June 2006
IMF Country Report No. 06/202

Switzerland: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Switzerland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 6, 2006, with the officials of Switzerland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 8, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 2, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Switzerland.

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

Selected Issues Paper

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

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 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Switzerland

Approved by Alessandro Leipold and G. Russell Kincaid

May 8, 2006

- The mission visited Bern and Zürich during February 24–March 6, 2006 and held discussions with Finance Minister Merz, Chairman Roth of the Governing Board of the Swiss National Bank, Director Gerber of the State Secretariat for Economic Affairs, other senior officials, and representatives of cantons. Outreach activities included members of parliament, NGOs, the private sector, think-tanks, and academia. Messrs. Zurbrügg (Executive Director) and Schaad (Advisor) attended the meetings.

- The mission comprised B. Traa (Head), A. Gagales, A. Carare (all EUR), M. Khamis (MFD), and X. Debrun (FAD).

- The mission held a joint press conference on the concluding statement.

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Websites for Swiss Data

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

Special Data Dissemination Standard website of the IMF ...http://www.imf.org/external/country/CHE/index.htm

Acronyms

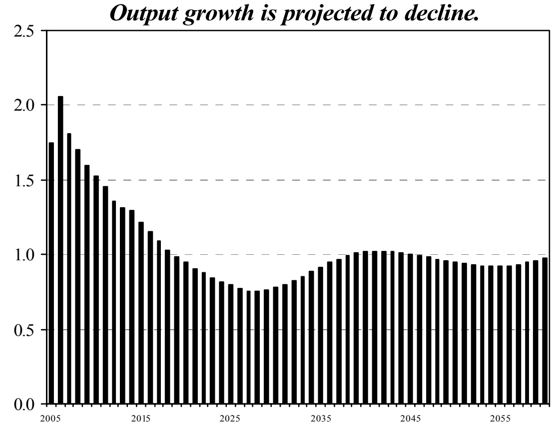
AHV .... Old Age and Survivors Insurance
ALV................. Unemployment Insurance
BfS................... Federal Statistical Office
BPV .... Federal Office of Private Insurance
EFV .... Federal Finance Administration
EBK................. Federal Banking Commission
ETH .... Federal Institute of Technology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

I. Introduction

1. **Following a period of mixed performance, the Swiss economy is now picking up.** An educated labor force and business friendly environment support high per-capita incomes, skillful monetary management delivers low inflation, and flexible labor markets keep unemployment subdued. However, a slow pace of structural reforms has kept productivity growth low among industrial countries, and some sheltered sectors contribute to a high domestic price level. As a result, Switzerland's relative economic position declined in the past 15 years, with growth averaging only 0.9 percent a year and the public debt ratio rising steadily (Figure 1, Table 1). Nevertheless, the economic cycle is now picking up with strong global growth, a disciplined policy framework, and the onset of some reforms.

2. **The main policy challenges are of a medium-term nature, reflecting moderating potential growth and fiscal pressures from aging.** Driven by demographics, the authorities and the staff project potential output growth to drop below 1 percent a year in ten years. Without measures, the primary fiscal deficit could rise to 5 percent of GDP by 2030 (IMF Country Report/05/190), highlighting the interaction of subdued growth and higher entitlement costs.

Output growth is projected to decline.

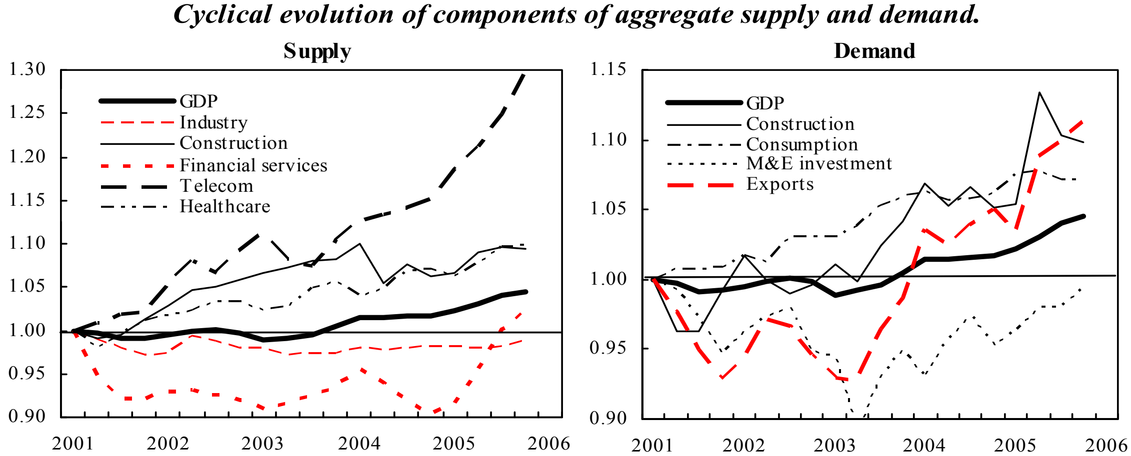


Sources: BFS and IMF staff projections.

II. Recent Developments

3. **The slowdown that followed the burst of the equity bubble has come to an end.** On the supply side, the financial sector was particularly affected and made a negative contribution to growth of 1.8 percentage points of GDP (cumulative) during 2001–04. However, reduced policy interest rates supported a revival in residential construction, the

Cyclical evolution of components of aggregate supply and demand.



telecommunications sector benefited from liberalization, and spending on health care services continued its upward trend. From a demand perspective, the stagnation in 2001–04 was driven by the weakening of external demand and a protracted slowing of equipment spending. More recently, the economic rebound in 2005 was supported by exports and an accommodative monetary policy. Private consumption gained pace as unemployment stabilized, and concerns about the soundness of the second pillar pension system subsided.[1] Housing investment benefited from low interest rates and a demand shift to owner-occupied apartments. In turn, exports were supported by strong external demand and some weakening of the Swiss franc.[2] GDP grew by 1.8 percent in 2005, narrowing the output gap to -½ percent (Figure 2).

Switzerland: Aggregate Demand

	2004				2005				Annual rates			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2004	2005	2004	2005
	(Annualized rates of change, in percent)								Average		Q4 over Q4	
Final domestic demand	1.7	0.5	1.5	-0.7	2.8	5.7	-0.1	0.9	1.8	1.9	0.8	2.3
Private consumption	2.3	0.0	0.1	1.2	2.4	2.1	2.2	0.7	1.4	1.6	0.9	1.8
Public consumption	1.3	-2.2	0.3	1.6	5.1	1.0	-2.5	0.1	1.4	1.3	0.3	0.9
Investment	0.3	3.6	6.2	-7.0	2.9	18.8	-4.8	2.1	3.3	3.1	0.6	4.4
Machinery and equipment	*-8.0*	*12.2*	*7.0*	*-8.4*	*4.6*	*7.4*	*0.0*	*5.6*	*2.7*	*2.7*	0.3	4.4
Construction	*11.2*	*-5.9*	*5.2*	*-5.3*	*0.8*	*34.1*	*-10.3*	*-1.9*	*4.1*	*3.5*	1.0	4.4
Stock building 1/	-1.1	1.1	-0.1	-0.8	0.8	-1.2	0.6	1.0	-0.7	0.2	-1.0	3.4
Net foreign balance 1/	1.8	-1.1	-0.1	1.0	-1.0	0.7	0.3	-0.7	1.0	-0.1	1.5	0.0
Exports	21.7	-8.0	9.5	2.0	-4.1	28.7	0.8	4.7	8.9	4.5	6.4	6.1
Imports	5.0	6.0	8.2	-4.8	2.9	16.8	2.5	12.2	7.4	5.3	3.5	8.4
GDP	4.1	0.2	0.5	0.3	1.9	3.6	3.5	2.1	2.1	1.9	1.3	2.8

Sources: SECO and IMF staff calculations.
1/ Contribution to growth. Includes also statistical discrepancy.

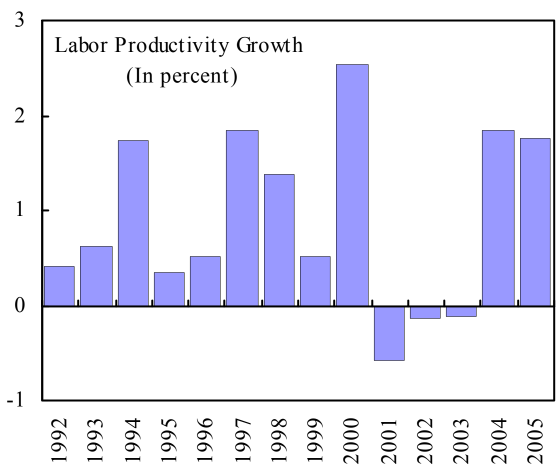
4. **The financial sector accounted for almost half the growth rebound in 2005**. It benefited strongly from the recovery in global equities and expanded funds under management. The EU Savings Directive went into effect with a 15 percent withholding tax on interest income, but did not affect significantly savings intermediation (partly because investors moved to non-interest bearing instruments).

[1] The decline in equity prices and interest rates after 2000 negatively affected the funded pension system (see Section III-E).

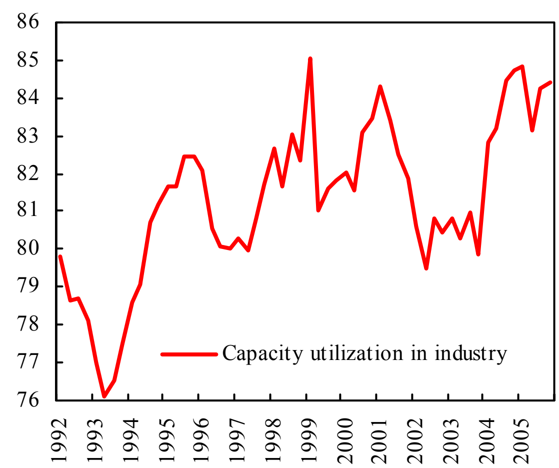
[2] During 2005, the franc weakened by 1.9 percent in real effective terms (ULC) and 2.7 percent in nominal effective terms, dropping below its long-term upward trend. The franc declined slightly against the U.S. dollar and remained stable against the euro (two-thirds of Swiss exports go to Europe).

5. **Job creation and unemployment responded with some delay.** The labor market normally lags economic activity (generating productivity gains first), but the reaction was also somewhat tentative relative to earlier recoveries. With enterprises still cautious, part-time jobs expanded faster than full-time employment (Figure 3). Foreign employment from EU countries expanded, including with the entry of high-skilled workers from Germany. In early 2006, unemployment (s.a.) eased to 3.5 percent and vacancies increased.

The recovery brought about productivity gains...



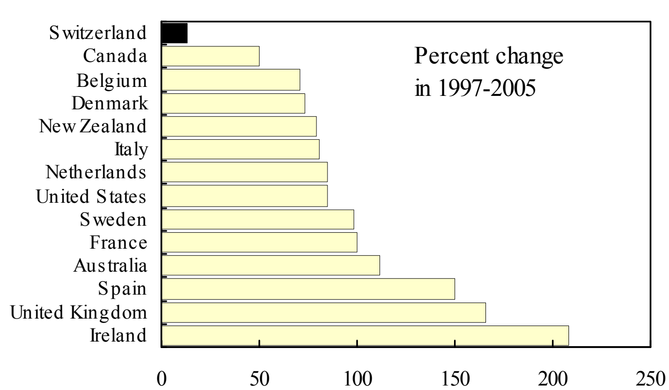
… and higher capacity utilization.



6. **Inflation is low.** CPI inflation averaged 1.2 percent in 2005 and early 2006—within the SNB's definition of price stability (0–2 percent)—and core inflation was 0.5 percent. Low inflation has benefited from declining nonoil import prices (including from China and India); increased competition in domestic goods and services markets (in telecommunications, and with lower retail prices following the entry of foreign retailers); higher productivity growth; and moderate wage developments (including with the relaxation of restrictions on employment of EU workers) (Figure 4). Nominal wages increased by 1.4 percent in 2005 and are projected to rise by 1.6 percent in 2006, at par with labor productivity growth.

7. **As growth picked up, the SNB resumed raising interest rates.** The SNB increased the 3-month policy rate to 1 percent and 1.25 percent in December 2005 and March 2006, respectively. Still, interest rates remained below their historic averages and short-term rates are slightly negative in real terms (Figure 5). Long-term interest rates continued to decline, flattening the yield curve. The

Overall house price increases in Switzerland have been moderate.



Source: Economist and SNB.

slight weakening of the franc also eased monetary conditions somewhat. Money and credit growth remained strong (Figure 6) while equity prices rose to approach their peak of end-2000. Real estate prices rose moderately, with the exception of owner-occupied apartments whose prices rose sharply, driven by demographics and shifts toward smaller families (Figure 7).

8. **The fiscal impulse was neutral in 2005.** Disciplined budgetary operations, with successful implementation of the debt brake, and tax buoyancy lowered the federal government deficit below budget. Subnational governments also consolidated, benefiting from stronger than expected growth. A surge in investment income reduced the social security deficit, but its structural deficit still deteriorated. Overall, the general government deficit halved to 0.6 percent of GDP but the structural deficit remained unchanged (Tables 2 and 3). General government gross debt eased to 52 percent of GDP (when deducting the proceeds from the SNB gold sales, 4.6 percent of GDP, it dropped below 50 percent).

Box 1. Fund Recommendations and Implementation

The authorities tend to pursue prudent monetary, fiscal, and financial sector policies that have been well aligned with Fund advice. They have found it more difficult to implement structural reforms. With the high standard of living and absence of pressing difficulties, the status-quo bias is strong. Moreover, political power is diffused across the highly autonomous levels of government and referenda on reforms are frequent.

The authorities value the Fund surveillance, but also suggested new means to get the message to the public, such as publishing the Concluding Statement in German and French and, perhaps, preparing an op-ed article for the main newspapers.

Monetary policy: Focuses on price stability. The Fund has praised the monetary framework for its design, transparency, and the SNB for it skillful implementation.

Fiscal policy: The Fund has supported the authorities' efforts to phase out the federal deficit mainly through expenditure restraint. It has underscored the risks of unfunded future entitlement costs for long-term fiscal sustainability and has encouraged the publication of fiscal sustainability reports. Expenditure adjustment plans have been enacted and implemented; the authorities are now preparing a long-run fiscal sustainability report; and are developing innovative proposals to tackle aging costs.

Financial sector: In line with recommendations of the 2002 FSAP, the authorities have enhanced their surveillance of the financial system and strengthened the supervision and regulation of insurance. A focused FSAP update is planned for November 2006.

Structural and trade policies: A recurring theme in the consultations has been the need to strengthen domestic competition through opening up sheltered sectors, dismantling barriers across the internal market, and further liberalizing network industries and agricultural trade. The government's 17-point growth agenda (2004) contains valuable steps, some of which have begun to be implemented, but the unfinished reform agenda remains large. Progress in liberalizing agricultural trade remains slow.

III. Report on the Discussions

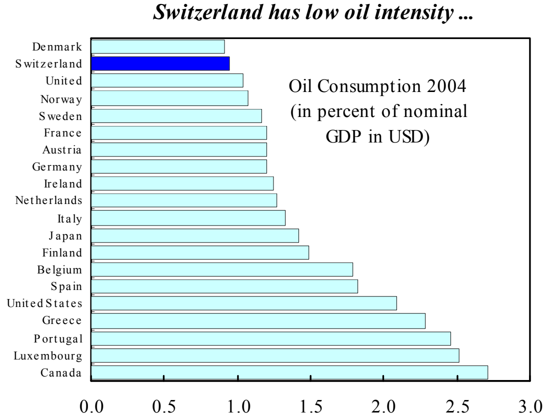
9. **With the economy rebounding and effective policy frameworks in place, the discussions focused on three main issues: ensuring fiscal sustainability in the face of population aging; fiscal federalism; and the effects of structural reform on prices and growth**. The mission also discussed the pace and timing of the withdrawal of monetary stimulus, the determinants of the large current account surplus and the exchange rate, and the outlook for and supervision of the financial sector and the occupational pension schemes.

10. **There was substantial agreement on the direction of policies**. Staff encouraged faster structural reforms, especially opportune now that the cycle is clearly strengthening. The authorities agreed but underscored the need to build political support for reforms to be adopted.

A. Short-Term Outlook

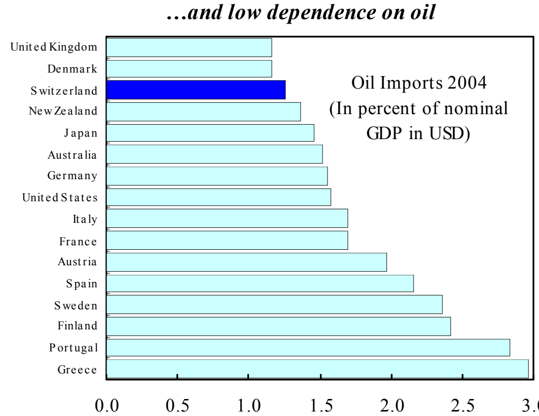
11. **The staff and forecasters expect growth to accelerate to over 2 percent in 2006, closing the negative output gap.** The strength of leading indicators suggests that the growth momentum will carry into 2006 (Figure 8). Growth is benefiting from continued strong external demand, still-supportive monetary policy, and stronger business investment encouraged by high capacity utilization, low corporate bond spreads, and improved balance sheets. Low oil dependency is limiting the direct adverse effects from elevated oil prices, and some increased competition in domestic markets is helping to dampen inflation. The staff projects growth to taper off in 2007 toward potential.

Switzerland has low oil intensity ...



Source: IEA, Fund staff calculations.

…and low dependence on oil



Source: COMTRADE, Fund staff calculations.

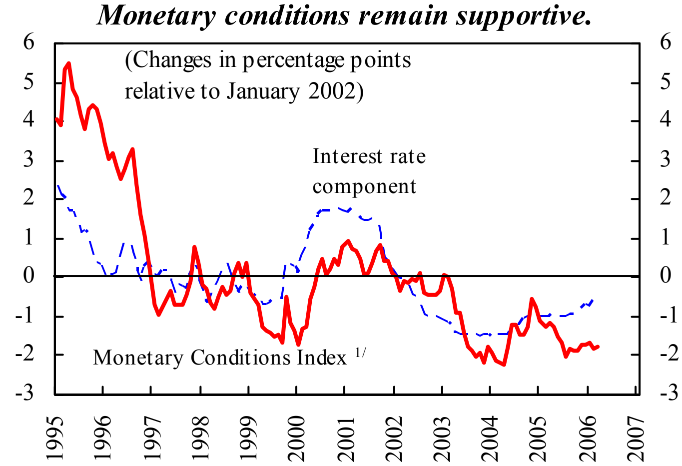
12. **Risks are mostly external.** The downside risk with most serious repercussions, but also uncertain probability, would be a disorderly unwinding of global imbalances. If the U.S. dollar were to fall sharply, and U.S. interest rates were to spike, Swiss exports would suffer and global equity markets could drop sharply. With Switzerland being a premier global wealth manager, this would reverberate significantly into the Swiss financial sector. Additional risks were geopolitical instability, which could suddenly push up the franc as a

safe-haven currency, and indirect oil price effects if these were to slow global growth. An avian flu pandemic could also disrupt growth and the authorities were examining personnel and IT systems contingencies to mitigate its possible effects. On the upside, the global environment may remain buoyant with imbalances yet unwinding slowly and smoothly. Success with implementing domestic reforms could lift potential output growth, and further assist the expansion in the near term.

B. Monetary Policy

13. **The authorities intend to continue to tighten monetary policy at a measured pace.** The authorities noted that mixed signals about the strength of the recovery in early 2005, and very low inflation, had justified the suspension of monetary tightening that had been started in mid-2004. By December 2005, however, the outlook had clearly brightened whereas real interest rates remained below neutral levels. To keep inflation expectations well anchored, the SNB resumed the gradual normalization of the monetary policy stance.

