaled that there will be further rate increases this year. We expect two further upward interest rate moves in 2017.

Signs of a more solid recovery in the eurozone; ECB could signal less accommodative policy

In spite of all the political risks, the economy also seems to be in robust shape in the eurozone. Except in the eurozone heavyweight Italy, as well as in Greece, the recovery seems to be increasingly self-sustaining. We expect continued solid growth in the coming months which will enable a further fall in unemployment and should so continue to support consumer spending. The backdrop for this is being created by a number of supportive factors such as low interest rates, a gradual pickup in credit growth, relatively stable commodity prices and a very weak euro. The question as to when and how quickly the European Central Bank (ECB) will taper its asset purchases in this environment is likely to increasingly become the focus of debate among market participants.

Global recovery also supporting emerging markets, but momentum more modest here

Even in the emerging markets the global upturn is evident, even if not quite as pronounced. This is due to the fact that China's growth is stabilizing rather than accelerating, while India continues to struggle with the effects of its demonetization and only seems to be recovering from it gradually. In Russia the economy is currently recovering rapidly and business sentiment is back to the levels of 2011. This is not yet the case in Brazil, however, as business confidence remains depressed here. However, the government is making progress with its reforms and the central bank is able to ease monetary policy thanks to falling inflation.

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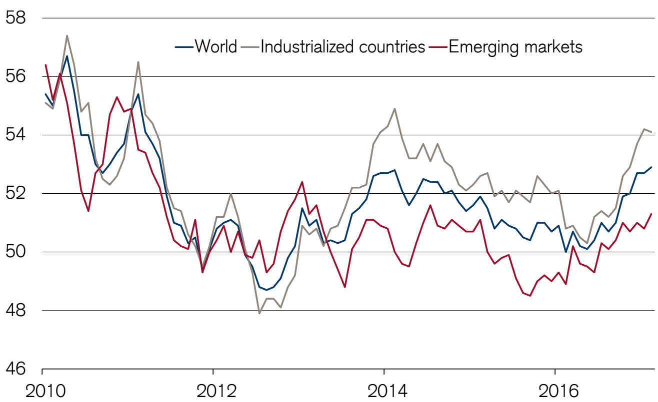
Global economy continuing to recover

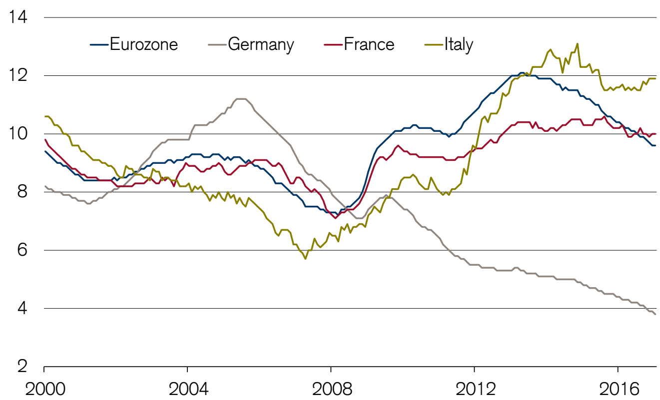
Index levels, purchasing managers' indices for the manufacturing sector



Source: Datastream, Credit Suisse

Unemployment rate falling in the eurozone

As a % of the workforce



Source: Datastream, Credit Suisse

European Risk Barometer

Important Decisions Dominating the Landscape in Europe in 2017

Key decisions are on the agenda in Europe in 2017 which will lead to elevated political risks in the EU. The Credit Suisse European Risk Barometer measures the extent to which these risks are already priced in by the markets.

