May 2001
IMF Country Report No. 01/74

Switzerland: 2001 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of 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 2001 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 29, 2001,** 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 April 16, 2001.** 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 staff statement of **May 9, 2001** updating information on recent economic developments.
- a Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its May 9, 2001, discussion** of the staff report that concluded the Article IV consultation.
- a statement by the authorities of Switzerland.

The document(s) listed below have been or will be separately released.

Mission Concluding Statement
Selected Issues paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with Switzerland

Approved by C. M. Watson and G. Russell Kincaid

April 16, 2001

The 2001 Article IV consultation discussions were held in Zürich and Bern during January 19-29, 2001. The mission comprised Messrs. Corker (Head), Danninger, Gagales, and Ms. Krajnyák (all EU1). Messrs. Cippà, Executive Director for Switzerland, and Zurbrügg, Advisor, attended the meetings. The mission met with Federal Councilor Villiger, Minister of Finance; President Roth, Chairman of the Governing Board of the Swiss National Bank (SNB); senior officials of the federal administration and the SNB; and various private sector representatives. The authorities released the mission's concluding statement and have agreed to the publication of the staff report.

Switzerland has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix II) and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Switzerland publishes and provides to the Fund timely and comprehensive economic data that are generally adequate for surveillance; and subscribes to the Fund's Special Data Dissemination Standard (SDDS). However, statistical deficiencies exist in some areas (Appendix III).

The last Article IV consultation was concluded on February 14, 2000 (SUR/00/15). At that time, Directors commended the authorities for sound macroeconomic policies, which had contributed to improved performance since 1997. While acknowledging that ongoing fiscal consolidation and some tightening of monetary policy had provided a degree of insurance against risks to price stability, Directors saw scope for a further firming of monetary conditions as remaining economic slack was absorbed. Directors welcomed the new monetary policy framework, which focuses on medium-term price stability, as well as plans to balance the federal budget over the business cycle. To enhance longer-term growth prospects, they urged the authorities to make further progress in reforming product markets.

At the last general elections in 1999, the four-party coalition that has held power for over 40 years remained in office, albeit with some change in the balance. The authorities have been taking steps toward greater participation in international affairs, including preparing the ground for UN membership. EU membership remains a long-term objective of the federal government, despite the rejection by a large margin in 2001 of a peoples' initiative to start immediately negotiations for EU accession. Seven bilateral agreements on closer cooperation with the EU are expected to be ratified by EU member-states by mid-2001. The autonomy of Switzerland's 26 cantons and the system of direct democracy, with referenda required for many decisions, limit the scope of federal action.

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Appendices

Main Websites for Swiss Data

Data in this Staff Report reflects information received by March 28, 2001. 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

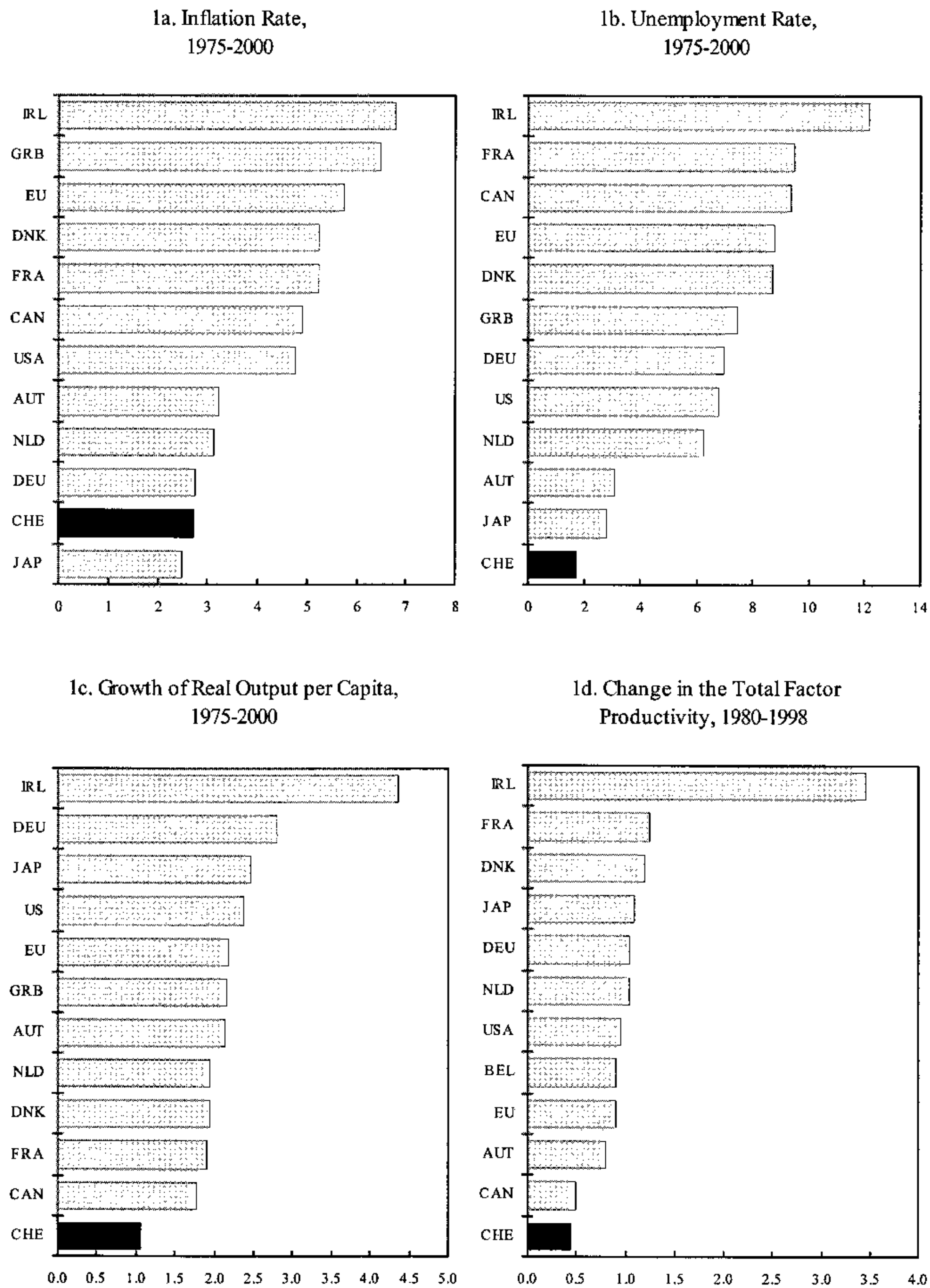
Federal Ministry of Finance....................http://www.efd.admin.ch

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://dsbb.imf.org/country.htm

Figure 1. Switzerland: Indicators of Long-Term Performance



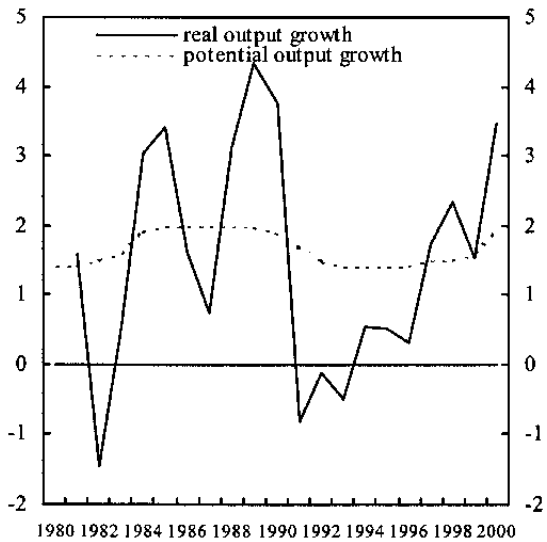
Sources: IMF, World Economic Outlook; and OECD.

I. Economic Background

➢ *Strong growth has brought output back to capacity, inflation and unemployment are low, and the current account surplus has risen to record heights*

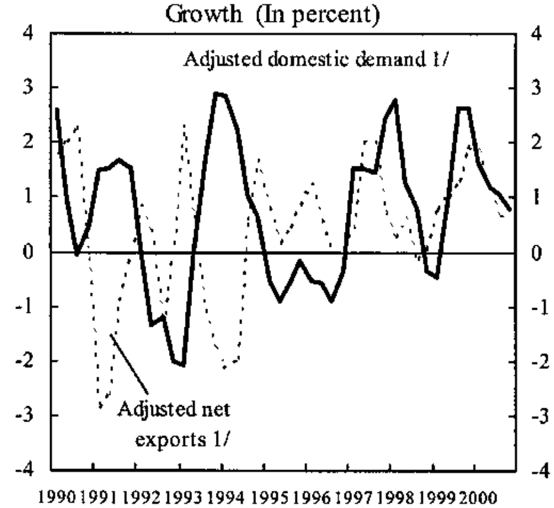
1. **Switzerland has had a mixed macroeconomic performance over the past quarter century.** On the one hand, Switzerland's open market economy has delivered a high standard of living; inflation performance has been outstanding thanks to an inflation-averse central bank and population (Figure 1a); and unemployment has been the lowest among industrial countries owing to a flexible labor market (Figure 1b). On the other hand, per capita GDP growth has been near the lowest for advanced economies, averaging about 1 percent a year, primarily because of poor total factor productivity (Figures 1c and 1d). Although measurement problems likely account for part of the poor productivity performance, the slow pace of regulatory reform, especially in sheltered sectors, also bears much responsibility. Productivity growth has picked up recently, but continues to be lower than in other industrial countries.

Figure 2. Switzerland: Real GDP Growth
(Percent change)



Sources: Swiss Institute of Business Cycle Research (KOF) database; and staff estimates

Figure 3. Switzerland: Contribution of Demand Components to Real GDP Growth (In percent)

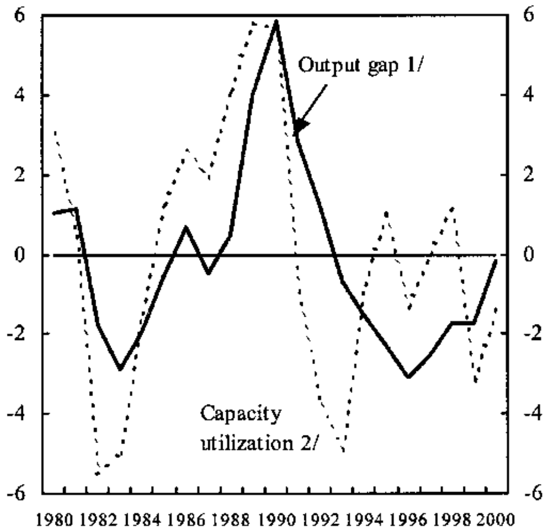


Sources: KOF database; and staff estimates.
1/ Because of their high import content, changes in inventories and investment in machinery and equipment are excluded from both domestic demand and imports.

2. **After stagnating in the 1990s, the Swiss economy has finally shown some spark** (Figure 2). Jolted by a surge in export demand, activity gathered momentum and real GDP growth became broadly based in the second half of 1999 (Figure 3). Growth accelerated to 4 percent in early 2000, bringing capacity utilization close to its historic average and largely eliminating the estimated output gap (Figure 4). However, growth slowed to a 2 percent

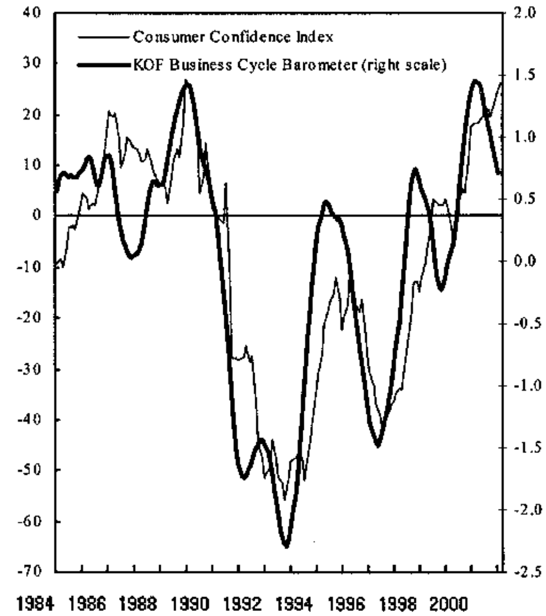
annualized rate in the second half of 2000 as private consumption eased. With consumer confidence at its highest level in 12 years, and export volume still growing at 7 percent, real GDP growth is likely to have been sustained in early 2001 despite some weakening of leading indicators (Figure 5).

Figure 4. Switzerland: Indicators of Economic Slack



Sources: KOF database; and IMF, World Economic Outlook.
1/ In percent of potential GDP.
2/ Percentage deviation of capacity utilization in industry from its average level in 1980-1999.

Figure 5. Switzerland: Leading Indicators



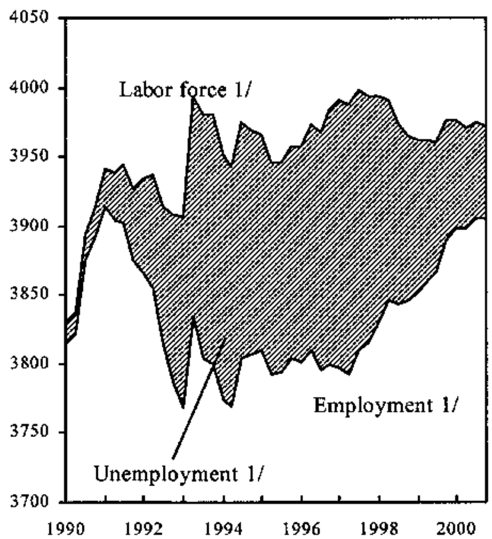
Sources: KOF database; and Bloomberg.