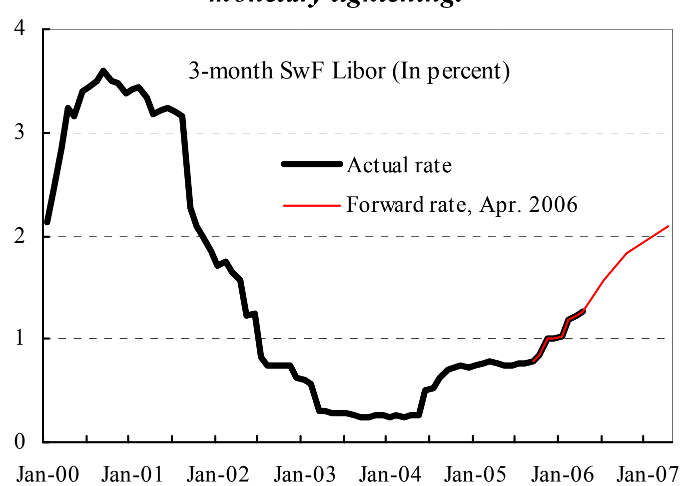
Monetary conditions remain supportive.



1/ A weighted average of the 3-month interest rate (3/4) and the detrended nominal effective exchange rate (1/4).

14. **The SNB intends to constantly assess the appropriate pace of interest rate increases against key economic indicators**. Mindful of the substantial transmission lag from monetary policy to economic activity, the closing output gap, and the risks of keeping interest rates low for too long, the SNB had signaled to the market its tightening bias. At the same time, officials noted that gauging the equilibrium interest rate had become difficult as several factors (absence of wage pressures, stronger productivity growth, globalization, and the effects of domestic reforms) may have reduced the neutral rate—at least temporarily. Markets expect a gradual increase in the policy rate to 2 percent by January 2007.

With the recovery gathering steam, markets expect monetary tightening.



15. **The authorities are vigilant about a possible unwinding of global imbalances.** They emphasized that monetary policy would be relaxed appropriately in the event of an abrupt appreciation of the franc, which could undermine activity and threaten deflation.

16. **The SNB has a transparent and open communication strategy**. Market participants appreciate the quality of information and guidance provided by the SNB through publications and speeches. There was consensus that good communication is key to avoiding surprises in financial markets.

17. **The SNB and the mission discussed two specific features of the monetary policy framework.** Staff noted that it would be preferable to decouple the legal link between housing rents and mortgage rates, which hinders the effectiveness of policy rates in controlling inflation and could cause interest rate overshooting.[3] The authorities concurred, but noted that because of the extended period of stable interest rates, this link had been somewhat less distortive recently. Moreover, the SNB and the mission agreed that a proposed popular initiative (KOSA) to earmark SNB profits above a certain floor to financing the social security system could compromise the independence of the SNB and its ability to focus on price stability. The KOSA initiative is scheduled for a vote in September 2006.

C. External Balance and Exchange Rate

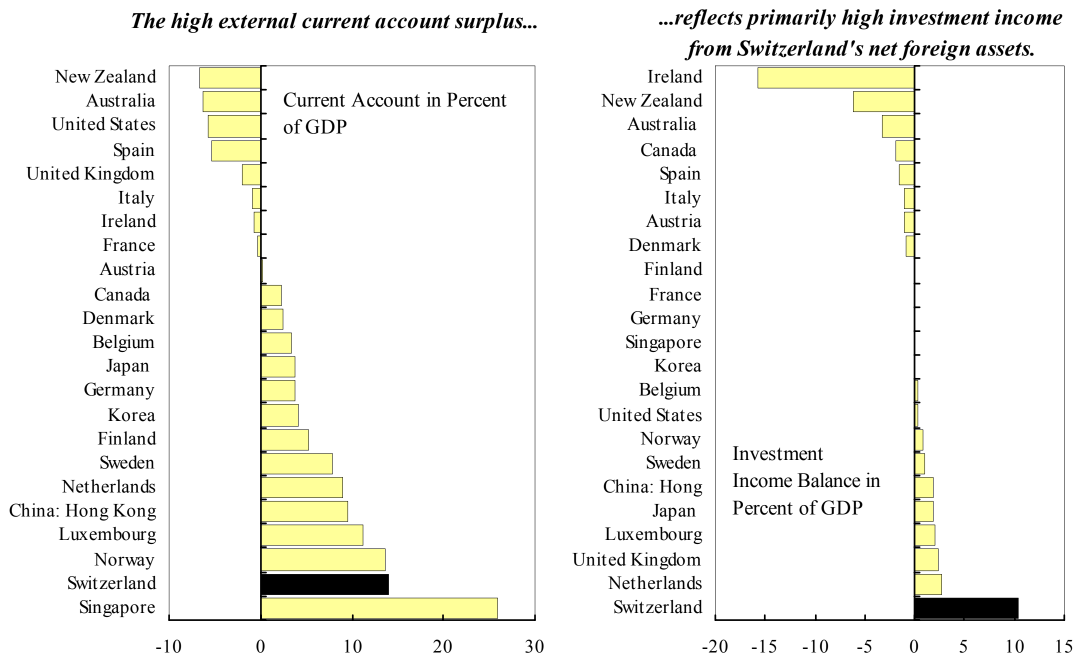
18. **The current account surplus is likely to remain high.** The main contributor to the surplus is the 10 percent of GDP earnings on Switzerland's large *net* foreign assets (140 percent of GDP) (Figure 9). From a saving-investment perspective, the current account surplus reflects high gross savings, which in recent years have exceeded 30 percent of GDP, with gross investment also strong at over 20 percent of GDP. The *business sector* accounts for more than half of gross national savings, reflecting favorable corporate income tax rates combined with a stable political and business environment that has attracted many multinationals. Given the complexity of multinational business transactions, it is possible that the statistical recognition of corporate savings in the Swiss accounts is overstated, but on the basis of preliminary data the authorities could not readily discern a significant bias.[4] [5] At 9 percent, the *household* savings rate is not exceptionally high by international standards and reflects the stage of the lifecycle of the population (high income levels just prior to a wave of

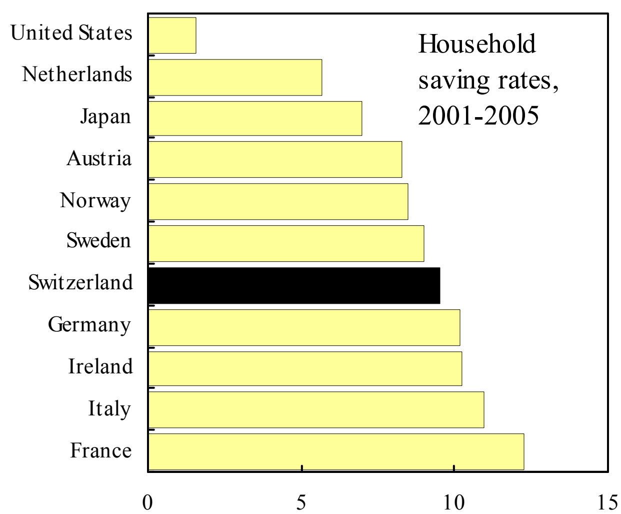
[3] Legislation stipulates that if mortgage rates go up, landlords are entitled to raise rents. Thus, monetary tightening could perversely raise inflation through the rental markets.

[4] NFI and NFA are based on the *residency* concept. Several countries with large multinationals have found that the concept of *ultimate beneficiary owner* can lead to significantly lower NFI and NFA.

[5] The U.S. profits repatriation act (providing temporary tax relief for companies repatriating profits from abroad) promptly led to substantial profit outflows from Switzerland to the U.S. in 2005.

retirements). In addition, the emphasis on *funded pension schemes* also tends to boost national savings. In terms of net lending to abroad, the household sector together with occupational pension funds account for the bulk of the current account surplus.





19. **The trend real appreciation of the franc has paused, but the SNB saw scope for it to continue without jeopardizing competitiveness.** This is consistent with the staff's assessment that the Swiss franc is 5–20 percent below its medium-term equilibrium rate, reflecting mostly undervaluation vis-à-vis the U.S. dollar.[6] The authorities do not intervene

[6] Market forward rates signal the expectation that the franc appreciation will resume.

in the foreign exchange markets, and were not concerned that the gradual trend real effective appreciation (on average about 0.7 percent a year)[7] would undermine economic activity given that manufacturing is oriented toward price-inelastic, high value-added markets and the financial sector (wealth management) tends to benefit from a strong franc (Figure 10).

20. **The authorities discussed several reasons why the real exchange rate may have paused in its long-run trend appreciation:**

- Domestic reforms could temporarily put downward pressure on the real exchange rate (a reverse Balassa-Samuelson effect). With prices in sheltered sectors exceeding by 30 percent those in neighboring EU countries, liberalizing domestic reforms will spur productivity gains and lower mark-ups, especially in these sheltered and nontradable sectors.[8] This puts relative downward pressure on nontradables prices and *depreciates* the equilibrium real exchange rate.

- The very low growth since the housing market collapse in the early 1990s brought with it a long period of weak absorption, also alleviating the real exchange rate.

- Monetary policy has been supportive of growth with very low interest rates for some time, generating negative interest rate differentials vis-à-vis the U.S. dollar.

21. **Thus, while there is room for the franc to appreciate, the exchange rate is reflecting market factors**. The strengthening of domestic growth should boost absorption. The tightening bias toward neutral policy interest rates also should support the franc. However, if domestic reforms continue, nontradables inflation could remain subdued for some time and lower the equilibrium real exchange rate.

D. Fiscal Policies

22. **The authorities were confident that they would meet their objective to eliminate the structural federal deficit by 2007**. Two short-run adjustment packages had been put in place in 2003 and 2004 to meet the objectives of the federal debt brake. These packages aim at restraining annual expenditure growth to 1.7 percent per year in 2006–09 (almost half the rate of nominal GDP growth). The debt brake mechanism was working well in focusing public attention on the need for adjustment and, with the key measures now in place, automatic stabilizers would be allowed to operate.

23. **Adjustment in cantons and communes was more moderate**. Moreover, after some consolidation, subnational governments were facing increasing pressures for spending in education and healthcare. At the time of the mission there was uncertainty to which extent

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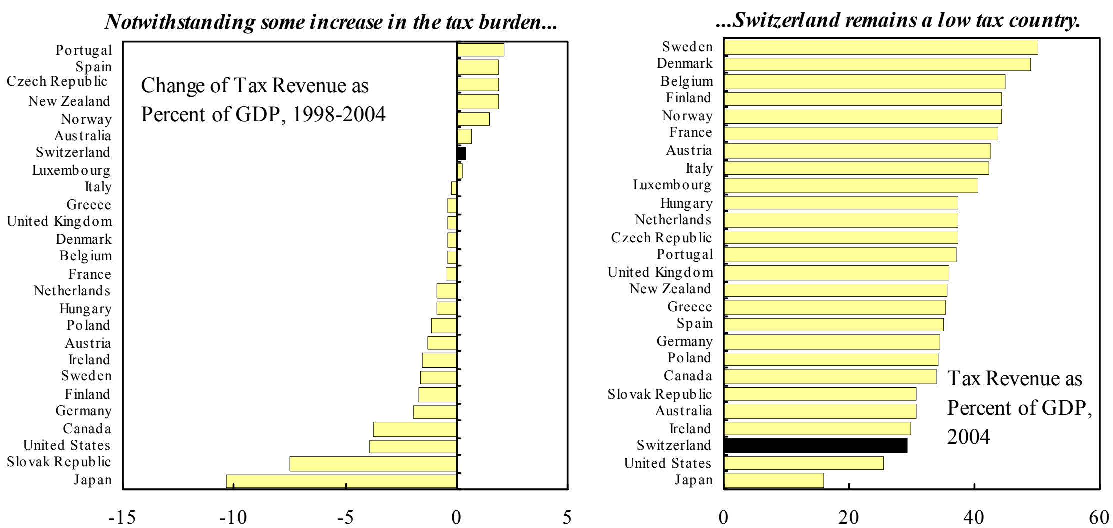
[7] On the franc's long-term trend appreciation, see IMF Country Report 04/166.

[8] Switzerland's excellent inflation performance, despite very low policy interest rates and oil shocks, is consistent with these beneficial effects beginning to take hold.

cantons would use the proceeds from gold sales to retire debt.[9] Officials noted that 18 out of 26 cantons had announced tax cuts (especially for high income persons; also, some cantons have no debt). They underscored, however, that most cantons and communes had fiscal rules and tended to pursue prudent fiscal policies.

24. **Regarding tax competition between the cantons in Switzerland's highly devolved federalism, the authorities were not concerned that it would degenerate into a race to the bottom** because: (i) the new financial equalization scheme discouraged "predatory" tax cuts by linking equalization transfers to a standardized tax base (thus local tax cuts might lead to *smaller* revenue transfers) (ii) the attempts at "competitive" tax cuts were limited to very small cantons with minimal spillovers to large ones and, (iii) should tax competition reach harmful levels, public pressure for harmonization would increase and thus undermine the cantons closely guarded independence. Indeed, rather than fearing tax competition, the authorities felt that in combination with direct democracy, where tax increases are often subject to referendum (mandatory for federal tax increases), some horizontal tax competition had helped to contain the size of government and limited the spending bias associated with the common pool problem (Box 2).



Source: OECD Revenue Statistics of OECD Member Countries, Vol 2005.

[9] In 2005, the SNB transferred the proceeds from gold sales to the federal government (⅓) and cantons (⅔). The federation will use its share to bolster the old age pension fund. Most cantons would lower debt, but some were considering, or had already implemented, tax reductions.

Box 2. Fiscal Federalism in Switzerland

Switzerland has one of the most decentralized government systems in the world, alongside Canada and the US. [1/] As cantons can freely raise own revenues, horizontal competition is intense, fostering accountability. Together with direct democracy, these arrangements tie the size of government to citizen's demand for public goods and services rather than to policy makers eagerness to spend, resulting in a relatively small government sector and low taxes.

Strongly devolved federalism raises policy coordination issues. First, gearing ex-ante fiscal policy towards macroeconomic objectives is challenging, with a greater risk of procyclical policies and difficulties to internalize intertemporal pressures. Second, horizontal tax competition may weaken the government's ability to meet citizen's demands. Third, extended devolution may limit economies of scale.

Empirical evidence confirms that the fiscal stance of the general government has been procyclical, reflecting mainly subfederal policies. The policy response to rising public debt in the 1990s has been slow, with the burden of adjustment falling mostly on the federation. However, tax competition is unlikely to reach harmful levels as net equalization transfers respond negatively to competitive tax cuts. Also, the mere threat of harmonization discourages cantons to overplay competitive tax reforms.

Fiscal federalism arrangements matter for the policy response to aging. The current system is more effective at preventing new spending programs than containing pressures from existing ones. In particular, frictions between the confederation and the cantons on sharing the cost of adjustment for aging may delay reforms. The federation, currently seen (although legally it is not) as the financier of last resort for social security, is exposed to the bulk of spending pressures at unchanged policies, which may encourage free riding by subnational governments.

With limited scope for ex-ante coordination, promoting greater transparency on intertemporal challenges is essential. The authorities are working on a Long-Term Fiscal Sustainability report, and are considering extending debt-brake type fiscal rules to entitlement programs. The strong transparency and discipline imposed by such far-reaching innovations could contain free riding problems.

[1/] See accompanying Selected Issues paper on "Coordinating Fiscal Policy in Switzerland: Issues, International Experience and Prospects."

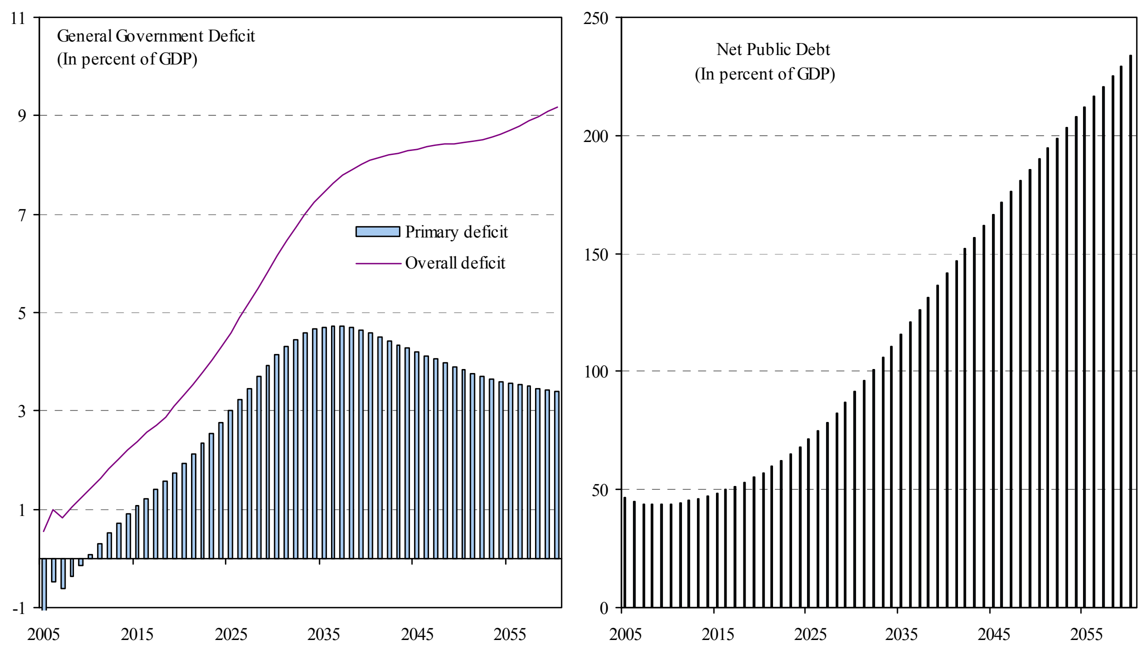
25. **For the long run, the authorities agreed that social security and health systems were not well-calibrated to absorb the pressures from aging.** The debt brake was working well for the federal budget within a *cyclical* context, but given its exposure to deficits in the entitlement programs, it might not be robust to *structural* pressures from aging. The authorities felt that the federation was approaching its limits of budgetary flexibility with current discretionary expenditure having been reduced considerably, while tax increases would be subject to mandatory referendum. Thus, given the mounting pressures from social security and with a view to preserving the credibility of the debt brake, the authorities agreed that structural fiscal reforms would be needed—and, indeed, were being prepared. They had already launched a comprehensive review of federal tasks and subsidies (reports would be prepared by year end).

Social security has been a drag on federal finances.
(In percent of GDP)

	2002	2003	2004	2005
Federal government overall balance	**-1.0**	**-0.9**	**-0.6**	**-0.2**
Federal government primary balance	**-0.1**	**-0.1**	**0.1**	**0.6**
Social security and health care 1/	-2.9	-3.0	-3.1	-3.1
Transfers to social security 2/	-2.4	-2.6	-2.6	-2.7
Health Care expenditures 3/	-0.4	-0.4	-0.5	-0.5
Other	2.8	2.9	3.2	3.7
Interest service	**-0.9**	**-0.8**	**-0.7**	**-0.8**

Sources: Federal Finance Administration, and IMF staff calcuations.
1/ 2005 are the budget numbers.
2/ Direct transfers to old age pensions (AHV), disability insurance (IV), unemployment insurance (ALV) and compensation for loss of earnings (EO) funds, and VAT transfers to these funds.
3/ Subsidies for health care premia (KV) included in the federal budget.

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



26. **To place the social programs on a sounder long-run footing, the authorities were considering several measures, some of which would be far-reaching and require careful discussion with the public**:

- **Disability insurance.** More timely intervention for, and faster reintegration of disabled workers, and slightly higher payroll taxes. The authorities also envision a 0.8 percentage point increase in the VAT, earmarked for the disability fund.

- **Health care.** In consultation with cantons, the excess supply of clinics would need to be reduced. Hospital efficiency would be improved through benchmarking and applying performance pay. And there would be increased freedom to contract health and insurance providers, thus leveraging competition. Raising copayments was also under consideration.

- **First pillar pensions.** The authorities intend to raise the female retirement age from 64 to 65 (planned for 2009), seek to extend the working life of older workers, and would consider reducing indexation for pensions, subject to safeguards for the needy.

