May 2008
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Switzerland: 2008 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 2008 Article IV consultation with Switzerland, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 17, 2008, 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 29, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 23, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Switzerland.

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

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INTERNATIONAL MONETARY FUND

SWITZERLAND

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with Switzerland

Approved by Alessandro Leipold and G. Russell Kincaid

April 29, 2008

Executive Summary

Impressive growth in the recent global cyclical upswing is set to be followed by an unexpectedly sharp slowdown. The upswing was impressive in its strength and in the shift from traditional manufacturing to higher value-added production and service delivery. With continued inflows of skilled labor, this augurs well for the future. Yet, the marked slowdown in the United States, its knock-on effects on Europe, and the continuing shake up in the global financial system are set to take their toll on the Swiss economy. While staff sees a lower growth outcome than the authorities, there is much agreement on the scope and balance in the policy approaches to deal with these developments.

The key objective is to maintain financial stability. Instability in the Swiss financial system would also generate negative spillovers for global finance. The authorities' response has blended active liquidity management and, increasingly, forward-looking actions to limit risks in the banking sector. In this regard, the approach to reinforce capital buffers is especially important. However, strengthening the supervisor—who is at a resource disadvantage vis-à-vis the major banks—remains a challenge and may need to be supplemented by transparent performance benchmarks and a stronger role of host country supervisors in overseeing global operations.

Monetary policy has steered a careful course in an uncertain environment. The September 2007 increase in the SNB policy rate signaled concern about rising inflation. Since then, when the 3-month Libor has tended to rise above the mid-point of the target band, the authorities have used short-term repo operations to steer the rate down. This has provided useful accommodation. There is some scope for further easing of monetary policy since inflation is expected to gradually decline and economic weakness is projected to persist.

A conservative fiscal stance, in keeping with the medium-term fiscal framework, is appropriate. The authorities emphasized that despite a small stimulus this year, they do not see a fiscal stimulus as helpful for reviving growth. Instead, they are focused on long-term fiscal sustainability, which remains a challenge despite the recent decrease in the public debt-to-GDP ratio. The authorities' intent to identify specific measures for this purpose is timely, as is the proposed inclusion of "extraordinary" expenditures in the debt-brake rule.

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I. THE CONTEXT

1. **The Swiss economy performed impressively during the recent global upswing.** Although its international preeminence has eroded in some respects, Switzerland rode the global expansion with much success, with growth exceeding the euro area average in the past four years. High-value added manufacturing gained in strength, Switzerland's position as a major global financial center was reinforced, and a broader emphasis on services delivery has opened up new growth possibilities. Building on long-standing strengths—advanced infrastructure, a skilled and flexible workforce, openness to the flow across its borders of trade, capital, and people, low tax rates, and a small government—these developments augur well for the future.

2. **But the risks to its financial service industry threaten to dent the gains achieved.** The two major international banks—UBS and Credit Suisse—are closely intertwined in and have felt the full force of the international financial turbulence. The authorities have responded appropriately to limit the knock-on effects of the financial tensions, injecting liquidity and coordinating with major central banks. However, the still-unfolding developments will have a significant bearing on Swiss growth and impose important policy challenges, with implications not just for Switzerland but also for financial and economic developments in the rest of the world.

3. **In light of Swiss susceptibility to externally-generated volatility, the discussions focused on the near-term outlook and policies to mitigate the risks of instability.** The very strengths of the Swiss economy—its openness and its dynamic financial sector—also expose it to adverse developments overseas. As such, the economy experiences sharper swings than most advanced economies (Box 1). In turn, the risk-management strategies of Swiss banks can amplify international shocks, while also generating negative spillovers for the global financial system and the world economy. The policy task is to pay particular attention to decisions made by domestic financial players. This is best achieved by focusing directly on financial sector regulation and supervision. Monetary and fiscal policies are likely to play supportive roles within their well-defined frameworks.

Box 1. The Influence of International Shocks on the Swiss Economy

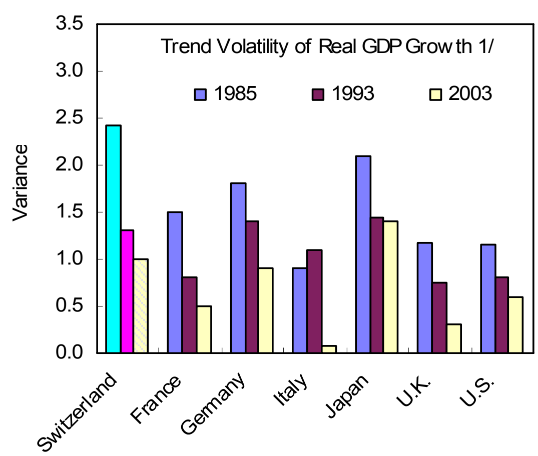
Developments in the global economy have a significant bearing on Swiss growth. A factor structural vector autoregression (FSVAR) method was used to decompose deviations of real GDP from trend, as in Stock and Watson (2005).[1] The methodology identifies: (i) country-specific or "own" shocks; (ii) common "international" shocks that affect all countries within the same period; and (iii) idiosyncratic shocks that "spillover" into the domestic economy after a one quarter lag. The following conclusions emerge:

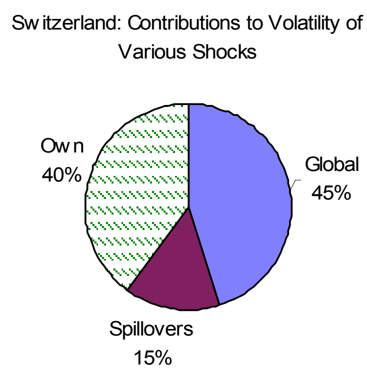
- In all countries, deviations from trend growth—a measure of volatility—have declined over time (left panel below).

- However, they remain relatively large for Switzerland (only in Japan are they larger).

- For Switzerland, just under half of these deviations are due to international shocks; another 15 percent arise from spillovers from other countries in this sample (right panel).

The implication is that, in periods of high international volatility, Swiss growth will be particularly subject to large fluctuations.





1/ Variance of band-pass-filtered GDP; multiplied by 10,000.

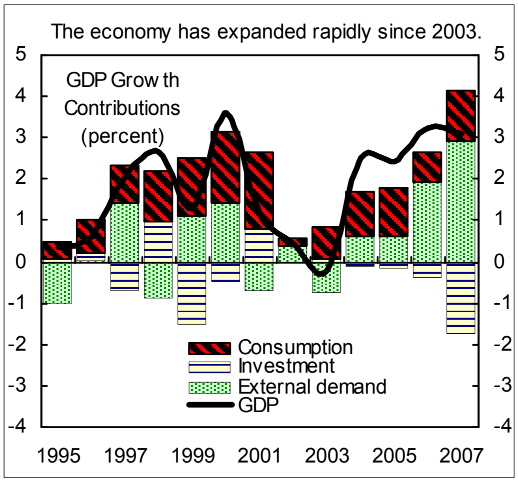
[1] J. Stock and M. Watson, "Understanding Changes in International Business Cycle Dynamics," *Journal of the European Economic Association,* September 2005.

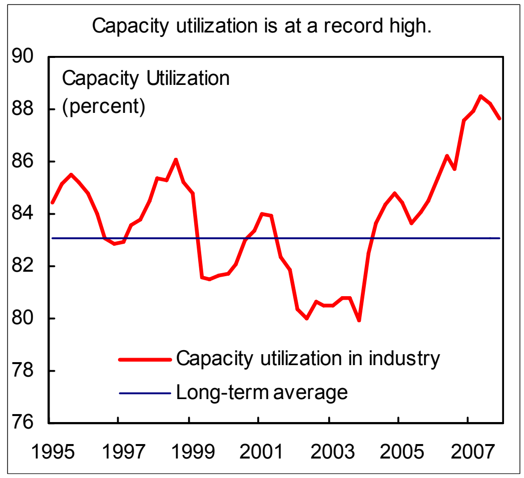
II. The Near-Term Growth Outlook

A. Background

4. **In 2007, the economy was buoyed by external demand, with some pickup in consumption.** GDP growth accelerated to 3.1 percent, capping the resurgence that began in early 2004 (Table 1). External demand, particularly from Germany, remained strong. Private consumption rose with improving consumer confidence and falling unemployment. Machinery and equipment investment was underpinned by strong corporate profitability and

by capacity utilization—at 88 percent—well above its long-term average. Construction investment, however, fell as transportation projects were delayed. And inventories were drawn down.





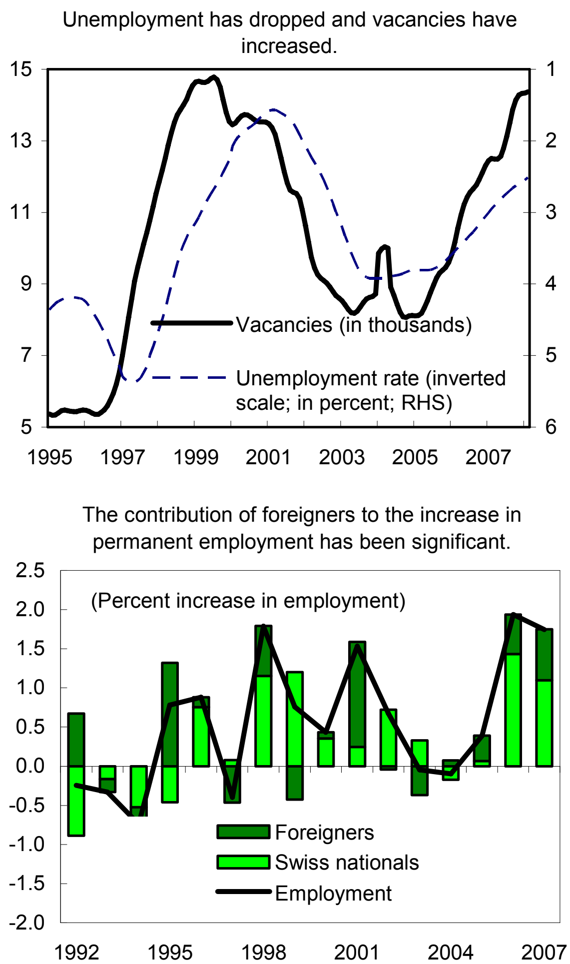
5. **The rebound extended an ongoing structural shift—productivity growth in services was supported by robust increase in skilled employment**. Labor productivity growth rose smartly in the cyclical upturn. While Switzerland's manufacturing transformation—from chocolates and watches to genetics and informatics—has continued, productivity growth in the trade and financial services sectors reinforced trends initiated in the mid-1990s. Employment continued to increase through 2007 despite financial sector woes, which slowed gains in the second half of the year. The unemployment rate was down to 2.7 percent in December, and vacancy rates continued to rise. Businesses were reporting particular shortages in technical and IT areas. Strong immigration and cross-border commuter flows—with rising skill content—have supported labor supply (Figure 1).

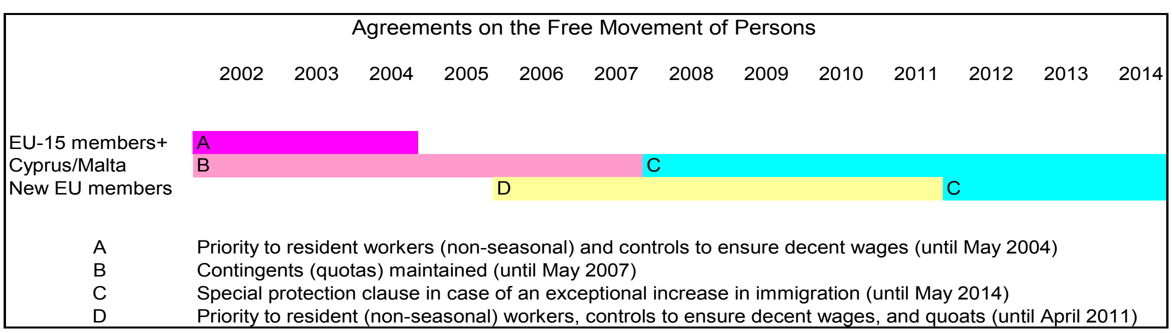
Switzerland: Annual Growth Rates of Sectoral Hourly Labor Productivity

	1991-2000	2000-03	2003-06	1991-2006
Composite of traded and non-traded sector	2.08	0.35	1.72	1.66
Traded sector	2.30	4.01	0.99	2.37
Non-traded sector	2.02	-1.13	2.05	1.38
Construction	0.09	3.13	0.25	0.72
Trade	0.70	3.26	1.49	1.36
Financial intermediation	1.98	-4.92	2.93	0.75

Source: SNB; based on SFSO national accounts and working hour statistics. The traded sector contains the SFSO codes Industry, excluding construction. Values for 2006 are estimated from OECD data.

Figure 1. Switzerland: Labor Market Developments





Sources: Country authorities; and Fund staff calculations.

1/ Tertiary education starts above high school, or apprenticeship level.

6. **The structural change accompanying the rebound has raised the potential growth rate, but the extent of the increase is unclear.** The authorities' estimates of potential growth have a large range. The methodologies that generate higher estimates of potential growth (and lower output gaps) are those that allow for time varying trends. These higher estimates reflect a shift from manufacturing, where capacity constraints apply in the short-run, to services-based growth, where capital is not a constraint and labor supply has recently met the skills demanded. Such a benign interpretation of developments is not unreasonable and could even imply no current output gap. However, for fiscal planning, staff and the authorities use a more conservative potential growth rate of 1.8 percent, which implies a positive output gap averaging some 1 percent in 2007-08.

