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Switzerland: 2007 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 2007 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 5, 2007, with the officials of Switzerland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 16, 2007. 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 1, 2007 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Switzerland.

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

Financial Sector Stability Assessment Update

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 2007 Article IV Consultation

Prepared by Staff Representatives for the 2007 Consultation with Switzerland

Approved by Alessandro Leipold and G. Russell Kincaid

April 16, 2007

Executive Summary

The economy is performing well. In its fourth year of expansion, growth is balanced, inflation low and the external position strong. Employment picked up and unemployment is low. Cautious fiscal policies produced a surplus one year ahead of schedule. The outlook is favorable with 2007 growth around 2 percent and inflation below 1 percent.

Focus of the policy discussions:

- **Potential growth.** Ongoing reforms in goods and labor markets increased productivity and facilitated above trend growth. The authorities agree that opening the labor market to EU workers and stronger retail competition has kept inflation in check, but are hesitant to assume permanently higher potential growth.
- **Monetary and exchange rate policies.** The SNB continues normalizing interest rates. Surprisingly, the tightening of monetary policy has coincided with a weakening of the exchange rate—linked in part to carry trades. Given prevailing uncertainties, monetary policy needs to remain flexible. Competitiveness is strong and the current account surplus large.
- **Financial sector and FSAP update**. The financial sector is performing well. In a favorable setting, increasingly sophisticated and evolving risk exposures require close monitoring. The FSAP update recommends a strengthening in the draft Act establishing the unified financial market supervisor (FINMA). The authorities agree with many of the FSAP Update's findings, and that funding and regulatory independence of FINMA are crucial.
- **Fiscal policies and sustainability.** Fiscal policies have been strong, with help of the *debt brake,* but the authorities are planning substantial extraordinary budgetary expenditures outside of the debt brake in 2008. With strong revenues and positive incentives from a new equalization system, the cantons are cutting taxes. The staff recommends bringing the extrabudgetary expenditures under the debt brake to preserve its credibility, and avoid procyclical policies. The authorities are preparing measures to reduce long-term fiscal pressures, and a *Long-Run Sustainability Report* to inform the public.

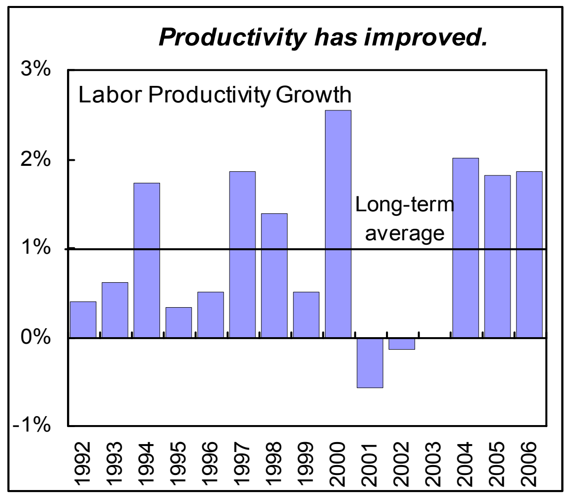
Contents Page

I. Recent Developments and Outlook

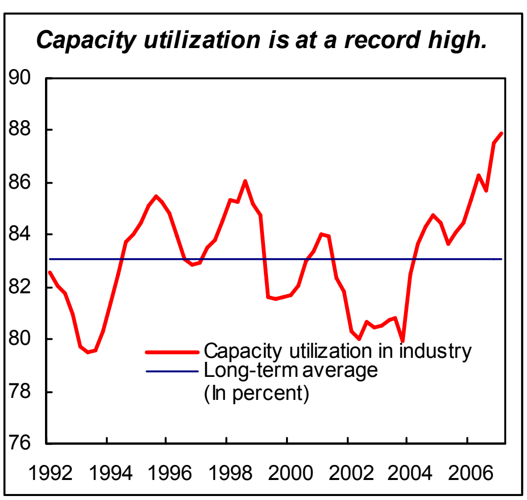
1. **The economy is performing well.** The expansion is entering its fourth year with low inflation and strong employment growth. Confidence is high, and growth is projected at 2.0 percent in 2007, exceeding trend. The budget moved to a surplus one year ahead of schedule, and the external environment remains broadly favorable.

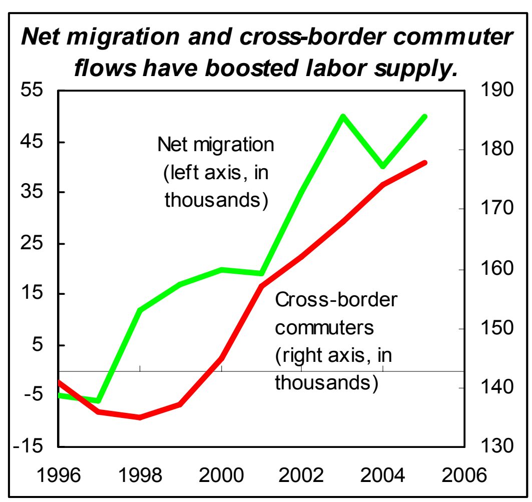
2. **Switzerland holds parliamentary elections in October.** The election cycle is subdued, but high fiscal revenues are inducing some expenditure pressures. The outgoing parliament is not taking up new reforms, so the mission aimed the discussions and its outreach at post-electoral progress.

3. **Stronger policies and global growth have reactivated the economy.** Performance has long been hampered by sheltered sectors (e.g., agriculture) that limited productivity growth and contributed to a high domestic price level. As a result, average per-capita growth lagged peers for two decades through 2003 and Switzerland's relative income position declined. However, since 2004 the economy has rebounded with stronger fiscal policies (the *debt brake*) and reforms in retail and labor markets—while taking advantage of buoyant global activity (Figures 1 and 2).



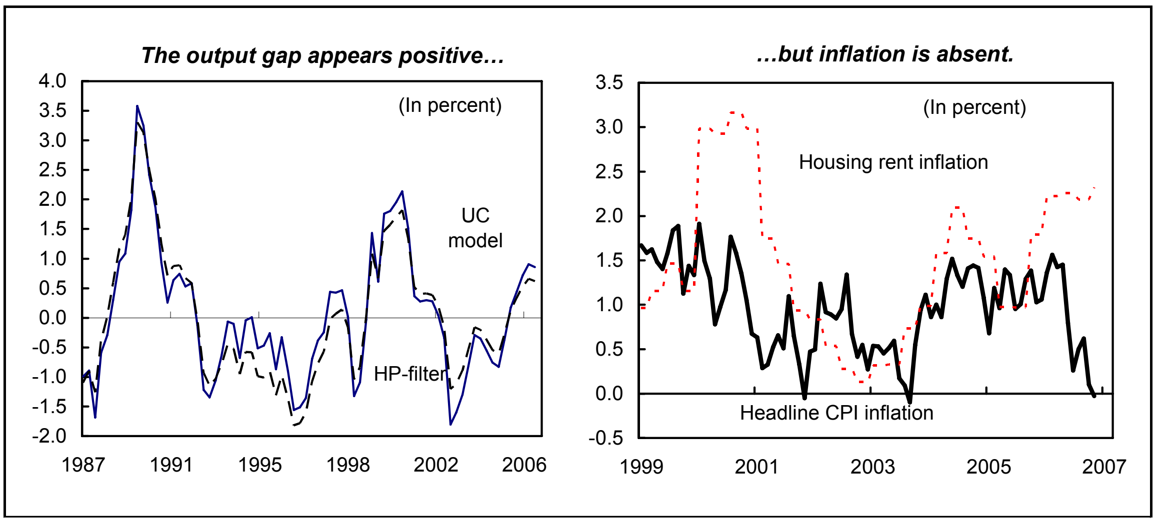
4. **Growth accelerated and became broad based in 2006.** Private consumption picked up with rising employment, and business investment with high capacity utilization; construction rebounded from weather-related lows in 2005. Pharmaceutical, precision instruments, and financial services' exports boomed with the EU recovery and some weakening of the franc. GDP growth of 2.7 percent in 2006 closed the output gap.



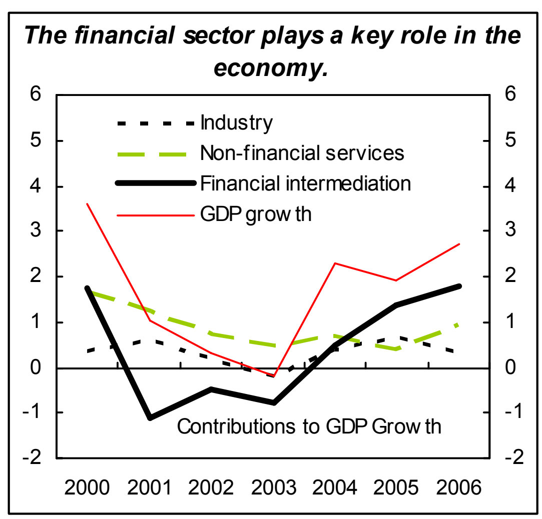


5. **Full-time employment increased in manufacturing, construction, and the financial sector.** Unemployment fell to 3 percent recently and surveys suggest a further decline ahead. Opening the labor market to EU workers helped to fill skill gaps and keep wage growth down, underscoring the value of flexible labor markets and effective migration policies (Figure 3).

6. **CPI inflation and wage pressures have been low.** Inflation was 1 percent in 2006 and real wages grew by 0.7 percent. Labor market openness, reduced exchange rate pass through, rebounding productivity, lower oil prices, and increased domestic retail competition together with higher policy interest rates contained inflation. February 2007 inflation even dropped to zero. When excluding housing rents linked to rising policy interest rates, it was negative. Nevertheless, producer prices are rising somewhat faster, consistent with the weaker exchange rate (Figure 4).



7. **The SNB has raised policy rates in five quarterly steps of 25 bp each to 2.25 percent by March 2007.** Real rates at 1¾ percent are now close to those in the U.S. and euro zone. In the March policy statement, the SNB leaned toward continuing lifting interest rates, partly based on the high level of capacity utilization and the weak exchange rate, but noted the need to remain flexible. Market participants on average price in a slight rate increase for June 2007 (Figures 5 and 6).



8. **The systemically important financial sector is doing well in a favorable setting.** This sector has a large impact on GDP, accounting for 5 percent of employment and 15 percent of value

added in the economy. Financial soundness indicators have improved and bank profitability is strong. The two large banks (UBS and Credit Suisse) are global enterprises in wealth management, derivatives markets, and as prime brokers to hedge funds and private equity firms. The pension and life insurance sectors are recovering from balance sheet pressures, low interest rates, and the downturn earlier this decade in financial asset prices. Real estate prices have increased but remain well below their peak before the crisis of the mid-1990s—there are no signs of price bubbles (Figures 7-9).

9. **The 2006 fiscal result exceeded the budget.** With tight expenditure control and buoyant revenues, the general government achieved a surplus of 0.8 percent of GDP—versus a budgeted 1 percent deficit. Together with the proceeds from Swisscom share sales, this reduced gross debt to 48.2 percent of GDP.

Staff Medium-Term Projections, 2006-2011

(Percentage change from the previous period, unless otherwise indicated)

	2000-05	2006	2007	2008	2009	2010	2011
Real GDP	1.5	2.7	2.0	1.8	1.8	1.8	1.8
Total domestic demand	1.2	2.2	2.2	1.9	1.5	1.7	1.7
Private consumption	1.3	1.9	2.1	1.9	1.8	1.8	1.8
Gross fixed investment	1.3	3.9	3.9	3.4	2.0	2.0	2.0
Foreign balance (contribution)	0.3	0.6	0.0	0.1	0.3	0.2	0.1
Unemployment rate	2.7	3.3	2.8	2.8	2.9	2.9	2.9
Employment rate	0.6	0.9	0.6	0.4	0.4	0.5	0.5
CPI inflation, p.a.	1.0	1.0	0.7	1.0	1.0	1.0	1.0
Savings 1/	34.0	39.0	38.2	37.2	37.3	37.7	38.3
Investment 1/	21.9	21.5	20.9	21.1	21.4	21.9	22.7
Savings-investment balances 1/	12.1	17.5	17.3	16.1	15.9	15.8	15.7
Private	12.4	17.3	16.3	15.0	15.1	15.6	16.2
Public	-0.3	0.2	1.1	1.1	0.7	0.2	-0.6

1/ In percent of GDP.

10. **The outlook is favorable but tail-end risks warrant monitoring.** External demand, even discounting some slowing, remains supportive overall. Investment and consumption are expected to remain buoyant (Figure 10). Staff projections are in line with consensus. While low-probability events, a disorderly unwinding of global imbalances or a shock from hedge funds or private equity could have pronounced consequences given Switzerland's large role in financial intermediation. Another downside risk would include increased currency volatility linked to Swiss franc carry trades. Upside potential could materialize if the franc were to continue being weak or migration and employment growth accelerated further.

11. **The main long-run challenge for Switzerland relates to population aging, its associated fiscal pressures and decline in potential growth.** Driven by demographics, the staff projects potential growth to slow to around 1¼ percent by 2020. Although there is upside potential with improved competition and migration, unchanged fiscal policies would nevertheless generate a large primary deficit from higher entitlement costs, as shown below.

II. Policy Discussions

12. **With the economy performing well, the mission focused on core issues:**

- **Potential output:** Reforms in goods and labor markets are bearing fruit with increased productivity and lower inflation. Discussions focused on whether these supply improvements could sustain more rapid growth without price pressures.

- **Monetary and exchange rate policies:** The exchange rate has weakened despite the SNB tightening and a growing current account surplus. These conditions, and uncertainty about cyclical and inflation turning points, complicate monetary policy.

- **Financial sector:** Switzerland would be sensitive to a disorderly resolution of global imbalances. The November FSAP update mission assessed these and other risks.

- **Fiscal sustainability:** The debt brake has limited spending in recent years, but the authorities are now placing extraordinary spending off-budget. Also, the debt brake is not robust to aging pressures, and measures to address these need to be formalized.

A. Potential Output

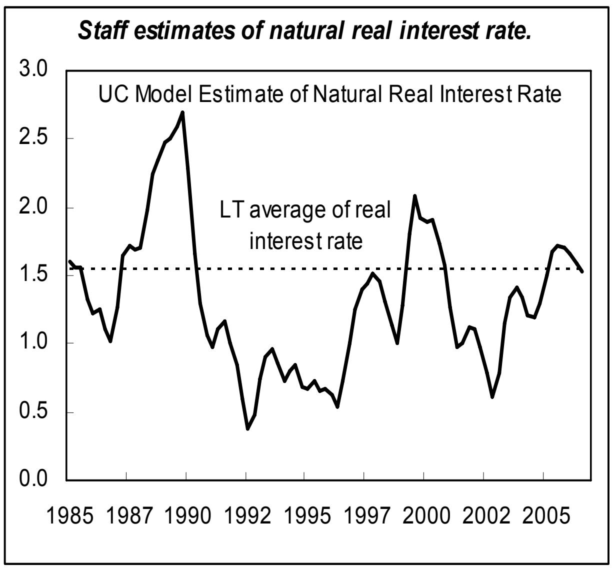
13. **The authorities were guarded about the possibility that potential growth had increased.** They estimate current potential growth of 1½ percent a year; the staff thought that it could be closer to 2 percent for now. The authorities agreed that opening the labor market and tighter domestic retail competition had facilitated the rebound, and that Switzerland was a large beneficiary of globalization, putting downward pressure on domestic prices. Their caution centered on whether improvements were temporary or permanent. There were logistical and political limitations to (im)migration. Also, their analytical work did not yet suggest higher potential. They would monitor indicators for policy implications because if potential growth were higher, financial policies could be slightly easier.

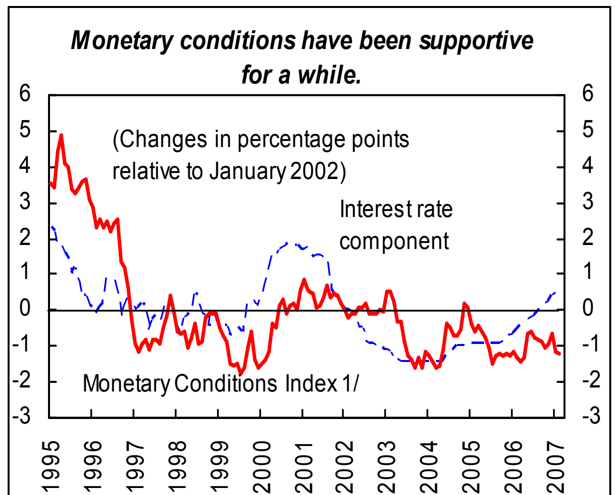
Staff Projections of Long-Run Potential Output Growth
(Average percentage change a year, unless otherwise indicated)

	1990-99	2000-09	2010-19	2020-29	2030-39	2040-49
Real GDP	**1.1**	**1.7**	**1.6**	**1.3**	**1.3**	**1.2**
Total Factor Productivity (TFP)	**0.2**	**1.1**	**1.0**	**1.0**	**1.0**	**1.0**
Total Hours Worked	**0.1**	**0.0**	**0.0**	**-0.3**	**-0.2**	**-0.2**
Working Age Population	0.6	0.7	0.1	-0.4	-0.3	-0.2
Participation Rate	0.2	-0.3	0.2	0.1	0.1	0.0
Employment Rate	0.5	0.6	0.2	-0.3	-0.2	-0.2
Hours per Employee	0.0	-0.3	-0.1	0.0	0.0	0.0
Real Capital Stock	**1.9**	**2.1**	**1.8**	**1.5**	**1.4**	**1.3**
Memorandum items:						
Labor share of income (in percent)	59.10	60.10	60.00	60.00	60.00	60.00
Population, e.o.p. (thousands)	7,002	7,435	7,854	8,076	8,156	8,116

B. Monetary and Exchange Rate Policies

14. **The normalization of interest rates was close to ending.** The SNB agreed that short-term inflation pressures appeared absent, but (in their estimate) a positive output gap, high credit growth, weak exchange rate, and falling unemployment signaled higher prices in the medium-term. Exchange rate and wholesale price pass-through effects could reappear. Moreover, monetary policy had been accommodative for a while—which would impact expectations at some point. The staff considered that econometric modeling grounded in past data would have difficulty picking up the benefits from reform on higher potential growth, as these affect the economy in a forward looking way. Still, some of the SNB's models indicated a neutral rate of 2.5 percent (real 1.5 percent; inflation 1 percent), and the SNB tightened further in March.





