

Switzerland: 2002 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 2002 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **March 4, 2002**, 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, 2002.** 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 May 29, 2002 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Switzerland.

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

Selected Issues Paper
Financial System Stability Assessment

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

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INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the
2002 Consultation with Switzerland

Approved by Alessandro Leipold and G. Russell Kincaid

May 8, 2002

The 2002 Article IV consultation discussions were held in Zürich and Bern during February 22-March 4, 2002. The mission comprised Messrs. Corker (Head), Gagales, and Klingen (all EU1). Mr. Hilbers and Ms. Moretti (both MAE) joined the mission to discuss the draft report of the FSAP mission in October-November, 2001. Messrs. Cippà, Executive Director for Switzerland, and Zurbrügg, Advisor, attended the meetings. The mission met with President Villiger, Minister of Finance; Federal Counselor Couchepin, Minister of Economics; President Roth, Chairman of the Governing Board of the Swiss National Bank (SNB); senior officials of the federal administration and the SNB; and several academics and private sector representatives. The authorities released the mission's concluding statement and have agreed to the publication of the staff report.

Switzerland has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix II) and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Switzerland subscribes to the Fund's Special Data Dissemination Standard (Appendix III).

The last Article IV consultation was concluded on May 9, 2001 (SM/01/110). Directors commended the authorities for their macroeconomic policy management, which had facilitated a strong recovery in 2000 after a decade of low growth. With inflation expected to remain subdued, they considered that the SNB had scope to cut interest rates if the emerging global slowdown intensified. They stressed, however, the importance for medium-term growth prospects of pursuing more rigorously structural reforms, particularly the opening up of sheltered sectors to competition.

In March 2002, accession to the UN was accepted in a referendum. The objective of the federal government is to join the EU, but this goal lacks popular support at this stage. General elections are slated for 2003.

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Main Websites for Swiss Data

Data in this Staff Report reflects information received by May 3, 2002. In most cases, more recent data can be obtained directly from the following internet sources:

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

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

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

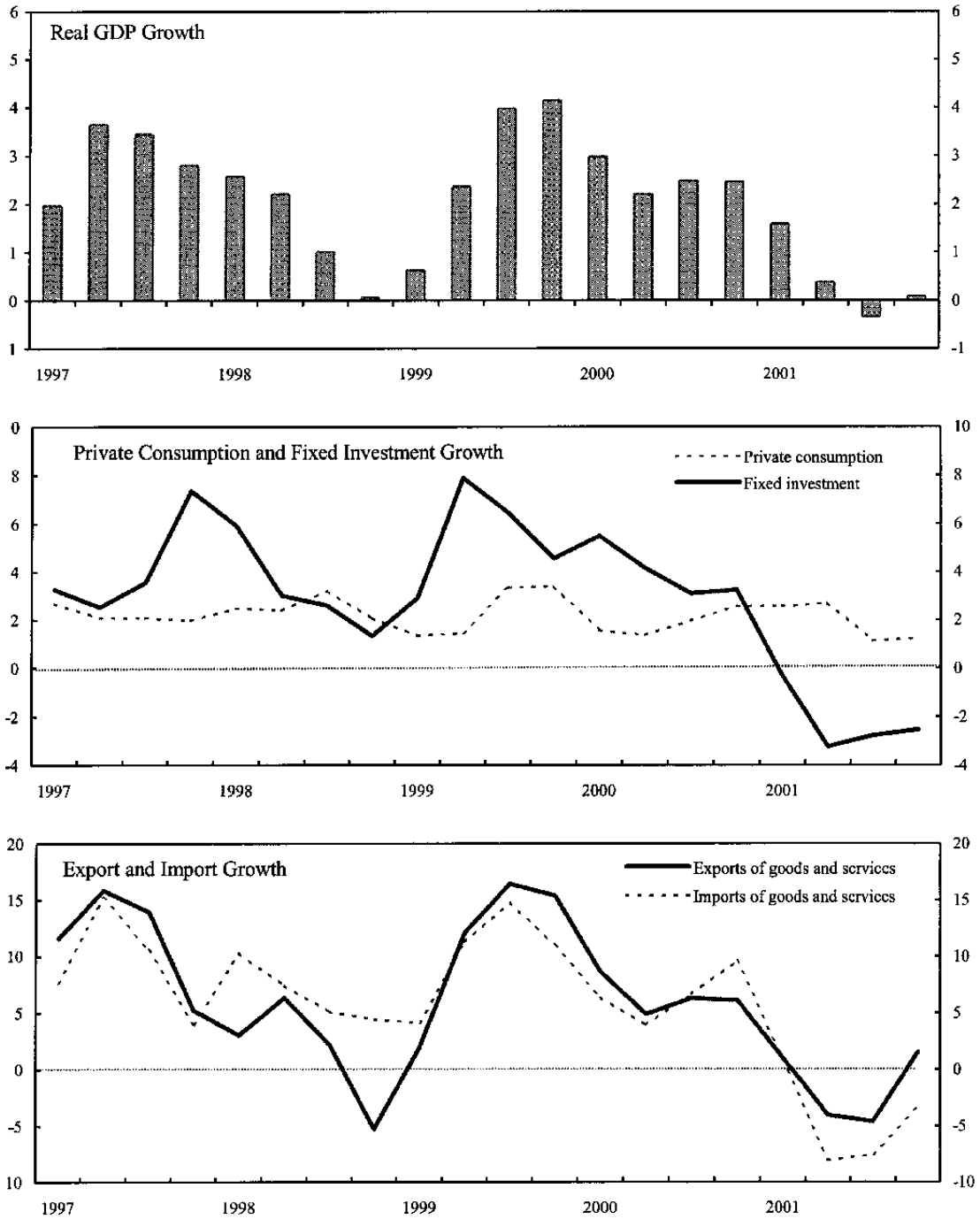
Federal Ministry of Finance <http://www.efd.admin.ch>

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

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

Information and documentation on Swiss
economic statistics can be found at the Special
Data Dissemination Standard website of the IMF <http://dsbb.imf.org/country.htm>

Figure 1. Switzerland: GDP and its Components, 1997-2001
(Annualized quarter-on-quarter rates of change)



Source: IMF, World Economic Outlook.

I. ECONOMIC BACKGROUND

1. **The Swiss economy performed solidly in the late 1990s following a protracted period of stagnation.** Annual GDP growth recovered to 2.2 percent in 1997-2000, albeit still below the EU average of 2.9 percent, and unemployment dropped to 1.7 percent. The output gap was closed and businesses reported growing shortages of skilled labor. Nonetheless, inflation remained around 1 percent, the lowest in Europe. The external current account surplus soared, reaching a record 13 percent of GDP in 2000. Consolidation brought the fiscal accounts into structural surplus.

2. **More recently, growth has again weakened.** As in many industrial countries, growth started to weaken in early 2001 with a retrenchment in investment as “new economy” euphoria came to an end, and in response to earlier interest rate increases. The downturn intensified during 2001 when the global slowdown and an appreciation of the Swiss franc hit exports, and firms scaled back investment sharply as business sentiment plunged (Figure 1). Although private consumption held up well, economic activity stagnated in the second half of 2001, reducing annual real GDP growth to 1.3 percent after a decade-high 3 percent in 2000 (see tabulation below). Unemployment edged up and by end-2001 output is estimated to have slipped to about 1 percent below potential.¹

Expectations surveys suggest that the slowdown may have bottomed in early 2002. However, as of April, the evidence of a turning point was less compelling than in many other industrial countries (Figure 2).

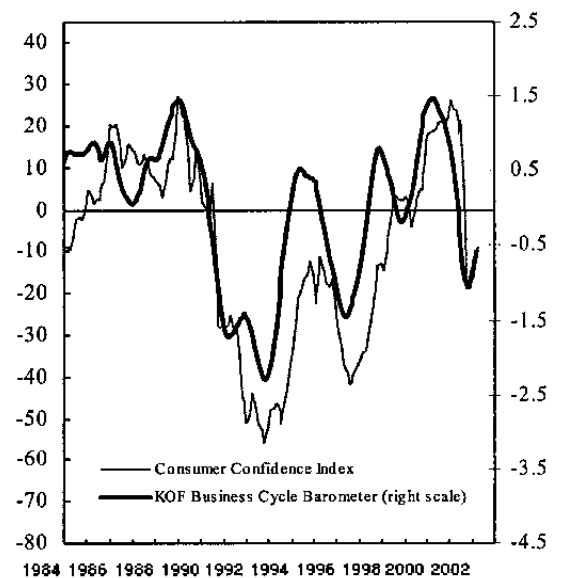
GDP and its Main Components
(Annual rates of change, in percent)

	1997-2000	2000	2001
Total domestic demand	2.3	2.5	0.9
Private consumption	2.0	2.2	2.2
Gross fixed investment	3.6	4.9	0.0
Net exports 1/	-0.1	0.6	0.5
Exports of goods and nonfactor services	7.2	10.0	1.0
Imports of goods and nonfactor services	7.6	8.5	0.0
GDP	2.2	3.0	1.3

Source: Fund staff estimates.

1/ Contribution to GDP growth

Figure 2. Switzerland: Leading Indicators, 1984-2002

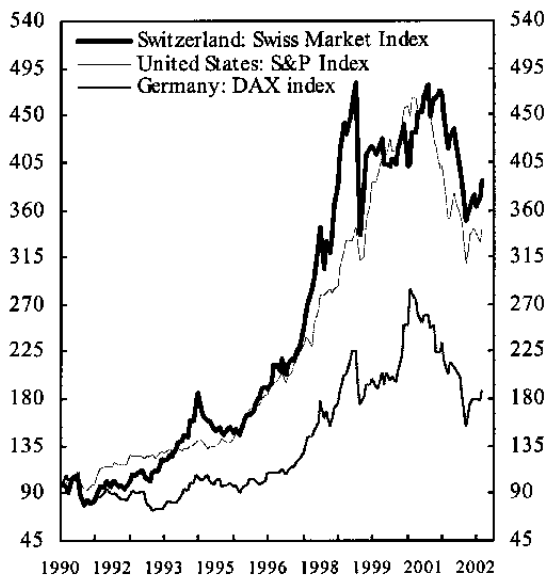


Sources: KOF database; and Bloomberg.

¹ The output gap estimate is subject to considerable uncertainty, not least because an elastic pool of foreign workers makes it difficult to gauge potential labor supply.

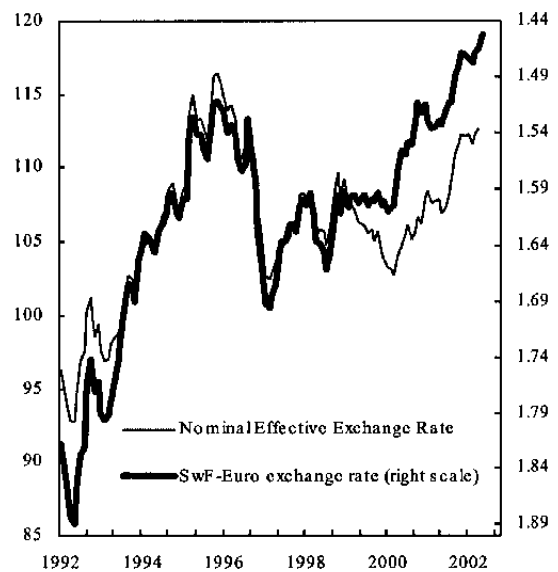
3. **The economic reverberations of the September terrorist attacks were relatively pronounced in Switzerland.** The attacks were the final straw in bankrupting Swissair, tourist activity slumped, and insurance companies will have to make large payments on policies covering the World Trade Center.² Other effects, including a safehaven-related appreciation of the Swiss franc, a sharp decline in business and consumer confidence, and a fall in stock prices, had large temporary components, with the stock market quickly returning to pre-September 11 levels and pressures on the exchange rate subsequently easing somewhat. Even so, and in line with developments in international markets, stock prices were in April 2002 about 20 percent below their end-2000 peak (Figure 3). And a significant part of the Swiss franc's safehaven gains persisted with the exchange rate in the first quarter of 2002 about 4 percent more appreciated in nominal effective terms than it was at end-2000 (Figure 4). The Swiss franc came under renewed upward pressure in April.