7. **Notwithstanding these favorable developments, the financial turbulence, felt with force in Switzerland, has raised systemic concerns—though no immediate credit contraction.**

- As elsewhere, the tensions were first manifested in the interbank markets for short-term liquidity, and these have continued to recur.

- The asset portfolio of UBS—and to a lesser extent of Credit Suisse—has had to be significantly written down, and UBS has required two rounds of capital injection.

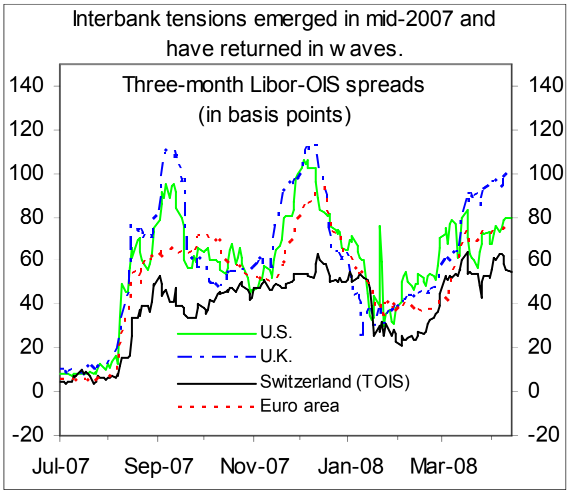
- While asset deleveraging is ongoing and the big banks are increasing their liquidity, domestic lending has remained surprisingly steady. In contrast, the torrid pace of foreign lending is sharply down.

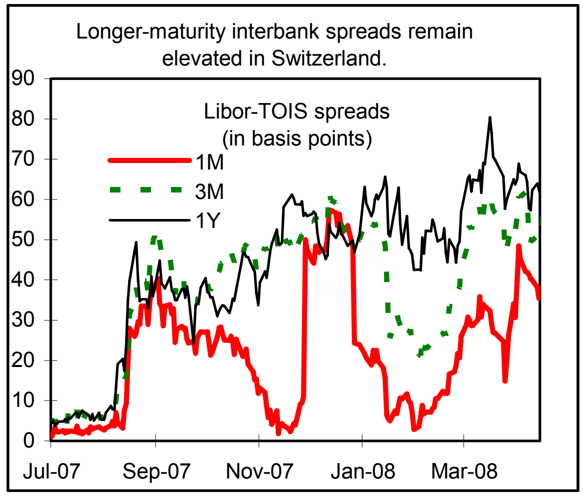
Subprime Related Losses and Capital Injections 1/
(as of April 24, 2008; in billions of US dollars)

Firm	Total Losses	Capital Injections
Citigroup	40.9	37.2
UBS	38.0	27.2
Merrill Lynch	31.7	16.1
Bank of America	14.8	13.0
RBS	14.7	23.7
Morgan Stanley	12.6	5.0
HSBC	12.5	2.0
JPMorgan Chase	9.8	6.0
Credit Suisse	9.7	1.5
IKB	9.0	13.3
Other institutions	115.0	67.2
Total	308.7	212.2

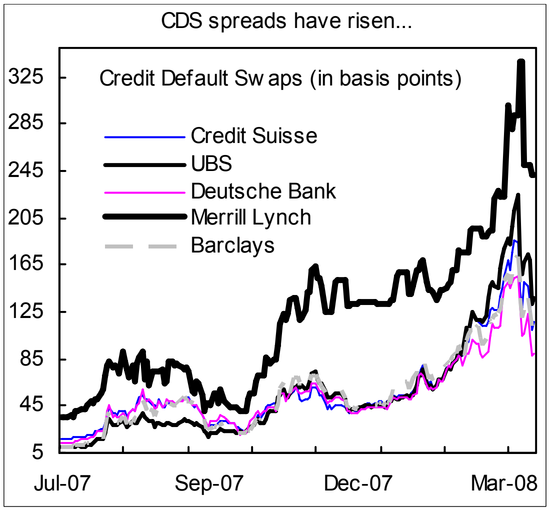
Sources : Bloomberg and staff estimates.
1/ Writedowns and charges related to subprime assets.

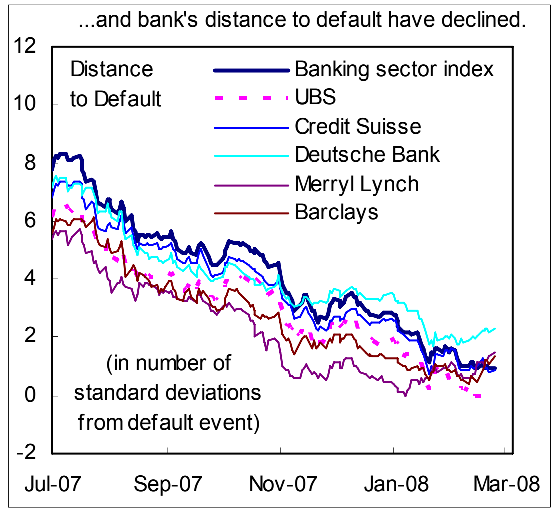
8. **Liquidity in interbank markets, particularly for term money, has periodically threatened to dry up—and spreads in these markets remain elevated, especially at longer maturities.** Following the onset of the financial turbulence in July 2007, interest rate spreads (over the tomorrow/next index swap) widened—though less so than in other major financial markets. Spreads then seemed to fall and stabilize in much of the final quarter of 2007. They have, however, been subject to new waves of anxiety. In the most recent wave, longer-term interbank borrowing has been subject to substantially larger premiums than short-term borrowing. Clearly, banks are reluctant to lend for extended maturities and, especially the two large banks, have been building their liquidity reserves.



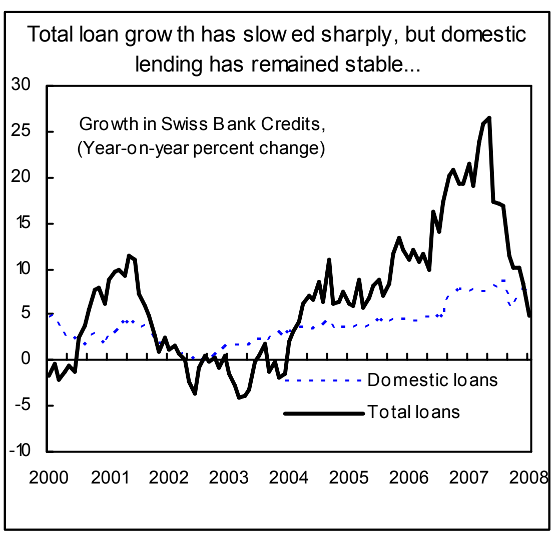


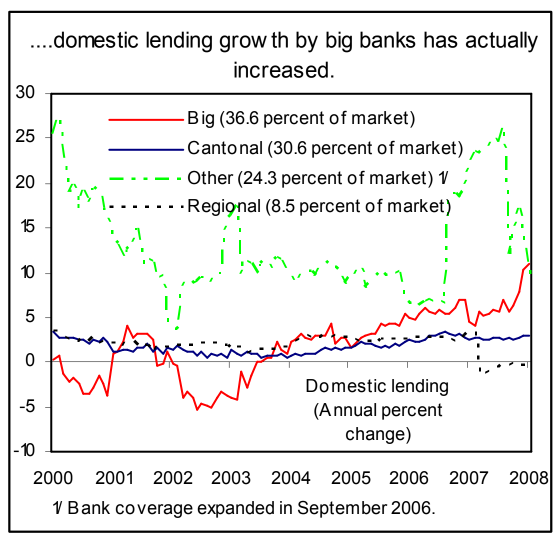
9. **Pressures at the two large banks have also raised broader systemic issues.** Concerns about their creditworthiness have remained elevated, evident in wide spreads on credit default swaps, a sharp fall in equity prices, and a declining estimated "distance to default." Despite its allegedly riskier asset portfolio, reflected in higher credit default spreads before 2007, Credit Suisse earned estimated profits of \$7.8 billion in 2007. However, in the first quarter of this year, concerns grew with the mark down of \$5.3 billion on structured credit positions, resulting in a loss of \$2.1 billion. UBS has been hit hard, reflecting its particularly high exposure to the US subprime assets. With writedowns now about \$38 billion, UBS ended 2007 with a loss of \$4 billion and reported a further loss of \$12 billion in the first quarter of 2008. Since last summer, the long-term rating of UBS has been lowered from AA+ to AA- by Fitch and by S&P, and from Aaa to Aa1 by Moody's. However, markets have responded favorably to a rights issue, which follows the capital injections earlier in the year from a sovereign wealth fund, a large private investor, and payment of dividend in stock rather than in cash. According to Fitch's measure of the intrinsic strength of the banking system, the Swiss banking system has slipped from A (very high) to B (high).





10. **Despite these pressures, domestic credit growth has remained steady, while foreign lending has decreased sharply.** The decline in overall credit growth is principally the consequence of a sharp contraction in the growth rate of foreign loans, from the elevated 70 percent annualized rate in mid-summer. Domestic private sector credit, which grew at a healthy rate of 5½ percent year-on-year through the summer of 2007, actually accelerated to 7 percent thereafter, despite global tensions. In this regard also, the Swiss experience has matched the experience in the eurozone, where domestic credit growth has remained relatively stable.

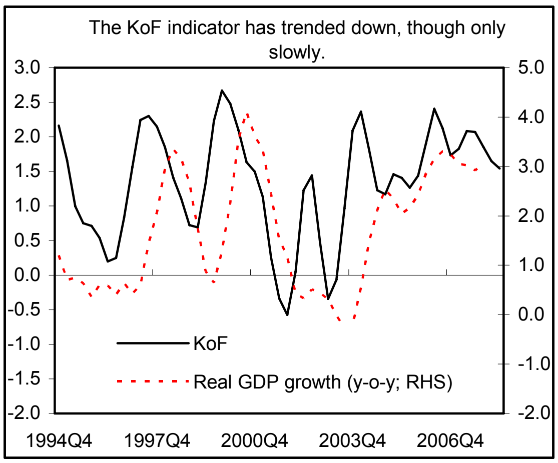


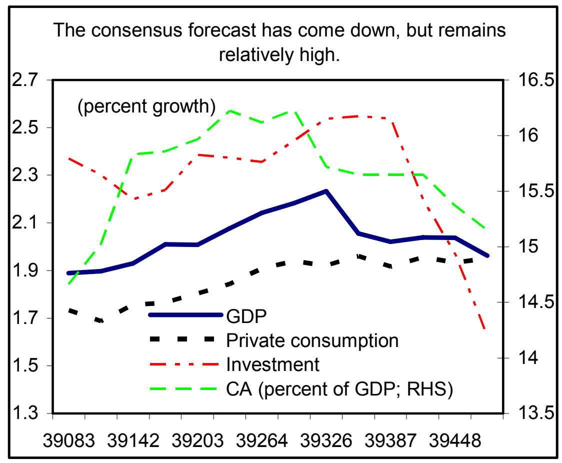


B. Growth Prospects

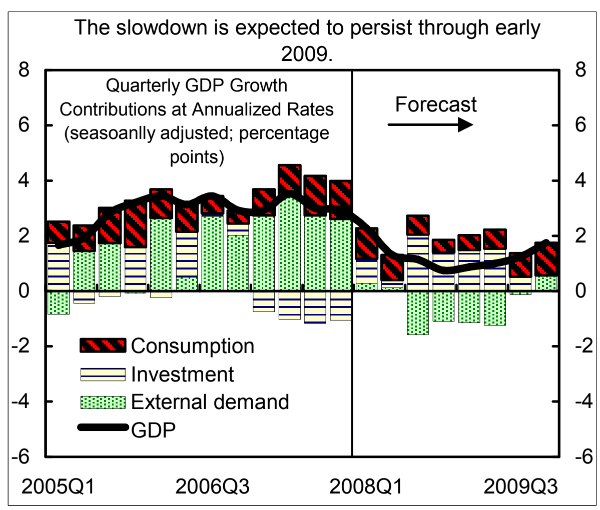
11. **As the authorities emphasized, real sector forward-looking indicators have remained surprisingly positive.** The momentum from buoyant growth in much of Europe

during 2007 is still evident. Industrial capacity utilization and order books suggest continued strength, and sentiment indicators are moderating only gradually. Manufactured goods' demand from Europe and Asia has remained relatively steady. The KoF composite leading indicator has trended down but only slowly. Nervousness in the financial sector notwithstanding, lending surveys do not yet foreshadow a credit squeeze. Indeed, some analysts regard corporate liquidity and profitability as constraining demand for credit. Consensus forecasts for growth in 2008 have come down since October 2007, but the average is still high—at around 2.0 percent—though with a large variance.