Whole series of landmark political decisions due in Europe in 2017

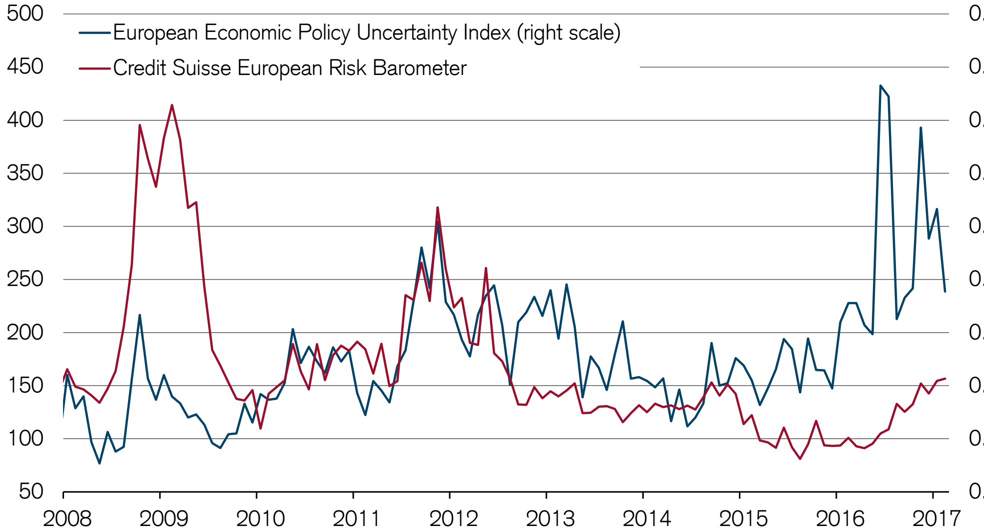
In spite of the increasingly positive macroeconomic situation, political uncertainty is intensifying in Europe in 2017. The reason for this is the many upcoming elections and political decisions in important member states of the European Union. The first round of the French presidential elections with the populist and nationalist candidate Marine Le Pen will be held on April 23. Greece is due to repay bonds to the ECB and other national central banks in April and there could be new elections in Italy in September.

"Ode to Joy", "Muddling Through" or "Inferno"?

Based on these risks we have come up with three scenarios for Europe's political and economic future. In the **"Ode to Joy"** scenario Greece is granted its next bailout package. France elects a center-right president (Macron or Fillon) but not a far-right president (Le Pen). The Italian elections produce a government under the leadership of the Democratic Party (PD) and other reforms, even if only implemented slowly, enable the banks to raise fresh capital and continue to clean up their balance sheets. In the **"Muddling Through"** scenario the Greek saga continues, Marine Le Pen achieves a strong result in the first round of the French elections before losing narrowly to Emmanuel Macron in the second round, but the nature and composition of the French government are unclear. The macroeconomic data is stable, but not outstanding. The gulf between the ECB's hawks (who want to raise interest rates) and doves (who want to cut interest rates or extend the asset purchase program) widens, as Mario Draghi's term of office is nearing its end and there is a north-south divide as regards the improvement in the macroeconomic data. Italy makes little progress. In the **"Inferno"** scenario the EU/euro crisis returns and Greece struggles to raise the funds to meet its obligations. Marine Le Pen wins in France but faces a hostile parliament.

Political risks in Europe not fully captured by the markets

European Risk Barometer and European Economic Policy Uncertainty Index



Source: Bloomberg, Barclays, Datastream, Economic Policy Uncertainty, Credit Suisse

“Muddling through” in Europe very likely

Even though “Ode to Joy” is not our main scenario, we attach a probability of around 30% to it. Despite the currently weak euro, our European Risk Barometer suggests that the markets are positioned close to this scenario. If we actually did end up in this world, a gradual tightening of monetary policy by the ECB would strengthen the euro and so take considerable pressure off the Swiss franc. If European politics “muddle through” (main scenario with a 50% probability) any monetary tightening by the ECB is likely to occur later, which should ensure there is little upward pressure on the euro. Under the pessimistic “Inferno” scenario and the associated revival of the eurozone crisis, the Swiss franc is likely to increasingly take on the role of a “safe haven” for investors. Upward pressure on the franc would therefore increase sharply. However, we regard this scenario as unlikely.

European Risk Barometer below its ten-year average

The European Risk Barometer, which has been developed in-house by Credit Suisse, is intended to indicate how far the political risks and scenarios we have discussed above are already priced into markets. It is based on parameters for liquidity, longer-term country ratings, and various indicators of market expectations for volatility and the form and size of tail risks. The current level of the barometer indicates a slightly below-average implicit market risk. The main reasons for this are relatively low money market and credit spreads, low bid-ask spreads in government and corporate bonds, low implied volatility of corporate bonds and equities and lower interest rates for personal and commercial lending.