3. **Registered unemployment declined sharply during the upswing and was below 2 percent in early 2001 amidst reports of increasing shortages of skilled labor** (Figure 6).[1] Contrary to earlier years, unemployment has declined on the back of employment growth rather than increased participation in active labor market programs. Employment rose by 1.9 percent in the year to the fourth quarter of 2000, with employment of foreign workers

[1] Registered unemployment slightly overstates the tightness of the labor market as it excludes participants in training and employment programs and those who have no incentive to register after reaching the two-year benefit eligibility limit. The unemployment rate according to the quarterly labor market survey, which follows ILO guidelines but is available with a six-month lag, is typically about ½ percentage point higher.

(which is strongly pro-cyclical) rising by 3.8 percent.[2] Vacancies and indicators of labor shortages—especially in information technology related skills—have been on the rise. However, shortages do not seem to be generalized and remain significantly less acute than in the previous upswing in the late 1980s (Figure 7).

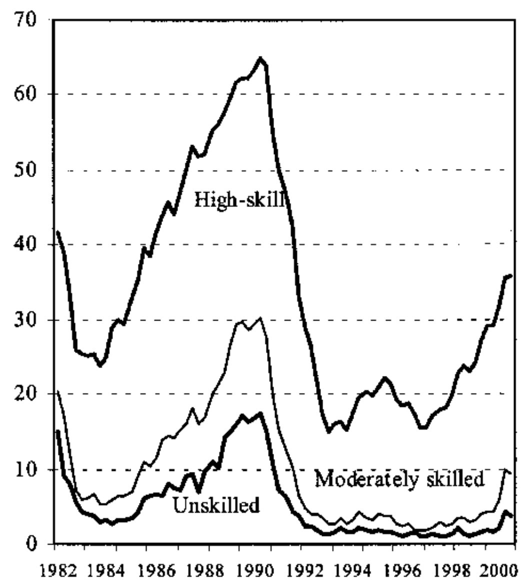
Figure 6. Switzerland: Employment and Unemployment (Seasonally adjusted)



Source: KOF database.

1/ In thousands; excludes the unregistered unemployed.

Figure 7. Switzerland: Indices of Labor Shortages



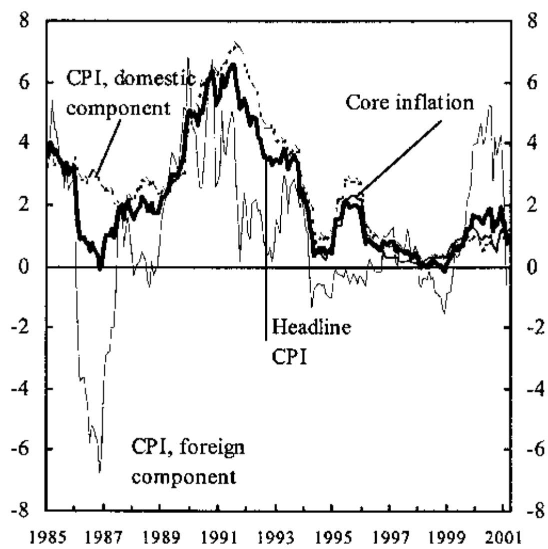
Source: KOF database.

4. **Inflation remains subdued** (Figure 8). The surge in oil prices pushed headline inflation slightly above 1½ percent in 2000, up from 0.8 percent in 1999. However, the effects of ongoing deregulation in telecommunications (telephone charges declined by 14 percent during 2000), increased competition in retail trade, and wage moderation, all helped to keep the lid on domestic inflation. Reflecting some reversal of oil price rises, headline inflation dipped back to 1 percent in early 2001. Core inflation (which excludes foodstuff, seasonal products, and energy) also continues to hover around 1 percent. Wage demands remain moderate despite tighter labor markets: nominal wages are estimated to have increased by

[2] Several cantons exhausted their quotas for annual work permits in 2000, but bottlenecks have been avoided by allocating additional permits to cantons that had not exceeded their limits in 1999 and reallocating unused quotas across cantons. Employment of cross-border workers is not subject to quotas. Foreign employment accounts for a quarter of total employment and the share of foreigners in the resident population edged up to 19.3 percent in 2000. A recent referendum on limiting the share of foreigners in the resident population to 18 percent was rejected.

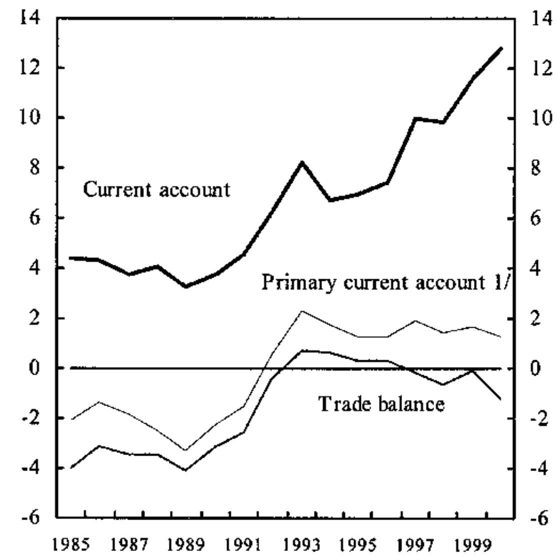
1½ percent in 2000 and recent wage agreements envisage rises of about 3 percent in 2001. Although the increase in earnings is likely to be higher due to the rising importance of bonuses and stock options, pay developments appear to be compatible with price stability given the pick-up of productivity growth.

Figure 8. Switzerland: Consumer Prices
(12-month percent change)



Source: KOF database.

Figure 9. Switzerland: External Balances
(In percent of GDP)



Source: IMF, World Economic Outlook.
1/ Current account minus net investment income.

5. **Switzerland's longstanding current account surplus reached almost 13 percent of GDP in 2000** (Figure 9). While the merchandise trade deficit widened by 1 percentage point of GDP owing to strong domestic demand and the deterioration in the terms of trade, net investment income surged to 11½ percent of GDP. The latter reflected the high (and rising) net foreign asset position (143 percent of GDP at end-1999), higher returns on foreign assets, and the weakening of the Swiss franc against the dollar.[3] On the capital account, the surplus was matched by large outflows of direct and portfolio investment reflecting increased activity in mergers and acquisitions, especially among insurance companies and banks.

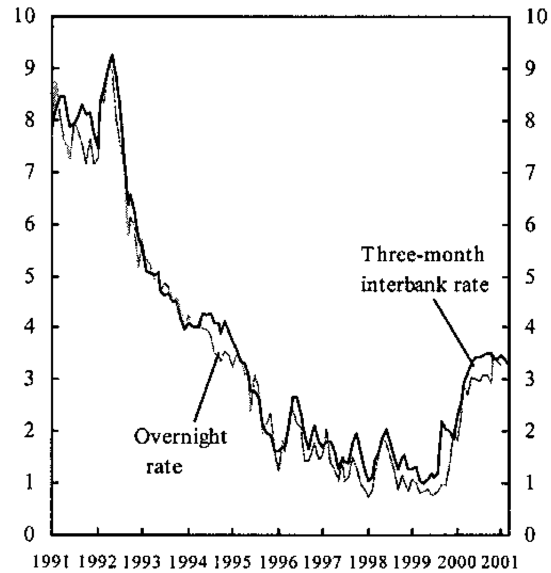
- *Monetary policy is broadly neutral while an unexpected fiscal surplus is budgeted to be partly run down in 2001*

6. **Monetary policy acted promptly to head off inflation pressures.** At the beginning of 2000, the SNB formally abandoned its monetary-targeting framework for one focused

[3] At end-1999, US dollar denominated instruments accounted for 34 percent of foreign assets and 24 percent of foreign liabilities.

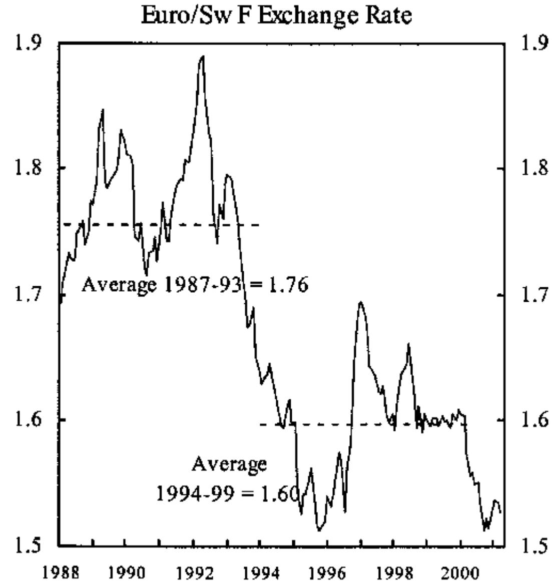
principally on medium-term price stability.[4] Prompted by a pessimistic assessment of inflation prospects, and surprisingly strong GDP growth, the SNB raised the mid-point of its key operational interest rate target (three-month LIBOR) from 1 percent in September 1999 to 3½ percent in June 2000 (Figure 10). With rate increases more aggressive than those of the ECB, the Swiss franc also began to appreciate against the euro after having been stable against it for more than a year (Figure 11). The SNB kept interest rates unchanged between June 2000 and March 2001, although some additional modest firming of the Swiss franc against the euro (the cumulative appreciation since March 2000 has been about 4 percent) implied a moderate further tightening of monetary conditions (Figure 12). In March 2001, amidst indications of a weakening external environment and benign inflation prospects, the SNB reduced the mid-point of its operational interest rate target by ¼ percentage point.

Figure 10. Switzerland: Short-term Interest Rates (In percent)



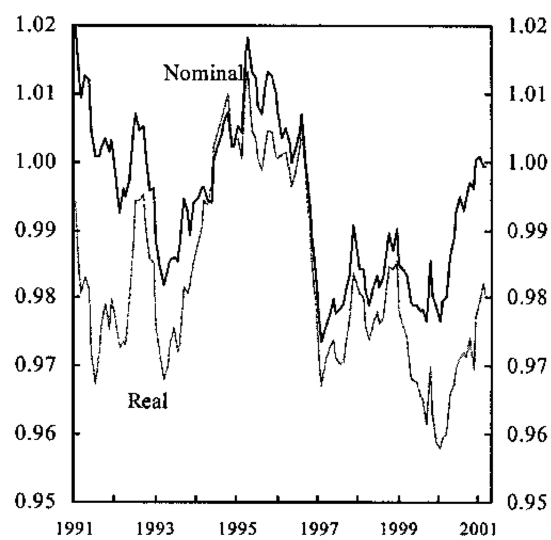
Source: IMF, International Financial Statistics database.

Figure 11. Switzerland: Nominal Euro/Sw F Exchange Rate



Source: IMF, International Financial Statistics database.

Figure 12. Switzerland: Monetary Conditions Index 1/ (1994 = 1)



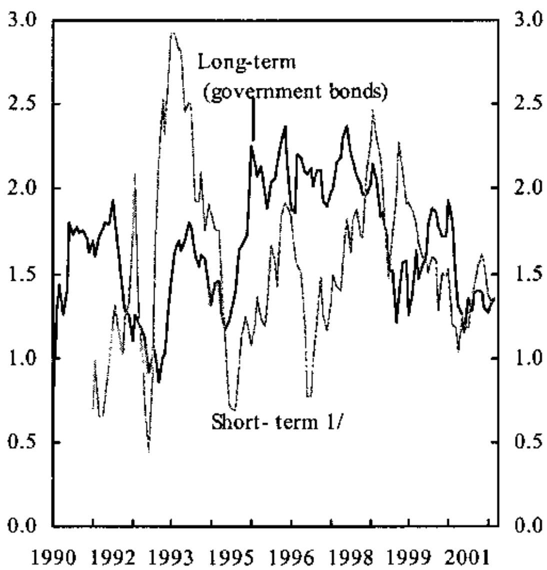
Source: Staff estimates.

1/ The weights of the interest rates and the exchange rates are proportional to 2.5 to 1, respectively.

[4] Inflation is to be kept below 2 percent over the medium term.

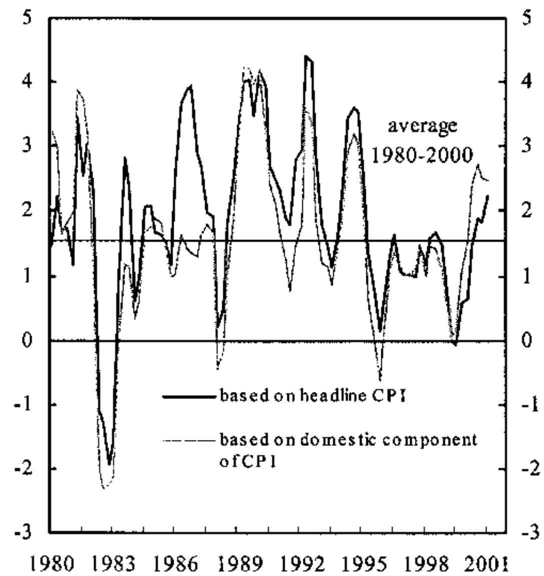
Figure 13. Switzerland: Interest Rates and Stock Prices

13a. Interest Rate Differentials
(Germany - Switzerland)



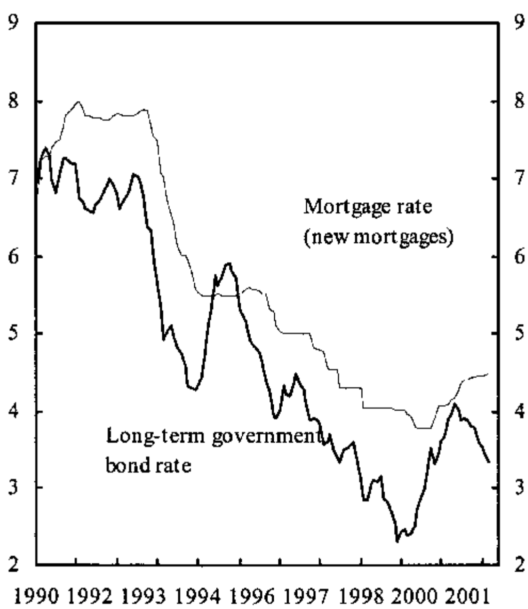
Source: IMF, International Financial Statistics database.