Figure 3. Share Price Indices, 1990-2002 (1990=100)



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

Figure 4. Switzerland: Exchange Rates, 1992-2002

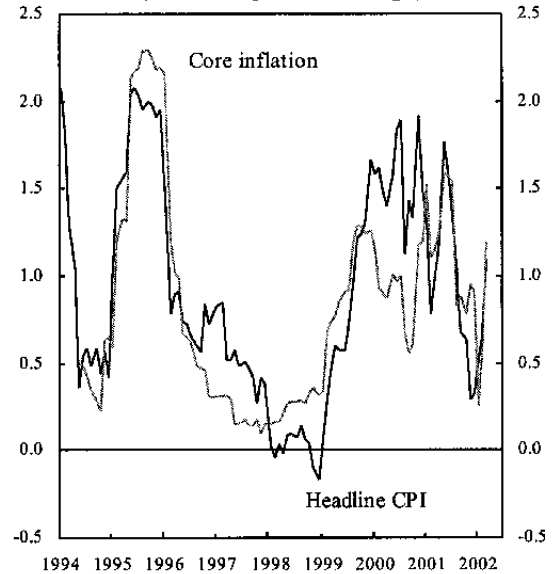


Sources: IMF, International Financial Statistics; and Fund staff estimates.

² The Swissair failure is estimated to have resulted in 4,500 job losses and entailed fiscal costs of SwF 2.5 billion (0.6 percent of GDP). WTC-related liability claims on the two largest insurance companies are estimated at US\$2 billion (¾ percent of GDP), but are likely to be paid over a number of years. To the extent that such claims will be paid out of insurance companies' technical reserves, the payments will not affect GDP; they will show up as current transfers, reducing the external current account surplus and national income.

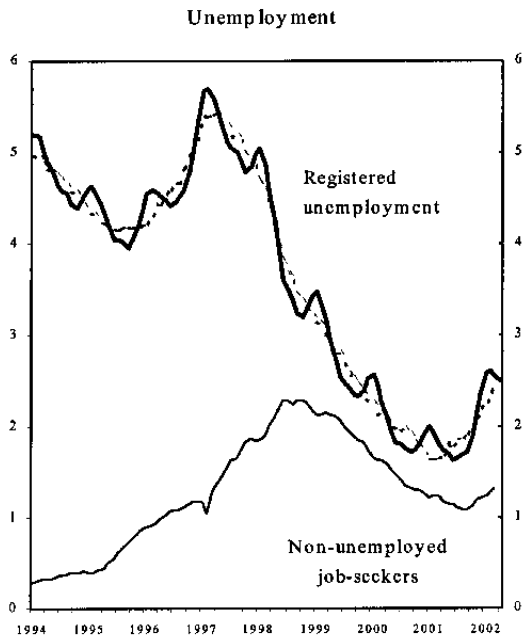
4. **Inflation and unemployment remain very low.** Headline and core consumer price inflation have generally been below 1 percent since mid-2001 (although both measures jumped up to just over 1 percent in April due to special factors), benefiting from the appreciation of the Swiss franc, lower oil prices, and increasing competition in domestic markets (Figure 5). Price stability has been underpinned by moderate wage increases. Despite still low unemployment (2.5 percent in April 2002) and remaining shortages of skilled labor, wages rose by only 2½ percent in 2001 and are expected to decelerate in 2002 (Figure 6).

Figure 5. Switzerland: Consumer Prices, 1994-2002 (12-month percent change)

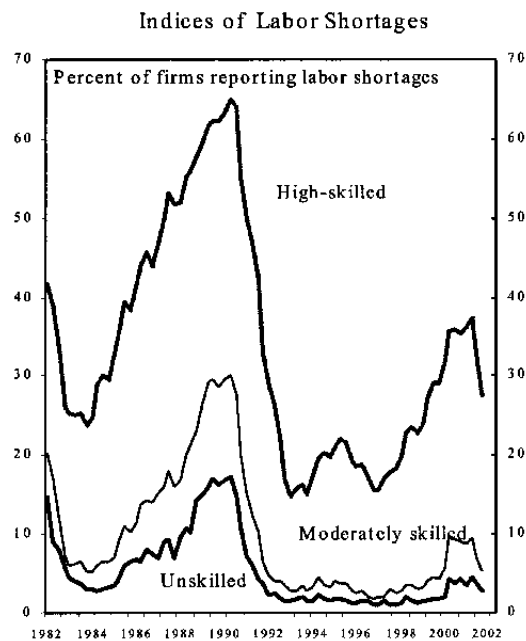


Source: KOF database.

Figure 6. Switzerland: Labor Market Indicators



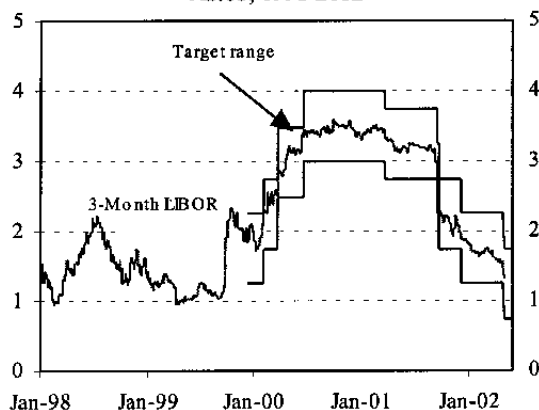
Source: KOF database.



Source: KOF database.

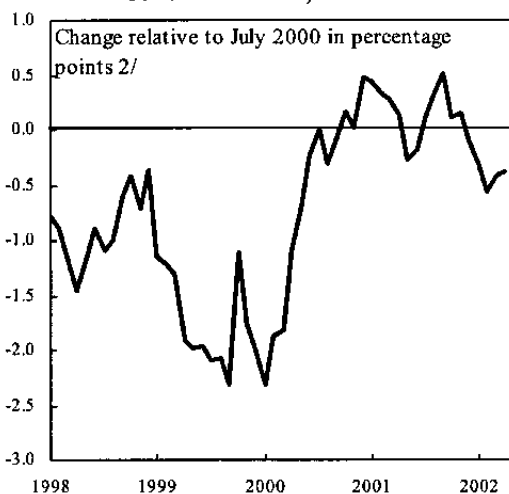
5. **A benign inflation outlook allowed the SNB to cut interest rates aggressively, but exchange rate appreciation has blunted the easing of monetary conditions.** Beginning in 2000, the SNB adopted a framework in which its medium-term inflation forecast plays a key role.³ Amid intensifying signs of weakening economic activity and moderate projected inflation, the SNB cut its policy rate on four occasions in 2001 by a total of 175 basis points, with most cuts (150 basis points) concentrated in the period following September 11 (Figure 7). As a result, real short-term interest rates fell to ½ percentage point below their historical average, although because of exchange rate appreciation, monetary conditions did not appear particularly easy by recent historical standards (Figure 8). The SNB cut rates by a further 50 basis points at the beginning of May 2002. Interest rates at both the long and short end of the spectrum remain significantly below euro area rates. With SNB cuts exceeding those of the ECB since September 11 by 100 basis points, the differential has increased recently (Figure 9).

Figure 7. Switzerland: Short-Term Interest Rates, 1998-2002



Source: Bloomberg.

Figure 8. Switzerland: Monetary Conditions Index, 1/ 1998-2002



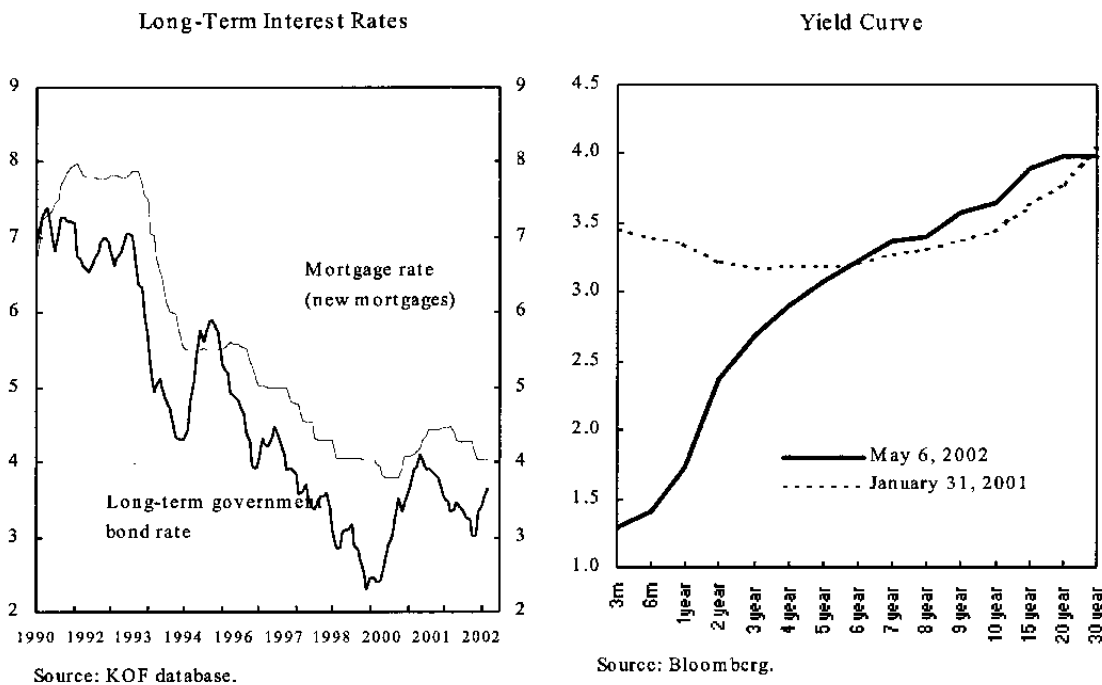
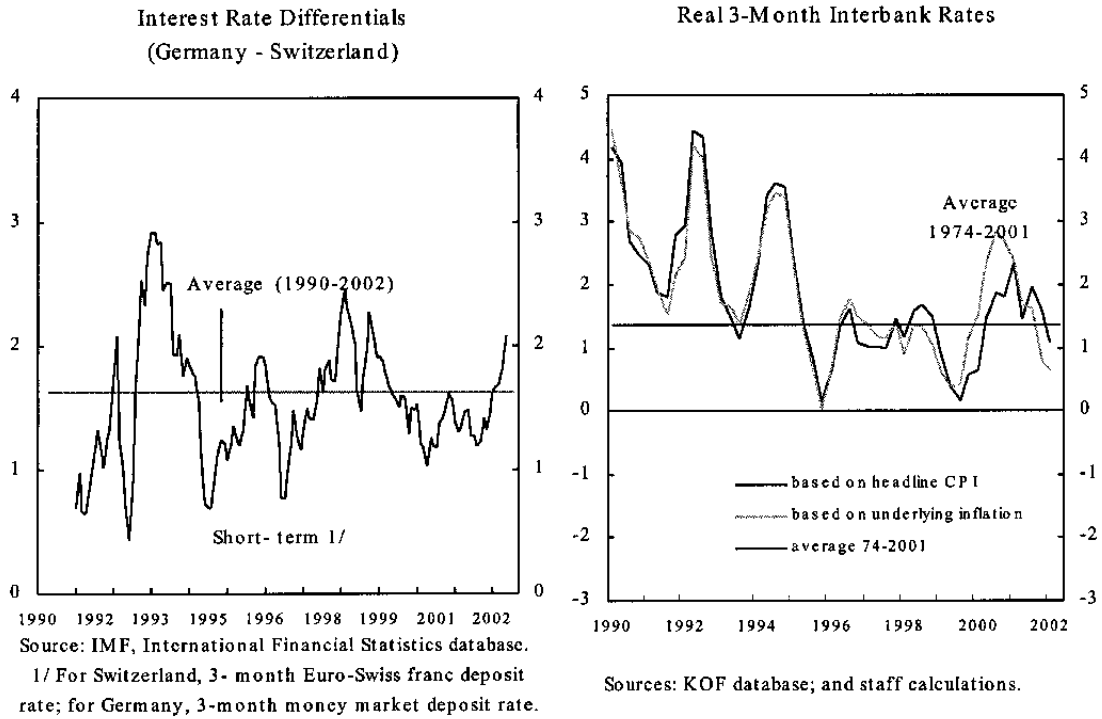
Source: Fund staff estimates.