- **Civil service pensions.** The authorities plan to split the civil service pension fund in two: one for retirees, with grandfathering of current provisions; and another for current employees who will be transferred to a defined contribution scheme, without grandfathering.[10]

27. **The authorities agreed that dealing successfully with aging would require that these proposals be placed in a long-run comprehensive policy framework and be coordinated across levels of government**. Therefore, they were preparing the Long-Run Fiscal Sustainability Report, which could bring out policy options and their separate impact on the confederation, cantons, communes, and the social security funds. The mission recommended that the Report include a preliminary public sector balance sheet that incorporates an estimate of the net present value of projected future deficits under current policies (Box 3). This could help assess what public assets are vital for the functioning of the state, and provide indications of the need for fiscal structural reforms.

[10] While details are still being worked out, switching to a defined contribution scheme would limit the contingent government liabilities related to uncertain returns on assets and longevity.

Box 3. Preliminary Public Sector Balance Sheet [1/]

A comprehensive public sector balance sheet provides useful information on the health of public finances. The balance sheet should include all assets and liabilities of the general government and the present value of the future stream of fiscal balances that is expected to be generated under current policies.

Preliminary calculations for Switzerland suggest an intertemporal imbalance. The Swiss public sector owns substantial assets that more than offset the 2004 accumulated net financial liabilities. However, the present value of unfunded liabilities over the next fifty years is estimated at 153 percent of GDP. [2/] Taken together, this suggests a negative intertemporal net worth of 103 percent of GDP.

Public Sector Balance Sheet

	2002	2003	2004 Staff proj.
	(In billions of SwF)		
A. Intertemporal financial position (I+II)	-756	-775	-793
I. Financial net worth	-102	-107	-113
Financial assets	146	142	139
Financial liabilities	-248	-249	-251
II. Net present value of future fiscal balances	-654	-667	-681
B. Nonmarketable financial position	93	96	94
C. Public sector capital stock	237	242	247
D. Contingent liabilities	-7	-7	-7
Public sector net worth (A+B+C+D)	-432	-443	-459
	(In percent of GDP)		
A. Intertemporal financial position (I+II)	-175	-178	-178
I. Financial net worth	-24	-25	-25
Financial assets	34	33	31
Financial liabilities	-57	-57	-56
II. Net present value of future fiscal balances	-152	-154	-153
B. Nonmarketable financial position	22	22	21
C. Public sector capital stock	55	56	55
D. Contingent liabilities	-2	-2	-2
Public sector net worth (A+B+C+D)	-100	-102	-103

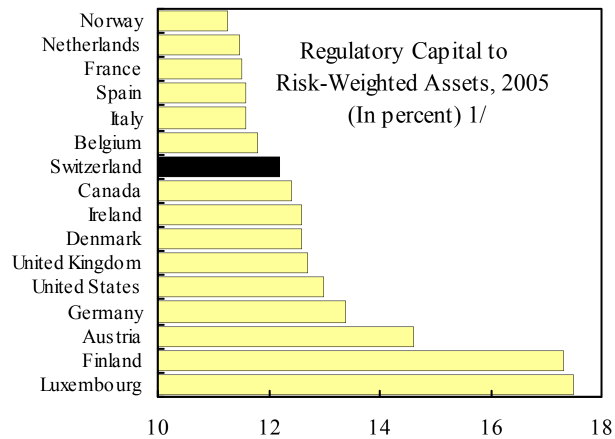
Source: Swiss National Bank, Federal Finance Administration and IMF staff calculations.

[1/] See accompanying Selected Issue paper "A Preliminary Public Sector Balance Sheet for Switzerland."
[2/] This number is indicative of the challenge faced by the debt brake and fiscal rules at the lower level governments. The authorities acknowledge that the debt brake by itself, without structural fiscal reforms, would not be robust to this pressure.

E. Financial Sector Developments

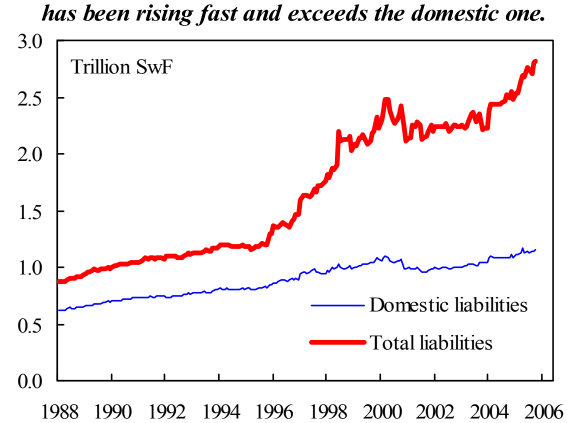
28. **The authorities noted that the banking sector was robust, adequately capitalized, profitable, liquid and dynamic**. They saw Switzerland as retaining a strongly competitive banking sector with high-quality and innovative institutions, good supervision and legal infrastructure, and excellent macroeconomic stability. At the same time, they noted that wealth management by Swiss institutions was expanding rapidly in Asia, where demand was most dynamic. Financial soundness indicators were at comfortable levels and banks' equity prices were strong (Tables 5–8, Figure 11). Bank profits rose in 2005, benefiting from an expansion of asset management and trading activities, lower provisioning, and restructuring. At the same time, intensifying competition had put some pressure on interest rate margins. Low interest rates continued to stimulate mortgage lending but stress tests suggested limited vulnerability of households thanks to moderate levels of loan-to-value and debt-service ratios.

Swiss banks are comfortably capitalized and ...



Sources: Financial Soundness Indicators Databank, IMF.
1/ Based on national definition of risk-weighting; which is relatively strict in Switzerland.

… the international part of their balance sheet has been rising fast and exceeds the domestic one.

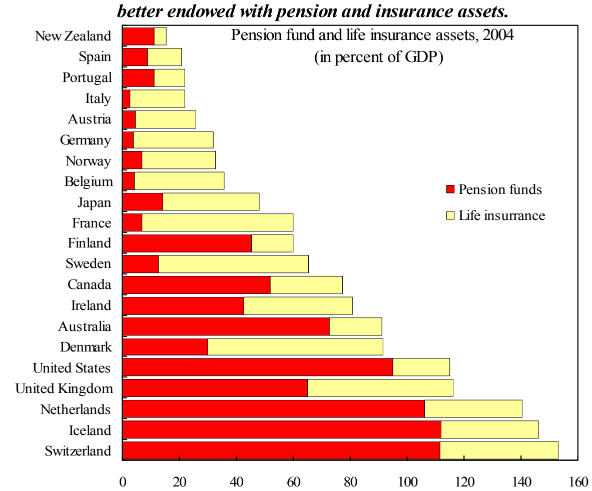


29. **Risks in the banking sector appeared well contained and supervisors remained vigilant**. Stress tests conducted by the SNB indicated that for the banking sector as a whole, an *extreme scenario* of recession combined with a collapse in equity prices and a rise in interest rates would reduce the sector's excess capital without breaching the regulatory minimum. Lending standards, interest rate and credit risks, and risk transfers, need to be monitored carefully now that banks are emerging from a long period of low interest rates. Also, the large international banks would be vulnerable to an abrupt unwinding of global imbalances. The mission welcomed progress made by the authorities in assessing systemic risks and recommended that the assessments include stress tests by the large banks using scenarios specified by the SNB in collaboration with the supervisory office (EBK).

30. **The health of the insurance sector has improved.** Balance sheets benefited from rising equity prices, improved risk management, higher premia, and restructuring. However, supervisors noted that reserve deficiencies remained in *life insurance*, and the distribution of risk management expertise was uneven in the sector. In *reinsurance*, profitability was reduced by the natural disasters in the United States but capital remained adequate.

31. **Banking and insurance supervision are being strengthened.** Officials confirmed their intention to make operational in 2008 the integrated Financial Market Supervisory Authority (FINMA), which brings under one roof the supervision of banking, insurance, securities, and anti-money laundering. Moreover, cross-border supervisory cooperation and crisis management capabilities were being strengthened through bilateral memoranda of understanding with foreign supervisors. Supervisors had started to monitor banks' exposure to hedge funds (still limited) and developments in domestic and international credit risk transfer. The implementation of *Basel II* was scheduled for January 2007. For insurance, the authorities are on track to introduce in 2008 the *Swiss Solvency Test*, an advanced risk-based regulatory framework similar to the EU's Solvency II.[11]

Compared to other industrial countries, the Swiss are better endowed with pension and insurance assets.



32. **Underfunding in the large second pillar (occupational) pension system continued to decline and improvements in the supervisory framework were being considered**. At end-2004, underfunding amounted to 6.3 percent of GDP (4.7 percent of GDP is state guaranteed). However, the authorities concurred that published data were likely to understate underfunding because future liabilities were discounted with an average technical interest rate slightly below 4 percent, almost double the yield on long-term bonds, and did not reflect adequately increasing life expectancy. Staff noted that the solvency of the system required moving away from administratively set parameters that generally do not reflect changing market and demographic conditions. In addition to the technical discount rate, these include the guaranteed rate of return, and the conversion rate (determining benefits at retirement) that does not seem to reflect its actuarially fair value. In this context, the authorities were considering whether the recently approved gradual reduction of the conversion rate from 7.2 to 6.8 percent was sufficient, given increasing life expectancy and the decline in long-term interest rates.

33. **The authorities welcomed the opportunity to discuss best practices for supervision of occupational pension funds in the FSAP follow-up scheduled for November 2006.** In this context, the mission encouraged the authorities to review options to

[11] Insurance companies will be expected to meet the risk-based capital requirements by 2011.

relax restrictions on asset allocation (to improve portfolio performance and risk management), and to strengthen the regulatory and supervisory framework. Supervision of pension funds has traditionally been conducted by the cantons, which has led to fragmentation, and some lack sufficient expertise and resources. The mission welcomed plans to harmonize supervision across cantons but considered that a centralized regulatory and supervisory system oriented toward risk-based regulation and supervision might be more appropriate for a small country like Switzerland.[12] The mission also noted that different regulations between second pillar funds and life insurance funds created distortions.

F. Structural Issues

34. **The authorities agreed that structural reforms remain essential to improving growth performance (Figure 12)**. Growth regressions indicate that market-based reforms aimed at reducing mark-ups could boost annual productivity growth, especially in retailing, health, agriculture, and network industries. Benefits would also accrue from reducing regulations and red tape, and substantial market opening in agriculture.

35. **Some valuable progress is underway:**

- Parliament approved a **Revised Internal Market Law**, which reduces the ability of cantons to impede cross-border supply of services.

- Parliament is also advancing toward the **liberalization of the electricity market**, with a two-stage opening of the electricity market in 2007 for commercial consumers and in 2012 for the rest. However, some interlocutors still voiced regulatory concerns.

- The authorities have suspended Swisscom's **"last mile" monopoly**, which has kept fixed-line network access fees too high.

36. **In addition, the authorities are launching three new reform initiatives; all strongly supported by the mission**:

- **Privatizing Swisscom shares.** The authorities are working on modalities to make this acceptable under the high likelihood that it will have to pass a referendum.

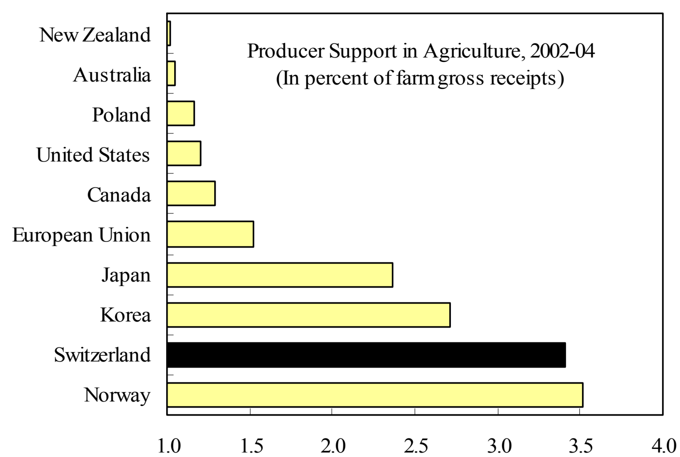
- **Adopting the "*Cassis-de-Dijon principle.*"** Products (including packaging and labeling) approved in the EU would automatically be recognized in Switzerland. This would help lower nontariff barriers and strengthen retail competition.

[12] The accompanying Selected Issues paper "A Comparison of the Swiss, Dutch, and U.K. Pension Systems, with Emphasis on the Occupational Pension Pillars" describes cross-country experiences and reforms in the aftermath of the equity bubble. These comparator countries have centralized supervision for banking, insurance, and pension funds, which helps to identify overlapping vulnerabilities and reduce regulatory distortions.

- **Reducing red tape and simplifying regulations,** to lower transaction costs in the economy.

37. **The authorities agreed that the unfinished agenda remained large (Figure 13) and stressed the need to garner public support**. They were pleased by the outcome of recent referenda (including on the extension of shopping hours), and by the entry of two **large foreign retailers** which had sharply intensified competition with visible effects on prices. It was also clear that consumers were becoming more assertive to seek lower prices, linked by some interlocutors to aging and more citizens shifting to fixed incomes.

38. **One of Switzerland's strengths is its flexible labor market**. Opening up to the EU-15 was alleviating shortages of skilled labor without evidence that it had raised unemployment. The extension of the free movement of labor to the EU-10 members, which was accepted in a referendum last year, would bring further flexibility. The authorities noted their aspiration to raising further the already high participation rate (Figure 14) by (i) paring existing incentives for early retirement, tightening the conditions for disability insurance and improving the modalities of post-retirement employment and, (ii) constructing more daycare centers to raise female participation. Given the importance of human capital for growth, staff welcomed plans to raise participation in tertiary education and enhance continuous education.



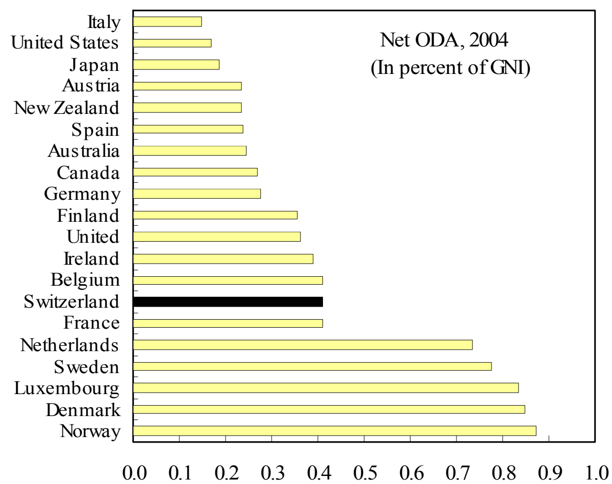
39. **Progress in opening up agriculture is slow**. The marginal tariff for some products is 700 percent and direct producer support, at 2 percent of GDP, is higher than value added in agriculture. Ongoing reforms aim to increase reliance on market mechanisms and replace price subsidies with direct income payments. The implementation of bilateral agreements with the EU will liberalize trade in several agricultural products, in particular cheese, by 2007. However, this appeared unambitious as it would be several years before protection would drop even to the high levels in the EU. Officials emphasized the importance of agriculture for Swiss society but noted that new liberalizing reforms were being prepared for beyond 2007, when the current program expires.

G. Other Issues

40. **Ties with the EU have deepened through bilateral agreements**. A first package, including the free movement of labor, took effect in June 2002 and was extended to the new EU member states following a referendum in September 2005. A second package—including the EU savings directive—was signed in October 2004 and associate Schengen membership was approved in a referendum in June 2005. The Swiss government plans to present in 2006 a report on strategic medium-term options with the EU. However, the electorate remains very divided over full EU membership.

41. **Officials expressed guarded optimism about the outcome of the Doha round**. They felt that the eventual outcome now depended largely on a compromise that is needed between the largest players. Meanwhile, the authorities were exploring the possibility of bilateral free-trade agreements with several countries, including the U.S., Japan and Canada.

42. **Switzerland provides official development assistance at 0.4 percent of GNI.** Swiss ODA has been praised by DAC for its high level of effectiveness and strong focus on poor countries. Switzerland has also reduced duties on agricultural imports from LDCs and supports the Multilateral Debt Relief Initiative.



43. Switzerland underwent an AML/CFT assessment in April 2005 by members of the Financial Action Task Force Secretariat and FATF experts. The report is available on the FATF website and the authorities are following up on its recommendations.

44. Some deficiencies in the timeliness of economic statistics remain (Appendix II).

IV. Staff Appraisal

45. **Growth prospects for 2006 are favorable and risks appear contained.** The economy emerged from 2005 with momentum and is expected to grow over 2 percent—thereby closing the output gap in 2006. Although the gradual recovery in the euro area provides a favorable backdrop for Switzerland, there are some risks—most notably if a disorderly unwinding of global imbalances were to occur. Headline inflation is projected to remain slightly over 1 percent, despite the rise in oil costs and sustained supportive monetary conditions, thanks also to slowly improving competition in domestic markets.

46. **The recovery provides an important opportunity to advance structural reforms to boost long-run potential growth**. Despite welcome progress, the reform agenda remains large. The adoption of the "Cassis de Dijon" principle on a broad basis would improve competitiveness and significantly benefit consumers. Farming could be supported by less distortive instruments than quotas and steep import tariffs that keep food prices high. Reforms in network industries should be accelerated and their regulatory framework strengthened.

47. **The key task of the Swiss National Bank is to assure that inflation expectations remain firmly anchored.** Therefore, monetary policy needs to move gradually to a neutral stance as the output gap is closing. The appropriate pace of monetary tightening needs to be gauged carefully against key economic indicators, while allowing benefits from reforms and increased productivity, as they occur, to lift growth. This should not undermine the expansion. The SNB needs to remain flexible, as in recent years, with willingness to act promptly and decisively, in symmetrical fashion, if signs emerge of price pressures, or if exchange rate volatility disturbs monetary conditions (e.g. a safe-haven shock to the franc).

48. **The monetary policy framework is functioning well.** Its institutional underpinnings could be further strengthened by severing the link between rents and interest rates. Linking social security funding to SNB profits should be avoided.

49. **The franc exchange rate is determined by market forces and is now below its long-run level marked by gradual appreciation.** Faster growth and the normalization of policy interest rates are expected to strengthen the franc, while success with domestic reforms could depreciate somewhat the equilibrium real exchange rate, at least for a transition period. Competitiveness is strong and the gradual appreciation is expected to resume over the medium term.

50. **Fiscal performance improved in 2005, and should consolidate further in 2006.** The fiscal impulse was neutral, with monetary policy largely on hold—this policy mix was appropriate. Building on the success of the debt brake mechanism, and recent adjustment packages, the federal accounts should be in structural balance by 2007. Gradual consolidation should also continue in the subnational governments.

51. **Fiscal challenges are of a medium-term nature, related to the combined effects of moderating potential growth and expenditure pressures from aging.** The federal debt brake mechanism is working well, but is best equipped to deal with cyclical pressures and does not appear sufficiently robust to withstand structural fiscal pressures. The authorities are appropriately framing a set of potentially far-reaching and innovative structural fiscal reforms to begin containing the deficits in social programs. Reaching consensus on such bold structural fiscal reforms is not easy, however, and will require effective coordination with cantons and communities in Switzerland's highly autonomous—and successful—federalism, and extensive discussion with the public.

52. **The authorities' commitment to preparing a Long-Run Fiscal Sustainability Report is welcome and could help to forge the needed consensus.** A Sustainability Report that clearly sets out a baseline scenario showing the extent of the task, and presents policy options and a tentative time table for their implementation can be very valuable in this respect.

53. **The Fiscal Sustainability Report could usefully include a preliminary intertemporal public sector balance sheet.** Containing an estimate of the net present value of future implicit liabilities under the welfare state, the balance sheet would help to communicate the need for action, allow an assessment of what assets are vital for the functioning of the state, and provide information on the long-run benefits from real and fiscal structural reforms.

54. **The financial sector appears healthy and well placed to support growth.** Profitability and balance sheets are favorable, and the system is effectively supervised and regulated. Though global imbalances pose risks, especially for internationally active institutions, their defenses are strong. Domestically, supervisors should continue to monitor closely lending standards, interest rate and credit risks, and risk transfers as interest rates begin to rise. The introduction of the *Swiss Solvency Test* should bring significant benefits to insurance, and the activation of integrated supervision (FINMA) should strengthen cohesion and effectiveness of supervision and regulation.