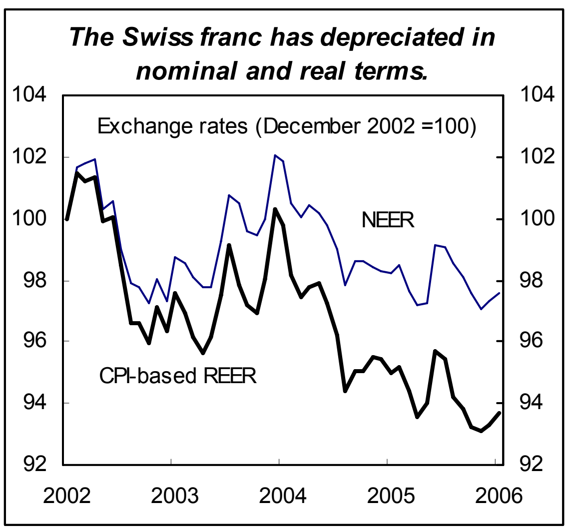
1/ A weighted average of the 3-month interest rate (3/4) and the detrended nominal effective exchange rate (1/4).

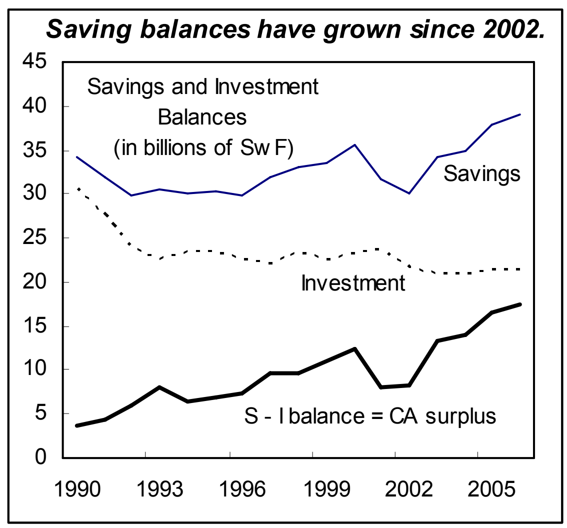
15. **While the SNB leaned toward further rate increases, they noted that upcoming decisions were not clearcut.** The SNB stressed foremost the need to stay ahead of inflation expectations (the yield curve has flattened, Figure 5). On the exchange rate, as long as its weakness did not affect expectations, it was not a concern. The policy stance would respond flexibly to unfolding events.

16. **The monetary policy framework and communication strategy serve Switzerland well.** The SNB publishes every quarter a three-year inflation projection as a communication device, which appears to have contributed to keeping financial markets well informed about policy intentions. On a technical level, the staff continued to feel uneasy about the regulated link between interest rates and housing rents, which creates a policy distortion (higher rates *causing* rental inflation). Moreover, cantonal banks are under (local) political pressure to keep mortgage rates stable as policy rates rise—evidence of a second distortion related to public ownership of banks.

17. **The exchange regime is an independent float.** The value of the franc is determined by demand and supply. The SNB reserves the right to intervene, but has not done so in years. The system is free of restrictions except for security reasons notified to the Fund.

18. **Competitiveness is strong and the external surplus large**. Despite strong fundamentals, the franc has depreciated by 2½ and 6½ percent in nominal and real effective terms since 2002. Calculations using the Fund's macroeconomic balance approach (CGER) suggest the franc is 0-20 percent undervalued. The staff projects the current account surplus to remain at 16-17 percent of GDP, in part reflecting earnings on Switzerland's large foreign assets from occupational pension funds, insurance companies, and corporate holdings (Figure 11). Moreover, financial service earnings have grown fast as new IPOs and M&As increased underwriting fees and commissions; natural disaster related premium adjustments boosted insurance company receipts; and high commodity prices and trading activity raised merchanting revenue. At the same time, the strong demand for precision instruments and pharmaceuticals increased the merchandise trade surplus to 1 percent of GDP.[1] The authorities noted that the current account surplus largely went into direct investment outflows, especially by foreign controlled holdings. Neverthless, interpreting the surplus is complex, and its connection to domestic demand is not straightforward (Box 1).





[1] Switzerland has a merchandise *deficit* with the EU and small *surpluses* with the US and Asia.

Box 1. The Swiss Current Account Surplus

Interpreting the large current account surplus is complex. The (entirely private sector) surplus reflects structural and cyclical components that have grown with globalization and as Swiss multinationals expand. The surplus does not connect in a simple way to domestic absorption, or even to Swiss nationals.

- **Net foreign assets** exceeding 110 percent of GDP mostly reflect pension plans' and Swiss multinational foreign assets. Even at moderate returns of some 6 percent, these assets alone contribute (a structural) income of 7 percent of GDP.

- **Swiss multinationals are very profitable.** The global upswing has boosted profitability of Swiss firms in chemical, pharmaceutical, machine tool, and financial services industries. They are world leaders in their field, conducting mostly business overseas. In comparison with a small home base, their global profits are structurally improving and also currently cyclically strong, thus exerting a large impact on the Swiss balance of payments.

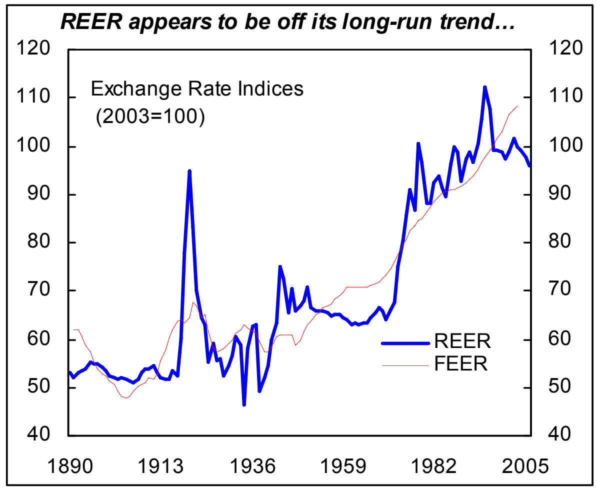
- **Merchandise trade account.** The trade balance was around zero in the 1990s and a small surplus more recently, reflecting slow average growth. Going forward, absorption is likely to increase as the economy continues to strengthen, and reforms further liberalize internal markets. Investment is picking up and consumption taxes are low (see chart in para. 29), yet stronger absorption could only reduce part of the large external surplus.

- **Foreign holding companies.** Switzerland is home to foreign controlled holdings, who are attracted by location, a stable political system, excellent legal, physical, and financial infrastructure, and moderate tax regime. As residents, their profits are in the Swiss balance of payments. Most of their earnings are in-and-out, but their net retained earnings abroad are a Swiss surplus—these have grown from -1 percent of GDP in 2001 to nearly 3 percent in 2006.

- **Not all of the surplus is "Swiss."** Balance of payments data reflect residency. Many firms in Switzerland are fully (foreign holdings) or partially (foreign share ownership in Swiss firms) owned by foreigners. A preliminary staff analysis based on data received from the authorities suggests that nearly 7 pps of GDP of the current account surplus in 2005-2006 is attributable to foreigners.

19. **The authorities agreed that it was unclear whether recent exchange rate weakness would be sustained or was temporary:**

- Strong fundamentals and narrowing interest differentials point to the franc resuming its century long trend appreciation at some point.

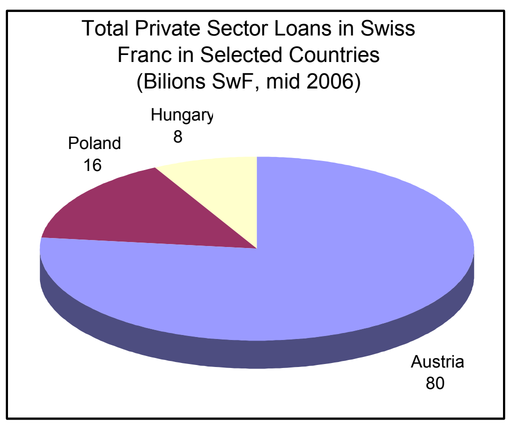


- However, reforms that are lowering nontradable prices are consistent with a *depreciating* equilibrium exchange rate (a "reverse" Balassa-Samuelson effect).

- Moreover, hedge fund and retail carry trades (contracting SwF mortgages in Eastern Europe) may have contributed to weakening the franc. Even some exporters have discontinued hedging their contracts. The limits to this process are uncertain, but the SNB warned that carry trades were risky, and would remain alert for cross-border spillovers (Box 2).

Box 2. Carry Trade Spillovers

Low interest rates and volatility have made the Swiss Franc the currency of choice for mortgage and other private loans in Eastern Europe. This carry trade is growing rapidly, particularly through Austrian banks, with a stock at over SwF 100 billion by mid-2006 (25 percent of Swiss GDP). Swiss banks have limited direct exposure. The originating banks hedge currency exposure, but could be hit by counterparty risk.



Spillovers could take different forms. Repercussions for Swiss banks are unclear. Net external interbank lending from Swiss banks is growing but represents only ½ percent of their international claims. To the extent these funds are used to finance foreign SwF retail loans, a sharp appreciation of the SwF could stress retail borrowers in Eastern Europe and reverberate back into Switzerland. Moreover, some foreign banks directly place paper on the Swiss exchange and international markets. Swiss policies or exogenous shocks that appreciate the franc could stress retail borrowers and carry traders and eventually affect their SwF lenders.

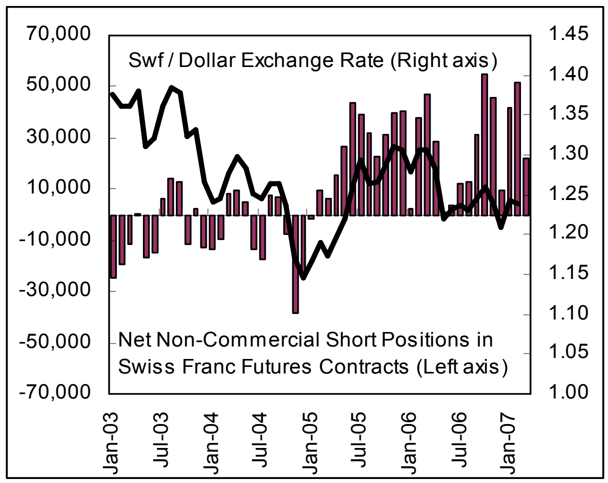
- The emergence of the euro (franc weakness is mainly against the euro) may have reduced the safe-haven role of the franc (Box 3). Nevertheless, the authorities felt that this effect, and low volatility, could be temporary—and that currency appreciation would resume as risk appetites normalized.

The authorities agreed that a floating exchange regime was best to handle these uncertainties.

Box 3. Has the Swiss Franc Lost Its Luster?

The franc has weakened lately after appreciating by 0.7 percent annually in real effective terms for a century.

One factor has been *carry trades* as the yen and Swf were main funding currencies (2006 BIS Annual Report). Carry traders short low yielding currencies, with the proceeds going long on high yielding assets. SwF futures contracts on the CME indicate a marked increase in short positions since 2004.



Two, the Swf may have lost status as a *safe haven currency*. In 2001, the Swiss constitution was amended to allow SNB gold sales and, in 2005, a substantial amount of gold was sold with the proceeds distributed to government. The response of the Swf to gold prices appears to have weakened recently, and global turbulence has not caused Swf appreciation as in the past.

Three, the Swf has lost share as *official reserve currency*. As global reserve holdings increased from 4 percent of GDP in 1990 to 10 percent in 2005, the Swf share has diminished (BIS data). Given the more active reserves management, this might reflect low yields in Switzerland, the currency's decoupling from gold, and substitution to the euro as the new preferred asset.

C. The Financial Sector and FSAP Update

20. **The authorities welcomed the FSAP update accompanying the consultation.** The FSAP team and SNB designed stress scenarios, including a weaker dollar and higher U.S. interest rates that the large banks applied in their proprietary risk models. The banks and supervisory authorities felt that the stress exercises were helpful, and would explore how they could be used to improve risk management. The accompanying *Financial System Stability Assessment* reports on the findings and recommendations in detail.

21. **The FSAP update found the financial system resilient to significant shocks, but identified several areas for policy attention.** An abrupt unwinding of global imbalances could have strong effects because a large repricing of financial assets or currencies would adversely affect banks and portfolios of insurance and pension funds. The growing importance of hedge funds, private equity leverage, and derivatives trading merited closer monitoring. Indeed, while challenging for a small country, it was crucial to maintain a proactive supervisory stance to guard against falling behind in understanding the evolving operating models and risk exposures in the large institutions. Counterparty default and ring-fencing needed to be examined in stress testing models, complemented by targeted audits.

22. **The FSAP update felt that there was scope to strengthen the draft Act establishing the Financial Market Supervisory Authority (FINMA).** The FINMA will become operational in 2009 and unify banking, insurance, securities, and anti-money laundering supervision. The draft Act could be strengthened through additional budgetary and policy independence, and by granting FINMA independent authority to impose civil money penalties. The staff also recommends dealing with concerns about the costs of regulation in the *Guidelines for Financial Market Regulation*, rather than explicitly in the law itself, to avoid regulatory capture. The authorities agreed that funding and regulatory independence are crucial, but were less concerned than staff about risks of regulatory capture. They also noted that powers to impose civil money penalties already exist in the Ministry of Finance and on the cantonal level (criminal prosecution), which they consider sufficient.

23. **The implementation of Basel II capital adequacy was well advanced; now additional efforts were needed to bolster liquidity supervision.** Supervisors need to keep an ongoing dialogue with the banks on Basel II, and internal models need to be continuously evaluated given their high *unweighted* leverage ratios, and other risks not evaluated by the stress tests including systemic events in hedge funds and the derivatives markets. Additional on-site audits are underway and lead auditors are periodically rotated. After a delay, the authorities are now updating their liquidity regulations along BIS standards.

24. **Reforms in transition through 2010 will move Switzerland's insurance regulation to international best practices.** Through the application of the Swiss Solvency Test (SST), the authorities are moving toward a risk-based system equivalent to EU solvency II. Meanwhile, some weaknesses are present in the system, as several companies were found to be too vulnerable to financial and real asset price drops. The authorities were considering more focused inspections to assess and address risk exposures of these firms.

25. **The authorities noted that there was no political consensus to centralize pension supervision.** The FSAP update found that pension supervision remained fragmented and uneven among cantons, carrying risks for fiscal sustainability and contingent liabilities. Also, underfunding needs to be resolved and integrity standards and rules governing investment structure upgraded. While the central authorities do not have formal jurisdiction over pension supervision, a central High Supervisory Board would coordinate regulation, moving to a risk-based solvency system with higher valuation reserves and tighter integrity standards.

26. **The FSAP update recommended that cantonal banks focus on profit maximization and be granted further operational independence.** It found that cantonal banks were less efficient than private banks, partly because they had to carry out social functions with contingent risks. The authorities agreed that the banks needed to minimize costs as their state guarantees could be withdrawn. Meanwhile, the banks had become more efficient since the real-estate crisis in the mid-1990s. They also noted that social mandates were decided by cantons that could not be revoked by national authorities.

D. Fiscal policies

27. **The authorities were satisfied with the operation of the debt brake, but recognized its limitations.** The staff agrees that the debt-brake, which seeks balance over the cycle, has been instrumental in reaching the 2006 surplus. However, it applies only to the confederation, excluding social security, and does not provide an anchor for long-term fiscal sustainability. Long-term solutions would need to fit within the devolved federal system, but significant progress was unlikely during this election year.