13b. Real 3-Month Interbank Rates,
1980-2000



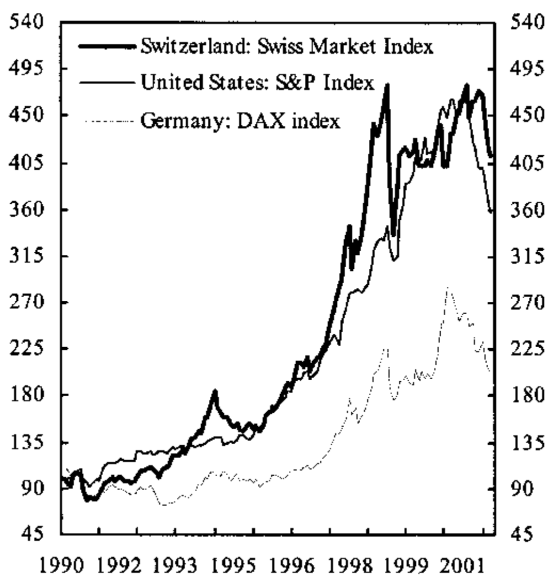
Sources: KOF database; and staff calculations.

13c. Long-term Interest Rates



Source: KOF database.

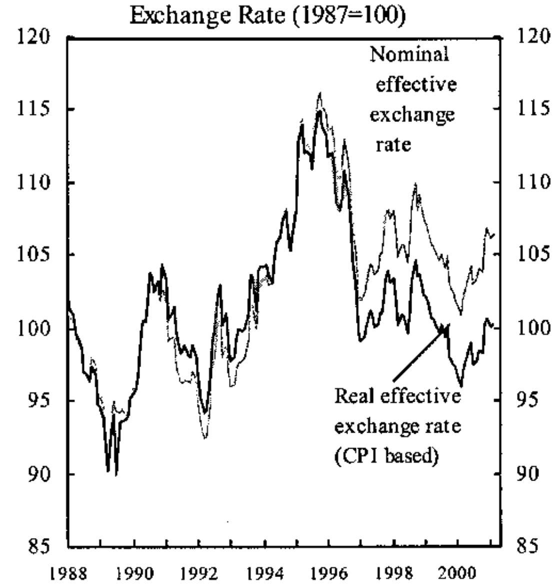
13d. Share price index (1990=100)



Sources: KOF database; and IMF, International Financial Statistics.

7. **Monetary conditions are broadly neutral.** Short-term interest rates are, as they have been for many years, below comparable euro area rates (Figure 13a), but in real terms they are just above their historical average of 1½ percent (Figure 13b). After briefly exceeding 4 percent, long-term government bond yields have receded to around 3½ percent (Figure 13c) and the yield curve has become fairly flat. Despite appreciating against the euro, the franc is still slightly weaker in nominal and real effective terms than it was prior to the advent of the euro—reflecting mainly the weakness of the euro against the dollar (Figure 14). Broad money has been declining as depositors shift to non-deposit instruments—it was instability in the monetary aggregates that prompted the abandonment of monetary targeting. The Swiss Market Index (SMI) recovered in 2000, helped by a shift of investor sentiment from "new economy" to large capitalization stocks and the robust performance of pharmaceuticals and insurance companies (Figure 13d). But the SMI lost 13 percent in the first quarter of 2001 when international financial markets plunged. The New Market Index, which has been following the fortunes of similar markets abroad, has dropped 60 percent since its peak in March 2000, with half the fall occurring in the first quarter of 2001.

Figure 14. Switzerland: Effective Exchange Rate (1987=100)



Source: IMF, International Financial Statistics database.

8. **Windfall revenue gains and the strong economy helped to generate a sizable fiscal surplus in 2000.** Following the deterioration of the public finances in 1991–1997 and the steep build-up of public debt, fiscal policy at the federal level has been guided by a 1998 constitutional requirement to balance the federal budget by 2001. The objective was overshot in 2000 with the *federal* budget ending in a surplus of 0.9 percent of GDP,[5] compared with a budgeted deficit of 0.9 percent of GDP and, in 1999, a deficit of 0.8 percent of GDP. While stronger-than-expected growth contributed to good revenue performance, a spike in stamp duty and withholding tax receipts, which reflected unusually high turnover and earnings on securities, was the main factor. Expenditures also undershot budget targets somewhat. The *cantons and communes,* which have also been trying to reduce debt levels, recorded a surplus of 0.4 percent of GDP, up from 0.2 percent of GDP in 1999. Accordingly, the *general government* balance swung from a deficit of 0.4 percent of GDP in 1999 to a surplus of 1.8 percent of GDP in 2000. However, about 1½ percentage points of GDP of this swing is estimated to reflect one-time revenues, which probably have little impact on domestic demand,

[5] Excludes proceeds from UMTS license auctions (0.1 percent of GDP).

Table 1. Switzerland: General Government Finances, 1997-2004

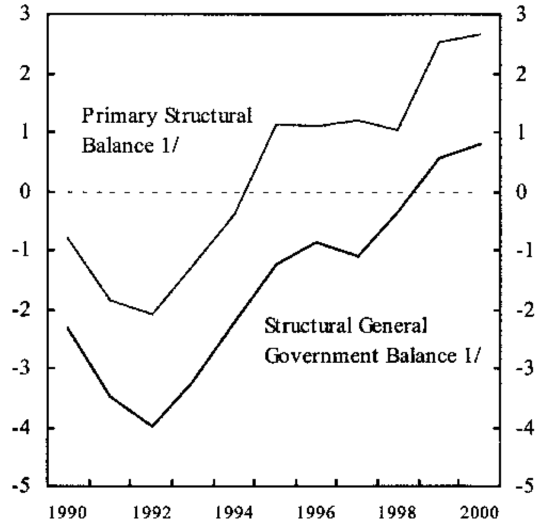
	1997	1998	1999	2000	Projections 2001	2002	2003	2004
	(In percent of GDP)							
General government budget balance 1/	-2.4	-0.4	-0.4	1.8	0.3	0.2	1.2	1.0
Confederation 2/	-1.5	0.0	-0.8	0.9	-0.2	-0.1	0.1	0.1
Cantons	-0.8	-0.3	0.2	0.2	0.2	0.2	0.1	0.0
Communes	-0.2	-0.1	0.0	0.2	0.2	0.1	0.1	0.1
Social security system	0.1	0.0	0.2	0.5	0.1	0.1	0.9	0.8
General government gross debt	51.5	54.4	51.3	48.6	46.8	45.1	43.4	41.9
Memorandum items:								
General government revenue	37.0	38.7	38.2	39.5	37.7	37.1	37.5	36.7
General government expenditure	39.4	39.1	38.6	37.7	37.4	36.9	36.3	35.8
General government balance, excluding exceptional items 3/	-2.1	-1.9	-0.1	0.6	0.3	0.2	1.2	1.0
Structural budget balance 4/	-0.8	-1.0	0.5	0.7	0.4	0.3	1.1	0.9
Primary structural balance 4/	1.2	1.0	2.5	2.6	2.5	2.3	3.1	2.9
Fiscal impulse (minus sign = withdrawal of stimulus) 5/	-0.1	0.2	-1.5	-0.1	0.1	0.2	-0.8	0.3
Output gap	-2.6	-1.7	-1.7	-0.2	-0.1	0.0	0.0	0.0
Real GDP growth	1.7	2.3	1.5	3.4	2.0	2.0	2.1	2.1

Sources: Data provided by the authorities; and staff estimates and projections. These include measures incorporated in the 2001 budget and the 2002-04 Finance Plan.

1/ Cash basis.
2/ Including spending on railway infrastructure financing fund equivalent to 1/4 percent of GDP per annum.
3/ Exceptional items comprise privatization proceeds and staff estimates of transitory components of the withholding tax and the stamp duty.
4/ Staff estimates based on general government data including social security but excluding exceptional items.
5/ Change in primary structural budget balance.

not least because a significant portion of the windfall taxes on securities transactions and investment earnings would likely have been paid by nonresidents. Adjusting for these revenues, as well as for the economic cycle, the *structural general government surplus* is estimated to have risen by only about ¼ percent of GDP to ¾ percent of GDP in 2000 (Table 1, Figure 15).[6] At end-2000, the debt/GDP ratio was, at about 49 percent, down sharply from its peak of 54½ percent in 1998, but still double its level in the early 1990s.

Figure 15. Switzerland: Fiscal Indicators
(In percent of GDP)



Source: Staff estimates.
1/ Excluding proceeds from the partial privatization

9. **The 2001 federal budget is projected to revert to a small deficit (0.2 percent of GDP) as the windfall revenue from the withholding tax and the stamp duty dissipates.**[7] The only significant measure in the budget was to introduce some exemptions from the stamp duty on security transactions (costing 0.1 percent of GDP). Cantonal and communal finances are projected to register small surpluses implying a general government surplus of 0.3 percent of GDP in 2001. The general government structural surplus is projected to decline slightly to just under ½ percent of GDP.

> *The economic outlook is favorable, but the global economic slowdown is a cloud on the horizon*

10. **The economy is projected to grow at a more sustainable pace in the near-term.** The authorities, private forecasters, and staff expect growth to slow from 3½ percent in 2000 to about 2 percent in 2001-02, in line with potential growth. A slowdown in trading partners' economies should dampen export growth, while the effects of earlier monetary tightening should continue to restrain domestic demand. Nonetheless, real GDP growth is expected to be underpinned by investment in machinery and equipment, reflecting high capacity utilization, while strong competitiveness and the results of restructuring during the protracted stagnation of the 1990s should limit the slowdown of export growth. Wealth effects from falling stock prices are likely to be weak given the limited reliance of enterprises on equity financing and

[6] The two-year system of income tax assessment has tended to make tax collections higher in odd years than in even ones, thus further complicating the interpretation of structural balances. By next year, most cantons will have moved to current year tax assessments.

[7] This is consistent with a balanced budget under the constitutional rule, which excludes certain capital expenditures.

the still small direct equity holdings of households. Barring an upset from the wage negotiations, staff expects **underlying inflation to remain below 1½ percent** in 2001 as deregulation continues to dampen increases in the prices of services and rents. Headline inflation could persist below 1½ percent if the reversal of oil price rises is sustained.

11. **The balance of risks to the growth forecast, however, are on the downside.** The global slowdown, and contagion effects on Europe, could be stronger and more prolonged than expected. A snap back of the Swiss franc (a safe haven should investor confidence in the U.S. deteriorate markedly) against the dollar could compound the adverse impact on the Swiss economy, as could a resurgence of oil prices—although, helped by conservation efforts, oil imports now only amount to 0.8 percent of GDP. For example, under a pessimistic scenario in which world growth weakened substantially and average annual EU growth in 2001-02 was 1 percentage point lower than assumed in the current World Economic Outlook exercise, growth in Switzerland could drop to 1 to 1½ percent in 2001-02, thereby reopening an output gap. Recent downward revisions to the Consensus Forecast for Switzerland underline the bias in the risks to the outlook.

II. Report on the Discussions

12. The discussions focused on the broad policy framework: the initial experience with the new monetary policy framework, the proposed revision to the medium-term fiscal rule, and the structural policy agenda.

A. The Short-Term Policy Stance

- *Are circumstances now tilting toward an easing of monetary policy? Is the run down in the fiscal surplus a concern from the perspective of demand management?*

13. **The staff and authorities broadly agreed on the immediate outlook for the economy and the policy implications.** The authorities had been pleasantly surprised by the strength of economic growth, the fastest for a decade. More importantly, and contrary to the previous episode of strong growth, the recent tightening of labor market conditions had not been accompanied by wage pressures. The authorities expressed guarded optimism that wage moderation reflected structural factors such as better labor market flexibility (closer alignment of wages to performance) and more intense competition (limiting the capacity of enterprises to pass on wage increases). But they also agreed that the economy was operating in a region where it was necessary to be vigilant for signs of emerging wage and price pressures. The number of foreign workers was starting to strain against quota levels implying that the usual safety valve for labor shortages was beginning to close, particularly for skilled workers.

14. **The stance of fiscal policy in 2001 is appropriate.** The authorities noted that, at the federal level, the 1 percentage point of GDP swing from surplus to a small deficit in 2001 mainly reflected the reversal of unexpected gains in taxes on securities transactions toward the end of last year. Because these gains were probably transitory, and had likely been collected in large part from non-residents, staff agreed that the impact of their reversal on domestic demand would be limited. Abstracting from these one-time gains, the stimulus was only about

¼ percent of GDP. Indeed, even if the demand stimulus were larger, it would not be worrisome in current circumstances—and could be beneficial if the downside risks to the growth forecast materialized. However, staff stressed that the authorities should strongly resist political pressures to use the temporary revenue gains from 2000 to finance tax cuts or new expenditures, which would likely prove enduring. Having acquired a reputation for overly conservative fiscal planning, the authorities explained that, in order to deflect such pressures, they had asked an independent research group to look more closely into the reasons for the overshooting of tax revenues.

15. **Against this background, staff and the SNB agreed that the bias of monetary policy had shifted toward loosening.** The common view at the time of the January mission was that monetary conditions had been tightened sufficiently to head off inflation concerns. Indeed, with real interest rates above their long-term average, with growth having already slowed from its earlier unsustainable pace, and with the risks to the outlook if anything biased downward, the most likely next move in interest rates would be a cut. The staff emphasized that the case for easing would become clearer were the Swiss franc to appreciate further, particularly against the euro, given the openness of the economy and the sensitivity of growth to exchange rate developments. Subsequent to the mission, headline inflation fell sharply and the SNB cut its reference interest rate by ¼ percentage point, citing the weakening of the external environment and the benign inflation outlook. Should evidence of a marked softening of global demand and domestic growth prospects persist, the staff would view further cuts in interest rates in the period ahead as being compatible with maintaining price stability.

