June 2005
IMF Country Report No. 05/190

Switzerland: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Switzerland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 7, 2005 with the officials of Switzerland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 13, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 6, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Switzerland.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the 2005 Consultation with Switzerland

Approved by Alessandro Leipold and G. Russell Kincaid

May 13, 2005

- Discussions were held in Bern and Zürich during February 25-March 7, 2005. The mission, comprising B. Traa (Head), A. Gagales, B. Braumann and M. Polan (all EUR), met with Federal Councilor Merz, Minister of Finance; Messrs. Roth, Chairman of the Governing Board of the Swiss National Bank; Gerber, Director of the State Secretariat for Economic Affairs; and other senior officials; representatives of cantons, trade unions, the private sector, and academia. Messrs. Zurbrügg and Schaad, Executive Director and Advisor for Switzerland, respectively, attended the meetings.

- Switzerland accepted the obligations under Article VIII and, apart from security restrictions, maintains an exchange system free of restrictions (Appendix I).

- Switzerland subscribes to the Special Data Dissemination Standard, and comprehensive economic data are generally available on a timely basis (Appendix II).

- The authorities and the mission held a press conference on the concluding statement and the authorities intend to publish the consultation reports.

Contents Page

Appendices

Main Websites for Swiss Data

Data in this Staff Report reflect information received by April 29, 2005. In most cases, more recent data can be obtained directly from the following internet sources:

Swiss Federal Statistical Office ....http://www.statistik.admin.ch

Swiss National Bank...http://www.snb.ch

State Secretariat for Economic Affairs (SECO).....................................http://www.seco-admin.ch

Federal Ministry of Finance..http://www.efd.admin.ch

Federal Customs Administration ....http://www.zoll.admin.ch

Institute for Business Cycle Research at the
Federal Institute of Technology (KOF) ....http://www.kof.ethz.ch

Information and documentation on Swiss
economic statistics can be found at the Special
Data Dissemination Standard website of the IMF .... http://www.imf.org/external/country/CHE/index.htm

Main Acronyms

AHV .... Old Age and Survivors Insurance
ALV................. Unemployment Insurance
BfS................... Federal Statistical Office
BPV .... Federal Office of Private Insurance
EFV .... Federal Finance Administration
EBK................. Federal Banking Commission
ESPOP............ Statistics on Annual Population Status
ETH .... Federal Institute of Technology in Zürich
FINMA .... Financial Sector Supervisory Authority
IV..................... Disability Insurance
KOF .... Institute for Business Cycle Research at the Federal Institute of Technology in Zürich
KV .... Sickness Insurance
SAKE.............. Swiss Labor Force Survey
SECO............... State Secretariat for Economic Affairs
SMI.................. Swiss Market Index
SNB .... Swiss National Bank
SUVA .... Swiss Accident Insurance

EXECUTIVE SUMMARY

The Swiss economy returned to growth in 2004 with supportive external demand and domestic policies. However, the recovery has been fragile. With inflation projected to remain well inside the 0-2 percent range of price stability, the Swiss National Bank has been pursuing an accommodative monetary policy. The general government fiscal deficit was contained to 1 percent of GDP and the federal authorities are taking further steps under the debt-brake rule to eliminate the structural deficit at the federal level.

Growth is projected to continue in 2005, albeit at a slower pace. Staff projects growth of 1¼ percent, from 1.7 percent in 2004, with some risks still on the downside. Potential growth is estimated at 1½ percent and is projected to decline in the medium term to ¾ percent as a result of population aging.

The SNB can afford to be patient in withdrawing monetary stimulus. With strong credibility helping to anchor inflation expectations and the recovery in a soft patch, the SNB has appropriately placed monetary policy on hold. The staff recommends maintaining this accommodative stance until the recovery gains traction.

The public finances will need to continue improving, both at the federal and other levels, including social security. The authorities plan to eliminate the structural federal deficit in the short run while allowing automatic stabilizers to operate along this path. They are undertaking a review of public expenditures to reduce the size of the government for longer-lasting savings. The proceeds from gold sales are expected mostly to be applied toward debt reduction. The cantonal governments, in particular, need to guard against creating new permanent expenditures with the proceeds of gold sales. The new constitutional structure for fiscal federalism improves the allocation of tasks between the levels of government and removes some incentives for excessive spending.

More needs to be done to address the rising pressures on the public finances from population aging. The sustainability of the first pillar pension system and healthcare remains to be established. There is also a need to supplement the debt-brake rule with a long-run fiscal framework encompassing all levels of government and the social security system that includes a path for the debt-GDP ratio consistent with long-term sustainability.

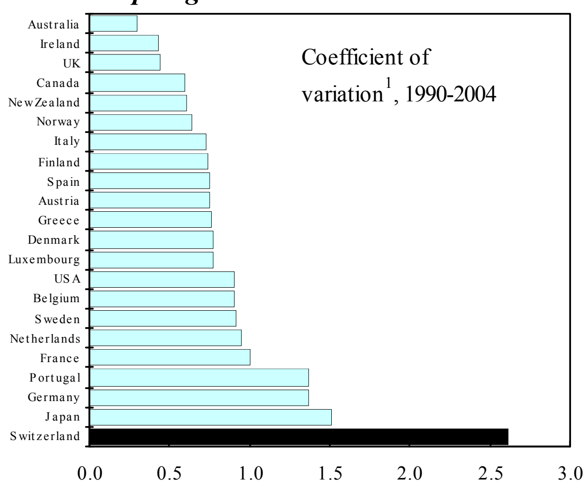
The financial sector appears healthy and dynamic although underfunding continues in some second pillar pension funds. Supervisors remain appropriately vigilant and proactive. Further reforms need to include the uniform rating of debtors, and the shift to actuarial and risk-based assessments of second-pillar pension schemes.

The unfinished product market reform agenda remains long and the cost of inaction is large—placing undue pressure on fiscal policies in the context of aging. Non-tariff barriers are widespread and, despite some progress, agricultural protection remains very high.

I. INTRODUCTION

1. **Switzerland is affluent but slow-growing.** Switzerland has an educated labor force, technological prowess, and a business-friendly environment. Flexible labor markets have kept unemployment among the lowest in international comparison. And skillful monetary management has delivered excellent inflation results (Table 1). However, the slow pace of structural reform is eroding economic dynamism and average growth is now among the weakest and most volatile in industrial countries (Figure 1). This is producing strains in the public finances. Staff estimates suggest that on current policies future potential growth will decline to below 1 percent a year, with slowing demographics and tepid productivity gains.

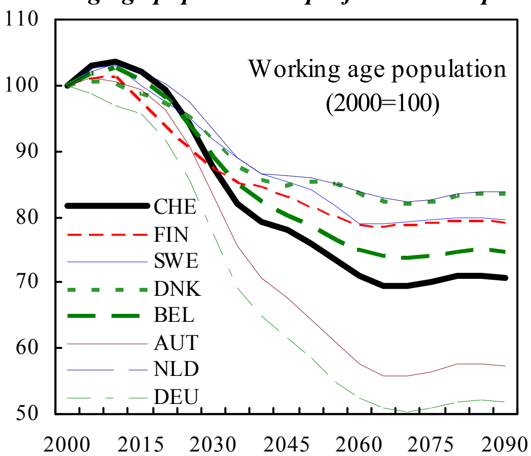
Per capita growth has been volatile.



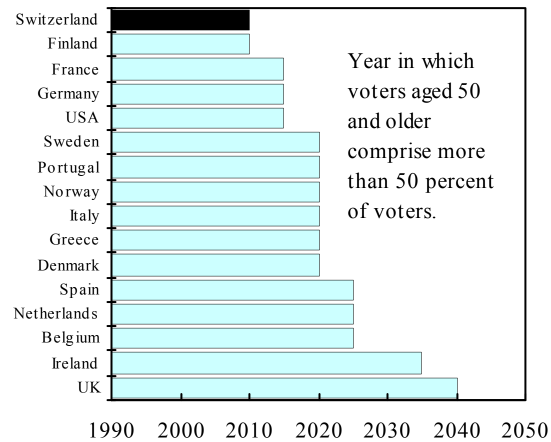
1. Ratio of standard deviation of growth to average growth.

2. **The main policy challenges are boosting potential growth and developing an intertemporally consistent strategy to manage aging**. Concerned about low growth, the authorities launched last year a reform agenda to open sheltered sectors and bolster competition in the economy. But the preparation for aging had a setback in 2004 with the rejection in a referendum of measures to strengthen the social security finances. More than half of the electorate will be over 50 years of age by 2010, swelling the constituency averse to reform.

Working age population is projected to drop...



...while time is short for reforms.

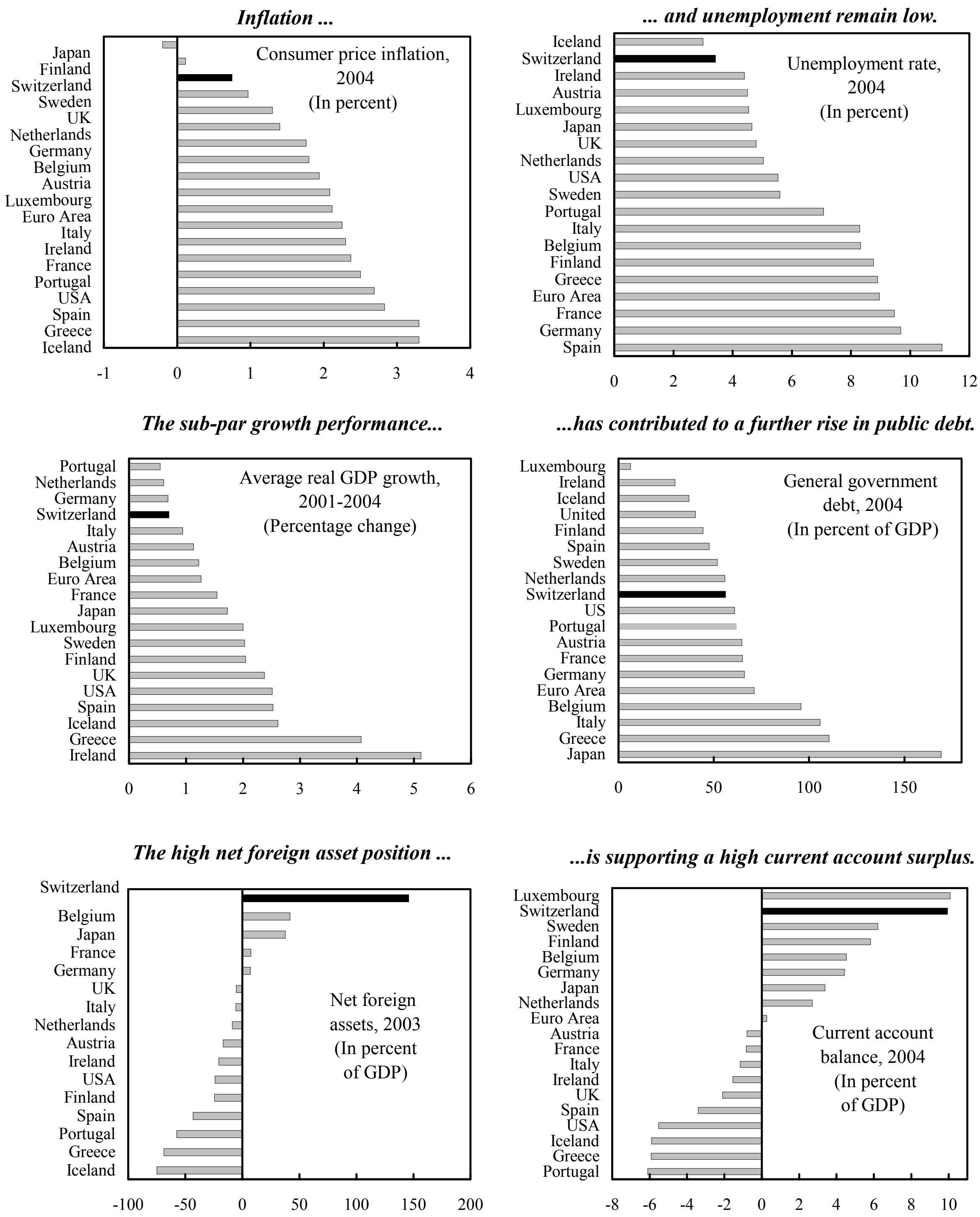


Box 1. Implementation of Fund Policy Advice

Implementation of Fund policy advice has been mixed. The authorities' monetary, fiscal, and financial sector policies have been well-aligned with Fund advice. However, Fund recommendations to accelerate structural reform have met with less success. The federal authorities have proposed reforms, but they face complacency afforded by the (still) high living standard, reinforced by extensive vested interests. Also, political power in Switzerland is particularly diffused among lower levels of government and the voters tend to call referenda on reforms.

Recent Fund advice has centered on the monetary and fiscal frameworks, namely the shift from targeting monetary aggregates to medium-term price stability and the debt-brake rule. The monetary policy framework is evolving along the lines suggested in consultations and is working well. The debt-brake rule has been fine tuned to allow greater cyclical responsiveness. While the authorities' efforts to restore balance in the federal finances have been in line with Fund advice, important challenges remain in addressing aging-related pressures. Also, strengthening competition in domestic markets through opening up sheltered sectors remains a recurring and difficult theme.

Figure 1. Main Economic Indicators in International Perspective



Sources: IFS; and WEO.

II. Recent Developments: A Moderate Recovery

3. **The economy has pulled out of recession, but the recovery is fragile and dependent on external demand.** A moderate recovery has been in place since mid-2003, initiated by supportive monetary and fiscal policies, and growing external demand. In 2004, investment and construction benefited from improving prospects and low interest rates, while a soft labor market and rising energy costs held back household consumption. However, an unexpected dip in investment contributed to a contraction of GDP in the last quarter. For the year as whole, real GDP expanded by 1.7 percent, narrowing the output gap to 1 percent. In early 2005, business indicators continued to be relatively weak (Figures 2 and 3).

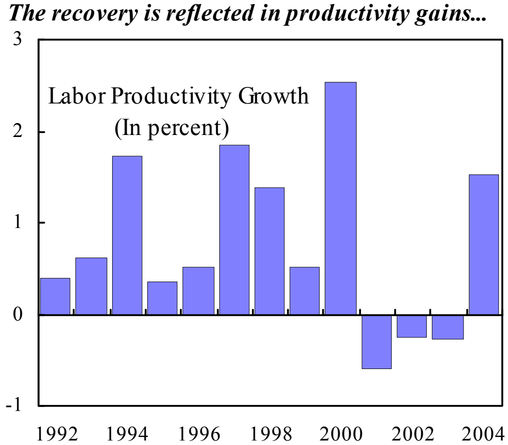
Switzerland: Aggregate Demand Components

	2003				2004				2005 2/			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	(Annualized rates of change, in percent)											
Private consumption	0.6	0.6	1.0	1.5	2.3	0.5	0.8	0.7	0.7	0.8	1.2	1.3
Public consumption	-0.1	2.1	2.1	1.4	2.1	0.6	-1.3	1.0	0.2	0.2	0.2	0.2
Machinery and equipment investment	0.1	-19.1	18.9	10.6	-7.9	14.8	2.3	-3.4	1.0	2.0	4.0	4.0
Construction investment	5.6	1.2	3.7	8.4	6.7	0.5	2.1	-8.6	1.5	1.5	1.5	1.0
Stock building 1/	0.1	-0.1	-0.5	0.0	-1.6	1.3	0.6	-0.6	0.0	0.1	0.0	0.1
Exports	-15.8	6.1	10.7	11.4	12.0	-0.4	4.9	4.5	4.0	4.5	6.0	6.0
Imports	3.1	-1.2	10.1	14.3	-4.9	12.9	9.1	-4.6	3.4	4.8	5.9	5.9
GDP	-4.3	0.1	2.0	2.6	1.4	2.2	1.6	-0.3	1.0	1.5	1.8	2.2

Sources: SECO; and IMF staff estimates and projections.
1/ Contribution to growth.
2/ Projections.

4. **The return to growth has not yet improved labor market conditions**. Employment was flat as enterprises improved productivity before stepping up hiring. In manufacturing, which is more exposed to international competition, employment declined (Figure 4). Simultaneously, labor supply growth was muted by workers moving into training and retirement. As a result, unemployment rose to 3.9 percent in 2004.

The recovery is reflected in productivity gains...

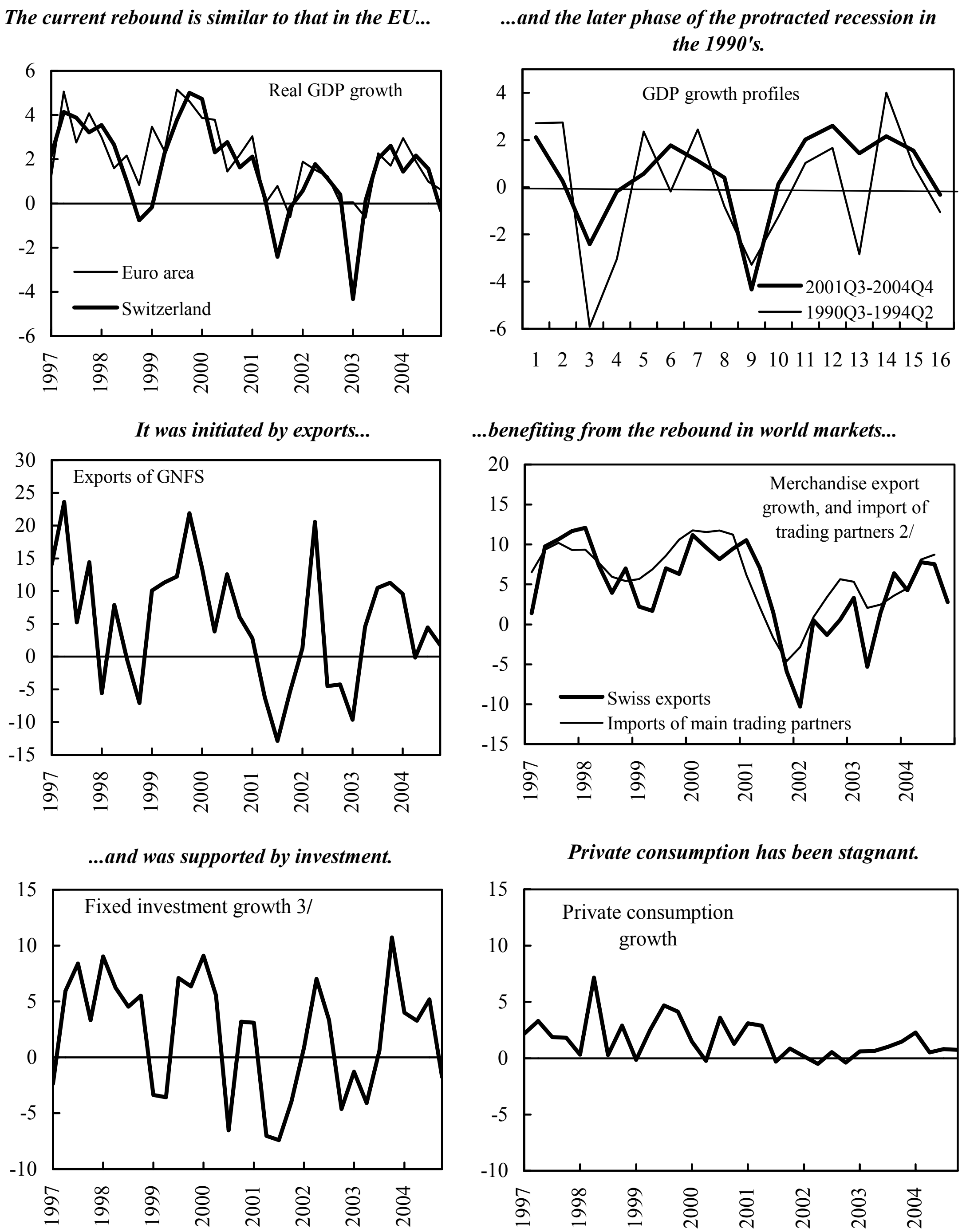


… rather than employment.