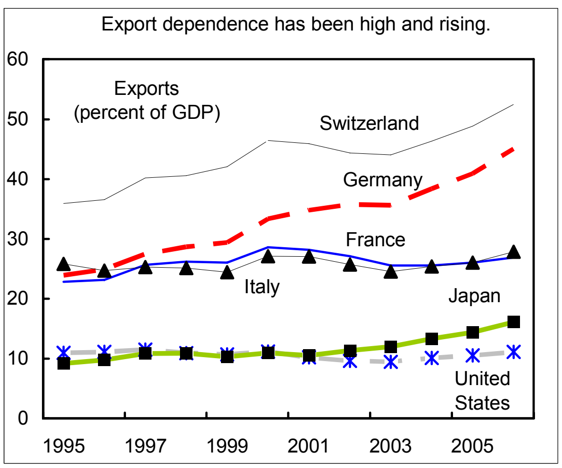
12. **Staff forecasts, however, assume that the global developments will take their toll on the Swiss economy.** In the discussions, staff acknowledged that the current global environment is characterized by a high degree of uncertainty and, hence, projections are subject to more than the usual imprecision. Yet, consistent with the Fund's projections for the U.S. and Europe, a sharp Swiss deceleration is anticipated. Because of presumed lag effects, the impact of the pronounced U.S. slowdown is expected to persist even after the U.S. bottoms out. For this reason, staff projects Swiss GDP growth to slow to 1.4 percent in 2008, and then to 1.3 percent

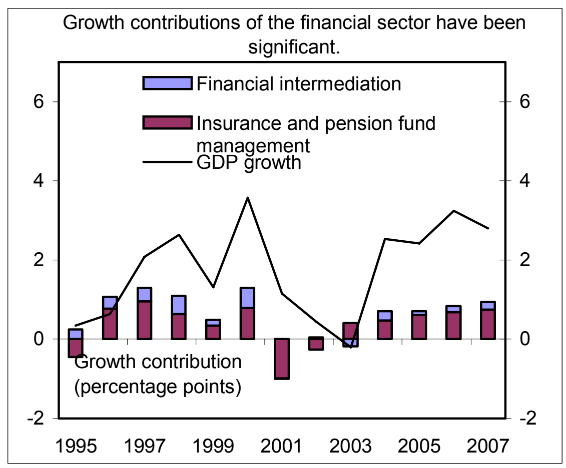


in 2009.[1] Largely because the authorities anticipate a less severe U.S. downturn, implying also a more modest European slowdown, the SNB projects GDP growth of between 1.5 and 2 percent in 2008, and the State Secretariat for Economic Affairs has a point estimate of 1.9 percent; both expect deceleration in 2009.

13. **The slowdown stems from several sources, which will likely emerge sequentially.**

- Exports of goods and services will slow at first, as U.S. and European imports decelerate. Given Switzerland's strong export orientation, this influence will likely manifest early with reduced growth of goods' exports and a sharp curtailment of financial service income. The authorities' historical analysis shows that a sharp fall in stock prices, as has recently occurred, is accompanied by a sharp decline in financial service exports. While the stronger Swiss Franc has not reached levels that would significantly hurt exports of goods, continued appreciation could have a material effect. In the short-run, GDP growth will likely be held up by consumption growth, given the recent strength in employment.





[1] Staff estimates presume that the 2007 quarterly pattern of growth would be redistributed due to significant inventory effects in the 4th quarter national accounts. There was agreement that the national statistics office would most likely revise the 2007 data, with the peak of the cycle moved to the second quarter. Absent this adjustment, the carry-over effects from reported 4th quarter growth alone would be about 1½ percent, and the 2008 growth rate would be in the 1.6-1.7 range.

- The drop in banks' earnings will also have a direct and early impact on GDP growth, given the financial sector's relatively large contribution to growth swings in recent years.

- Finally, slowing exports, the inflationary effects of the oil price increase and, in particular, the global financial tensions can all be expected to dent consumer confidence, leading to weaker consumption expenditures in the late 2008 and especially 2009 (Box 2). This expected weakness in consumption contributes, especially in 2009, to staff's difference in GDP growth projections relative to those of the authorities. While corporate profitability and existing orders should underpin machinery and equipment investment for a while, the uncertainty will likely engender caution.

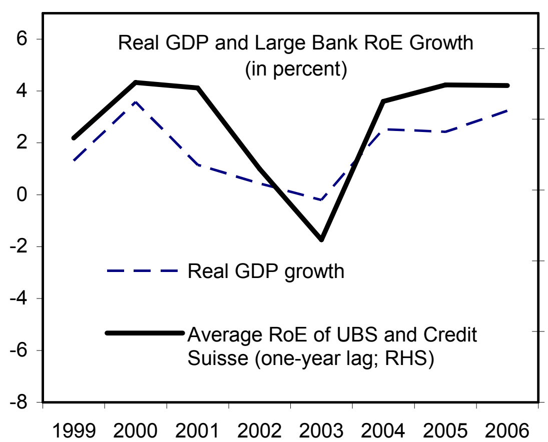
III. Maintaining Financial Sector Stability

14. **The Swiss authorities have responded vigorously to limit the knock-on effects of the current financial tensions.** They have injected liquidity into the banking system, often in coordination with other major central banks, maintained an enhanced oversight of the major banks and insurance companies, and worked actively with other regulators to share information, coordinate supervisory activities, and draw lessons for the future.

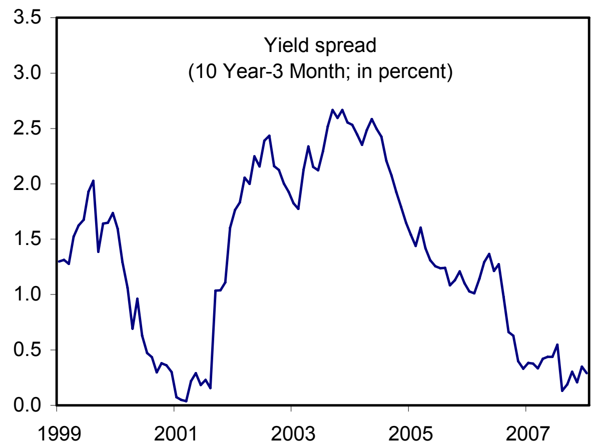
Box 2. Global Financial Conditions Weigh on Swiss Growth

Past relationships suggest that the global financial downturn points to continued risks. Staff analysis shows a remarkable correlation between profits at the two big banks and growth one year ahead. Based on recorded 2007 profits, this statistical relationship projects a sharply slowing growth rate in 2008. Further investigation suggests that profits at the two banks are a reflection of global financial conditions and are, in particular, correlated with the so-called term spread (the difference between the 10-year and 3-month interest rates). Just as the dropping profits in 2001 and 2002 predicted the slowdown of 2003, so did the shrinking term spread (or the flattening yield curve).

Growth is correlated with large banks' RoE.

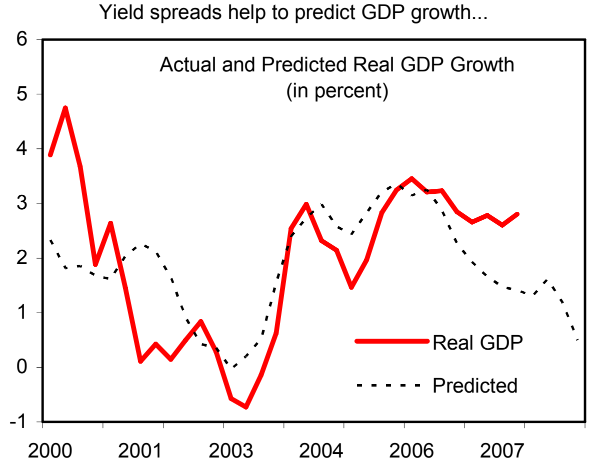


Yield spreads have declined.

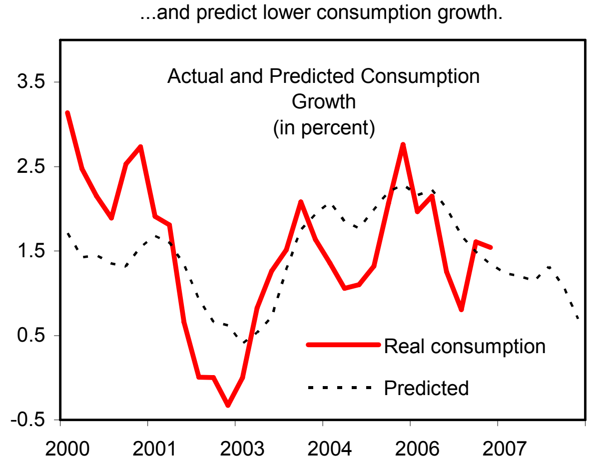


The yield curve's well-established record of predicting growth rates applies to Switzerland. Temporary rapid growth tends to push up short-term rates either because monetary authorities seek to cool the economy or market rates rise independently. Because future growth expectations do not rise, long-term rates stay stable or even decline, and the spread narrows. The spread between the 10-year Swiss confederation bond yield and the 3-month CHF Libor has dramatically declined in recent quarters. For the Swiss economy, the real GDP growth rate is well forecasted by this yield spread. The coefficient on the yield spread is statistically significant at one percent level and the model shows a high predictive power (0.8 *R-squared*) for future GDP growth. The yield spread is particularly successful in predicting the consumption component of GDP, implying that it is an early indicator of consumer sentiments and confidence. These forecasts predict weakness 4-6 quarters ahead.

Yield spreads help to predict GDP growth...



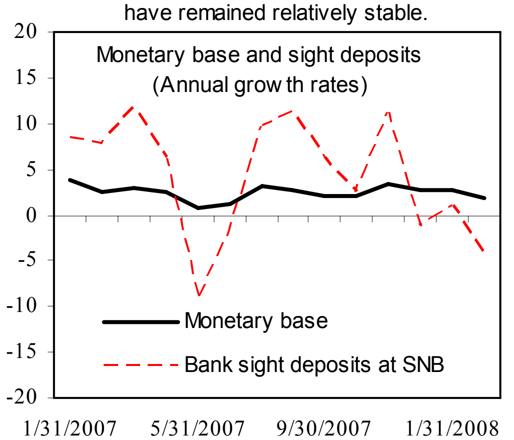
...and predict lower consumption growth.



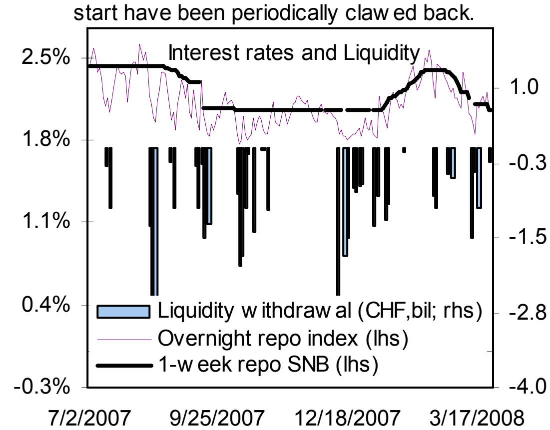
A. Interbank Liquidity

15. **In line with central banks in other major financial centers, the Swiss National Bank (SNB) has provided the necessary liquidity to ease interbank tensions.** Heavier than normal doses of liquidity provision have occurred on days of heightened concerns or at the start of maintenance periods. However, despite an active policy to enhance availability of liquidity, the monthly average level of commercial bank sight deposits at the central bank (a measure of SNB provided liquidity) has not grown more rapidly than in the past since liquidity injections and withdrawals have been carefully-timed. An expanded list of collateral eligible for SNB repos was approved in June 2007, prior to the onset of the crisis, and has proved adequate so far. The SNB also coordinated with the Federal Reserve and the European Central Bank in providing dollar liquidity.

Bank deposits at the SNB, and the monetary base, have remained relatively stable.



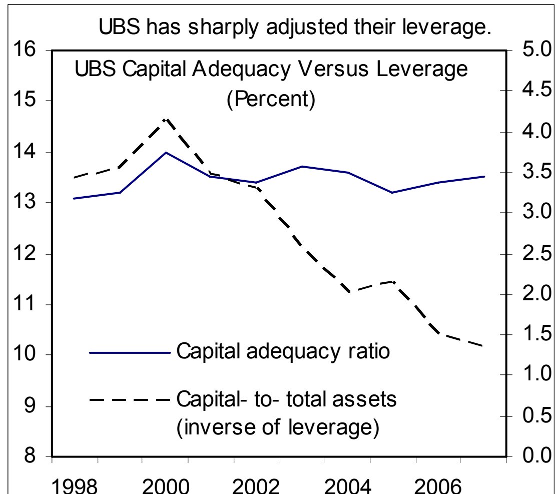
As liquidity injections at the maintenance period's start have been periodically clawed back.