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Country Risks at a Glance

Netherlands

A large majority of the Dutch electorate decided not to back the right-wing populist Geert Wilders and his PVV party, who won 13% of the vote, and therefore rejected an anti-European policy. The center-right VVD party under the leadership of Mark Rutte emerged as election winners, even though the VVD's vote share was down by almost 5 percentage points compared with 2012 and the right-wing populists under Wilders gained just under 3 percentage points. The election result means that at least four parties will have to come together to create a parliamentary majority of 76 seats. Forming such a coalition will take some time.

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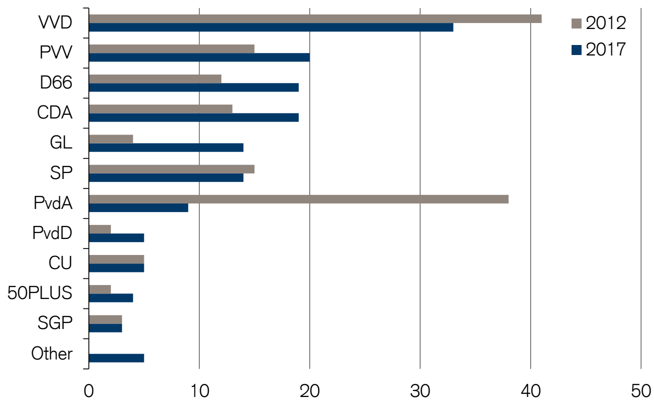
Dutch opt for Europe

Seats in the lower house by party (Total: 150 seats)



Source: Lower chamber of the States General

France

The presidential election campaign is underway. The National Front (FN) candidate Marine Le Pen has put forward an aggressive manifesto. The key components of her presidential program are a return to the French franc and drastic protectionist measures. Le Pen is leading in the first round of the elections in a number of polls, but would lose in the run-off against either the independent candidate Emmanuel Macron or the Republican candidate François Fillon. We share this view and believe this is the most likely scenario.

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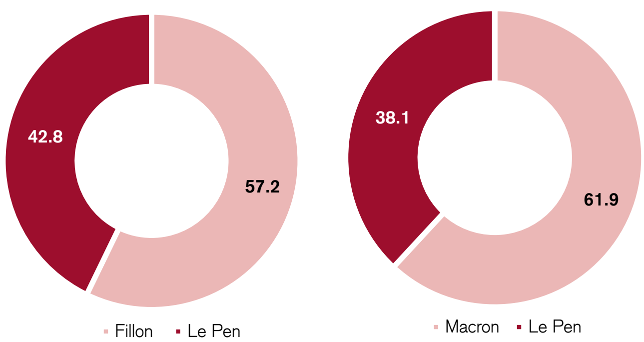
Le Pen expected to lose in the second round

2nd round: average of selected opinion polls (in percent)



Source: OpinionWay, Ifop, Harris, Elabe; Credit Suisse, last data point:24.03.2017

Italy

The defeat of the referendum on political reform in December led to the resignation of Prime Minister Renzi (PD). The leader of the PD then called for an open contest for the party leadership, which means that the risk of early elections in the second quarter has fallen. New elections could still take place in September 2017, however. Until then there will probably be no fundamental structural reforms. Given the high level of government debt, the sluggish pace of economic growth will continue this year.

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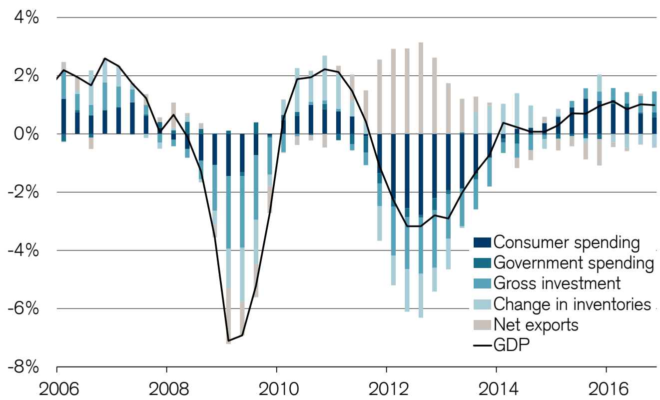
Weak economic growth in Italy

Contribution to GDP growth in percentage points



Source: Datastream, Credit Suisse

Country Risks at a Glance

Greece

The creditors are at odds over the second review of the third bailout package for Greece, which runs to EUR 86 billion. The IMF has made its participation conditional on lower targets for the primary surplus and debt relief measures. Germany is opposed to debt relief and is arguing for further economic reforms. Greece's next large redemption payment of EUR 6.1 billion is due in June and an agreement about the next tranche of the bailout will have to be reached before then. There are no signs of a rapid solution, but an uncontrolled escalation is not a very realistic prospect either.