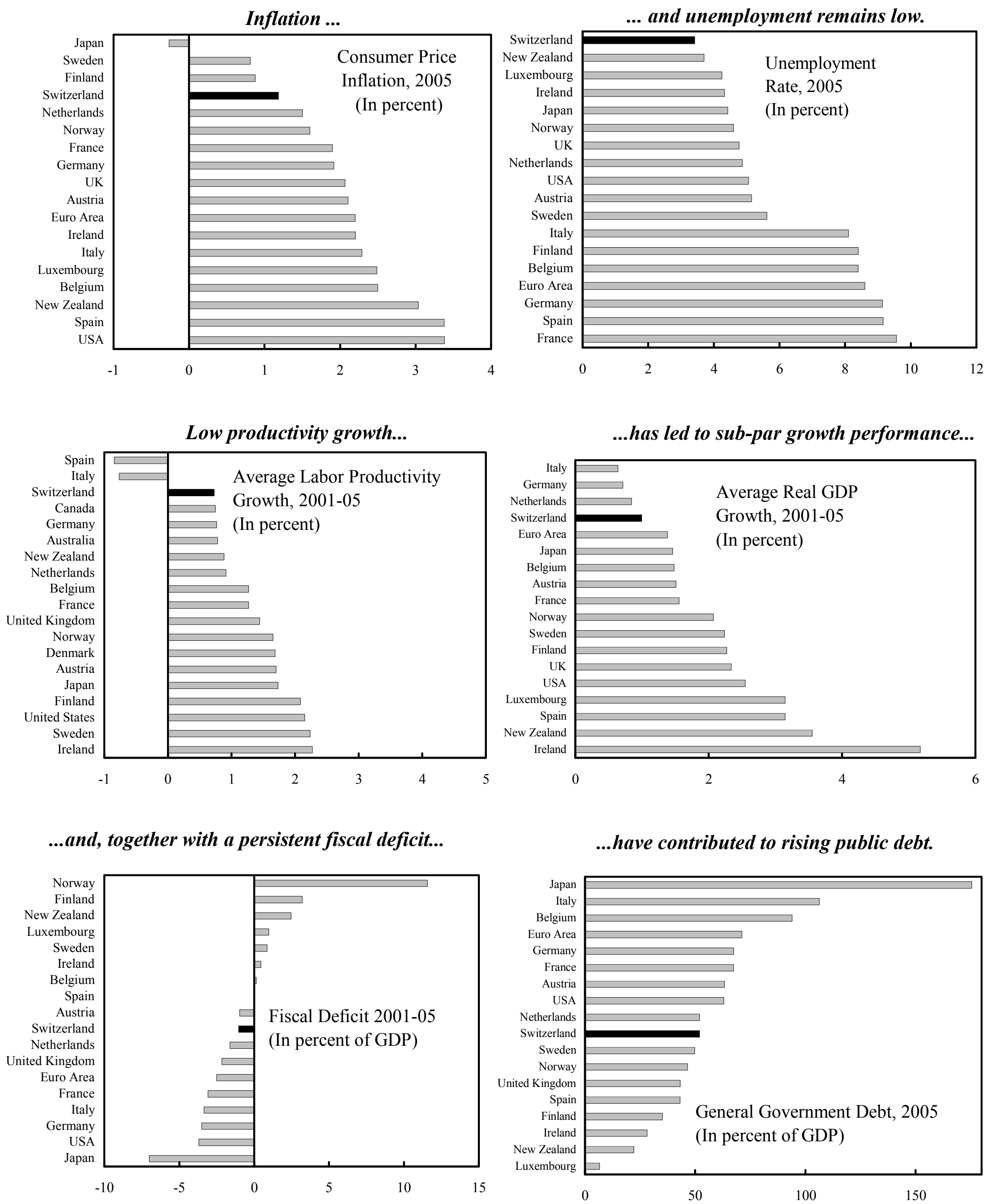
55. **The financial position of the second pillar pension schemes has improved, but underfunding remains**. It would be important to remove the various regulatory restrictions including on the discount rate, the guaranteed rate of return, and the conversion rate on the liabilities side; and constraints on asset allocation that could weaken returns and risk management capabilities. In supervision, consideration should be given to unifying the regulatory and supervisory frameworks across cantons, introduce risk-based supervision, and strengthen disclosure requirements.

56. **Economic policy could benefit from more timely statistics.** Fiscal data for subnational governments have long delays, making monitoring difficult.

57. **Switzerland's comparatively high level of ODA is welcome.** Poor countries could also benefit from additional efforts to reduce agricultural protection.

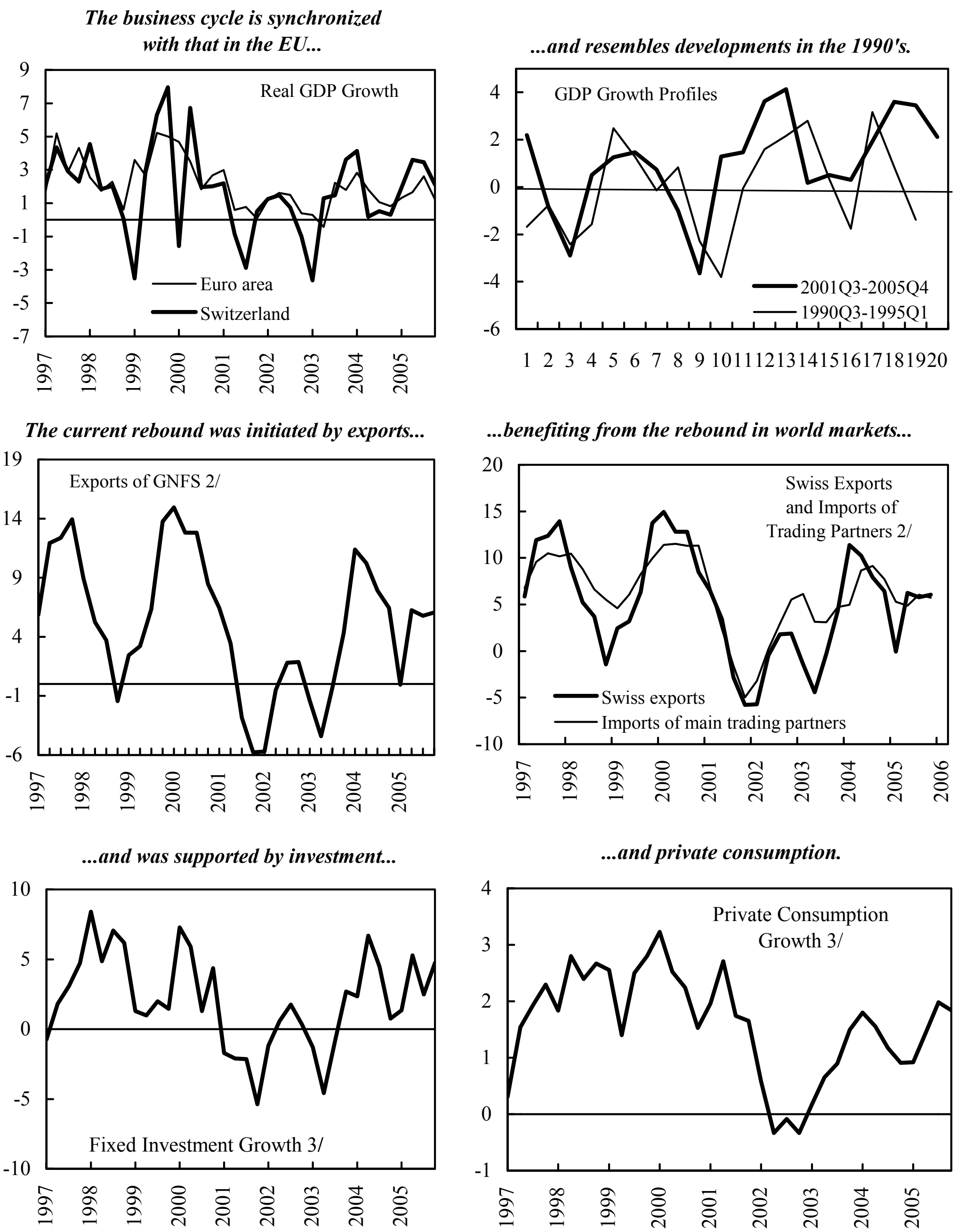
58. It is recommended that the next Article IV consultation with Switzerland be held on the standard twelve-month cycle.

Figure 1. Main Economic Indicators in International Perspective



Sources: IFS; OECD; and WEO.

Figure 2. Switzerland: The Recovery is Underway 1/



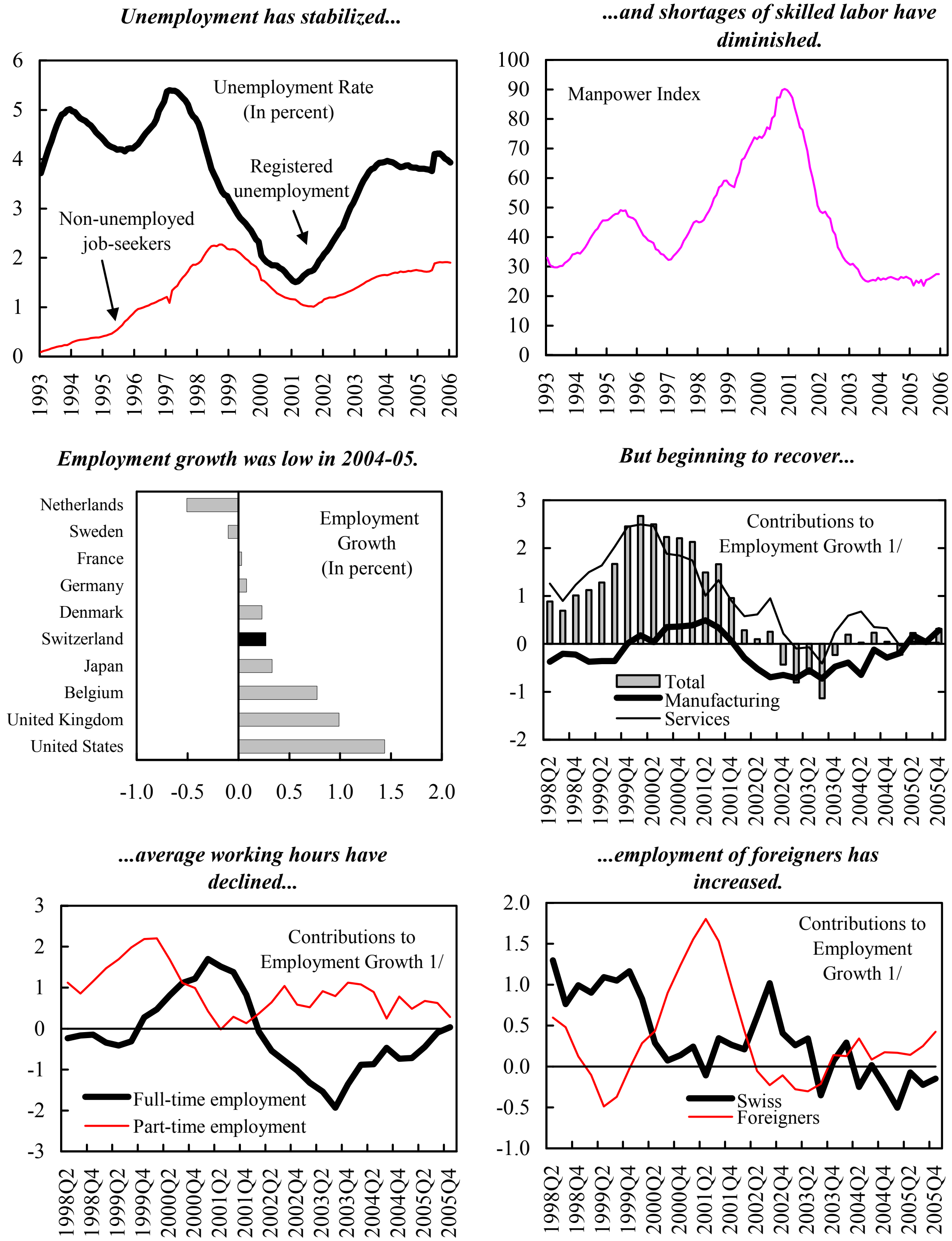
Source: SECO; and IMF, World Economic Outlook.

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

2/ Year-on-year percent change of goods and non-factor services.

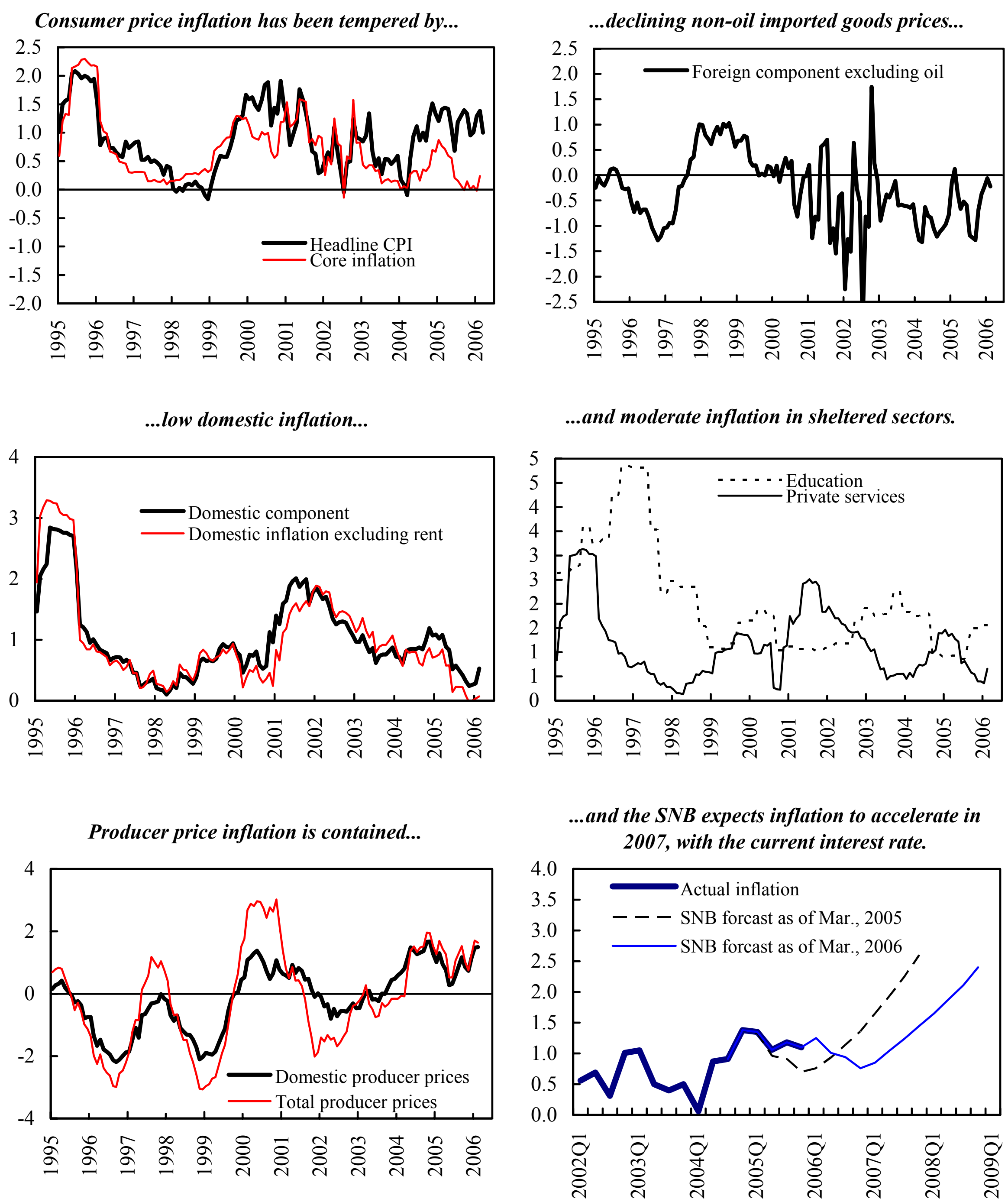
3/ 4-quarter moving average of annualized growth rates in percent.

Figure 3. Switzerland: The Labor Market



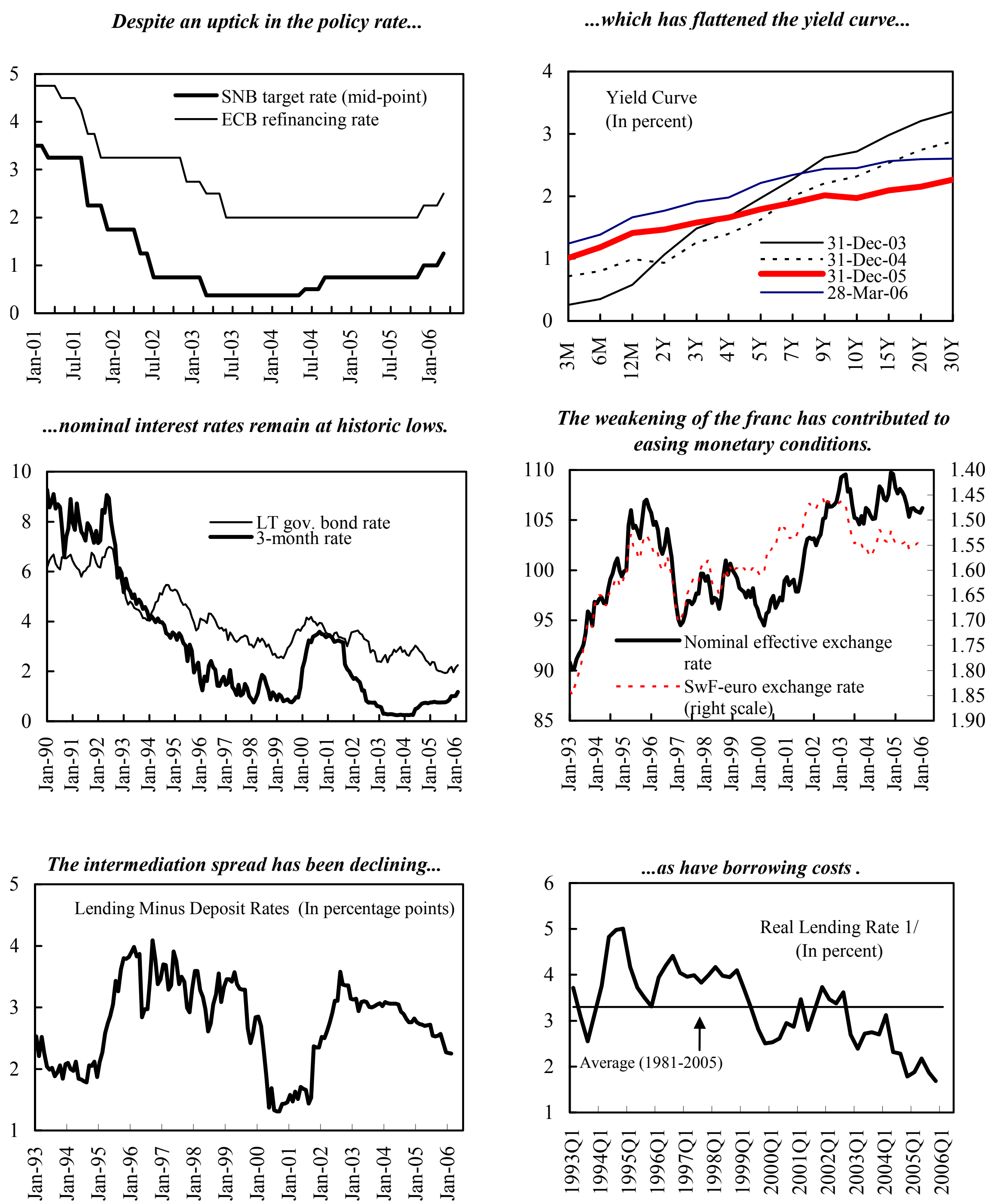
Sources: IMF, World Economic Outlook; and KOF Institute.
1/ Percentage points.