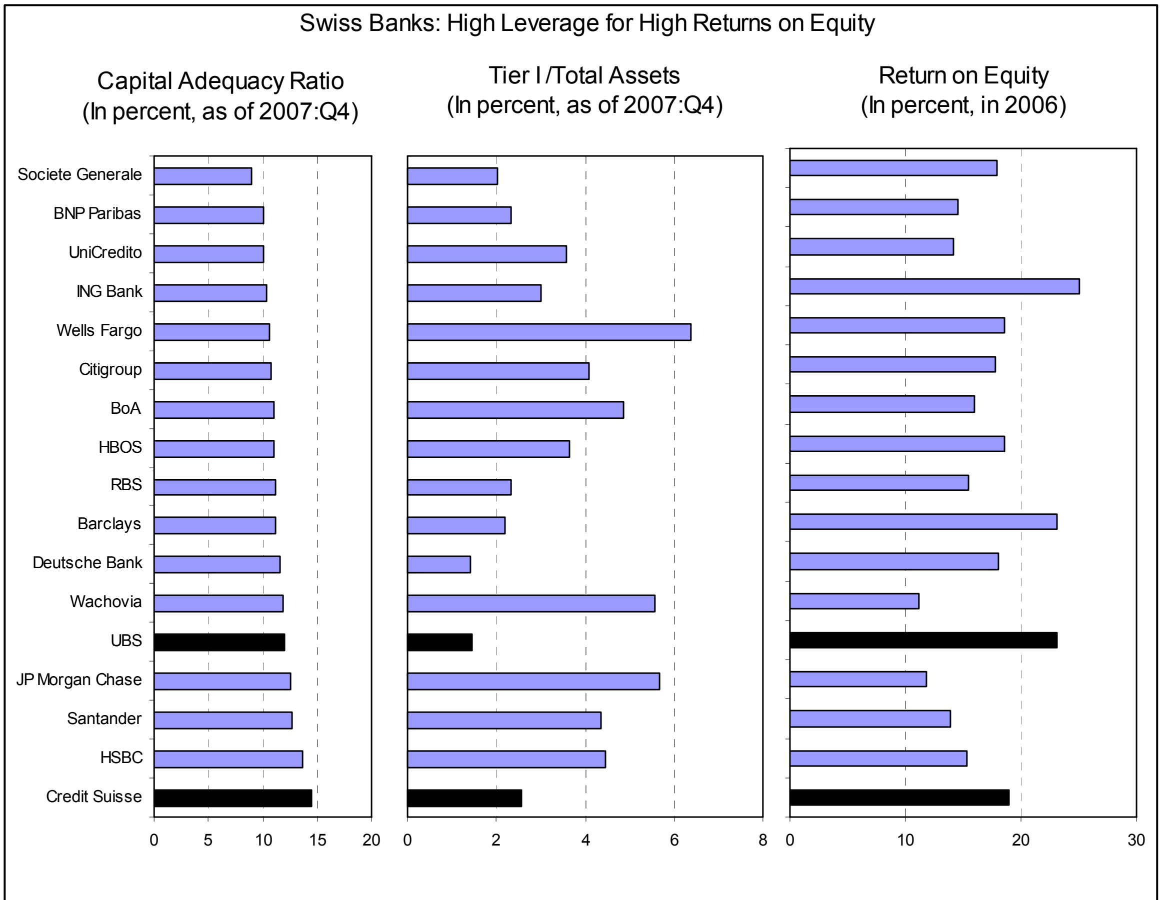
B. Capital Adequacy

16. **Banks' business models have evolved to economize on capital, thereby however raising systemic risk.** The search for new, often low-margin, businesses in the increasingly competitive international financial markets has led to banks acquiring of apparently low-risk assets, often certified as such by rating agencies. The low assigned risk weights allowed some banks to comfortably meet their regulatory capital requirement (Tier-1 plus Tier-2 capital as a proportion of risk-weighted assets) while maintaining very high leverage (low ratios of capital-to-total assets).

UBS has sharply adjusted their leverage.



The UBS trends, in this regard, are striking. Other European banks, including Credit Suisse, have also taken this approach. In good times, this earned high returns for banks' equity holders, as in 2006. However, *ex post*, their greater riskiness than earlier recognized and their illiquidity have reinforced each other. Actions of individual banks may have created spillover risks because of the perception of common vulnerability across European banks.



Source: Thomson Financial.

17. **Undercapitalization of UBS has been an important concern.** Measured by international standards, UBS remains adequately capitalized but maintaining these standards has required it to rebuild capital to levels consistent with its positioning as a global banking group with major asset management as well as banking operations. In conjunction with reporting its first round of write-offs in December, UBS announced efforts to add SwF 19.4 billion (about $17.8 billion) to the bank's Tier-1 capital. Despite initial reservations, shareholders approved capital injection by Singapore's GIC and an unnamed private investor, though the cost was reportedly high for a then Moody's Aaa-rated issuer

and relative to other recent capital injections.[2] A second round of new capital ($15 billion), to be raised in a rights issue following the second round of write-offs, has been underwritten by major U.S. and European investment banks. This will restore capital ratios close to levels prevailing before the credit market turmoil.

C. Banking Regulation

18. **The lessons from recent events have identified the need for focus in four areas:**

- Better risk assessment and risk management;
- Increased capital buffers;
- More liquidity; and
- Greater disclosure.

19. **More realistic risk assessment is crucial.** The call for more prudent risk management has followed two, complementary, tracks: better governance and enhanced regulation. Existing management structures clearly proved an insufficient restraint on risk taking. However, the effectiveness of proposed corporate governance measures remains unclear, especially with regard to compensation schemes and the role of non-executive directors, and implementation will need new industry norms. In contrast, it is widely accepted that the buildup of structured finance positions would have been lower had the Basel II regulatory framework been fully implemented.[3] Compared with Basel I, the new framework captures off-balance-sheet assets better and takes a more sophisticated approach to measuring risks. The Swiss authorities have now largely implemented Basel II, including the Pillar 2 (supervisory review) process.[4] But they are also revisiting their risk-based capital framework, drawing on the recently revealed outcomes and correlations across asset classes. These reassessments will, in turn, lead to typically higher capital requirements.

20. **However, given the limits of any risk-based framework, consideration of additional capital is merited to cushion against unanticipated risks.** The authorities are

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[2] The two-year convertible notes for SwF 13 billion (about $12 billion) have been placed with the Government of Singapore Investment Corporation (SwF 11 billion) and an undisclosed Middle Eastern investor (SwF 2 billion) at a 9 percent annual interest rate. Additional capital is to be raised through the resale of treasury shares and the replacement of the 2007 cash dividend with a stock dividend.

[3] Basel II regulations came into force on January 1, 2007 and were adopted by all banks on January 1, 2008.

[4] They will implement Pillar 3 requirements (disclosure in relation to market discipline) from the start of 2008.

considering the use of a leverage ratio for large banks to supplement existing capital requirements. Such an approach could add a transparent capital buffer. As staff noted and the authorities recognize, the approach has its limitations, not least the possibility that banks will have an increased incentive to “hide” their assets by moving them off-balance-sheet. However, staff agreed that implemented with Basel II and appropriate safeguards, a leverage ratio approach could serve as a useful complement to the existing regime, while helping to strengthen the supervisory response to future increased risk-taking by the banks.

21. **While additional capital will also mitigate liquidity risks, further development of liquidity risk management in response to recent events is a priority.** In line with the recommendations in the Financial Sector Assessment Program (FSAP) update in May 2007, the authorities are developing a stress testing framework to improve global liquidity risk management by the major banks and are actively reviewing banks’ contingency plans and liquidity management policies. They are also collaborating with other regulators internationally to enhance global practices.

22. **The Swiss Federal Banking Commission also recognizes that a lack of adequate disclosure amplified market anxieties and is working with regulators internationally on improvements.** The Commission’s immediate focus is on close monitoring of the two big banks and reported it had the relevant information necessary for supervisory purposes. However, the authorities have also called for increased transparency of commercial banks’ risk positions in order to improve market discipline. They suggested that greater public disclosure requirements need careful consideration and standardization, particularly regarding complex financial instruments, to be useful to the public. The Commission is, therefore, pursuing options for enhanced disclosure mainly within the context of international discussions and developments.

D. Insurance Developments

23. **Despite their risk-reduction efforts, Swiss insurance companies would suffer from a major global downturn.** The insurers operate in a mature domestic market, derive a large share of premium income from overseas business, and have a major presence in global reinsurance. Since the problems experienced in the weak equity markets of 2001-03, the insurance sector has performed impressively, risk exposures have been reduced, and recent events in global credit markets have had a much smaller impact than on the banks. The authorities are closely monitoring credit exposures and noted that all companies currently meet minimum solvency standards, on a statutory basis. However, greater earnings volatility is now expected.

24. **Although not a binding solvency requirement until 2011, the Swiss Solvency Test (SST) is spurring improvements in risk management and in the quality of supervisory dialogue.** Regulators are using the SST to improve both their insights into insurers’ risks (for

example the continuing exposure to worsening global economic and financial conditions) and their monitoring of solvency levels. The SST has been applied to major insurance companies since the start of 2006, and is now being extended to reinsurance companies (and smaller primary insurance companies). The regulator is also embedding the SST within a wider risk-based supervisory framework encompassing requirements on corporate governance, risk management and internal controls. These are welcome developments, broadly in line with the recommendations of the 2007 FSAP.

25. **The insurance regulation agenda needs continued prioritization and attention to overall resources.** As well as building on the success of the SST, there is a need to develop a system of onsite supervision linked to risk assessment, to increase supervisory resources for reinsurance and to strengthen international supervisory cooperation, particularly with regulators outside Europe. While the regulator has plans in these areas, staff observed that limited resources in relation to the scale of the tasks would require careful prioritization. The authorities noted there would be risks in deferring key parts of what is an integrated reform program and placed the emphasis on maintaining adequate resources overall.

E. Regulatory Capabilities

26. **Regulatory enhancements will be of limited value without effective supervision and enforcement.** The launch, on January 1, 2009, of FINMA—the new regulator, integrating banking, insurance, and anti-money-laundering—is an opportunity to further strengthen supervision. Although the authorities see limited scope for harmonizing regulatory requirements across sectors, they stressed that their vision for FINMA is for an even more effective regulator of the domestic financial sector and a more influential voice in international regulatory fora. As well as the continuing implementation of Basel II and the new insurance solvency requirements, FINMA will face early challenges in implementing regulatory change resulting from current credit market events.

27. **A key to delivering the vision for FINMA will be to secure adequate skills and resources.** The authorities noted that under the proposed staff regulations, if approved by the Federal Council, FINMA will have adequate flexibility to offer remuneration that will retain and attract the skilled staff. This flexibility will extend to FINMA's wider budgeting and strategic planning. In this context, staff expressed concern that the full complement of board members as well as the chief executive or other members of the general management had not yet been appointed. The authorities recognized this as a priority.

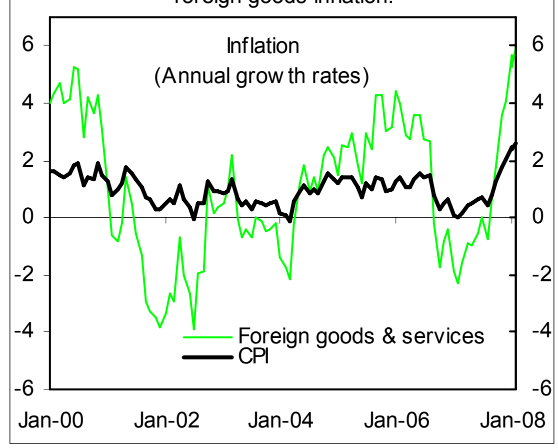
28. **FINMA's special challenge lies in supervising the major banking and insurance groups.** The authorities expect that FINMA will carry forward the existing approach that relies on close supervision, with extensive involvement of auditors. Staff recommended continued expansion of onsite activities by the Swiss Banking Commission to bring a better balance with the work of the auditors. Staff also supported a targeted rules-based framework,

with transparent benchmark performance measures and linked supervisory responses for capital requirements. The authorities indicated their openness to such an approach. Also, particularly for the banking groups, close coordination of supervisory activities with key overseas regulators has worked well. However, the authorities recognized that maintaining the stability of global operations of their large, complex financial institutions will require stronger commitments from host supervisors, especially in adverse circumstances when conflicts of interest may appear.

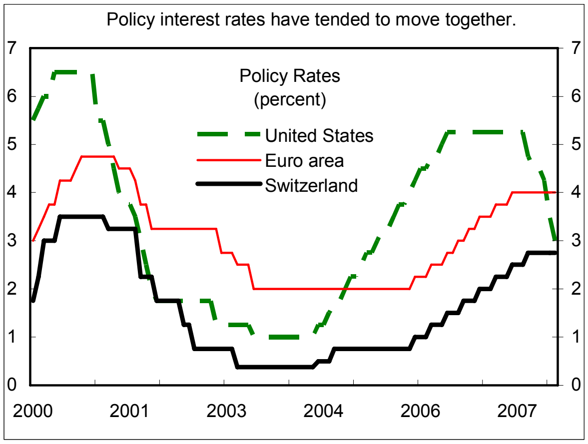
IV. Monetary Policy

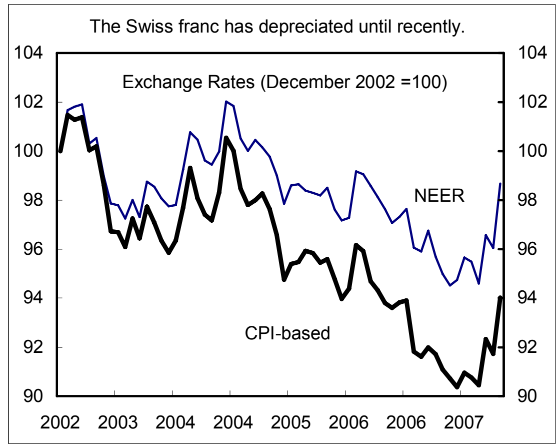
29. **The current conjuncture poses special challenges for monetary policy.** CPI inflation averaged a modest 0.7 percent in 2007, while core inflation was 0.6 percent. Foreign labor flows kept wage inflation contained (nominal wages rose by 2 percent—a 1.3 percent real increase, below productivity gains). However, fueled by oil and food prices, inflation reached 2.6 percent in March. For 2008, the average inflation rate is projected at 2.0 percent, falling to 1.4 percent in 2009, as also assessed by the SNB in the context of its March policy decision. Despite the projected decline in the inflation rate to below 2 percent, the risk is that the current high externally-generated inflation may feed into wages and core inflation. The greater inflation risk has unfortunately coincided with worsening growth prospects. At successive policy decision points since September, this polarization has increased, heightening the trade-offs involved. Moreover, the consideration of safeguarding against a particularly adverse outcome has added to the complexity of decision making.