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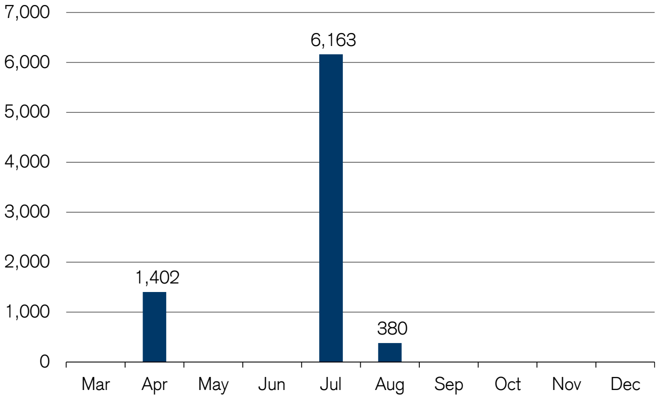
Large debt repayment due in the summer

Monthly redemptions of Greek bonds in 2017 (EUR million)



Source: Bloomberg, Credit Suisse

Germany

Chancellor Angela Merkel is running for a fourth term of office. The opinion polls are pointing to a neck-and-neck race between the CDU/CSU and the SPD, as support for the SPD has surged since the nomination of Martin Schulz. Irrespective of whether the SPD or the CDU/CSU win the election, in either case the government and the political direction would be pro-European. However, if there is a center-left coalition government spending could rise and some economic reforms could be reversed. A center-left government is likely to take a more accommodating stance on fiscal policy issues in the peripheral countries.

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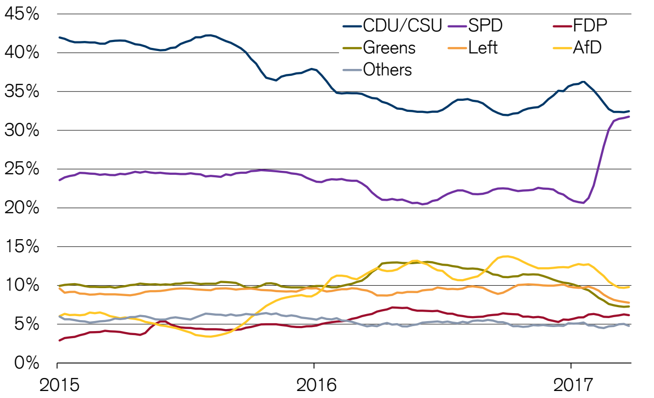
Nomination of Martin Schulz improves the SPD's prospects

Vote shares by party (in percent)



Source: Various opinion polls, Credit Suisse

United Kingdom

Following the activation of article 50 the UK is expected to leave the EU within two years. Depending on how the GBP/CHF exchange rate and the UK economy perform, this will also have an impact on Switzerland. The pound sterling is the primary variable that is prone to volatility. Nonetheless, we do not expect the exchange rate to have a big impact on trade between Switzerland and the UK, as pharmaceutical products account for a large proportion of Swiss exports and their customers tend to be less price-sensitive.