B. The Monetary Policy Framework

- *How has the new monetary policy framework fared to date? What might be done to further enhance its effectiveness?*

16. **There was general agreement that the new monetary policy framework had worked well in its first year.** It had helped focus the policy debate on maintaining medium-term price stability rather than on the interpretation of an unstable intermediate target, ultimately making monetary policy more predictable.[8] The SNB had also dispelled market misconceptions that it had been targeting the franc/euro rate. Moreover, during 2000, the medium-term orientation of the framework had proved flexible for accommodating the first round effect of the oil price surge without noticeable impact on inflation expectations. At the operational level, the switch from internal targets on bank reserves to a publicly announced target band for the 3-month LIBOR rate had enhanced the transparency of the SNB's operational procedures. The SNB noted, however, that efforts to fine tune interest rates through announcing sub-targets within the band had not been clearly understood by market participants: the only unambiguous signal of policy intent was to shift the entire target range.

[8] The Selected Issues paper accompanying this report contains staff analysis of the new framework and the monetary transmission mechanism.

17. **The SNB nonetheless acknowledged that it had scope to enhance communication of its decision making process** (Box 1). The staff observed that the limited information provided by the SNB regarding the assumptions behind its inflation forecast and the rationale for monetary policy decisions had inhibited the market's understanding of the SNB's intentions. This diminished transparency because there was insufficient public information on which to evaluate policy actions in light of forecasts and outturns and to anticipate how monetary policy would react in situations with no precedent so far, making the framework less effective. The SNB explained that, in the future, it intended to provide more detailed information on the assumptions and analytical framework behind its inflation forecasts, including the role of the monetary aggregates, which SNB representatives believed contained valuable information about medium-term inflation. But they argued that there were limits to how far it could take transparency, not least because the SNB wanted to avoid giving the false impression that policy decisions were pre-programmed. They were also skeptical about the benefits of suggestions to provide more frequent full updates of the inflation forecast (the forecast is revised in June and December—although qualitative statements about the inflation outlook are provided in between) because this could deflect focus away from the medium-term objective of price stability. And SNB representatives did not believe that specific suggestions to enhance the accountability of decision takers, such as publishing minutes of policy meetings, would be helpful, arguing that inflation forecasts and monetary policy decisions were built up by institutional consensus.

C. The Fiscal Framework

- *How can competing fiscal objectives and strains be reconciled? What are the strengths and weaknesses of the proposed modifications to the balanced budget rule?*

18. **The authorities' fiscal strategy is to reduce the debt/GDP ratio through maintaining a balanced federal budget.** Within this framework, expenditure constraint would be necessary to make room for some reduction in taxes in the next few years and, over the longer term, to accommodate the effects of an aging population. The authorities plan to increase the scope for the automatic stabilizers to operate by amending the balanced budget rule to allow the actual balance to fluctuate about zero depending on the state of the economy (Box 2).[9] The definition of budget balance would also be refined to include spending on all capital projects and exclude net lending to the unemployment insurance fund. The authorities' financial plan for 2001-04 envisages expenditure restraint on the order of ½ percent of GDP to accommodate the new budget balance definition and the modest cost of tax reforms aimed, among other things, at reducing the income tax marriage penalty.

[9] The Council of States approved the authorities' proposals in March 2001, although approval by the National Council and a referendum are required before the proposals can be implemented. Assuming it passed, the new budget rule would not be in place before 2003.

Box 1. The Monetary Policy Framework

The SNB's new monetary policy framework, in place since January 2000, borrows some features from inflation targeting countries and adds a few of its own (Box 1 Table).

Key features of the framework include:

- **Main objective: price stability**. In practice, this translates into keeping headline inflation at less than 2 percent, but positive, over the medium-term. However, the SNB is not a fully-fledged inflation targeter as its mandate also includes responsibility for fostering growth.
- **Inflation target: "soft-edged" target range for medium-term headline CPI inflation.** The choice of the inflation target (headline CPI) facilitates communication of monetary policy objectives to the general public. As this target is subject to transitory shocks unrelated to monetary policy, the target band is "soft-edged" (inflation may be outside the target range in the short run).
- **Inflation forecast: consensus-based forecast published at year-end and updated every six months**. After agreeing on the assumptions, the SNB staff produces a three-year inflation forecast based on model results (from structural as well as VAR-type indicator models) and an analysis of the economic situation and the monetary aggregates. The report is then discussed and approved by the Governing Board, which takes a formal decision to publish the three-year official consensus forecast of the SNB.
- **Operating target: 100 basis point range for 3-month Swiss franc LIBOR**. Having a range target rather than a point target for a policy interest rate allows more flexibility (e.g., liquidity or exchange rate shocks can be accommodated without signaling a change in the monetary policy stance), but it poses questions regarding controllability (given that open market operations are conducted at shorter maturities) as well as its signaling value. So far, the Swiss experience has been positive on both accounts: the SNB has been able to steer the 3-month LIBOR and shifts in the target range have provided a clear signal of monetary policy changes.

Staff analysis in the accompanying Selected Issues Paper shows that the relatively long and variable lags in the transmission of monetary policy shocks to output and inflation are consistent with the SNB's choice of a three-year horizon for monetary policy decisions and inflation forecasts. It also provides some empirical evidence that SNB inflation targets were in the past successful in focusing inflationary expectations. The new monetary policy framework should make influencing inflationary expectations easier, as it enhances the transparency of the conduct of monetary policy: the policy objective is more easily communicated to the public, and channels are in place to explain monetary policy decisions. However, stepped-up use of some of these channels (more detailed explanation of the inflation forecast, including assumptions, risks and uncertainties; ex ante explanation and ex post evaluation of monetary policy actions) could enhance the clarity and efficiency of communications, and help build a track record for the SNB's policy actions under the new framework.

Box 1 Table. Monetary Policy Framework in Selected Countries

	Switzerland	Canada	ECB	New Zealand	Sweden	United Kingdom
Inflation targeter	no	yes	no	yes	yes	yes
Objective	price stability	price stability	price stability	price stability	price stability	price stability
Institutional commitment	no	yes	"first pillar"	yes	yes	yes
Inflation rate	headline CPI	core inflation	headline HICP	CPIX	headline CPI	RPIX
Inflation level	<2%, but positive	2% with tolerance of ± 1%	<2%, but positive	0-3%	2% with tolerance of ± 1%	2.5%
Horizon	medium term	2 years	medium term	1½ to 2 years	2 years	2 years
Inflation report						
Frequency	4x per year	2x per year	2x per year staff forecast	4x per year	3x per year	4x per year
Detail	little	detailed	little	detailed	detailed	detailed
Operating target	3-mo SwF LIBOR; 100 bp. range	overnight rate; level	3-mo repo rate; level	official cash rate; level	1-week repo rate; level	2-week repo rate; level
Operating procedures	repo	repo	repo	repo	repo	repo
Decision maker	Gov. Board	Gov. Board	Executive Board	Governor	Gov. Board	MPC
Accountability	Central bank accountable to Federal Government	Accountable to Federal Government	Accountable to European Parl., Council of Min, Commission	Governor personally accountable	Central bank accountable to Parliament; "Open letter"	"Open letter"

Box 2. The Revised Balanced Budget Rule

The revised fiscal framework would be permanent in nature and strongly rule driven. Among countries with expenditure rules, only the Netherlands and Sweden have similarly detailed sets of regulations. However, the Swiss rule relies on a one-year planning horizon, in contrast to multi-year forecasts in other countries, constitutionally fixes the deficit and debt goal, and tightly defines escape clauses from the rule (Box 2 Table).

The main goal of the new rule is to balance the budget on a permanent basis and thereby prevent further federal debt accumulation—hence its name *Schuldenbremse,* or debt-brake. The rule specifies a one-year ahead ceiling on all central government spending, including infrastructure investment, equal to forecast revenue adjusted by a factor reflecting the cyclical position of the economy. The ceiling for the next year's budget is given by:

$$G^c_{t+1} = E_t(R_{t+1}) * E_t(C_{t+1})$$

where G^c_{t+1} is the spending ceiling for period $t+1$. $E_t(R_{t+1})$ and $E_t(C_{t+1})$ denote expectations at time t of, respectively, revenue and the ratio of trend-to-real GDP at time $t+1$. Thus the rule allows for a deficit in a recession and a surplus in a boom, while achieving balance over the whole cycle. It is proposed that trend GDP be calculated by applying the HP-filter to time series data, while revenue and GDP forecasts are based on government projections. A record of spending differences between ex ante targets and ex post outcomes is kept in a fictitious account. Negative balance from unanticipated overspending must be eliminated over time. The expenditure ceiling is binding at both the budgetary planning and execution stage—i.e., it also extends to budget amendments during the fiscal year. It can only be breached under exceptional circumstances supported by a qualified majority of both chambers of parliament.

The new rule allows the automatic stabilizers to work but the degree of cyclical flexibility is limited. At the extreme of the cycle when the output gap was, say, 5 percent, federal expenditures could only deviate from revenues by 5 percent—and by less if taxes are not very responsive to unexpected cyclical developments. With federal revenues about 10 percent of GDP, this translates into a cyclical deficit of only 0.5 percent of GDP. During protracted, recessions, and when unintended overspending has to be eliminated due to the built-in correction mechanism, this could lead to procyclical fiscal restraint. On the other hand, during upswings, unexpected surpluses do not need to be used for debt reduction—rather they could be used to lift government spending. These problems are underscored by the unpredictable nature of tax revenues and large forecasts errors in the past.

The irregularity of Swiss business cycles poses a further potential challenge to effective implementation of the rule. Swiss cycles have been characterized by abrupt changes in growth and varying lengths of up- and downswings. HP-filter based estimates of the business cycle could aggravate measurement problems as they are afflicted by end-point biases and are sensitive to changes in the length of the business cycle. These problems might be lessened by a production function or structural model approach to estimating potential output.

Box 2 Table. Comparison of Fiscal Policy Frameworks in Selected Countries

	Objective	Planning horizon	Operating variables
Switzerland	Debt control through permanently balanced budget	Permanent rule applied each year	Expenditure ceiling while allowing cyclical budget variation
European Union Growth and Stability Pact	Sound budgetary positions close to balance or in surplus	Permanent rule, exceptions possible	Countries have to provide multiyear stability programs
Austria	Balanced budget	Four year stability program	Revenue and expenditure side measures
Australia	Sound fiscal policy through public scrutiny: budget balance over the cycle	Three year fiscal strategy statements; also sustainability assessment for next 40 years	Annually specified in budget strategy program which includes short term fiscal measures.
Belgium	Deficit and debt targets of Maastricht	Four year stability program	Target ceilings for social expenditure growth
Canada	Balanced budget with supplementary growth enhancing measures	Two year budget plan under prudent planning	Restraints in program spending
Denmark	Budget surplus and debt reduction	Four year stability program	Tax reform and expenditure restraints
Finland	Deficit reduction and in future tax cuts	Four years on an annually rolling basis	Expenditure ceilings
France	Balanced budget	Three year stability program	Tax reduction and expenditure growth target
Germany	Deficit and debt targets of Maastricht	Five year target plan for budget	Expenditure restraint and tax reform
Ireland	Budget surplus to curb inflation	Two year stability program	Tax reform and expenditure control
Italy	Balanced Budget	Three year stability program	Tax and primary expenditure cuts
Netherlands	Deficit reduction and tax cuts	Four years set at beginning of coalition period	Expenditure ceilings for government and social security
New Zealand	Operational surplus; decline of debt-to-GDP ratio; improved credibility	Long-run goals set forth in budget policy statement; no specific time horizon	Expenditure restraints, and revenue measures
Portugal	Eliminating deficit by 2002	Five year medium-term outlook	Expenditure control
Spain	Deficit targets for each level of government	Four year stability program	Expenditure control
Sweden	Debt reduction through budget surplus of 2 percent	Three years based on macro forecasts	Expenditure ceiling on categories
U.K.	Balanced budget over cycle holding debt to GDP ratio at prudent level (40 percent)	Three years on a two year rolling basis	Expenditure restraint while allowing cyclical budget variation
United States	Balanced budget as defined in Budget Enforcement Act 1997	Four year reform program ends in 2002	Expenditure ceiling for each fiscal year, expenditure changes tied to revenue measures

19. **The staff supported the authorities' objectives but noted that, with the federal government only representing about one third of the public sector, the plan to balance the federal budget over the cycle would not by itself eliminate procyclical tendencies in fiscal policy or necessarily provide an overall "debt brake".** Staff observed that while fiscal policy might be expected to play a limited demand management role in a small open economy like Switzerland's, its procyclicality in the 1980s and 1990s had almost certainly made business cycle swings more pronounced. That said, the staff calculated that the amended fiscal rule would only permit the federal budget balance to vary in a fairly narrow range (±½ percent of GDP).[10] Given the past tendency of the cantons and communes to behave procyclically, it would be important to ensure that the unemployment insurance system (which is outside the federal government) supported the automatic stabilizers. Consequently, the staff supported the exclusion of net lending to the unemployment insurance fund from the definition of budget balance. But the staff expressed concern that, in an upswing, there would be insufficient safeguards to ensure that unexpected surpluses were saved and, in a prolonged downswing, to prevent automatic feedback rules from prematurely eliminating the budget deficit. The latter problem could be exacerbated by the mechanical method envisaged for estimating the cyclical position of the economy.[11]

20. **The authorities noted that they had built safeguards into the new fiscal rule and intended to improve the working of the unemployment insurance fund.** In particular, they planned to build up the reserves of the unemployment insurance fund to reduce the need for procyclical adjustments of contribution rates. In any case, parliament could, with a qualified majority, allow a temporary derogation from the federal expenditure ceiling in exceptional circumstances. The authorities agreed that the benefits of the fiscal rule would be enhanced by strengthening the automatic stabilizers and noted that the reduction in income tax collection lags by cantons would help in this regard. They would also consider in future using alternative (e.g., production function based) methods to measure output gaps and hence better calibrate expenditure ceilings. On risks that the rule might not provide an effective debt brake, the authorities conceded that it was hard to design any rule to prevent politicians spending surpluses—although the problem was perhaps worse without formal constraints. The authorities expected the lower levels of government to contribute to the overall debt brake because many cantons and communes tended to budget conservatively and were uncomfortable with high debt levels, which had been built up during the low growth years of the 1990s.