Inflation has remained subdued despite spikes in foreign goods inflation.

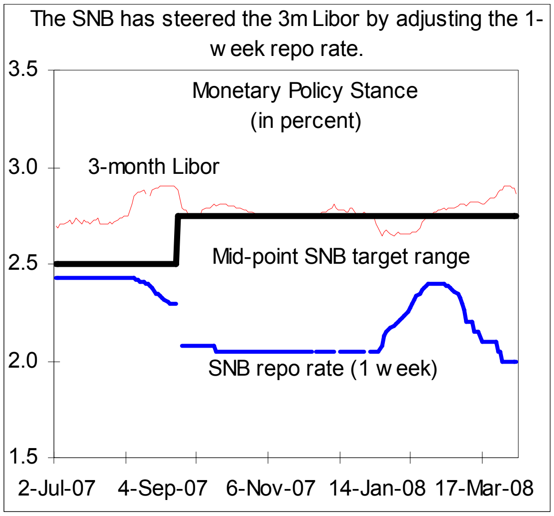


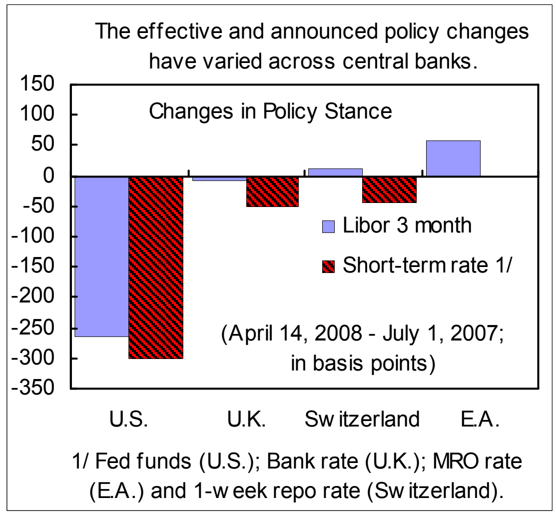
30. **In this complex and uncertain environment, the SNB signaled its concerns regarding inflation in its September decision.** Under a floating exchange rate, the SNB's monetary policy seeks price stability, defined as a positive headline annual inflation rate but one below 2 percent. Policy decisions are guided by inflation forecasts over a three-year horizon. Within this objective, the SNB takes due account of business cycle conditions. The SNB seeks to influence the 3-month Libor, allowing that rate to move in a 1 percentage point band. The September decision to raise the target band by ¼ percentage point, led to a cumulative increase of over 200 basis points from mid-2005 to the 2.25-3.25 percent range. In doing so, the SNB maintained relatively stable monetary conditions as the decline in the exchange rate mirrored the increase in policy rates.





31. **Recognizing that monetary conditions are tight, the SNB has eased by steering down the 3-month Libor when the risk premium has tended to rise.** In September, the ongoing market turmoil had pushed the Libor rate to above the mid-point of the existing range, where it is typically maintained. In response to this market-driven tightening of monetary conditions, the SNB lowered the 1-week repo rate to bring the 3-month Libor down to 2.75 percent, the mid-point of the range. The SNB's focus on the 3-month Libor recognizes this rate's significance as a benchmark for a variety of longer-term rates, which directly influence lending and borrowing decisions. Thus, resisting an increase in this rate helped contain borrowing costs. In its March 2008 report, noting the strengthening of the Swiss franc, the SNB stated "on the whole, monetary conditions are tighter than they were in December" and was "of the opinion that an adjustment in the interest rate (the 3-month Libor) was not called for under the current circumstances." While it has kept the target range of the 3-month Libor unchanged, slower expected growth and the insurance motive have continued to influence policy implementation (Box 3). Maintaining the 3-month Libor at or close to 2.75 percent—and in practice, preventing it from rising—has been achieved through lowering shorter-term repo rates. Because the SNB states its policy stance in terms of the 3-month Libor, it requires a comparison of the shorter-term policy rates of other central banks with the SNB's 1-week repo to recognize that the SNB has eased in line with the Bank of England (text figure).





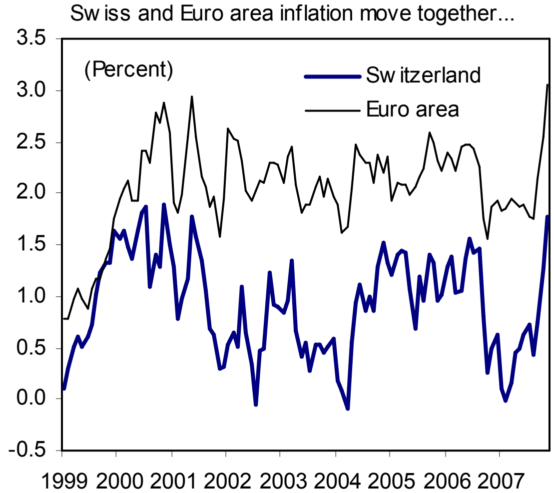
32. **Staff supported the effective easing of monetary policy.** The authorities themselves preferred to use the term "accommodative" to describe their effective easing. Inflation expectations remain well anchored, core inflation is below 1 percent, and the SNB's medium-term headline inflation forecasts are well within the central bank's definition of price stability. The monetary policy response has been appropriate, especially because fiscal policy, which was not especially effective in the previous downturn, could not have responded at the necessary speed and, as the authorities also emphasized, is subject to external leakages. Indeed, with its lower growth and contained inflation scenario, staff conveyed support of further modest monetary easing.

33. **In contrast to the broad agreement on the monetary policy stance, the discussions on the operational framework were inconclusive.** At the time of the September decision the target range for the 3-month Libor and the operational 1-week repo rate were moved in opposite directions. Thus, while the stance was signaling a tightening, accommodation was being engineered. Since September, the SNB has maintained its target range—and, hence, policy stance—steady, but provided monetary accommodation when necessary by adjusting the 1-week repo rate. The authorities rightly maintained that this has imparted some flexibility to the conduct of monetary policy in this stressful period. However, the implication is that the monetary policy stance of the SNB cannot always be inferred from its announced target range in the same way as that for other central banks. Thus, if SNB's changes in the policy stance (inferred from the movements in the 3-month Libor) are compared to those of policy changes at other central banks, the SNB appears to have slightly tightened (text figure) while the others (U.S. and U.K.) have held steady or eased. However, when comparing like-for-like, the SNB has eased about the same as the Bank of England, with the ECB and the U.S. at the two extremes. Staff sees this as going beyond a communication issue, and its operational and substantive implications deserve further analysis.

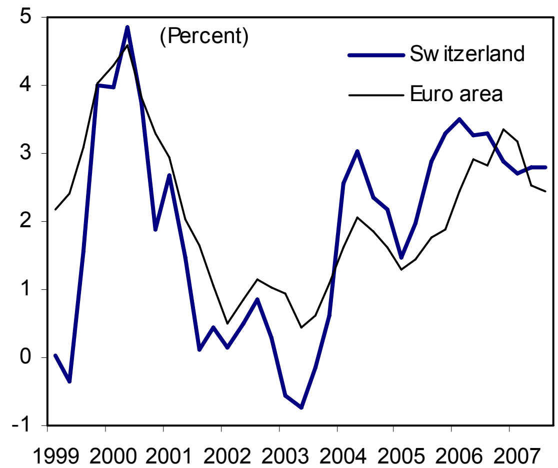
Box 3. Monetary Policy Under Uncertainty

Under tail-end shocks, monetary policy may be guided by an insurance motive. Switzerland has become increasingly integrated with international markets. Growth and inflation are closely tied to developments in the euro zone. Capital markets are tightly integrated with Europe—and even labor markets are quickly moving in that direction. Since integration gradually reduces the possibility of fine tuning inflation, the SNB's decisions are typically related, though with some leads and lags, to the broader movement of official rates. However, significant independent response is sometimes called for, as in the severe downturn of 2001-2002.

Swiss and Euro area inflation move together...

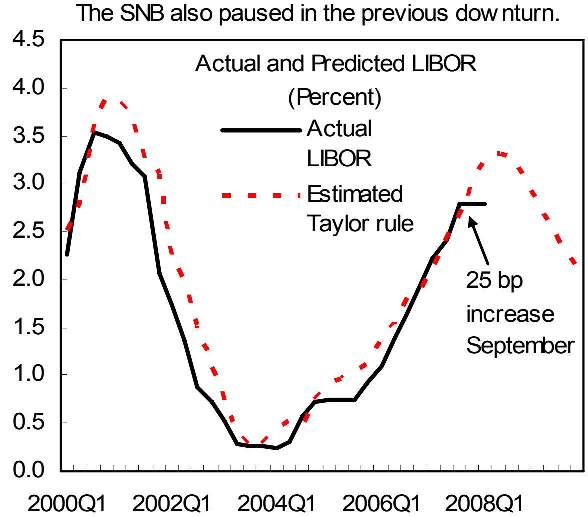


...GDP growth rates are also highly correlated.



Such an insurance motive may be operative now. Gauged by a Taylor's rule, the decision to hike the rate by 25 basis points in September was consistent with the view that inflation was a concern. However, the decision was a surprise in view of the ongoing financial turmoil, and while inflation considerations may have suggested continued tightening into December, the SNB, citing uncertainty, then paused. A similar pause was evident in the previous downturn. Currently many financial markets appear to be in the midst of tail-end shocks. Theory and practice (including in Switzerland in the previous downturn) support such caution.

The SNB also paused in the previous downturn.



V. PUBLIC FINANCES

34. **Though strengthened by recent efforts, the long-run sustainability of public finances is not yet assured.** The federation's debt-brake fiscal framework, calling for a cyclically-adjusted balance over the cycle, helped achieve a fiscal surplus in 2006, a year ahead of schedule, and the surplus increased further in 2007. However, the debt brake can only deal with cyclical pressures at the federal level. It does not apply to the social security system; and the confederation cannot impose a fiscal rule on subnational governments. The highly devolved Swiss federalism requires time to coordinate a response to aging. The authorities are formulating comprehensive long-term policy initiatives, which the staff continues to support.

A. Fiscal Developments

35. **The 2007 fiscal result was better than budgeted as tax revenues expanded with the continued economic strength.** With tight expenditure control and buoyant revenues, the general government achieved a surplus of 2.2 percent of GDP in 2007, implying an improvement in the structural surplus to 1.7 percent of GDP. Surpluses at the federal level were supplemented by a balanced budget in social security accounts and surpluses at the cantonal and communal levels. Taken together, these efforts reduced the gross debt to 44 percent of GDP.

Fiscal Developments
(Percent of GDP)

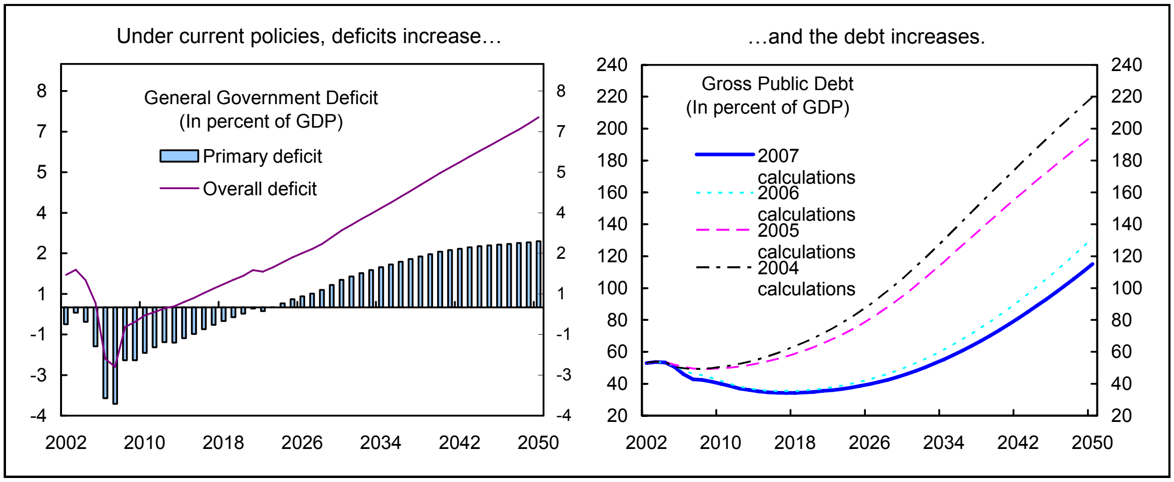
	2006	Est. 2007	Proj. 2008	2009
Real GDP growth	3.2	3.1	1.4	1.3
Balance 1/	1.9	2.2	0.8	0.7
Revenues	37.8	37.2	37.2	36.7
Expenditure 1/	35.9	35.0	36.5	35.9
Cyclically adjusted balance 2/	1.5	1.7	0.5	0.7
Structural balance 3/	1.5	1.7	1.4	0.7
Debt-GDP ratio	45.9	44.0	42.3	40.4

1/ 2008 includes extraordinary expenditures of SwF 5,247 million, about 1 percent of GDP.
2/ Excludes cyclical items, but includes extraordinary expenditures.
3/ Excludes cyclical and one-off items (extraordinary expenditures).