Labor Market Developments in 2002-04 (Changes in thousands)	
Population over 14 years	**120**
Employed	**-6**
Swiss	-21
Foreigners	15
Full-time	-44
Part-time	38
Unemployed	**59**
Non-active persons	**66**
In training	29
Homemakers	-4
Pensioners	42

Source: BfS, SAKE and ESPOP

Figure 2. Switzerland: A Moderate Recovery is Underway 1/



Source: IMF, World Economic Outlook.

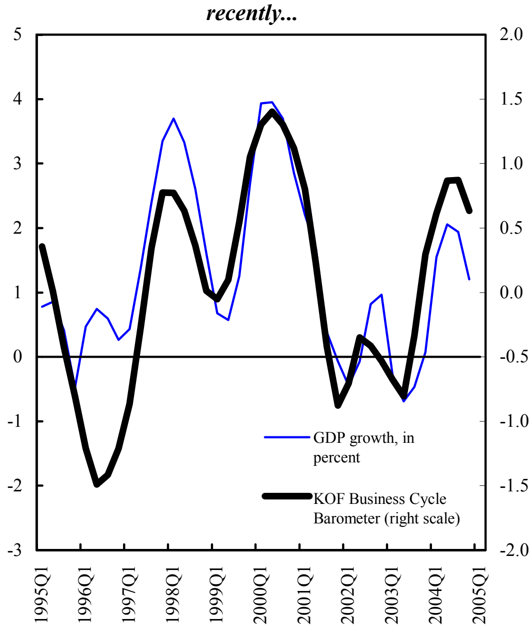
1/ Seasonally adjusted annualized growth rates in percent, unless otherwise indicated.

2/ Year-on-year percent change.

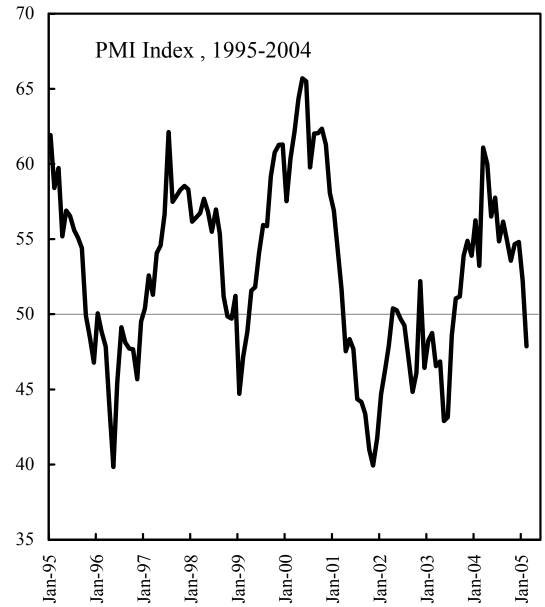
3/ Moving average of annualized growth rates in percent

Figure 3. Switzerland: The Recovery May Have Peaked

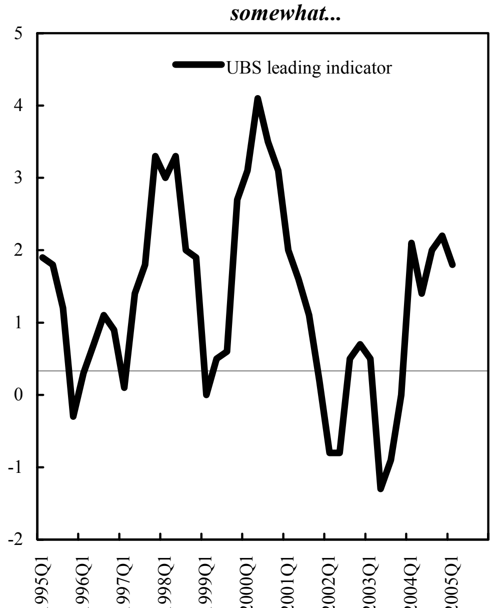
The leading economic indicator has weakened recently...



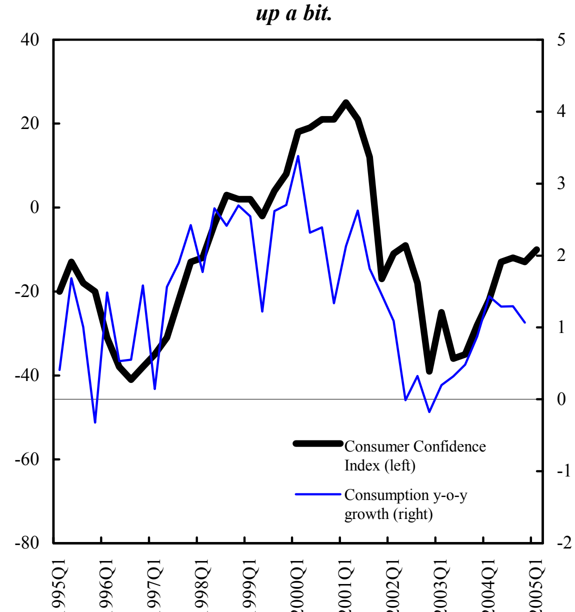
...a trend confirmed by the Purchasing Managers Index.



The UBS leading indicator also turned down somewhat...

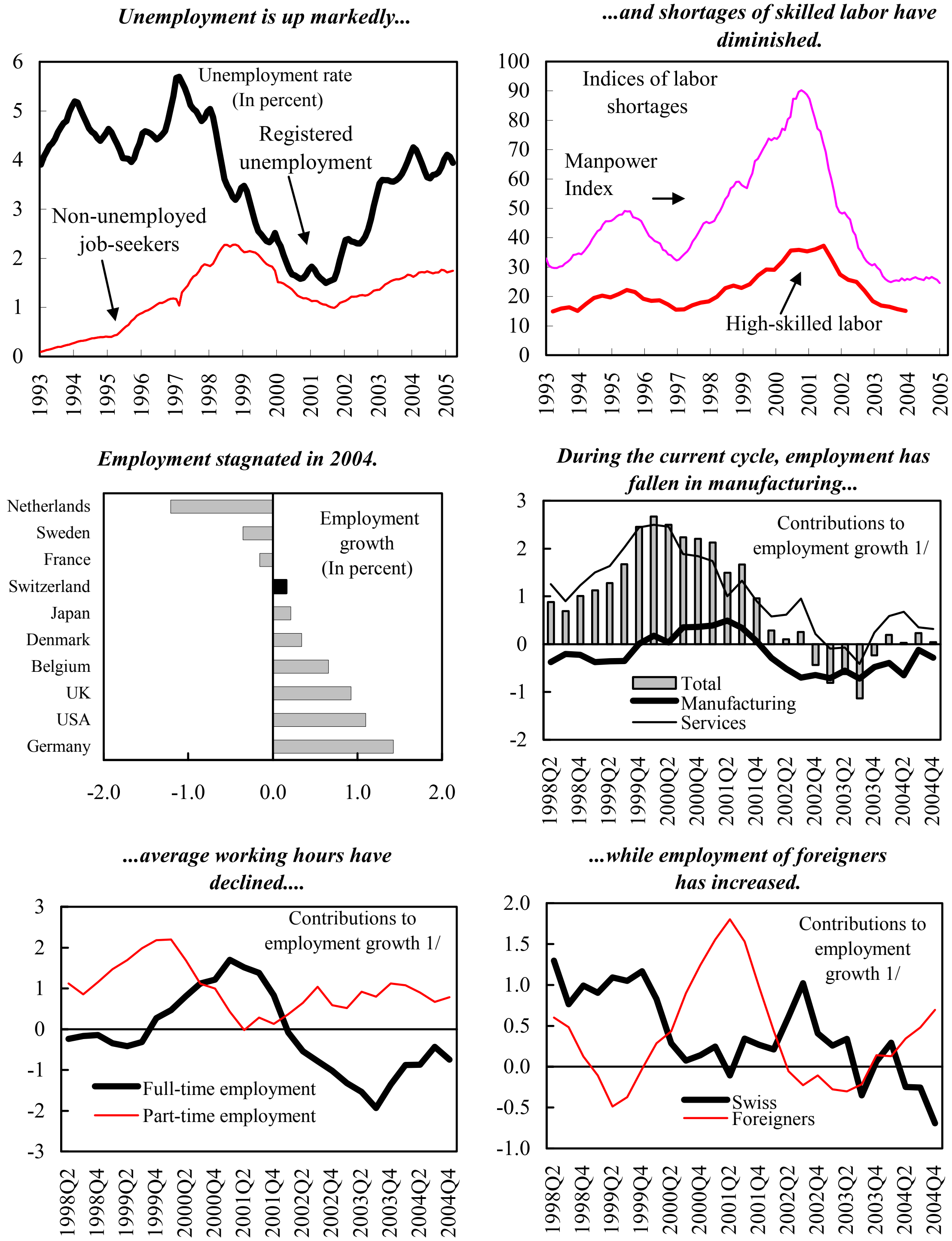


... but the consumer confidence index has picked up a bit.



Sources: KOF database; and Bloomberg.

Figure 4. Switzerland: Return to Growth Has Not Yet Eased The Slack in the Labor Market



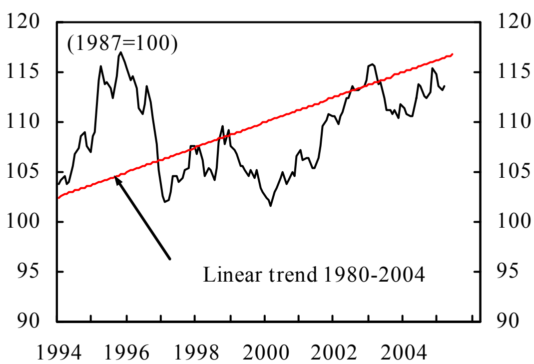
Sources: IMF, World Economic Outlook; and KOF Institute.
1/ Percentage points.

5. **Inflation remained low, the oil shock notwithstanding.** In early 2005, headline CPI inflation picked up to 1.4 percent and core inflation rose from ¼ to 1 percent (Figure 5). Second-round effects have been virtually absent. Average wages rose by 0.9 percent in 2004 and are likely to increase by around 1¼ percent in 2005.

6. **Monetary conditions remained expansionary.** With activity picking up in early 2004, the SNB raised the three-month policy rate in June and September 2004 by 25 basis points each after having kept it historically low at 0.25 percent for more than a year. Still, the three-month rate remained negative in real terms. Since markets remain confident about inflation, long-term interest rates hardly moved (Figure 6). The rapid monetary growth of previous years subsided—as shifting into liquidity ran its course—and credit expansion was tame with increasing credit to households tempered by declining credit to enterprises (Figure 7). Equity prices improved to 30 percent below their peak of end-2000, in line with other markets. Average real estate prices remained subdued (Figure 8).

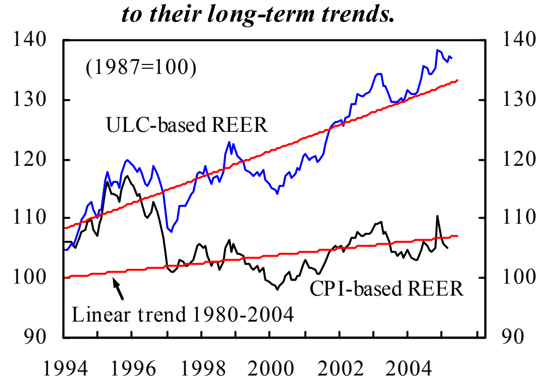
7. **The Swiss franc strengthened, removing some monetary stimulus.** Since end-2003, the franc has appreciated by 3.7 percent in real effective terms and by 1.2 percent in nominal terms, reflecting an appreciation vis-à-vis the US dollar (the franc-euro rate remained stable). The franc is now close to its long-term upward trend.[1]

The nominal effective exchange rate...



Sources: IMF, International Financial Statistics; and staff calculations.

...and the real ones are close to their long-term trends.



Sources: IMF, International Financial Statistics; and staff calculations.

8. **Fiscal policy was slightly restrictive.** The federal government deficit was below budget because of tax buoyancy and lower interest payments. Subnational governments also consolidated their finances. The general government deficit is estimated to have narrowed to 1 percent of GDP in 2004, despite some widening of the social security deficit (Tables 2 and 3).

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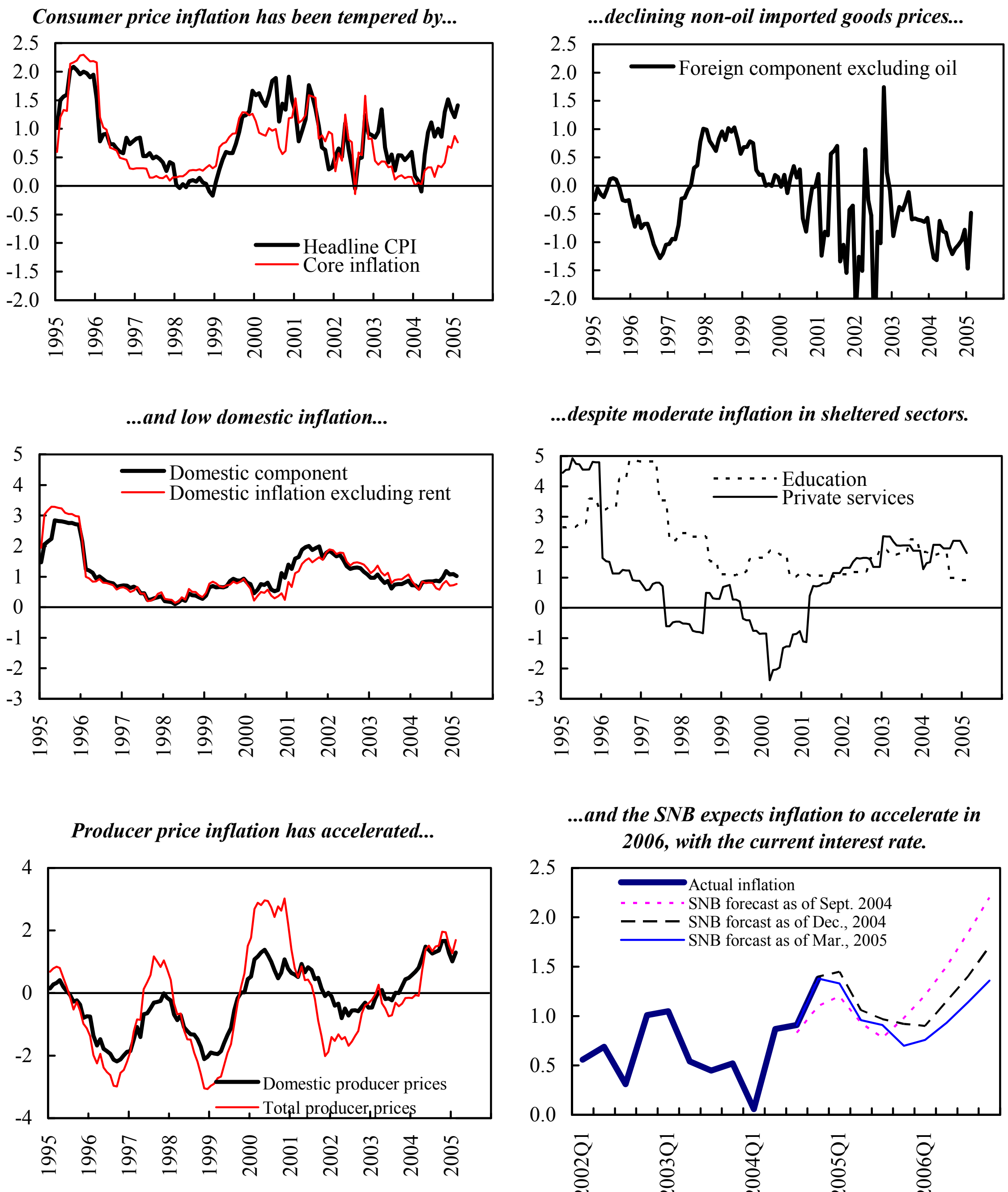
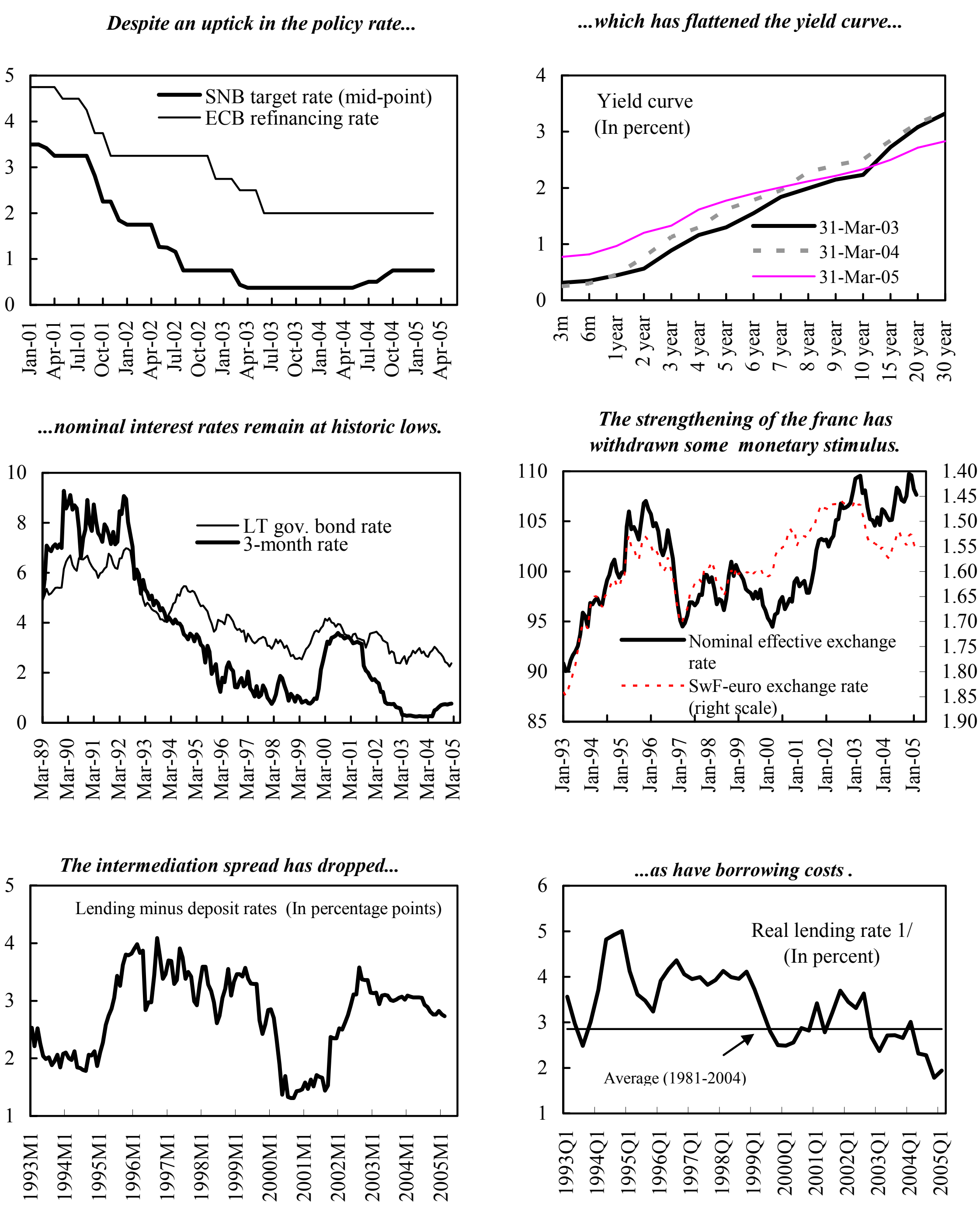
[1] On the franc's long-term trend, see *IMF Country Report No. 04/166*.