1/ The weights of the interest rate and the detrended exchange rate are proportional to 3 to 1, respectively.

2/ At this date, the economy is estimated to have been at potential.

³ The new monetary policy framework, which was analyzed in *Switzerland: Selected Issues*, IMF Country Report No. 01/75 (May 2001), defines price stability as headline inflation of less than 2 percent but positive and sets monetary policy on the strength of the SNB's three-year ahead inflation forecast. A 100 basis point target range for the three-month Swiss franc LIBOR is used as the operational target.

Figure 9. Switzerland: Interest Rates, 1990-2002
(In percent)



6. **Fiscal policy was expansionary in 2001 and is expected to remain moderately so in 2002.** The general government structural balance deteriorated by 0.8 percent of GDP last year reflecting support for Swissair, the biannual adjustment of pensions, and revenue losses of cantons. The actual general government balance deteriorated far more, to an estimated deficit of 0.3 percent of GDP in 2001, after a surplus of 2.4 percent of GDP in 2000. At the federal level, the deficit slightly exceeded the limit consistent with the constitutionally mandated balanced budget. However, more than half of the deterioration in the public finances can be attributed to declines in withholding taxes on capital income and stamp duties, which are erratic revenue sources, from record levels in 2000 (Table 1). Excluding movements in erratic revenue items and one-off revenues from a share buy-back by Swisscom (a partly publicly-owned telecommunications firm), staff estimates a small fiscal impulse for 2002. Gross public debt is projected to rise to 53 percent of GDP at end-2002.⁴ In January 2003, Switzerland's new

Table 1. Switzerland: Fiscal Estimates and Projections

	2000 Actual	2001 Preliminary	2002 Proj.
	(In percent of GDP)		
General government			
Balance	2.4	-0.3	0.1
Erratic revenue items 1/	2.6	1.0	1.6
Privatization proceeds 2/	0.1	0.1	0.7
Balance excl. erratic revenue items and privatization proceeds	-0.3	-1.5	-2.1
Structural balance 3/	1.4	0.6	0.2
Fiscal impulse	-2.2	0.8	0.4
<i>Memorandum items</i>			
Federal government balance 4/	1.1	-0.3	0.4
Support for Swissair	0.0	0.3	0.3
Output gap (percent of potential GDP)	-0.3	-0.7	-1.5

Source: Fund staff calculations.

1/ Withholding tax and stamp duties. Understood to be mostly borne by foreigners.

2/ Also includes proceeds from Swisscom's share buy-back.

3/ Corrects for the business cycle and privatization proceeds; smooths erratic revenue items.

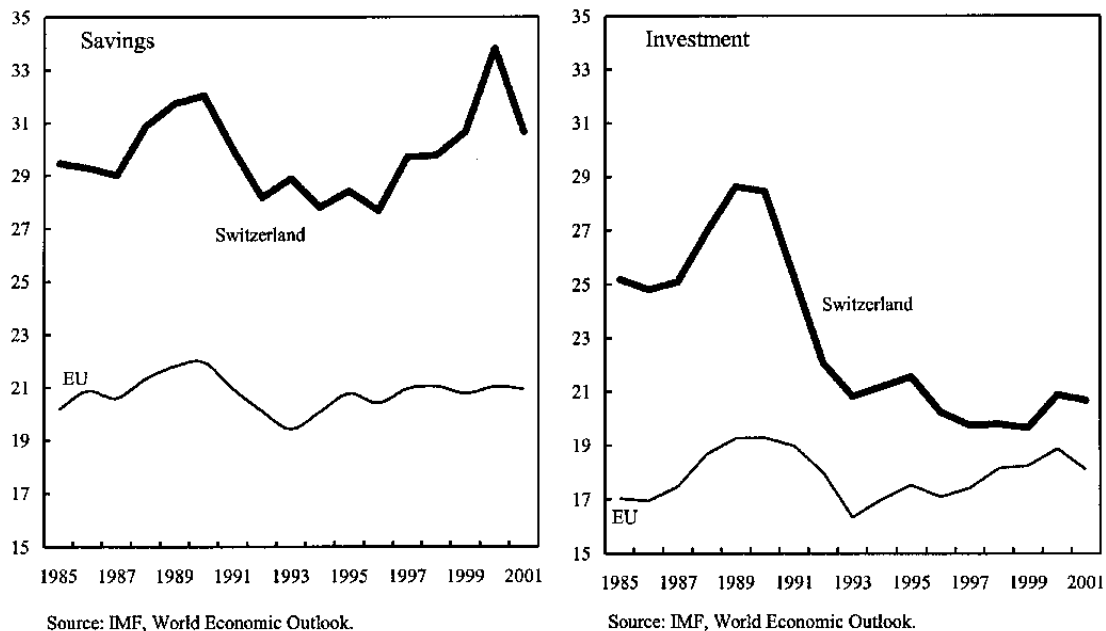
4/ Excluding the railway fund.

⁴ In recent years, gross debt has increased by more than the deficit largely because the government assumed the debt and has begun to capitalize the pension funds of public enterprises that were commercialized. The largest operation related to Swiss Rail. Capitalization of these pension funds is well advanced, but further injections will be required in the years ahead to bring them into actuarial balance.

fiscal framework will go into effect—the so-called “debt brake”, which requires the federal accounts to be in balance after adjustment for the economic cycle.⁵

7. **Lower returns on foreign assets led to a sharp reduction in the external current account surplus, although it remains one of the largest among industrial countries.** The current account surplus fell to 10 percent of GDP in 2001 mainly due to a 2½ percent of GDP decline in net investment income on Switzerland’s large net foreign assets (124 percent of GDP at end-2000). The large surplus reflects high national savings (mainly of corporations) and a drop in the investment rate in the 1990s, albeit to a still high level by international standards (Figure 10). Much of the drop in the investment rate was due to the correction of an earlier real estate bubble. But investment has also been affected by globalization, which has generated demand for foreign investment, and by falling capital goods prices.

Figure 10. Switzerland: National Savings and Investment, 1985-2001
(In percent of nominal GDP)



⁵ The new fiscal framework was analyzed in *Switzerland: Selected Issues*, IMF Country Report No. 01/75 (May 2001). Under the debt brake, federal expenditure levels are set equal to revenues scaled by the ratio of potential (or trend) to actual GDP. Unanticipated deficit outcomes must be reversed in the following years. The debt brake can be breached in exceptional circumstances, although this must be supported by a majority of members in both chambers of parliament.

II. POLICY DISCUSSIONS

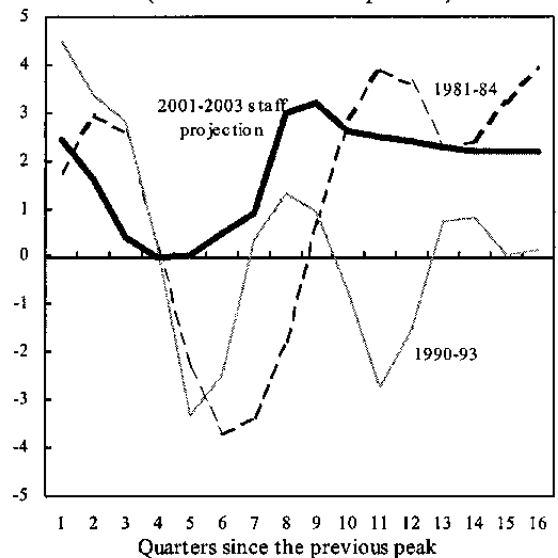
8. **The discussions focused on the role policies should play in the face of the economic slowdown and on the scope for accelerating structural reforms to strengthen longer-term growth performance.** With fiscal policy guided by a constitutional mandate to balance the budget, the main issue for the near term concerned the appropriate stance of monetary policy: specifically, had the bottom of the interest rate cycle been reached and what factors should trigger interest rate moves in coming months. Staff also used the opportunity of the recent Financial Sector Assessment Program (FSAP) mission to review the impact of economic developments on the health of the financial system. Looking further ahead, a key question was whether the better growth performance of the past five years represented a break from Switzerland's longer-run low growth performance. It was agreed that, to underwrite faster potential growth, the main requirement was to improve competition in domestic markets.

A. The Economic Outlook and Macroeconomic Policies

9. **Staff and the authorities viewed the short-term outlook with cautious optimism.**

The authorities, private forecasters, and staff expected the slowdown to be short-lived and shallow by historical standards, with growth largely stagnating in the first half of 2002 and gathering momentum in the second half of the year (Figure 11). A rebound of exports and investment was considered key to recovery and relied primarily on a global pickup in the second half of 2002 and the effects of the monetary easing in 2001. Even so, average real GDP growth is projected to be only about 1 percent in 2002 and the output gap would widen to 1½ percent. And although growth is projected to pick up to 2½ percent in 2003, the output gap would not be closed until the following year at the earliest. The risks are balanced: while the prospects for global recovery have improved markedly, recent gyrations in oil prices have added some new uncertainties to the outlook. Given current global imbalances and Switzerland's role as a major international financial center, volatility of the Swiss franc cannot be ruled out. The economy thus remains vulnerable to a sharp exchange rate

Figure 11. Switzerland: GDP Growth Over the Business Cycle
(Annualized rates in percent)



Source: IMF, World Economic Outlook; and Fund staff estimates.

appreciation—either due to safehaven effects in the event of turbulence in international financial markets or if the Swiss franc were caught up in the tail wind of a strengthening of the euro vis-à-vis the U.S. dollar.⁶

10. **With the outlook for inflation seen as benign and monetary conditions supportive of growth, the SNB favored a wait-and-see posture for the period ahead.** Both staff and the SNB expected headline CPI inflation to remain under 1 percent for most of 2002 and to rise only moderately in 2003 and 2004, staying well within the SNB's definition of price stability. Staff noted that the SNB's medium-term inflation forecast assumed that interest rates stayed at current low levels: more realistically, rates would be expected to rise over the course of the cycle, further dampening medium-term inflation. As core inflation was already low, the output gap was still widening, and exchange rate appreciation had blunted the impact of interest rate cuts on monetary conditions, the SNB had room to lower rates if the expected economic recovery appeared to falter. SNB officials pointed out that the economy was only slightly below potential and that the global recovery could be stronger than expected. They thus favored keeping interest rates on hold in the near term, emphasizing that monetary conditions were expansionary and the transmission process was drawn out. If the recovery proceeded as expected, they anticipated that interest rates would need to be raised later in the year. The SNB would, however, take into consideration the impact on monetary conditions of a further, significant appreciation of the Swiss franc. Subsequent to the mission in early May, in response to renewed appreciation pressures and their assessment that recovery was taking hold more slowly than anticipated, the SNB cut rates by a further 50 basis points.