28. **Spending pressures were building but officials were confident that medium-term offsets could be found**. The budget aims at a surplus in 2007, but extraordinary off-budget expenditures exceeding 1 percent of GDP were planned for 2008. These include the creation of a new permanent off-budget infrastructure fund and funding of a public pension obligation—all outside the debt brake.[2] To compensate, the authorities cut discretionary spending, were negotiating structural reductions in government tasks and subsidies, and planning a VAT increase for the disability fund (see below).[3] The staff expressed concern about the extraordinary expenditures and that fiscal policy was becoming procyclical. The authorities explained that their objective is to bring all outlays into the fiscal target over the medium-term—safeguarding the spirit of the debt brake. However, they said that some operations are lumpy and one-time and can not be accommodated in the annual debt brake rule. They would continue debt reduction, including with further sales of Swisscom shares.

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[2] The authorities are also reducing taxation on couples, potentially lowering revenues by ¼ percent of GDP a year from 2010, and considering eliminating double taxation on dividends.

[3] The *report on government tasks and subsidies*, which parses government functions and subsidies, should be ready by mid-2007, aiming at SwF 2.9 billion savings over 2008-10.

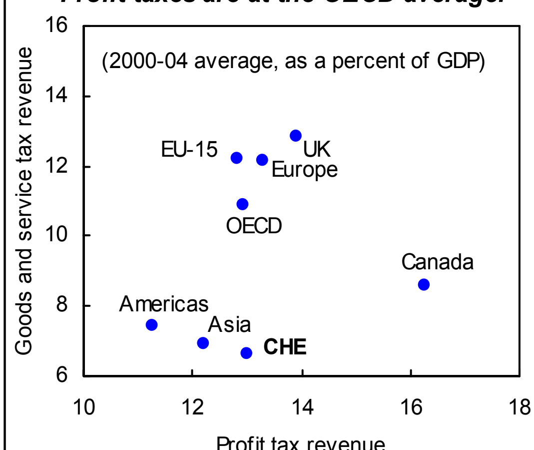
Fiscal Developments and Staff Projections1/
(In percent of GDP)

	2005	Est. 2006	Proj. 2007	2008	2009	2010	2011
Revenue	**38.6**	**38.2**	**38.0**	**37.8**	**37.5**	**37.5**	**37.5**
o/w Taxes	30.5	30.7	30.5	30.3	30.0	30.0	30.0
Primary Expenditure	**37.1**	**35.9**	**35.9**	**36.7**	**35.8**	**35.8**	**35.9**
Wages and salaries	10.9	10.7	10.6	10.4	10.4	10.3	10.2
Transfers	17.6	17.0	17.2	17.6	17.4	17.6	17.8
Other	8.5	8.2	8.2	8.7	8.0	8.0	7.9
Primary balance	**1.5**	**2.3**	**2.1**	**1.1**	**1.7**	**1.7**	**1.6**
Interest	1.6	1.5	1.5	1.4	1.3	1.2	1.2
Overall balance	**-0.1**	**0.8**	**0.6**	**-0.3**	**0.4**	**0.4**	**0.4**
Cyclically adjusted balance	0.1	0.7	0.5	-0.4	0.3	0.4	0.4
Debt-GDP ratio	51.4	48.2	46.2	45.3	43.6	41.8	39.9
Memorandum items							
Balance	-0.1	0.8	0.6	-0.3	0.4	0.4	0.4
Federal government	-0.2	0.5	0.3	-0.8	0.3	0.3	0.4
Cantons	0.1	0.2	0.1	0.1	0.0	0.0	0.1
Communes	0.2	0.2	0.2	0.2	0.1	0.2	0.2
Social security	-0.2	0.0	0.0	0.2	0.0	-0.1	-0.3

1/ Not including planned VAT increase.

29. **The authorities saw cantonal tax competition as part of fiscal federalism.** Cuts in income tax rates reflected the reduction in cantonal debt with the distribution of gold sales proceeds; robust cyclical revenues; and the move to a new financial equalization system.[4] Officials said that while the cantons were free to set their local rates, there was a natural limit to cuts based on revenue impact. The combined confederation and cantonal profit tax burden was average for Europe, but consumption taxes were relatively low. The authorities preferred tax cuts over expenditure hikes, but agreed that they were procyclical.

Profit taxes are at the OECD average.



[4] In the old regime, cantons with high tax rates tended to get more transfers; in the new system, incentives are to moderate tax pressure. This effect is transitory until the new system is fully adopted.

30. **To cut long-term fiscal pressures, the government is working in several areas:**

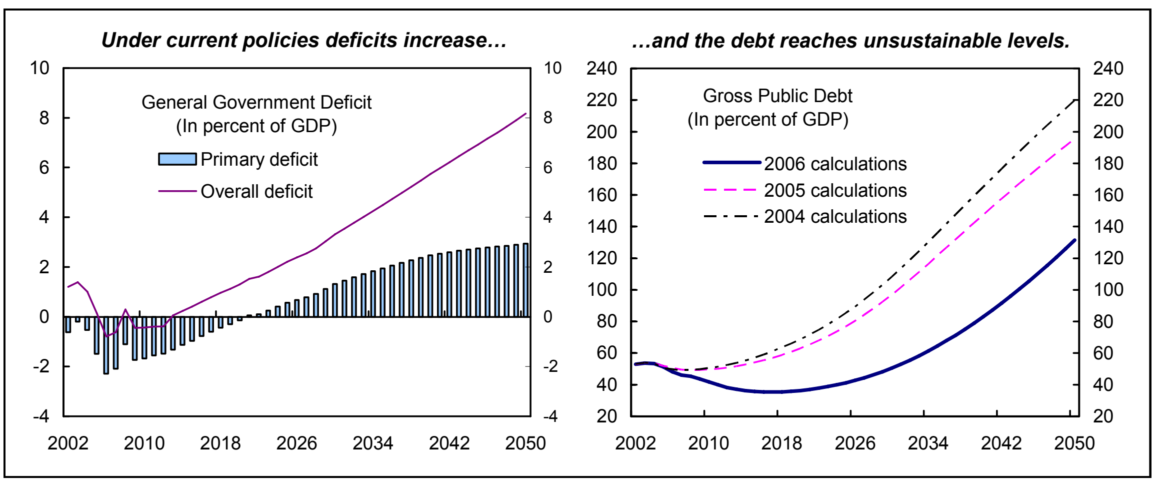
- **Health care.** Use of generic drugs has increased, hospital budgets tightened, and physician reimbursements linked to specific services rather than the length of stay.

- **Disability insurance.** Eligibility is being tightened, and reintegration of the disabled back into the workforce is showing early success.

- **VAT.** The authorities plan to resubmit for approval the VAT increase of 0.8 pps, earmarked to reduce debt in the disability insurance fund. They are also developing plans for the unification of VAT rates and abolition of exemptions.

- **First pillar pensions.** A proposal to raise the female retirement age from 64 to 65 is in parliament, and plans are to raise the threshold for early retirement. In addition, the CPI weight in pension indexation would be increased, moderating benefit growth.

- **Second pillar pensions.** To cut underfunding, the conversion rate (translating capital into a retirement annuity) and regulated minimum interest rate can be reduced.



31. **Nevertheless, the authorities agreed that dealing successfully with population aging would require further structural adjustments.** To inform the public about needed fiscal adjustments, so important in Switzerland's referendum/political system, the authorities are preparing a *Long Run Sustainability Report* (LRSR) for end-2007. It will contain the baseline fiscal projections at unchanged policies. A follow-up report, including options to address booming health care costs, is expected in 2008. The staff strongly supports these efforts and noted that the LRSR could include a preliminary inter-temporal public sector balance sheet (Table 4) to show that unfunded future liabilities are over 2 times the size of today's gross debt. Indeed, the mission's projections suggest that government net worth (including the implicit liabilities) is improving, but a large long-run shortfall still exists.

III. Staff Appraisal

32. **The economy is doing well, growth prospects are positive, and risks appear balanced.** After two decades of sluggish performance, the economy has perked up, benefiting from strengthened policies and a favorable external environment. The outlook holds promise but care should be taken that fiscal policies do not become procyclical. Short-run capacity appears stretched, but inflation is low as globalization and tighter domestic competition limit pass-through and the opening to EU citizens keeps wage pressures in check. Downside risks could emerge if external growth were to slow significantly or global imbalances unwind abruptly. Continued weakness in the franc and accelerating employment constitute upside risks.

33. **A key challenge is to avoid complacency and consolidate the good performance with structural reforms.** The expansion is in its fourth year, reflecting cautious monetary and fiscal policies, and reforms can further support potential growth and lower prices. Switzerland needs to seize this opportunity to address long-term structural and fiscal issues, especially since population aging pressures are not resolved.

34. **Monetary policy needs to remain flexible in the face of greater uncertainty.** The SNB has anchored inflation expectations by tightening policies as the expansion progressed. Judging the correct stance becomes more difficult going forward, however, as growth appears to have peaked. Labor supply and productivity improvements suggest that growth can be higher than in the past without generating inflation. Nevertheless, the SNB needs to remain alert as weakness in the exchange rate could still affect costs.

35. **The recent Swiss franc weakness is a conundrum**. Improving fundamentals (a large external surplus and international investment position, and above average growth) point to an appreciation in the franc. However, the strong euro as a competing safe-haven currency and lower domestic prices point to a depreciation in the franc. Carry trades—which weaken the currency—provide persistent noise. The floating exchange rate regime is best to handle this uncertainty.

36. **Competitiveness is strong.** Currency weakness, the large stock of NFA, and the large financial companies play a key role in the strong external position. Switzerland's excellent conditions for the location of multinational holdings may also contribute to the external surplus. Deeper internal reforms could further energize domestic demand and make a contribution, appropriate to Switzerland's size, to the reduction in global imbalances.

37. **The FSAP update found that the financial sector is performing well, but risks persist.** While stress testing indicates that the financial sector is generally resilient to shocks, bank operations are increasingly complex, involving exotic instruments and high-leveraged counterparties; some insurers remain vulnerable to asset price adjustments; and occupation pension funds continue to experience underfunding and fragmented regulation. The main

downside risk is that healthy balance sheets and profits may be building a degree of complacency, creating vulnerability to increased volatility or shocks.

38. **Therefore, regulatory and supervisory arrangements need to be first-best.** The new consolidated regulator (FINMA) needs to have the operational independence and financial resources to be a constructive and appropriately forceful supervisor and regulator of the very large systemic financial institutions. Continuing efforts are needed to evaluate the large banks' operating models and to ensure that liquidity and capital regimes are sufficient.

39. **Fiscal policies have been sound, generating a surplus one year ahead of schedule.** The debt brake has functioned well and the authorities are to be commended in their steadfast implementation of the two sizable expenditure reduction programs. This strong record needs to be extended into the medium term to meet the challenges of population aging.

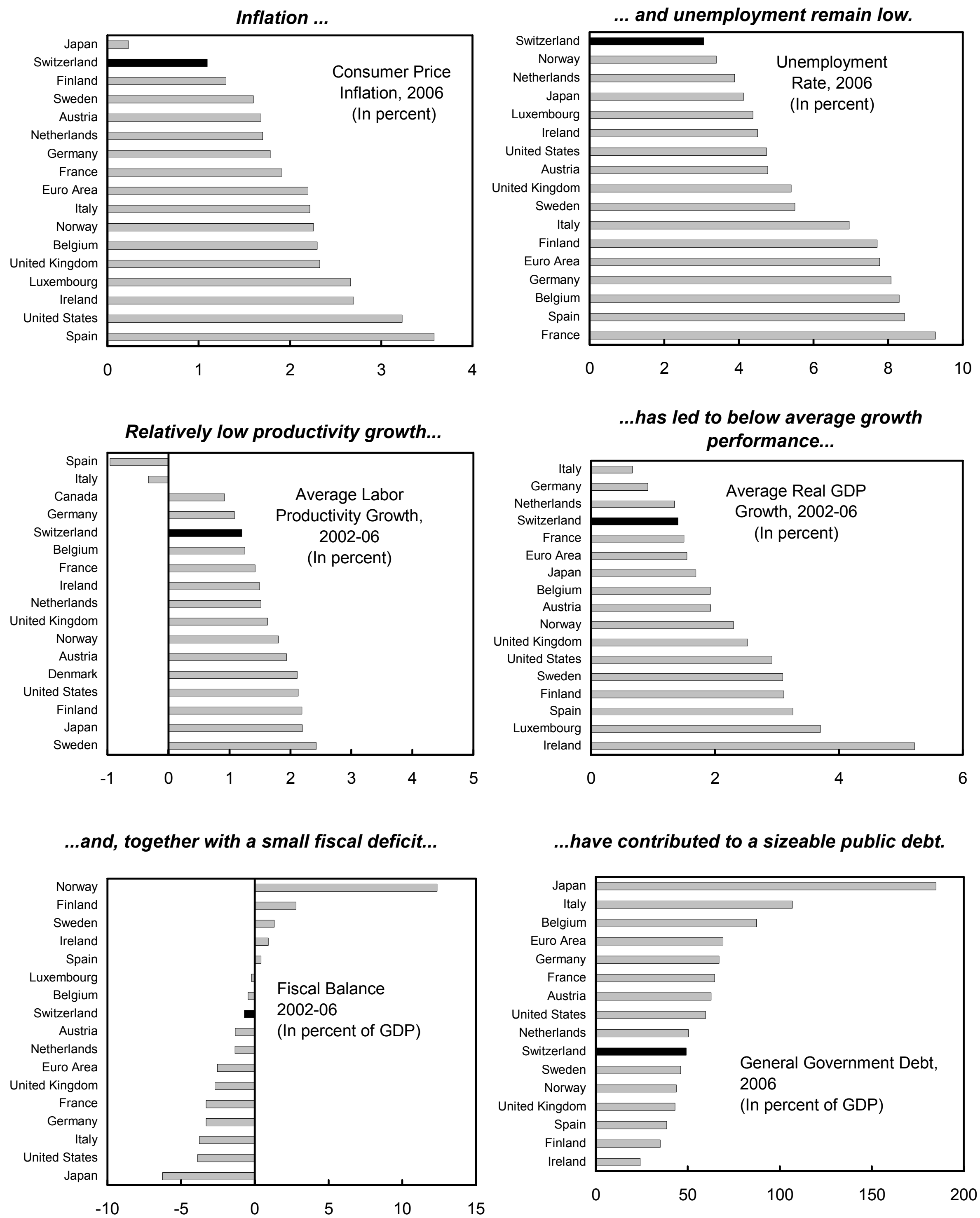
40. **Procyclical fiscal policy should be avoided and the integrity of the debt brake maintained.** Fiscal policy for 2007-08 is projected to be expansionary, reflecting large extraordinary expenditures and overdue pension funding outside the debt brake. These expenditures should be compensated within the debt brake mechanism in the medium term. Similarly, while cantonal tax cuts partly reflect the move to a new equalization system, they demonstrate how Switzerland's competitive federalism can generate procyclical tax cuts—in the face of unresolved longer-term social security deficits.

41. **The main fiscal challenge is to resolve structural spending pressures.** The debt brake applies only to the confederation and is not robust to pressures from population aging. The authorities have taken important steps to limit future obligations, but more will be needed. The long-run fiscal sustainability report needs to offer insight into fiscal dynamics under current policies and provide the public with clear tools to understand the impact and distributional effects of possible solutions.

42. **Policy making requires timely statistics.** Cantonal and local governments provide fiscal data with long lags. Inflation assessments are hampered by inadequate wage data.

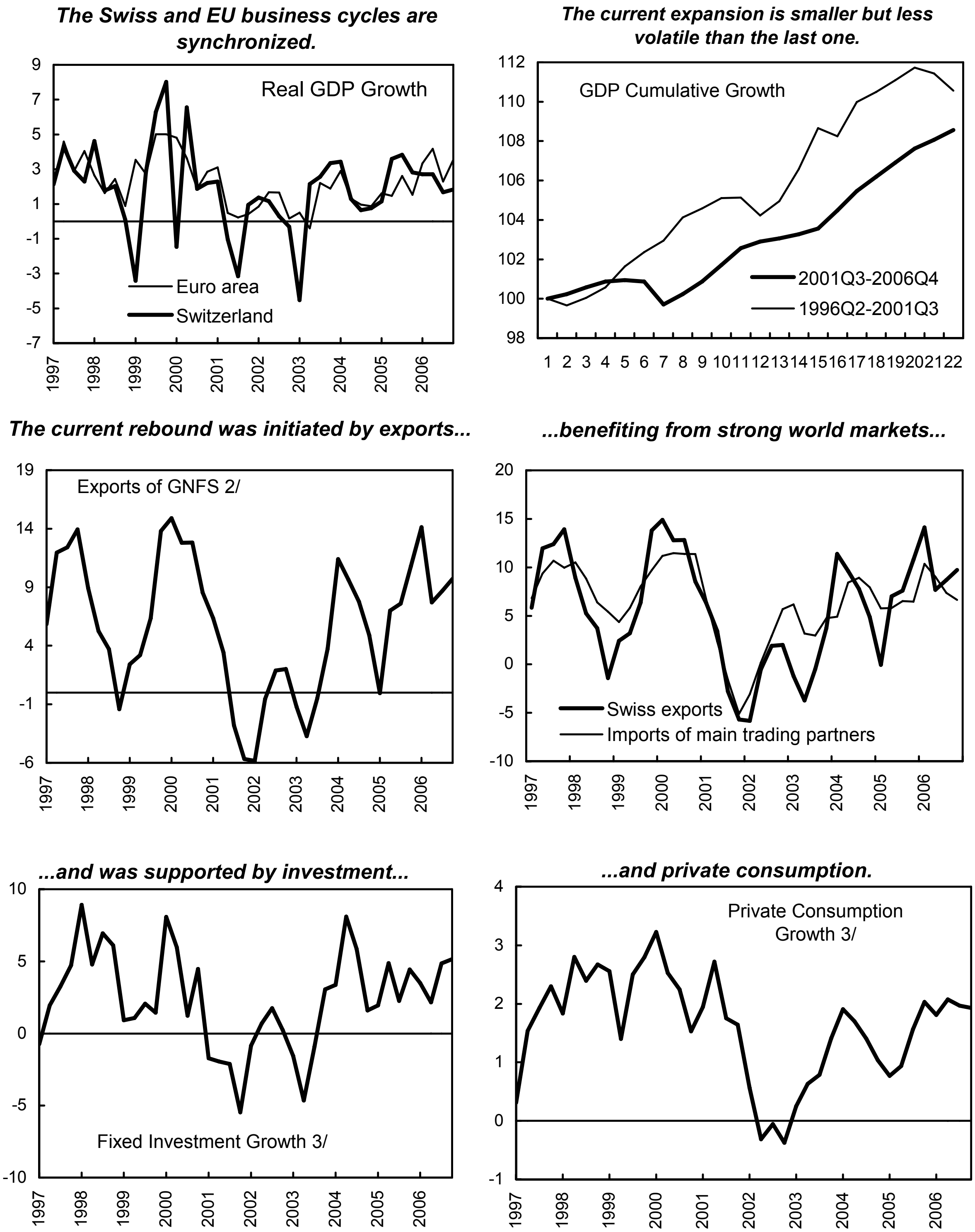
43. It is recommended that the next Article IV consultation with Switzerland be held on the standard twelve-month cycle.