Figure 5. Switzerland: Concerns About Deflation Have Abated
(12-month percent change)



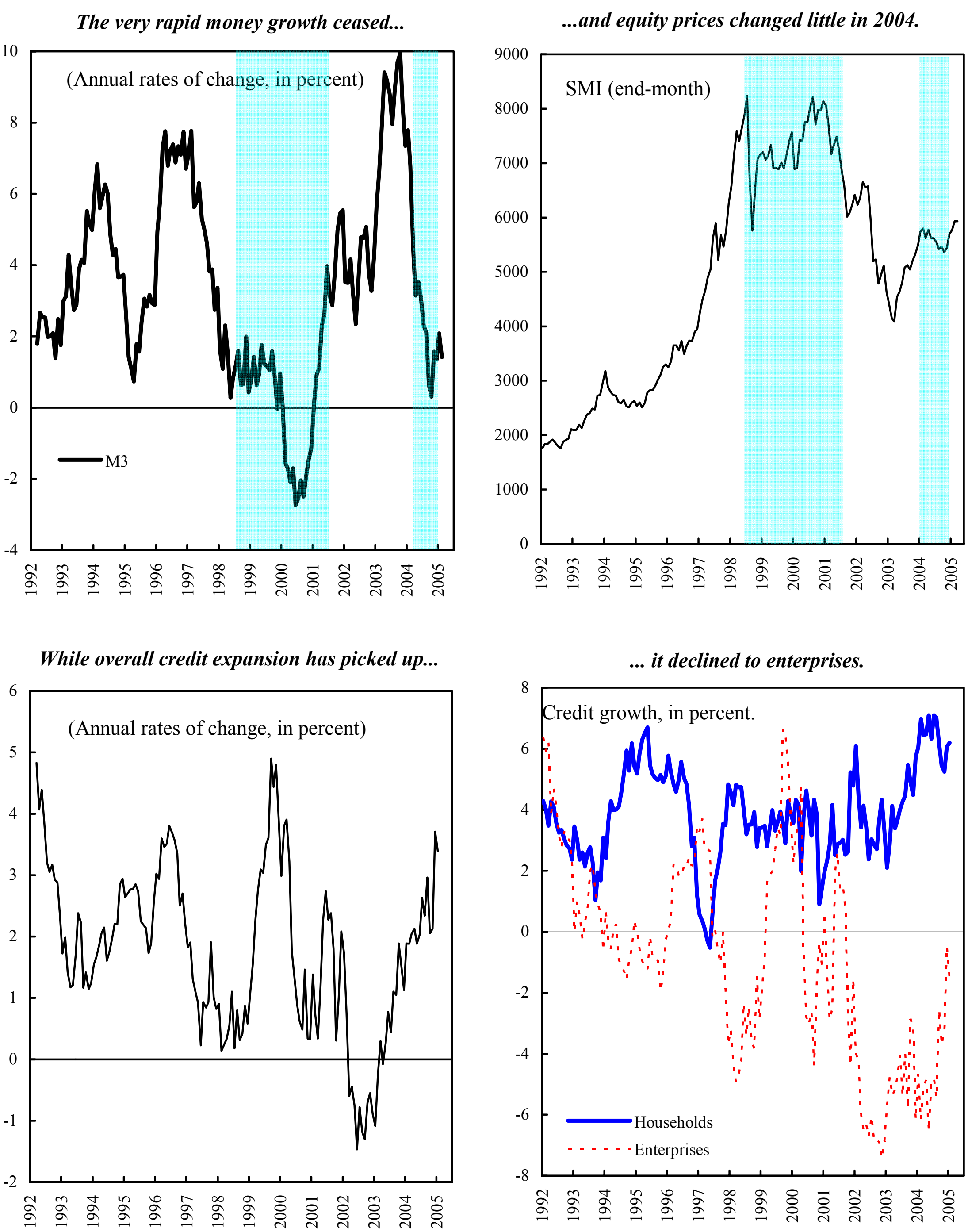
Source: KOF database.

Figure 6. Switzerland: Monetary Conditions Remain Accommodative



Sources: KOF database; Bloomberg; International Financial Statistics; and IMF staff estimates.
1/ Actual rates minus 12-month change in CPI index.

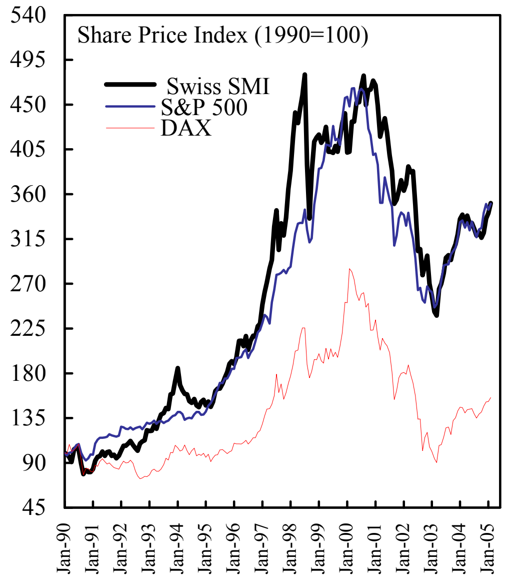
Figure 7. Switzerland: Money and Credit Aggregates Provide Mixed Signals



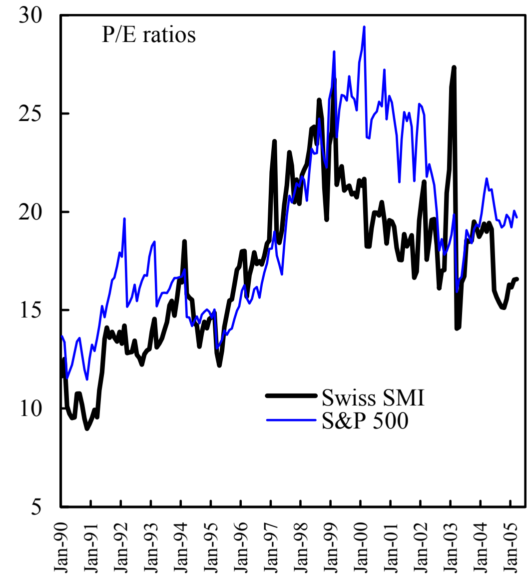
Source: IMF, World Economic Outlook; and KOF Institute.

Figure 8. Switzerland: Asset Prices

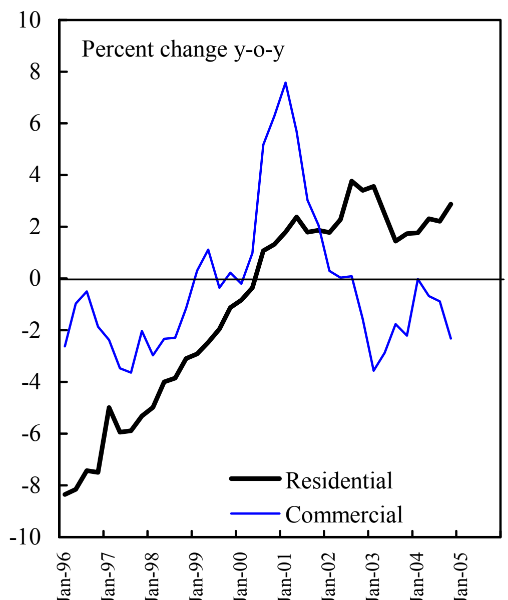
Equity prices mirrored movements in the S&P 500....



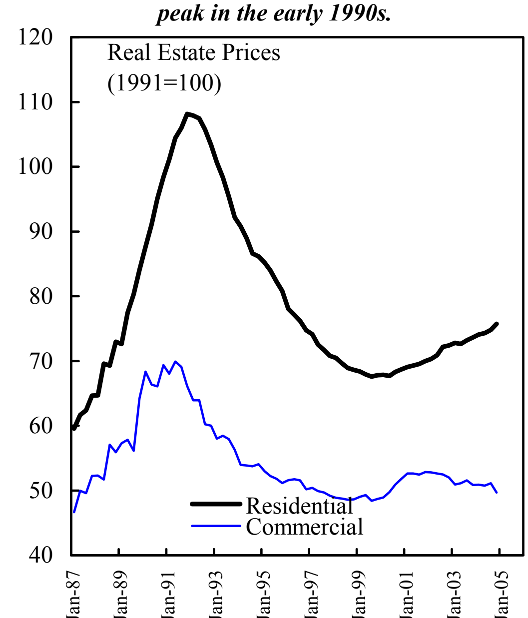
...and the P/E ratio remains above its historical average.



Growth in real estate prices is subdued...



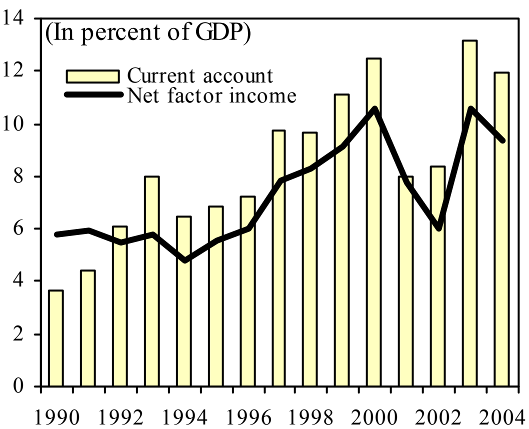
...and current price levels are well below their peak in the early 1990s.



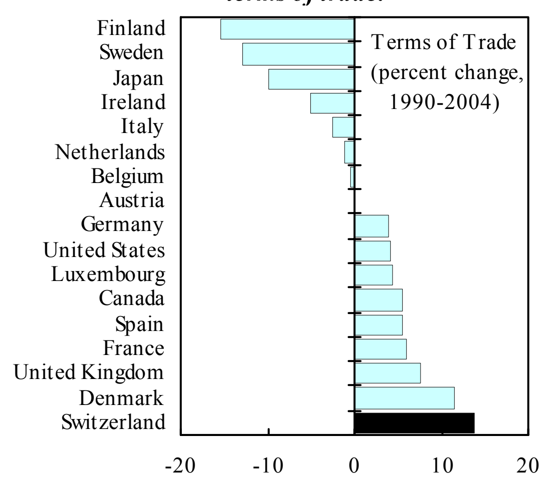
Sources: KOF database; BIS; Bloomberg; and IMF, International Financial Statistics; and IMF staff estimates.

9. **The external current account surplus remained high.** Three-quarters of the current account surplus of 12 percent of GDP in 2004 reflects investment income from large net foreign assets, and the trend improvement in the terms of trade as exporters are oriented toward specialty high-value-added markets (Table 4).[2]

The current account has been driven by net investment income ...



... and supported by the improving terms of trade.



III. Report on the Discussions

10. **The consultations focused on the costs of inaction in bolstering long-term growth, the need for sustained fiscal adjustment, and the appropriate current policy stance.** Staff estimates suggest that future potential growth will trend to below 1 percent a year, driven by demographics, declining average hours worked and low TFP growth. Moreover, absent measures, the public deficit would gradually rise to unsustainable levels. Against this background of slow growth and challenging public finances, the discussions focused on the need to accelerate product and labor market reforms, recalibrate the long-run social security finances, and fine-tune the "debt brake" to anchor better the public debt. The discussions addressed also the pace and timing of the withdrawal of the monetary stimulus and progress in the adjustment of the financial sector. There was substantial agreement on the general direction of policies, with the authorities striving to build consensus on steps to bolster the social security accounts and to implement structural reforms.

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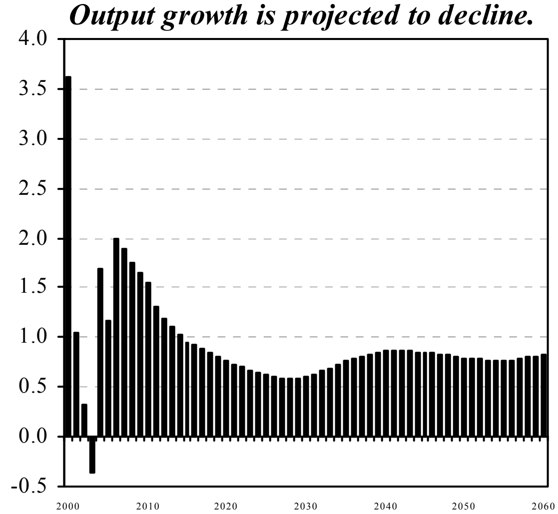
[2] Including specialty chemicals, pharmaceuticals, designer watches and jewelry, and in services, wealth management.

Output growth is projected to decline.



Sources: BFS and IMF staff projections.

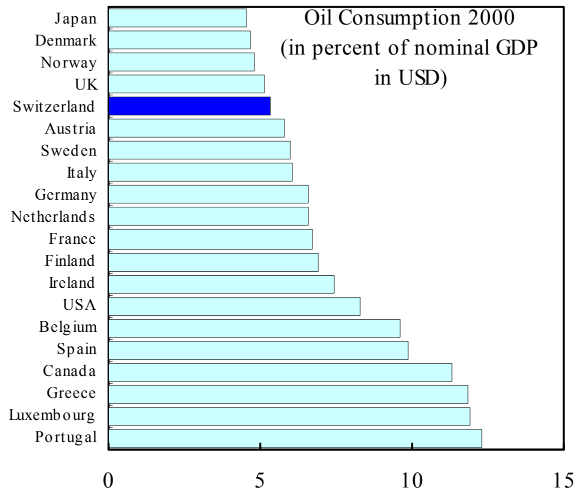
A. Short-Run Outlook

11. **The authorities, staff, and private forecasters shared similar views on the short-run outlook.** The staff was cautiously optimistic that the easing of growth in late 2004 reflected a temporary soft patch that would be overcome in the course of 2005 with a renewed pick up in external demand (as in the WEO), and continued support from monetary policy. With improving corporate balance sheets and enterprise profitability, staff did not see major domestic imbalances to hold back the recovery. However, because the carry-over in growth from 2004 was weak, average growth would be somewhat lower at 1¼ percent in 2005, with activity gaining strength in the second half. The authorities were more sanguine about domestic demand and projected growth at 1½ percent.

12. **The outlook is cautious, but there remain some downside risks.** So far in 2005, indications of an upturn are weak and the projections for euro area growth (comprising 60 percent of Swiss exports) are being trimmed. Moreover, the authorities noted that Switzerland could be adversely affected if global imbalances were to unwind suddenly, triggering a safe-haven appreciation of the franc. Also, corrections in international financial markets could strain Switzerland's important financial sector. Persistently high oil prices also pose risks for Switzerland, despite its low oil dependency, because they could reduce further partner countries' growth.[3]

[3] Switzerland is less dependent on oil than many industrial countries due to greater reliance on alternative power and active energy conservation policies. Nevertheless, the SNB estimated that a 40 percent increase in crude oil prices for a three year period would lower growth by 0.4 percentage points and add 0.6 percentage points to prices.

Swiss oil intensity is low.



Source: IEA, Fund staff calculations.

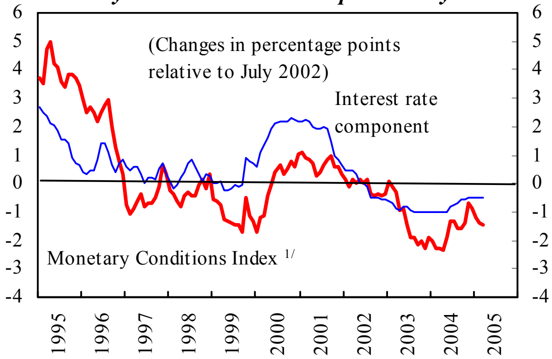
13. **Inflation is projected to remain below 2 percent through 2006.** This favorable outlook reflects the SNB's strong credibility, which has firmly anchored expectations, and flexible labor markets, which reduces second-round effects.

B. Monetary and Exchange Rate Policy: Supporting the Recovery

14. **Monetary policy is applied pragmatically.** With inflation projected to remain moderate through 2006, even at the current very low interest rates, the SNB has maintained its accommodative policy stance. On indications that activity eased again toward end-2004 and with the appreciating franc already slightly tightening monetary conditions, the SNB paused raising the policy interest rate. Staff agreed that the lifting of the policy rate through mid-2004 was opportune. This did not inhibit activity, but provided a useful signal of leaning against the wind of oil prices—thus helping to anchor expectations. Also, the move created some room for policy maneuver downward if that were necessary.

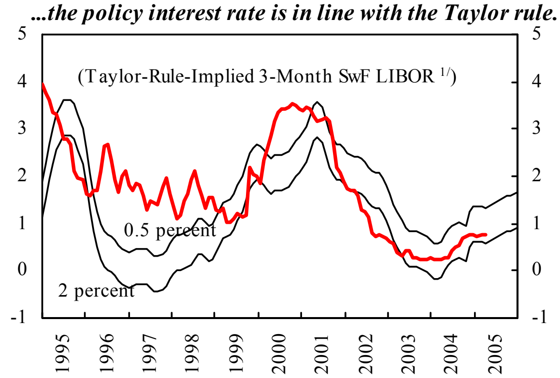
15. **The staff saw room for continued patience with policy rates until the recovery regained traction.** Patience was warranted by the negative output gap and the absence of price pressures. The lagged effects from the appreciation of the franc would already withdraw some stimulus. The SNB agreed, but would remain vigilant for signs of price pressures. In its quarterly assessment of monetary policy in March, it left the policy rate unchanged.