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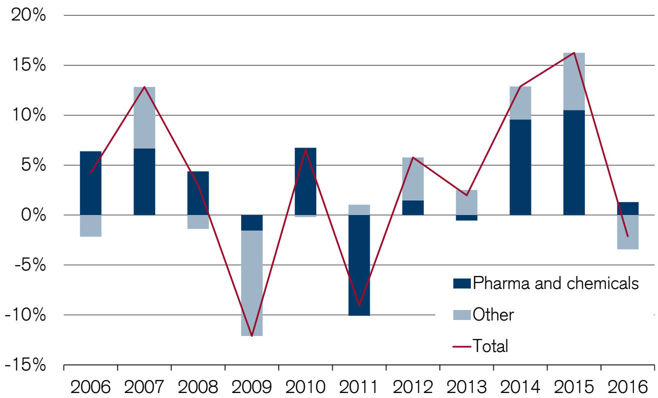
Switzerland mainly exports pharmaceutical products to the UK

Contribution of the pharma industry to export growth to the UK (in percentage points)



Source: Swiss Federal Customs Administration, Credit Suisse

Swiss Economy

Economic Growth to Accelerate Further

The Swiss economy is set to grow by 1.5% in 2017 and so slightly faster than 2016 (1.3%) and significantly more quickly than in the immediate aftermath of the Swiss franc appreciation in 2015 (0.8%). The SNB may again tolerate a stronger franc.

"Frankenshock" of 2015 no longer a big issue at the beginning of 2017...

2017 has got off to a promising start; the mood is better than it has been for years. The purchasing managers' index we compile in conjunction with procure.ch based on a survey of the manufacturing industry recently reached its highest level since April 2011. The rise in our export barometer also reflects solid demand for Swiss exports in the importing countries. It is therefore likely that more and more sectors will be able to grow their exports in spite of the current overvaluation of the franc against the euro and so boost their investment in the expectation of stronger orders. Consumer confidence, which is surveyed by SECO every quarter, was at its highest level since July 2014 at the beginning of 2017. A key part of this rising confidence is an improvement in consumers' assessment of their job security. There is evidently now only limited potential for contagion to the domestic economy from the strength of the franc. Accordingly, we are maintaining our forecast that the Swiss economy will expand by 1.5% in 2017.

... although some SMEs remain under pressure

According to the KOF Business Situation Indicator, however, there remain clear differences in business confidence by size of enterprise. SMEs' assessment of their business situation is still worse than before the lifting of the Swiss franc cap, whereas this is no longer the case for big companies. The labor market statistics also suggests that SMEs have been harder hit, particularly in short-time working. SMEs often have fewer opportunities to protect their margins by buying more abroad. This puts some limits on their growth potential.

SNB may tolerate a stronger franc

Inflation is expected to remain in positive territory over the course of the year and average 0.5%. Rising price levels and solid economic growth should allow the SNB to be less active. However, at the moment the SNB still seems to be busily intervening on the foreign exchange market. We expect it to move to a less expansionary monetary policy by the summer at the latest. Specifically, we expect it to reduce its intervention in the foreign exchange market, while a rate hike is not on the horizon for now.

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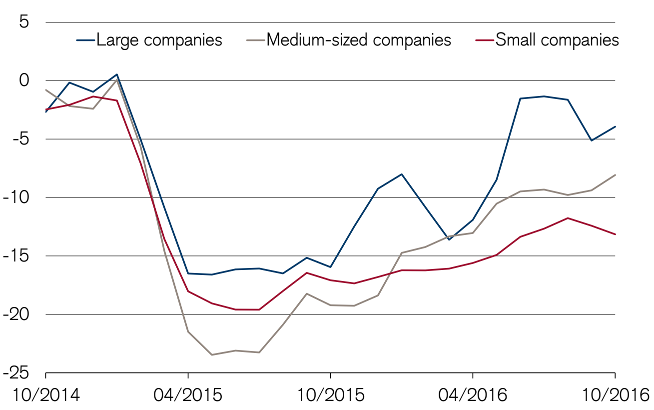
Switzerland has a "size gap"

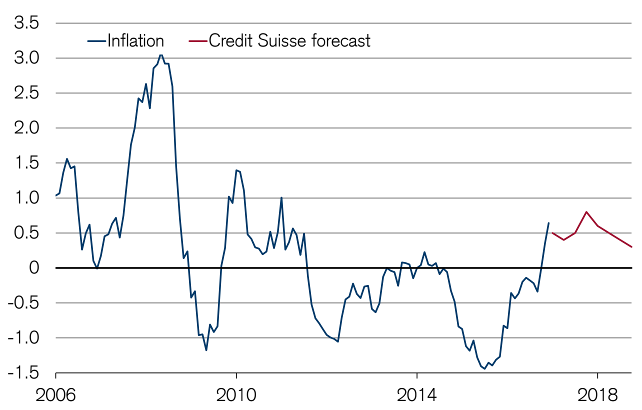
Business situation, balances in percentage points, 3-month averages