B. Fiscal Projections and Policy

36. **The federal fiscal balance is projected to weaken and provide a small stimulus in 2008.** An overall surplus of 0.8 percent of GDP is projected for 2008 (Tables 2 and 3), representing a big swing from a surplus of 2.2 percent in 2007. The authorities explained that the stimulus will, however, be small. About 1 percent of GDP constitutes extraordinary expenditures, with the bulk of it a transfer to the Infrastructure Fund. However, only about a quarter of this will be spent in this fiscal year. Another ¼ percent of GDP reflects accounting changes that reports expenditures already incurred in 2007 in the 2008 budget. The authorities stated that the modest positive impulse was not intended since their experience has been that a stimulus cannot be well timed and the additional expenditures largely increase imports. Thus, the stimulus applied in the downturn of 2001-2003 had little effect. Staff agreed with the policy stance. By 2009, some inevitable slowdown of revenue generation will occur. However, the authorities believe that projected surpluses in the cantons will likely be revised upwards.

37. **Although the public debt-to-GDP ratio is currently on the decline, long-run fiscal sustainability has not yet been achieved**. Staff projections of an inter-temporal balance sheet suggest that the government's net worth (including implicit liabilities from future aging costs and pension underfunding) is improving but a long-run shortfall still exits. As such, under current policies, debt will begin to increase in about 15 years (Table 4) in response to the projected rise of health care expenditures and other long-term pressures. The *Long-Term Sustainability Report* due to be published in May marks an important step in recognizing the tasks ahead and raising awareness of needed actions. However, as staff emphasized and the authorities recognize, this needs to be followed by concrete measures to contain expenditures. The authorities reported that while specific new actions had not yet been determined, the focus is likely to be on: (i) an increase in the VAT rate to finance disability insurance; (ii) an orderly reform of social benefits; and (iii) containment of health care expenditures. In this regard, staff suggested that the savings to be achieved through the *Task Evaluation Program* could prevent aging-related expenditures from crowding out other social expenditures. Staff also recommended the use of an inter-temporal government balance sheet as a tool for planning and communication.



38. **The debt brake rule is to be augmented to cover extraordinary expenditures.** A concern with the debt brake rule has been that it exempts "extraordinary expenditures." Since this exemption can be abused and since legitimate extraordinary expenditures for funding large projects will nevertheless occur, the proposal requires the authorization of these expenditures be contingent on additional measures over the medium term. Any extraordinary revenues will reduce the necessary compensation amount accordingly. The proposal has been submitted for public consultation in April and is expected to be approved by the parliament during the course of 2009. It is expected to enter in application with the 2011 budget.

39. **The confederation is committed to improving the attractiveness of Switzerland as a business location**. In this respect, the corporate income tax reform just approved, and to be implemented from 2009, will eliminate the double taxation of dividends for qualifying individual shareholders and, therefore, improve incentives to increase investment and remove biases favoring particular forms of project financing. A unified VAT framework, which will eliminate exemptions, improve efficiency, reduce administrative costs, and allow for a lower rate of 6 percent (currently 7.6 percent), could become effective as of 2011 at the earliest. Finally, the elimination of the marriage penalty tax has, for most married couples, reduced the high taxation of second earners and should increase labor force participation of skilled women. Similarly, cantons, with their low debt and traditionally-conservative fiscal stance, are likely to continue to lower their corporate tax rates. The authorities reiterated that these measures were consistent with their international obligations and that they served to create incentives for other countries to improve their public finances to create space for reduced taxation.

VI. Assessment of External Stability

40. **Switzerland's sizeable and growing current account surplus appears disconnected from developments in the real exchange rate.** The current account surplus has steadily increased from 8 percent of GDP early in the decade to 17 percent of GDP in

2007 (Table 5). During that same period, the nominal and real exchange rates depreciated by about 7 and 10 percentage points respectively. This may suggest that a depreciating exchange rate has contributed to the growing surplus. However, the link appears tenuous:

- Despite the depreciating effective exchange rate, the trade surplus has remained small and relatively flat at about 1½ percent of GDP.

- The export of services produced a services balance surplus of 7½ percent of GDP in 2007, largely due to the two international banks and the insurance sector.

- Continuing its surge, investment income reached 12 percent of GDP in 2007. Soaring profits of Swiss multinationals from their rapidly rising stock of overseas investment and pension assets generate substantial income from abroad.

41. **For 2008, the current account surplus is projected to decline to about 14 percent of GDP.** Investment income is expected to take the biggest hit—about 1½ percent of GDP—with lower expected yields on foreign assets. Weaker goods exports and, especially, the slower financial market turnover is projected to lower financial service income.

Switzerland: Balance of Payments, 2002-07
(Percent of GDP)

	2002	2003	2004	2005	2006	2007
Current account	8.3	12.9	12.9	13.5	14.7	16.9
Goods	1.2	1.0	1.5	0.6	1.0	1.9
Services	5.5	5.6	5.7	6.1	6.8	7.7
Tourism	0.6	0.5	0.4	0.3	0.2	0.5
Financial services	2.4	2.4	2.4	2.5	2.7	3.0
Other	2.5	2.7	2.9	3.3	3.9	4.2
Labor and investment income	3.8	8.0	7.5	10.0	9.5	9.7
Labor	-2.1	-2.2	-2.2	-2.3	-2.3	-2.3
Investment	5.9	10.2	9.7	12.3	11.8	12.0
Portfolio	2.6	2.6	2.5	2.7	2.8	2.7
Direct investment	2.4	6.7	6.5	8.6	8.5	8.4
Other	0.9	1.0	0.7	1.0	0.5	0.9
Transfers	-2.1	-1.7	-1.7	-3.2	-2.7	-2.4

Sources: SNB; and staff estimates.

42. **Both sides agreed that the current account surplus mostly reflected structural factors.** The Swiss structural balance is large, given the country's high per capita income, its aging population, and the country's role as an international financial center. Special features of the Swiss current account are also evaluated in assessing the level and sustainability of the

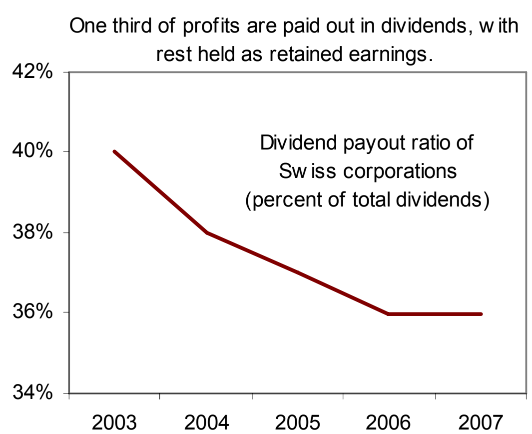
current account (Box 4).[5] The recent CGER estimates under all three standard approaches—external stability, macro balance, and the equilibrium exchange rate—lead to the conclusion that the real exchange rate is broadly in line with fundamentals, especially after considering the Swiss Franc's appreciation by about 5 percent in real effective terms over the last few months.

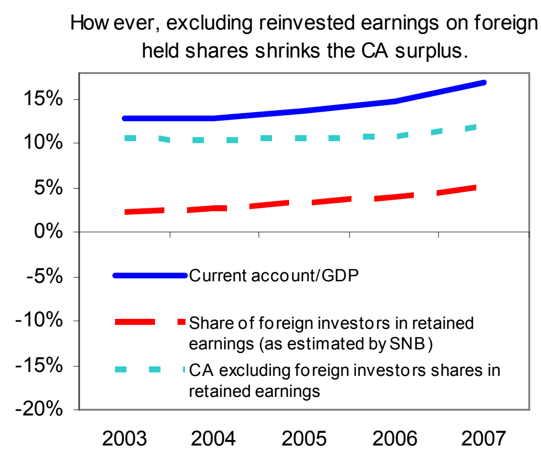
- The external stability approach suggests an undervaluation of 8 percent. This corresponds to a 3½ percent of GDP gap between the underlying and NFA-stabilizing current account surpluses (12½ and 9 percent of GDP, respectively). The estimate adjusts for the accounting treatment of retained earnings (Box 4).
- The macro balance approach estimates an undervaluation of 7 percent, reflecting a 2½ percent of GDP gap between the underlying current account and the current account norm (10 percent of GDP, making the same allowance for accounting factors).
- Under the equilibrium exchange rate approach, staff analysis finds undervaluation of about 7 percent.

[5] Also, the Swiss NFA position has grown much more slowly than would be expected from the accumulating current account surpluses. The authorities, with access to the detailed data, have concluded that this is because of valuation changes and exchange rate movements.

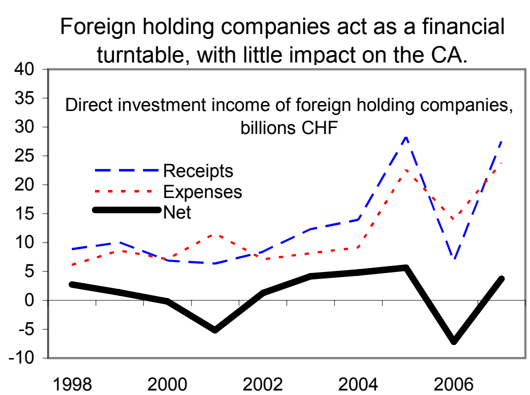
Box 4. Special Features of the Swiss Current Account

The authorities stressed that the accounting treatment of investment income complicated the assessment of the current account surplus. Most of the earnings of Swiss multinationals are not paid out in dividends but rather are kept as retained earnings. Under IMF balance of payments accounting rules, these are treated as income inflows into the Switzerland, with counterpart FDI outflows through the capital account. Thus, although no money crosses borders—either coming into or exiting from Switzerland—the capital and current accounts are inflated. At the same time, foreigners hold Swiss assets mainly as stocks, and the retained earnings of the underlying companies are not treated as income outflows. This asymmetrical treatment overestimates the current account surplus by 4-5 percentage points of GDP. The elimination of the double taxation of dividends for qualifying individual shareholders by 2009 may increase the payout ratio and help to lower the current account surplus in the future.





The authorities also noted that the foreign controlled holding companies domiciled in Switzerland had a minor effect on the surplus. Switzerland has attracted foreign controlled finance and holding companies that do business throughout Europe. These companies have made large direct investments abroad, but also have sizable direct investment liabilities with their foreign parent companies. Because they earn investment income from abroad and pay investment income to the parent company, their average net impact on the current account had been less than 1 percent of GDP.



VII. Staff Appraisal

43. **The resilience and dynamism displayed recently by the Swiss economy is now being tested by the realities and uncertainties of the global shake up.** From the doldrums at the start of the decade, the Swiss economy emerged on an impressive cyclical rebound with clear evidence of structural change and an increase in its potential growth rate. A cyclical correction was to be expected. But events have moved rapidly. The sharp anticipated slowdown in U.S. and European growth and the financial tensions that continue to test the global system carry serious implications for Switzerland. Growth is set to decelerate, perhaps quickly, with risks for the financial sector. And as a major international financial center, Swiss public policy actions have international consequences.

44. **The policy priority is to pay due attention to securing greater domestic financial stability.** The task is challenging and the lessons from the ongoing financial tensions can only slowly be incorporated into regulatory and supervisory practice. Nevertheless, the proactive approach of the Swiss authorities to increase buffers in the financial system is welcome. Monetary and fiscal policies must play supportive roles within their well-defined frameworks. In this regard, the tendency of monetary policy to be accommodative and impart a modest stimulus while the fiscal stance remains conservative appears to strike the right balance for now. As events unfold, these choices may need to be revisited.

45. **The authorities have responded vigorously to limit the knock-on effects of the current financial tensions.** They have injected liquidity into the banking system, often in coordination with other major central banks, maintained an enhanced oversight of the major banks and insurance companies, and worked actively with other regulators to share information, coordinate supervisory activities, and draw lessons for the future.

46. **Looking ahead, the authorities are rightly focused on increasing the buffers in the financial system.** More comprehensive risk assessment within the Basel II framework, and taking into account the recent outcomes and correlations, will lead to higher capital requirements. However, the lesson also is that additional capital buffers would cushion against unanticipated risks. In this regard, a leverage ratio approach, implemented alongside Basel II and appropriate safeguards, could serve as a useful complement to the existing regime. Consistent with the May 2007 FSAP update, the authorities are developing a stress testing framework to improve liquidity risk management and are more actively reviewing banks' contingency plans and liquidity management policies. Finally, progress in implementing the Swiss Solvency Test for insurance companies is being bolstered through greater emphasis on internal controls and strengthening onsite supervision and international supervisory cooperation. This extensive work program requires careful management within the existing resource envelope.

47. **Regulatory refinements, however, will be insufficient without boosting supervisory capabilities and resources.** Since FINMA will remain at a resource disadvantage relative to the groups it deals with, it deserves to be bolstered in various ways. Early decisions to complete the appointment of the board and senior management of FINMA would reinforce the vision for the new integrated regulator as a force in domestic and international initiatives to improve financial regulation. The regulators' preference for an approach based on close supervision of the major groups is well-founded, given the market is dominated by a small number of such players. But it may need to be supplemented by rules that specify transparent benchmark performance measures and supervisory responses. In this context, also of value would be a further shift to onsite activities by supervisors, with appropriate reliance on external auditors to monitor regulatory compliance. So too would be efforts to build on existing cross-border supervisory arrangements for global groups, to secure even more active support of host supervisors in maintaining the stability of global operations.