21. **The authorities agreed that threats to the tax base added emphasis to the need for expenditure control in coming years.** The required fiscal consolidation of about ½ percent of GDP could rise if the federal budget were denied its share of proceeds from planned increases

[10] By contrast, the present rule allows a deficit of up to 0.2 percent of GDP.

[11] The Selected Issues paper accompanying this report provides more extensive analysis of the fiscal rule. See also Box 2.

in VAT, which are mainly to finance the public pension scheme. The tax base could also come under threat from dwindling stamp duty receipts, to the extent that financial services were driven offshore, and the authorities agreed that further reductions in stamp duty over and above those in the 2001 budget might be inevitable. Likewise, the staff noted that a proposed EU-wide withholding tax could have a negative effect on Swiss withholding tax revenues if Switzerland agreed to introduce measures to prevent tax evasion by EU residents. While the Swiss authorities were opposed to a softening of bank secrecy, they were studying the feasibility of alternative options to work with the EU on this matter.

22. **Over the longer term, the main challenge is to accommodate pressures on the social security system from the rapidly aging population.** Even though Switzerland is better placed than many countries to address population aging issues—it has a well-developed fully-funded pillar of the pension system—staff projections indicate that the financing gap of the PAYG state pension scheme (AHV) and healthcare would rise to 1½ percent of GDP by 2010 and 3 percent of GDP by 2025. The authorities agreed that current proposals for earmarked increases in VAT and cost savings measures did not safeguard the financial position of AHV after 2010, recognized the benefits of early action, and noted that an expert group had been set up to consider changes in benefits, retirement age, and financing options. On the basis of its proposals (expected in 2003) a revision of AHV was planned by 2005. In order to prevent pressures on labor costs, the authorities favored covering the financing needs of AHV more with increases in VAT (the standard rate is, at 7½ percent, low by European standards) rather than increases in contributions. However, they recognized that a review of benefits, and increases in the retirement ages, might also be needed. Regarding healthcare, the authorities explained that cost cutting measures took effect in 2001 and the finances of hospitals were under review.

23. **The fragmented nature of the federal system in Switzerland leads to some inefficiencies in expenditure and complexity in the tax system.** The authorities were optimistic that a new horizontal and vertical revenue sharing agreement (*Finanzausgleich*) among the various levels of government would lead to a better allocation of expenditure responsibilities and the elimination of some duplicated services. They expected that the much-delayed agreement could be put to parliament by the end of 2001. The staff acknowledged that tax competition between cantons had helped to keep tax rates low, but pointed out that wide variations in tax rates and exemptions between cantons distorted economic decisions. The authorities agreed that more could be done to harmonize tax systems—although harmonizing rates was not on the agenda—and explained that the recent culmination of a ten-year project to harmonize tax base definitions across cantons represented significant progress in this regard.

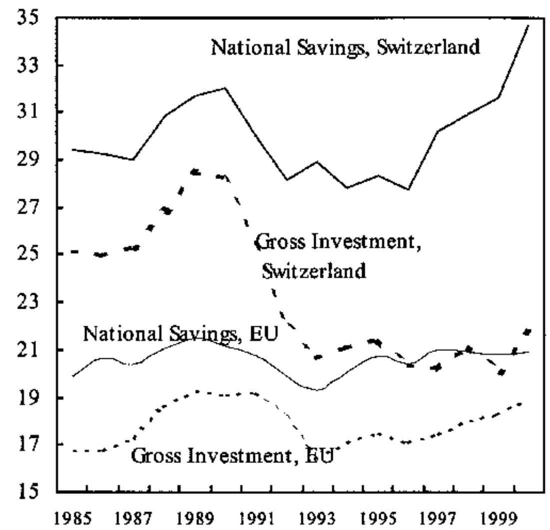
D. The External Current Account Surplus and the Exchange Rate

- *What are the implications of the large current account surplus?*

24. **The authorities shared the view that the current account surplus would remain high but did not consider this to be a manifestation of major distortions.** From a saving-investment perspective, the current account surplus reflects high national savings, which in

recent years have exceeded 30 percent of GDP, and a drop in the investment ratio from 27 percent to 20 percent of GDP since the early 1990s. The business sector accounts for almost 80 percent of national savings, a reflection of favorable corporate income tax rates in Switzerland—among EU countries, only Ireland features lower rates—and the sizable presence of multinationals. Given the complexity of multinationals' business transactions, it is possible that corporate savings are overstated, however the authorities did not believe that any biases were significant. At around 10 percent, the household savings rate, is not exceptionally high by international standards in light of the ageing of the population and the emphasis on private pensions. Most of the fall in the investment ratio in the 1990s reflected the unwinding of the previous decade's construction boom. Despite its fall, the investment ratio remains above the EU average and the efficiency of overall investment, albeit much improved, appears to remain low by international standards (Figure 16). Given flexible labor markets, a well-educated labor force, and relatively low taxes, the authorities and private sector representatives did not appear overly concerned about Switzerland's attractiveness as a business location.

Figure 16. Switzerland: National Saving and Investment
(In percent of Nominal GDP)



Source: IMF, World Economic Outlook.

25. **The SNB saw scope for the gradual real appreciation of the franc in past decades (on average about 2/3 percent a year) to continue without jeopardizing competitiveness.** This is broadly consistent with the staff's assessment that, with an unchanged real effective exchange rate, the current account surplus would remain in the medium term well above the level given by fundamentals. A portfolio allocation approach indicates Switzerland might be expected to run a surplus of 6 percent of GDP over the medium term (see SM/00/15). Most of the implied misalignment of the Swiss franc would be against an over-valued dollar.

E. Financial Sector Issues

- *What are the current challenges for financial sector supervisors? Are efforts to counteract money laundering effective?*

26. **Although there is little prima facie reason to be concerned about the health of the financial system, globalization, recent strains in financial markets, and changing savings behavior will keep the supervisory authorities on their toes.** Both the two large banks and the domestic banking sector appear to be comfortably capitalized (the latter after having successfully restructured in the 1990s) and fundamentally sound (Table 2). In the authorities' assessment, the banking sector was not particularly exposed to potential shocks, such as a

Table 2. Switzerland: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000 1/
External Indicators					
Exports (annual percentage change, in U.S. dollars)	-2.1	-4.8	3.7	2.0	-0.6
Imports (annual percentage change, in U.S. dollars)	-2.2	-3.3	5.3	0.4	2.4
Terms of trade (annual percentage change)	0.6	-0.8	3.2	3.1	-3.3
Net factor income	4.3	6.3	6.7	8.2	9.8
Current account balance	7.4	10.0	9.8	11.6	12.8
Foreign direct investment (net)	-4.4	-4.3	-3.6	-9.5	-12.5
Portfolio investment (net)	-3.3	-4.2	-1.8	-15.8	-3.2
Official Reserves (in billions of U.S. dollars, end-of-period)	38.4	39.0	41.2	36.3	32.3
Official reserves in months of imports	5.0	5.2	4.9	4.6	3.9
Broad money to reserves ratio	8.9	8.4	8.4	8.3	8.7
Central bank foreign liabilities (in billions of U.S. dollars)	0.0	0.0	0.1	0.1	0.1
Foreign assets of the financial sector (in billions of U.S. dollars)	234.7	280.1	336.7	339.8	...
Foreign liabilities of the financial sector (in billions of U.S. dollars)	220.2	260.8	293.3	346.4	...
Total external claims 2/	288.1	330.8	365.8	427.8	
Total external debt 2/	190.8	245.6	270.9	326.1	...
Of which: General government debt	0.2	0.2	0.2	0.2	...
External debt to GNFS exports ratio	5.2	6.0	6.6	7.6	...
External interest payments to exports (in percent)	12.5	12.8	20.8	20.2	28.8
Exchange rate against U.S. dollar (period average)	1.24	1.45	1.45	1.50	1.69
Nominal effective exchange rate	111.1	104.3	107.0	105.1	103.1
Real effective exchange rate (CPI based, 1990=100)	109.1	100.9	102.2	100.2	97.8
Financial Markets Indicators					
3-month interest rate	2.0	1.6	1.6	1.4	3.1
3-month interest rate (real)	1.2	1.1	1.6	0.6	1.5
Spread of 3-month interest rate vs. Euro Area	-1.3	-1.2	-1.2	-1.2	-1.1
Share prices of financial institutions (percent change, end of period)	7.4	74.2	4.6	20.3	16.4
New Market Index, SNMI (percent change, end of period)	...	...	...	...	28.3
Overall stock market index, SMI (percent change, end of period)	19.5	58.9	14.3	5.7	7.5
Market capitalization	148.0	226.0	249.0	279.0	217.0
Financial Sector Risk Indicators					
Total loans to assets	42.0	36.1	31.8	30.8	30.0
Total loans to deposits	87.4	80.3	72.9	70.3	73.2
Foreign exchange loans (in billions of U.S. dollars)	98.9	117.3	147.0	132.2	182.6
Net foreign exchange loans (in billions of U.S. dollars)	-43.9	-48.3	-42.4	-80.1	-88.0
Share of foreign exchange loans in total lending (percent)	21.1	23.6	27.4	23.8	31.6
Deposits in foreign exchange (in billions of U.S. dollars)	174.0	196.5	261.2	238.0	233.9
Share of foreign deposits in total deposits	32.7	35.8	40.3	38.6	40.7
Share of foreign denominated liabilities in total liabilities (percent)	58.2	50.8	44.7	41.8	39.5
Share of foreign denominated assets in total assets (percent)	56.9	49.7	43.7	41.8	40.4
Share of mortgage credits to total loans (in percent)	69.3	69.4	70.5	67.0	65.2
Share of non-performing loans in total loans (percent)	6.2	6.2	5.2	4.7	4.1
Share of non-performing loans in total assets	3.1	2.8	2.3	1.9	1.7
Capital adequacy ratio	10.3	10.7	11.3	11.3	11.2
Profitability ratio	0.3	5.0	12.2	18.5	14.8

Sources: Swiss National Bank; Swiss Federal Banking Commission; IMF, International Financial Statistics; IMF, World Economic Outlook.
1/ Preliminary estimates.
2/ Excluding foreign direct investment.

sharp downturn in the U.S. economy or large exchange rate movements, or to real estate market risk. Moreover, smaller banks had reduced their trading portfolios following the introduction of new own-funds regulations in 1999 and larger banks had put in place risk management systems. However, over the longer run, the banks' strategy of entering more volatile markets in response to changes in household and enterprise savings behavior, as reflected in a declining deposit base, and threats to the international reputation of the Swiss financial sector could give rise to vulnerability. In the insurance sector, the life insurance segment was performing satisfactorily but other segments were in a weak financial situation. Some consolidation in the insurance sector was underway, including examples of mutual involvement of banks and insurance companies.

27. **The authorities acknowledged that changes in the structure of financial markets posed challenges for the supervisors.** Two expert groups had recently been set up to review the structure of financial sector supervision and the legal framework for bank restructuring and deposit insurance. Recommendations from one of these groups included merging banking and insurance supervision. The staff noted that the upcoming FSAP would provide a timely opportunity to review the plans to reform supervision and to assess more fully risks and vulnerabilities for the Swiss financial markets.

28. **The authorities recognized that preserving reputation was essential to Switzerland's standing as an international financial center.** The authorities argued that efforts to combat money laundering—in particular, the 1998 Money Laundering Act, as well as the recent reorganization of the Money Laundering Commission (MLC) that monitors compliance—were helping to improve the image of the Swiss financial sector. However, the MLC lacked adequate enforcement powers, its resources for effectively monitoring the financial sector (including non-banks) were limited, and international cooperation remained weak. The authorities strongly disagreed with the Financial Stability Forum's decision to classify Switzerland as an offshore center. They did not consider bank secrecy an impediment to fighting tax evasion, and were prepared to grant administrative assistance in cases of tax fraud in tax treaties with OECD countries. Switzerland is a member of the Financial Action Task Force (FATF) on money laundering and is subject to mutual evaluation.

F. Structural Policies and the Longer-Term Economic Outlook

- *Has trend growth increased? What are the priorities for structural policies?*

29. **Despite the strong showing of the economy, the authorities were cautious about declaring an end to the period of low trend growth.** The consensus (including some private sector estimates) was that potential growth has probably picked up to about 2 percent a year on the back of somewhat faster total factor productivity growth following business restructuring in the 1990s. Recently signed bilateral agreements with the EU would also contribute to growth through trade enhancing opportunities and more labor mobility.[12] But the authorities

[12] For more details, see the Staff Report for the 1999 Article IV Consultation, Box 4, page 22.

acknowledged that there was a dearth of hard evidence on an underlying productivity pick up as the recent improvement could turn out to be cyclical in nature. Nor did they put much store in "new economy" effects, not least because Switzerland is not a major producer of IT goods. That said, the authorities (and private sector representatives) could point to no obvious barriers to the adoption of new technology nor, other than a degree of cultural conservatism, to the availability of venture capital. And surveys generally showed that internet penetration was high and corporations were quick to adopt new technology.

30. **The authorities agreed that the puzzle of Switzerland's low trend growth in the 1990s reflected two main elements: mis-measurement and slow progress in opening up sheltered domestic sectors.** The statistical problems relate in particular to the measurement of output in the services sector, which is likely significantly understated.[13] Available capital stock estimates are also derived from investment data and probably fail to account for the structural changes that have taken place in the past 30 years as well as changes in the quality of capital. However, to the extent that statistical measurement problems are common to many countries, they cannot explain Switzerland's relatively low growth by international standards.