Monetary conditions remain expansionary and...



1/ The MCI is calculated as a weighted average of the 3-month interest rate and the detrended nominal effective exchange rate with respective weights 0.75 and 0.25.

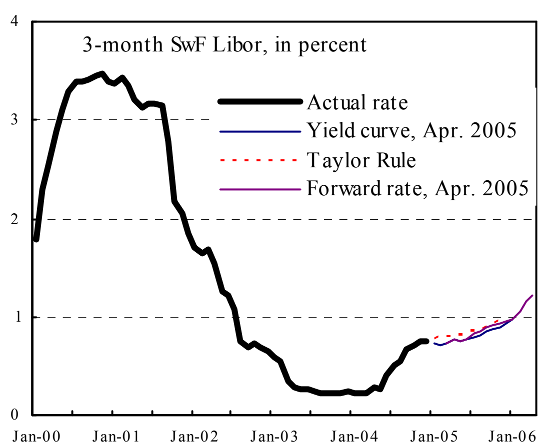
...the policy interest rate is in line with the Taylor rule.



1/ The Taylor Rule rate, R_{TR}, is derived from: $R_{TR}=1.1+\pi_{-1}+0.5\,(\pi_{-1}-\pi^{*})+0.5\,\text{outputgap}_{-1}$ for two alternative target inflation rates, $\pi^{*}=0.5$ and 2 percent.

16. **Looking further out, the SNB and the staff agreed that further withdrawals of monetary stimulus would be needed at some point**. Real interest rates have been well below neutral levels for two years and, until recently, broad money had been growing rapidly. Given that monetary policy operates with long lags, the authorities were mindful of the risks associated with unduly delaying a return to more neutral policies. Staff agreed that the question was not whether monetary policy should move to a more neutral rate eventually, but rather about the timing of this move. Markets expect little tightening in 2005.

Markets expect little tightening in 2005



17. **The authorities noted some concern about spillovers from global current account imbalances**. A rapid exchange rate appreciation of the franc against the U.S. dollar could take inflation toward negative territory. With current low interest rates, the SNB would have little room for maneuver and would include in its options some foreign exchange intervention.

18. **On the exchange rate, the authorities shared the staff assessment that a gradual appreciation of the franc along its long-run trend could continue**. Staff estimates suggest that the franc might be slightly undervalued, based on the macroeconomic balance approach, fundamental equilibrium approach and panel estimates of purchasing power parity—adjusted for factors such as terms of trade and net factor income. While the long-run trend appreciation has resulted in a decline in manufacturers export market shares, this development has been offset by improving terms of trade as Swiss firms increasingly focus on high value-added markets. The trend appreciation was also seen as beneficial to the Swiss financial sector. Lastly, the high domestic price level (compared to the EU) reflected weak competition in sheltered sectors, for which the solution remained product market reform, rather than depreciation.

19. **Private sector representatives commended the SNB's communication strategy and were supportive of the monetary policy framework**. They valued the open communications policy which avoided surprises on interest rate decisions. To fine-tune this strategy, the SNB had started releasing quarterly its 3-year ahead inflation forecast together with an assessment of monetary conditions. Moreover, to enhance public accountability, as stipulated in the new National Bank Act, the SNB had started submitting to parliament an annual report on the fulfillment of its tasks. Staff agreed that the monetary policy framework was working well,[4] having delivered average inflation of 0.9 percent since its inception in 2000 while steering clear of deflation, and thereby maintained strong credibility.

C. Fiscal Policy: Restoring Balance and Addressing Long-Term Challenges

20. **The public finances are managed carefully, but longer-term strains are nevertheless visible.** The general government deficit in 2004 was moderate and consistent with approximate short-run stability in the debt ratio. However, strains are building up in the pension and healthcare systems, which in recent years were running a combined deficit (before budgetary subsidies) of over 5 percent of GDP. With unchanged policies, the impending demographic shift and unabated rise in healthcare spending are projected to widen the fiscal deficit, even increasing the public debt to unsustainable levels over the medium-term—as shown in the extended debt sustainability analysis until 2060 in the accompanying *Selected Issues*. The authorities explained that a public consensus how to address these long-term fiscal challenges was still lacking, and that recent efforts to raise the retirement age and increase the VAT rate to finance social security had been rejected in a referendum.

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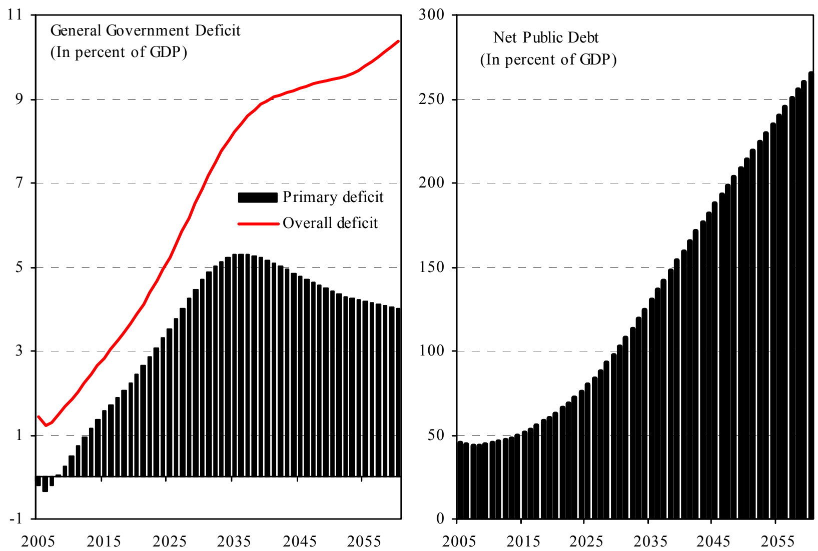
[4] The framework aims to keep the headline CPI inflation over a three year horizon "below 2 percent but positive". Within this objective, the SNB calibrates its policy to avoid disruptive exchange rate variations and a large degree of economic slack.

Under current policies, aging would raise public debt to unsustainable levels.



Source: IMF staff estimates. Baseline paths assuming that the general government runs a primary surplus of 6 percent of GDP (excluding transfers to the pension system and healthcare). See Chapter I of the accompanying *Selected Issues*.

21. **The federal government is leading fiscal adjustment:**

- **Federal fiscal policy** was guided by the debt-brake rule.[5] The authorities' objective is to eliminate the recent federal structural deficit in the short run, while allowing automatic stabilizers to operate around this path. They had introduced two expenditure-based consolidation programs (*Entlastungsprogramme 2003 and 2004*)—the second is now passing through the legislature—based on slowing annual expenditure growth to 1.5 percent (slightly below nominal GDP growth).

- **The subnational governments** had achieved consolidation in 2004 as well, but were expected to spend a share of gold sales in 2005-06 (see below), and were facing increasing spending pressures on health care. In additional, some measures may be needed to offset spillovers from consolidation at the federal level.

[5] The debt-brake rule requires the federal accounts to be in balance after adjusting for the business cycle. Expenditure is set equal to projected cyclically-adjusted revenue. Unanticipated deficits must be reversed in the following years. The debt-brake rule can be relaxed in exceptional circumstances by a majority in both chambers of parliament.

22. **An important event in 2005 is the transfer to the government of 4.6 percent of GDP in proceeds from SNB gold sales**.[6] The government decided that ⅓ of these proceeds will be transferred to the federal government and ⅔ to the cantons. The staff strongly urged the authorities to apply these amounts to debt reduction. The federal authorities indicated their intention to do so, and they projected that cantons would use 80-85 percent of their allocation for debt reduction as well. However, they underscored that they could not force the cantons to do so. The staff agreed with the SNB that the gold sale is a one-time event that reduces future SNB profit distributions, and that the proceeds should therefore be saved.

Overview of Federal Consolidation Programs 2003 and 2004

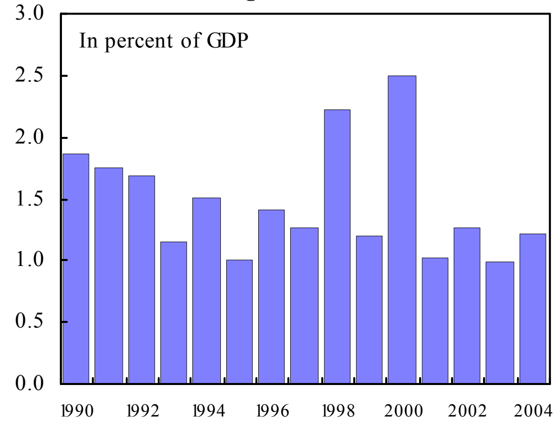
	2004	2005	2006	2007	2008
	(Cumulative measures in million SwF)				
Total	**1,005**	**3,025**	**4,137**	**4,875**	**4,983**
Expenditure measures	**805**	**2,646**	**3,724**	**4,335**	**4,443**
Current expenditure	268	794	1,236	1,441	1,542
Current transfers	310	1,125	1,496	1,829	1,753
Investment	227	663	945	967	982
Other	-	64	47	98	166
Revenue measures	**200**	**379**	**413**	**540**	**540**
	(In percent of GDP)				
Total	**0.2**	**0.7**	**0.9**	**1.0**	**1.0**
Expenditure measures	**0.2**	**0.6**	**0.8**	**0.9**	**0.9**
Current expenditure	0.1	0.2	0.3	0.3	0.3
Current transfers	0.1	0.2	0.3	0.4	0.4
Investment	0.1	0.1	0.2	0.2	0.2
Revenue measures	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**
Memorandum item:					
Nominal GDP	444.6	455.2	469.8	484.7	499.4

23. **The authorities felt that risks to the medium-term fiscal outlook were manageable.** Staff cautioned that competition from other financial centers could erode withholding taxes and stamp duties and that the current level of profit distribution from the SNB would decline in future. The authorities acknowledged some pressures on financial (and corporate) taxes and indicated that revenue losses would need to be compensated with

[6] Between May 2000 and March 2005, and in coordination with other central banks, the SNB sold 1,300 tons of gold. The SNB still holds 1,290 tons of gold, corresponding to ⅓ of its foreign exchange reserves. There is no intention to reduce gold holdings further.

expenditure cuts. In a broader context, they noted that while the debt brake rule had been very valuable as a guide for fiscal policy, the accompanying annual adjustment programs were beginning to cause adjustment fatigue, and thus they were searching for structural longer-lasting solutions to deficit pressures in an expenditure review for the federal government.

Withholding tax and stamp duty revenues have been eroding.



24. **The authorities shared the staff's concerns regarding long-run fiscal pressures from population aging**. Switzerland's old-age dependency ratio is projected to increase by 16 percentage points over the next thirty years and, under current policies, this puts the first pillar of the pension system and the health care system (Box 2) on a path of sharply rising deficits. Staff estimated the net present value of future liabilities of these programs at 180 percent of GDP, roughly the equivalent of a 7½ percentage point hike in the VAT. Cognizant of these problems, the authorities were reviewing social security entitlements and had begun to frame proposals to strengthen the finances of disability insurance.

25. **Officials agreed that long-term fiscal sustainability required a coordinated strategy, embracing fiscal consolidation and reforms.** Staff noted that the financing gap of social security was too large to be closed by fiscal consolidation alone, especially since tax increases could worsen distortions and adversely affect Switzerland's already slow output growth. On their part, the authorities felt that a potential rise in the retirement age would need to be accompanied by the creation of work opportunities for older workers. There was agreement that a viable strategy would involve a balanced mixture of pension and healthcare reforms to reduce social security deficits; product market reforms to raise output and employment growth; and expenditure-based fiscal consolidation to close any remaining gap. In this regard, staff saw the need to aim fiscal policies at a downward path for the public debt-to-GDP ratio beyond 2007. Staff also recommended the publication of comprehensive periodic reports on the long-run sustainability of the public finances as a policy guide and to improve public awareness and catalyze reform.

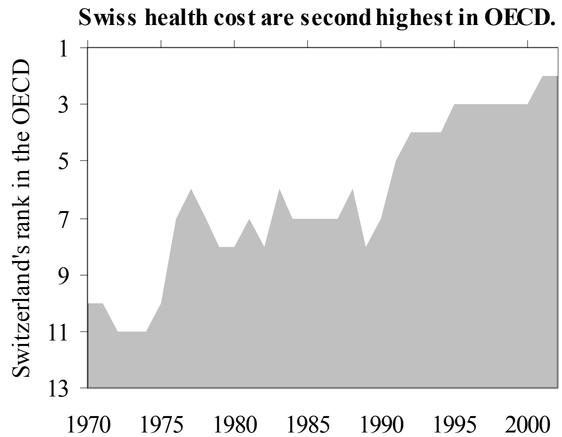
Box 2. The Challenge of Healthcare Costs[1]

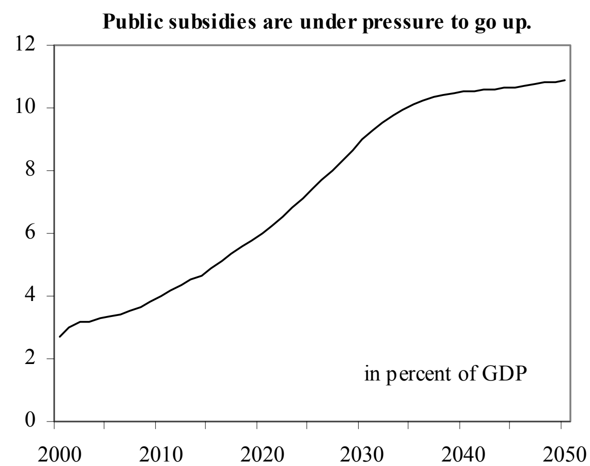
Switzerland has become the second most expensive country for health care in the world. The ratio of health costs to GDP was 11.5 percent in 2003--more than double its level in 1970. In real per-capita terms, health expenditures grew by 3 percent per year.

High prices rather than large quantities characterize the Swiss health sector, which suggests distortions on the supply side. In particular, the system suffers from regional fragmentation with small units, financial fragmentation, supply-pushed demand in medications and treatments, and insufficient competition.

Switzerland's health care system is financed largely by the private sector, much in contrast to the rest of Europe. High growth in insurance premia and out-of-pocket payments have a regressive effect on income distribution, which the government tries to counter by subsidizing low-income households. This strategy has the virtue of keeping non-wage labor costs low.

However, because there is little cost control, healthcare subsidies in the public finances could grow rapidly in the future. Staff calculations show that on present trends, the share of subsidized households would rise from 34 now to over 60 percent in 2015 and 90 percent in 2050.





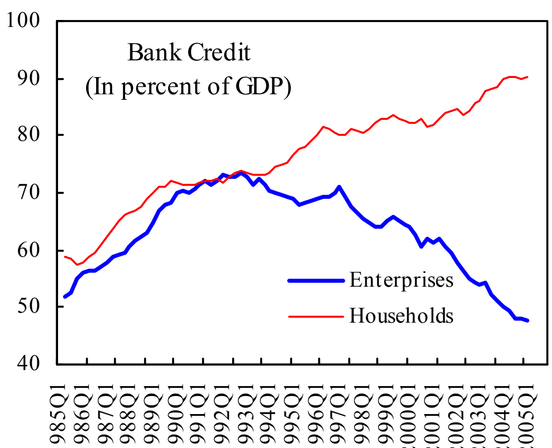
[1] See Chapter II in the accompanying *Selected Issues.*

26. **Proposals for overhauling Switzerland's system of intergovernmental fiscal relations were accepted in a referendum** (Box 3). The staff shared the authorities' view that this reform has strengthened fiscal federal relations. Key elements were the improved assignment of tasks and responsibilities between federal and subnational governments, and improved inter-regional equity. The reform also sharply reduced perverse spending incentives for poor cantons. Nevertheless, staff noted that, given the pronounced autonomy of the cantons in the Swiss federal system, and the relatively small size of the federal government (representing less than ⅓ of general government spending), it will remain difficult for Switzerland to run a coordinated fiscal policy stance unless the cooperation between federal and cantonal governments is further strengthened.

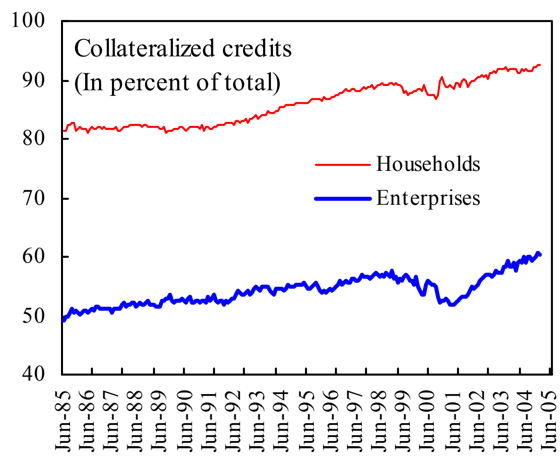
D. Financial Sector Stability

27. **The authorities underscored that the banking sector remained resilient, adequately capitalized, and dynamic**. In 2004, bank profitability has risen helped by cost cuts and consolidation. Balance sheets have strengthened further (Tables 5-8, Figure 9). Low interest rates have stimulated a rapid mortgage lending to households but supervisors' simulations suggest that a rise in interest rates would not impair households' ability to service debts as loan-to-value ratios were moderate and price increases in the real estate market had remained subdued. Lending to enterprises has been declining for several years. Supply has declined as banks have tightened lending practices and introduced risk-based interest rates, thereby increasing the intermediation spread. Demand has also moderated due to lower investment and enterprises' efforts to strengthen their balance sheets. The overall decline has been mitigated by increased lending from regional banks, which does not appear to have compromised their lending standards.

Bank lending to enterprises has been dropping...



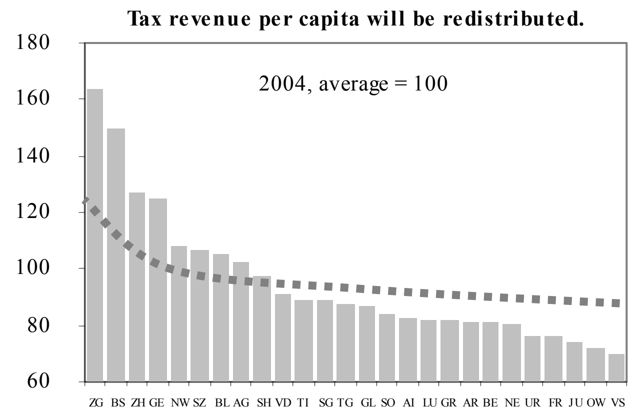
...and the shares of collateralized loans has been rising.



Box 3. The New Financial Equalization Scheme (NFA)

In Switzerland, subnational governments enjoy a great degree of autonomy. The central government is responsible mainly for foreign policy, defense, pensions, postal, telecommunications and railways services and the currency. All other responsibilities are handled by the cantons, in particular economic regulation, education, healthcare, and most of the judiciary.