Source: Swiss Institute for Business Cycle Research at ETH Zurich, Credit Suisse

Moderate rise in inflation

In % year on year



Source: Swiss Federal Customs Administration, Credit Suisse

Monetary Policy | Deep Dive

The SNB Is Battling a Structurally Strong Swiss Franc

A number of highly productive sectors are responsible for Switzerland's current account surplus. Due to the low exchange rate sensitivity of these sectors, designing appropriate economic policies to combat the strength of the franc is very difficult.

Highly competitive export sector could lead to partial deindustrialization

After huge gas fields were discovered in the Netherlands in 1959, Dutch exports soared in the 1960s and 70s. The resulting income from gas exports led to large inflows of foreign capital into the Netherlands which, after being converted into guilders (then the Dutch currency), led to a currency appreciation. This currency appreciation hurt the competitiveness of other tradable goods and services and so put profits in non-gas-related export sectors as well as domestic sectors that competed with imports under pressure. Based on this phenomenon, an export boom which is founded on only one or a small number of sectors and the resulting currency appreciation is often referred to as "Dutch disease."

Switzerland shows some of the symptoms of "Dutch disease"

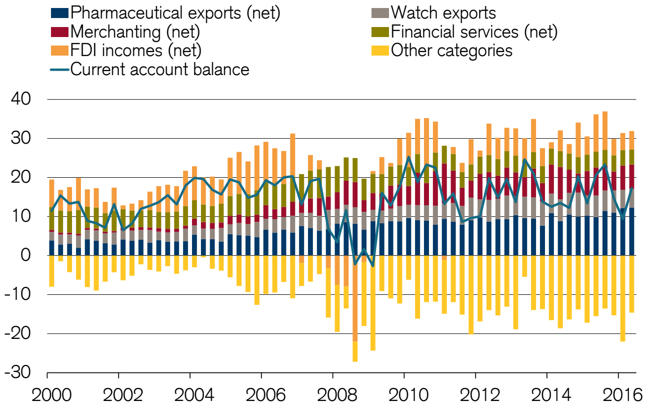
With the strong Swiss franc and high foreign earnings, Switzerland shares some of the characteristics of the Netherlands in the 1970s. The Swiss current account balance, which comprises Switzerland's earnings from foreign trade plus net investment income on foreign assets, is currently in surplus to the tune of around CHF 65 billion per annum or 10% of gross domestic product (GDP). Moreover, this surplus has remained largely unchanged since 2008 in spite of the sharp appreciation of the Swiss franc. This raises some questions about the policies of the Swiss National Bank (SNB). The SNB has been attempting to weaken the franc with negative interest rates and regular foreign exchange intervention for some time. However, Switzerland's large current account surplus implies that the Swiss franc is not really overvalued.

Surplus derives from just a few highly productive sectors

However, as was the case in the Netherlands, most of this large surplus is generated by a small number of sectors, namely pharmaceuticals, the watch industry, commodities trading/ merchanting and financial services. These sectors account for around 20% of GDP, but only 8% of employment. Unsurprisingly, the sectors that have such a large external surplus are also extremely productive, i.e. they generate a high level of added value per employee.

Current account surplus driven by a small number of categories

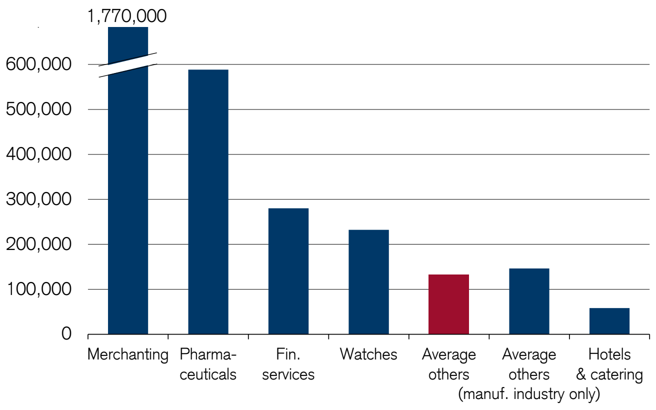
In CHF billion



Source: Swiss National Bank, Swiss Customs Administration, Credit Suisse

Surplus sectors are highly productive

In CHF per employee



Source: Swiss Federal Statistical Office, Swiss Trading and Shipping Association, Credit Suisse