48. **In a highly uncertain environment, monetary policy has had to balance inflation risks in a worsening growth environment.** The SNB has steered a carefully calibrated policy course. While signaling its concern with regard to inflation in its September 2007 decision by raising the target band for the 3-month Libor rate, the SNB has lowered its 1-week repo rate to guide the 3-month LIBOR to the midpoint of the target band. The effective easing thus engineered has been appropriate in the context of the potentially serious downside risks and prospective alleviation of inflation pressures. Looking forward, the relatively contained inflation outlook appears to provide scope for further easing. For its part, the operational framework combining the 3-month Libor and the shorter-term repo rates has revealed a potentially useful flexibility. But, in view of the difference vis-à-vis other central banks, its signaling and substantive effects deserve further analysis.

49. **The state of public finances continued to improve in 2007—and the authorities remain committed to a conservative fiscal approach.** With a smaller surplus in 2008, a small stimulus is anticipated in 2008. However, since it has had limited effectiveness in the past, the authorities rightly do not anticipate a more vigorous use of the fiscal stimulus even if growth were to slow markedly. Although the public debt-to-GDP ratio is declining, long-term fiscal sustainability requires continued fiscal prudence and structural reforms. While this awareness exists, the next step is to formulate specific actions. In the short run, valuable savings can be achieved through the *Task Evaluation Program*. Also, a useful tool for planning and communication would be an inter-temporal government balance sheet. Finally, the proposal to extend the debt-brake rule to incorporate "extraordinary" expenditures is welcome.

50. **The external current account surplus largely reflects structural factors.** Switzerland's large surplus is expected to come down this year. The surplus reflects the country's high per capita income, its aging population, and its position as a major financial

center. In addition, accounting norms and the specificities of the investment outflows and inflows tend to overstate the surplus relative to other countries. Taking into account these considerations, the current account surplus and the exchange rate appear to be broadly in line with fundamentals.

51. It is recommended that the next Article IV consultation with Switzerland be held on the standard 12 month cycle.

Table 1. Switzerland: Basic Data

Area and population

Total area	41,293 square kilometers	GDP per capita (2006)	51,635
Total population (end-2006)	7.5 million	GNP per capita (2006)	54,183

	2005	2006	2007 1/	2008 1/	2009 1/	2010 1/
	(Percentage changes at constant prices, unless otherwise indicated)					
Demand and supply						
Total domestic demand	1.9	1.4	0.2	2.2	1.9	1.7
Private consumption	1.8	1.5	2.1	1.4	1.3	1.8
Public consumption	0.5	-1.4	0.1	-0.1	0.7	0.0
Gross fixed investment	3.8	4.3	3.0	0.3	0.7	1.3
Final domestic demand	2.1	1.8	2.1	0.9	1.1	1.5
Inventory accumulation 2/	-0.2	-0.4	-1.7	1.1	0.7	0.2
Foreign balance 2/	0.6	1.9	2.9	-0.6	-0.5	0.2
Exports of goods and nonfactor services	7.3	9.9	9.9	1.2	-0.9	7.2
Imports of goods and nonfactor services	6.7	6.9	5.2	2.7	0.0	8.0
GDP	2.4	3.2	3.1	1.4	1.3	1.8
GNP	4.4	2.8	3.2	0.2	1.4	1.5
Nominal GDP (billions of Swiss francs)	463.7	486.2	508.4	520.5	532.1	546.8
Employment and unemployment						
Employment (percent change)	0.1	0.9	1.0	0.6	-0.1	0.2
Unemployment rate (in percent)	3.4	3.3	3.1	3.1	3.8	3.6
Output gap (in percent of potential)	-0.9	0.3	1.3	0.6	0.0	-0.1
	(Percentage changes, unless otherwise indicated)					
Prices and incomes						
GDP deflator	0.3	1.6	1.4	1.0	1.0	1.0
Consumer price index	1.2	1.0	0.7	2.0	1.4	1.0
Nominal wage growth	1.0	1.6	1.8	2.8	2.3	2.2
Unit labor costs (total economy)	-1.3	-0.7	-0.3	2.1	1.0	0.7
	(In percent of GDP)					
General government finances						
Revenue	37.5	37.8	37.2	37.2	36.6	36.5
Expenditure	37.4	35.9	35.0	36.4	35.9	35.8
Balance 3/	0.1	1.9	2.2	0.8	0.7	0.7
Cyclically adjusted balance 4/	0.4	1.5	1.7	0.5	0.7	0.7
Structural balance 5/	0.4	1.5	1.7	1.4	0.7	0.7
Gross debt	50.5	45.9	44.1	42.3	40.5	38.7
	(Percentage changes in annual averages)					
Monetary and credit data						
Broad money (M3)	4.2	2.5	2.0	…	...	...
Domestic credit	4.0	5.5	7.5	…	...	...
	(Period averages in percent)					
Interest rates						
Three-month rate	1.5	1.6	2.2	...	...	...
Yield on government bonds	2.1	2.5	2.9	...	...	...
	(In percent of GDP)					
Balance of payments						
Current account	13.5	14.7	16.9	14.1	12.8	12.9
Trade balance	0.6	1.0	1.9	1.4	0.9	1.0
Net investment income	12.3	11.8	12.0	10.6	10.3	10.1
Other	0.6	1.9	2.9	2.1	1.6	1.8
	(Levels)					
Exchange rates						
Swiss francs per U.S. dollar (annual averag	1.24	1.25	1.15	...	...	...
Swiss francs per euro (annual average)	1.55	1.57	1.57	...	...	...
Nominal effective rate (avg., 1990=100)	109.8	108.4	106.0	...	...	...
Real effective rate (avg., 1990=100) 6/	104.0	101.7	98.0	...	...	...

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

1/ Fund staff estimates and projections unless otherwise noted.
2/ Change as percent of previous year's GDP.
3/ Including railway loans as expenditure. In 2005, excludes revenue from gold sales equal to 4.6 percent of GDP.
4/ Excludes cyclical items only.
5/ Excludes cyclical and one-off items: expenditures of SwF 4,500 million (about 1 percent of GDP) in 2008.
6/ Based on relative consumer prices.

Table 2. Switzerland: General Government Finances 2005-10 1/

	2005	2006	2007	2008	2009	2010
			Est.	Staff projections		
			(In millions of Swiss francs)			
General government						
Revenue 2/	173,692	183,704	188,986	193,754	195,257	199,922
Expenditure	173,309	174,480	177,845	189,749	191,263	196,258
Balance	383	9,224	11,141	4,005	3,994	3,665
Federal government 3/ 4/						
Revenue 2/	52,984	58,506	58,958	58,847	58,757	60,422
Expenditure 5/	52,607	53,096	54,351	60,243	57,371	58,848
Balance	377	5,410	4,608	-1,396	1,387	1,574
Cantons						
Revenue 2/	70,580	75,134	76,598	79,327	78,089	79,505
Expenditure	70,283	73,069	73,111	76,207	76,192	77,906
Balance	296	2,065	3,487	3,120	1,897	1,599
Communes						
Revenue	45,838	47,525	48,889	49,291	49,715	50,798
Expenditure	45,078	45,550	46,350	47,022	48,554	49,791
Balance	760	1,974	2,539	2,269	1,160	1,006
Social security 6/						
Revenue	49,531	50,547	52,096	54,913	55,881	56,992
Expenditure	50,580	50,771	51,589	54,901	56,331	57,508
Balance	-1,049	-224	507	12	-450	-516
			(In percent of GDP)			
General government						
Revenue	37.5	37.8	37.2	37.2	36.6	36.5
Expenditure	37.4	35.9	35.0	36.4	35.9	35.8
Balance	**0.1**	**1.9**	**2.2**	**0.8**	**0.7**	**0.7**
Federal government	0.1	1.1	0.9	-0.3	0.3	0.3
Cantons	0.1	0.4	0.7	0.6	0.4	0.3
Communes	0.2	0.4	0.5	0.4	0.2	0.2
Social security	-0.2	0.0	0.1	0.0	-0.1	-0.1
Memorandum items:						
Cyclically adjusted balance 7/	0.4	1.5	1.7	0.5	0.7	0.7
Structural fiscal balance 8/	0.4	1.5	1.7	1.4	0.7	0.7
Gross debt 9/	50.5	45.9	44.1	42.3	40.5	38.7

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

1/ Excludes VAT increase planned for 2010, 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 1,350 million, 2006: SwF 2,100 million).
5/ 2008 total expenditures include extraordinary spending (SwF 5,247 mln).
2008-11 total expenditures exclude transfers 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 premiums (KV), which are included in the federal budget.
7/ Excludes cyclical items, but includes the one-off extraordinary expenditure of SwF 5,247 million (1 percent of GDP) in 2008.
8/ Excludes cyclical and one-off items: expenditures of SwF 5,247 million (1 percent of GDP) in 2008.
9/ Includes debt of Confederation (and special funds), cantons, and communes. Social security cannot issue debt.

Table 3. Switzerland: Federal Government Finances 2005-10 1/

	2005	2006	2007	2008	2009	2010
			Est.	Staff projections 2/		
			(In millions of Swiss francs)			
Revenue	52,984	58,506	58,958	58,847	58,757	60,422
Current revenue	52,704	58,317	58,761	58,645	58,550	60,209
Taxes	48,870	54,761	54,692	54,519	54,432	56,119
Direct taxes	20,266	24,643	23,486	22,865	22,696	23,337
Indirect taxes	28,604	30,118	31,206	31,654	31,736	32,782
Nontax revenue 3/ 4/	3,834	3,556	4,069	4,126	4,118	4,090
Capital revenue	280	189	198	202	207	213
Expenditure 5/	52,607	53,096	54,351	60,243	57,371	58,848
Current expenditure	46,073	47,106	48,250	50,365	50,789	51,878
Wages and salaries	5,714	5,662	5,776	5,518	6,150	6,176
Goods and services	4,153	4,346	3,868	4,062	4,506	4,535
Interest payments	3,577	3,731	3,938	3,400	3,801	3,778
Transfers	32,630	33,367	34,668	37,385	36,332	37,389
Capital expenditure	6,534	5,990	6,100	9,878	6,582	6,970
Overall balance	377	5,410	4,608	-1,396	1,387	1,574
			(In percent of GDP)			
Revenue	11.4	12.0	11.6	11.3	11.0	11.0
Current revenue	11.4	12.0	11.6	11.3	11.0	11.0
Tax revenue	10.5	11.3	10.8	10.5	10.2	10.2
Nontax revenue	0.8	0.7	0.8	0.8	0.8	0.7
Capital revenue	0.1	0.0	0.0	0.0	0.0	0.0
Expenditure	11.3	10.9	10.7	11.6	10.8	10.7
Current expenditure	9.9	9.7	9.5	9.7	9.5	9.5
Capital expenditure	1.4	1.2	1.2	1.9	1.2	1.3
Overall balance	0.1	1.1	0.9	-0.3	0.3	0.3
Memorandum items:						
Cyclically adjusted balance 6/	0.4	1.0	0.4	-0.5	0.2	0.3
Structural fiscal balance 7/	0.4	1.0	0.4	0.3	0.2	0.3
Gross debt	28.1	25.4	25.8	25.4	24.6	23.6

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

1/ Includes the balance of the Confederation, Railway Infrastructure Financing Fund, and Swiss Federal Institute of Technology.
2/ Excludes VAT increase planned for 2010, 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/ Excludes revenues from Swisscom share sale (2002: SwF 3,703 million, 2005: SwF 1,350 million, 2006: SwF 2,100 million).
5/ 2008 total expenditures include extraordinary spending (SwF 5,247 million).
2008-11 total expenditure exclude transfer out of the special Infrastructure Fund created in 2008, due to lack of data.
6/ Excludes cyclical items, but includes one-off extraordinary expenditures.
7/ Excludes cyclical and one-off items: expenditures of SwF 4,500 million (about 1 percent of GDP) in 2008.

Table 4. Preliminary Public Sector Balance Sheet, 2002-07

	2002	2003	2004	2005	2006	2007
					Staff estimates	
(Billions of Swiss francs)						
A. Intertemporal financial position (I+II)	**-752**	**-767**	**-789**	**-791**	**-584**	**-572**
I. Financial net worth	-98	-100	-108	-99	-93	-88
of which: gross debt	228	234	239	234	223	218
II. Net present value of future fiscal balances 1/	-654	-667	-681	-692	-488	-485
B. Other assets	78	81	81	90	91	93
C. Public sector capital stock	237	242	247	250	252	254
D. Contingent liabilities	-7	-7	-12	-11	-11	-10
Public sector net worth (A+B+C+D)	**-444**	**-451**	**-473**	**-462**	**-251**	**-236**
(Percentages of GDP)						
A. Intertemporal financial position (I+II)	**-175**	**-176**	**-176**	**-174**	**-123**	**-113**
I. Financial net worth	-23	-23	-24	-22	-20	-17
of which: gross debt	53	54	53	51	47	43
II. Net present value of future fiscal balances 1/	-152	-153	-152	-152	-104	-95
B. Other assets	18	19	18	20	19	18
C. Public sector capital stock	55	56	55	55	53	50
D. Contingent liabilities	-2	-2	-3	-2	-2	-2
Public sector net worth (A+B+C+D)	**-103**	**-104**	**-106**	**-102**	**-54**	**-46**

Sources: Swiss National Bank; Federal Finance Administration; and IMF staff calculations.
1/ Reflecting mainly future deficits in social security. 2006 and 2007 improvements come from significant structural adjustment.
Costs to the budget due to expenditures on old age, health and long term care assumed to increase 5.0% of GDP by 2050, same as the authorities projections in the *Long Term Sustainability Report*.