Figure 4. Switzerland: Inflation is Low
(12-month percent change)



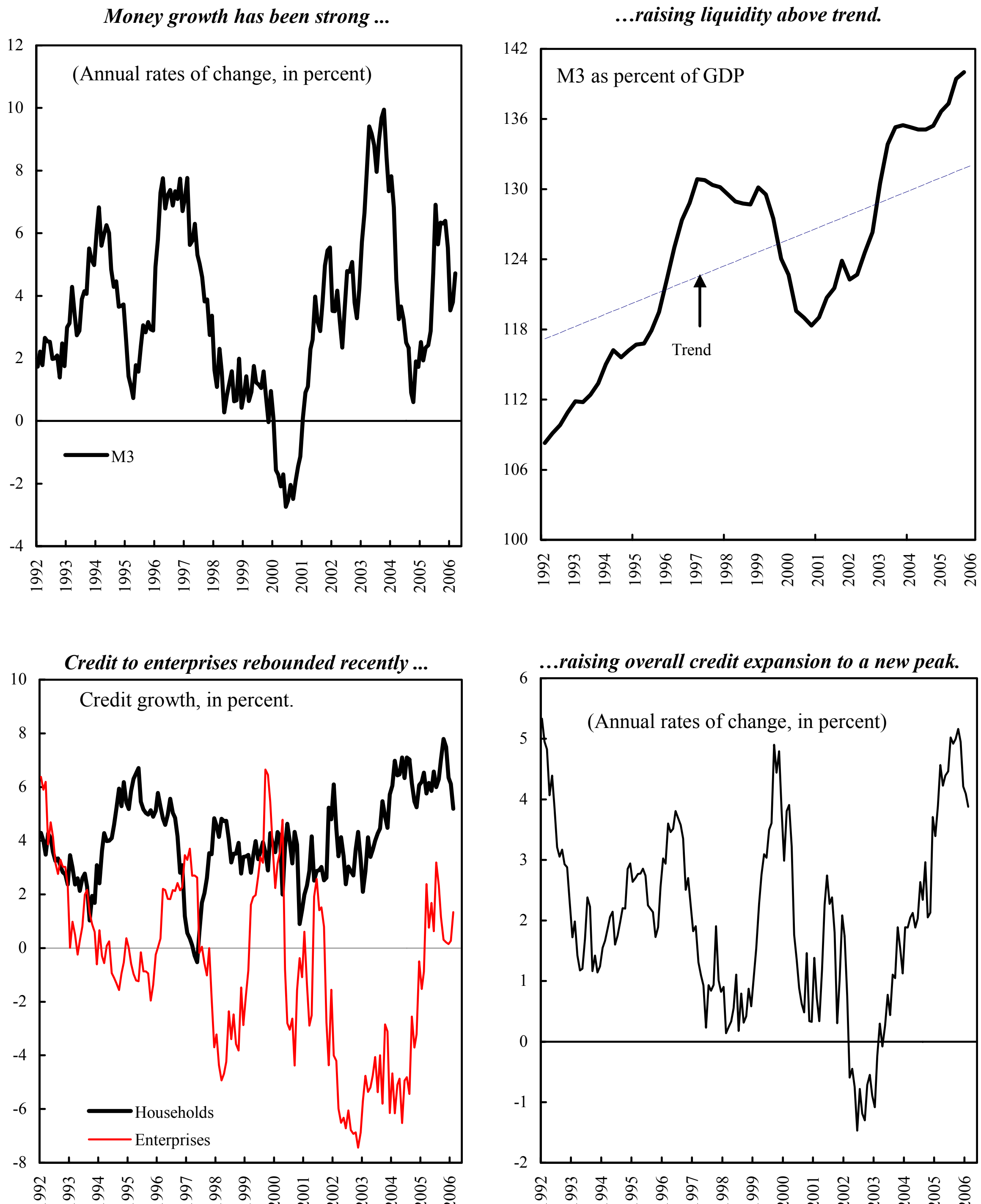
Source: KOF database.

Figure 5. Switzerland: Monetary Conditions Remain Supportive



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

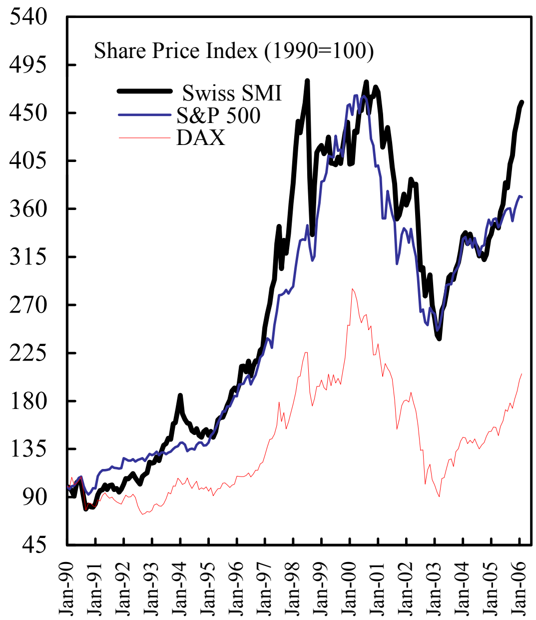
Figure 6. Switzerland: Money and Credit Aggregates Have been Growing Robustly



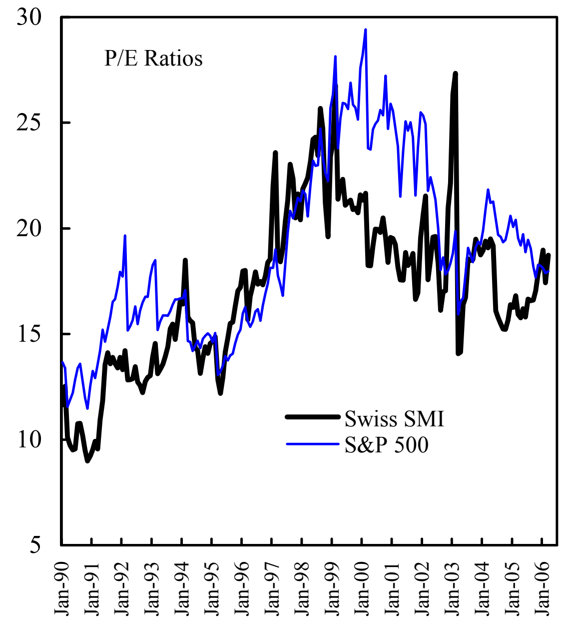
Source: IMF, World Economic Outlook; and KOF Institute.

Figure 7. Switzerland: Asset Prices

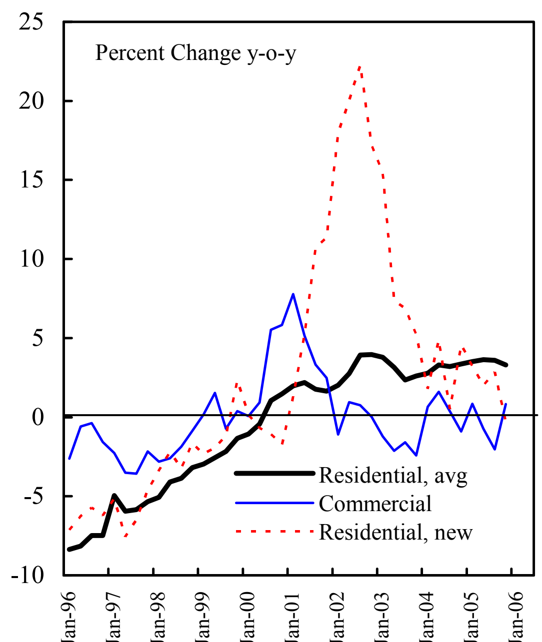
Equity prices now outpace the S&P 500....



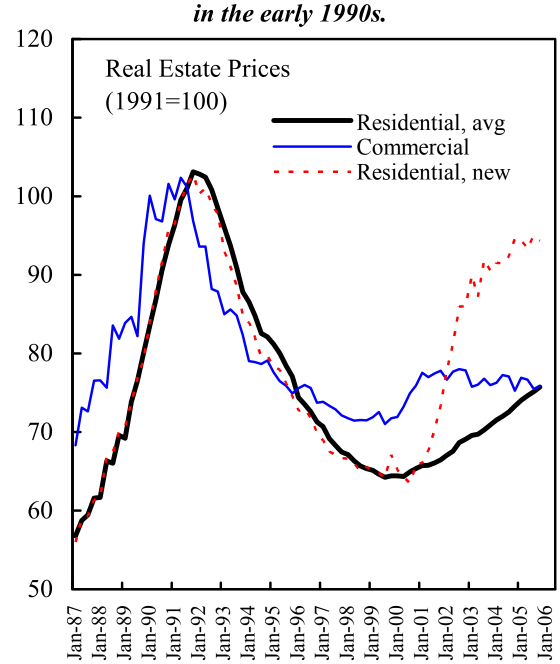
...and the P/E ratio remains above its historical average.



Growth in real estate prices is subdued...

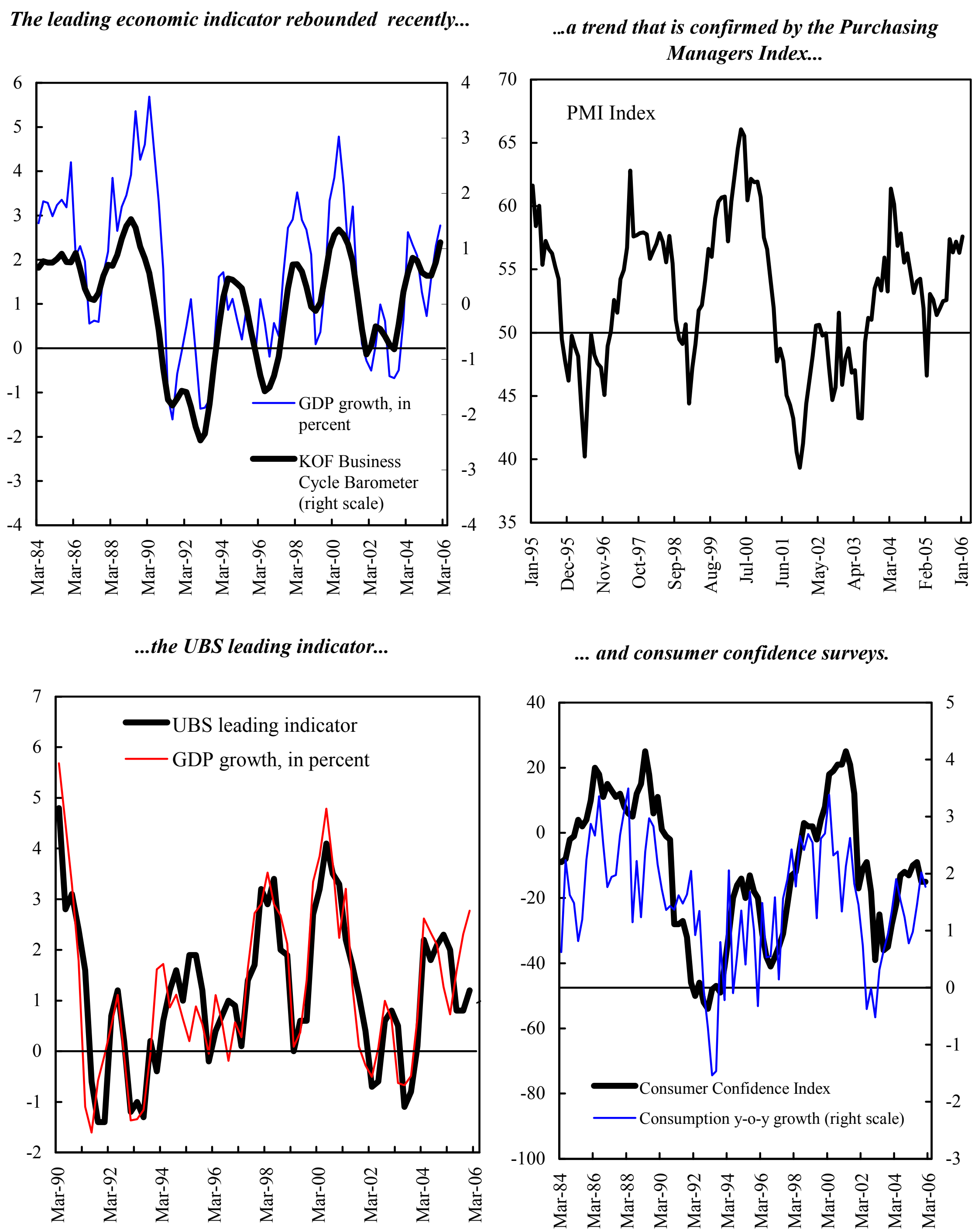


...current price levels remain below their peak in the early 1990s.



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

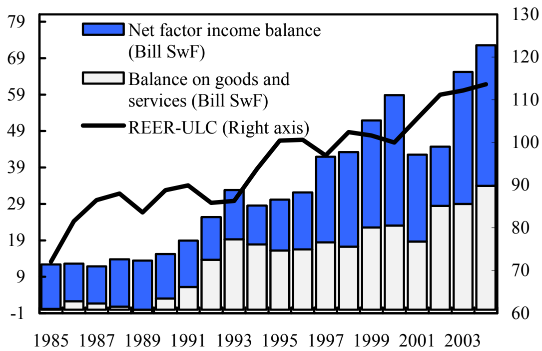
Figure 8. Switzerland: Leading Indicators Suggest that the Recovery will Continue



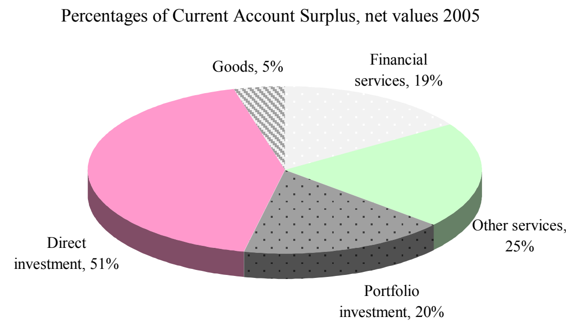
Sources: KOF database; and Bloomberg.

Figure 9. Switzerland: External Competitiveness

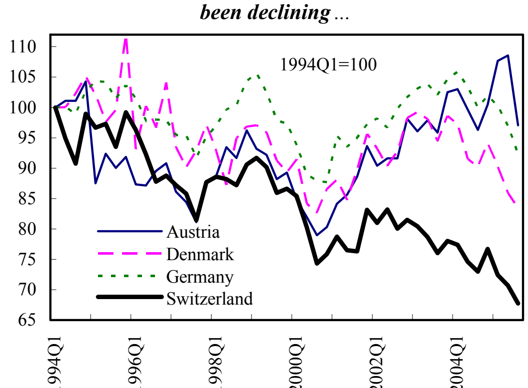
The current account surplus has increased, despite some real appreciation on ULC terms ...



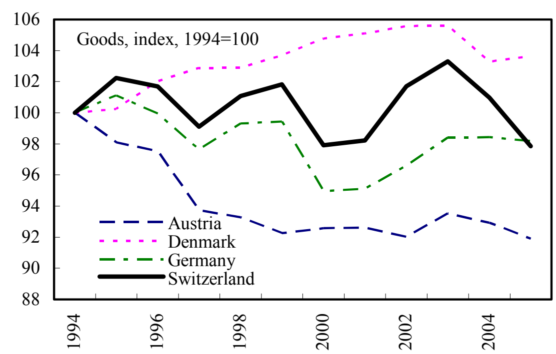
...since the higher surplus arises mostly from strong net financial and other services performance, and net investment income.



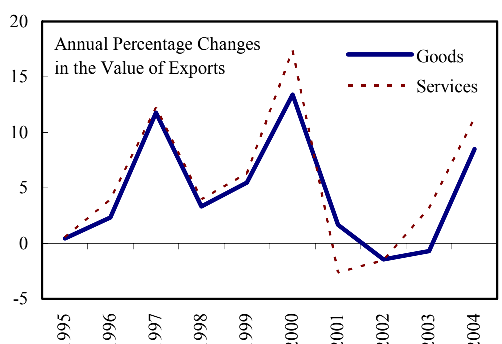
However, the Swiss goods market share has been declining ...



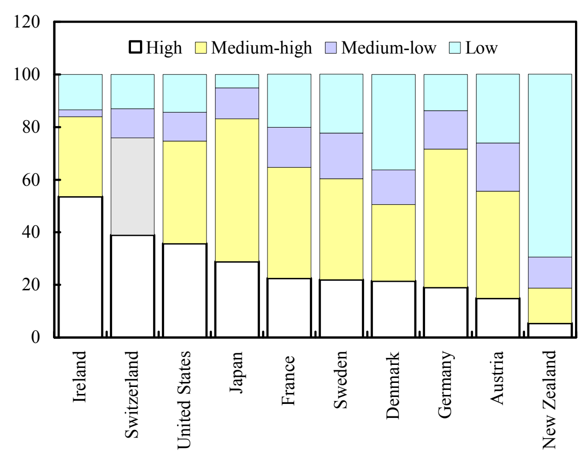
...and the terms of trade have stagnated.



Nonetheless, the goods exports sector remains competitive...

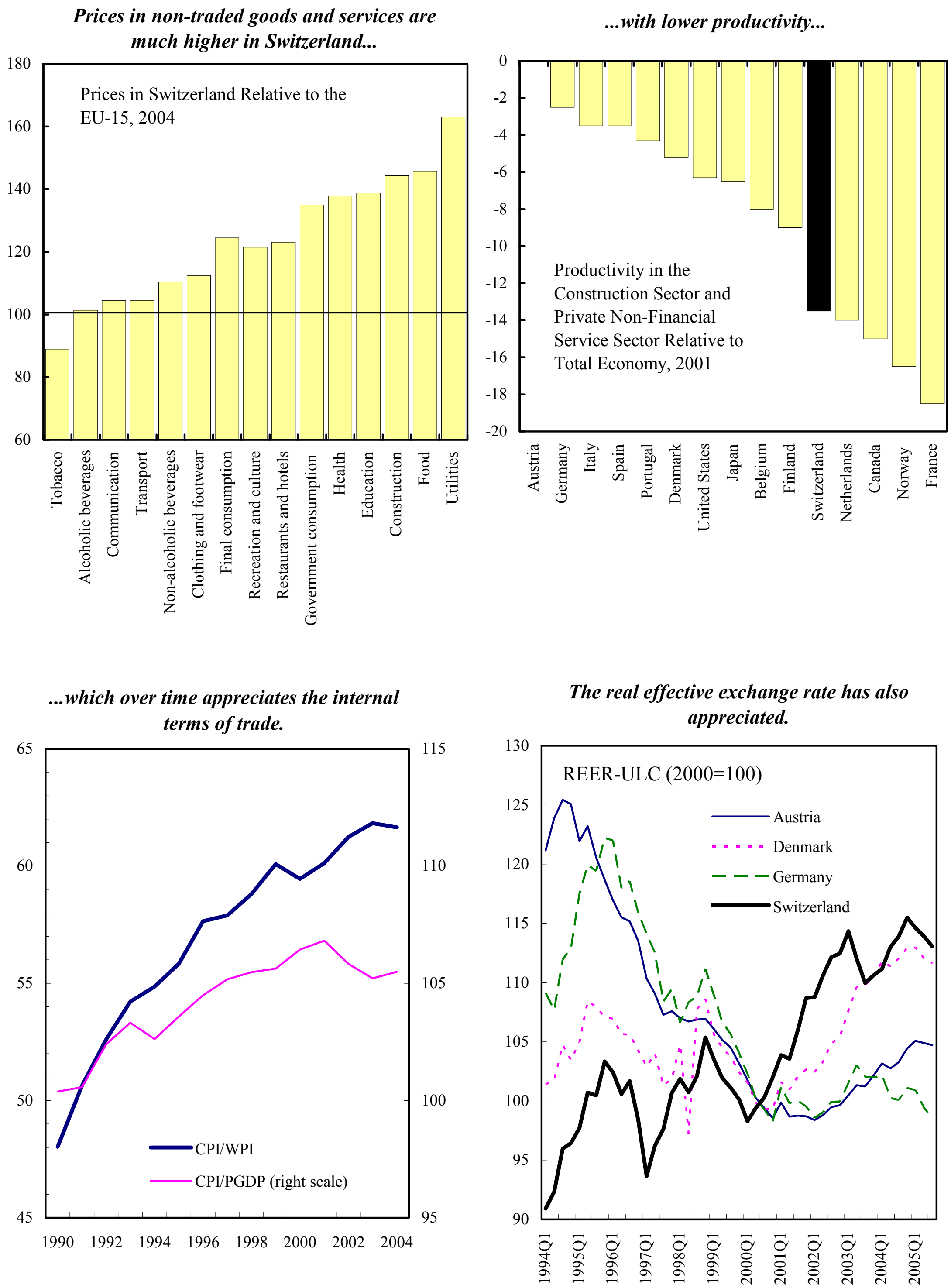


...and it has the second highest share of high technology exports in the world.