The average added value in these sectors amounts to almost CHF 640,000 per employee (measured in full-time equivalents), with the peak figure of CHF 1,770,000 being achieved in merchanting. As a comparison, added value in other heavily export-oriented manufacturing sectors stands at an average of less than CHF 150,000 per employee. If domestically-oriented services are also included, this figure falls to an average of CHF 130,000. Tourism (hotels and restaurants), another export-oriented sector, generates an even lower average added value of less than CHF 60,000 per employee per annum.

Less competitive industries much more sensitive to exchange rates

If we exclude the four sectors with surpluses (plus income from foreign direct investment [FDI] – more on this below), the other categories of the current account balance (the yellow bars in the left-hand chart on the previous page) have performed more or less as expected in response to the rise in the Swiss franc. The (net) deficit in these categories was relatively small up until the global financial crisis in 2008 and has increased since then in line with the appreciation of the franc. This trend can be interpreted as a sign that the franc is overvalued, but the increase in the deficit is not particularly large. The deficit amounted to around 1.5% of GDP before 2008 and rose to around 2.5% of GDP by 2016.

A fundamentally justified appreciation should not be countered with FX intervention

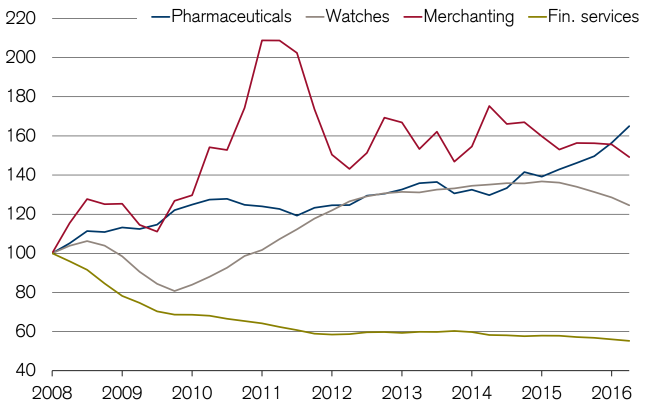
It is therefore doubtful whether Switzerland is really suffering from the Dutch disease. Leaving the pharmaceutical industry aside, the other three sectors are not experiencing a full-scale boom, even if they continue to generate substantial incomes. Moreover, it is not clear whether a currency appreciation due to Dutch disease is necessarily bad for economic growth. As long as the exchange rate does not deviate from its equilibrium value (i.e. the currency is neither undervalued nor overvalued), in the view of some economists the rise in the currency should not have any impact on long-term growth. In an analysis of existing research on this issue, the International Monetary Fund (IMF) effectively found no evidence that Dutch disease reduces growth. Economic policy should therefore not be focused on preventing a stronger currency resulting from a booming export sector (or a large current account surplus), even if this leads to a deindustrialization in other sectors of the economy.

Intervention is appropriate, however, if the exchange rate temporarily overshoots

Does this mean that the SNB's foreign exchange intervention to weaken the franc in recent years was mistaken? Not necessarily. If FX market intervention – as in this case – is designed to reduce a temporary overvaluation and is not a reaction to a fundamentally justified appreciation of the currency, it is appropriate. However, it is difficult to assess the scale of an overvaluation if it involves export sectors that are flourishing and are largely insensitive to fluctuations in exchange rates. The resulting current account surplus is usually interpreted as an expression of a fairly valued, if not even undervalued currency.