Figure 1. Main Economic Indicators in International Perspective



Sources: IFS; OECD; and WEO.

Figure 2. Switzerland: The Recovery is in its Fourth Year 1/



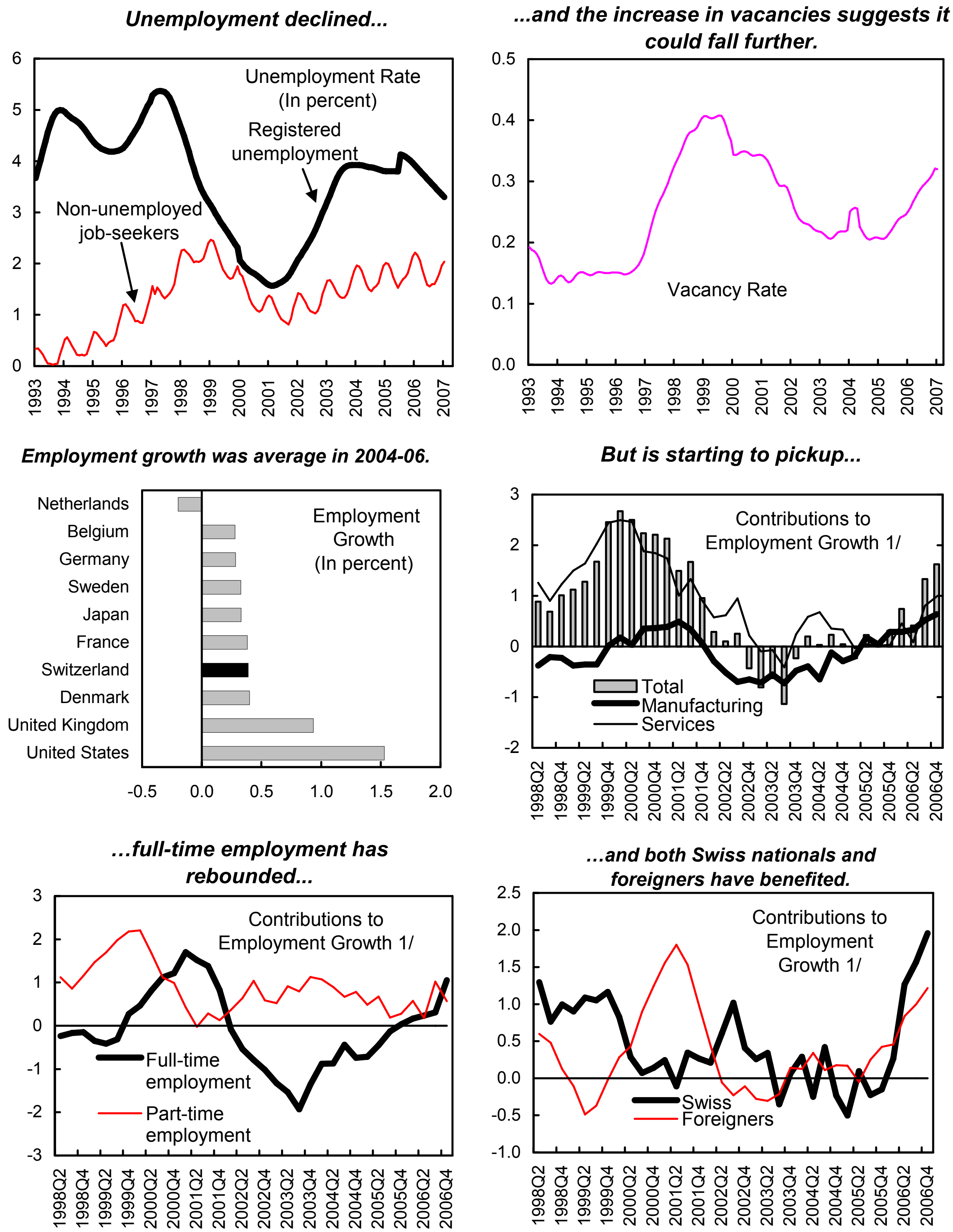
Source: SECO; and IMF, World Economic Outlook.

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

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

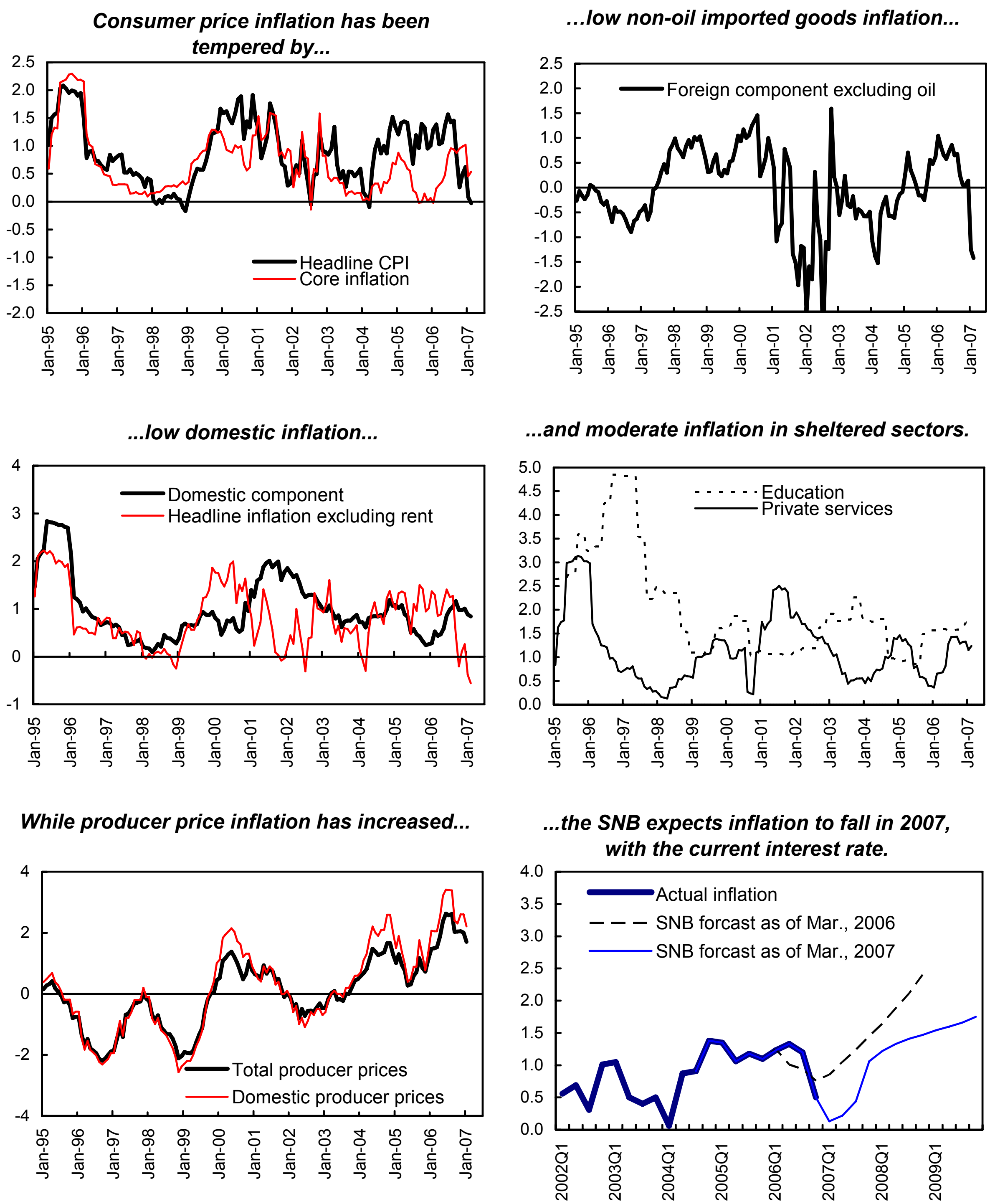
3/ 4-quarter moving average of annualized growth rates in percent.

Figure 3. Switzerland: The Labor Market



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

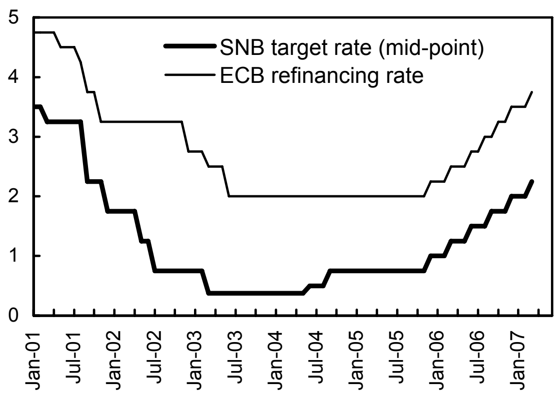
Figure 4. Switzerland: Inflation is Low
(12-month percent change)



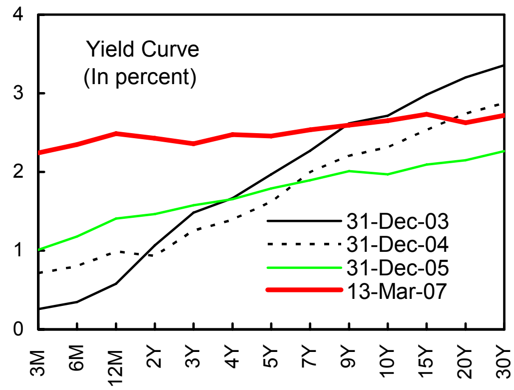
Source: KOF database.

Figure 5. Switzerland: Monetary Conditions Have Been Supportive

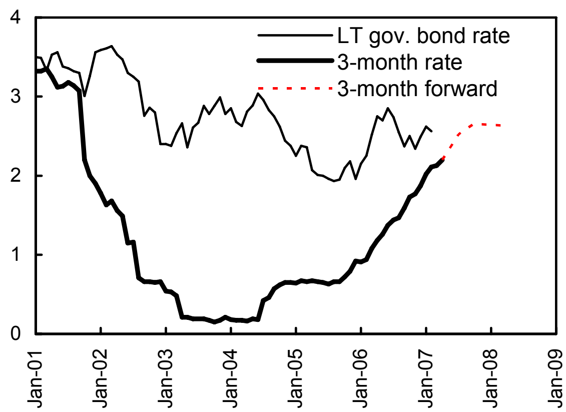
Despite an uptick in the policy rate...



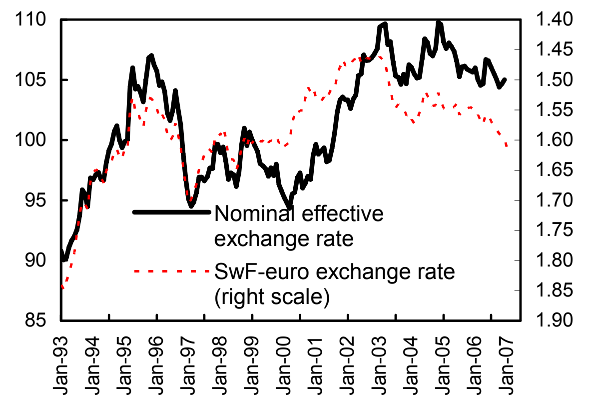
...which has flattened the yield curve...



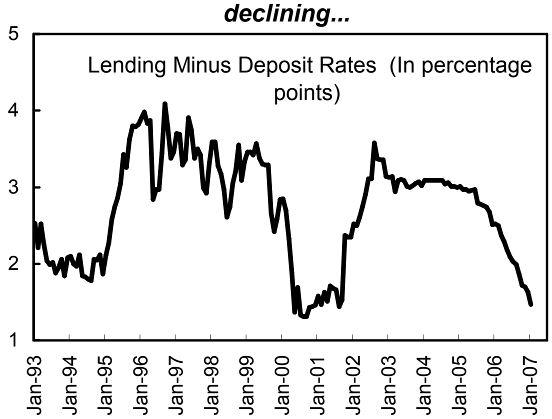
...nominal interest rates remain low.



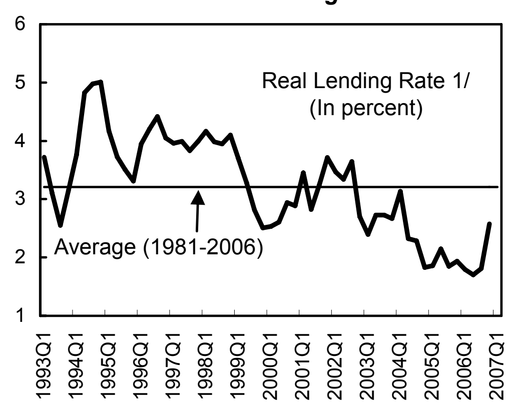
The weakening of the franc has contributed to easing monetary conditions.



The intermediation spread has been declining...

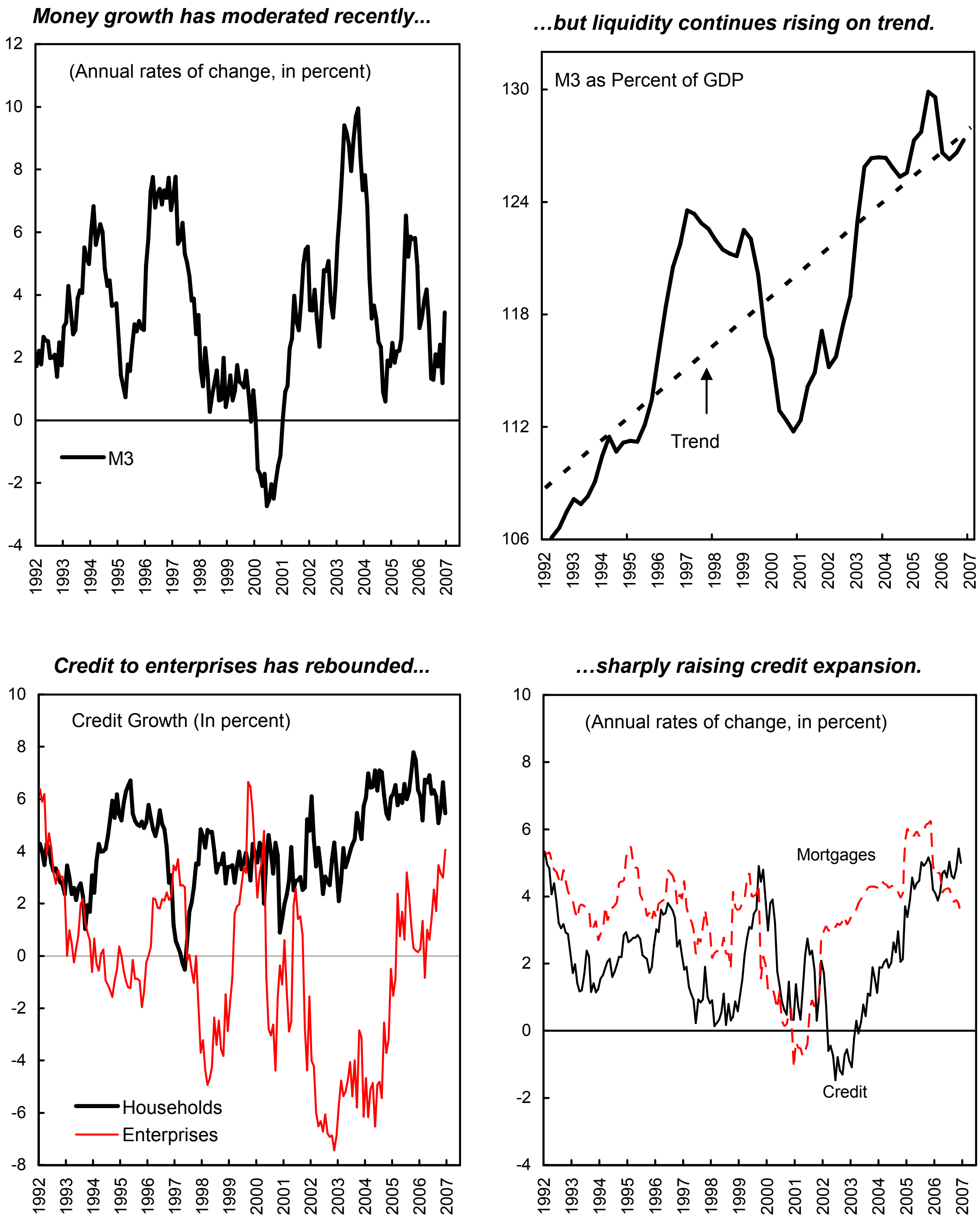


...as have borrowing costs.