Sources: Direction of Trade database, IFS, OECD, SNB, WEO, and IMF staff calculations.

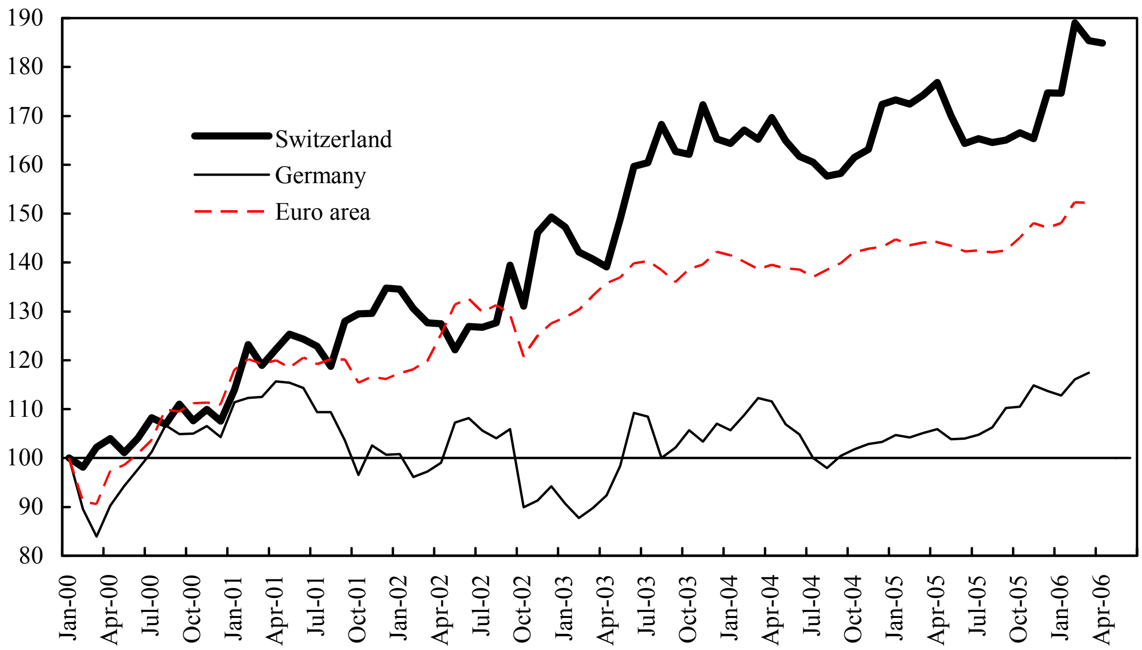
Figure 10. Switzerland: Structural Reforms and Real Exchange Rate Appreciation



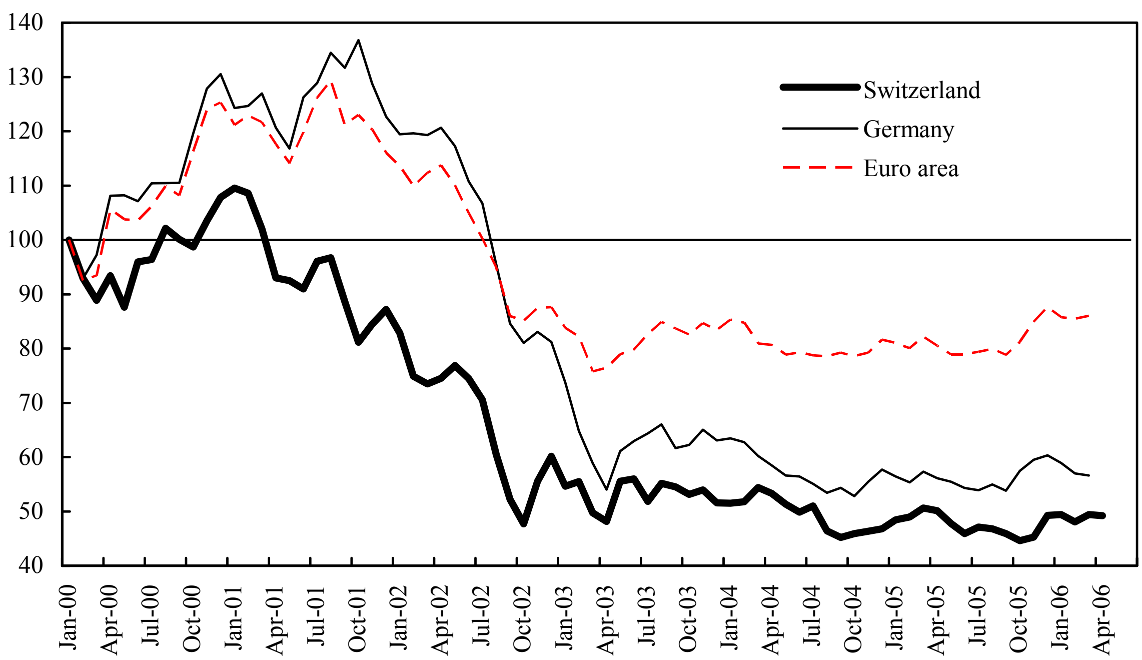
Sources: OECD, WEO and IMF staff calculations.

Figure 11. Equity Prices for Bank and Insurance Sectors
(As ratio to total market index; January 2000 = 100)

Banks' relative share prices have picked up...

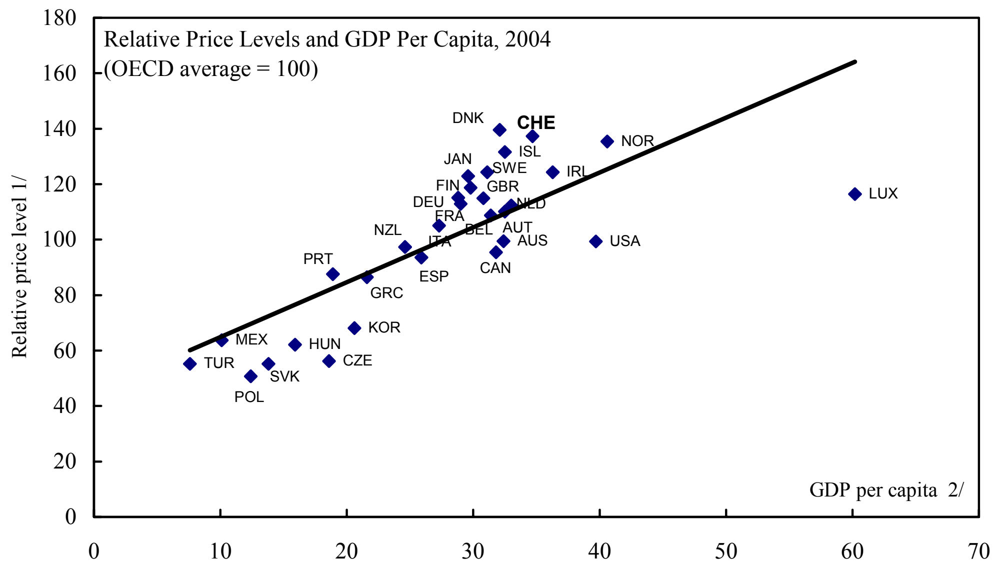


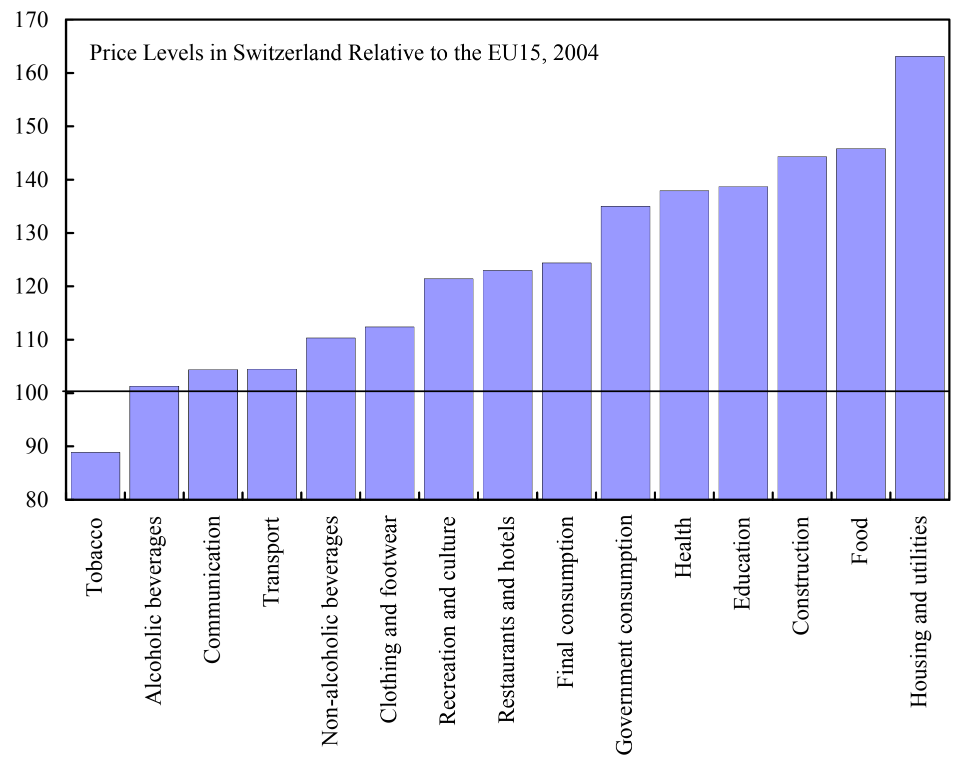
...but those of the insurance sector remain depressed.



Source: Datastream.

Figure 12. The Price Level in Switzerland is High, Even After Adjusting for the Level of Income

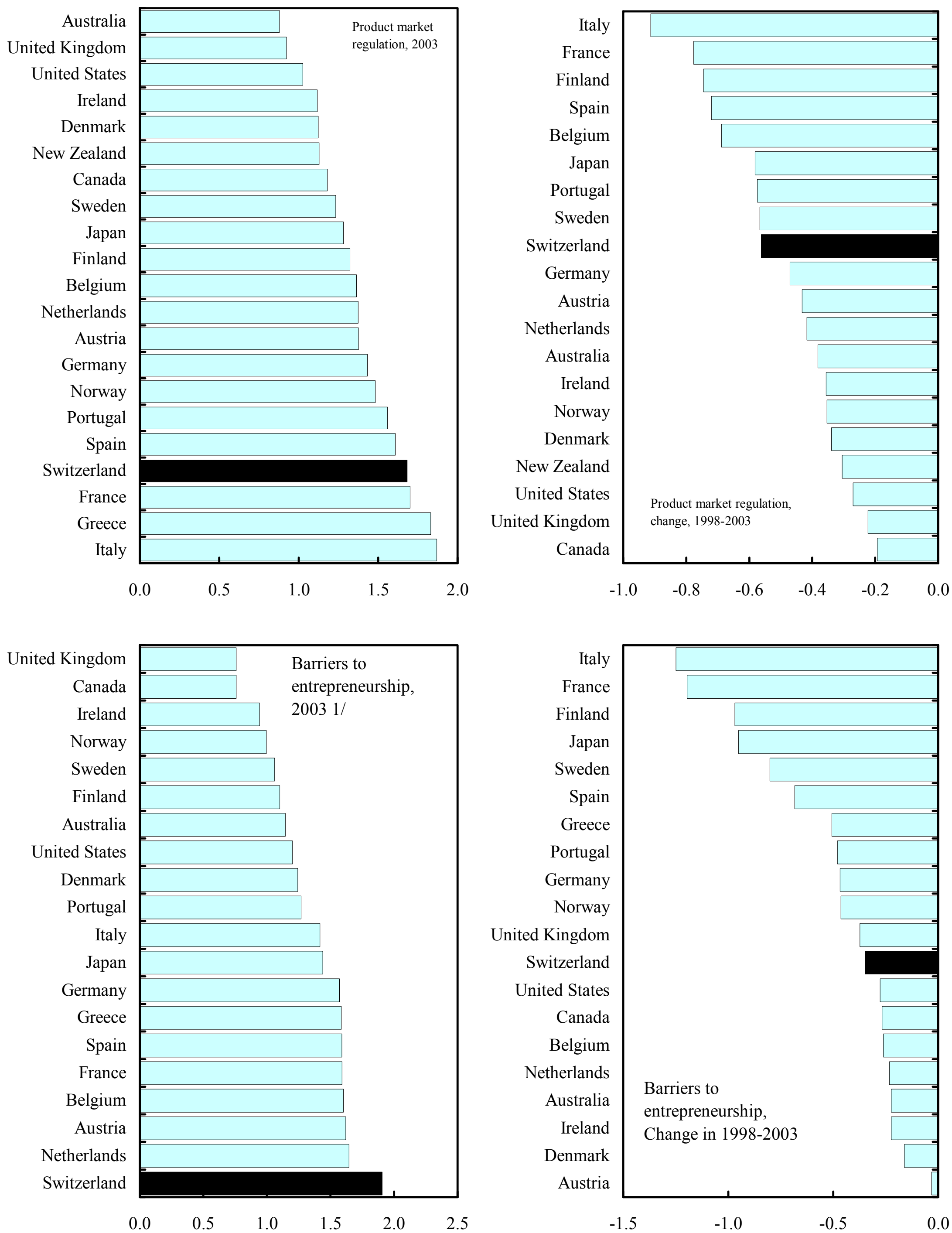




Sources: OECD, Eurostat and IMF staff calculations.
1/Purchasing power parities divided by the exchange rate.
2/In thousand of US dollars converted for PPP.

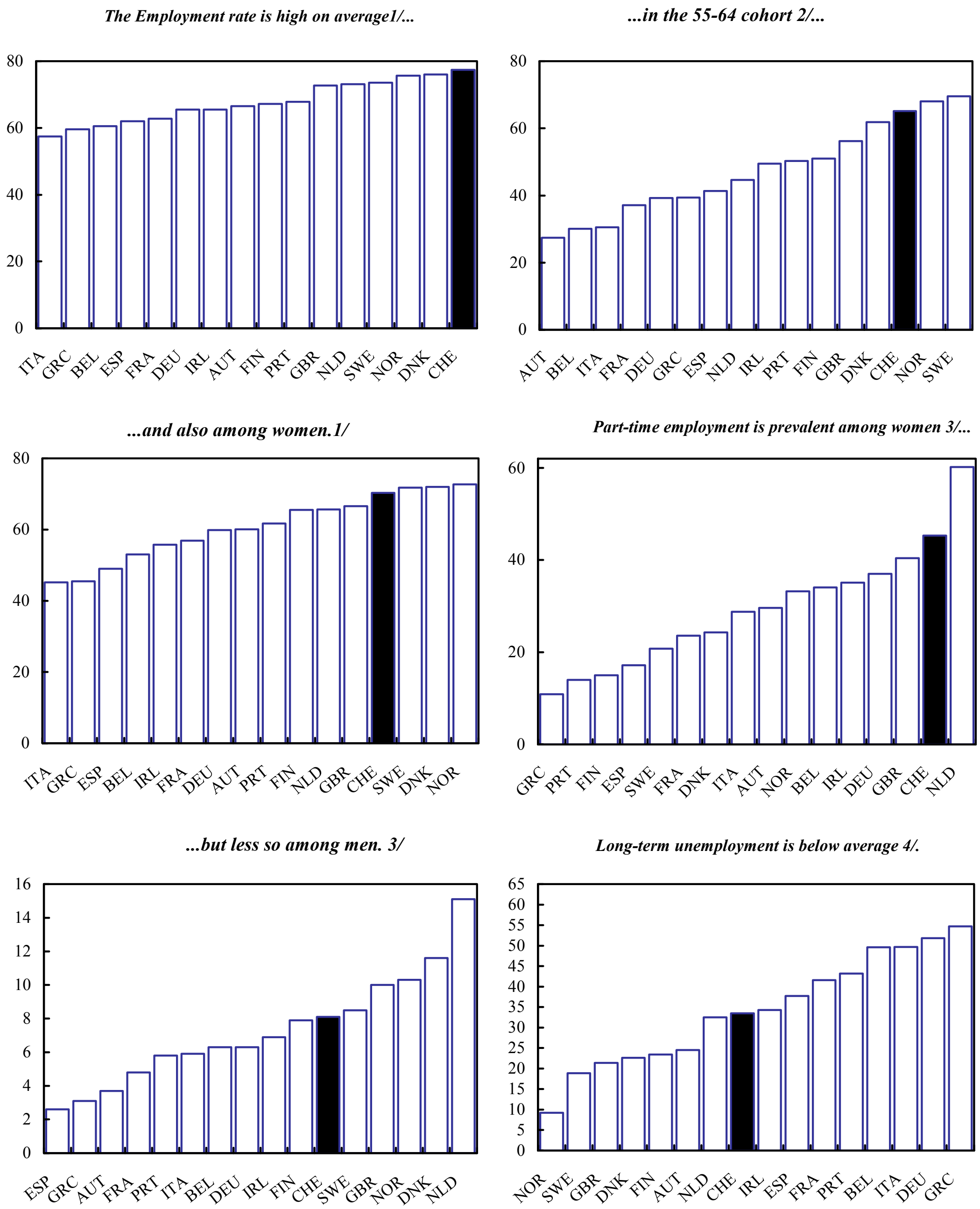
Figure 13. Switzerland: Product Market Regulation, 1998-2003

Regulation is high and coming down slowly.



Source: Conway, P., V. Janod, and G. Nicoletti (2005), "Product Market Regulation in OECD Countries, 1998 to 2003", OECD Economics Department Working Paper, No 419
1/ Mainly due to red tape and cross-cantonal restrictions (regulatory segmentation).