11. **The new monetary policy framework is working well.** The focus on medium-term inflation helped the SNB to respond swiftly and straightforwardly last year to business cycle and exchange rate developments. In canvassing financial market participants' views, staff found that the framework appears to have provided an effective vehicle for communicating policy intentions and was well understood. SNB officials noted that they had started publishing details of their inflation models and intended to continue to expand the information provided about the analytical underpinnings to the inflation forecast and the rationale for policy decisions. At the same time, they saw no reason to make modifications to the basic framework. For example, they did not see any significant benefit in specifying a point target for medium-term inflation, compared to the current arrangement: the gains from perhaps helping financial markets to form more precise inflation expectations would be minimal at best. And while the SNB had so far not made much use of the 1 percentage point band for its intermediate interest rate target, the officials viewed the range as providing potentially valuable room to move its intermediate rate, particularly in response to exchange rate movements, without signaling a more fundamental change in the stance of monetary policy.

⁶ In past episodes of significant weakening of the U.S. dollar, the Swiss franc tended to appreciate against European currencies.

12. **The authorities noted that countercyclical fiscal policy in 2001 and 2002 was not intentional and that arresting public debt growth remained their priority.** The strong fiscal position in 2000 had allowed them to let automatic stabilizers play, absorb the fallback of erratic revenue items, and accommodate unplanned expenditure. They viewed the breach of the balanced budget amendment in 2001 as regrettable, but explained that it had been caused by unplanned expenditure (largely on Swissair) that had been explicitly sanctioned by parliament. With receipts from the share buy-back by Swisscom, they believed budget balance could be easily achieved in 2002, even though tax revenues would remain weak for cyclical reasons and erratic revenue items would again come in low. Staff pointed out that, in the current economic situation, some fiscal stimulus would not be problematic. However, in a small open economy, monetary policy should shoulder the main burden of countercyclical macroeconomic policy. In this vein, it would be important that one-off revenues that had not been anticipated, such as the receipts from Swisscom, should not give rise to additional stimulus via new spending or tax breaks. Rather, such revenues should be used to keep a rein on public debt.

13. **Compliance with the new debt brake framework in 2003 and beyond will require some fiscal consolidation and greater expenditure flexibility.** Staff estimates a medium-term adjustment need on the order of $\frac{1}{4}$ to $\frac{1}{2}$ percent of GDP, depending on whether pending new requests are rejected or adopted. The authorities saw an adjustment need toward the lower end of this range in 2003 and 2004 and believed that savings already incorporated in the current financial plan would be sufficient to balance the budget by 2005, notwithstanding already-approved tax cuts. At any rate, they fully agreed that there was no room for additional tax cuts or spending initiatives in the coming years—and that legislators would have to learn to conform to the strictures of the debt brake. In this context, staff pointed to the need for more expenditure flexibility to safeguard the quality of public spending in the face of consolidation and to increase the efficiency of expenditure more generally. Not only were transfer obligations sizable, but the widespread practice of earmarking revenues (earmarked revenues account for some 20 percent of federal revenue) further reduced spending flexibility. The authorities were open to the staff's suggestion of subjecting earmarked revenues to sunset clauses, but were unsure about its political viability.

14. **The authorities and staff both rejected tax hikes as the way to meet the requirements of the debt brake.** Although official statistics put the revenue ratio at 38 percent of GDP, which is low by OECD standards, the estimate excludes publicly mandated pension contributions and health insurance premia amounting to about 7 percent of GDP. While it was agreed that pension contributions might not have the same economic effects as taxes, the authorities accepted that a higher tax burden was unwarranted. Staff also pointed out that Switzerland's tax structure appeared to be skewed toward the taxation of capital income with a relatively light burden on consumption and labor income.⁷ Staff encouraged the authorities to consider this issue when designing future tax reform.

⁷ See Chapter II of the accompanying Selected Issues Paper.

15. **The debt brake will help to consolidate Switzerland's public finances ahead of demographic aging.** Although public debt equivalent to over 50 percent of GDP can no longer be considered particularly low, cross-country comparisons need to take into account the sizable capitalization of second-pillar pension funds. Such funds have assets equivalent to about 120 percent of GDP, of which just under one half are related to mandatory contributions. The authorities explained that public debt will increase further in the next couple of years, but only because of off-budget operations related to capitalizing civil service pension funds.

16. **The debt brake provides room for automatic stabilizers to play but erratic revenue items and actions by lower-level governments could still give rise to procyclical fiscal policy.** Given the relatively small share of the federal budget in general government operations, the automatic stabilizers at the federal level might not be sufficient to help counter large demand shocks in a setting where monetary policy was constrained by low interest rates. Moreover, fluctuations in withholding tax and stamp duty revenue can easily swamp cyclical effects on government revenue. Staff encouraged the authorities to implement the debt brake in a manner that prevented shortfalls in erratic revenue items from forcing expenditure cuts at times of weak economic activity. It also stressed that automatic stabilizers needed to operate in the social security funds and lower levels of government. Staff thus encouraged the authorities to pursue their objective of building up a reserve in the unemployment insurance fund so that it could remain in balance over the business cycle, avoiding the need for procyclical changes in contribution rates, as had occurred in the past. This might require delaying plans to reduce contribution rates.⁸

B. Financial System

17. **Financial institutions currently face a challenging economic environment, but in general appear to be well-capitalized.** The performance of the large international banks weakened in 2001 due to dwindling fee income from trading and investment banking activity, worsening asset quality worldwide, and stock market losses. However, these banks had moved swiftly to cut costs, and capital adequacy ratios were comfortably high (Table 2). Their exposures were closely monitored by the Swiss Federal Banking Commission (SFBC) and the banks had state-of-the-art risk management systems—although large off-balance sheet exposures made it hard for staff to assess vulnerability to shocks from international financial markets.⁹ The domestically-oriented banks were also sensitive to the business cycle, but according to the assessment of Switzerland's financial sector under the FSAP, which was undertaken in conjunction with the Article IV consultation, the economic climate would need to worsen considerably before problems became acute (Box 1). Outside banks, the

⁸ Higher contribution rates since 1996 have put the unemployment insurance fund into surplus and are expected to help eliminate by 2003 the debt that the fund accumulated during the recession of the 1990s.

⁹ Off-balance sheet positions are regularly monitored by banks and supervisors, but were not evaluated in the staff's stress testing exercise.

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

	1996	1997	1998	1999	2000	Prel. 2001
External Indicators						
Exports (annual percentage change, in U.S. dollars)	-2.2	-5.1	4.2	1.1	0.2	3.8
Imports (annual percentage change, in U.S. dollars)	-2.8	-3.5	5.8	-0.7	3.2	3.2
Terms of trade (annual percentage change)	0.6	-0.8	3.3	3.0	-2.6	-0.4
Net factor income	4.3	6.3	6.8	7.8	9.8	7.3
Current account balance	7.4	9.9	10.0	11.0	12.9	10.0
Foreign direct investment (net)	-4.4	-4.3	-3.7	-8.3	-11.0	-1.4
Portfolio investment (net)	-3.3	-4.2	-1.8	-15.8	-4.9	-18.1
Official reserves (in billions of U.S. dollars, end-of-period)	38.4	39.0	41.2	36.3	32.3	32.0
Official reserves in months of imports	5.0	5.2	5.3	5.1	4.0	4.2
Broad money to reserves ratio	8.9	8.4	8.4	8.3	8.7	9.4
Central bank foreign liabilities (in billions of U.S. dollars)	0.0	0.0	0.1	0.1	0.1	0.0
Foreign assets of the financial sector (in billions of U.S. dollars)	234.7	280.1	336.7	345.2	401.8	...
Foreign liabilities of the financial sector (in billions of U.S. dollars)	220.2	260.8	293.3	346.4	411.7	...
Total external claims 1/	288.1	330.8	366.7	431.4	458.6	...
Total external debt 1/	190.8	245.6	271.5	334.5	393.8	...
Of which: General government debt	0.2	0.2	0.2	0.2	0.2	...
External debt to GNFS exports ratio	5.4	6.3	6.8	8.1	8.8	...
External interest payments to exports (in percent)	12.9	13.3	21.5	22.9	30.2	28.9
Exchange rate against U.S. dollar (period average)	1.24	1.45	1.45	1.50	1.69	1.69
Nominal effective exchange rate	111.1	104.3	107.1	106.0	105.1	109.2
Real effective exchange rate (CPI based, 1990=100)	109.1	100.9	102.2	100.2	97.9	100.6
Financial Markets Indicators						
3-month interest rate	1.9	1.5	1.6	1.4	3.1	2.9
3-month interest rate (real)	1.1	1.0	1.5	0.6	1.5	1.9
Spread of 3-month interest rate vs. Euro Area	-1.3	-1.6	-2.0	-1.5	-1.3	-1.3
New Market Index, SNMI (percent change, end of period)	...	...	...	...	28.3	-57.9
Share prices of financial institutions (percent change, end of period)	7.4	74.2	4.6	20.3	16.4	-8.4
Overall stock market index, SMI (percent change, end of period)	19.5	58.9	14.3	5.7	7.5	-21.1
Market capitalization (SPI)	147.6	226.0	249.1	279.3	310.9	199.7
Financial Sector Risk Indicators						
Total loans to assets	42.0	36.1	32.3	31.2	33.1	32.9
Total loans to deposits	87.4	80.3	74.1	71.2	79.4	78.2
Deposits in foreign exchange (in billions of U.S. dollars)	174.0	196.5	261.2	238.0	222.8	249.5
Share of foreign deposits in total deposits	32.7	35.8	40.3	38.6	42.6	44.6
Share of foreign denominated liabilities in total liabilities (percent)	41.8	49.2	55.3	58.2	54.9	56.4
Share of foreign denominated assets in total assets (percent)	43.1	50.3	56.3	58.2	56.1	58.3
Share of mortgage credits to total loans (percent)	69.3	69.4	69.4	66.1	65.1	65.2
Share of non-performing loans in total loans (percent)	6.2	6.2	5.2	4.6	3.8	...
Share of non-performing loans in total assets (percent)	3.1	2.8	2.3	1.9	1.7	...
Capital adequacy ratio (percent)	10.3	10.7	11.4	11.4	12.8	11.8
Profitability ratio (percent)	0.3	5.0	17.1	18.8	18.2	...

Sources: Swiss National Bank, Monthly Statistical Bulletin; Swiss Federal Banking Commission; IMF, International Financial Statistics; and IMF, World Economic Outlook.

1/ Excluding foreign direct investment.

Box 1. Switzerland: Main Conclusions of the Financial System Stability Assessment

- Switzerland's financial sector is highly developed and diversified. Two banks, ranked among the world's largest, dominate the system. Although their performance weakened in 2001, both are well-capitalized. Profitability in the private banking segment has been high, but the segment faces increasing competitive pressure from foreign onshore wealth managers. Some further consolidation among smaller, domestically-oriented players in the retail sector is likely and would further enhance the system's efficiency. A phasing out of cantonal banks' preferential treatment is desirable to create a level playing field in the system. Stress tests suggest that banks are overall resilient to shocks, the main risk arising from a deep and global recession.
- Swiss securities markets are liquid and efficient and have an increasingly international orientation. The market infrastructure, including electronic trading, clearing and settlement systems, is highly advanced. The insurance sector is large and has a history of strong performance. Strains are emerging, however, following the September 11 terrorist attacks and lower financial market returns. The mandatory minimum 4 percent return on pension accounts, and longer life expectancy against a fixed 7.2 percent payout ratio at retirement, are a challenge for insurance companies and pension funds alike.
- Supervision of banks, securities markets, and insurance by the SFBC and the Federal Office for Private Insurance is effective. It has been strengthened in recent years in terms of quality and quantity, with a focus on large institutions and a more risk-based approach. In light of the large number of financial institutions in Switzerland and the modest resources of the supervisory authorities, external auditors and self-regulatory bodies play a key role within the supervisory process. This dualistic approach, which has served the system well, would benefit from a more formalized quality assurance program for supervising external auditors and an increase in joint onsite inspections, for which an expansion of professional staffing levels would be warranted.
- Further integration of banking and insurance supervision would be welcome. If a single supervisory authority were to be created, it should have full financial and operational independence. Supervision of pension funds could be included under its responsibilities. The recently established Competence Center for Systemic Stability in the SNB will provide a useful additional line of defense against financial sector problems.
- Systems of regulation and supervision are in general fully or largely compliant with international financial standards and codes. The assessments of banking supervision, securities regulation, and insurance supervision identified a lack of budgetary independence and weak information sharing arrangements among domestic agencies as lacunae that could become sources of vulnerability in a stressful market environment. The coverage of the regulatory framework appears to have some gaps, notably with regard to individual asset managers and to non-financial companies, whose power to take deposits from employees should be withdrawn. New legislation currently being prepared will help to close these gaps.
- The Swiss anti-money laundering (AML) regime in the financial supervisory area is broadly in line with international best practice. The legal and institutional framework against money laundering has recently been enhanced and extended to cover the application of AML rules to nonbank financial intermediaries.

insurance sector had been affected by claims related to the September 11 terrorist attacks and low capital market returns. The effect of the latter was exacerbated by the mandatory minimum 4 percent return on pension accounts. The authorities considered the sector to be sufficiently capitalized to weather the current situation but agreed with staff that, in a low interest rate environment, mandatory minimum rates of return and payout ratios on pension assets needed to be determined by more flexible formulae.