Boom years over in most of the surplus sectors

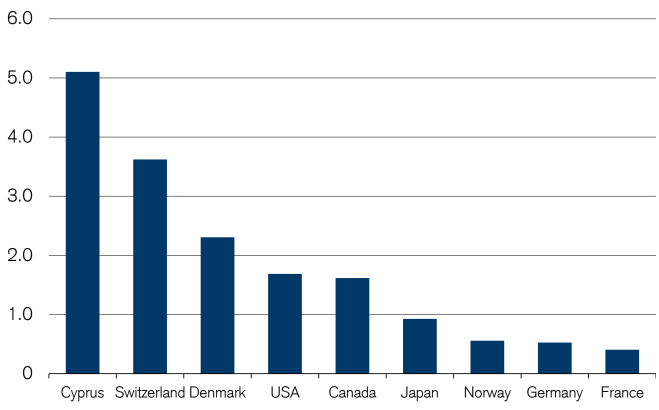
Nominal net exports (except watches), four-quarter average, indexed: Q1 2008 = 100)



Source: Swiss National Bank, Swiss Customs Administration, Credit Suisse

Retained earnings of foreign subsidiaries very high

As a % of GDP



Source: International Monetary Fund, Credit Suisse

For the SNB this means that its foreign exchange intervention must be focused on preventing the exchange rate from overshooting, i.e. a temporary currency appreciation shock. However, it is very difficult to assess a priori whether such a shock is temporary or permanent. For example, the SNB's intervention to weaken the franc in 2009 and 2010 is difficult to justify from today's standpoint, because our valuation model suggests that the rise in the franc at this time was caused by fundamental factors. These factors were, however, difficult to identify at the time.

Solid fiscal policy should continue to strengthen Switzerland's external balance

Fiscal policy can mitigate the impact of Dutch disease. By saving (i.e. taxing) the profits generated in the booming export industry and reinvesting these funds abroad, it can contribute to reducing the upward pressure on the currency. This strategy is pursued by a number of commodity exporters, including Norway and Saudi Arabia, who have used their oil revenues to build up sovereign wealth funds. In Switzerland's case, however, the state is unlikely to be able to tax the profits of specific sectors and use the revenues to finance a fund of this kind. Companies are mobile – to a greater or lesser degree – and could leave the country if they considered taxes to be excessive (the watch industry and the financial services sector are exceptions in this regard, as their “Swissness” is an integral part of the reputation and value of their products and services). In the case of merchanting in particular it was also probably the low tax rates that attracted companies in the first place and so contributed to increasing the foreign income generated by Switzerland.

Relatively high proportion of retained earnings at multinational companies contributes to external surplus

Against this backdrop it is worthwhile taking a closer look at a final characteristic feature of the Swiss current account surplus: income from foreign direct investments (FDI). Switzerland is a base for many large multinational companies with subsidiaries abroad. The income earned by these subsidiaries helps to boost Switzerland's current account surplus, especially if it is held in the form of retained earnings (a sub-category of FDI income). As these multinational companies are largely in the hands of foreign investors, the retained earnings of their subsidiaries effectively belong to these companies' foreign shareholders and are therefore “incorrectly” counted as part of Swiss investment income. To illustrate this phenomenon we have carried out an international comparison (where data are available), which shows that the retained earnings of foreign subsidiaries in Switzerland account for a relatively high proportion of GDP. The relatively low Swiss tax rates for foreign companies are also likely to play an important role in this, as they lead multinational companies to book their profits in Switzerland in order to reduce their tax liability. However, the proposed Swiss corporate tax reform should reduce this effect.

The longer the franc remains at current levels, the less foreign exchange intervention appears justified

This gives rise to two conclusions. Firstly the Swiss franc will remain a fundamentally strong currency in the long term driven by the large profits of a small group of surplus sectors, provided there are no adverse fundamental changes, such as a sustained rise in inflation or a decline in productivity in these sectors. Unlike countries with extensive natural resources, Switzerland has little scope to use its fiscal policy to mitigate the upward pressure on the currency generated by the surplus sectors. Indeed, Switzerland's attractive tax policies could even have encouraged the emergence of these sectors. Secondly, the franc will possibly not be far below current levels when the SNB eventually begins to normalize its monetary policy, particularly since its overvaluation is only likely to ease gradually due to the continued profitability of these sectors. Some of the less productive export sectors may never recover from the latest currency shock. However, in the long term targeted measures to support the sectors most affected by the strength of the franc are at best likely to temporarily delay an inevitable economic adjustment process.

The Netherlands has since recovered from its “disease” by joining a large common currency area which its leading trading partners are also members of. A possible lesson for Switzerland?

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