Figure 14. Switzerland: Labor Market Indicators, 2004



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

Table 1. Switzerland: Basic Data

Area and population			
Total area	41,293 square kilometers	GDP per capita (2005)	50,483
Total population (end-2005)	7.3 million	GNP per capita (2005)	53,532

	2000	2001	2002	2003	2004	2005	2006 1/	2007 1/	2008 1/
	(Percentage changes at constant prices, unless otherwise indicated)								
Demand and supply									
Total domestic demand	2.2	2.3	-0.5	0.5	1.1	2.0	2.1	1.7	1.4
Private consumption	2.3	2.0	0.0	0.8	1.4	1.6	1.8	1.7	1.6
Public consumption	2.6	4.2	1.7	2.2	1.4	1.3	1.2	1.3	1.2
Gross fixed investment	4.3	-3.1	0.3	-1.4	3.3	3.1	3.4	2.3	1.4
Final domestic demand	2.8	1.0	0.2	0.5	1.8	1.9	2.1	1.8	1.5
Inventory accumulation 2/	-0.6	1.2	-0.7	0.0	-0.7	0.2	0.0	0.0	0.0
Foreign balance 2/	1.5	-1.2	0.7	-0.7	1.0	-0.1	0.2	0.1	0.3
Exports of goods and nonfactor services	12.2	0.2	-0.7	-0.5	8.9	4.5	5.4	4.6	4.8
Imports of goods and nonfactor services	9.6	3.2	-2.6	1.3	7.4	5.3	5.5	5.0	4.7
GDP	3.6	1.0	0.3	-0.3	2.1	1.9	2.2	1.7	1.7
GNP	5.2	-2.0	-1.2	3.3	2.3	1.7	1.6	1.9	2.0
Nominal GDP (billions of SwF)	415.5	422.5	430.5	434.6	445.9	456.9	471.8	485.1	499.2
Employment and unemployment									
Employment (percent change)	1.0	1.6	0.4	-0.2	0.2	0.1	0.6	0.4	0.4
Unemployment rate (in percent)	1.8	1.7	2.5	3.7	3.9	3.8	3.7	3.6	3.4
Output gap (in percent of potential)	1.8	1.4	0.3	-1.5	-1.0	-0.7	0.0	0.1	0.2
Prices and incomes									
GDP deflator	0.8	0.6	1.6	1.2	0.5	0.6	1.0	1.1	1.2
Consumer price index	1.6	1.0	0.5	0.6	0.8	1.2	1.1	1.2	1.2
Nominal wage growth	1.3	2.5	1.8	1.4	0.9	1.0	1.6	2.3	2.5
Unit labor costs (total economy)	0.8	3.1	1.9	1.5	-0.9	-0.7	0.0	1.0	1.2
	(In percent of GDP)								
General government finances									
Revenue	38.9	37.9	37.4	37.9	37.8	38.0	36.9	37.0	37.0
Expenditure	36.7	37.9	38.6	39.3	39.0	38.5	37.9	37.8	37.7
Balance 3/	2.2	0.0	-1.2	-1.4	-1.2	-0.6	-1.0	-0.8	-0.7
Structural balance 4/	0.6	-0.1	-0.8	-0.5	-0.3	-0.3	-0.6	-0.5	-0.5
Gross debt	49.9	49.4	53.0	53.9	53.7	52.0	50.7	49.6	48.3
	(Percentage changes in annual averages)								
Monetary and credit data									
Broad money (M3)	-1.8	3.1	3.8	8.3	3.2	4.5	...	...	...
Domestic credit	1.7	1.5	-0.5	0.6	2.3	4.5	...	...	...
	(Period averages in percent)								
Interest rates									
Three-month rate	3.1	2.9	1.2	0.4	0.5	0.7	...	...	...
Yield on government bonds	3.8	3.3	3.1	2.5	2.6	2.1	...	...	...
	(In percent of GDP)								
Balance of payments									
Current account	12.4	8.0	8.3	13.3	14.6	13.8	13.7	13.1	13.3
Trade balance	-1.0	-1.1	1.2	1.0	1.5	0.7	0.8	0.3	0.1
Net investment income	10.6	7.8	5.9	10.5	10.9	10.7	10.1	9.9	10.2
Other	2.9	1.3	1.2	1.8	2.2	2.4	2.8	2.9	3.0
	(Levels)								
Exchange rates									
SwF per US$ (annual average)	1.69	1.69	1.56	1.36	1.24	1.25	...	...	...
SwF per euro (annual average)	1.56	1.51	1.48	1.51	1.54	1.55	...	...	...
Nominal effective rate (avg., 1990=100)	100.0	103.7	108.2	108.6	108.4	108.2	...	...	...
Real effective rate (avg., 1990=100) 5/	100.0	102.5	106.3	106.4	105.6	104.0	...	...	...

Sources: IMF, World Economic Outlook database; Swiss National Bank; and Swiss Institute for Business Cycle Research.
1/ Fund staff estimates and projections unless otherwise noted.
2/ Change as percent of previous year's GDP.
3/ Including railway loans as expenditure. In 2005 excludes revenue from gold sales equal to 4.6 percent of GDP.
4/ Excluding privatization proceeds and gold sales; smooths erratic revenue items.
5/ Based on relative consumer prices.

Table 2. Switzerland: General Government Finances

	2000	2001	2002	2003	2004	2005 Prel.	2006 Proj.	2007 Proj.	2008 Proj. 1/
					(In millions of SwF)				
General government									
Revenue 2/	161,816	160,305	161,206	164,723	168,454	173,541	173,909	179,492	184,747
Expenditure	152,655	160,130	166,384	170,772	173,911	176,059	178,639	183,549	188,159
Balance	9,161	176	-5,178	-6,048	-5,457	-2,518	-4,730	-4,056	-3,412
Federal government 3/ 4/									
Revenue 2/	51,994	49,440	47,728	47,511	48,945	51,634	52,390	54,591	56,389
Expenditure 5/	48,208	51,140	51,927	51,284	51,534	52,603	53,491	54,991	56,045
Balance	3,786	-1,700	-4,199	-3,773	-2,590	-969	-1,101	-401	344
Cantons									
Revenue 2/	62,818	65,191	66,290	65,731	67,913	69,000	69,000	71,000	71,900
Expenditure	60,193	63,900	66,591	67,946	68,893	69,750	69,899	71,900	72,800
Balance	2,624	1,291	-301	-2,215	-980	-750	-900	-900	-900
Communes									
Revenue	42,068	43,033	43,651	44,123	44,850	45,750	46,839	47,999	49,283
Expenditure	40,599	41,709	42,498	44,131	45,250	45,501	46,689	47,849	49,133
Balance	1,469	1,324	1,153	-8	-400	250	150	150	150
Social security 6/									
Revenue	42,319	42,102	43,163	48,485	48,122	49,792	49,074	50,509	51,379
Expenditure	41,037	42,842	44,994	48,537	49,609	50,841	51,953	53,415	54,384
Balance	1,282	-740	-1,831	-52	-1,487	-1,049	-2,879	-2,906	-3,005
					(In percent of GDP)				
General government									
Revenue	38.9	37.9	37.4	37.9	37.8	38.0	36.9	37.0	37.0
Expenditure	36.7	37.9	38.6	39.3	39.0	38.5	37.9	37.8	37.7
Balance	2.2	0.0	-1.2	-1.4	-1.2	-0.6	-1.0	-0.8	-0.7
Federal government	0.9	-0.4	-1.0	-0.9	-0.6	-0.2	-0.2	-0.1	0.1
Cantons	0.6	0.3	-0.1	-0.5	-0.2	-0.2	-0.2	-0.2	-0.2
Communes	0.4	0.3	0.3	0.0	-0.1	0.1	0.0	0.0	0.0
Social security	0.3	-0.2	-0.4	0.0	-0.3	-0.2	-0.6	-0.6	-0.6
Memorandum items:									
Structural fiscal balance 7/	0.6	-0.1	-0.8	-0.5	-0.3	-0.3	-0.6	-0.5	-0.5

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

1/ Excludes VAT increase planned for 2008, since it has not yet been approved.
2/ Excludes SNB gold sales transfers of SwF 21 billion, 4.6 percent of GDP, in 2005.
3/ Includes the balance of the Confederation, Railway Infrastructure Financing Fund, and Swiss Federal Institute of Technology.
4/ Excludes revenues from Swisscom share sale (2002: SwF 3,703 million, 2005: SwF 1350 million).
5/ 2004 total expenditures exclude policy reserves of the ETH, Swiss Post, Skyguide (SwF 1,071 million) and capital injection to Skyguide (SwF 50 million).
6/ Includes old age pensions (AHV), disability insurance (IV), unemployment insurance (ALV), and loss of earnings insurance (EO). Excludes subsidies for health care premia (KV), which are included in the federal budget.
7/ Structural balance excludes cyclical and one-off items.

Table 3. Switzerland: Federal Government Finances 1/

	2000	2001	2002	2003	2004	2005 Prel.	2006 Proj.	2007 Proj.	2008 Proj. 2/
	(In millions of SwF)								
Revenue	51,994	49,440	47,728	47,511	48,945	51,634	52,390	54,591	56,389
Current revenue	50,742	46,692	45,921	46,766	48,522	51,354	52,201	54,396	56,189
Taxes	46,492	42,873	42,748	43,281	44,755	47,533	48,645	50,545	52,207
Direct taxes	21,033	16,568	16,765	16,665	17,205	18,916	19,429	20,553	21,234
Indirect taxes	25,459	26,305	25,983	26,616	27,550	28,617	29,216	29,992	30,973
Non-tax revenue 3/ 4/	4,251	3,819	3,173	3,484	3,768	3,821	3,556	3,852	3,982
Capital revenue	1,252	2,748	1,807	745	422	280	189	194	200
Expenditure 5/	48,208	51,140	51,927	51,284	51,534	52,603	53,491	54,991	56,045
Current expenditure	41,651	43,025	44,190	43,149	44,648	46,096	47,138	48,523	49,290
Wages and salaries	5,284	5,815	5,716	5,825	5,830	5,714	5,662	5,645	5,589
Goods and services	5,119	4,862	4,904	4,923	4,336	4,404	4,346	4,301	4,362
Interest payments	3,493	3,398	3,768	3,293	3,172	3,578	3,631	4,038	4,030
Transfers	27,755	28,950	29,803	29,107	31,309	32,401	33,498	34,538	35,310
Capital expenditure	6,557	8,115	7,737	8,135	6,887	6,507	6,353	6,469	6,755
Overall balance	3,786	-1,700	-4,199	-3,773	-2,590	-969	-1,101	-401	344
	(In percent of GDP)								
Revenue	12.5	11.7	11.1	10.9	11.0	11.3	11.1	11.3	11.3
Current revenue	12.2	11.1	10.7	10.8	10.9	11.2	11.1	11.2	11.3
Tax revenue	11.2	10.1	9.9	10.0	10.0	10.4	10.3	10.4	10.5
Non-tax revenue	1.0	0.9	0.7	0.8	0.8	0.8	0.8	0.8	0.8
Capital revenue	0.3	0.7	0.4	0.2	0.1	0.1	0.0	0.0	0.0
Expenditure	11.6	12.1	12.0	11.8	11.6	11.5	11.3	11.3	11.2
Current expenditure	10.0	10.2	10.3	9.9	10.0	10.1	10.0	10.0	9.9
Capital expenditure	1.6	1.9	1.8	1.9	1.5	1.4	1.3	1.3	1.4
Overall balance	0.9	-0.4	-1.0	-0.9	-0.6	-0.2	-0.2	-0.1	0.1
Memorandum item:									
Structural fiscal balance 6/	-0.5	-0.7	-1.1	-0.9	-0.5	-0.4	-0.2	-0.1	0.0

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

1/ Includes the balance of the Confederation, Railway Infrastructure Financing Fund, and Swiss Federal Institute of Technology.
2/ Excludes VAT increase planned for 2008, since it has not yet been approved.
3/ Excludes SNB gold sales transfers of SwF 21 billion, 4.6 percent of GDP, in 2005.
4/ Exclude revenues from Swisscom share sale (2002: SwF 3,703 million, 2005: SwF 1350 million).
5/ 2004 total expenditures exclude policy reserves of the ETH, Swiss Post, Skyguide (SwF 1,071 million) and capital injection to Skyguide (SwF 50 million).
6/ Excludes cyclical and one-off items.

Table 4. Switzerland: Balance of Payments

	2000	2001	2002	2003	2004	2005	2006 1/	2007 1/	2008 1/
	(In billions of SwF, unless otherwise indicated)								
Current account	51.7	33.7	35.7	57.9	65.1	63.0	64.6	63.6	66.4
(In percent of GDP)	12.4	8.0	8.3	13.3	14.6	13.8	13.7	13.1	13.3
Trade balance	-4.2	-4.7	5.1	4.3	6.7	3.3	3.6	1.5	0.5
Service balance	27.3	23.4	23.3	24.7	27.3	28.6	31.2	32.3	33.2
Net investment income	44.0	32.9	25.5	45.7	48.8	49.0	47.7	47.9	50.8
Net compensation of employees	-8.3	-9.1	-9.2	-9.6	-10.2	-10.6	-10.6	-10.6	-10.6
Net private transfers	-3.9	-5.7	-5.7	-4.1	-4.1	-4.2	-4.3	-4.3	-4.4
Net official transfers	-3.2	-3.1	-3.3	-3.2	-3.3	-3.0	-3.0	-3.1	-3.1
Net foreign direct investment	-42.9	-15.9	-2.5	1.2	-34.5	…	…	…	…
Outward	-75.4	-30.8	-12.3	-20.9	-32.4	…	…	…	…
Inward	32.5	14.9	9.8	22.1	-2.1	…	…	…	…
Net portfolio investment	-19.9	-69.1	-35.2	-47.0	-49.7	…	…	…	…
Outward	-37.7	-72.3	-46.6	-44.5	-53.3	…	…	…	…
Inward	17.8	3.2	11.4	-2.5	3.6	…	…	…	…
Net banking sector	11.0	18.0	-26.8	-6.8	16.9	…	…	…	…
Memorandum items:									
Net investment income	44.0	32.9	25.5	45.7	48.8	…	…	…	…
(In percent of GDP)	10.6	7.8	5.9	10.5	10.9	…	…	…	…
Net external assets	463.2	527.3	526.4	525.4	531.2	…	…	…	…
(In percent of GDP)	111.5	124.8	122.3	120.9	119.1	…	…	…	…
Official reserves (billions of US$, end period)	32.3	32.0	40.2	47.7	55.5	...	...	...	...
Reserve cover (months of imports of GNFS)	3.8	3.7	4.4	4.5	4.4	...	...	...	...

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

Table 5. Switzerland: Major Financial Institutions, 2002-05

	2002	2003	2004	2005
Union Bank of Switzerland (SwF millions)				
Profit	3,535	6,239	8,016	14,029
Operating Income	34,121	33,790	42,411	50,975
S&P Credit Ratings	AA+	AA+	AA+	AA+
Credit Swiss Group (SwF millions)				
Profit	-4,448	770	5,628	5,850
Operating Income	47,245	51,353	55,139	60,632
S&P Credit Ratings	AA-	A-1	A-1	A-1
Zurich Financial Services (US$ millions)				
Profit USD millions	-3,362	2,009	2,466	3,214
Operating Income	40,302	57,208	61,214	67,186
S&P Credit Ratings	A	A	A-	A-
Swiss Life (SwF millions)				
Profit 2/	-1,694	233	606	874
Operating Income	20,624	21,088	22,328	21,542
S&P Credit Ratings	A-	A-	A-	A-
Swiss Re (SwF millions)				
Profit (SwF millions)	-91	1,702	2,475	1,451
Operating Income	34,415	36,430	36,093	35,009
S&P Credit Ratings	AA+	AA	AA	AA
Total				
Profit (SwF millions)	-7,921	11,648	19,788	26,199
Profit (percent of GDP)	-1.8	2.7	4.4	5.7
Operating Income (SwF millions)	199,019	219,648	231,999	251,678
Operating Income (percent of GDP)	46.2	50.5	52.0	55.1

Source: Company reports; and IMF staff calculations.

Table 6. Switzerland: Financial Soundness Indicators

	1999	2000	2001	2002	2003	2004	2005
Banks							
Capital adequacy							
Regulatory capital as percent of risk-weighted assets	11.6	11.7	12.2	12.3	12.6	12.5	12.2
Regulatory Tier I capital to risk-weighted assets	10.3	10.7	11.8	12.2	12.6	11.8	11.2
Non-performing loans net of provisions as percent of tier I capital	5.0	2.7	2.5	0.7	-0.6	-2.8	-1.7
Asset quality and exposure							
Non-performing loans as percent of gross loans	2.7	2.4	2.3	1.9	1.4	0.9	0.5
Sectoral distribution of bank credit to the private sector (percent)1/							
Households	56.7	57.3	58.1	60.8	63.7	65.2	66.6
Agriculture and food industry	1.5	1.5	1.4	1.3	1.3	1.3	1.2
Industry and manufacturing	5.0	4.7	4.7	4.5	4.1	3.7	3.4
Construction	3.4	2.9	2.7	2.5	2.2	2.1	1.9
Retail	5.5	5.2	5.0	4.6	4.1	3.7	3.6
Hotels and restaurants / Hospitality sector	2.0	1.7	1.7	1.6	1.5	1.4	1.3
Transport and communications	1.5	1.2	1.2	1.1	1.1	1.1	1.1
Other financial activities	3.8	3.7	3.9	3.0	2.2	2.2	2.4
Insurance sector	0.8	1.1	1.0	0.7	0.5	0.5	0.4
Commercial real estate, IT, R&D	12.8	13.3	12.8	12.5	12.3	12.2	12.1
Public administration (excluding social security)	3.1	3.5	3.6	3.5	3.3	3.1	2.6
Education	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Healthcare and social services	1.5	1.4	1.4	1.4	1.3	1.3	1.3
Other collective and personal services	1.7	1.7	1.7	1.6	1.5	1.5	1.5
Other 2/	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Earnings and profitability							
Gross profits as percent of average assets (ROAA)	0.7	1.0	0.5	0.3	0.5	0.7	0.7
Gross profits as percent of average equity capital (ROAE)	14.8	18.5	8.3	5.1	9.5	13.0	14.3
Net interest income as percent of gross income	32.1	34.4	37.2	37.6	42.9	38.6	32.8
Non-interest expenses as percent of gross income	61.1	61.4	67.8	66.6	67.8	67.1	62.8
Liquidity							
Liquid assets as percent of total assets	25.2	25.9	25.3	24.1	28.1	26.0	25.3
Liquid assets as percent of short-term liabilities	89.2	80.7	72.0	71.6	77.5	71.9	69.1

Source: Swiss National Bank.

1/ As percent of total credit to the private sector.
2/ Mining and extraction, production and distribution of electricity, natural gas and water, financial intermediation,

Table 7. Switzerland: Encouraged Set of Financial Soundness Indicators

	1999	2000	2001	2002	2003	2004	2005
Banking sector							
Capital adequacy							
Capital as percent of assets (leverage ratio) 1/	4.4	5.9	5.6	5.5	5.7	5.3	5.1
Asset quality and exposure							
Foreign currency loans as percent of total loans	48.0	51.1	55.6	48.4	48.0	48.0	46.6
Foreign currency liabilities as percent of total liabilities	56.4	57.0	59.1	57.9	57.6	60.7	64.3
Geographical distribution of bank credit as percent of total bank credit							
Switzerland	...	...	64.9	65.1	68.0	64.6	59.0
EMU countries	...	...	5.3	4.9	4.7	4.7	5.2
Other developed countries	...	...	20.9	21.2	16.7	18.9	22.6
Central and eastern European countries	...	...	0.5	0.4	0.5	0.5	0.5
Emerging markets and developing countries	...	...	8.5	8.4	10.2	11.3	12.7
Earnings and profitability							
Trading income as a percent of gross income	19.8	20.3	15.2	13.3	7.8	12.7	17.0
Personnel expenses as percent of non-interest expenses	57.6	57.2	56.8	57.0	59.7	60.8	60.6
Liquidity							
Customer deposits as percent of total (non-interbank) loans	94.9	79.8	81.3	81.6	81.8	81.1	80.0
Exposure to derivatives							
Gross asset position in derivatives as a percentage of tier I capital	174.7	146.5	174.9	242.1	244.8	263.5	261.0
Gross liability position in derivatives as a percentage of tier I capital	203.0	159.8	174.8	246.0	261.3	289.2	283.6
Pension funds							
Under-funding as percent of total liabilities	...	...	...	22.6	19.6	...	...
Share of underfunded funds as percent of all pension funds	...	...	...	19.8	11.9	...	...
Households							
Household debt to banks as a precentage of GDP	116.0	114.0	114.9	116.9	122.3	...	...
Household debt service and principal payments to income (percent)							
Corporate sector							
Total debt to equity (percent, without financial corporations)	49.3	43.9	54.2	63.8	59.0	...	...
Real estate markets							
Annual increase of real estate prices	0.0	1.5	3.1	5.6	4.9	2.6	1.8
Mortgage loans as percent of total loans	23.2	25.8	27.9	53.9	27.9	26.7	25.1

Sources: Swiss National Bank; and Social Security Administration.
1/ Simple ratio of capital to total assets, without risk weighting.