Regional autonomy coupled with a mountainous topography has led to large income disparities. Most of Switzerland's GDP is produced in the prosperous lowland cantons and differences in cantonal tax revenue per capita exceed a factor of 2.



Currently, financial equalization among cantons is done through an array of 34 subsidy schemes. The subsidies are often linked to infrastructure projects, with the federal government contributing inversely to a canton's income level. This obscures the amount of regional transfers and creates incentives for poor cantons to inflate the number of eligible subsidized projects.

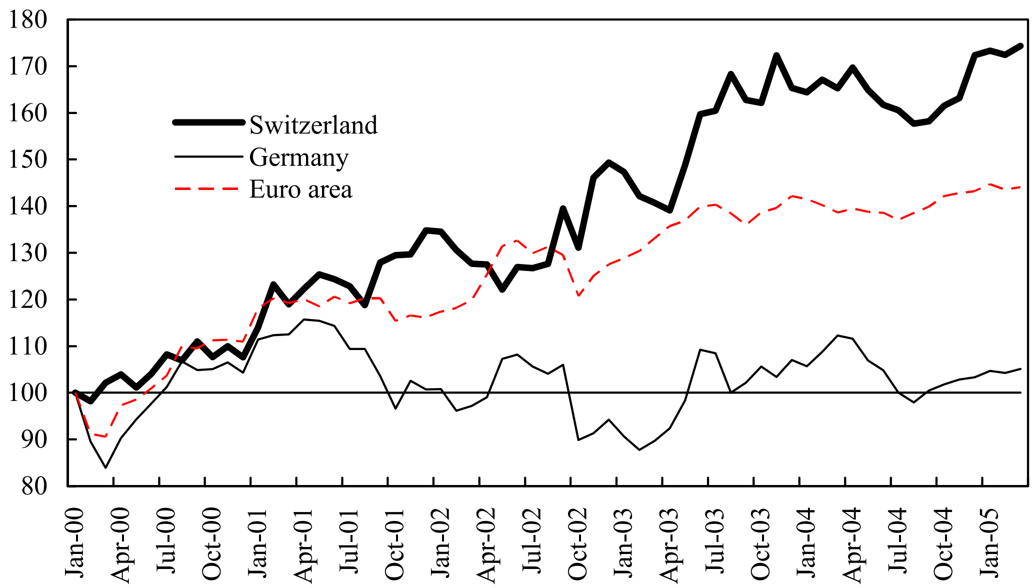
The NFA (*Neuer Finanzausgleich*) will replace project subsidies by simple grants. The grants take into account cantonal per-capita tax revenues and the extent of mountainous areas. This will make the budget more transparent, as regional subsidies show up as individual items. Expenditures should also decline with fewer incentives for unnecessary projects.

The NFA defines better cantonal and federal tasks. It envisages a broad-based shift from joint financing towards a clear division of labor. Old age pensions, disability insurance, military expenses, and interstate highways would be financed exclusively by the federal government. Health care and airports would fall under the responsibility of the cantons. Also, cantons would be encouraged to cooperate in areas with large economies of scale, such as specialized medicine and universities.

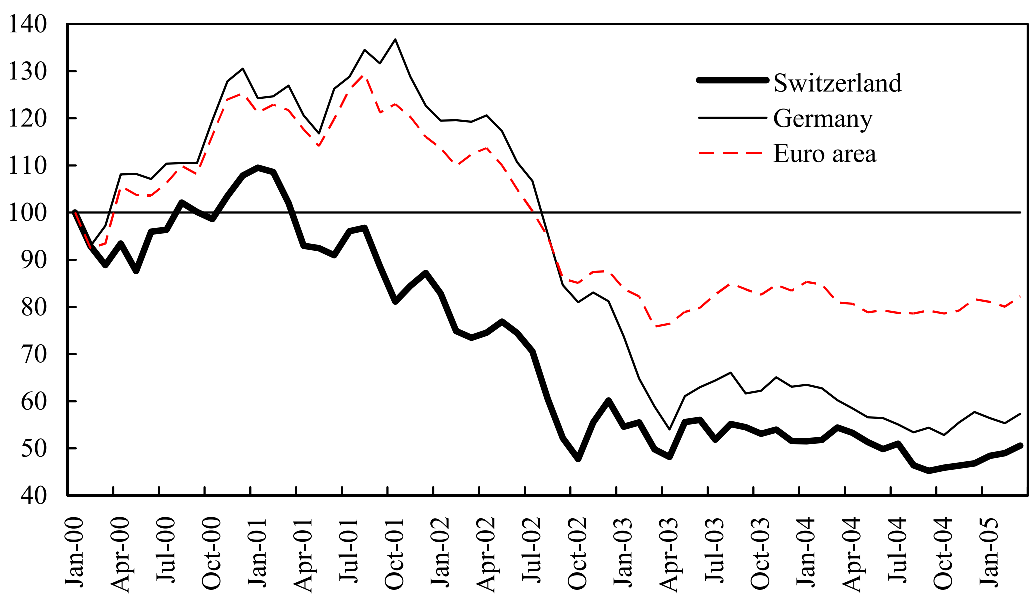
Full implementation of the NFA will take another four years. In November 2004, a referendum approved the necessary constitutional changes. Specific laws are planned to be passed by parliament in 2006-07, and—if accepted in referenda—implemented in 2008-09.

Figure 9. Equity Prices for Bank and Insurance Sectors
(As ratio to total market index; January 2000 = 100)

Banks' relative share prices have picked up...



...but those of the insurance sector remain depressed.



Source: Datastream.

28. **Supervisors viewed the capital base of the banking system as robust.** Stress tests suggested that internationally active banks were exposed to a depreciation of the dollar and a correction in the US real estate market. For all banks, a domestic economic downturn and stronger than anticipated interest rate increases were potential sources of stress. The tendency of some institutions to increase their risk profile in search for yield was being monitored closely.

29. **The authorities noted that financial conditions in the insurance sector had improved with the recovery of global capital markets and cost cuts, but some weaknesses remained**. Among nonlife insurers, profitability had increased, reflecting better underwriting performance and higher premia. Among life insurers, profitability had also improved. However, low interest rates on assets vis-à-vis regulatory minimum guaranteed returns on life insurance policies limited progress. The authorities saw scope for further consolidation in the insurance sector. Risk management was being strengthened with a new risk-based capital adequacy regime that anticipates the requirements of the EU Solvency II framework.

30. **Despite improvement, underfunding remained a problem in second pillar pension funds.** In 2003, 12 percent of the funds were underfunded, with a total shortfall equivalent to 6 percent of GDP. Some additional progress was made in 2004, helped by higher equity prices and a reduction in the regulatory minimum return on assets. In addition, undercapitalized funds were allowed to reduce further the return on assets and levy supplementary contributions, including from pensioners. A number of pension funds reduced the discount rate used to determine the present value of pension liabilities, providing a more realistic measure of underfunding. Finally, parliament approved the gradual reduction from 7.2 to 6.8 percent of the rate at which accumulated savings are converted into annuities (thus recognizing longer life spans) and requiring more transparent accounting standards for pension liabilities. Further reforms were underway to harmonize supervision across cantons. The authorities agreed that the supervisory system would benefit from a shift of emphasis towards actuarial and risk-based assessments.

31. **The authorities highlighted progress toward strengthening the supervisory framework.** On July 1, 2004, the revised Banking Act was put into force, harmonizing under the sole responsibility of the Swiss Federal Banking Commission the supervision, reorganization and liquidation of banks. Officials reaffirmed their intention to make the Financial Market Supervision Authority (FINMA) operational by the beginning of 2007. They considered extending supervision to independent asset managers, brokers and foreign exchange dealers, and improving coordination with the supervision of second pillar pension funds, which remained separate. As from 2005, external auditors of banks and brokers were required to prepare risk analysis/audit reports. The parliament adopted the revised Insurance Supervision Act, which moved to risk-based supervision and aligned Swiss legislation with EU directives. To implement the revised FATF recommendations, the authorities were preparing amendments to the Money Laundering Act to extend its application to professions

and activities outside the financial sector, and improve the transparency of owners of bearer shares. An evaluation by FATF was scheduled for 2005.

E. Structural Issues: Invigorating Growth

32. **The authorities agreed that improving Switzerland's growth performance remains a priority.** Slow growth performance in the past quarter century has been eroding Switzerland's standing in terms of per capita GDP (Figure 10). Adjusting for terms-of-trade gains and income from investments abroad reduces but does not eliminate the "growth deficit". The authorities acknowledged that multifactor productivity growth has been among the lowest in industrial countries and, with the participation rate already high and working age population set to decline, policies to spur productivity growth would be key to improving growth performance. Earlier staff research suggested that reforms could add ½ percentage points to growth[7] and, more recently, the OECD has estimated similar effects from the opening up of the health, agriculture, electricity, and gas sectors. These findings demonstrate the high costs that are being incurred by the difficulties to implement far-reaching reforms (Box 4).

Switzerland: Longer-Term Growth and its Determinants

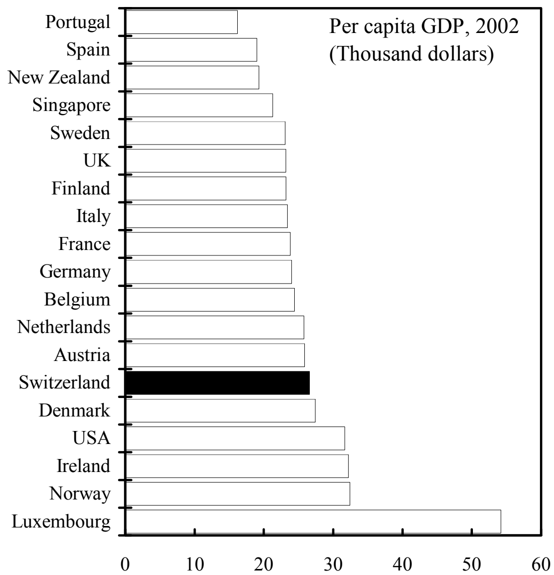
	1970-79	1980-89	1990-99	2000-04	2005-09	2000-09	2010-19	2020-29	2030-39	2040-49	2050-59
	(Annual rates of change, in percent)										
GDP growth	**0.9**	**2.1**	**1.1**	**1.3**	**1.7**	**1.5**	**1.1**	**0.7**	**0.7**	**0.8**	**0.8**
Labor productivity	**1.4**	**1.0**	**0.9**	**1.4**	**1.3**	**1.3**	**1.2**	**1.2**	**1.1**	**1.0**	**1.0**
TFP growth	0.4	0.2	0.4	0.7	0.9	0.8	0.8	0.7	0.7	0.7	0.7
Capital deepening	1.1	0.8	0.5	0.6	0.4	0.5	0.5	0.5	0.4	0.3	0.3
Total hours worked	**-0.6**	**1.1**	**0.1**	**-0.1**	**0.4**	**0.1**	**-0.2**	**-0.5**	**-0.3**	**-0.2**	**-0.2**
Hours worked	**-0.4**	**-0.7**	**-0.4**	**-0.8**	**-0.3**	**-0.5**	**-0.2**	**0.0**	**0.0**	**0.0**	**0.0**
Employment growth	**-0.1**	**1.8**	**0.5**	**0.7**	**0.7**	**0.7**	**0.0**	**-0.5**	**-0.3**	**-0.2**	**-0.2**
Unemployment, change	0.0	0.0	-0.2	-0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Participation rate	-0.5	0.9	0.2	0.5	0.4	0.4	0.2	0.1	0.0	-0.1	0.0
Activity rate	0.2	0.3	-0.2	0.1	0.0	0.1	-0.3	-0.6	-0.2	0.1	-0.1
Population	0.2	0.5	0.7	0.3	0.2	0.2	0.1	0.0	-0.1	-0.2	-0.2

Sources: Federal Statistical Office; OECD; and IMF staff calculations.

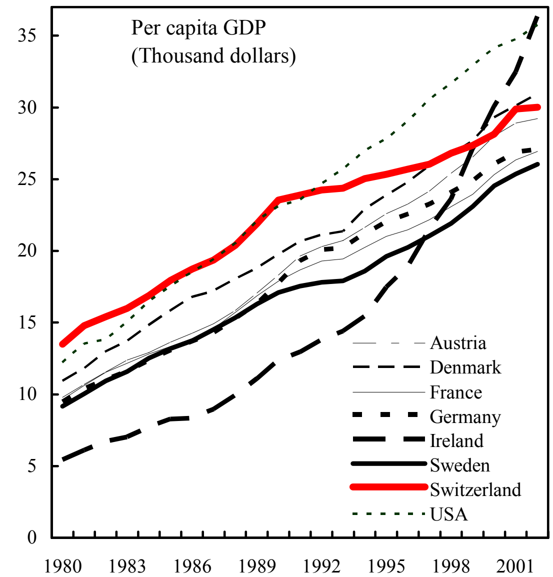
[7] WP/02/153: *Growth in Switzerland: Can Better Performance be Sustained?*

Figure 10. Switzerland: High but Eroding Living Standards
(Per capita GDP at constant PPP dollars)

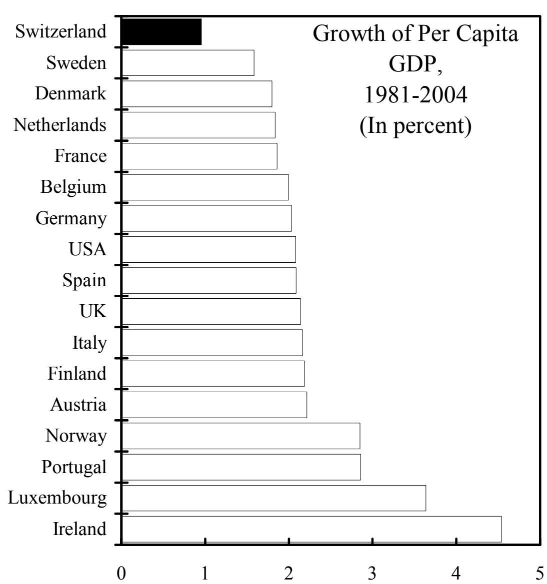
Switzerland is in an enviable position in terms of per capita GDP...



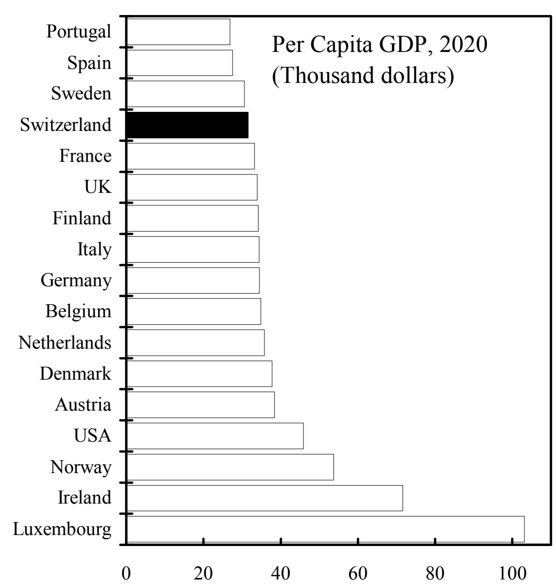
...but other countries are moving up.



If the poor growth performance of the past 25 years continues...



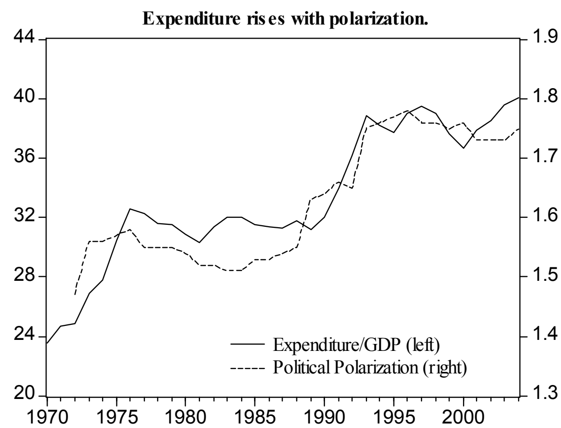
...then by 2020 Switzerland's international standing will have slipped considerably.



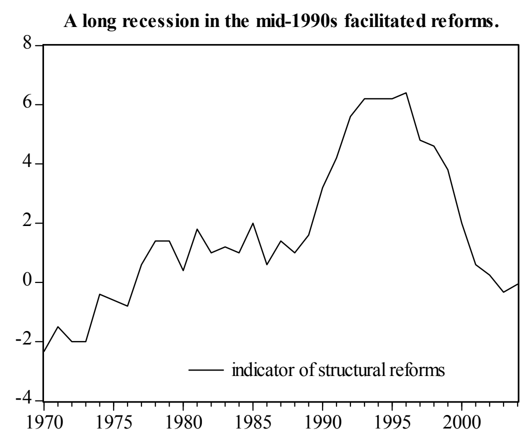
Sources: IBRD, World Development Indicators; OECD, Analytical Data Base; and IMF staff calculations.

Box 4. The Political Economy of Reform

The Swiss system of direct democracy is strong and far-reaching. Voters can challenge almost any legislation in referenda, including structural reforms and other policies. As voters can overrule parliament, consensus is important. For this reason, the federal government has included the four main parties since 1959 and all law proposals go through extensive public consultation. However, laws may still be rejected in a referendum if the electorate is polarized, which has happened with some frequency.



Polarization of the electorate seems to be related to the economic cycle. Economic upturns seem to encourage radicalization, while recessions facilitate compromise and moderation.[1]



As a result, Swiss fiscal policy has been procyclical. Fiscal adjustment occurred mostly during recessions, and slippages during booms. The recently introduced debt-brake rule is an attempt to break this pattern and, so far, the results are encouraging. For the first time in decades fiscal adjustment is taking place during an upturn.

Structural reforms are hampered by a status-quo bias, but can succeed under high economic pressure. The many checks and balances make structural reforms difficult to pass and favor incremental progress. Nevertheless, under pressure the system is able to change, and the prolonged recession in the mid-1990s facilitated significant reforms. The recent recovery has once again slowed the reform momentum.

[1] See Chapter III of the accompanying *Selected Issues*.

33. **The authorities highlighted steps to implement their strategy for structural reform.** A growth package was adopted last year aiming at opening up sheltered sectors, intensifying external economic relations, reducing the role of the state, raising further labor market participation, and improving the education system. In this context, the authorities prepared:

- An **amendment to the Internal Market Law** that, if adopted, would (i) significantly reduce the ability of cantons to impede cross-border supply of services and, (ii) empower the Competition Authority to challenge at the Federal Court cantonal and local governments' rules and regulations that constitute barriers to market entry.

- A bill for the **liberalization of the electricity market** in two steps. Commercial consumers would be able to choose their supplier starting in 2007, and the rest five years later. A previous liberalization effort was rejected in a referendum in 2002.