18. **Supervision is adapting to structural changes in financial markets.** In view of the important role of financial conglomerates, the authorities were preparing legislation to integrate banking and insurance supervision and establish a combined supervisory authority. A Center for Financial Stability had also been set up in the SNB to monitor developments in the financial system and identify vulnerabilities. Other initiatives included the setting up of two expert groups to (1) review the current supervisory framework with a view to strengthening safeguards in the use of external bank auditors and increasing reliance on onsite inspections by the SFBC, and (2) review the existing systems of bank reorganization and liquidation and depositor protection. The insurance supervision law was also being revised to address, among other things, the issue of inter-jurisdiction and inter-agency exchange of information, and corporate governance. Staff welcomed these initiatives, which were in line with the recommendations in the FSSA report. The authorities support measures to counter the financing of terrorism, have implemented UN Security Council Resolution 1267, and intend to ratify the UN Conventions on the financing of terrorism as well as the FATF's special recommendations. The anti-money laundering regime in the financial supervisory area is broadly in line with international best practice. A doubling of the resources of the Money Laundering Control Authority is planned.

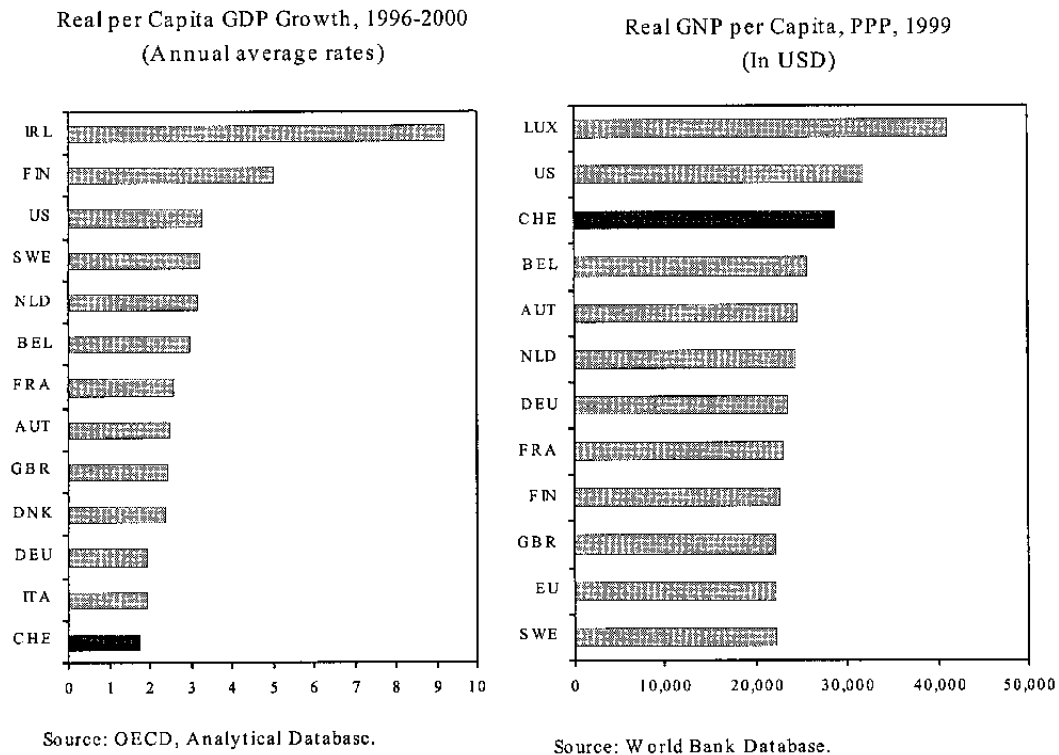
C. Potential Growth, Structural Policies, and Competitiveness

19. **Boosting growth performance remains a challenge.** Real GDP growth averaged barely 2 percent a year in the last upswing despite significant enterprise restructuring during the long recession that preceded it, putting Switzerland at the bottom of the growth league (Figure 12). Staff analysis suggests that growth could be sustained around 2 percent in the medium term.⁹ The authorities were more cautious, noting that slow productivity growth in major services sectors (health care, education) and in agriculture would continue to act as a drag on growth, although attaining 2 percent potential growth might be possible if skill shortages were addressed and technological progress accelerated. There was consensus that, while Switzerland's relatively slow growth was partly a catch-up phenomenon of other countries (Switzerland is still one of the richest countries in terms of per capita GNP), product market inefficiencies were also to blame. Globalization has intensified restructuring in

⁹ See Chapter I of the accompanying Selected Issues Paper.

enterprises exposed to international competition but restructuring in sheltered sectors remains slower than in other industrial countries.¹⁰

Figure 12. Real Output Growth in Selected Countries



20. **Staff thus encouraged efforts to strengthen competition policy.** Domestic markets remain fragmented, reflecting entry barriers at the cantonal (state) level and informal cartel agreements, which lead to inefficiencies and high domestic prices. To boost competition, the authorities noted that legislation to strengthen the Competition Commission's ability to impose sanctions on cartels should soon gain parliamentary approval. And under new guidelines, the Commission would take a stricter line against vertical agreements in the distribution chain. Staff welcomed the initiatives, but noted that the new law might not provide for sufficient deterrence as envisaged fines for offenders failed to systematically exceed cartel profits. Moreover, the critical issue would be to provide the Competition Commission with the support and resources to implement the new law and guidelines rigorously. The Commission should also be given powers to prosecute suspected violators of the Internal Market Law. However, to

¹⁰ Switzerland had the slowest pace of regulatory reform in product markets among OECD countries in 1978-98, and rose from 18th to 5th position in terms of the restrictiveness of its regulatory framework (OECD, Economic Department, Working Paper 312).

be successful, the standing of the law would also need to be enhanced: courts currently tend to support cantons' rights over the imperatives of the Internal Market Law.

21. **The pace of liberalization of sheltered sectors remains slow.** Deregulation has been fastest in the *telecommunications* sector, where prices have dropped below OECD averages and services have expanded considerably. But unbundling of the “last mile” of the network continues to be held up by legal complications. In *electricity*, where there are over a 1,000 different suppliers operating in segmented markets and prices for industrial users are among the highest in Europe, parliament has approved a bill to open up the market over a six-year period along the lines of the EU model. But the regulatory framework remains to be decided and public support for liberalization is weak: the authorities anticipated that more work would be needed on the bill and accompanying regulations to enhance its referendum prospects later this year. The legislative process for the liberalization of the *gas* and *postal services* is at a very early stage and resistance from interest groups is strong. In *agriculture*, subsidies amount to three quarters of value added and tariff protection is high (see below). Productivity in agriculture is only half the national average and grows at much slower rates than in comparable industrial countries. The reform agenda for 2004-07, currently in the public consultation process, envisages a further shift from agricultural price supports to direct payments. Staff welcomed the shift away from price supports but noted that it would take years before protection of agriculture dropped to even the high level of the EU.

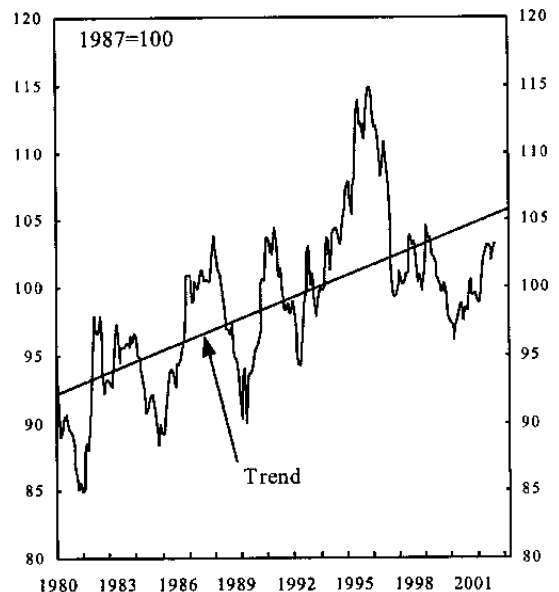
22. **The failure of Swissair and the poor performance of several major enterprises have raised questions about the quality of corporate governance.** These cases highlighted that a lack of transparency of operations, restrictions in voting rights, a lack of separation between board and management, and cross-memberships in boards of directors contributed to weak shareholder control and performance.¹¹ Partly in response, an employer's organization and the Swiss Stock Exchange had proposed codes of conduct aimed at strengthening disclosure requirements and setting out guidelines for good corporate governance. The authorities were also planning to abolish restrictions on the participation of foreigners in boards of Swiss corporations, thereby broadening the pool of talent for Swiss corporations. Staff welcomed the moves as first steps. It encouraged the authorities to foster debate on the topic and look to where the legal code might also be amended to provide support to better corporate governance. Staff further encouraged the authorities to conduct a review of standards and codes based on the OECD Principles of Corporate Governance. On Swissair, staff welcomed the government's stated intention not to provide additional budgetary support and to disengage from the successor airline, Swiss, at an early date.

¹¹ A recent study by the St. Gallen Institute of International Management showed that in 60 percent of listed public companies the governing boards do not have active auditing and planning subcommittees and many boards include persons associated with their domestic competitors. Family- or bank-controlled listed companies tended to have the weakest checks and balances.

23. **A flexible labor market has contributed to low unemployment. Shortages of skilled workers are, however, a drag on growth.** Fairly liberal policies towards foreign work permits—foreigners account for one fourth of the labor force—have mitigated skill shortages, but the authorities acknowledged that reforms in the education system would be needed to address skill shortages on a more permanent basis. A proposed amendment to the unemployment insurance law that envisages a shorter duration of unemployment benefits and lower contribution rates would help to sustain Switzerland's low structural unemployment rate.

24. **Short-term adjustment problems stemming from the recent appreciation notwithstanding, competitiveness was not seen as a concern.** The latest appreciation has brought the real effective exchange rate roughly back in line with its longer-term underlying trend; in the past twenty years, real appreciation, as measured by relative CPIs, has been about 0.6 percent a year (Figure 13). The trend real appreciation is consistent with the large external current account surplus and the trend improvement in the terms of trade.¹² The authorities were not concerned about the underlying appreciation of the franc and noted that traditional competitiveness indicators should be interpreted with caution in a country like Switzerland where manufacturing is oriented increasingly toward niche markets (competing for quality rather than price) and the large financial services sector tends to benefit from a strong franc. Staff suggested that the high domestic price level (as much as 30 percent above comparable EU countries) reflected a lack of competition in sheltered sectors for which the solution was product market reforms that would decrease non-traded goods prices, rather than depreciation.¹³

Figure 13. Switzerland: Real Effective Exchange Rate (CPI based), 1980-2002



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

¹² Under the assumption of an unchanged real effective exchange rate, staff projects that the current account surplus would persist at over 10 percent of GDP in the medium term. This would be higher than estimates of the equilibrium current account surplus based on historical relationships of the savings-investment balance and analysis presented in Chapter II of *Switzerland: Selected Issues*, IMF Country Report No. 00/43 (April 2000).