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

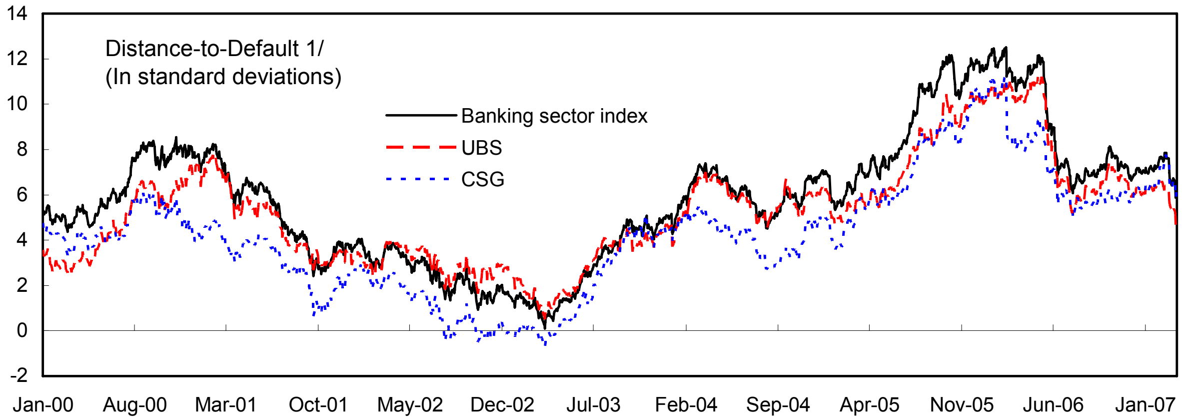
Figure 6. Switzerland: Money and Credit Aggregates



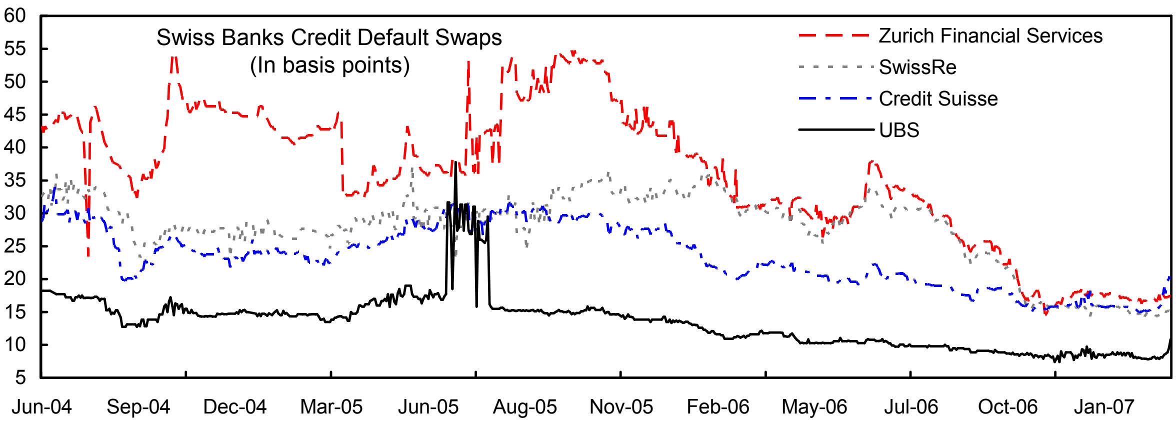
Source: IMF, World Economic Outlook; and KOF Institute.

Figure 7. Switzerland: Financial Sector Indicators

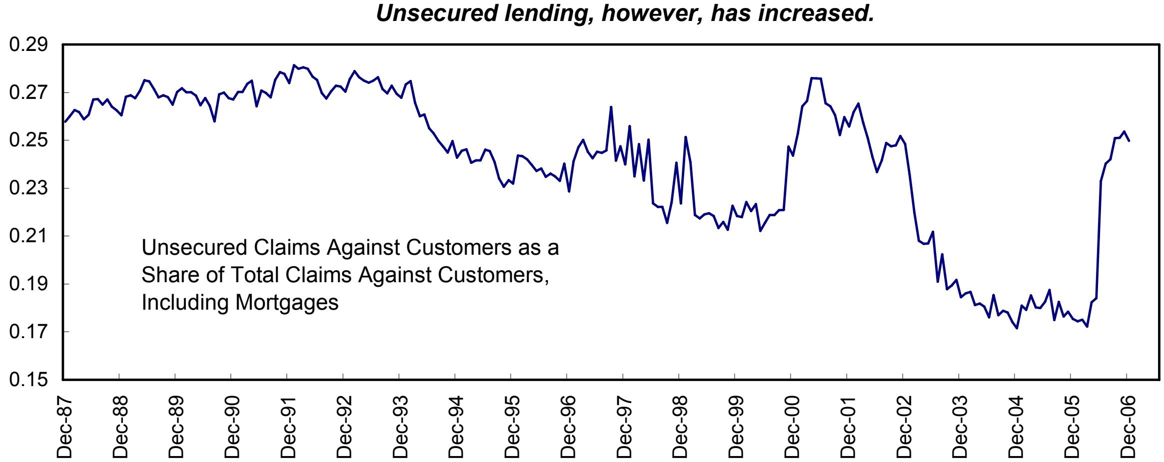
Distance to default indicators have improved from their 2003 lows.



Credit default swaps reflect favorable market perceptions.



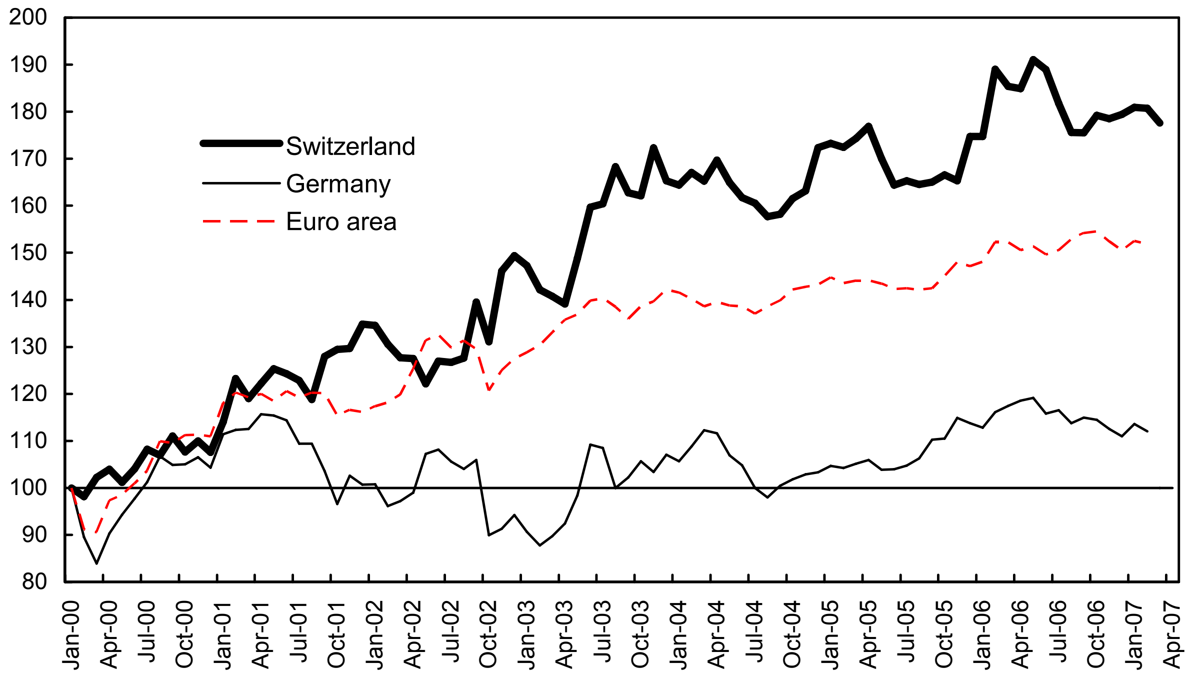
Unsecured lending, however, has increased.



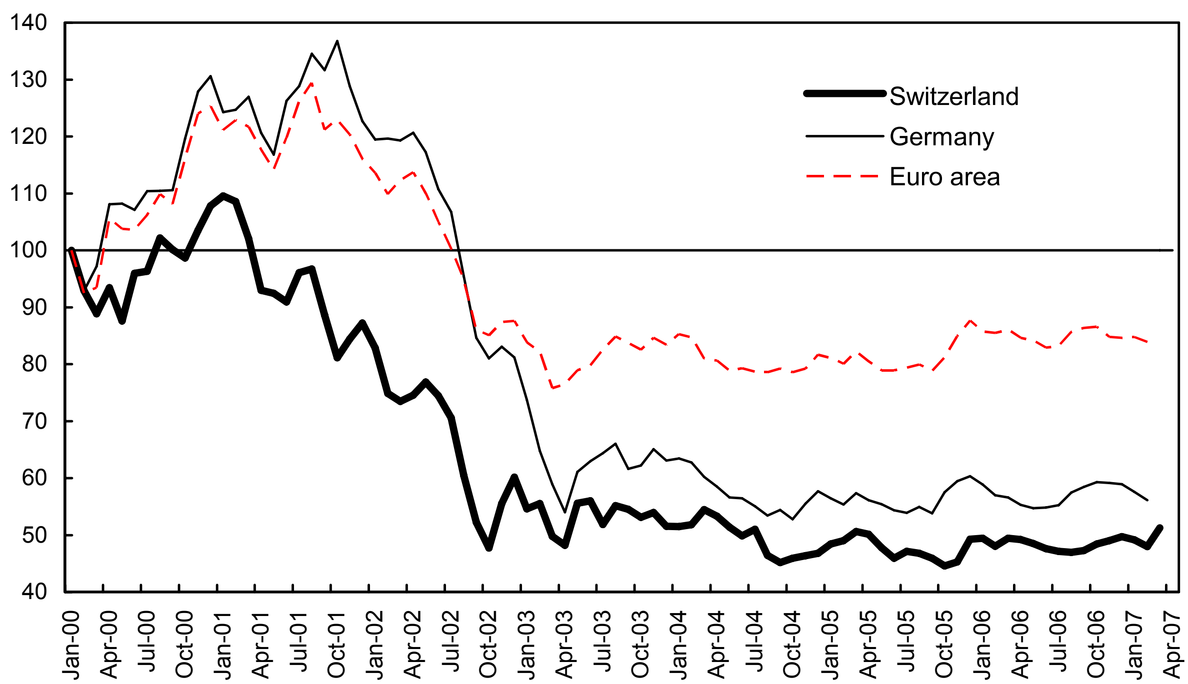
Source: Bloomberg, SNB, and IMF staff calculations.
1/ The index includes 15 listed banks, in addition to UBS and Credit Suisse. The Distance to Default Index is defined as the number of standard deviations away from a default event.

Figure 8. Equity Prices for Bank and Insurance Sectors
(As ratio to total market index; January 2000 = 100)

Banks' relative share prices have picked up...

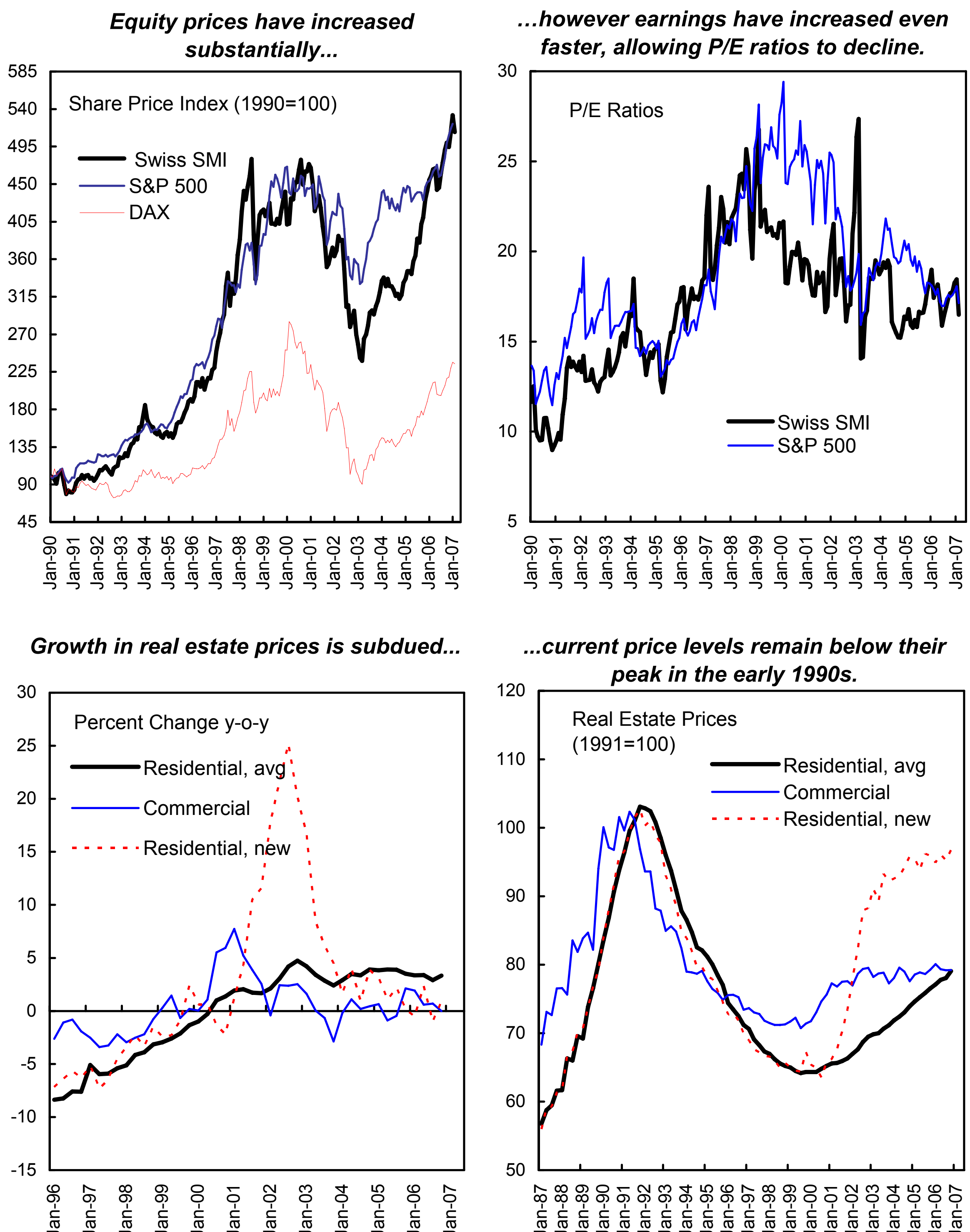


...but those of the insurance sector remain depressed.