Table 8. Switzerland: Structure of the Financial System

	1999	2000	2001	2002	2003	2004	2005
	(Number of institutions)						
Banks	372	375	369	356	342	338	337
Cantonal banks	24	24	24	24	24	24	24
Large banks	3	3	3	3	3	3	2
Regional and savings banks	106	103	94	88	83	83	79
Raiffeisen banks	1	1	1	1	1	1	1
Other banks	200	204	205	200	190	188	189
Trading banks	16	13	12	11	9	8	7
Stock exchange banks	54	57	61	62	55	53	56
Other banks	7	7	7	5	4	4	4
Foreign controlled banks	123	127	125	122	122	123	122
Branches of foreign banks	21	23	25	25	26	25	28
Private banks	17	17	17	15	15	14	14
Insurance companies - Life	30	28	29	24	24	24	…
Insurance companies - General	101	101	106	123	124	124	…
Pension funds	…	9,096	…	8,134	…	…	…
Concentration							
Banks 2/	67	63	64	64	63	66	67
	(In SwF billions)						
Assets							
Banks	2,244	2,125	2,227	2,252	2,237	2,491	2,846
Cantonal banks	296	303	305	313	311	314	327
Large banks	1,505	1,340	1,416	1,444	1,409	1,644	1,910
Regional and savings banks	74	76	78	79	81	81	84
Raiffeisen banks	66	77	82	93	102	106	108
Other banks	266	291	312	290	302	314	382
Trading banks	53	55	53	41	42	43	45
Stock exchange banks	64	71	69	81	83	86	106
Other banks	3	3	3	3	3	4	3
Foreign controlled banks	146	162	187	166	174	182	228
Branches of foreign banks	22	19	17	16	16	15	17
Private banks	15	18	17	16	17	17	17
Insurance companies - Life	284	291	300	301	311	303	…
Insurance companies - General	423	447	495	507	530	536	…
Pension funds	…	491	…	441	…	…	…
Deposits							
Banks	988	885	937	932	974	1,044	837
Cantonal banks	152	153	155	164	169	180	74
Large banks	601	491	529	506	526	577	424
Regional and savings banks	44	44	45	46	50	51	47
Raiffeisen banks	46	49	53	59	65	71	69
Other banks	131	135	143	142	149	153	134
Trading banks	35	34	33	25	26	**27**	27
Stock exchange banks	35	36	37	46	49	47	27
Other banks	1	2	2	2	2	2	2
Foreign-controlled banks	59	64	71	69	72	76	78
Branches of foreign banks	3	2	2	2	2	2	5
Private banks	10	11	11	12	13	11	4

Source: Swiss National Bank.

1/ Credit institutions governed by the Swiss law, including those with Swiss-majority and foreign-majority shareholdings.
2/ Share in percent of three largest banks in total assets of the sector.

Switzerland: Fund Relations
(As of March 31, 2006)

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

		SDR Million	% Quota
II.	**General Resources Account:**	SDR Million	% Quota
	Quota	3,458.50	100.00
	Fund holdings of currency	3,073.90	88.88
	Reserve position in Fund	384.64	11.12
III.	**SDR Department:**	SDR Million	% Allocation
	Holdings	5.58	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. Switzerland's exchange system is free of restrictions on the making of payments and transfers for current international transactions. However, in accordance with UN Security Council resolutions, Switzerland has frozen the financial assets and economic resources of persons and entities associated with the Taliban, Osama bin Laden and Al Qaeda, as well as those of the former regimes in Iraq, Liberia, Sudan, Democratic Republic of Congo, and Côte d'Ivoire, and specific individuals and entities suspected of involvement in the bombing that killed former Lebanese Prime Minister Hariri. Furthermore, in accordance with identical measures taken by the European Union, Switzerland has frozen the financial assets and economic resources of certain persons related to the former regime in the Federal Republic of Yugoslavia, as well as those of certain persons with important government functions in Myanmar and Zimbabwe. In addition to the asset freeze, the Swiss regulations usually also include a prohibition to make available to the targeted persons or entities, directly or indirectly, financial assets or economic resources. These restrictions have been notified to the Fund.

VIII. **Article IV Consultations:**
Switzerland is on the standard 12-month Article IV consultation cycle.

IX. **Technical Assistance:** None

X. **Resident Representatives:** None

XI. **Other** FSAP, October 2001

Switzerland: Statistical Issues

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

- the SNB does not compile a monetary survey;
- reliable general government finance statistics appear with considerable lags, mainly due to delays in compiling fiscal accounts at the level of cantons and communes;
- internationally comparable fiscal statistics on an accrual basis are not available;
- pension statistics are published with a long lag;
- GDP by industry appears with a considerable lag;

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

The SNB launched in 2004 a quarterly survey on the **cost of borrowing** and completed the pilot phase in June 2005. From July 2006, the SNB plans to conduct the survey on a monthly basis. In September 2005, the SNB started compiling more comprehensive **statistics on mutual funds.** In October 2005, the SNB published, in collaboration with the Federal Statistical Office, **annual financial accounts** for 1999–2003 (stock data). Data on financial flows and non-financial assets will be published in 2007.

Annual national accounts were upgraded in 2003 to the *European System of Accounts 1995* (ESA95) and with the release of the Q4 2004 data, the Secretariat for Economics (SECO) revised accordingly its **quarterly national account estimates**. SECO started publishing in March 2006 a quarterly production account. The main innovations in the new national accounts were in investment (with detail on information and communications technology), private and public consumption (hospitals were transferred to the private sector), and the use of chain price indices (without adjustment for quality).

In 2004, a **statistical cooperation agreement** was concluded with the EU as part of Bilateral II for the harmonization of several Swiss statistics with EU standards.

The Federal Finance Administration has started preparations for **revamping fiscal statistics** with the adoption of the *Government Finance Statistics Manual 2001*, the reform of the accounting standards for cantons and communes (*Weiterentwicklung der Rechnungslegung* *der Kantone und Gemeinden*) and the introduction of full accrual budgeting and accounting at the level of the federal government (*Neues Rechnungsmodell Bund*) along the lines of the International Public Sector Accounting Standards (IPSAS). Figures according to the new accounting standards are expected in 2009. In the interim, government finance statistics for publication in the *GFS Yearbook* will be reported on a cash basis but presented in the *GFSM 2001* framework.

Quarterly balance of payments and international investment position data are compiled by the SNB and meet international standards. However, monetary gold transactions relating to sales of gold reserves not required for monetary policy purposes have not been correctly reflected in the balance of payments. Also, there are inconsistencies between the reserves template and the reserves data in the international investment position in connection with balances arising from the distribution to the confederation and cantons during 2005 of the proceeds from gold sales.

Adoption by the authorities of the Standardized Report Forms for reporting **monetary data** to STA will enhance the analytical usefulness of the data. The data on deposit money banks currently submitted by the SNB to STA for publication in *International Financial Statistics (IFS)* lack adequate sectorization and instrument breakdown. The SNB expects to report more detailed data in the second half of 2006.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of February 3, 2006)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Jan 25/06	Jan 25/06	D	M	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jan 06	Jan 06	M	M	M
Reserve/Base Money	Dec 05	Jan 06	M	M	M
Broad Money	Dec 05	Jan 06	M	M	M
Central Bank Balance Sheet	Jan 06	Jan 06	M	M	M
Consolidated Balance Sheet of the Banking System	Dec 05	Jan 06	M	M	M
Interest Rates[2]	Jan 06	Jan 06	D	M	D
Consumer Price Index	Dec 05	Jan 06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4]	2005	Jan 06	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government[3]	Dec 05	Jan 06	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 05	Jan 06	Q	Q	Q
External Current Account Balance	Q3/05	Jan 06	Q	Q	Q
Exports and Imports of Goods and Services	Nov 05	Jan 06	M	M	M
GDP/GNP	Q3/05	Dec 05	Q	Q	Q
Gross External Debt	Q3/05	Jan 06	Q	Q	Q

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

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

Public Information Notice (PIN) No. 06/63
FOR IMMEDIATE RELEASE
June 12, 2006

IMF Executive Board Concludes 2006 Article IV Consultation with Switzerland

On June, 2, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

After a period of mixed performance, the Swiss economy is showing some spark. Supported by a favorable external environment and accommodative monetary policy, the economy recovered in 2005, with the financial sector accounting for almost half of the rebound. Unemployment, has started to recede. Despite rising oil prices, inflation remains under control and the current account is running a large surplus.

As the recovery gained traction, the Swiss National Bank (SNB) resumed raising its policy interest rate. Nonetheless, monetary conditions remain supportive as short-term interest rates are still slightly negative and the effective exchange rate has weakened somewhat. The general government deficit was halved in 2005 to 0.6 percent of GDP but the structural deficit remained unchanged owing to the deterioration of the underlying position of social security. The federal government is on track to eliminate its small structural deficit by 2007.

The staff projects growth to accelerate in 2006 to over 2 percent, closing the negative output gap, and consumer price inflation to remain just above 1 percent. The risks to the short-term outlook are mostly external and appear balanced, assuming Switzerland is able to make additional progress on structural reform.

Executive Board Assessment

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

Switzerland's economy continues to gain momentum with low inflation and increasing employment. Directors commended the Swiss authorities for their prudent macroeconomic management, sound monetary and fiscal policy frameworks, and flexible labor markets, and welcomed continued efforts to advance structural reforms. While potentially exposed to a disorderly unwinding of global imbalances, short-term risks facing Switzerland generally appear contained. Directors noted that the main medium-term policy challenges are to strengthen potential economic growth while addressing the fiscal pressures from an aging population.

Directors noted that the current recovery presents an important opportunity for Switzerland to advance with ambitious economic reforms in order to boost potential growth. In this regard, they welcomed the efforts at reforming and further opening up the domestic product markets and network industries. At the same time, Directors underlined the importance of moving forward decisively with further liberalization of sheltered sectors, including by reducing red tape and state regulations, lowering nontariff barriers to trade, and reducing the very high levels of protection and subsidization in the agriculture sector.

Directors supported the authorities' intention to eliminate the structural federal deficit by 2007. Noting the strains likely to be put on the public finances by population aging, Directors strongly supported the authorities' launching of structural fiscal reforms to place social programs on a sound long-term footing. In this context, a number of Directors were disappointed that several cantons preferred to use their share of the proceeds of the gold sale to lower taxes.
They welcomed the authorities' commitment to prepare a Long-Run Fiscal Sustainability Report, which should bolster public understanding of the issues involved, and help forge the needed consensus for reform, including at the subnational levels.

Directors noted that the monetary policy framework continues to serve Switzerland well, underpinned by effective communication practices of the Swiss National Bank (SNB). Directors supported the SNB's move to tighten monetary policy gradually to a neutral stance, while closely monitoring the pace of tightening against evolving economic conditions. They noted in particular that the SNB should stand ready to act promptly and decisively if signs of price pressure emerge or in the event of disruptive exchange rate volatility. Directors welcomed the authorities' policy of non-intervention in the foreign exchange markets, in keeping with the Swiss franc's freely floating regime.

Directors noted that the Swiss financial system appears to be healthy and dynamic.
They welcomed the strengthening of the regulatory and supervisory framework, and the authorities' appropriate vigilance in monitoring financial sector risks. Nevertheless, Directors noted that there remains room for improving pension industry regulations, and urged the authorities to consider a unified regulatory and supervisory system, to introduce risk-based supervision, and to improve disclosure standards.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with Switzerland is also available.

Switzerland: Selected Economic Indicators

	2002	2003	2004	2005	2006 1/
Real Economy					
Real GDP	0.3	-0.3	2.1	1.9	2.2
Real total domestic demand	-0.5	0.5	1.1	2.0	2.1
CPI (year average)	0.6	0.6	0.8	1.2	1.1
Unemployment rate (in percent of labor force)	2.5	3.7	3.9	3.8	3.7
Gross national saving (percent of GDP)	30.0	34.3	35.0	34.6	34.4
Gross national investment (percent of GDP)	21.7	21.0	20.4	20.8	20.7
Public finances (percent of GDP)					
Confederation budget balance 2/	-1.0	-0.9	-0.6	-0.2	-0.2
General government balance 2/3/	-1.2	-1.4	-1.2	-0.6	-1.0
Gross public debt	53.1	53.9	53.7	52.0	50.7
Balance of payments					
Trade balance (in percent of GDP)	1.2	1.0	1.5	0.7	0.8
Current account (in percent of GDP)	8.3	13.3	14.6	13.8	13.7
Official reserves (end of year, US$billion) 4/5/	40.2	47.7	55.5	36.3	34.8
Money and interest rates					
Domestic credit (annual average) 6/	-0.5	0.6	2.3	4.5	6.3
M3 (annual average) 6/	3.8	8.3	3.2	4.5	3.8
Three-month Libor rate (in percent) 5/	3.1	2.5	2.6	2.1	2.4
Government bond yield (in percent) 5/	3.1	2.5	2.6	2.1	2.4
Exchange rate					
Exchange rate regime Managed float					
Present rate (April 13, 2006) SwF 1.29 per US$1					
Nominal effective exchange rate (1990=100) 7/	108.2	108.6	108.4	108.2	106.9
Real effective exchange rate (1990=100) 8/	106.3	106.4	105.6	104.0	103.3

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

1/ Staff estimates and projections.

2/ Including privatization revenue.

3/ Including Confederation, cantons, communes, and social security.

4/ Excluding gold.

5/ Figures for 2006 refer to March,.

6/ Figures for 2006 refer to a change from February 2005 to February 2006.

7/ Figures for 2006 refer to February.

8/ Based on consumer prices, figures for 2006 refer to January.

Statement by Thomas Moser, Executive Director for Switzerland
June 2, 2006

1. On behalf of my Swiss authorities, I would like to thank the staff for the very constructive policy discussions and the concise staff report. The report gives an accurate account of the economic situation in Switzerland and the main policy challenges. My authorities largely agree with the staff's appraisal and welcome the policy recommendations. They also particularly appreciated the selected issues paper, which provides a valuable contribution to the on-going discussions within Switzerland on fiscal federalism, government finances and pension scheme reform.

2. Over the last two years, the performance of the Swiss economy has exceeded expectations and the expansion is set to continue at a favorable pace. In the fourth quarter of 2005, GDP increased by 2.7 percent on a year-to-year basis, bringing GDP growth to roughly 2 percent for the year as a whole. Economic growth is broadly based. While the external environment continued to stimulate export growth in 2005, domestic demand has strengthened. Investment growth, which has been relatively slow in view of favorable financing conditions and positive developments in earnings, has gained momentum towards the end of 2005. More remarkable, however, was the relatively strong rebound of private consumption in 2005, given that it took place without a strong recovery in the labor market.

3. The reaction of the labor market to the recovery has been weaker than in earlier cycles. However, several indicators suggest an ongoing upturn in employment since the end of 2005. In the first quarter of 2006, employment expanded considerably and companies' hiring intentions improved further. Unemployment, seasonally adjusted, has further eased to 3.4 percent in April and consumer sentiment has improved markedly at the beginning of 2006.

Monetary policy

4. The Swiss National Bank (SNB) shares staff's analysis of monetary conditions and monetary policy in Switzerland. After a pause in the normalization of the monetary policy stance due to very low inflation and uncertainty about the strength of the recovery in early 2005, the SNB resumed its gradual monetary tightening in December 2005, by increasing the three-month LIBOR for Swiss francs to 1 percent. In March 2006, the SNB took a further step and increased the rate to 1.25 percent, a level at which monetary policy is still expansionary. The most recently published inflation forecast confirms that 1.25 percent does not represent a steady-state equilibrium level for the three-month Libor. At this juncture – characterized by the closing of the output gap – and considering the very long transmission lag of monetary policy in Switzerland and the risks of keeping interest rates low for too long, it is important – in order to anchor inflation expectations – that the SNB signals that it has a

tightening bias. The pace of future tightening will be assessed in the light of new inflation forecasts and the evolution of key economic indicators.

5. The SNB welcomes staff's appraisal that the monetary policy framework is well designed, transparent and effective. It also appreciates staff's assessment that its communication strategy has worked well. The SNB fully shares staff's recommendation that the legal link between housing rents and mortgage rates should be lifted. Moreover, the SNB strongly concurs with the staff's assessment that the KOSA popular initiative, which proposes to earmark SNB profits above one billion Swiss francs for financing the social security system, could compromise central bank independence and the SNB's ability to focus on price stability.

Fiscal policy

6. As noted in the staff report, fiscal developments have been quite positive. My authorities are pleased with the over-performance at the federal level in 2005, which resulted in an essentially balanced outcome compared with a projected deficit of 0.4 percent of GDP. This result stems mainly from lower-than-projected expenditures. Overall, expenditure growth has been effectively curbed by both a consistent implementation of the debt brake and the two expenditure reduction programs mentioned in the report. Achieving structural balance at the federal level is now within reach.

7. Staff is right to once again stress the medium and long term challenges posed by rising social security and health spending. The Swiss authorities are well aware of these challenges and have, therefore, taken important steps to tackle the mounting pressures. The Federal Council has launched an ambitious project aimed at systematically reviewing the full range of tasks of the central government. Based on a classification of these tasks into 40 categories, decisions will be taken regarding the areas in which government activity can be reduced or even eliminated. This will increase the possibilities to act on new challenges and set the stage for a growth-oriented economic policy.

8. In the context of this review of central government tasks, the Federal Council recently adopted the objective to contain the overall growth of federal budget spending until 2015 at the level of nominal GDP growth. Given the spending pressures stemming from social areas, this will require ambitious reforms and a substantial trimming-down of existing central government activities. Looking forward, the time line envisages the completion of an action plan by end-2006, at which time it should be ready for discussion with cantons and other stakeholders.

9. With the new financial equalization framework (NFA) in its final stage of preparation, issues relating to fiscal federalism are being debated more actively than usual. My authorities are thus grateful that staff took up their request to assess in detail the

macroeconomic aspects of Swiss fiscal federalism. Overall, the analysis highlights some of the key advantages of highly devolved federalism, such as containing the size of the public sector. But the staff rightly highlights the challenges that such a system offers in terms of coordination failures. Cantons can and actually do overcome at least part of these problems by intercantonal co-operation and cost compensation. Furthermore, the NFA encourages enhanced horizontal coordination. In this respect, the federal Parliament will, in a sense, play the role of an arbitrator, because it may force cantons to co-operate under certain conditions. The respective constitutional amendment covers, amongst other things, high school and university education.

10. A further step toward harmonization was taken with the popular vote on May 21, 2006. The proposed constitutional amendments that will enhance vertical co-operation between the Confederation and the cantons in education were accepted by a large majority.

11. The selected issues paper further outlines a very preliminary draft of a public sector balance sheet for Switzerland. As it includes a forward-looking component, the analysis takes into account future effects of population aging on public finances. The balance sheet view is a useful complement to the usual budgetary flow presentation. The results, while useful, ought to be interpreted with caution, however. Data on the public sector capital stock is hardly more than an educated guess. Furthermore, estimates of the intertemporal financial position are sensitive to underlying assumptions. As noted in footnote 39 of the selected issues paper, it would have been interesting to see how the staff's estimate reacts to alternative assumptions on key variables. Nonetheless, the analysis is a useful input to the challenging task of elaborating a comprehensive picture of long-term fiscal developments in Switzerland.

12. The Federal Finance Administration is currently preparing a sustainability report which includes all three levels of government as well as social security programs, specifically old-age pensions (the first pillar), disability insurance, and means-tested health-insurance support. The main result of this exercise will be to show the effects of aging on public finances under a no-policy-change assumption over a time horizon of 50 years. As long-term projections are highly uncertain, a sensitivity analysis for key parameters such as interest rates, productivity growth and demographic variables will be carried out. This will constitute a crucial element of the report, which should thus provide a comprehensive picture of future fiscal developments.

Financial sector

13. Regarding the financial sector, my authorities fully agree with the staff's findings and they share the assessment that risks in the banking sector are low. On the strengthening of cross-border cooperation among supervisors, the amendment of the provision on

administrative assistance in stock exchange matters will likely improve matters substantially. The amendment, which entered into force on February 1, 2006, facilitates and accelerates the administrative assistance for regulatory purposes in line with international minimum standards.

14. My authorities very much welcomed the comparison of the occupational (funded) pension pillars of the Netherlands, the UK and Switzerland. As in every country, the Swiss pension system is characterized by a variety of specific goals and parameters that determine its performance. The Swiss authorities agree that further reforms in the second pillar, and especially a strengthening of its supervision, are needed. In this respect, options for addressing the main identified weaknesses have already been put forward. They are contained in a report by an expert commission published in March, on which the government's forthcoming proposals will be based. The reforms under way aim for a uniform application of revised and stricter supervisory rules across cantons.

15. The Swiss authorities are looking forward to discussing these issues in greater depth in the context of the FSAP update to be undertaken later this year.

Structural issues

16. The staff report presents accurately the authorities' structural reform efforts. Increasing productivity growth in the domestic sector is indeed the most important structural issue. Reforms are needed in health and network industries, agriculture, public services, mandatory pension schemes, the education sector, and the real estate and construction sectors. Reform efforts are being undertaken in several of these areas. The authorities are currently also undertaking a number of reforms to further improve the business-friendly environment in Switzerland, ranging from corporate governance to corporate taxes.