31. **As to opening up the sheltered sectors, the authorities pointed to recent progress but acknowledged the sizable unfinished agenda.** In telecommunications, where the pace of liberalization has been fastest, price declines have been large—30-50 percent in the case of fixed-line telephony in 2000—and services have expanded. Nonetheless, legal hurdles have been delaying the opening up of "last-mile" access to Swisscom's fixed-line network.[14] In electricity—where charges for industrial users are the highest in Europe—parliament has approved a deregulation plan that stipules third-party access to the national grid and the phased opening of the market over a six-year period. Consultations have also started for the liberalization of the gas and postal markets. Competition and the cost of doing business in

[13] Available statistics tend to underestimate the level and growth of Swiss GDP. For example, business expenditure on software, which has been rising rapidly, is treated as intermediate production rather than investment; financial intermediation services are only partially accounted for in GDP; and revenues from patents (amounting to about 1 percent of GDP) are excluded. Although these deficiencies will be addressed with the introduction of ESA95, a potentially larger bias relates to the design of deflators which, unlike in the U.S. and some European countries, do not account for quality changes. This leads to an overestimation of inflation and, correspondingly, an underestimation of growth. Particularly affected by this problem are the financial sector (where productivity is notoriously hard to measure) and branches of industry that rely on continuous incremental innovation. More generally, a shift in the structure of production toward the services sector, which is characterized by low *measured* productivity growth, further biases estimated overall productivity growth downward.

[14] Since the opening of the telecommunications market in 1998, the market share of Swisscom has dropped to 68 percent for domestic and 49 percent for international calls but remains at 95 percent for local calls. Swisscom's share of mobile telephony is 66 percent.

Switzerland have been benefiting from the increasingly active role of the Competition Commission in dismantling cartel arrangements and ensuring non-discriminatory access to network infrastructure (notably in electricity and telecommunications). Price differentials relative to the EU, although perhaps still as high as 30 percent, have declined. The staff noted that the effectiveness of the Competition Commission was diminished by a lack of resources and powers to impose penalties and prosecute cases. The work of the Commission could also be complemented by more effective internal market legislation. Staff urged the early opening up last-mile access in telecommunications, an important factor for the development of the internet economy, and noted that catching up with the ongoing liberalization in the EU (e.g., in the electricity sector) would improve competitiveness. The authorities acknowledged that the reform process had been slow but noted the difficulty of forcing the pace of change in Switzerland's system of direct democracy.

G. Other Issues

32. **Trade policy is marred by the high protection of agriculture.** Agricultural subsidies amount to three quarters of valued added (double the OECD average), the average tariff on farm products is 34 percent (nearly four times the Swiss average), and agricultural export subsidies are high.[15] Ongoing reforms aim to increase reliance on market mechanisms and replace price subsidies with direct income payments. The implementation of the bilateral agreements with the EU, expected to come into force in 2001, would accelerate liberalization. However, staff noted that the goals appeared unambitious as it would be several years before protection of agriculture would drop to even the relatively high levels in the EU. The authorities emphasized the importance of agriculture for Swiss society and noted that preparations were underway to formulate the reform agenda beyond 2002, when the current program expires. The authorities confirmed their support for the launching of a new round of WTO negotiations that would, among other things, emphasize agricultural liberalization. They also supported the further opening up of Swiss markets to imports from poor countries but did not have specific plans, such as providing them with duty free access, at this stage.

33. **The authorities intend to raise official development assistance (ODA) from 0.3 to 0.4 percent of GDP within the next decade.** They also noted that Switzerland provided sizeable international assistance in forms not classified as ODA, such as humanitarian assistance in the Balkans. Swiss ODA policy has been favorably reviewed by the DAC for its effectiveness and its focus on poor countries.

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[15] Switzerland's trade regime is characterized by a system of specific tariffs which generates a highly dispersed tariff structure. Overall tariff protection, measured by ad valorem equivalents, averages around 9 percent (unweighted) but ranges from 2.3 percent for non-agricultural products to 34 percent for agricultural products. The maximum rate of 678 percent applies to out-of-quota imports of meat.

III. Staff Appraisal

34. **Recent Swiss economic performance has been impressive.** The strongest growth in a decade has pushed unemployment down to a very low level without reawakening inflation. The challenge is to lock in the gains and to continue to address structural obstacles to better long-term economic growth.

35. **With inflation subdued, growth slowing, and the balance of risks to the outlook on the down side, the scales are tipped toward monetary easing.** While labor markets are on the tight side, the prompt tightening of monetary policy during the first half of 2000 has headed off risks to medium-term price stability stemming from an earlier unsustainable pace of economic growth. Thus, with real interest rates above their long-term average and growth already having slowed from its earlier unsustainable pace, the March 2001 interest rate cut was justified. Indeed, the SNB has scope to ease interest rates further in the period ahead should evidence of a marked slowing of global demand and domestic growth persist. The case for easing would be even stronger if the Swiss franc were to appreciate further, particularly against the euro.

36. **The task of monetary policy has been made easier by the strong efforts—at both the federal and cantonal levels—to place the fiscal accounts on a solid basis.** Eliminating the federal deficit ahead of schedule has added to the credibility of the fiscal authorities and the unwinding of last year's surplus would not seem to be problematic from a cyclical point of view—especially given the likely one-time nature of revenue gains. Nonetheless, it is worth stressing, given ever-present political pressures, that windfall revenues should not be used to justify new expenditures or tax cuts.

37. **Refinements to the monetary and fiscal policy frameworks should enhance the implementation of macroeconomic policies.** First **monetary policy**. The transition to the new framework, with its explicit emphasis on a target for medium-term inflation, has been smooth. Within the framework, the SNB was able to accommodate the first round effects of oil price rises without a noticeable effect on inflation expectations. The SNB's performance is not surprising given the considerable credibility it has accumulated over the years. But even so, and as the SNB itself recognizes, the communication of monetary policy decisions could be improved by enhancing transparency, in particular by more fully articulating the assumptions underlying the inflation forecast and the reasons for policy decisions.

38. **The proposal to balance the federal budget *over the cycle* is also a welcome innovation that should help arrest public debt growth and reduce procyclical tendencies in fiscal policy.** While the amount of additional cyclical flexibility would be modest, the authorities have thought carefully about necessary safeguards—in particular the escape clause—should the economy enter a prolonged downturn. However, it will be important to follow up on proposals to shore up the unemployment insurance fund to avoid procyclical changes in contribution rates. And it will be important to ensure that under the rule unanticipated surpluses are put toward debt reduction.

39. **Within the fiscal framework, expenditure restraint will continue to play an important role**. Restraint is needed in the medium term to complete consolidation to the more comprehensive definition of federal budget balance and to accommodate family tax cuts. The rising strains on pension and health benefits over the next 10 years can probably be met by VAT increases. But a review of pension and health benefits is also warranted if longer-term pressures arising from population ageing are to be adequately addressed, and in a timely framework given the slow process of Swiss direct democracy.

40. **The optimistic view that Switzerland has put its period of low trend growth behind it would be strengthened if reforms to sheltered sectors were accelerated.** Steep price declines from the liberalization of the telecom sector provide visible evidence of the benefits of structural reform. Completing liberalization of the telecom sector, speeding up liberalization of the electricity sector, giving anti-cartel legislation more teeth, and strengthening the Competition Commission would all help to bolster economic growth.

41. **While liberalization of domestic sectors might conceivably reduce the high current account surplus, the surplus does not appear to be primarily a reflection of economic distortions.** Nor does the surplus reflect an inappropriate policy mix or a low investment ratio. Nonetheless, the surplus is higher than analysis would suggest is normal. This gives more weight to the view that the Swiss franc should continue to appreciate as it has in past decades.

42. **The outward signs suggest that the financial sector remains in good health, although supervisors will need to remain vigilant, particularly as globalization and new technology provide new opportunities and risks.** This is all the more so in light of turbulence in stock markets and uncertainties about the strength of the global economy. In view of the importance of reputation, the staff encourages the authorities' efforts to ensure that adequate resources are provided to combat money laundering. The upcoming FSAP should provide a timely opportunity to review vulnerability and supervision issues more thoroughly.

43. **A more ambitious timetable for dismantling the very high level of agricultural protection would remove the main blemish on trade policy.** To the extent that lower protection benefited agricultural exporters in poor countries, Switzerland's commendable plan to raise ODA to 0.4 percent of GDP would be complemented. Switzerland might also consider providing duty free access to products from poor countries.

44. **Further efforts are needed to improve the quality and comprehensiveness of economic statistics**. Weaknesses in the national accounts, government finance, and balance of payments statistics impede the conduct of effective economic management and analysis. The compilation of timely, high frequency wage statistics and reliable productivity statistics are particularly needed to strengthen the implementation of the SNB's new monetary policy framework. Additional resources for economic statistics would be desirable.

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

Switzerland: Basic Data

Area and population	
Total area	41,293 square kilometers
Total population (end-2000)	7.2 million
GDP per capita (2000)	$ 33,626
GNP per capita (2000)	$ 36,933

	1997	1998	1999	2000 1/	2001 1/	2002 1/	2003 1/	2004 1/	2005 1/
	(Percentage changes at 1990 prices)								
Demand and supply									
Private consumption	1.4	2.2	2.2	2.0	1.4	1.6	1.6	1.6	1.6
Public consumption	0.0	0.7	-0.4	0.1	0.2	0.2	0.2	0.2	0.2
Gross fixed investment	1.5	4.5	1.8	6.5	5.7	5.3	5.0	4.9	4.9
Construction	-1.5	0.4	-5.3	2.1	1.3	1.6	1.5	1.5	1.5
Machinery and equipment	4.9	8.9	8.8	10.3	9.2	8.0	7.5	7.2	7.0
Final domestic demand	1.2	2.6	1.7	2.9	2.4	2.4	2.4	2.4	2.4
Inventory accumulation 2/	0.1	1.7	-0.2	0.1	-0.3	-0.5	-0.3	-0.3	-0.2
Total domestic demand	1.3	4.3	1.4	2.9	2.0	1.9	2.0	2.1	2.2
Exports of goods and nonfactor services	8.6	5.0	5.9	9.5	4.5	4.1	4.5	4.4	4.2
Imports of goods and nonfactor services	7.6	9.6	5.5	8.3	4.5	4.0	4.3	4.3	4.3
GDP	1.7	2.3	1.5	3.4	2.0	2.0	2.1	2.1	2.1
GNP	3.7	2.5	2.3	4.9	0.5	1.7	2.1	2.1	2.1
	(In billions of Sw F, at current prices)								
GDP	371.4	380.9	389.0	408.8	422.6	436.6	451.1	465.6	480.6
	(In millions, unless otherwise indicated)								
Employment and unemployment									
Employment	3,806	3,848	3,873	3,916	3,941	3,964	3,987	4,007	4,026
(Percent change)	-0.3	1.1	0.6	1.1	0.6	0.6	0.6	0.5	0.5
Unemployed (registered)	0.19	0.14	0.10	0.07	0.07	0.07	0.07	0.07	0.07
Unemployment rate (in percent)	5.2	3.9	2.7	1.9	1.9	1.8	1.8	1.8	1.8
	(Percentage changes, unless otherwise indicated)								
Prices and incomes									
GDP deflator	-0.2	0.2	0.6	1.6	1.4	1.3	1.2	1.1	1.1
Consumer price index	0.5	0.0	0.8	1.6	1.4	1.5	1.4	1.3	1.3
Nominal wage growth 3/	0.5	0.7	0.3	1.4	2.5	1.8	1.6	1.5	1.4
Unit labor costs (total economy)	0.5	-0.4	-0.6	-0.9	1.2	0.4	0.1	-0.1	-0.2
Real disposable income	3.0	0.9	2.1	3.9	0.8	1.6	1.9	1.9	1.9
Personal savings ratio (in percent)	10.1	8.9	8.8	10.5	10.0	10.0	10.2	10.5	10.8
	(In percent of GDP)								
Public finances									
Central government financial balance 4/	-1.5	0.0	-0.8	0.9	-0.2	-0.1	0.1	0.1	0.1
Gross debt	25.1	27.6	25.3	23.8	23.2	22.6	21.8	21.0	20.3
General government									
Financial balance 4/	-2.4	-0.4	-0.4	1.8	0.3	0.2	1.2	1.0	0.9
Structural balance	-0.8	-1.0	0.5	0.7	0.4	0.3	1.1	0.9	0.9
Gross debt	51.5	54.4	51.3	48.6	46.8	45.1	43.4	41.9	40.5
Expenditure	39.4	39.1	38.6	37.7	37.4	36.9	36.3	35.8	35.3

1/ Staff estimates and projections unless otherwise noted.
2/ Change as percent of previous year's GDP.
3/ Nominal wage growth per employee.
4/ Including railway loans as expenditure.