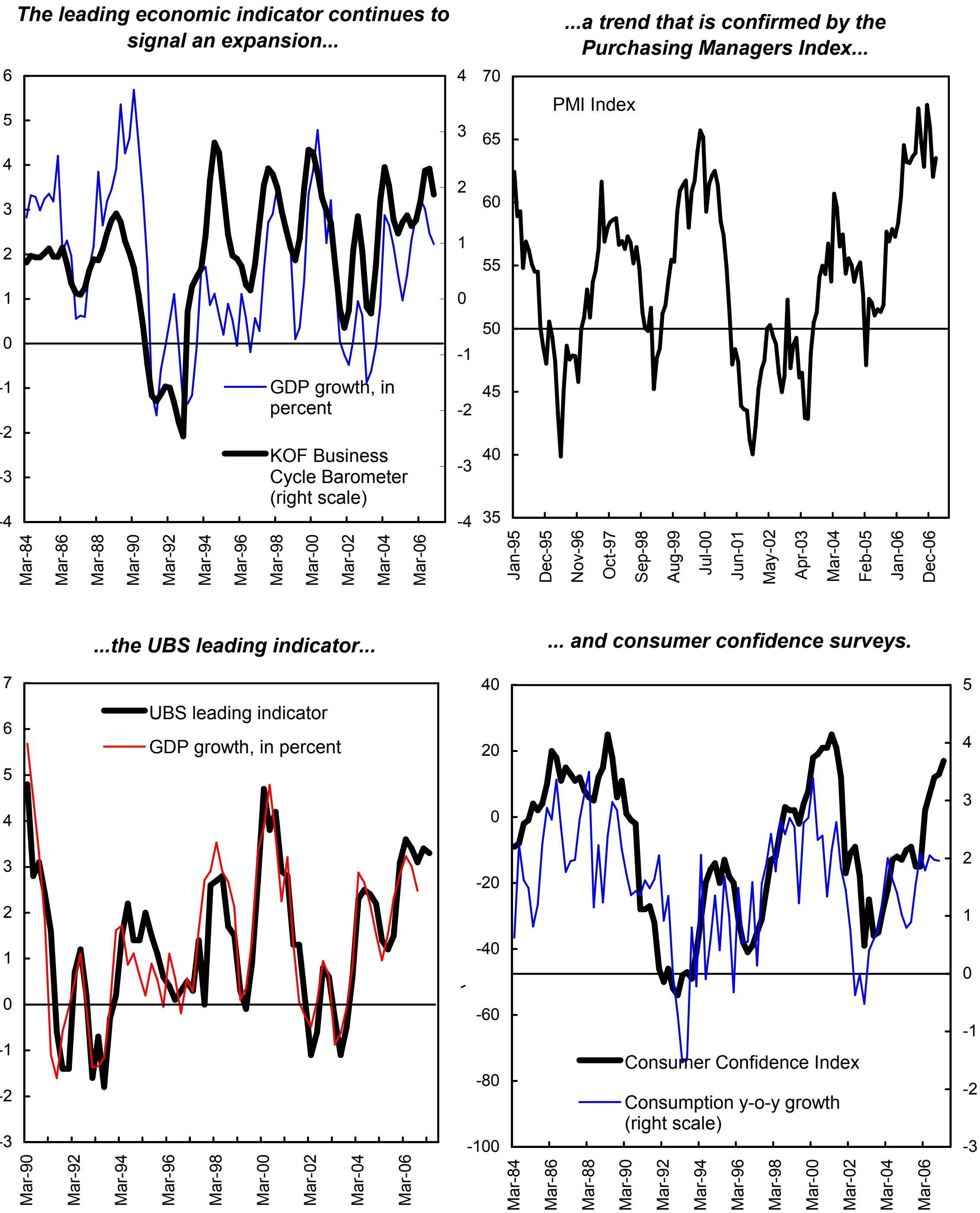
Source: Datastream.

Figure 9. Switzerland: Asset Prices



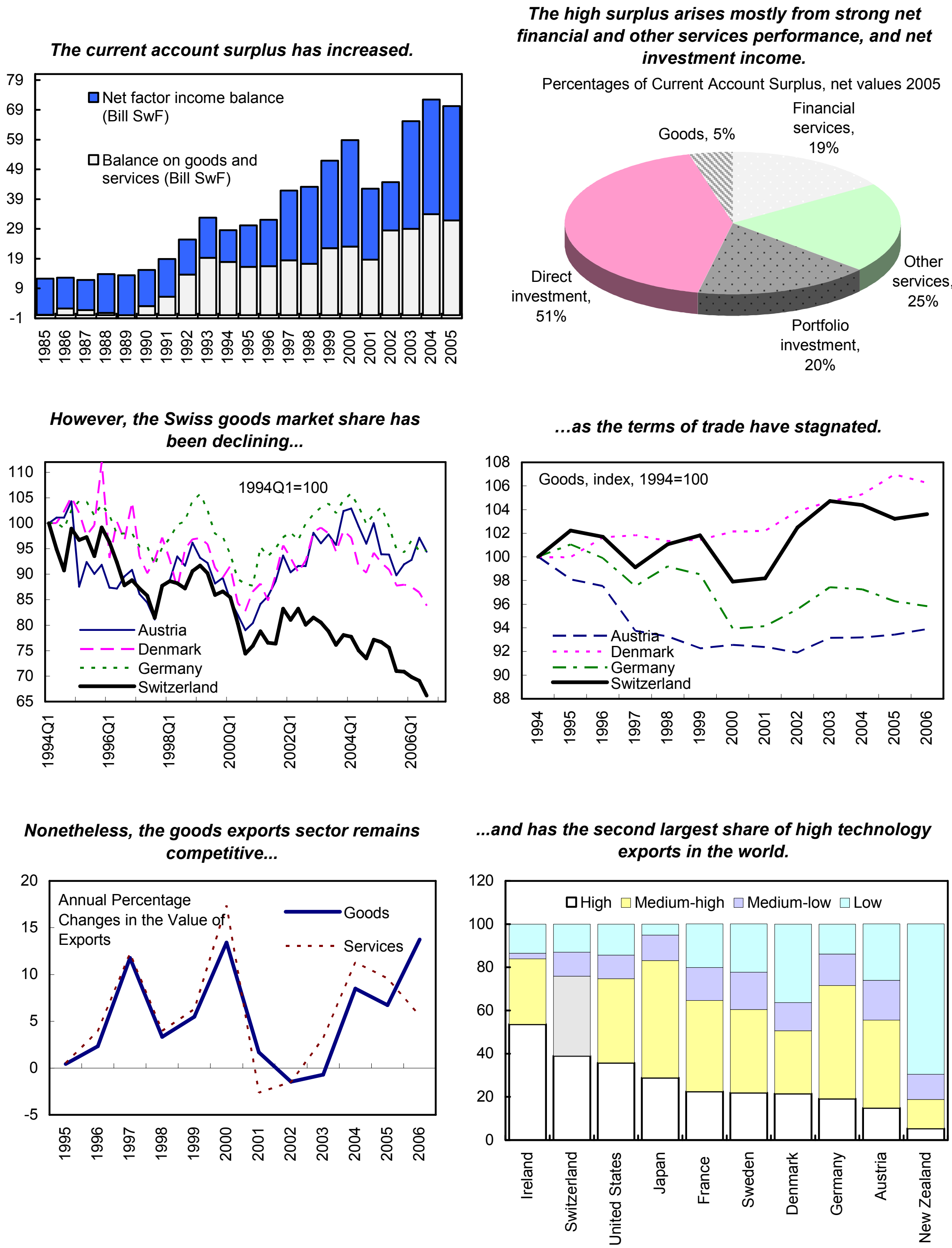
Sources: KOF database; BIS; Bloomberg; and IMF, International Financial Statistics; and IMF staff estimates.

Figure 10. Switzerland: Leading Indicators Suggest That the Expansion Will Continue



Sources: KOF database; and Bloomberg.

Figure 11. Switzerland: External Competitiveness



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

Table 1. Switzerland: Basic Data

Area and population

Total area	41,293 square kilometers	GDP per capita (2006)	50,176
Total population (end-2006)	7.5 million	GNP per capita (2006)	54,063

	1993-2002 Annual Avg.	2003	2004	2005	2006 1/	2007 1/	2008 1/
	(Percentage changes at constant prices, unless otherwise indicated)						
Demand and supply							
Total domestic demand	1.3	0.4	1.6	1.2	2.2	2.2	1.9
Private consumption	1.3	0.8	1.5	1.3	1.9	2.1	1.9
Public consumption	1.1	2.6	-0.8	-1.6	-0.5	-0.3	0.3
Gross fixed investment	1.6	-1.4	4.5	3.2	3.9	3.9	3.4
Final domestic demand	1.3	0.5	1.9	1.4	2.1	2.2	2.1
Inventory accumulation 2/	0.0	0.0	-0.3	-0.2	0.1	0.0	-0.2
Foreign balance 2/	0.2	-0.6	0.8	0.8	0.6	0.0	0.1
Exports of goods and nonfactor services	4.1	-0.4	8.4	6.4	9.9	12.7	8.5
Imports of goods and nonfactor services	4.5	1.0	7.4	5.3	9.9	14.4	9.3
GDP	1.3	-0.2	2.3	1.9	2.7	2.0	1.8
GNP	1.2	3.4	2.2	4.8	2.1	1.3	0.8
Nominal GDP (billions of SwF)	391.0	434.8	447.3	455.6	472.7	487.2	502.0
Employment and unemployment							
Employment (percent change)	0.4	-0.2	0.3	0.1	0.9	0.6	0.4
Unemployment rate (in percent)	3.2	3.4	3.5	3.4	3.3	2.8	2.8
Output gap (in percent of potential)	-0.4	-1.4	-0.6	-0.3	0.4	0.5	0.3
	(Percentage changes, unless otherwise indicated)						
Prices and incomes							
GDP deflator	0.8	1.2	0.6	-0.1	1.0	1.0	1.2
Consumer price index	1.1	0.6	0.8	1.2	1.0	0.7	1.0
Nominal wage growth	1.4	1.4	0.9	1.0	1.6	1.8	1.8
Unit labor costs (total economy)	1.0	1.4	-1.1	-0.8	-0.2	0.4	0.4
	(In percent of GDP)						
General government finances							
Revenue	36.6	37.9	37.7	38.6	38.2	38.0	37.8
Expenditure	38.1	39.3	38.7	38.7	37.4	37.4	38.1
Balance 3/	-1.5	-1.4	-1.0	-0.1	0.8	0.6	-0.3
Structural balance 4/	-1.2	-1.2	-0.7	0.0	0.8	0.5	-0.4
Gross debt	48.5	53.7	53.4	51.4	48.2	46.2	45.3
	(Percentage changes in annual averages)						
Monetary and credit data							
Broad money (M3)	3.0	8.3	3.2	4.2	3.0	...	...
Domestic credit	2.0	0.6	2.3	4.5	6.3	...	...
	(Period averages in percent)						
Interest rates							
Three-month rate	2.5	0.4	0.5	0.8	1.5	...	...
Yield on government bonds	3.8	2.5	2.6	2.1	2.5	...	...
	(In percent of GDP)						
Balance of payments							
Current account	8.8	13.3	14.0	16.6	17.5	17.3	16.1
Trade balance	0.0	1.0	1.5	0.7	1.0	1.4	1.2
Net investment income	7.2	10.5	10.4	14.1	13.7	12.3	10.8
Other	1.6	1.8	2.1	1.8	2.8	3.6	4.1
	(Levels)						
Exchange rates							
SwF per US$ (annual average)	1.5	1.36	1.24	1.25	1.25	...	...
SwF per euro (annual average)	1.6	1.51	1.54	1.55	1.58	...	...
Nominal effective rate (avg., 1990=100)	102.6	110.0	110.4	109.8	108.4	...	...
Real effective rate (avg., 1990=100) 5/	103.6	106.4	105.6	104.0	101.7	...	...

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 1/

	1995-2004	2005	2006	2007	2008	2009	2010	2011
	Annual Avg.		Est.	Staff projections				
	(In millions of SwF)							
General government								
Revenue 2/	151,837	175,658	180,525	185,153	189,676	194,200	199,574	205,225
Expenditure	155,976	176,332	176,782	182,131	191,177	192,006	197,310	203,080
Balance	-4,139	-674	3,743	3,021	-1,501	2,195	2,264	2,144
Federal government 3/ 4/								
Revenue 2/	44,622	51,634	55,303	56,929	57,809	59,049	60,411	62,131
Expenditure 5/	47,701	52,606	53,097	55,513	61,820	57,735	58,774	60,154
Balance	-3,079	-972	2,206	1,416	-4,011	1,314	1,636	1,977
Cantons								
Revenue 2/	59,955	70,581	71,000	73,173	76,041	76,023	78,278	80,600
Expenditure	60,664	70,237	70,200	72,480	75,583	76,042	78,013	80,015
Balance	-709	344	800	693	458	-19	266	586
Communes								
Revenue	41,073	46,100	46,985	48,206	49,576	51,187	52,708	54,273
Expenditure	40,790	45,100	45,979	47,238	48,675	50,438	51,789	53,143
Balance	283	1,001	1,006	968	901	749	918	1,131
Social security 6/								
Revenue	42,027	49,516	50,937	51,875	54,021	54,965	56,119	57,582
Expenditure	42,662	50,563	51,170	51,930	52,870	54,814	56,675	59,131
Balance	-635	-1,048	-233	-55	1,151	151	-556	-1,549
	(In percent of GDP)							
General government								
Revenue	37.3	38.6	38.2	38.0	37.8	37.6	37.5	37.5
Expenditure	38.4	38.7	37.4	37.4	38.1	37.2	37.1	37.1
Balance	**-1.1**	**-0.1**	**0.8**	**0.6**	**-0.3**	**0.4**	**0.4**	**0.4**
Federal government	-0.8	-0.2	0.5	0.3	-0.8	0.3	0.3	0.4
Cantons	-0.2	0.1	0.2	0.1	0.1	0.0	0.0	0.1
Communes	0.1	0.2	0.2	0.2	0.2	0.1	0.2	0.2
Social security	-0.2	-0.2	0.0	0.0	0.2	0.0	-0.1	-0.3
Memorandum items:								
Structural fiscal balance 7/	-1.0	0.0	0.8	0.5	-0.4	0.4	0.5	0.5
Gross debt 8/	50.7	51.4	48.2	46.2	45.3	43.6	41.8	39.9

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

1/ Excludes VAT increases initially 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, 2006: SwF 2100 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). 2008 total expenditures include extraordinary spending (SwF 5,331 million). 2008-2011 total expenditures exclude transfer out of the special. Infrastructure Fund created in 2008, due to lack of data.
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.
8/ Includes debt of confederation (and special funds), cantons and communes. Social security cannot issue debt.

Table 3. Switzerland: Federal Government Finances 1/

	1995-2004	2005	2006	2007	2008	2009	2010	2011
	Annual Avg.		Est.	Staff projections 2/				
				(In millions of SwF)				
Revenue	44,622	51,634	55,303	56,929	57,809	59,049	60,411	62,131
Current revenue	43,356	51,354	55,114	56,734	57,609	58,843	60,198	61,912
Taxes	39,999	47,520	51,558	52,665	53,663	54,725	56,105	57,697
Direct taxes	16,269	18,916	21,440	21,398	21,865	22,776	23,137	23,725
Indirect taxes	23,731	28,604	30,118	31,267	31,798	31,949	32,968	33,972
Non-tax revenue 3/ 4/	3,357	3,834	3,556	4,069	3,946	4,118	4,093	4,215
Capital revenue	1,266	280	189	195	200	206	213	219
Expenditure 5/	47,701	52,606	53,097	55,513	61,820	57,735	58,774	60,154
Current expenditure	41,109	46,110	47,151	49,461	51,992	51,191	51,931	53,108
Wages and salaries	5,270	5,714	5,662	5,645	5,589	5,750	5,771	5,842
Goods and services	4,997	4,153	4,346	4,301	4,362	4,506	4,540	4,675
Interest payments	3,315	3,577	3,731	4,038	4,030	4,092	3,665	3,511
Transfers	27,526	32,667	33,411	35,477	38,011	36,843	37,956	39,080
Capital expenditure	6,592	6,496	5,946	6,052	9,829	6,544	6,843	7,046
Overall balance	-3,079	-972	2,206	1,416	-4,011	1,314	1,636	1,977
				(In percent of GDP)				
Revenue	10.9	11.3	11.7	11.7	11.5	11.4	11.4	11.3
Current revenue	10.6	11.3	11.7	11.7	11.5	11.4	11.3	11.3
Tax revenue	9.8	10.4	10.9	10.8	10.7	10.6	10.5	10.5
Non-tax revenue	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Capital revenue	0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	11.7	11.5	11.2	11.4	12.3	11.2	11.0	11.0
Current expenditure	10.1	10.1	10.0	10.2	10.4	9.9	9.8	9.7
Capital expenditure	1.6	1.4	1.3	1.2	2.0	1.3	1.3	1.3
Overall balance	-0.8	-0.2	0.5	0.3	-0.8	0.3	0.3	0.4
Memorandum item:								
Structural fiscal balance 6/	-1.0	-0.2	0.4	0.2	-0.8	0.3	0.3	0.4
Gross debt	25.6	28.6	26.6	25.5	25.6	24.6	23.6	22.5

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 initially 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, 2006: SwF 2100 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). 2008 total expenditures include extraordinary spending (SwF 5,331 million). 2008-11 total expenditure exclude transfer out of the special Infrastructure Fund created in 2008, due to lack of data.
6/ Excludes cyclical and one-off items.

Table 4. Preliminary Public Sector Balance Sheet

	2002	2003	2004	2005	2006
				Staff estimates	
(Billions of SwF)					
A. Intertemporal financial position (I+II)	**-752**	**-767**	**-789**	**-791**	**-586**
I. Financial net worth	-98	-100	-108	-99	-98
Gross debt	228	234	239	234	228
II. Net present value of future fiscal balances 1/	-654	-667	-681	-692	-488
B. Other assets	78	81	81	90	91
C. Public sector capital stock	237	242	247	250	252
D. Contingent liabilities	-7	-7	-12	-11	-11
Public sector net worth (A+B+C+D)	**-444**	**-451**	**-473**	**-462**	**-254**
(Percentages of GDP)					
A. Intertemporal financial position (I+II)	**-175**	**-176**	**-176**	**-174**	**-124**
I. Financial net worth	-23	-23	-24	-22	-21
Gross debt	53	54	53	51	48
II. Net present value of future fiscal balances 1/	-152	-153	-152	-152	-103
B. Other assets	18	19	18	20	19
C. Public sector capital stock	55	56	55	55	53
D. Contingent liabilities	-2	-2	-3	-2	-2
Public sector net worth (A+B+C+D)	**-103**	**-104**	**-106**	**-102**	**-54**

Sources: Swiss National Bank, Federal Finance Administration and IMF staff calculations.
1/ Reflecting mainly future deficits in social security.