¹³ Relatively slow reform of domestic product markets in Switzerland tends to accentuate productivity growth differentials between the traded- and non-traded goods sectors and lead to real appreciation (Balassa-Samuelson effect) without loss of competitiveness.

D. Other Issues

25. **Switzerland has an open trade regime, with the exception of agriculture where protection remains very high.**¹⁴ Average tariff protection for agriculture goods is 34 percent and some import duties are almost 700 percent. The authorities noted their support for the launching of the Doha trade round as well as their active involvement in international liberalization initiatives at the multilateral, regional and bilateral levels. Switzerland was committed to eliminating all barriers to imports from the least developed countries by 2006.

26. The authorities reaffirmed their intention to raise **official development assistance** from 0.3 to 0.4 percent of GDP by 2010.

27. Despite continuing improvement, deficiencies in the availability and quality of **economic statistics** remain. In particular, general government statistics are incomplete and subject to long delays; high frequency wage statistics are not available; the national accounts are still waiting to be upgraded to ESA95 and quarterly data are incomplete. The authorities noted that budgetary constraints impeded efforts to address such problems.

28. Swiss legislation conforms to the OECD Convention on **anti-bribery**, except in respect of liability of legal persons for bribery. The authorities expect the requisite additional legislation will be introduced by 2003.

III. STAFF APPRAISAL

29. **Sound macroeconomic policies have put the economy in a good position to weather the current economic slowdown.** Indications are that the economy is now more resilient than it was in the 1990s and hence better placed to benefit from the expected upswing in global activity. Policy makers can facilitate sustained recovery by continuing to adhere to stability-oriented macroeconomic policies and by accelerating the structural reform agenda, particularly as regards product markets.

30. **With inflation risks low and output below potential, monetary policy can afford to remain accommodative in the period ahead.** The latest interest rate cut was justified given the tightening of monetary conditions implicit in recent renewed upward pressure on the Swiss franc and the still only tentative signs of recovery. However, should the recovery turn out to be robust, it will be necessary to begin raising interest rates later this year.

31. **The monetary policy framework is working well.** The focus on medium-term inflation has allowed the SNB to respond flexibly to business cycle conditions and exchange rate developments. So far, the framework has provided an effective vehicle for communicating

¹⁴ Switzerland's rating in the IMF's trade restrictiveness index is 4 (on the 1-10 scale, with 1 being the least restrictive), similar to that of most industrial countries.

policy intentions and appears to be well understood by financial markets. The SNB is encouraged to continue expanding the information it provides about its inflation forecast and the rationale for policy decisions.

32. Fiscal policy is also supporting recovery, although its role should be constrained. While fiscal stimulus in 2002 is not problematic from a cyclical perspective, slippage in the form of new expenditure or tax relief should be strongly avoided, especially as it would add to the adjustment strains next year when the “debt brake” mechanism takes effect. Unbudgeted one-time revenues, for example from the buyback by Swisscom of its shares, should be used to reduce government debt—not to finance new expenditures.

33. Savings are likely to be needed at the federal level in coming years to comply with the debt brake. The principle of running balanced budgets over the economic cycle and stopping the accumulation of public debt is prudent given the need to plan for longer-run demographic strains. The solution to future budget constraints should not be higher taxes. Instead, expenditure growth needs to be restrained. This will require changes in behavior at all budget levels: demands for supplementary appropriations will need to be scaled back and greater flexibility in reshuffling expenditure items will need to be exercised if high-priority items are to be accommodated without tax hikes. A reduction of the currently pervasive earmarking of revenues would enhance such flexibility.

34. The financial sector is well-capitalized and the lines of defense against potential financial sector problems appear to be functioning properly, but the risk in the current environment requires continued vigilance. In this context, moves to further strengthen cooperation among financial regulators, for example along the lines of the proposed single supervisory authority, and to introduce a more formalized quality assurance program for supervising external auditors, are welcome. Ongoing efforts to prevent money laundering and the authorities’ initiatives to track terrorist financing are also important safeguards for the reputation of the Swiss financial system.

35. Enterprise restructuring in the 1990s holds the promise of improved economic performance in coming years, but competition in sheltered domestic sectors will need to be increased. Productivity performance is the key to achieving a higher underlying growth rate. Switzerland has a competitive export sector, including a vibrant financial services industry, which has adapted to the discipline of an upward trend in the real exchange rate. The externally-oriented sector will need to continue to live with such discipline in the future given the large external current account surplus. By contrast, vitality in the more sheltered domestic markets has been lacking and it is here that improved performance will be needed.

36. To sustain faster productivity growth, the drive for reforms should be strengthened. The proposed new Competition Law should provide a significantly better framework to address restrictive practices in Switzerland and the Competition Commission should be given the support to implement it rigorously. Consumers, and particularly industrial users, would benefit from opening up the electricity market, where prices are high by

international standards. A faster phasing-out of distortive subsidies and tariff barriers in agriculture would confer significant benefits to consumers as well as redirecting resources to more productive sectors.

37. **The collapse of Swissair has put the spotlight on the need for higher standards of corporate governance.** Transparent reporting requirements, high accounting standards, structures that allow fair representation of shareholder interests, and strong safeguards against conflicts of interest are necessary ingredients of good governance. In this regard, proposed codes of conduct represent a useful first step. Further strengthening the codes and the supporting legal framework is recommended.

38. **Flexible labor markets and a qualified labor force should remain key competitive advantages of the Swiss economy.** In recent years, policies and an open approach to foreign labor have contributed to the smooth functioning of labor markets. As economic growth relies increasingly on a skilled, well-educated population, it will be important that the education system turns out adequate numbers of suitably qualified persons.

39. Staff welcomes the authorities' initiative to eliminate trade barriers for the poorest countries and encourages them to bring forward their 2010 target for raising **official development assistance** to 0.4 percent of GDP.

40. **Economic statistics would benefit from further upgrading.** Notwithstanding progress in improving the statistical infrastructure, deficiencies remain in key areas such as the national accounts, wages, and fiscal data.

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

Switzerland: Basic Data

Area and population

Total area	41,293 square kilometers
Total population (end-2001)	7.2 million
GDP per capita (2001)	S 34,110
GNP per capita (2001)	S 36,590

	1997	1998	1999	2000	2001	2002 1/	2003 1/	2004 1/	2005 1/
(Percentage changes at 1990 prices)									
Demand and supply									
Private consumption	1.4	2.3	2.2	2.2	2.2	1.8	2.3	2.3	2.2
Public consumption	0.0	1.3	0.5	-0.3	-0.4	0.5	0.5	0.6	0.8
Gross fixed investment	1.5	4.5	3.7	4.9	0.0	-0.3	4.7	4.2	3.5
Final domestic demand	1.2	2.7	2.3	2.5	1.2	1.1	2.7	2.6	2.4
Inventory accumulation 2/	-0.4	0.7	0.3	0.0	-0.4	-0.5	0.3	0.0	-0.1
Total domestic demand	0.8	3.5	2.6	2.5	0.9	0.6	3.0	2.6	2.2
Exports of goods and nonfactor services	8.4	5.4	5.2	10.0	1.0	1.4	5.2	5.3	5.5
Imports of goods and nonfactor services	6.1	8.3	7.5	8.5	0.0	0.8	6.1	6.0	5.7
GDP	1.7	2.4	1.6	3.0	1.3	0.9	2.6	2.2	2.1
GNP	3.7	2.5	2.0	4.7	-0.9	0.5	3.0	2.2	2.1
(In billions of SwF, at current prices)									
GDP	371.4	380.0	388.6	404.4	416.7	423.7	439.0	453.4	468.4
(In thousands, unless otherwise indicated)									
Employment and unemployment									
Employment	3,805	3,841	3,867	3,908	3,925	3,923	3,962	3,992	4,020
(Percent change)	-0.3	1.0	0.7	1.1	0.4	0.0	1.0	0.8	0.7
Unemployment rate (in percent)	5.2	3.9	2.7	2.0	1.9	2.5	2.1	1.9	1.9
(Percentage changes, unless otherwise indicated)									
Prices and incomes									
GDP deflator	-0.2	0.0	0.6	1.0	1.7	0.8	1.0	1.0	1.2
Consumer price index	0.5	0.0	0.8	1.6	1.0	0.9	1.0	1.1	1.1
Nominal wage growth 3/	0.5	0.7	0.3	1.2	2.5	2.0	2.1	2.4	2.4
Unit labor costs (total economy)	0.5	-0.4	0.2	-1.6	1.6	1.0	0.5	1.0	1.0
Real disposable income	3.0	0.5	2.8	1.0	2.4	2.2	2.5	2.1	2.2
Personal savings ratio (in percent)	10.1	8.6	9.1	8.1	8.3	8.6	8.9	8.7	8.7
(In percent of GDP)									
Public finances									
General government									
Revenue	37.0	38.8	38.4	40.2	37.9	38.5	36.9	36.8	36.5
Expenditure	39.4	39.2	38.6	37.8	38.3	38.3	37.2	36.4	35.7
Financial balance 4/	-2.4	-0.4	-0.2	2.4	-0.3	0.1	-0.3	0.4	0.8
Structural balance	-0.8	-1.1	-0.8	1.4	0.6	0.2	0.0	0.6	0.8
Gross debt	51.5	54.5	51.4	51.3	51.6	53.0	51.7	49.9	48.5
Central government									
Revenue	10.5	12.4	11.1	12.8	11.7	12.4	11.6	12.1	12.1
Expenditure	12.0	12.4	11.9	11.8	12.2	12.3	12.1	12.3	12.3
Balance 4/	-1.5	0.0	-0.8	0.9	-0.5	0.1	-0.5	-0.2	-0.3
Gross debt	25.1	27.7	25.3	26.0	27.5	29.5	29.0	28.0	27.3

1/ Fund staff estimates and projections unless otherwise noted.

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

3/ Nominal wage growth per employee.

4/ Including railway loans as expenditure.