Staff welcomed these reforms and urged the authorities to supplement them with stronger efforts to eliminate ubiquitous nontariff barriers for a host of services and products.

34. **The authorities negotiated some important bilateral agreements with the EU.** Membership in the EU is not on the horizon at the moment, but deepening commercial and security ties are seen as effective instruments to foster reforms. A first package of bilateral agreements, including the free movement of labor, took effect in June 2002. Their extension to the new EU members, with transitional safeguards, has now been approved subject to a referendum scheduled for September. A second package of agreements—including the EU savings directive and associate Schengen membership—was signed in October 2004, and a referendum on Schengen membership is scheduled for June.

35. **The Swiss labor market is quite flexible and not considered a main source of distortions**. Employment and participation ratios are at the top among OECD countries, unionization is low, employment legislation is flexible, and active labor market policies relatively effective (Figure 11). The opening up of the labor market vis-à-vis the EU could attract skilled labor, which in previous upswings had been a drag on growth.[8] Moreover, the extension of free labor mobility to the new EU members could help to ameliorate the effects of population aging.

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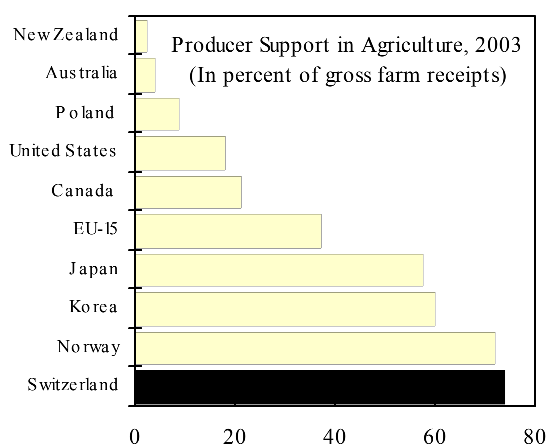
[8] The agreement stipulates the complete opening of the labor market by 2007 for existing EU members and the gradual opening by 2011 for the new EU member countries. Switzerland could impose restrictions until 2014 in case of a disruptive influx.

F. Other Issues

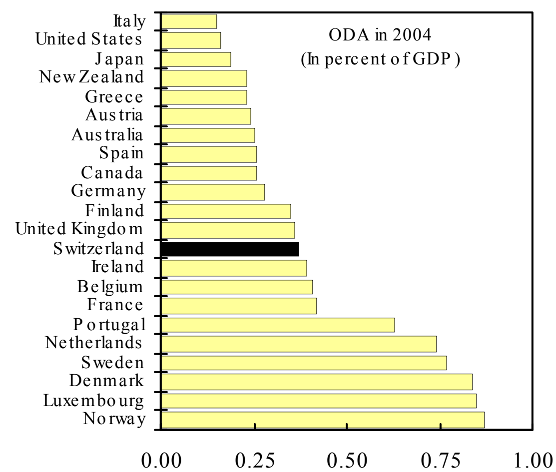
36. **Very high agriculture protection remains a notable feature of the Swiss trade regime**. Switzerland has the second highest level of export subsidies in the world.[9] The marginal tariff for some agricultural products is 700 percent and direct producer support exceeds the value added of agricultural production. While price support is being dismantled in favor of direct payments, staff noted that it would take years at the current pace before protection dropped even to the high EU level. At the same time, the authorities acknowledged that the public has been increasingly questioning the very high price level in Switzerland relative to neighbors, for food products in particular.

Agricultural subsidies are very high.



Source: OECD.

ODA is about average.



Source: OECD.

37. **Official development assistance (ODA) is nearly 0.4 percent of GNI**. This does not include sizeable international assistance (such as for refugees) that is not classified as ODA. Moreover, Swiss ODA is seen by DAC as effective and well-focused on poor countries.

38. Despite welcome improvement, **deficiencies remain in the quality and coverage of economic statistics** (Appendix II). The authorities explained that the pace of improvements in this area is determined by budgetary constraints.

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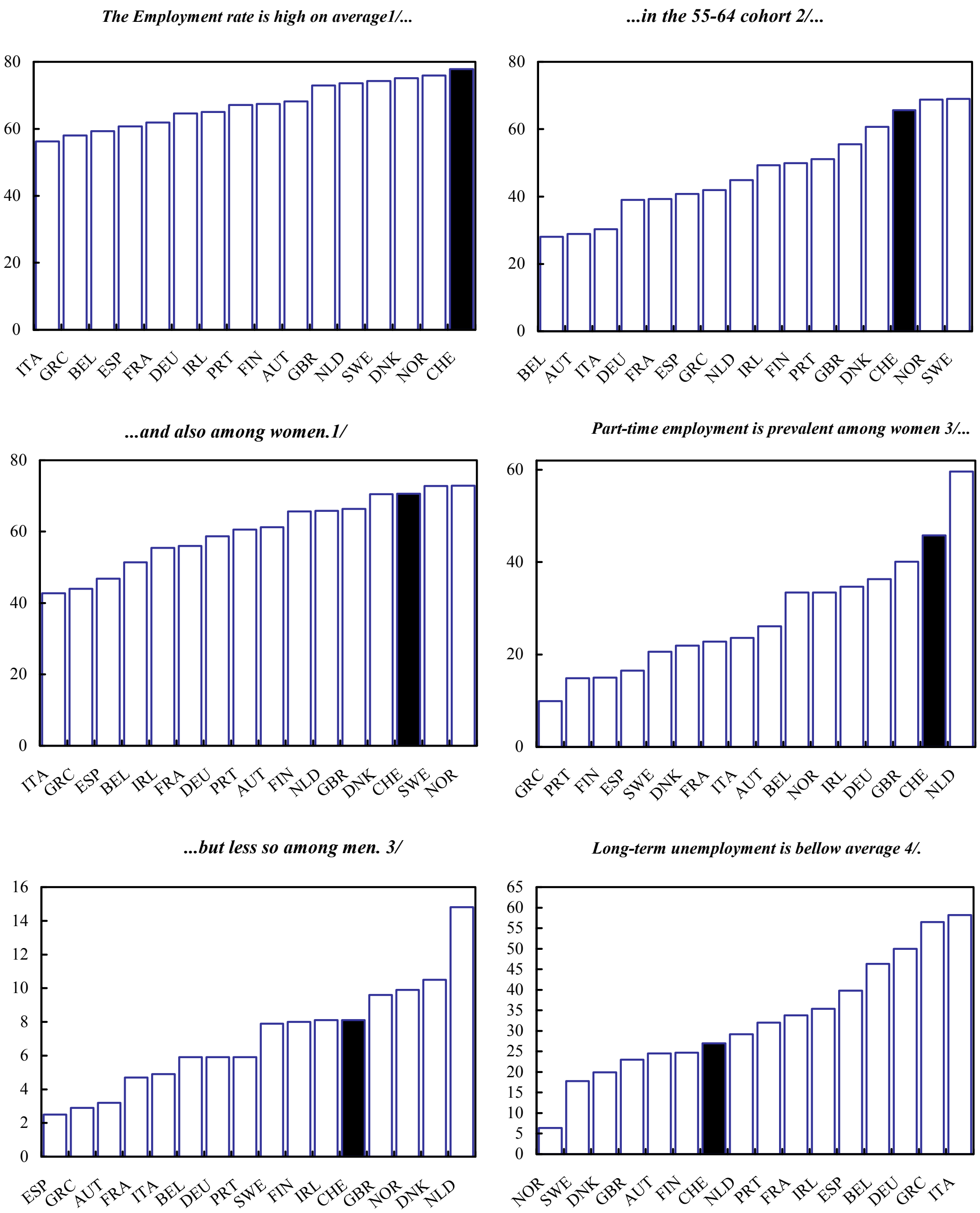
[9] Trade Policy Review, WTO, November 2004.

Figure 11. Switzerland: Labor Market Indicators, 2003



Sources: OECD; and IMF staff estimates.
1/ In percent of population aged 15-64 years.
2/ In percent of population aged 55-64 years.
3/ In percent of employment.
4/ In percent of total unemployment.

IV. Staff Appraisal

39. **The Swiss economy is wealthy and has a robust external sector, flexible labor markets, and sound monetary and fiscal policy frameworks; however, some strains are showing as a result of sustained slow growth.** The public finances are difficult to manage in a slow-growth environment, and the debt ratio is no longer low. In addition, efforts by the authorities to advance structural reforms to boost growth have met with limited success. While growth may not be a cure-all, a more dynamic output performance would appear necessary to manage the challenges from aging and mitigate the burden on fiscal adjustment—but building a consensus around such policies has proven difficult.

40. **Economic growth in 2005 is projected to continue, albeit at a slower pace.** Weaker demand in the euro area and the U.S. dollar depreciation have dented the modest recovery. External factors are projected to improve again as the year unfolds but there remain some downside risks to the outlook: persistent euro-area softness, higher oil prices, and potential for a disorderly adjustment of international imbalances with especially marked repercussions for a traditional safe-haven country. Inflation is expected to remain low, despite higher oil prices.

41. **The SNB can afford to be patient with monetary policy.** The Bank raised policy interest rates slightly in the course of 2004 as economic activity accelerated. As the economy hit a soft patch, monetary policy was appropriately placed on hold again and should remain so until the recovery firms up. Inflation expectations are well anchored, with strong SNB credibility, and inflation is projected to remain inside the price stability range until 2006, underpinning the case for a continued accommodative stance.

42. **The monetary policy framework is working well and the SNB's communications strategy has been fine-tuned.** The publication of quarterly monetary reports and inflation forecasts is welcome.

43. **The franc's gradual appreciation reflects a fundamental longer-term trend.** This trend has not been a drag on the external current account with manufacturers producing higher value-added exports, the international financial system benefiting from the strong currency, and net factor income being persistently very high.

44. **Public finances were stronger than expected in 2004, and need to continue improving in the medium term.** The objective to eliminate the federal government structural deficit is well placed. Low average real GDP growth and mounting pressure on social security require fiscal prudence. In this regard, the conduct of fiscal policy could benefit from an in-depth analysis of the key public sector tasks, focusing resources on priority activities and aiming at lasting structural adjustment. In an increasingly globalized environment, the emphasis of fiscal adjustment will need to be on reducing expenditures.

45. **The proceeds from SNB gold sales are one-time flows and should be used to reduce debt.** Being a temporary source of income, the sales should not be used for expenditure or for delaying reforms, which would make future fiscal adjustment more

difficult. The federal government's decision to use the proceeds from the gold sales for debt reduction is welcome, and should be replicated by the cantons.

46. **A considerable task remains to ensure the sustainability and efficiency of the pension and healthcare systems.** The affordability of first-pillar pension entitlements needs to be reevaluated; parameters such as the retirement age and the replacement rate need to be recalibrated as well as the roles of and relation between the first and second pension pillars. In healthcare, the main challenge is to contain costs by using economies of scale and encouraging competition for providers and pharmaceuticals.

47. **A multi-year fiscal framework is needed to ensure the intertemporal consistency of policies to address population aging.** It should encompass all levels of government, including social security, stipulate a path for the public debt-to-GDP ratio consistent with long-term fiscal sustainability, and include provisions for fiscal policy coordination among the various levels of government. Representing less than one-third of general government expenditure, the federal government is ill-equipped to face these tasks on its own.

48. **A significant effort will have to be made to impress upon the public the need for such a long-run fiscal strategy**. This requires putting the analytical issues in the public debate, including a discussion of burden sharing. Fiscal consolidation is not a substitute for reforms, and options will need to include different mixtures of revenue increases, expenditure cuts, entitlement rationalization (keeping in mind the need to protect the most vulnerable members of society), and structural reforms to bolster growth. The regular publication of fiscal sustainability reports could enhance public awareness that delays in addressing these challenges are likely to make the solution more painful.

49. **The new constitutional structure for fiscal federalism is welcome.** It achieves a better assignment of tasks between the levels of government and removes some incentives for spending. This strengthens accountability and efficiency.

50. **The financial system appears to be generally healthy and dynamic, but supervisors' continued vigilance is important given the large size of this sector in the economy**. While banks are comfortably capitalized, they run some risks—especially if global imbalances were to unwind suddenly and financial asset prices were to fall sharply. In the domestic economy, lending to households has been strong, mainly for mortgages, but without signs of pressure on real estate prices so far. The authorities' proactive attitude in supervision is commendable but efforts to bolster further the quality of external audits and facilitate uniform assessments of debtors would be welcome. The switch to risk-based supervision should bring considerable benefits to insurance.

51. **The second-pillar pension plans continue to show some strains which deserve attention.** It would be important to align the annuity conversion rate with its actuarially neutral value, and the discount rate with market interest rates. If market interest rates stay low, the regulatory minimum interest rate may need to be brought down further. In supervision, the plans to harmonize standards across cantons are welcome and need to be

supplemented by a shift to actuarial assessments and a more timely disclosure of financial statements.

52. **Additional resources need to be allocated to the improvement of economic statistics.** Although some welcome progress has been made, gaps, deficiencies and delays remain that affect economic analysis and management.

53. **The authorities are encouraged to lower the levels of agricultural tariff and non-tariff protection.** Switzerland has well-targeted programs for ODA, but the poorest countries would be greatly assisted also by efforts to eliminate trade barriers, including those in agriculture under the Doha trade round.

54. It is recommended that the next Article IV consultation with Switzerland be held on the standard twelve-month cycle.

Table 1. Switzerland: Basic Data

Area and population

Total area	41,293 square kilometers	GDP per capita (2004)	$	49,146
Total population (end-2004)	7.3 million	GNP per capita (2004)	$	52,645

	2000	2001	2002	2003	2004	2005 1/	2006 1/	2007 1/
	(Percentage changes at constant prices, unless otherwise indicated)							
Demand and supply								
Total domestic demand	2.2	2.3	-0.8	0.2	1.0	1.1	1.5	1.7
Private consumption	2.3	2.0	0.3	0.5	1.3	0.8	1.3	1.7
Public consumption	2.6	4.2	3.2	1.4	1.2	0.2	0.2	1.0
Gross fixed investment	4.3	-3.1	0.3	-0.4	3.4	0.8	2.1	1.8
Final domestic demand	2.8	1.0	0.7	0.4	1.8	0.7	1.3	1.6
Inventory accumulation 2/	-0.6	1.2	-1.3	-0.2	-0.7	0.3	0.1	0.1
Foreign balance 2/	1.5	-1.2	1.1	-0.5	0.8	0.1	0.6	0.3
Exports of goods and nonfactor services	12.2	0.2	-0.2	0.0	6.6	3.7	5.5	5.1
Imports of goods and nonfactor services	9.6	3.2	-2.8	1.4	5.6	3.9	4.8	5.1
GDP	3.6	1.0	0.3	-0.4	1.7	1.2	2.0	1.9
GNP	5.2	-2.0	-1.1	3.1	0.8	1.4	1.9	2.4
Nominal GDP (billions of SwF)	415.5	422.5	431.1	433.4	444.6	455.2	469.8	484.7
Employment and unemployment								
Employment (percent change)	1.0	1.7	0.6	-0.1	0.2	0.7	0.9	0.8
Unemployment rate (in percent)	1.8	1.7	2.5	3.7	3.9	4.2	4.0	3.8
Output gap (in percent of potential)	1.9	1.5	0.4	-1.3	-1.1	-1.4	-1.0	-0.7
Prices and incomes								
GDP deflator	0.8	0.6	1.7	0.9	0.9	1.2	1.2	1.3
Consumer price index	1.6	1.0	0.5	0.6	0.8	1.2	1.0	1.3
Nominal wage growth	1.3	2.5	1.8	1.2	1.3	1.4	1.8	2.2
Unit labor costs (total economy)	0.8	3.1	2.0	1.5	-0.2	0.9	0.7	1.1
	(In percent of GDP)							
General government finances								
Revenue	39.4	38.8	37.9	37.7	37.6	37.9	37.6	37.4
Expenditure	37.2	38.7	39.1	39.3	38.7	39.3	38.9	38.7
Balance 3/	2.2	0.1	-1.2	-1.6	-1.0	-1.4	-1.2	-1.3
Structural balance 4/	0.6	-0.1	-0.8	-0.8	-0.2	-0.3	-0.3	-0.6
Gross debt	49.9	50.5	54.5	55.4	55.6	50.6	49.8	49.2
	(Percentage changes in annual averages)							
Monetary and credit data								
Broad money (M3)	-1.8	3.1	3.8	8.3	3.0	...	...	...
Domestic credit	1.7	1.5	-0.5	0.6	2.3	...	...	...
	(Period averages in percent)							
Interest rates								
Three-month rate	3.1	2.9	1.2	0.4	0.5	...	...	...
Yield on government bonds	3.8	3.3	3.1	2.5	2.6	...	...	...
	(In percent of GDP)							
Balance of payments								
Current account	12.4	8.0	8.4	13.2	12.0	11.1	11.3	11.2
Trade balance	-1.0	-1.1	1.2	1.0	0.9	-0.2	-0.6	-0.9
Net investment income	10.6	7.8	6.0	10.6	9.4	9.6	9.8	10.0
Other	2.9	1.3	1.2	1.6	1.7	1.8	2.1	2.1
	(Levels)							
Exchange rates								
SwF per US$ (annual average)	1.69	1.69	1.56	1.36	1.25	...	...	...
SwF per euro (annual average)	1.56	1.51	1.48	1.51	1.54	...	...	...
Nominal effective rate (avg., 1990=100)	100.0	103.7	108.2	108.6	108.4	...	...	...
Real effective rate (avg., 1990=100) 5/	99.8	102.8	106.6	106.2	105.2	...	...	...

Sources: IMF, World Economic Outlook database; Swiss National Bank; and Swiss Institute for Business Cycle Research.

1/ Fund staff estimates and projections unless otherwise noted.

2/ Change as percent of previous year's GDP.

3/ Including railway loans as expenditure. In 2005 exncludes revenue from gold sales equal to 4.6 percent of GDP.

4/ Excluding privatization proceeds and gold sales; smooths erratic revenue items.

5/ Based on relative consumer prices.