Table 5. 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**	**57.8**	**62.5**	**75.6**	**82.7**	**84.4**	**80.8**
(In percent of GDP)	12.4	8.0	8.3	13.3	14.0	16.6	17.5	17.3	16.1
Trade balance	-4.2	-4.7	5.1	4.1	6.5	3.4	4.9	7.0	5.9
Exports	137.7	140.1	138.0	137.1	148.7	158.7	185.7	210.7	230.3
Imports	-142.0	-144.8	-132.9	-132.9	-142.2	-155.3	-180.8	-203.7	-224.4
Service balance	27.3	23.4	23.3	24.7	26.9	29.8	32.9	37.1	40.0
Net investment income	44.0	32.9	25.5	45.7	46.7	64.1	64.6	59.7	54.4
Net compensation of employees	-8.3	-9.1	-9.2	-9.6	-10.2	-10.4	-11.0	-10.6	-10.6
Net private transfers	-3.9	-5.7	-5.7	-4.1	-4.1	-8.3	-5.7	-5.8	-5.9
Net official transfers	-3.2	-3.1	-3.3	-3.2	-3.3	-3.0	-3.0	-3.0	-3.1
Private capital and financial account	**-58.4**	**-32.5**	**-32.0**	**-53.3**	**-60.8**	**-97.6**	**-82.3**	**-84.4**	**-80.8**
Net foreign direct investment	-42.9	-15.9	-2.5	1.2	-32.4	-69.2	-70.7	-70.7	-70.7
Net portfolio investment	-19.9	-69.1	-35.2	-47.0	-49.7	-59.1	-53.5	-37.1	-33.5
Net banking sector	11.0	18.0	-26.8	-6.8	16.9	14.3	16.6	23.6	23.6
Other 2/	-6.6	34.5	32.5	-0.6	4.4	16.4	25.3	-0.2	-0.2
Official reserve flows 3/	**6.7**	**-1.1**	**-3.7**	**-4.5**	**-1.8**	**22.0**	**-0.4**	**0.0**	**0.0**
Memorandum items:									
Official reserves (billions of US$, end period)	32.3	32.0	40.2	47.7	55.5	36.3	38.1	…	…
Reserve cover (months of imports of GNFS)	3.8	3.7	4.4	4.5	4.4	3.0	2.8	...	...

Sources: IMF, World Economic Outlook database; and Swiss National Bank.
1/ Fund staff estimates and projections unless otherwise noted.
2/ Includes errors and omissions.
3/ Official gold sales in 2005.

Table 6. Switzerland: Major Financial Institutions, 2002-06

	2002	2003	2004	2005	2006
Union Bank of Switzerland (SwF millions)					
Profit	3,866	6,151	7,718	9,896	11,638
Operating Income	34,121	32,957	35,971	39,896	47,171
S&P Credit Ratings	AA+	AA+	AA+	AA+	AA+
Credit Swiss Group (SwF millions)					
Profit	-3,326	3,269	4,996	4,526	8,281
Operating Income	28,038	24,325	27,033	30,489	38,603
S&P Credit Ratings	AA-	A-1	A-1	A-1	A-1
Zurich Financial Services (US$ millions)					
Profit USD millions	-3,362	2,009	2,466	3,214	4,527
Operating Income	40,302	57,208	61,214	67,186	65,000
S&P Credit Ratings	A	A	A-	A-	A-
Swiss Life (SwF millions)					
Profit	-1,694	233	606	874	954
Operating Income	20,624	21,088	22,328	21,542	21,531
S&P Credit Ratings	A-	A-	A-	A-	A-
Swiss Re (SwF millions)					
Profit (SwF millions)	-91	1,702	2,475	2,304	4,560
Operating Income	34,415	36,430	36,093	38,012	40,266
S&P Credit Ratings	AA+	AA	AA	AA	AA-
Total					
Profit (SwF millions)	-6,468	14,059	18,858	21,595	31,106
Profit (percent of GDP)	-1.5	3.2	4.2	4.7	6.6
Operating Income (SwF millions)	179,812	191,787	197,453	213,459	229,020
Operating Income (percent of GDP)	41.8	44.1	44.1	46.9	48.4

Source: Company reports; and IMF staff calculations.

Table 7. Switzerland: Financial Soundness Indicators

	2001	2002	2003	2004	2005	Jun-06
Banks						
Capital adequacy						
Regulatory capital as percent of risk-weighted assets	12.4	12.6	12.4	12.6	12.4	12.7
Regulatory Tier I capital to risk-weighted assets	12.6	13.1	13.5	13.3	13.0	13.0
Non-performing loans net of provisions as percent of capital 1/	2.0	0.6	-0.5	-1.2	-1.0	…
Asset quality and exposure						
Non-performing loans as percent of gross loans	2.1	1.8	1.3	0.9	0.5	…
Sectoral distribution of bank credit to the private sector (percent) 2/						
Households	58.1	60.8	63.7	65.2	66.6	66.6
Agriculture and food industry	1.4	1.3	1.3	1.3	1.2	1.2
Industry and manufacturing	4.7	4.5	4.1	3.7	3.4	3.5
Construction	2.7	2.5	2.2	2.1	1.9	1.9
Retail	5.0	4.6	4.1	3.7	3.6	3.5
Hotels and restaurants / Hospitality sector	1.7	1.6	1.5	1.4	1.3	1.2
Transport and communications	1.2	1.1	1.1	1.1	1.1	1.0
Other financial activities	3.9	3.0	2.2	2.2	2.4	3.0
Insurance sector	1.0	0.7	0.5	0.5	0.4	0.6
Commercial real estate, IT, R&T	12.8	12.5	12.3	12.2	12.1	11.8
Public administration (excluding social security)	3.6	3.5	3.3	3.1	2.6	2.5
Education	0.2	0.2	0.2	0.2	0.2	0.2
Healthcare and social services	1.4	1.4	1.3	1.3	1.3	1.2
Other collective and personal services	1.7	1.6	1.5	1.5	1.5	1.4
Other 3/	0.5	0.5	0.5	0.5	0.5	0.6
Earnings and profitability						
Gross profits as percent of average assets (ROAA)	0.6	0.5	0.7	0.8	0.9	…
Gross profits as percent of average equity capital (ROAE)	10.0	8.9	11.7	14.3	18.0	…
Net interest income as percent of gross income	34.8	34.9	40.2	36.4	30.9	29.4
Non-interest expenses as percent of gross income	63.3	61.7	63.5	62.7	59.2	62.3
Liquidity						
Liquid assets as percent of total assets	11.8	10.9	12.1	11.2	11.4	12.0
Liquid assets as percent of short-term liabilities	64.1	62.6	64.5	60.7	60.3	63.0

Source: Swiss National Bank.
1/ Until 2004, general loan-loss provisions were made; as of 2005, specific loan-loss provisions have been carried out.
2/ As percent of total credit to the private sector.
3/ Mining and extraction, production and distribution of electricity, natural gas and water, financial intermediation, social security, ex-territorial bodies and organizations, other.

Table 8. Switzerland: Encouraged Set of Financial Soundness Indicators

	2001	2002	2003	2004	2005	Jun-06
Capital adequacy						
Capital as percent of assets (leverage ratio)	5.6	5.5	5.7	5.3	5.1	4.9
Asset quality and exposure						
Foreign currency loans as percent of total loans	50.7	48.7	49.4	52.5	57.1	60.7
Foreign currency liabilities as percent of total liabilities	59.1	57.9	57.6	59.1	62.9	66.1
Geographical distribution of bank credit as percent of total bank credit						
Switzerland	48.6	49.0	48.3	45.2	40.8	…
EMU countries	10.6	10.7	8.1	7.7	8.4	…
Other developed countries	36.3	35.6	38.6	41.6	44.3	…
Central and eastern European countries	0.3	0.3	0.3	0.3	0.4	…
Emerging markets and developing countries	4.2	4.3	4.8	5.2	6.1	…
Earnings and profitability						
Trading income as a percent of gross income	14.2	12.3	7.3	11.8	15.9	16.9
Personnel expenses as percent of non-interest expenses	56.8	57.0	59.7	60.8	60.6	62.5
Liquidity						
Customer deposits as percent of total (non-interbank) loans	74.8	77.3	79.5	78.6	73.7	…
Exposure to derivatives						
Gross asset position in derivatives as a percentage of tier I capital	174.9	242.1	244.8	263.5	268.6	115.7
Gross liability position in derivatives as a percentage of tier I capital	174.8	246.0	261.3	289.2	286.4	119.0
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 percentage of GDP	100.3	103.4	108.1	109.9	114.4	...
Corporate sector						
Total debt to equity (percent, without financial corporations)	54.2	63.8	59.0	...	…	…
Real estate markets						
Annual increase of real estate prices	3.1	5.6	4.9	2.6	1.8	…
Total real estate loans as percent of total loans (Global level)	32.8	34.9	35.7	33.8	32.0	29.4

Sources: Swiss National Bank; and Social Security Administration.

Table 9. Switzerland: Structure of the Financial System

	2001	2002	2003	2004	2005	Jun-06
			(Number of institutions)			
Banks	369	356	342	338	337	…
Cantonal banks	24	24	24	24	24	…
Large banks	3	3	3	3	2	…
Regional and savings banks	94	88	83	83	79	…
Raiffeisen banks	1	1	1	1	1	…
Other banks	205	200	190	188	189	…
Trading banks	12	11	9	8	7	…
Stock exchange banks	61	62	55	53	56	…
Other banks	7	5	4	4	4	…
Foreign controlled banks	125	122	122	123	122	…
Branches of foreign banks	25	25	26	25	28	…
Private bankers	17	15	15	14	14	…
Insurance companies - Life	29	24	24	24	…	…
Insurance companies - General	106	123	124	124	…	…
Pension funds	…	8,134	…	…	…	…
						…
Concentration						…
Banks 1/	64	64	63	66	67	…
			(In SwF billions)			
Assets						
Banks	2,227	2,252	2,237	2,491	2,846	3,006
Cantonal banks	305	313	311	314	327	334
Large banks	1,416	1,444	1,409	1,644	1,910	2,073
Regional and savings banks	78	79	81	81	84	83
Raiffeisen banks	82	93	102	106	108	78
Other banks	312	290	302	314	382	45
Trading banks	53	41	42	43	45	116
Stock exchange banks	69	81	83	86	106	3
Other banks	3	3	3	4	3	228
Foreign controlled banks	187	166	174	182	228	26
Branches of foreign banks	17	16	16	15	17	…
Private bankers	17	16	17	17	17	19
Insurance companies - Life	300	301	311	303	…	…
Insurance companies - General	495	507	530	536	…	…
Pension funds	…	441	…	…	…	…
Deposits						
Banks	937	932	974	1,044	1,211	2,170
Cantonal banks	155	164	169	180	186	…
Large banks	529	506	526	577	700	…
Regional and savings banks	45	46	50	51	54	…
Raiffeisen banks	53	59	65	71	73	…
Other banks	143	142	149	153	185	…
Trading banks	33	25	26	27	28	…
Stock exchange banks	37	46	49	47	61	…
Other banks	2	2	2	2	3	…
Foreign-controlled banks	71	69	72	76	93	…
Branches of foreign banks	2	2	2	2	2	…
Private banks	11	12	13	11	11	...

Source: Swiss National Bank.

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

SWITZERLAND—ANNEXES TO THE 2007 ARTICLE IV CONSULTATION STAFF REPORT

Contents Page

Annex I. Switzerland: Fund Relations
(As of February 28, 2007)

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	3,156.12	91.26
	Reserve position in Fund	302.38	8.74
III.	**SDR Department:**	SDR Million	% Allocation
	Holdings	189.88	N/A
IV.	**Outstanding Purchases and Loans:**	None	
V.	**Financial Arrangements:**	None	
VI.	**Projected Obligations to Fund:**	None	

VII. **Exchange Rate Arrangement:**

The exchange rate of the Swiss franc is determined by supply and demand in the foreign exchange market, and therefore classified as an independently floating exchange rate regime. The Swiss National Bank reserves the right to intervene in the foreign exchange market. All settlements are made at free market rates. Switzerland maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for restrictions in place for security reasons notified to the Fund pursuant to Decision No. 144-(52/51).

On March 13, 2007, Switzerland notified the IMF of the exchange restrictions that have been imposed against certain countries, individuals, and entities, in accordance with relevant UN Security Council resolutions and EU regulations.

In accordance with UN Security Council resolutions, restrictions are currently in place with respect to specific individuals and entities associated with the former government of Liberia, Iraq, Osama bin Laden, the Taliban, and the Al-Qaïda network**,** specific individuals and entities posing a threat to international peace and security in Côte d'Ivoire, in the Democratic Republic of the Congo (DRC), impeding the peace process in Sudan, suspected of involvement in the bombing that killed former Lebanese Prime Minister Rafik Hariri, engaged in the Democratic People's Republic of Korea's (DPRK) Weapons of Mass Destruction (WMD)–related programs, ban on financing and financial services related to the provision of arms and related materiel to Lebanon, specific individuals and entities involved in the nuclear and/or ballistic missile programs of the Islamic Republic of Iran. The lists of individuals and entities against whom financial sanctions are in force are based on the decisions by the competent UN Security Council sanctions committee and are amended regularly.

In accordance with EU regulations, restrictions are currently in place with respect to specific individuals associated with the previous government of the former Republic of Yugoslavia, Zimbabwe, Myanmar, ban on financing and the provision of financial services related to military activities in Uzbekistan, specific individuals and entities associated with the government of Belarus. The lists of targeted individuals are identical to the list in the corresponding EU regulations.

VIII. **Article IV Consultation:**

Switzerland is on the standard 12-month Article IV consultation cycle. The 2007 mission visited Bern and Zürich during February 26–March 5, 2007 and held discussions with Finance Minister Merz, Chairman Roth of the Governing Board of the Swiss National Bank (SNB), Interior Minister Couchepin and other senior officials. Outreach activities included discussions with members of parliament, NGOs, the private sector, and think-tanks. Messrs. Moser (Executive Director) and Weber (Advisor) attended some of the meetings.

The mission comprised B. Traa (Head), K. Ross, and A. Carare (EUR). B. Johnston (MCM) participated in meetings related to the FSAP update.

In agreement with the authorities, the mission focused on core surveillance issues. No background papers have been produced.

The mission held a joint press conference on the concluding statement. The authorities have agreed to the publication of the staff report.

IX. **Technical Assistance:** None

X. **Resident Representatives:** None

XI. **Other** FSAP Update, November 2006

Annex II. Switzerland: Statistical Issues

Switzerland generally publishes timely economic statistics and posts most of the data and the underlying documentation on the internet. In June 1996, Switzerland subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are currently posted on the Dissemination Standards Bulletin Board. Switzerland is in full observance of SDDS requirements, and it is availing itself of the SDDS's flexibility options on dissemination of production index data (for periodicity and timeliness) and of wages and earnings data (for periodicity). 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:

- 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 deficiencies, the authorities are taking 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 conducts 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 2008. In the interim, government finance statistics for publication in the *GFS Yearbook* will be reported on a cash basis but presented in the *GFSM 2001* format.

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. For legal reasons, and until the distribution of the proceeds of gold sales between the SNB and the Federal Department of Finance was concluded in February 2005, the proceeds of the gold sales not needed for monetary purposes were considered as part of the official reserves in the balance of payments. After that date, they appear in the position "other assets of the SNB" in the balance of payments.

Switzerland participated in the Coordinated Compilation Exercise for Financial Soundness Indicators (FSIs). Data and metadata on a benchmark set of indicators of the soundness of the financial system (for year-end 2005) will soon be posted on the IMF website.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of April 4, 2007)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Mar 07	Mar 07	D and M	M and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb 07	Mar 07	M	M	M
Reserve/Base Money	Feb 07	Mar 07	M	M	M
Broad Money	Feb 07	Mar 07	M	M	M
Central Bank Balance Sheet	Feb 07	Mar 07	M	M	M
Consolidated Balance Sheet of the Banking System	Jan 07	Mar 07	M	M	M
Interest Rates[2]	Feb 07	Feb 07	D and M	M and M	D and M
Consumer Price Index	Feb 07	Mar 07	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4]	2006	Mar 07	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government[3]	2006	Mar 07	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2006	Mar 07	Q	Q	Q
External Current Account Balance	Q3/06	Jan 07	Q	Q	Q
Exports and Imports of Goods and Services	Jan 06	Mar 07	M	M	M
GDP/GNP	Q4/06	Mar 07	Q	Q	Q
Gross External Debt	2006	Mar 07	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

Public Information Notice (PIN) No. 07/63
FOR IMMEDIATE RELEASE
June 4, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Switzerland

On June 1, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

The economy is performing well. The expansion moved into its fourth year with above average growth and employment, and few signs of inflation. This favorable outcome can be traced to a vibrant external environment, including in global financial markets, strong macropolicies and key structural reforms in retailing and labor markets.