Switzerland: Basic Data (concluded)

	1997	1998	1999	2000	2001	2002 1/	2003 1/	2004 1/	2005 1/
(In billions of SwF, unless otherwise indicated)									
Balance of payments									
Trade balance	-0.5	-2.3	-0.3	-4.2	-3.6	0.2	-0.2	-0.1	0.3
Service balance	18.9	19.6	20.0	23.4	22.0	22.2	23.1	24.0	25.4
Balance on goods and non-factor services	18.4	17.3	19.7	19.2	18.4	22.4	22.9	23.8	25.7
Factor income balance	23.4	25.9	30.5	39.6	30.3	30.1	33.6	35.0	36.5
Net private transfers	-3.0	-3.1	-5.2	-4.7	-4.7	-4.8	-4.8	-4.9	-5.0
Net official transfers	-1.9	-2.3	-2.3	-1.9	-2.4	-1.9	-2.0	-2.0	-2.0
Current account	36.9	37.9	42.7	52.3	41.6	45.7	49.6	51.9	55.1
(In percent of GDP)	9.9	10.0	11.0	12.9	10.0	10.8	11.3	11.4	11.8
Foreign direct investment	-16.1	-14.2	-32.4	-44.5	-6.0	...	...	...	...
Outward	-25.7	-27.2	-50.0	-72.0	-26.0	...	...	...	...
Inward	9.6	13.0	17.6	27.5	20.0	...	...	...	...
Portfolio investment	-15.5	-6.7	-61.5	-19.9	-75.4	...	...	...	...
Outward	-28.6	-21.6	-70.4	-37.7	-75.0	...	...	...	...
Inward	13.1	14.9	8.9	17.8	-0.4	...	...	...	...
Banking sector, net	-1.2	-16.7	27.3	11.0	35.0	...	...	...	...
Memorandum items:									
Net investment income	30.0	32.4	37.0	46.5	38.0	...	...	...	...
(In percent of GDP)	8.1	8.5	9.5	11.5	9.1	...	...	...	...
Net external assets	449.1	493.7	575.2	500.6	542.0	...	...	...	...
(In percent of GDP)	120.9	129.9	148.0	123.8	130.0	...	...	...	...
Official reserves (billions of US\$, end period) 2/	39.0	41.2	36.3	32.3	32.0	31.5	...	...	...
Reserve cover (months of imports of GNFS) 2/	5.2	5.3	5.1	4.0	4.2	3.9	...	...	...
(Percentage changes in annual averages)									
Monetary and credit data 2/									
Money (M1)	10.1	8.0	8.6	-1.9	-0.2	6.6	...	...	...
Broad money (M3)	5.1	1.2	1.0	-1.8	2.8	3.1	...	...	...
Domestic credit	1.1	0.5	3.2	1.7	1.7	...	...	...	...
(Period averages in percent)									
Interest rates 3/									
Three-month rate	1.5	1.6	1.4	3.1	2.9	1.3	...	...	...
Yield on government bonds	3.5	2.9	2.9	3.8	3.3	3.5	...	...	...
(Levels)									
Exchange rates 2/									
SwF per US\$ (end of period)	1.46	1.38	1.60	1.63	1.65	1.67	...	...	...
SwF per US\$ (annual average)	1.45	1.45	1.50	1.69	1.69	1.69	...	...	...
SwF per euro (annual average)	1.64	1.61	1.60	1.56	1.51	1.48	...	...	...
Nominal effective rate (1990=100)	105.1	107.1	106.0	105.1	109.2	112.2	...	...	...
Real effective rate (1990=100) 4/	100.9	102.2	100.2	97.9	100.6	103.2	...	...	...

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

1/ Fund staff estimates and projections unless otherwise noted.

2/ Data for 2002 refer to March.

3/ Data for 2002 refer to May.

4/ Based on consumer prices.

Switzerland: Fund Relations
(As of March 31, 2002)

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

II. General Resources Account:	SDR Million	% Quota
Quota	3,458.50	100.00
Fund holdings of currency	2,237.82	64.71
Reserve position in Fund	1,220.67	35.29
Operational budget transfers (net)	55.00	

III. SDR Department:	SDR Million	% Allocation
Holdings	130.45	N/A

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None

VII. **Exchange Rate Arrangement:**

The Swiss National Bank does not maintain margins in respect of exchange transactions. However, the Swiss National Bank has intervened when warranted by the circumstances. Switzerland's exchange system is free of restrictions on the making of payments and transfers for current international transactions. However, Switzerland continues to apply exchange restrictions vis-à-vis Iraq (since August 1990).

VIII. **Article IV Consultations:**

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

IX. **Technical Assistance:** None

X. **Resident Representatives:** None

XI. **Other** FSAP, October 2001

Switzerland: Statistical Appendix

Switzerland publishes timely economic statistics and posts most of the data and the underlying documentation on the internet. Switzerland is in full compliance with the Fund's Special Data Dissemination Standard (SDDS) and its metadata are currently posted on the Dissemination Standards Bulletin Board. However, a number of statistical gaps and deficiencies remain to be addressed: wage statistics are available only on an annual basis; reliable general government 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; the quarterly national accounts lack a production account; national accounts are still based on ESA79; national accounts by industry appear with considerable lag; capital stock data are not available; moreover, there are no flow-of-funds data. To a large extent, these deficiencies reflect a lack of resources and the limited authority of the Federal Statistical Office (BFS) to request information.

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

The SNB has shortened from nine to six months the lag of publishing annual data on the international investment position and plans to publish, starting from 2003, quarterly foreign debt statistics. In 2001, the SNB revised also its effective exchange rate indices (adopting the Törnqvist methodology) and monthly credit statistics (information is now provided on credits to small- and medium-sized debtors and on non-performing loans). The SNB will also participate in the Coordinated Portfolio Investment Survey.

The BFS published in 2001 statistics on the composition of wages in 2000, including bonuses and other fringe benefits; established a new business register that will allow the measurement of activity at the group/enterprise level; continued preparatory work for the introduction of ESA95, tentatively planned for 2003; has been reviewing the methodology of calculating value added in the financial services sector as well as the corresponding deflators; continued work on the methodology for compiling financial accounts (a joint project involving the FSO and the SNB); and has been negotiating a cooperation agreement with the EU for the harmonization of Swiss statistics with EU standards.

The Federal Finance Administration has started preparations for the adoption of the 2001 GFS classification and the revamping of the accounting framework, although implementation of the new framework is not expected before 2006. In the interim period, government finance statistics on a national accounts basis will have to be estimated.

Switzerland: Core Statistical Indicators
as of April 30, 2002

	Exchange Rates	Foreign Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt
Date of Latest Observation	4/02	4/02	4/02	3/02	2/02	4/02	4/02	3/02	Q4/01	2001	Q4/01	2000
Date Received	4/02	4/02	4/02	4/02	4/02	4/02	4/02	4/02	3/02	2/02	3/02	12/01
Frequency of Data	Daily	Each 10 th day	Each 10 th day	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Annual
Source of Update	TRE	SNB	SNB	SNB	SNB	TRE/RES	BFS	SNB KOF tape	SNB KOF tape	MoF	BFK BFS	SNB
Mode of Reporting	Electronic	Mail	Website	KOF tape Website	KOF tape Website	Electronic Website	KOF tape Website	KOF tape Website	KOF tape Website	Mail	Website	Mail
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Each 10 th day	Each 10 th day	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Monthly

BFS = Federal Statistical Office

SNB = Swiss National Bank

KOF = Swiss Institute for Business Cycle Research

MoF = Federal Ministry of Finance

BFK = Federal Office for Economic Policy



INTERNATIONAL MONETARY FUND

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International Monetary Fund
700 19th Street, NW
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IMF Concludes 2002 Article IV Consultation with Switzerland

On May 29, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.¹

Background

Following a protracted period of stagnation, average GDP growth recovered to 2.3 percent a year in 1997-2000, and unemployment dropped to 1.8 percent. The output gap was closed and shortages started to appear in the labor market. Nonetheless, inflation remained well below 2 percent, the lowest in Europe. The external current account surplus reached a record 13 percent of GDP in 2000. Fiscal consolidation brought the budget into structural surplus.

The economy cooled in 2001 as business investment fell and exports were hit by the global slowdown and an appreciation of the Swiss franc. Real GDP growth dropped to 1.3 percent, unemployment edged up, and the external current account surplus declined to 10 percent of GDP. Inflation remained low at around 1 percent.

A benign inflation outlook allowed the Swiss National Bank (SNB) to cut interest rates aggressively in 2001, especially after September 11, and real short-term interest rates are currently below their historical average. However, exchange rate appreciation has blunted the easing of monetary conditions. Fiscal policy was expansionary in 2001 and is expected to remain moderately so in 2002. Next year, Switzerland's new fiscal framework will go into

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.

effect—encompassed in the so-called “debt brake,” which requires the federal budget to be in balance after adjustment for the economic cycle.

IMF staff project real GDP will grow by just under 1 percent in 2002 on the back of a global recovery in the second half of the year and the effects of the monetary easing in 2001. Inflation is projected to remain under 1 percent for most of 2002 and to rise only moderately in 2003.

Executive Board Assessment

Executive Directors commended the authorities for their sound macroeconomic policies, which have put the economy in a good position to benefit from the global recovery following last year’s economic slowdown. Looking forward, the continued adherence to a stability-oriented and transparent macroeconomic policy framework, together with an acceleration of structural reforms, will underpin prospects for higher, sustained growth.

Noting that inflation risks remain low, output is below potential and signs of recovery are still tentative, Directors considered that monetary policy can afford to remain accommodative in the period immediately ahead. The latest interest rate cut was therefore welcome and an appropriate response to the recent upward pressure on the exchange rate. Looking forward, Directors considered a wait-and-see approach to be appropriate, but noted that the SNB may need to begin tightening the monetary stance later in the year, depending on the strength of the economic recovery.

Directors considered that the monetary policy framework, with its focus on medium-term inflation, has allowed the SNB to respond flexibly to business cycle conditions and exchange rate developments. The framework has provided an effective vehicle for communicating policy intentions, and the SNB should continue expanding information to the public about its inflation forecast and the rationale for policy decisions.

Directors agreed that the role of fiscal policy in supporting recovery will need to be constrained. While the current mildly stimulative stance of fiscal policy is not problematic from a cyclical perspective, slippages in budget implementation should be avoided, as this would add to adjustment strains next year when constitutionally mandated fiscal consolidation will be required. Directors also encouraged the authorities to use unbudgeted one-time revenues to reduce government debt.

Directors welcomed the adoption of the new fiscal framework requiring balanced budgets over the cycle, and saw the principle of a brake on public debt accumulation as prudent planning for longer-run demographic strains. They noted, however, that savings are likely to be needed at the federal level in coming years to ensure compliance. In this context, Directors emphasized that priority should be given to restraining expenditure growth over raising taxes. This will require scaling back demands for supplementary appropriations, as well as greater flexibility in redirecting expenditure items, which, Directors noted, would be facilitated by a reduction of the currently pervasive earmarking of revenues. Given the limited scope for the federal budget to play a counter-cyclical role under the new framework and the often procyclical behavior of lower

levels of government, they also encouraged the authorities to pursue their objective of building up a reserve in the unemployment insurance fund to prevent procyclical changes in contribution rates. More generally, it will be important to implement the debt brake in a manner that prevents shortfalls in erratic revenue items from forcing expenditure cuts at times of weak economic activity.

Directors welcomed Switzerland's participation in the Financial Sector Assessment Program, and endorsed the main findings and recommendations of the Financial System Stability Assessment. While the financial sector is well capitalized and the lines of defense against potential problems appear to be functioning properly, continued vigilance will nevertheless be warranted in the current challenging economic environment. In this regard, Directors supported moves to further strengthen cooperation among financial supervisors, to introduce a more formalized quality assurance program for external auditors, and to increase onsite inspections by the Banking Commission. They also encouraged the authorities to review the preferential treatment of the cantonal banks, pursue further integration of banking and insurance supervision, move ahead with plans to introduce mandatory deposit protection, and address the problems related to the mandatory minimum return on pension accounts. Directors commended the authorities for their efforts to combat money laundering and their initiatives to track down terrorist financing.

Directors agreed that an acceleration of product market reforms will be key to improve Switzerland's productivity performance and growth record. The challenge is therefore to inject more competition into sheltered domestic sectors, which would enhance economic efficiency and benefit consumers. In this regard, Directors welcomed proposals to strengthen the powers of the Competition Commission, and they encouraged the authorities to complete the liberalization of the telecommunications sector, speed up the opening of the electricity sector, and phase out distortive subsidies and high tariffs in agriculture. They also looked forward to the implementation of bilateral agreements with the European Union, and highlighted the importance of addressing shortages of skilled labor. Directors underscored the need for high standards of corporate governance, and considered the proposed codes of conduct a useful first step in this area.

Directors commended the authorities' initiative to eliminate trade barriers for the poorest countries, while encouraging them to bring forward their plans to raise official development assistance.

Directors noted that available statistics are adequate for surveillance purposes, but saw scope for further strengthening statistical infrastructure in key areas such as the national accounts, wages, and fiscal data.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Switzerland is also available.