Switzerland: Basic Data (concluded)

	1997	1998	1999	2000 1/	2001 1/	2002 1/	2003 1/	2004 1/	2005 1/
	(In billions of Sw F, unless otherwise indicated)								
Balance of payments									
Trade balance	-0.5	-2.3	-0.4	-4.8	-5.2	-5.5	-5.5	-5.6	-6.2
Service balance	18.9	19.6	19.8	22.6	24.6	25.9	27.1	28.3	29.4
Balance on goods and non-factor services	18.5	17.2	19.4	17.8	19.4	20.4	21.6	22.7	23.2
Factor income balance	23.4	25.5	31.9	40.2	35.0	34.8	35.7	37.0	38.3
Net private transfers	-3.0	-3.0	-3.9	-3.6	-3.7	-3.8	-3.9	-4.0	-4.2
Net official transfers	-1.9	-2.3	-2.3	-2.0	-2.1	-2.1	-2.2	-2.3	-2.4
Current account	37.0	37.5	45.0	52.4	48.7	49.3	51.3	53.3	55.0
(In percent of GDP)	10.0	9.8	11.6	12.8	11.5	11.3	11.4	11.4	11.4
Foreign direct investment	-16.1	-13.7	-36.9	-51.1	-15.0	-15.0	-15.0	-15.0	-15.0
Outward	-25.7	-24.1	-54.0	-66.9	-30.0	-30.0	-30.0	-30.0	-30.0
Inward	9.6	10.4	17.1	15.8	15.0	15.0	15.0	15.0	15.0
Portfolio investment	-15.5	-6.7	-61.5	-12.9	-28.5	-29.1	-31.1	-33.1	-34.8
Outward	-28.6	-21.6	-70.4	-37.7	-35.0	-35.0	-35.0	-35.0	-35.0
Inward	13.1	14.9	8.9	24.8	6.5	5.9	3.9	1.9	0.2
Banking sector, net	-1.2	-16.7	27.2	11.0	-10.0	-10.0	-10.0	-10.0	-10.0
Memorandum items:									
Net investment income	30.0	32.0	38.4	47.2	41.5	41.3	42.2	43.5	44.8
(In percent of GDP)	8.1	8.4	9.9	11.5	9.8	9.5	9.4	9.3	9.3
Net external assets	449.1	493.7	555.8	605.8	654.3	703.4	754.5	807.6	862.4
(In percent of GDP)	120.9	129.6	142.9	148.2	154.8	161.1	167.3	173.4	179.4
Official reserves (billions of US$, end period) 2	39.0	41.2	36.3	32.3	31.2	...	...	...	...
Reserve cover (months of imports of GNFS) 2/	5.2	4.9	4.6	3.9	2.5	...	...	...	...
	(Percentage changes in annual averages)								
Monetary and credit data									
Monetary base	4.8	3.0	2.4	1.1	...	...	...	...	...
Money (M1)	10.1	8.0	8.6	-1.9	...	...	...	...	...
Broad money (M3)	5.1	1.2	1.0	-1.6	...	...	...	...	...
Domestic credit	1.7	0.8	2.3	3.8	...	...	...	...	...
	(Period averages in percent)								
Interest rates 3/									
Three-month rate	1.5	1.6	1.4	3.5	3.4	...	...	...	...
Yield on government bonds	3.5	2.9	2.9	3.9	3.4	...	...	...	...
	(Levels)								
Exchange rates									
Sw F per US$ (end of period) 3/	1.46	1.38	1.60	1.63	1.73	...	...	...	...
Sw F per US$ (annual average) 3/	1.45	1.45	1.50	1.69	1.67	...	...	...	...
Sw F per euro (annual average) 3/	1.64	1.61	1.60	1.56	1.54	...	...	...	...
Nominal effective rate (1990=100) 3/	104.3	107.0	105.1	103.1	106.2	...	...	...	...
Real effective rate (1990=100) 3/ 4/	100.9	102.2	100.2	97.8	99.5	...	...	...	...

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

1/ Staff estimates and projections unless otherwise noted.

2/ Data for 2001 refer to February.

3/ Data for 2001 refer to March.

4/ Based on consumer prices.

Switzerland: Fund Relations
(As of February 28, 2001)

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	100.0
	Fund holdings of currency	2,479.42	71.7
	Reserve position in Fund	979.12	28.3
	Operational budget transfers (net)	127.00	
III.	**SDR Department:**	SDR Million	% Allocation
	Holdings	116.59	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, Switzerland continues to apply exchange restrictions vis-à-vis Iraq (since August 1990).

VIII. **Article IV Consultations:**

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

IX. **Technical Assistance:** None

X. **Resident Representatives:** None

Switzerland: Statistical Appendix

Switzerland publishes timely economic statistics and posts most of the data and the underlying documentation on the internet. Switzerland was also among the initial subscribers to 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 to be addressed: wage statistics are based on a narrow coverage and monthly data are not available; employment statistics are derived from disparate sources and are of variable quality; reliable general government statistics appear with considerable lags, mainly due to delays in compiling fiscal accounts at the level of cantons and communes; the compilation of quarterly national accounts is not integrated with that of annual national accounts; moreover, there are no flow-of-funds data.

Recent improvements in economic statistics include:

- The compilation of quarterly capital and financial account statistics.
- The publication of monthly data on the composition of its foreign exchange reserves in line with recommendations by the Committee on the Global Financial System.
- The release of monthly data on federal government expenditure and revenue (both on a cash basis) and quarterly data on general government debt.
- The compilation of quarterly indices of real estate prices, extending back to 1970.
- The revision of the CPI.
- The publication of GDP by industry.

The Statistical Program for 1999-2003 of the Federal Statistical Office (FSO) includes:

- The adoption by 2001 of the 1995 *European System of Integrated Economic Accounts (ESA)*. The 1979 ESA was adopted in mid-1997.
- Improved wage statistics by 2001 (current wage statistics are based on accident insurance information for blue collar workers).
- The harmonization of employment statistics by 2002.
- The completion of the methodology for the compilation of financial accounts (a joint project involving the FSO and the SNB) by 2001.
- A Maastricht-compatible accounting framework for the public finances by 2001.

The Swiss National Bank is likely to participate in the 2001 Coordinated Portfolio Investment Survey

Switzerland: Core Statistical Indicators as of March 29, 2001

	Exchange Rates	Foreign Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	GDP/ GNP	External Debt
Date of Latest Observation	3/01	2/01	3/01	2/01	1/01	3/01	2/01	2/01	Q3/00	2000	Q4/00	1999
Date Received	3/01	3/01	3/01	3/01	3/01	3/01	3/01	3/01	12/00	3/01	3/01	12/00
Frequency of Data	Daily	Each 10th day	Each 10th day	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Annual
Source of Update	TRE	SNB	SNB	SNB	SNB	TRE/RES	BFS	SNB KOF tape	SNB KOF tape	MoF	BFK BFS	SNB
Mode of Reporting	Electronic	Mail	Website	KOF tape Website	KOF tape Website	Electronic Website	KOF tape Website	KOF tape Website	KOF tape Website	Mail	Website	Mail
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Each 10th day	Each 10th day	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Monthly

BFS = Federal Statistical Office
SNB = Swiss National Bank
KOF = Swiss Institute for Business Cycle Research
MoF = Federal Ministry of Finance
BFK = Federal Office for Economic Policy

Statement by the IMF Staff Representative
May 9, 2001

This statement provides information on macroeconomic and fiscal developments that has become available since the issuance of the staff report (SM/01/110, 4/17/01). This information does not alter the thrust of the staff appraisal.

Recent indicators continue to point to a slowdown in growth: the composite leading economic indicator declined for the twelfth consecutive month in March 2001 and the Purchasing Managers Index fell below 50 percent in April. Against this background, the Swiss National Bank trimmed its growth forecast for 2001 from 2.2 percent to 2.0 percent, the same as the staff's projection. Inflation remains subdued with core inflation stable at 1.2 percent. After temporarily dropping to 1 percent in the first quarter, headline inflation inched up to 1.2 percent in April due to higher oil prices. Unemployment in April was at a 10-year low of 1.7 percent.

A supplementary budget spending request, submitted to parliament in April, would raise the federal deficit by 0.2 percent of GDP. The main spending items are: the conversion of an earlier deficit guarantee to Expo.2002 into a loan; a transfer to the Pension Fund of Public Employees (PKB) to cover an unexpected deficit due to poor performance of its portfolio; and higher military expenditure. With unchanged revenue, the federal deficit would widen to 0.4 percent of GDP in 2001, however it would remain within the ceiling allowed under the current balanced budget law. The staff would not see the somewhat higher deficit as a concern from a cyclical point of view.

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

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

IMF Concludes Article IV Consultation with Switzerland

On May 9, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

The Swiss economy had its best performance in a decade in 2000. Jolted by an upswing in exports and buoyant domestic demand, GDP growth rose to 4 percent in early 2000 before receding to a more sustainable pace in subsequent quarters. This has largely eliminated the earlier output gap and has pushed the unemployment rate below 2 percent. During the 1990s, Switzerland had experienced persistent low growth and the unemployment rate had risen to over 5 percent.

Despite indications of increasing shortages of skilled labor, inflation remains subdued. During 2000, increased competition and deregulation in telecommunications helped to offset steep oil price increases, keeping inflation below 2 percent. With the partial reversal of oil price hikes, headline inflation dipped below 1 percent in early 2001. Core inflation remains about 1 percent and the tightening in the labor market has bolstered wage demands only moderately.

The external current account surplus reached almost 13 percent of GDP in 2000. The record level mainly reflects the high net investment income (11½ percent of GDP) on Switzerland's large net foreign asset position (143 percent of GDP at end-1999).

[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. This PIN summarizes the views of the Executive Board as expressed during the May 9, 2001 Executive Board discussion based on the staff report.

Amidst evidence in early 2000 that the economy was growing at an unsustainable rate, monetary policy was adjusted promptly to head off inflation pressures. The Swiss National Bank (SNB) raised the mid-point of its key operational interest rate target (three-month LIBOR) from 1 percent in September 1999 to 3½ percent in June 2000. Interest rates were subsequently kept unchanged until March 2001 when signs of a weakening external environment and benign inflation prospects prompted the SNB to reduce its interest rate target by ¼ percentage point. At the beginning of 2000, the SNB abandoned formal monetary targeting in favor of a new monetary policy framework that aims at keeping inflation below 2 percent in the medium term.

The Swiss franc has appreciated by about 4 percent against the euro since March 2000, after having shadowed it closely for more than a year. However, due to the weakness of the euro, mainly against the dollar, the Swiss franc is still slightly weaker in nominal and real effective terms than it was prior to the advent of the euro.

Windfall revenues and the strong economy helped to generate a general government surplus of 1.8 percent of GDP in 2000 compared to a deficit of 0.4 percent of GDP in 1999. However, about 1½ percentage points of the swing reflected one-time revenues from the interest withholding tax and stamp duties on securities transactions. In 2001, the general government surplus is expected to shrink to 0.3 percent of GDP as withholding tax and stamp duties revert to normal levels.

In the past few years, fiscal policy has been guided by a constitutional requirement to balance the federal budget by 2001. Cantons and communes have also been trying to reduce high debt levels accumulated during the low growth 1990s. The fiscal framework has already helped to reduce the general government debt/GDP ratio from a peak of over 54 percent in 1998 to under 49 percent at end-2000. Recently, the Council of States approved a proposal to allow the federal budget to vary with the economic cycle—whilst remaining balanced on average—although approval by the National Council and a referendum are required before the proposal can be implemented.

Real GDP growth is projected to slow from 3½ percent in 2000 to about 2 percent in 2001-02. Although buoyant consumer confidence and investment in machinery and equipment are expected to underpin solid domestic demand growth, the weakening external environment should dampen export growth. Inflation is projected to remain at or below 1½ percent.

Executive Board Assessment

Executive Directors commended the Swiss authorities for maintaining sound macroeconomic policies, which have facilitated a strong recovery in economic activity and reduced unemployment to a very low level without rekindling inflation. Looking forward, Directors considered that the main challenge is to pursue more vigorously the structural reforms that are needed to improve Switzerland's long-term growth prospects.

Directors considered that the current expansion is likely to continue in 2001, albeit at a more sustainable pace, but viewed the growth projection as subject to downside risks from the weakened global economy. Noting that inflation remains subdued, and that the external current account is strong and the currency is appreciating, Directors welcomed the recent interest rate cut. They considered that the Swiss National Bank (SNB) has scope to ease interest rates further should the slowdown in economic activity become more pronounced.

Directors considered that the new monetary policy framework, with its explicit inflation forecast, has improved the effectiveness of monetary management since its introduction in January 2000. Within this framework, the SNB has been able to accommodate the first round effects of the oil price rise without a noticeable effect on inflation expectations. Directors noted that the SNB's credibility is high because of its tradition of independence and stability-oriented policymaking. Looking forward, they considered ways in which the policy framework could be even made more effective over time. In this regard, they welcomed the SNB's intentions to enhance its communication strategy, including the articulation of the assumptions underlying the inflation forecast and rationale for policy decisions.

Directors welcomed the elimination of the federal budget deficit ahead of schedule. In present circumstances, they did not see the projected sharp decline in last year's surplus of the general government as problematic from a cyclical point of view, especially as last year's surplus mainly reflected transitory revenue gains. However, they cautioned against the temptation to use the temporary revenue gains to finance tax cuts or new expenditures.

Directors welcomed the innovative rules-based approach to fiscal policy formulation adopted by the Swiss authorities and endorsed the government's proposal to balance the federal budget over the cycle, as this would help lower the public debt ratio and provide more room for automatic fiscal stabilizers to operate. Nevertheless, they expressed concern that the degree of cyclical flexibility of the budget is limited. In this context, they generally supported the exclusion of net lending to the unemployment insurance fund from the definition of the budget balance, and the plans to shore up the reserves of the fund to prevent procyclical changes in contribution rates as a way to further strengthen the automatic stabilizers. Directors considered that there remains scope for stronger mechanisms to ensure that unanticipated budget surpluses are put toward debt reduction. They also took note with interest of the proposals under consideration regarding the project to reform fiscal relations among different levels of government, which are intended to lead to improved fiscal redistribution among cantons, allowing them to compete on a more level playing field.

Directors underscored that ongoing public expenditure restraint will be needed to accommodate planned tax cuts and the rising strains on social security from population aging. They encouraged the authorities to review the sustainability of pension and health benefits, and take early action as needed.

Directors welcomed progress in opening up sheltered sectors to competition, but noted that more needs to be done to raise the relatively low trend rate of real growth in Switzerland. They stressed in particular the importance of completing liberalization in the telecommunications sector, accelerating plans to open up the electricity sector, making anti-cartel legislation more effective, and strengthening the Competition Commission.

Directors had a wide-ranging discussion on the links between competitiveness, openness, and exchange rate developments. They observed that Switzerland's external current account surplus has risen further owing to substantial earnings on foreign investments. Directors noted that the opening up of sheltered sectors could improve productivity and raise investment, allowing over time for a reduction of the current account surplus and for continued moderate real appreciation of the Swiss franc.