Table 2. Switzerland: General Government Finances

	2000	2001	2002	2003	2004 Est.	2005 Proj.	2006 Proj.	2007 Proj.
				(In millions of SwF)				
General government								
Revenue 1/	163,703	163,940	163,232	163,476	167,244	172,198	176,746	181,057
Expenditure	154,591	163,563	168,582	170,417	171,889	178,764	182,538	187,287
Balance	9,112	377	-5,349	-6,941	-4,645	-6,566	-5,792	-6,230
Federal government								
Revenue 1/	51,994	49,434	47,658	47,511	48,933	51,013	52,373	53,699
Expenditure	48,256	51,191	51,979	51,287	51,566	53,076	52,792	53,294
Balance	3,738	-1,757	-4,321	-3,776	-2,633	-2,063	-418	405
Cantons								
Revenue 1/	62,818	65,191	66,290	65,774	67,322	69,017	70,621	71,826
Expenditure	60,194	63,899	66,591	67,989	67,857	71,495	74,189	77,145
Balance	2,623	1,292	-301	-2,215	-535	-2,479	-3,568	-5,318
Communes								
Revenue	42,067	43,033	43,601	43,239	44,021	45,120	46,359	47,819
Expenditure	40,599	41,709	42,498	43,912	44,148	44,921	46,029	47,227
Balance	1,468	1,324	1,103	-673	-126	198	330	592
Social security								
Revenue	44,207	45,743	45,309	48,078	48,150	49,329	50,859	52,426
Expenditure	42,925	46,225	47,140	48,354	49,501	51,552	52,993	54,334
Balance	1,282	-482	-1,831	-276	-1,351	-2,223	-2,135	-1,908
				(In percent of GDP)				
General government								
Revenue	39.4	38.8	37.9	37.7	37.6	37.9	37.6	37.4
Expenditure	37.2	38.7	39.1	39.3	38.7	39.3	38.9	38.7
Balance	2.2	0.1	-1.2	-1.6	-1.0	-1.4	-1.2	-1.3
Federal government	0.9	-0.4	-1.0	-0.9	-0.6	-0.5	-0.1	0.1
Cantons	0.6	0.3	-0.1	-0.5	-0.1	-0.5	-0.8	-1.1
Communes	0.4	0.3	0.3	-0.2	0.0	0.0	0.1	0.1
Social security	0.3	-0.1	-0.4	-0.1	-0.3	-0.5	-0.5	-0.4
Memorandum items:								
Structural fiscal balance	0.6	-0.1	-0.8	-0.8	-0.2	-0.3	-0.3	-0.6

Sources: Federal Ministry of Finance; and IMF staff estimates.

1/ Excludes in 2005 transfers from SNB gold sales of SwF 21 billion, 4.6 percent of GDP.

Table 3. Switzerland: Federal Government Finances

	2000	2001	2002	2003	2004 Est.	2005 Proj.	2006 Proj.	2007 Proj.
	(In millions of SwF)							
Revenue	51,994	49,434	47,658	47,511	48,933	51,013	52,373	53,699
Current revenue	50,742	46,686	45,851	46,766	48,511	50,581	51,927	53,238
Taxes	46,492	42,873	42,748	43,281	44,755	46,736	48,090	49,780
Direct taxes	21,033	16,568	16,765	16,665	17,205	17,630	18,095	18,678
Indirect taxes	25,459	26,305	25,983	26,616	27,550	29,106	29,996	31,102
Non-tax revenue 1/	4,251	3,813	3,103	3,484	3,756	3,845	3,837	3,458
Capital revenue	1,252	2,748	1,807	745	422	432	446	460
Expenditure	48,256	51,191	51,979	51,287	51,566	53,076	52,792	53,294
Current expenditure	41,699	43,076	44,242	43,152	44,350	46,122	46,176	46,744
Wages and salaries	5,284	5,815	5,716	5,825	5,838	5,821	5,909	5,965
Goods and services	5,119	4,862	4,904	4,923	4,731	4,509	4,450	4,479
Interest payments	3,493	3,398	3,768	3,293	3,172	4,278	3,848	3,689
Transfers	27,803	29,001	29,855	29,111	30,609	31,513	31,970	32,611
Capital expenditure	6,557	8,115	7,737	8,135	7,216	6,955	6,616	6,550
Overall balance	3,738	-1,757	-4,321	-3,776	-2,633	-2,063	-418	405
	(In percent of GDP)							
Revenue	12.5	11.7	11.1	11.0	11.0	11.2	11.2	11.1
Current revenue	12.2	11.1	10.6	10.8	10.9	11.1	11.1	11.0
Tax revenue	11.2	10.1	9.9	10.0	10.1	10.3	10.2	10.3
Non-tax revenue	1.0	0.9	0.7	0.8	0.8	0.8	0.8	0.7
Capital revenue	0.3	0.7	0.4	0.2	0.1	0.1	0.1	0.1
Expenditure	11.6	12.1	12.1	11.8	11.6	11.7	11.2	11.0
Current expenditure	10.0	10.2	10.3	10.0	10.0	10.1	9.8	9.6
Capital expenditure	1.6	1.9	1.8	1.9	1.6	1.5	1.4	1.4
Overall balance	0.9	-0.4	-1.0	-0.9	-0.6	-0.5	-0.1	0.1
Memorandum item:								
Structural fiscal balance	-0.5	-0.8	-1.1	-0.9	-0.5	-0.3	0.0	0.2

Sources: Federal Ministry of Finance; and IMF staff estimates.

1/ Excluding in 2005 transfers from SNB gold sales of SwF 7 billion, 1.5 percent of GDP.

Table 4. Switzerland: Balance of Payments

	2000	2001	2002	2003	2004	2005 1/	2006 1/	2007 1/
	(In billions of SwF, unless otherwise indicated)							
Current account	51.7	33.8	36.2	57.1	53.2	50.7	52.9	54.3
(In percent of GDP)	12.4	8.0	8.4	13.2	12.0	11.1	11.3	11.2
Trade balance	-4.2	-4.6	5.1	4.5	3.9	-1.1	-2.9	-4.4
Service balance	27.3	23.4	23.3	24.0	24.7	25.2	27.0	27.6
Net investment income	44.0	32.9	25.9	45.8	41.7	43.8	46.1	48.5
Net compensation of employees	-8.3	-9.1	-9.2	-10.3	-10.0	-10.0	-10.0	-10.0
Net private transfers	-3.9	-5.7	-5.8	-3.9	-3.9	-4.0	-4.0	-4.1
Net official transfers	-3.2	-3.1	-3.1	-3.1	-3.2	-3.2	-3.2	-3.3
Net foreign direct investment	-42.9	-15.9	-2.8	-5.5	-5.5	…	…	…
Outward	-75.4	-30.8	-12.3	-21.1	-21.1	…	…	…
Inward	32.5	14.9	9.5	15.6	15.6	…	…	…
Net portfolio investment	-19.9	-69.1	-35.2	-47.0	-5.1	…	…	…
Outward	-37.7	-72.3	-46.6	-44.5	-35.0	…	…	…
Inward	17.8	3.2	11.4	-2.5	29.9	…	…	…
Net banking sector	35.7	12.8	-39.5	-17.1	-61.5	…	…	…
Memorandum items:								
Net investment income	44.0	32.9	25.9	45.8	41.7	…	…	…
(In percent of GDP)	10.6	7.8	6.0	10.6	9.4	…	…	…
Net external assets	521.5	596.5	583.7	580.5	633.5	…	…	…
(In percent of GDP)	125.5	141.2	135.4	133.9	142.5	…	…	…
Official reserves (billions of US$, end period)	32.3	32.0	40.2	47.7	55.5	...	...	...
Reserve cover (months of imports of GNFS)	3.8	3.7	4.4	4.6	4.3	...	...	...

Sources: IMF, World Economic Outlook database; and Swiss National Bank.
1/ Fund staff estimates and projections unless otherwise noted.

Table 5. Switzerland: Financial Development in Major Financial Institutions, 2002-04

	2002	2003	2004
Union Bank of Switzerland (SwF millions)			
Profit 2/	3,530	6,239	8044
Operating Income	34,107	33,790	37402
S&P Credit Ratings	AA+	AA+	AA+
Credit Swiss Group (SwF millions)			
Profit 2/	-4,448	770	5,628
Operating Income	47,245	51,353	54,014
S&P Credit Ratings	AA-	A-1	A-1
Zurich Financial Services (US$ millions)			
Profit USD millions 2/	-3,503	3,611	3,786
Operating Income	40,302	57,208	59,678
S&P Credit Ratings	A	A	A-
Swiss Life (SwF millions) 1/			
Profit 2/	-1,847	477	1,009
Operating Income	20,624	21,088	22,342
S&P Credit Ratings	A-	A-	A-
Swiss Re (SwF millions)			
Profit (SwF millions) 2/	-91	1,702	2,475
Operating Income	34,415	36,430	36,093
S&P Credit Ratings	AA+	AA	AA
Total			
Profit (SwF millions)2/	-8,316	14,051	21,916
Profit (percent of GDP)	-1.9	3.3	6.6
Operating Income (SwF millions)	199,206	219,700	224,881
Operating Income (percent of GDP)	46.6	51.0	67.8

Source: Company reports; and IMF staff calculations.
1/ Data for Swiss Life is for the first half of the year.
2/ Profit before taxes and minority interests.

Table 6. Switzerland: Core Set of Financial Soundness Indicators

	1999	2000	2001	2002	2003	2004
Banks						
Regulatory capital as percent of risk-weighted assets	11.3	12.7	11.8	12.1	11.2	11.0
Regulatory Tier I capital to risk-weighted assets	10.2	12.7	12.0	12.6	12.2	11.6
Non-performing loans net of provisions as percent of tier I capital	43.0	28.2	27.4	23.3	16.5	12.1
Non-performing loans as percent of gross loans	4.9	4.1	3.6	3.1	2.3	1.6
Gross profits as percent of average assets (ROAA)	1.1	1.4	1.1	1.1	0.9	0.9
Gross profits as percent of average equity capital (ROAE)	25.0	23.6	17.8	18.3	16.0	16.7
Net interest income as percent of gross income	32.1	34.4	37.2	37.6	42.9	38.6
Non-interest expenses as percent of gross income	61.0	61.3	67.8	66.6	67.8	66.5
Liquid assets as percent of total assets	28.5	23.4	23.3	21.6	26.1	27.0
Liquid assets as percent of short-term liabilities	52.2	49.3	48.4	47.9	52.9	54.9
Sectoral distribution of bank credit to the private sector	(As percent of total credit to private sector)					
Households	56.7	57.3	58.8	61.3	64.1	65.5
Agriculture and food industry	0.8	0.8	0.8	0.7	0.7	0.7
Industry and manufacturing	5.7	5.4	5.2	5.1	4.6	4.1
Construction	3.4	2.9	2.6	2.4	2.2	2.1
Retail	5.5	5.2	4.9	4.5	4.0	3.6
Hotels and restaurants / Hospitality sector	2.0	1.7	1.6	1.5	1.5	1.4
Transport and communications	1.5	1.2	1.2	1.0	1.1	1.1
Other financial activities	3.8	3.7	3.9	3.0	2.2	2.2
Insurance sector	0.8	1.1	1.0	0.7	0.5	0.5
Commercial real estate, IT, R&D	12.8	13.3	12.4	12.3	12.2	12.2
Public administration (excluding social security)	3.1	3.5	3.7	3.5	3.3	3.2
Education	0.2	0.2	0.2	0.2	0.2	0.2
Healthcare and social services	1.5	1.4	1.4	1.4	1.3	1.3
Other collective and personal services	1.7	1.7	1.7	1.6	1.5	1.5
Other 1/	0.5	0.5	0.6	0.5	0.5	0.5

Source: Swiss National Bank.

1/ Mining and extraction, production and distribution of electricity, natural gas and water, financial intermediation, social security, ex-territorial bodies and organizations, other.

Table 7. Switzerland: Encouraged Set of Financial Soundness Indicators

	1999	2000	2001	2002	2003	2004
Banking sector						
Capital as percent of assets 1/	4.9	6.0	5.6	5.4	5.2	5.0
Geographical distribution of bank credit as percent of total bank credit						
Switzerland	...	...	64.9	65.1	68.0	64.6
EMU countries	...	...	5.3	4.9	4.7	4.7
Other developed countries	...	...	20.9	21.2	16.7	18.9
Central and eastern European countries	...	...	0.5	0.4	0.5	0.5
Emerging markets and developing countries	...	...	8.5	8.4	10.2	11.3
Large exposures as percent of tier I capital 2/	...	...	...	...	...	...
Gross asset position in derivatives as a percentage of tier I capital	...	...	...	...	...	...
Gross liability position in derivatives as a percentage of tier I capital	...	...	...	...	...	...
Trading income as a percent of gross income	18.0	18.2	14.5	12.6	7.5	11.8
Personnel expenses as percent of non-interest expenses	57.6	57.2	56.8	57.0	59.7	60.7
Spread between reference loan and deposit rates 3/	...	...	...	...	...	...
Spread between highest and lowest interbank rate	...	...	...	...	...	...
Customer deposits as percent of total (non-interbank) loans	114.3	102.6	98.4	98.4	104.8	105.0
Foreign currency loans as percent of total loans	23.8	31.6	31.6	31.6	31.6	31.6
Foreign currency liabilities as percent of total liabilities	58.2	54.9	56.4	55.1	54.8	57.8
Pension funds						
Under-funding as percent of total liabilities	...	...	...	22.6	19.6	...
Share of underfunded funds as percent of all pension funds	...	...	...	19.8	11.9	...
Households						
Household debt to banks as a precentage of GDP	82.5	81.4	84.3	85.7	88.5	90.1
Real estate markets						
Annual increase of real estate prices	-2.1	0.3	1.9	2.8	2.3	2.3
Mortgage loans as percent of total loans	66.1	65.1	65.8	69.9	71.5	69.7

Sources: Swiss National Bank; and Social Security Administration.

1/ Simple ratio of capital to total assets, without risk weighting.
2/ Large exposure = larger than 10 percent of tier I capital.
3/ Difference between lending rate on loans <= 1 year and deposit rate on term deposits >= 1 month and <= 1 year.

Table 8. Switzerland: Structure of the Financial System

	1999	2000	2001	2002	2003	2004
			(Number of institutions)			
Banks	372	375	369	356	342	338
Cantonal banks	24	24	24	24	24	24
Large banks	3	3	3	3	3	3
Regional and savings banks	106	103	94	88	83	83
Raiffeisen banks	1	1	1	1	1	1
Other banks	200	204	205	200	190	188
Trading banks	16	13	12	11	9	9
Stock exchange banks	54	57	61	62	55	53
Other banks	7	7	7	5	4	4
Foreign controlled banks	123	127	125	122	122	122
Branches of foreign banks	21	23	25	25	26	25
Private banks	17	17	17	15	15	14
Insurance companies - Life	30	28	29	24	24	...
Insurance companies - General	101	101	106	123	124	...
Pension funds	...	9,096	...	8,134	...	...
Concentration						
Banks 2/	67.6	63.7	64.3	64.7	63.4	66.3
Insurance companies - Life 3/	...	15.0	15.0	15.2	14.1	...
Insurance companies - General 3/	...	8.3	7.1	7.5	7.4	...
			(In SwF billions)			
Assets						
Banks	2,244	2,125	2,227	2,252	2,237	2,491
Cantonal banks	296	303	305	313	311	314
Large banks	1,505	1,340	1,416	1,444	1,409	1,644
Regional and savings banks	74	76	78	79	81	81
Raiffeisen banks	66	77	82	93	102	106
Other banks	266	291	312	290	302	314
Trading banks	53	55	53	41	42	43
Stock exchange banks	64	71	69	81	83	86
Other banks	3	3	3	3	3	4
Foreign controlled banks	146	162	187	166	174	181
Branches of foreign banks	22	19	17	16	16	15
Private banks	15	18	17	16	17	17
Insurance companies - Life	...	...	...	301	311	...
Insurance companies - General	...	...	...	506	530	...
Pension funds	...	491	...	441	...	...
Deposits						
Banks	988	885	937	932	974	1,044
Cantonal banks	152	153	155	164	169	180
Large banks	601	491	529	506	526	577
Regional and savings banks	44	44	45	46	50	51
Raiffeisen banks	46	49	53	59	65	71
Other banks	131	135	143	142	149	153
Trading banks	35	34	33	25	26	28
Stock exchange banks	35	36	37	46	49	47
Other banks	1	2	2	2	2	2
Foreign-controlled banks	59	64	71	69	72	76
Branches of foreign banks	3	2	2	2	2	2
Private banks	10	11	11	12	13	11

Source: Swiss National Bank.

1/ Credit institutions governed by the Swiss law, including those with Swiss-majority and foreign-majority shareholdings.

2/ Share in percent of three largest banks in total assets of the sector.

3// Herfindahl's index

Switzerland: Fund Relations
(As of March 31, 2005)

I. **Membership Status:** Joined 5/29/92; Switzerland has accepted the obligations of Article VIII, Sections 2, 3 and 4.

II. **General Resources Account:**	**SDR Million**	**% Quota**
Quota	3,458.50	100.00
Fund holdings of currency	2,343.49	67.76
Reserve position	1,115.01	32.24

III. **SDR Department:**	**SDR Million**	**% Allocation**
Holdings	2,13	N/A

IV. **Outstanding Purchases and Loans:** None
V. **Financial Arrangements:** None
VI. **Projected Obligations to Fund:** None
VII. **Exchange Rate Arrangement:**

The Swiss National Bank does not maintain margins in respect of exchange transactions. However, the Swiss National Bank has intervened when warranted by the circumstances. Switzerland's exchange system is free of restrictions on the making of payments and transfers for current international transactions. However, in accordance with UN Security Council resolutions, Switzerland has frozen the financial assets and economic resources of persons and entities associated with the Taliban, Osama bin Laden and Al Qaeda, as well as those of the former regimes in Iraq and Liberia. Furthermore, in accordance with identical measures taken by the European Union, Switzerland has frozen the financial assets and economic resources of certain persons related to the former regime in the Federal Republic of Yugoslavia, as well as those of certain persons with important government functions in Myanmar and Zimbabwe. In addition to the asset freeze, the Swiss regulations usually also include a prohibition to make available to the targeted persons or entities, directly or indirectly, financial assets or economic resources. These restrictions have been notified to the Fund.

VIII. **Article IV Consultations:**

Switzerland is on the standard 12-month Article IV consultation cycle.

IX. **Technical Assistance:** None

X. **Resident Representatives:** None

XI. **Other:** FSAP, October 2001.

Switzerland: Statistical Issues

Switzerland publishes timely economic statistics and posts most of the data and the underlying documentation on the internet. Switzerland is in full compliance with the Fund's Special Data Dissemination Standard (SDDS) and its metadata are currently posted on the Dissemination Standards Bulletin Board. However, a number of statistical gaps and deficiencies remain, mainly reflecting a lack of resources and the limited authority of the Federal Statistical Office (BfS) to request information:

- the SNB does not compile a monetary survey;
- wage statistics are available only on an annual basis;
- reliable general government finance statistics appear with considerable lags, mainly due to delays in compiling fiscal accounts at the level of cantons and communes;
- internationally comparable fiscal statistics on an accrual basis are not available;
- pension statistics are published with a long lag;
- GDP by industry appears with considerable lag;
- capital stock data and flow-of-funds statistics are not yet available.
- The data on deposit money banks submitted by the Swiss National Bank (SNB) to STA for publication in *International Financial Statistics (IFS)* lack adequate sectorization and instrument breakdown. Adoption by the authorities of the Standardized Report Forms by the authorities for reporting monetary data to STA will enhance the analytical usefulness of the data.

To address statistical deficiencies, the authorities have recently taken or intend to take the following steps:

The SNB launched in 2004 a monthly survey on the **cost of borrowing** and expected the pilot phase to be completed by mid-2005. In Q3 2005, the SNB will introduce revised and more comprehensive **statistics on mutual funds**. In October 2005 the SNB will publish, in collaboration with the Federal Statistical Office, **annual financial accounts** for 1999-2003 (stock data only). Data for 2004 and flows will be published in the spring 2006.