The economy gathered speed in 2004-2005 and growth is estimated to have accelerated to 2.7 percent in 2006—thereby closing the output gap. Growth became broadly based in 2006, with a pickup in consumption and investment and a marked increase in exports linked to the EU recovery and weakness in the franc. With business and consumer confidence indicators remaining high, economic growth is expected to remain strong but at a somewhat slower pace—in line with developments in main trading partners—of about 2 percent. While the outlook is favorable, the authorities need to remain vigilant to global economic and political developments that could affect the economy, including through oil prices, and to (mostly external) risks that could impact on Switzerland's large financial sector.

Inflation was 1 percent in 2006 and is expected to be slightly lower in 2007. The opening of the labor market to EU workers, reduced exchange rate pass through, increased productivity, lower oil prices, and increased domestic competition and policy interest rates are containing inflation. Although unemployment has fallen to 3 percent, wage growth pressures are expected to remain

[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.

contained. As a result, competitiveness has improved and the current account surplus has now reached over 17 percent of GDP.

The SNB continued to normalize interest rates in 2006 and early 2007. With five quarterly step increases of 25 basis points, the policy rate now stands at 2¼ percent or about 1¾ percent in real terms, slightly above average for past cycles.

Aided by strong cyclical revenue, the 2006 fiscal balance exceeded the budget target. The general government achieved a surplus of 0.8 percent of GDP with balance in the social security accounts and small surpluses in federal, cantonal and local governments. Together with asset sales, gross debt fell to 48.2 percent of GDP.

The financial sector is performing well in a favorable cyclical setting. Bank profitability is strong and financial soundness indicators have improved. The two large Swiss banks are global players in wealth management and derivatives markets, and as prime brokers to hedge funds and private equity firms--they need to watch global financial market volatility. Insurance and pension sectors are recovering from previous balance sheet pressures and low interest rates.

Executive Board Assessment

Executive Directors commended the Swiss authorities for their prudent economic management and sound policy frameworks. In this setting, Switzerland's economy continues to perform well, with low inflation and strong employment growth backed by flexible labor markets, and the short-term growth outlook is strongly positive. The main policy challenge going forward is to seize the opportunities provided by these favorable developments to further strengthen potential economic growth, and to address long-term structural and fiscal issues given population aging.

Directors commended the Swiss National Bank's success in keeping inflation well under control in recent years, and considered the recent gradual tightening appropriate. They recognized the importance of ensuring that inflation expectations remain well anchored, especially in view of the strong run-up in capacity utilization. In this context, Directors agreed that monetary policy will need to remain flexible to respond appropriately to inflation signals. With the economy possibly transitioning to a higher level of potential growth, and absent signs of inflation, Directors considered that the Swiss National Bank (SNB) should continue to monitor economic conditions closely, and be prepared to adapt policy as necessary. Directors also recommended a removal of the regulated link between interest rates and housing rents, noting its distortionary effects on inflation signals and for publicly-owned banks. Directors noted that the SNB's communications strategy, with its rolling three-year inflation forecast, continues to serve Switzerland well.

Directors reviewed the factors affecting the recent weakness of the Swiss franc, despite rising policy rates and strong fundamentals. They noted that carry-trades could be temporarily weakening the franc to a level below its equilibrium, and considered that the present independent floating exchange rate regime is best to handle these uncertainties. These developments in carry-trades could also imply important spillover risks for other countries, especially in Eastern Europe, where the Swiss franc—by virtue of its low volatility and the low Swiss interest rate—is the currency of choice for loans that are contributing to rapid credit expansion. Directors accordingly supported close monitoring of such lending to limit related risks.

Directors noted that Swiss external competitiveness is strong. In addition, the large stocks of foreign assets of domestic pension funds and high-earning multinational corporations in Switzerland have contributed to a structurally large current account surplus. Thus, Directors noted that interpreting the surplus is complex and its connection to domestic demand is not straightforward. Going forward, Directors considered that deeper internal structural reforms could strengthen domestic demand and potential growth, and make a contribution—appropriate to Switzerland's size—to an orderly resolution of global imbalances. In this context, Directors noted the importance of further liberalization of sheltered sectors, including agriculture.

Directors welcomed the conclusions of the FSAP update that reaffirm the soundness of the Swiss financial system, and supported its recommendations. The crucial importance of the Swiss financial sector to both the domestic economy and the global financial system—as well as its large size and increasing complexity—heighten the need for continued vigilance and for the highest standards of financial supervision. In this context, several Directors welcomed the tripartite arrangement for supervisory cooperation between Switzerland, the United Kingdom, and the United States.

With regard to actions to strengthen financial sector supervision, Directors emphasized that the new supervisory authority, the Financial Market Supervisory Authority (FINMA), should be assured both financial and regulatory independence. Continuing efforts will also be important to evaluate large banks' operating models and to ensure that liquidity and capital regimes remain appropriate to changing circumstances. Directors also encouraged the authorities to take the opportunity of current favorable cyclical conditions to strengthen supervision for some insurance companies for which heightened risks were identified in last year's Swiss Solvency Test and to address underfunding in selected pension funds.

Directors commended the authorities for their strong fiscal performance guided by the valuable debt brake fiscal rule. Looking forward, they stressed that fiscal stimulus should be avoided and the integrity of the debt brake maintained. In this regard, many Directors were concerned about the large one-time expenditures in 2008 that would be treated outside the debt brake. They therefore welcomed the authorities' commitment to compensate for this spending in the medium term. Also, several Directors suggested that, in the current conjuncture, it would be appropriate that the cantons use their strong tax receipts to build up reserves to absorb future expenditure needs related to population aging—rather than to cut taxes. Directors looked forward to the publication of the long-run fiscal sustainability report, which should help to develop a consensus on the key fiscal challenges and the needed actions.

Directors encouraged the authorities to improve the timeliness and quality of some key data sources.

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 (use the free Adobe Acrobat Reader to view this pdf file) for the 2007 Article IV Consultation with Switzerland is also available.

Switzerland: Selected Economic Indicators

	2003	2004	2005	2006 1/	2007 1/
Real economy					
Real GDP	-0.2	2.3	1.9	2.7	2.0
Real total domestic demand	0.4	1.6	1.2	2.2	2.2
CPI (year average)	0.6	0.8	1.2	1.0	0.7
Unemployment rate (in percent of labor force)	3.4	3.5	3.4	3.3	2.8
Gross national saving (percent of GDP)	34.2	34.9	37.9	39.0	38.2
Gross national investment (percent of GDP)	20.9	20.9	21.3	21.5	20.9
Public finances (percent of GDP)					
Confederation budget balance 2/	-0.9	-0.6	-0.2	0.5	0.3
General government balance 2/ 3/	-1.4	-1.0	-0.1	0.8	0.6
Gross public debt	53.7	53.4	51.4	48.2	46.2
Balance of payments					
Trade balance (in percent of GDP)	1.0	1.5	0.7	1.0	1.4
Current account (in percent of GDP)	13.3	14.0	16.6	17.5	17.3
Official reserves (end of year, US$ billion) 4/	47.7	55.5	36.3	38.1	...
Money and interest rates					
Domestic credit (annual average) 5/	0.6	2.3	4.5	6.3	...
M3 (annual average) 5/	8.3	3.2	4.2	3.0	...
Three-month Libor rate (in percent)	0.4	0.5	0.8	1.5	...
Government bond yield (in percent)	2.5	2.6	2.1	2.5	...
Exchange rate					
Exchange rate regime				Managed float	
Present rate (April 3, 2007)				SwF 1.22 per US$1	
Nominal effective exchange rate (1990=100)	110.0	110.4	109.8	108.4	...
Real effective exchange rate (1990=100) 6/	106.4	105.6	104.0	101.7	...

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 a change from December 2005 to December 2006.
6/ Based on consumer prices.

Statement by Thomas Moser, Executive Director for Switzerland
June 1, 2007

1. On behalf of my Swiss authorities, I would like to thank the staff for the stimulating and constructive discussions and the useful reports. Both the staff report for the Article IV Consultation and the Financial System Stability Assessment add considerable value to the domestic policy discussions in Switzerland.

2. The Swiss economy is in very good shape and the outlook is favorable. After three years of solid recovery, growth is broad based and the economy is operating at full capacity. The unemployment rate has fallen below 3 percent, inflation is well below 2 percent, the budget is in surplus, and public debt has been reduced to less than 50 percent of GDP. Moreover, as the staff's Financial System Stability Assessment confirms, the Swiss financial sector is performing well and strong financial soundness indicators reflect the resilience of the financial system to the most relevant stress events.

Monetary Policy and the Exchange Rate

3. The Swiss National Bank (SNB) has continued its monetary policy course of gradual interest-rate normalization initiated in December 2005. The inflation forecast published at the last quarterly review in March 2007 shows that a central target for the reference interest rate (i.e., 3-month Libor) fixed at 2.25 percent is still somewhat on the expansionary side and that the normalization process is not yet completed. Even though some of the SNB's models indicate a neutral interest rate of 2.5 percent, the SNB does not attach too much value to a specific figure for the neutral interest rate, since such figures are very much model-dependent and cannot be estimated with precision.

4. The SNB agrees with the staff that the recent behavior of the exchange rate is difficult to reconcile with fundamentals (i.e., high growth, low inflation, rising interest rates), and they agree with the appraisal in paragraphs 34 and 35. However, the current weakness of the Swiss franc needs to be qualified somewhat. While the franc is relatively weak against the Euro and the pound sterling, it remains quite strong against the US dollar and the Japanese yen, and the current fluctuations do not appear to be extraordinarily high by historical standards. Moreover, as pointed out by staff, some depreciation might be due to enhanced competition and productivity in the non-traded goods sector of the Swiss economy.

5. The SNB is more cautious in assuming that the Swiss franc may have lost some of its safe haven status. Over the last years there have hardly been any serious tests for such an assumption. The SNB does also not believe that the currency's legal decoupling from gold or that gold sales diminished the franc's safe haven status. De facto, the gold link was already broken in the 1970s. As to the importance of carry trades and hedge funds in causing franc weakness, the SNB does not have sufficient data to either confirm or reject this hypothesis.

6. The Swiss authorities share the staff's view that interpreting the large current account surplus is complex and that the surplus does not connect in a simple way to domestic absorption. Concerning the question of domestic versus foreign origin, it is indeed the case that in 2005 nearly 7 pps of GDP of the surplus may be attributable to foreigners. However, my authorities believe the figure for 2005 to be inflated as a result of unusually high direct investment income of foreign holdings.

Fiscal policy

7. The fiscal accounts at all levels of government benefited from strong revenue performance in 2006, resulting in a general government surplus of 1.1 percent of GDP according to latest estimates (compared with a budgeted deficit of 1 percent). My authorities are particularly satisfied with the results at the federal level, where a surplus of 0.5 percent of GDP allowed the target of a structural balance to be achieved one year ahead of schedule.

8. Although the better-than-projected fiscal outcome is mainly the result of higher revenues, expenditure growth continues to be contained. The debt brake introduced in 2003 remains the key instrument for achieving and maintaining a balanced budget over the cycle at the federal level. It has strong support in the population and in parliament, and the binding requirements of the rule have facilitated the effective implementation of recent expenditure reduction programs. As noted by the staff, my authorities are currently considering ways to further strengthen the debt brake by extending the application of rule-based expenditure restrictions to areas not yet covered.

9. One area of particular concern is the treatment of extraordinary expenditure due to exceptional circumstances. Such expenditure is usually of a one-off nature and can be substantial, and it would lead to an undue compression of regular spending if it had to be accommodated within the annual spending ceiling of the debt brake rule. The conditions for which exceptional circumstances can be claimed are specified in the budget law and have to be approved by a majority in both houses of parliament.

10. My authorities would like to emphasize their restrictive approach to extraordinary spending. Particularly, they would like to dispel any notion that they are using the possibility of extraordinary spending to circumvent the debt brake. The cumulation of such spending in 2008 is coincidental. Nevertheless, this cumulation has increased the awareness that such expenditures could potentially undermine the spirit of the debt brake. The authorities are thus considering ways to introduce a rules-based system to compensate extraordinary spending with medium-term surpluses. The fact that the debt brake only applies to the Confederation is less concerning to my authorities, since the fiscal accounts of lower levels of government have traditionally been sound. Most cantons have various types of instruments to prevent serious fiscal imbalances, such as fiscal rules and financial referenda.

11. My authorities concur with the staff that they will need to pursue their work on the long-term fiscal challenges listed in paragraph 30. The authorities would like to further emphasize that the government has initiated two specific projects to advance this work. First, in order to reveal the strains on public finances caused by demographic change, a long-term Fiscal Sustainability Report is being prepared to present projections for the public sector (at the federal, cantonal and local levels, including social security) up to 2050 under a no-policy-change assumption, with sensitivity analyses for key variables such as productivity growth, interest rates, and demographics. Second, based on the Fiscal Sustainability Report, a separate document will discuss alternative policy options as part of the medium-term financial plan of the Federal government. Besides, the ambitious project aimed at systematically reviewing the full range of tasks of the central government should also help reduce spending pressures.

Financial Sector

12. My authorities would like to commend the staff for having set the right priorities in the FSAP update, and they welcome the overall positive assessment of the health and resilience of the Swiss financial system. They share the staff's view that the size, complexity, and systemic importance of the two large banks represent a major challenge. They concur with the staff recommendations on enhancing systemic stability, which are being followed up as a matter of priority:

- The Swiss Federal Banking Commission (SFBC) is conducting a thorough assessment of the capital situation of the two large banks as part of the implementation of the second pillar of Basel II, with a focus on stress tests.
- The SNB and the SFBC will initiate a regulatory project to improve the supervision and regulation of liquidity risk at the large banks. They consider it essential for the stability of the banking sector to ensure that the large banks' liquidity is commensurate with their risks.
- The SNB will endeavor to further improve international cooperation with its foreign counterparts. The focus will be on the provision of liquidity in exceptional situations. My authorities fully share the view that international cooperation among regulators and central banks is important and can effectively contribute to reducing the probability and costs of a systemic crisis.

13. With regard to institutional reform, my authorities fully agree that the planned unified financial supervisory authority (FINMA) should be strong and functionally, institutionally, and financially independent and adequately staffed. The independence of FINMA is a prerequisite for the agency to be able to fulfill its supervisory duties. My authorities do not share the staff's concerns as to the adequacy of the draft law in this regard, however:

- FINMA will have a comprehensive and effective set of sanctioning measures. Under the draft Federal Act on FINMA, the sanctioning regime has been harmonized, streamlined and refined, and new instruments have been introduced (confiscation of assets, occupational ban, and "naming and shaming"). As to civil money penalties, the Swiss legal system does not allow for such penalties being imposed by the supervisory authority. But the present system under which fines can be imposed by the Federal Finance Department and the cantons (criminal prosecution) has proved effective and no change is envisaged.
- My authorities do not believe that there are any provisions in the draft FINMA Act that impinge on FINMA's operational independence or prudential powers. The provisions aim for efficient and effective financial market supervision, taking into account the principle of proportionality. The latter will not bar FINMA from issuing adequate regulation and taking appropriate action.

14. My authorities have a certain degree of dissent with regard to recommendation five of the assessment. While they agree that there is scope for cantonal banks to strengthen their governance structures, they do not see clear evidence of distortions in the market conduct of cantonal banks, given the intensity of competition in Swiss retail banking.

15. As to the insurance sector, my authorities share the staff's view that significant improvements have been made in the regulatory framework and that the financial difficulties experienced by many large insurers in early 2003 have been overcome. They also concur with staff that going forward the insurance supervisor should focus on those insurers for whom heightened risks were identified by last year's Swiss Solvency Test (SST) field test. The supervisory authorities will also continue to consult with the reinsurance sector on the introduction of the SST.

16. On pension funds, it should first be noted that with an asset volume comfortably over 100 percent of GDP the Occupational Benefit Plan system in Switzerland is well endowed compared with many other countries. However, there is broad agreement among the authorities and the industry that pension funds should generally have a higher degree of coverage and that valuation reserves should be increased further. On the latter, many pension funds have recently significantly increased their valuation reserves. It should also be pointed out that legal provisions require pension funds to notify any undercoverage, so as to initiate corrective measures, on which reports (on implementation and effectiveness) must be submitted annually to the Federal Council.

17. While the staff prefers a more uniform and centralized approach to Switzerland's pension sector supervision, a decentralized and relatively liberal system is more in keeping with Swiss tradition and Switzerland's political system. A central supervisory authority, as recommended by the staff, is thus currently not on the political agenda. However, significant improvements with regard to the effectiveness of pension supervision will be achieved with

the strengthening of the existing federal supervisory authority. The envisaged new High Supervisory Board will be able to issue binding standards and regulations and allowed to carry out on-site inspections of the regional supervisory authorities. It will ensure that the regional supervisory authorities conduct supervision in accordance with uniform procedures and pre-defined standards.