Switzerland: Selected Economic Indicators

	1997	1998	1999	2000	2001 1/	2002 1/
Real economy						
Real GDP	1.7	2.4	1.6	3.0	1.3	0.9
Real total domestic demand	0.8	3.5	2.6	2.5	0.9	0.6
CPI (year average)	0.5	0.0	0.8	1.6	1.0	0.9
Unemployment rate (in percent of labor force)	5.2	3.9	2.7	2.0	1.9	2.5
Gross national saving (percent of GDP)	29.7	29.8	30.6	33.8	30.7	30.4
Gross national investment (percent of GDP)	19.8	19.8	19.7	20.9	20.7	19.5
Public finances (percent of GDP)						
Confederation budget balance 2/	-1.5	0.0	-0.8	0.9	-0.5	0.1
General government balance 2/ 3/	-2.4	-0.4	-0.2	2.4	-0.3	0.1
Gross public debt	51.5	54.5	51.4	51.3	51.6	53.0
Balance of payments						
Trade balance (in percent of GDP)	-0.1	-0.6	-0.1	-1.0	-0.9	0.0
Current account (in percent of GDP)	9.9	10.0	11.0	12.9	10.0	10.8
Official reserves (end of year, US\$ billion) 4/ 5/	39.0	41.2	36.6	32.3	32.0	31.5
Money and interest rates						
Domestic credit (end of year)	5.2	0.6	3.8	0.3	2.0	...
M3 (end of year) 5/	5.1	1.2	1.0	-1.1	5.0	3.1
Three-month Libor rate (in percent) 6/	1.5	1.6	1.4	3.1	2.9	1.3
Government bond yield (in percent) 6/	3.5	2.9	2.9	3.8	3.3	3.5
Exchange rate						
Exchange rate regime	Managed float					
Present rate (April 10, 2002)	SwF 1.66 per US\$					
Nominal effective exchange rate (1990=100) 5/	105.1	107.1	106.0	105.1	109.2	112.2
Real effective exchange rate (1990=100) 5/ 7/	100.9	102.2	100.2	97.9	100.6	103.2

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

1/ Staff estimates and projections.

2/ Excluding privatization revenue.

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

4/ Excluding gold.

5/ Figures for 2002 refer to March.

6/ Figures for 2002 refer to May.

7/ Based on consumer prices.

**Statement by Roberto F. Cippà, Executive Director for Switzerland
May 29, 2002**

On behalf of my Swiss authorities, let me thank staff for the constructive policy discussions held in Bern and Zürich in the context of both the Article IV Consultations and the Financial Sector Assessment Program (FSAP). I thank them also for the excellent and insightful reports. The date of the Board discussion marks the tenth anniversary of Switzerland's membership in the Fund. In the past decade, my authorities have learned to value highly the yearly surveillance exercise, which provides them with a frank and comprehensive assessment of the overall macroeconomic situation and policy stance. This year, the assessment is even more comprehensive than usual, as the background documentation is complemented with the results of the detailed analysis performed under the FSAP. Recognizing the macroeconomic relevance of domestic financial systems, Switzerland has supported the FSAP from the outset. Discussions with the multi-institutional team of experts were very stimulating. My authorities agree with the thrust of the assessments in the staff reports and generally agree with the set of useful recommendations made in the context of the FSAP exercise. As in the past, my authorities are looking forward to publishing all the staff documents.

Switzerland was not spared from the global deterioration of the macroeconomic situation last year. After a strong growth performance in 2000, real GDP growth slowed to 1.3 percent and is forecast at 1 percent in 2002. Inflation numbers and prospects are favorable. Last year, inflation was the lowest in Europe at 1 percent and is expected to remain stable. As regards the labor market, we are either at or not far from full employment.

Fiscal Policy

After a sizeable surplus in the general government balance in 2000, the fiscal situation deteriorated markedly in 2001. Both the general government budget as well as the federal budget recorded a deficit of 0.3 percent of GDP. As pointed out by staff, the deterioration of public finances reflected mainly the support for Swissair and decline of revenues from withholding taxes on capital income and stamp duties. The deficit in 2001 at the federal level was slightly above the limit constitutionally mandated by the "Budgetary Target 2001," namely 2 percent of revenues. The federal budget for 2002 is consistent with this limit, which continues to be binding until the new framework, the "debt brake," goes into effect in January 2003.

However, recent developments indicate that the federal deficit for 2002 could be higher than budgeted. The Federal Council has submitted a supplementary budget for 2002 amounting to SwF 601 million (1.2 percent of total expenditures). Furthermore, fiscal revenues may have been estimated too optimistically, as the economic recovery is taking hold more slowly than anticipated. As regards the use of unbudgeted one-time revenues, my authorities fully agree with staff that they should be used to reduce government debt. Accordingly, the unexpected

revenues resulting from the buy-back program of Swisscom shares in 2002 will be used exclusively to reduce the federal debt.

Under the new expenditure rule, the “debt brake,” the use of one-time revenues to reduce public debt will be dictated by law. The “debt brake” will require a balanced budget over the economic cycle. This means that extraordinary revenues will not lift the expenditure ceiling, and this will implicitly lead to a reduction of public debt. This can be seen as the logical counterpart of the escape clause that allows for an increase of the ceiling in case of extraordinary spending needs. Although my authorities agree with staff that the budget targets set by the “debt brake” should be achieved on the expenditure rather than on the revenue side, this is not a requirement in the new framework. This point was important in the design of the instrument, because of the stated intention to finance demographically induced future increases in social expenditure by increasing the VAT. This being said, measures on the revenue side will be rare, as federal tax rates are fixed in the constitution. The budgetary competence of the parliament is limited to the expenditure side. As to erratic tax revenues mentioned by staff, my authorities note that the “debt brake” framework contains a “compensation account,” which deals with this issue.

As regards staff’s comments on Switzerland’s tax structure, my authorities do not believe that it would be feasible to burden labor income more heavily. Quite to the contrary, the Federal Council is considering to shift part of the tax burden from labor to energy. However, taxation on consumption is planned to rise. As of January 1, 2004, VAT will be increased by 1 percentage point to finance the invalidity pension system.

Monetary Policy

My authorities welcome the staff’s positive assessment of the monetary policy pursued by the Swiss National Bank (SNB) and the new monetary framework. The staff report contains a good evaluation of the key monetary conditions, which largely coincides with the view of the SNB. Accordingly, I can limit my comment to two points.

The first regards the stance of monetary policy. In the staff’s view, the interest rate cuts after September 11, together with the appreciation of the Swiss franc, have eased monetary conditions to a lesser extent than in the view of the SNB (para 5 and para 10). The difference in opinion can be attributed to the fact that the staff attaches more weight to the monetary conditions index (MCI) than the SNB does. The SNB argues that measuring monetary conditions exclusively by the MCI gives an imperfect picture, particularly if the equilibrium exchange rate is changing over time. Long-term comparisons of the MCI are especially problematic. Taking into account additional monetary indicators suggests that the flexible reaction of the SNB led to a strongly expansionary monetary policy after September 2001: real short-term interest rates were very low, the term structure of interest rates turned much steeper and, finally, M3-growth increased substantially.

The second remark concerns the monetary policy framework. The staff report refers to an “intermediate interest rate target,” while the SNB regards the target range for the 3M-Libor

as being purely operational. The target range for the 3M-Libor should not be confused with an “intermediate target.” As an operating target, the 3M-Libor target range serves as guidance for setting the monetary policy instruments, and it is changed whenever the monetary policy stance has to be adjusted. An intermediate target, on the contrary, is fixed over a long period of time and concerns a variable that the central bank considers as a substitute for directly targeting the final goal of monetary policy.

Growth Performance and Structural Policy

As discussed in previous years and highlighted again in the Selected Issues Paper, explanations for slow trend growth in Switzerland cannot easily be identified. Attention should be paid to labor productivity trends, which were weak already in the 1980s and did not improve much in the second half of the 1990s.

However, it is important to note that growth from 1996 onwards no longer lagged behind other countries quite as much as it did before. The picture would be further improved if other standards for the National Accounts were adopted or if data were presented on a PPP basis. This could close the growth gap with better performing OECD countries by as much as 1 percent per annum. However, my authorities accept that the argument of other countries catching up provides only a partial explanation of the phenomenon and that political measures need to be taken in order to enhance growth in Switzerland. To this end, an inter-ministerial working party was set up this spring. A report, outlining recommendations for specific measures should be available in a year. In parallel to this work, several projects for structural reform are underway. The dominant item on the agenda is the September public referendum on the opening up of the electricity market. Since a broad political consensus was recently established regarding the accompanying regulations, my authorities now feel somewhat more confident about a positive outcome of the referendum. Other steps are also being considered like a follow up on the public debate on the provision of public services in peripheral regions and the liberalization of the milk market as proposed by the government in the project “agricultural policy 2007.”

As to competition policy, my authorities welcome staff’s encouragement of the ongoing initiatives to strengthen competition. The revision of the competition legislation will soon be discussed in parliament. The draft law allows for direct sanctions against participants in cartels, while current legislation permits sanctions only in case of a violation against a decision of the Competition Commission. The new law is comparable to legislations in other industrialized countries.

Regarding corporate governance, as mentioned by staff, many steps are being taken. In April, the Board of the Swiss stock exchange adopted rules regarding disclosure of relevant information by listed companies. The new rules satisfy minimal standards as defined for EU member countries. Of course, it would be possible to go further and parliament is currently debating whether it would be appropriate to do so.

We recognize that implementing structural reforms in Switzerland is a slow process, due largely to the very particular institutional setting of direct democracy. At the same time, it is encouraging to note that once a sector is liberalized, market dynamics are very effective. In the example of the telecom sector, prices have fallen below the OECD average in a short period of time.

Financial Sector

As noted at the outset, my authorities found the FSAP exercise very useful. The FSSA is of high quality and they share the thrust of staff's assessment of the Swiss financial sector and support a large majority of the recommendations. In the following, I would like to highlight some points for emphasis.

Swiss banks' resilience to shocks is high and this solidity is reflected in particularly comfortable levels of capitalization. It is worth underscoring that even under the extreme scenario used for the stress test the large banks would have sufficient capital to withstand the shock without having to use any part of their required capital. Hence, according to the stress test scenario, even a strong deterioration of the economic climate would not lead to an "acute problem," to use staff's terminology.

Despite the overall good health of the Swiss financial sector, it is nevertheless desirable to develop further tools to help assess its vulnerability from a systemic viewpoint, i.e., with a particular focus on the systemically relevant banks. Indeed, steps in this direction have already been taken within the newly established Competence Center for Systemic Stability at the SNB in collaboration with the Swiss Federal Banking Commission (SFBC). The authorities acknowledge the necessity to proceed with a number of reform projects currently under way in the financial regulatory field, which found strong support by staff. These include, in particular, the improvement of the framework for consolidated supervision of financial conglomerates, the strengthening of regulatory sanctioning powers, and the formalizing of a quality assurance program for supervising external auditors. My authorities also welcome the staff's support for the proposed bank reorganisation and liquidation framework and introduction of mandatory deposit protection.

The FSSA provides a comprehensive and balanced overview of the insurance sector. By pointing out the lacunae in the current statutes and practice and by suggesting ways to fill them in the context of larger structural change, the FSSA contributes to the ongoing discussions. The currently proposed insurance supervision legislation is particularly relevant, since the draft law addresses several key aspects of supervision such as conglomerate and intermediary oversight, corporate governance, and exchange of information and supervisor co-operation. It also aligns Swiss supervisory provisions and practices with EU legislation, an essential consideration for both the industry and the authorities.

Regarding anti-money laundering issues, the continued enhancement in the legal and institutional framework has been correctly highlighted in the reports. The most significant progress in this regard has been achieved in the area of the non-banking/non-insurance

sector. The Money Laundering Control Authority (MLCA) responsible for this sector has more than doubled its staff and adopted an effective organizational structure.

Finally, my authorities welcome the very positive assessment under the IMF Code of Good Practices on Transparency in Monetary and Financial Policies.