Annual national accounts were upgraded in 2003 to the *European System of Accounts 1995* (ESA95) and with the release of the Q4 2004 data, the Secretariat for Economics (SECO) revised accordingly its **quarterly national account estimates**. In this connection, has started also compiling a quarterly production account. The main innovations in the new national accounts were in investment (which now provides detail on ICT), private and public consumption (where hospitals were transferred to the private sector), and the use of chain price indices (but without adjustment for quality).

In 2004, a **statistical cooperation agreement** was concluded with the European Union as part of Bilateral II that will lead to the harmonization of several Swiss statistics with EU standards.

The Federal Finance Administration has started preparations for **revamping fiscal statistics** with the adoption of the *Government Finance Statistics Manual 2001* classification, the reform of the accounting standards for cantons and communes (*Weiterentwicklung der Rechnungslegung der Kantone und Gemeinden*) and the introduction of full accrual budgeting and accounting at the level of the federal government (*Neues Rechnungsmodell Bund*) along the lines of the International Public Sector Accounting Standards (IPSAS). Figures according to the new accounting standards are expected in 2008. In the interim, government finance statistics for publication in the *GFS Yearbook* will be reported on a cash basis but presented in the *GFSM 2001* framework.

Balance of payments and international investment position data are compiled by the SNB and meet international standards.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of May 4, 2005)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Apr 05	Apr 05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 05	Apr 05	each 10th day	M	each 10th day
Reserve/Base Money	Mar 05	Apr 05	M	M	M
Broad Money	Feb 05	Apr 05	M	M	M
Central Bank Balance Sheet	Apr 05	Apr 05	each 10th day	M	each 10th day
Consolidated Balance Sheet of the Banking System	Feb 05	Apr 05	M	M	M
Interest Rates[2]	Apr 05	Apr 05	D	M	D
Consumer Price Index	Mar 05	Apr 05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	Jan 05	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government[4]	2004	Jan 05	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2004	Jan 05	A	A	A
External Current Account Balance	Q4/04	Apr 05	Q	Q	Q
Exports and Imports of Goods and Services	Jan 05	Apr 05	M	M	M
GDP/GNP	Q4/04	Mar 05	Q	Q	Q
Gross External Debt	Q4/04	Apr 05	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

Statement by Fritz Zurbrügg, Executive Director for Switzerland
June 6, 2005

1. On behalf of my Swiss authorities, I would like to thank staff for the constructive policy discussions and the well written and comprehensive staff reports. They contain a very accurate description of the economic situation, particularly of the main policy challenges in the long run. My authorities largely agree with staff's appraisal and welcome the appropriate policy recommendations. They also welcome the shift of focus towards long-term issues and are looking forward to similar analyses for other "mature" economy countries – large and small.

2. After a GDP growth rate of 1.7 percent over the whole year of 2004, the recovery of the Swiss economy experienced a slight slowdown. Year-on-year growth in the fourth quarter of 2004 was 1.2 percent and slowed to 0.7 percent in the first quarter of 2005. However, compared to the last quarter, GDP growth recovered somewhat from a slightly negative number to zero. Consumer demand strengthened further by 0.2 percent, while investment was now able to hold its level. Exports decelerated by 1 percent (quarter-to-quarter) from a high level and imports came down slightly more (1.1 percent). In April 2005, the unemployment rate fell to 3.8 percent. The index of consumer sentiment remains unchanged since January 2005, suggesting a possible decrease in the GDP growth rate for 2005.

3. Downside risks mainly stem from Switzerland's trading partners' growth and from oil prices. Lower than expected growth in the EU combined with high oil prices could have unpleasant consequences for the Swiss economy.

Monetary policy

4. Staff's analysis of monetary conditions and monetary policy coincides with the view of the Swiss National Bank (SNB). Monetary policy is still supporting the recovery despite two rises in the short-term interest rate of 25 basis points. This was after the 3-months CHF Libor had been kept at a historically low level of 0.25 percent for more than a year. However, the fact that the current level of 0.75 percent remains negative in real terms indicates that the current situation is not a steady-state equilibrium and cannot be maintained indefinitely without threatening price stability in the medium-term, as shown by the SNB's inflation forecast.

5. My monetary authorities welcome the fact that staff judged the lifting of the policy rate through mid-2004 as appropriate. The SNB also agrees with staff's analysis that the main question will not be whether monetary policy should move to a more neutral rate, but rather about the timing of this move. However, even though markets expect little tightening in 2005, the SNB is more cautious than staff regarding the room for continued patience with a further adjustment of the policy rate. Waiting until recovery regains traction may be equivalent to waiting too long. It is true that the still negative output gap and well-anchored price expectations will ensure the absence of price pressures for the time being. Nonetheless,

considering the particularly long transmission lag of monetary policy impulses to the real economy and to prices in Switzerland, the room for continued patience concerning the timing of the interest rate move of up to a more neutral level – particularly in a context of a relatively strong rally of the dollar since the beginning of 2005 – might be somewhat smaller than suggested by staff.

6. The SNB welcomes staff's support for its monetary policy framework and communication strategy. Indeed, the communication strategy should contribute to avoid surprises on interest rate decisions. In this respect the newly introduced quarterly publication of three-year inflation forecasts, together with an assessment of monetary policy conditions, has worked well. However, this does not in any way mean that the SNB unduly follows market expectations. The SNB would not hesitate to take an interest rate decision called for by economic analysis and the inflation forecast, even if markets – despite the generally effective communication framework – would not expect it.

Fiscal Policy

7. Staff notes that the fiscal position is relatively sound and that the management of public finances has been reasonable. At the federal level, the fiscal balance has improved markedly due to large expenditure cuts and, to a lesser extent, due to higher revenues. After the consolidation program 2003, a second consolidation program 2004 is currently being discussed in parliament. This program intends to further improve the federal budget by CHF2.0 billion until the year 2008 mainly through lower spending. The 2005 federal budget is the third to comply with the debt-brake, which so far has proven to be effective.

8. In order to contain the subnational government deficits, many cantons have introduced instruments that are more or less similar to the debt brake. However, as staff rightly suggests, further efforts may be needed on the part of the cantons to offset the spillovers from the reduction of federal transfers. On the expenditure side, better inter-cantonal cooperation, which is also promoted by the New Financial Equalization scheme, will provide incentives for a better spending allocation. In a related vein, while staff emphasizes the need for improving the coordination of fiscal policies among the various levels of government, it should be noted that there are limits to this coordination in the context of the Swiss system of fiscal federalism. In this respect, my authorities think that it would be useful at the time of next year's discussion to look in greater detail at macroeconomic aspects of the interplay between the different levels of government.

9. As in most countries, significant longer-term challenges remain for fiscal policy. Staff rightly points out that the health system and the pay-as-you-go pillar of the social security system will be strained due to an aging population. The authorities are very aware of these challenges. As regards the pay-as-you-go pillar, the rejection by popular vote of the amendments proposed last year was a setback. The authorities have now proposed a more focused revision, which retains key parts of the former proposal, such as harmonizing the pension age at 65. However, it is important to note that Switzerland's three pillar system makes the social security system as a whole more resilient than in other countries, since the

funded mandatory second pillar plays a significant role. As regards the health system, important reforms, particularly aiming at improving cost control, were sent to parliament.

10. Staff argues that in order to ensure intertemporal consistency of fiscal policy, it may be useful to supplement the current budgetary framework with an instrument such as a long-term fiscal sustainability assessment to capture the effects of aging. The Ministry of Finance is considering the idea of a periodic long-run public finance sustainability report. In this respect, staff's analysis provides a useful guidance.

Financial Sector

11. Further improving the financial sector regulatory and supervisory framework in line with international standards and practices remains a priority for the Swiss authorities. The reform initiatives underway have made considerable progress, and some important reforms have been implemented during the last year, namely the revision of the Insurance Supervision Act and the adoption of measures to tackle the problem of underfunding of private pension funds. Other projects are at advanced stages of implementation. For example, this applies to the revised rules for granting administrative assistance relating to stock exchange dealings and the revised Act on Collective Investment Schemes. As for the draft legislation on an integrated financial market supervisory authority, fundamental decisions have been taken concerning the structure and organisation of the new authority. The parliamentary process on the draft law will start in 2006.

12. Switzerland is strongly committed to ensuring that its financial center is not abused for criminal purposes, in particular for money laundering or terrorist financing. We are currently drafting legislation in order to implement the revised recommendations of the Financial Action Task Force (FATF). At the same time, Switzerland's third mutual evaluation by FATF members is currently underway.

13. Efforts to improve the legal framework of the private pension system will further strengthen the stability of the second pillar, given the anticipated demographic shifts. Reform proposals, to be drafted by an expert commission, focus on strengthening supervision, the recapitalization of public pension funds and assessing the need for a new legal form tailored to pension funds.

Structural Issues

14. Raising the growth potential is the biggest policy challenge for Switzerland. Two major guidelines are at the center of the government's growth strategy: a more efficient domestic market and a more efficient public sector. In 2004, reforms have moved ahead at a good pace. There will be a referendum on a second package of bilateral agreements - including the extension of free movement of labor to the new EU members - in June and in September.

15. Staff mentions that agriculture protection remains very high. Here, it should be noted that the agricultural policy enacted in 2003 has introduced an almost complete switch from

price support to direct payments. This direct payment system assures full compatibility with strong ecological and animal welfare criteria. Moreover, total expenditures for agriculture are projected to decline in nominal terms until 2007 and further reductions of support are to be expected with the continuing reform of agricultural policies.

16. Despite strong budgetary pressures, official development assistance remains high on Switzerland's agenda. My authorities are particularly focusing on increasing the effectiveness of Swiss Official Development Assistance (ODA) and on harmonizing their activities in low-income countries with other donors. The fiscal consolidation programs have made a point to safeguard development outlays from spending cuts. After making the Swiss calculation methodology more akin to that of other OECD countries, Swiss ODA for 2004 is projected to be 0.41 percent of GNI. In terms of GNI, Switzerland's development expenditures ranked 8th out of 22 OECD countries in 2003.

17. With regard to the dismantling of trade protection as a contribution to helping poor countries, the objective of my authorities is to provide duty-free and quota-free access for all least developed country products. While most products of interest to least developed countries are already duty-free, tariff reductions for the remaining ones, namely agricultural products, amount from 55 to 75 percent. The work on the last phase of the preference scheme's extension to all least developed country products will start in early summer of 2005. Implementing the scheme will need parliamentary approval.

INTERNATIONAL MONETARY FUND
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June 10, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Switzerland

On June 6, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

The Swiss economy has returned to growth with supportive external demand and domestic policies. However, the recovery has been fragile and business indicators suggest that activity is currently experiencing a soft patch. Unemployment has crept up to 3.9 percent, which is low by international standards. Despite the increase in oil prices, inflation remains well under control and the current account is running a large surplus.

With inflation projected to remain inside the 0-2 percent range of price stability, and the recovery still fragile, the Swiss National Bank (SNB) has maintained an accommodative posture. Since raising the three-month policy rate to 0.75 percent in mid-2004, the SNB has put on hold the return of interest rates toward a neutral level. Indeed, the strengthening of the Swiss franc has already withdrawn some monetary stimulus. The general government deficit is estimated to have narrowed to 1 percent in 2004, and the federal government is taking further steps under the debt-brake rule to eliminate its structural deficit.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Growth is projected to continue, albeit at a lower pace. The staff projects growth of 1¼ percent in 2005, from1.7 percent in 2004, with some risks on the downside if demand from partner countries were to falter. Potential growth is estimated at 1½ percent and is projected to decline in the medium term to ¾ percent as a result of population aging.

Executive Board Assessment

Executive Directors commended Switzerland's sound macroeconomic management and flexible labor markets, which have secured low inflation and unemployment and a high standard of living. External demand conditions and accommodative domestic policies have led to a rebound of economic activity. Also, the country's external position remains strong, in part reflecting investment income from Switzerland's large net foreign assets. At the same time, Directors noted the existence of downside risks to the economic recovery, stemming from possible softening of demand in major trading partner countries, higher oil prices, and further appreciation of the franc.

Directors observed that raising the economic growth rate and tackling the fiscal pressures associated with population aging continue to be Switzerland's main challenges. They attributed the weak growth performance to the strong segmentation of internal product markets, substantial non-tariff import barriers, and lack of domestic competition. They stressed the importance of opening up sheltered sectors, intensifying competition in product markets, and eliminating non-tariff barriers, and welcomed the authorities' adoption last year of a growth package of reforms in these areas. Directors underscored that higher growth will make it easier to absorb the costs of population aging. They acknowledged the consensus-based nature of economic policy-making in Switzerland, and in this context stressed the need for a public education campaign to garner support for structural reforms.

Directors observed that the monetary policy framework has allowed the Swiss National Bank (SNB) to respond flexibly to economic developments and deliver low inflation. They considered that the current accommodative monetary stance remains appropriate. With inflation risks low, output below potential, and the economic recovery still fragile, the current low level of interest rates should be maintained for the time being. However, Directors noted that, with a narrowing output gap, some monetary tightening will be needed sooner or later. They welcomed the SNB's intention to remain vigilant for signs of price pressures, and to be prepared to return to more neutral interest rates as the recovery firms up, taking into account the lags in the effectiveness of monetary policy in Switzerland. Directors commended the SNB's effective communications strategy, and welcomed the steps taken to increase transparency through the quarterly publication of the three-year-ahead inflation forecast and the assessment of monetary policy conditions.

Directors welcomed the improvement in the public finances in 2004. They supported the authorities' plans to phase out the federal structural deficit while allowing the full play of automatic stabilizers around this path. They considered that the debt-brake rule provides a solid anchor for fiscal policy over the business cycle, and reduces the procyclicality of such policy. However, Directors stressed that the mounting pressure on the social security system and the possibility of loss of financial tax revenue due to competition from other financial centers require fiscal prudence and cooperation with cantonal governments. In this regard, they called for a comprehensive evaluation of public sector activities, with a view to focusing resources on priority activities and reducing expenditure, particularly expenditure on transfers and subsidies. Directors welcomed the agreement for a new structure of fiscal federalism, which should enhance coordination between the various levels of government, improve transparency, and reduce incentives for spending on non-priority projects. They supported the intention of the federal government to use the proceeds of gold sales exclusively for debt reduction, and strongly encouraged cantons to do likewise.

Directors underscored the importance of early and decisive action to address aging-related fiscal pressures and avoid an excessive burden on future generations. They encouraged the authorities to monitor regularly the underpinnings of first-pillar pension entitlements, and to recalibrate parameters such as the retirement age and the replacement rate.
They underscored the need to resolve the problem of underfunding of second-pillar pensions, and welcomed plans to harmonize supervisory standards across cantons. Directors also emphasized the need to check the rise of health care costs by exploiting economies of scale and encouraging competition among providers, and welcomed the reforms that were sent to Parliament.

Directors encouraged the authorities to develop a multi-year fiscal framework encompassing all levels of government and social security, and to determine a path for the public debt-to-GDP ratio consistent with long-term fiscal sustainability. They acknowledged that this is a challenging task given the high degree of autonomy of the cantons and the small size of the federal government relative to the general government. In this context, Directors considered that the publication of periodic fiscal sustainability reports could raise public awareness of the need for a comprehensive long-run fiscal strategy in the context of Switzerland's moderate long-term growth prospects.

Directors noted that the financial system appears to be healthy and dynamic.
They commended the efforts to strengthen further the supervisory framework, and stressed the importance of continued vigilance in monitoring financial sector risks. They welcomed steps to strengthen insurance supervision, including a switch to risk-based supervision. Directors also welcomed the significant progress that has been made in recent years to bring Switzerland's anti-money-laundering and anti-terrorism-financing regimes in line with the recommendations of the Financial Action Task Force, including the extension of the application of the Money Laundering Act to professions and activities outside the financial sector.

Directors welcomed the agreement with the European Union on a package of bilateral treaties, which could help advance the pace of reform and achieve greater integration with European economies, thereby increasing economic efficiency. They also welcomed the planned amendment of the internal market law and the liberalization of the electricity market to stimulate competition. They noted the high level of protection and subsidization of agriculture, and urged an accelerated pace of dismantling these distortions. Directors commended the authorities for the effectiveness of their official development assistance, and encouraged them to move closer to the United Nations target of 0.7 percent of gross national income. Directors noted that available economic statistics are generally adequate for surveillance purposes. However, they urged the authorities to correct the remaining data gaps, weaknesses, and delays so as to improve the quality of economic analysis and policy implementation.

Switzerland: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005 1/
Real economy						
Real GDP	3.6	1.0	0.3	-0.4	1.7	1.2
Real total domestic demand	2.2	2.3	-0.8	0.2	1.0	1.1
CPI (year average)	1.6	1.0	0.6	0.6	0.8	1.2
Unemployment rate (n percent of labor force)	1.8	1.7	2.5	3.7	3.9	4.2
Gross national saving (percent of GDP)	35.6	31.6	29.7	33.9	33.6	34.2
Gross national investment (percent of GDP)	23.2	23.7	21.3	20.8	21.6	23.1
Public finances (percent of GDP)						
Confederation budget balance 2/	0.9	-0.4	-1.0	-0.9	-0.6	-0.5
General government balance 2/ 3/	2.2	0.1	-1.2	-1.6	-1.0	-1.6
Gross public debt 4/	49.9	50.5	54.5	55.4	55.6	50.8
Balance of payments						
Trade balance (in percent of GDP)	-1.0	-1.1	1.2	1.0	0.9	-0.2
Current account (in percent of GDP)	12.4	8.0	8.4	13.2	12.0	11.1
Official reserves (end of year, US$ billion) 5/ 6/	32.3	32.0	40.2	47.7	55.5	55.0
Money and interest rates						
Domestic credit (end of year) 6/	1.7	1.5	-0.5	0.6	2.3	4.5
M3 (end of year) 7/	-1.8	3.1	3.8	8.3	3.0	2.0
Three-month Libor rate (in percent) 6/	3.1	2.9	1.2	0.4	0.5	0.8
Government bond yield (in percent) 6/	3.8	3.3	3.1	2.5	2.6	2.3
Exchange rate						
Exchange rate regime	Managed float					
Present rate (May 4, 2005)	SwF 1.19 per US$1					
Nominal effective exchange rate (1990=100) 6/	100.0	103.7	108.2	108.6	108.4	109.5
Real effective exchange rate (1990=100) 7/ 8/	99.8	102.8	106.6	106.2	105.2	105.0

Sources: IMF, International Financial Statistics; IMF, World Economic Outlook; and IMF staff projections.

1/ Staff estimates and projections
2/ Excluding privatization revenue and gold sale.
3/ Including confederation, cantons, communes, and social security.
4/ Assumes that gold sales are used to reduce the debt in 2005.
5/ Excluding gold.
6/ Figures for 2005 refer to March.
7/ Figures for 2005 refer to February.
8/ Based on consumer prices.