Directors noted that, while the financial sector appears to be in good health, supervisors will need to remain vigilant in light of the turbulence in stock markets and the weakening of the economic environment. They welcomed the authorities' review of the financial supervisory framework and their decision to undertake a Financial Sector Assessment Program (FSAP), which will provide a timely opportunity to review reform plans and assess vulnerabilities, particularly as globalization and changing technology provide new opportunities and risks. Directors encouraged the authorities to give adequate priority and resources to combat money laundering.

Directors commended Switzerland's commitment to liberal trade. They encouraged the authorities to accelerate the dismantling of high protection in agriculture and to consider providing more favorable access to Swiss markets for the least developed countries.

Directors commended the authorities for the effectiveness of their official development assistance (ODA) and welcomed their plan to raise ODA to 0.4 percent of GDP within the next decade. A few Directors expressed the hope that Switzerland would be able to raise its contribution further toward the UN target of 0.7 percent of GDP.

Directors noted that, while the statistical data are adequate for purposes of Article IV surveillance, further efforts are needed to improve the quality and comprehensiveness of the data so as to strengthen the basis for economic analysis and management.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Switzerland: Selected Economic Indicators

	1997	1998	1999	2000	2001 1/
Real economy					
Real GDP	1.7	2.3	1.5	3.4	2.0
Real total domestic demand	1.3	4.3	1.4	2.9	2.0
CPI (year average)	0.5	0.0	0.8	1.6	1.4
Unemployment rate (in percent of labor force)	5.2	3.9	2.7	1.9	1.9
Gross national saving (percent of GDP)	30.2	31.0	31.6	34.7	33.7
Gross national investment (percent of GDP)	20.2	21.1	20.0	21.8	22.2
Public finances (percent of GDP)					
Confederation budget balance 2/	-1.5	0.0	-0.8	0.9	-0.2
General government balance 2/ 3/	-2.4	-0.4	-0.4	1.8	0.3
Gross public debt	51.5	54.4	51.3	48.6	46.8
Balance of payments					
Trade balance (in percent of GDP)	-0.1	-0.6	-0.1	-1.2	-1.2
Current account (in percent of GDP)	10.0	9.8	11.6	12.8	11.5
Official reserves (end of year, US$ billion) 4/	39.0	41.2	36.3	32.3	...
Money and interest rates					
Monetary base (end of year)	2.7	4.0	4.7	-1.3	...
M3 (end of year)	3.4	0.4	1.0	-0.9	...
Three-month euro rate (in percent)	1.5	1.6	1.4	3.5	...
Government bond yield (in percent)	3.5	2.9	2.9	3.9	...
Exchange rate					
Exchange rate regime	Managed float				
Present rate (March 26, 2001)	Sw F 1.53 per US$				
Nominal effective exchange rate (1990=100)	104.3	107.0	105.1	103.1	...
Real effective exchange rate (1990=100) 5/	100.9	102.2	100.2	97.8	...

Sources: Data supplied by Swiss authorities; and IMF staff estimates

1/ Staff estimates and projections.
2/ Including large infrastructure projects.
3/ Including Confederation, cantons, communes, and social security.
4/ Excluding gold.
5/ Based on consumer prices.

Statement by Roberto F. Cippà, Executive Director for Switzerland May 9, 2001

I would like to thank the staff for the constructive policy discussions, the comprehensive report, and the well-focused background studies. My Swiss authorities agree with the thrust of the staff appraisal and look forward to disseminating the staff papers to the general public.

Last year, the Swiss economy grew at a rate significantly above potential. The inflation pressure remained subdued and the unemployment rate fell below 2 percent. In the recent past, several factors have led to an economic slowdown, bringing the Swiss economy back to a more sustainable growth path. With regard to the economic outlook, we agree with the staff that the balance of risks is on the downside. The uncertainty surrounding the economic performance of the three major global economic regions makes it more difficult to assess the future economic development in Switzerland. Nevertheless, the progress made in the nineties in reforming the domestic market has certainly reduced the vulnerability of the Swiss economy. In addition, a prudent and forward looking monetary policy as well as a sound fiscal policy will have positive impacts on economic growth.

Monetary Policy

My authorities welcome the positive assessment by staff of the Swiss National Bank's (SNB) new monetary framework and its conduct of monetary policy. The staff report presents a good evaluation of the key monetary conditions in Switzerland, which coincides with the view of the SNB. Since the description of the new monetary framework is an important part of the report, we would like to clarify some issues.

First, despite similarities with "soft-edged inflation targeting", it is important to note that the SNB does not pursue an inflation targeting strategy. Most importantly, the monetary framework does not contain an institutional commitment to an inflation target as the overriding objective of monetary policy. However, the SNB considers price stability to be a primary goal and regards price stability to be equivalent to an inflation rate - measured by the national consumer price index - of less than 2 percent per annum. While persistent inflation above 2 percent or deflation will be countered, the SNB may tolerate temporary deviations and there is no obligation to bring back inflation within a specific time horizon.

Second, the analysis of monetary aggregates is a very important input for the SNB's inflation forecasts. The development of M3 in Switzerland delivers important and reliable information, especially about the long-term inflation trend, since the demand for broader aggregates like M3 is stable. As these monetary aggregates continue to be important indicators for monetary policy decisions, we would have preferred this to be mentioned clearly in the description of the monetary framework, as it was done last year.

Third, the SNB recognizes that improved transparency with regard to its internal procedures for setting monetary policy is desirable and intends to publish more information regarding the forecasting models and the underlying assumptions of the forecasts. However, the SNB doubts that the current state of transparency has any negative impact on the effectiveness of its monetary policy. As the staff notes, the transition to the new framework has been smooth and the SNB can rely on high credibility based on a long history of independent and stability-oriented policy making.

Fiscal Policy

The strong economic growth as well as windfall gains generated a sizeable fiscal surplus in 2000. The federal budget showed a surplus of 0.9 percent of GDP and the general budget reached a surplus of 1.8 percent of GDP. My authorities fully agree with staff's assessment that the temporary revenue gains, which partly explain the fiscal outcome, should not be used to finance tax cuts or new expenditures.

Furthermore, the Federal Council has submitted a supplementary budget for 2001 amounting to Sw F 929 million, or 1.9 percent of total expenditures. However, this additional spending is expected to have a relatively small impact on the projected result for 2001. On the one hand, other factors will have a positive influence on the outcome (e.g. parliament approved a less costly reform of the stamp duty and the unexpected large surplus in 2000 has reduced debt service payments this year). On the other hand, experience shows that 3 percent of budgetary allocations are usually left unspent, which should allow for an overcompensation of the additional spending in the supplemental budget.

As regards the developments in the area of fiscal rules to ensure long-term fiscal stability, some comments are warranted. The Budgetary Target 2001 can be considered as the "old" constitutional amendment that will be replaced by the "new" Expenditure Rule (debt brake rule). If accepted, the Expenditure Rule will come into force the first time for the budget 2003, not sooner. My authorities are convinced that a rule-based approach to fiscal management is an appropriate instrument to cope with pressures for fiscal expansion that could arise from a cyclical downturn. Furthermore, by applying a rule, the risk of uncontrolled increases of the debt-to-GDP ratio is limited. Stabilizing or even reducing the debt-to-GDP ratio will help to cope with increasing pressures stemming from aging population.

As underlined in the report, staff seems to consider that the amplitude of the permissible government imbalance within the debt brake rule is too narrow. A strict application of the expenditure rule in Switzerland would only permit a deviation of expenditure from revenue of about 5 percent, i.e. a maximum cyclical deficit of about 0.5 percent of GDP. I would make the following comments on this issue.

First, a cyclical budget deficit or surplus of about 2 billion Swiss francs, which corresponds to the 5 percent deviation (0.5 percent of GDP) would already be an improvement compared to our experience with automatic stabilizers in the past. This holds particularly true regarding cyclical surpluses. Hence, the strict application of the rule implies an improvement. Second, we tend to overestimate revenues when the economy is entering a recession and to underestimate revenues when the economy gains momentum. This is a kind of an automatic stabilizer as well, which will add to the impact mentioned above. Third, when assessing the size of the automatic stabilizers under the new regime we have to remember that in future the unemployment insurance will be financed outside of the budget. It will receive loans from Government in recessions which will not be channeled through the budget. The loans will have to be repaid in periods of buoyant demand which again will not enter the budget as additional revenue. Thus, the unemployment insurance will act independently from the budget as an automatic stabilizer of its own. All in all, the full automatic stabilizer - taking these three effects together - will be significantly larger than 0.5 percent of GDP.

Let me now turn to tax issues. The Federal Constitution obliges the Confederation, the cantons and the municipalities to harmonize their system of direct taxes. This harmonization covers the tax liability, the object of the taxes, the tax period, the procedural law as well as the criminal law. However, the cantons remain responsible for determining the tax tariffs, the tax rates and tax-exempt amounts. This means that harmonization in Switzerland is limited to formal aspects. The staff acknowledged that tax competition between cantons had helped to keep tax rates low, but pointed out that wide variations in tax rates and exemptions between cantons distorted economic decisions. My authorities believe that a certain fiscal leveling is necessary. However, this should not be done by harmonizing tax tariffs, tax rates and tax-exempt amounts. Instead, the differences should be reduced by the so-called revenue sharing agreement (Finanzausgleich).

As regards possible threats of erosion of the tax base, the point mentioned by staff concerning withholding taxes is incorrect. In the context of a proposed EU-wide withholding tax, the introduction of equivalent measures by Switzerland to prevent tax evasion by EU residents (withholding tax on interest from foreign capital according to the paying agent principle) will not have a negative impact on the withholding tax revenues. These measures target interest payments that are currently not being taxed by means of a withholding tax so the tax base will not change.

Growth performance

Much has been said about Switzerland's low trend growth in the past decade. Staff has focused on this "puzzle" in previous Article IV consultations and a clear-cut explanation did not emerge. While some key factors were identified, it was well recognized that growth performance was affected by a broad range of issues. My authorities consider that staff's statement that the low trend growth problem reflected mainly measurement problems and slow progress in opening up sheltered sectors is unduly "reductionist". This particularly, because the explanatory content of the first argument is negligible, since measurement problems are not unique to Switzerland.

While my authorities have fully recognized the central role of structural rigidities in the sheltered domestic sector in explaining slow productivity growth, they have also stressed the importance of other factors that contributed to the long period of slow growth. The combination of a deep recession, a sharp real appreciation of the Swiss franc (causing market share losses on our export markets as well as on the domestic market), a rapid rise in unemployment (a new phenomenon for Switzerland, which significantly affected consumer confidence), and the deep restructuring of the domestic economy (with its well-known first round demand effects) are all part of the explanation. My authorities think it is important to recognize the interaction among these various negative developments that took place in the nineties when assessing Switzerland's growth performance.

Structural Policy

Several issues still remain on the structural reform agenda. However, a lot has been done and the current efforts can be characterized as a "second round" in areas where a first wave of reforms has taken place in the 90s. Anti-cartel legislation will be reformed so that direct sanctions can be imposed, the enforcement mechanisms in the internal market law shall be strengthened and the technical law will be aligned also in the two or three remaining areas to the prescriptions of our main trading partners. Also, a complete privatization of SWISSCOM and a further dismantling of the monopoly in the postal sector are currently being widely debated. Finally, the still pending reform in the electricity market shall be followed by a similar liberalization of the gas market. It goes without saying that the power crisis in California doesn't make it easier for our authorities to win the popular referendum scheduled for December, which was requested against the law on the liberalization of the electricity sector.

In trade policy, Switzerland considers market access for industrial products, including textiles, and for agricultural products an important issue. With regard to agricultural products, Switzerland is prepared to continue the process of negotiations on the basis of Art. 20 of the Agreement on Agriculture, and to gradually open the markets and achieve additional reduction in the level of domestic support and export subsidies, while taking account of the non-commercial interests and multifunctionality associated with agricultural activity. As staff mentions, Switzerland is undergoing a gradual reform in the area of agriculture. This reform is driven by the new goals of the Swiss agriculture as amended to the constitution in 1996 and the subsequent changes in the agricultural law and the commitments made in the framework of the WTO agreement on agriculture. According to the implementation of the new Agricultural Policy 2002 state monopolies and state trading companies have been abandoned and the market for all agricultural goods has been further liberalized.

Switzerland also supports the further opening of Swiss markets to imports from poor countries. It is important to note that Switzerland now envisages to provide, in the medium term and independently of the launching of a new round of multilateral trade liberalization, duty-free access to products from least-developed countries. These specific plans have yet to be approved.

Financial Sector

With its capital account free of restrictions, Switzerland has to be particularly vigilant as to developments on the international financial markets and the soundness of its financial sector.

My authorities agree with the staff that a comfortable capital base and improved risk management systems are the hallmarks of a strong Swiss banking sector. The efforts by the Swiss authorities to improve financial sector oversight reflect the considerable challenges originating from technological developments and increased cross-border and cross-sector consolidation in the financial sector. Pending further study, the current practice of joint supervision of financial conglomerates could be put on a regular basis by unifying bank and insurance supervision. In adjusting the regulatory and supervisory framework, high priority is given to preventing abuses of the infrastructure of our international financial center, most recently in tightening Know-your-Customer-rules for Internet banking.

As regards Switzerland's efforts to combat money laundering, the 1998 Money Laundering Act has put significant pressure on the non-bank financial industry to conform with the new provisions. A range of measures has been taken to address the difficulties that have arisen in the implementation of the new law. The Money Laundering Control Authority that monitors compliance with the Money Laundering Act in the non-bank sector is now better staffed, its position within the Administration has been strengthened and the cooperation with the self-regulating organizations has been put on a firm basis. In the areas of greatest economic importance, namely banks, securities dealers, and insurance firms, money laundering has been a long-standing focus of the competent supervisory authorities. The implementation of the new legislation in these segments presents no problems.

With a view to better assessing the potential vulnerabilities to the financial system, cooperation among the competent authorities with regard to systemic risks is also stepped up. The somewhat vague concept of reputation risk is being taken into consideration in this context. My authorities are looking forward to discussing the issues of financial stability and the adequacy of the regulatory framework with the staff in the context of the FSAP, which will take place in the second half of this year.