Table 5. Switzerland: Balance of Payments, 2005-13 1/

				Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(In billions of Swiss francs, unless otherwise indicated)								
Current account	**63**	**72**	**86**	**73**	**68**	**70**	**72**	**75**	**78**
Trade balance	3	5	10	7	5	5	6	7	7
Exports	163	186	207	209	210	229	249	271	295
Imports	-160	-181	-197	-201	-205	-223	-243	-264	-288
Service balance	28	33	39	37	35	36	37	37	38
Net investment income	57	57	61	55	55	55	55	57	59
Net compensation of employees	-11	-11	-12	-13	-14	-13	-13	-13	-13
Net private transfers	-11	-10	-9	-9	-9	-9	-9	-9	-10
Net official transfers	-4	-3	-3	-3	-4	-4	-4	-4	-4
Private capital and financial account	**-85**	**-72**	**-82**	**-73**	**-68**	**-70**	**-72**	**-75**	**-78**
Net foreign direct investment	-64	-55	-13	-20	-18	-24	-27	-28	-28
Net portfolio investment	-59	-54	-24	-58	-57	-61	-63	-68	-70
Net banking sector	16	24	6	5	7	14	18	20	20
Other 2/	22	13	-52	0	0	0	0	0	0
Official reserve flows 3/	**22**	**0**	**-4**	**0**	**0**	**0**	**0**	**0**	**0**
	(In percent of GDP, unless otherwise indicated)								
Current account	**13.5**	**14.7**	**16.9**	**14.1**	**12.8**	**12.9**	**12.8**	**13.0**	**13.1**
Trade balance	0.6	1.0	1.9	1.4	0.9	1.0	1.1	1.2	1.3
Exports	35.3	38.2	40.6	40.1	39.4	41.9	44.4	47.0	49.8
Imports	-34.6	-37.1	-38.7	-38.7	-38.6	-40.9	-43.2	-45.8	-48.5
Service balance	6.1	6.8	7.7	7.1	6.6	6.6	6.6	6.5	6.4
Net investment income	12.3	11.8	12.0	10.6	10.3	10.1	9.8	9.9	9.9
Net compensation of employees	-2.3	-2.3	-2.3	-2.6	-2.6	-2.4	-2.3	-2.3	-2.2
Net private transfers	-2.5	-2.0	-1.8	-1.7	-1.7	-1.7	-1.7	-1.6	-1.6
Net official transfers	-0.8	-0.7	-0.7	-0.7	-0.7	-0.7	-0.6	-0.6	-0.6
Private capital and financial account	**-18.3**	**-14.9**	**-16.2**	**-14.1**	**-12.8**	**-12.9**	**-12.8**	**-13.0**	**-13.1**
Net foreign direct investment	-13.8	-11.3	-2.5	-3.8	-3.4	-4.3	-4.7	-4.8	-4.6
Net portfolio investment	-12.7	-11.0	-4.6	-11.1	-10.7	-11.1	-11.3	-11.7	-11.8
Net banking sector	3.5	4.8	1.2	0.9	1.3	2.6	3.2	3.5	3.4
Other 2/	4.7	2.6	-10.3	0.0	0.0	0.0	0.0	0.0	0.0
Official reserve flows 3/	**4.7**	**-0.1**	**-0.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Net IIP (in percent of GDP)	122	117	142	152	162	170	179	187	195
Official reserves									
(billions of U.S. dollars, end period)	36.3	38.1	42.7	…	…	…	…	…	…
Reserve cover (months of imports of GNFS)	5.1	4.8	5.2	...	...	...	...	...	...

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's International Investment Position, 2002-07
(in millions of Swiss francs, unless otherwise indicated; total at year's end))

	2002	2003	2004	2005	2006	2007 1/
Foreign assets	**2,104,519**	**2,189,987**	**2,259,767**	**2,764,489**	**3,015,164**	**3,565,174**
Direct investment 2/	405,229	422,244	453,307	562,572	632,182	679,377
Portfolio investment	724,385	816,257	860,089	958,223	1,075,035	1,190,760
Other assets	889,556	865,439	861,908	1,167,900	1,229,279	1,610,008
Reserve assets	85,349	86,047	84,462	75,794	78,668	85,029
Foreign liabilities	**1,569,741**	**1,657,579**	**1,724,029**	**2,200,923**	**2,448,680**	**2,845,796**
Direct investment 2/	173,080	200,666	223,682	224,529	266,045	313,063
Portfolio investment	485,659	556,790	589,478	791,012	930,141	902,299
Other liabilities	911,003	900,123	910,869	1,185,382	1,252,495	1,630,434
Net investment position	**534,778**	**532,408**	**535,738**	**563,566**	**566,484**	**719,378**
Direct investment 2/	232,149	221,578	229,625	338,043	366,137	366,314
Portfolio investment	238,727	259,466	270,611	167,211	144,894	288,461
Other assets and liabilities	-21,446	-34,684	-48,961	-17,482	-23,216	-20,426
Reserve assets 3/	85,349	86,047	84,462	75,794	78,668	85,029
Memorandum items: 4/						
Foreign assets	485	500	501	596	620	701
Foreign liabilities	361	379	382	475	504	560
Net investment position	123	122	119	122	117	142

1/ As of September 2007.
2/ Expansion of reporting population in 2004.
3/ In 2005, distribution to Confederation and cantons of proceeds from gold sales.
4/ In percent of GDP.

Table 7. Switzerland: Financial Soundness Indicators

	2001	2002	2003	2004	2005	2006	Jun-07
Banks							
Capital adequacy							
Regulatory capital as percent of risk-weighted assets	12.4	12.6	12.4	12.6	12.4	13.4	12.5
Regulatory Tier I capital to risk-weighted assets	12.6	13.1	13.5	13.3	13.0	13.4	12.5
Non-performing loans net of provisions as percent of capital 1/	2.0	0.6	-0.5	-1.2	-1.0	-1.0	…
Asset quality and exposure							
Non-performing loans as percent of gross loans	2.1	1.8	1.3	0.9	0.5	0.3	…
Sectoral distribution of bank credit to the private sector (percent) 2/							
Households	58.1	60.8	63.7	65.2	66.6	68.5	67.9
Agriculture and food industry	1.4	1.3	1.3	1.3	1.2	1.4	1.3
Industry and manufacturing	4.7	4.5	4.1	3.7	3.4	3.0	3.3
Construction	2.7	2.5	2.2	2.1	1.9	1.7	
Retail	5.0	4.6	4.1	3.7	3.6	3.1	3.2
Hotels and restaurants / Hospitality sector	1.7	1.6	1.5	1.4	1.3	1.2	1.1
Transport and communications	1.2	1.1	1.1	1.1	1.1	1.0	1.1
Other financial activities	3.9	3.0	2.2	2.2	2.4	3.1	3.6
Insurance sector	1.0	0.7	0.5	0.5	0.4	0.4	0.4
Commercial real estate, IT, R&T	12.8	12.5	12.3	12.2	12.1	11.0	11.0
Public administration (excluding social security)	3.6	3.5	3.3	3.1	2.6	2.4	2.0
Education	0.2	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	1.1	1.1
Other collective and personal services	1.7	1.6	1.5	1.5	1.5	1.3	1.6
Other 3/	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Earnings and profitability							
Gross profits as percent of average assets (ROAA)	0.6	0.5	0.7	0.8	0.9	0.9	…
Gross profits as percent of average equity capital (ROAE)	10.0	8.9	11.7	14.3	18.0	17.7	…
Net interest income as percent of gross income	34.8	34.9	40.2	36.4	30.9	27.4	22.2
Non-interest expenses as percent of gross income	63.3	61.7	63.5	62.7	59.2	63.0	60.4
Liquidity							
Liquid assets as percent of total assets	24.6	23.2	26.7	24.5	24.7	25.2	26.0
Liquid assets as percent of short-term liabilities	63.2	61.5	63.7	59.6	59.4	60.4	62.0
Net long position in foreign exchange as a percentage of tier I capital	34.1	32.3	30.1	15.5	30.6	21.9	17.7

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 1/	...	22.6	19.6	16.9	17.7	19.7
Share of underfunded funds as percent of all pension funds 1/	...	19.8	11.2	10.6	3.4	2.6
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.

1/ Data for 2006 refers to Dec-06.

Table 9. Switzerland: Structure of the Financial System

	2001	2002	2003	2004	2005	2006
			(Number of institutions)			
Banks	369	356	342	338	337	331
Cantonal banks	24	24	24	24	24	24
Large banks	3	3	3	3	2	2
Regional and savings banks	94	88	83	83	79	78
Raiffeisen banks	1	1	1	1	1	1
Other banks	205	200	190	188	189	183
Trading banks	12	11	9	8	7	7
Stock exchange banks	61	62	55	53	56	52
Other banks	7	5	4	4	4	4
Foreign controlled banks	125	122	122	123	122	120
Branches of foreign banks	25	25	26	25	28	29
Private bankers	17	15	15	14	14	14
Insurance companies - Life	29	24	24	24	24	24
Insurance companies - General	106	123	124	124	124	124
Pension funds	…	8,134	…	…	…	…
Concentration						
Banks 1/	64	64	63	66	67	72
Insurance companies - Life 3/	…	…	…	…	…	…
Insurance companies - General 3/	…	…	…	…	…	…
Pension funds	...	...	...	...		...
			(In SwF billions)			
Assets						
Banks	2,227	2,252	2,237	2,491	2,846	3,194
Cantonal banks	305	313	311	314	327	343
Large banks	1,416	1,444	1,409	1,644	1,910	2,198
Regional and savings banks	78	79	81	81	84	86
Raiffeisen banks	82	93	102	106	108	114
Other banks	312	290	302	314	382	410
Trading banks	53	41	42	43	45	46
Stock exchange banks	69	81	83	86	106	122
Other banks	3	3	3	4	3	4
Foreign controlled banks	187	166	174	182	228	239
Branches of foreign banks	17	16	16	15	17	23
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	1,374
Cantonal banks	155	164	169	180	186	192
Large banks	529	506	526	577	700	834
Regional and savings banks	45	46	50	51	54	54
Raiffeisen banks	53	59	65	71	73	75
Other banks	143	142	149	153	185	206
Trading banks	33	25	26	27	28	29
Stock exchange banks	37	46	49	47	61	66
Other banks	2	2	2	2	3	2
Foreign-controlled banks	71	69	72	76	93	108
Branches of foreign banks	2	2	2	2	2	2
Private banks	11	12	13	11	11	11

Source: Swiss National Bank.

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

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

3/ Herfindahl's index

Annex I. Switzerland: Fund Relations

(As of April 29, 2008)

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

		SDR Million	% Quota
II.	**General Resources Account:**	SDR Million	% Quota
	Quota	3,458.50	100.00
	Fund holdings of currency	3,231.10	93.42
	Reserve position in Fund	227.38	6.57
III.	**SDR Department:**	SDR Million	% Allocation
	Holdings	149.14	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 April 25, 2008, 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, 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 2008 mission visited Bern and Zürich during March 3-17, 2008 and held discussions with Finance Minister Merz, Chairman Roth of the Governing Board of the Swiss National Bank (SNB), 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 A. Mody (Head), K. Ross, A. Carare (EUR), K. Ueda (RES), I. Tower and J. Tuya (MCM).

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's economic and financial statistics are adequate for surveillance purposes. 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 will become available for the central government in the second half 2008;
- 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 was published in 2007. In conjunction with the SNB's centennial, **long-run historical time series** covering monetary aggregates, capital markets, and the SNB balance sheet have been published. At the end of 2007, the SNB introduced a new monthly survey on **interest rates** for various banking products. Under the agreement with SFBC on reciprocal exchange of data, the SNB has since 2007, been collecting the new capital adequacy statement information, in accordance with Basel II. Also, since 2007, the SNB has conducted surveys of Liechtenstein-based companies when preparing its international investment position.

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 (as mentioned above). 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) has been posted on the IMF website.

The authorities have made progress on AML/ CFT recommendations. The Federal Council adopted a draft law implementing the revised FATF recommendations, which should be in force by end-2009. Supervisory ordinances on private insurance, gaming, and banking commission have also been adopted, and a revised banking association due diligence code will be in force by mid-2008. The Swiss authorities will report on these reforms to the FATF in October 2008.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of April 29, 2008)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Apr 08	Apr 08	D and M	M and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar 08	Apr 08	M	M	M
Reserve/Base Money	Mar 08	Apr 08	M	M	M
Broad Money	Mar 08	Apr 08	M	M	M
Central Bank Balance Sheet	Mar 08	Apr 08	M	M	M
Consolidated Balance Sheet of the Banking System	Feb 08	Apr 08	M	M	M
Interest Rates[2]	Mar 08	Apr 08	D and M	M and M	D and M
Consumer Price Index	Feb 08	Mar 08	M	M	M
Revenue, Expenditure, Balance and Composition of Financing – General Government[3,4]	2007	Mar 08	A	A	A
Revenue, Expenditure, Balance and Composition of Financing – Central Government[3]	2007	Mar 08	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2007	Mar 08	Q	Q	Q
External Current Account Balance	Q4/07	Apr 08	Q	Q	Q
Exports and Imports of Goods and Services	Feb 07	Apr 08	M	M	M
GDP/GNP	Q4/07	Mar 08	Q	Q	Q
Gross External Debt	2007	Mar 08	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
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May 29, 2008

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

IMF Executive Board Concludes 2008 Article IV Consultation with Switzerland

On May, 23, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Switzerland.[1]

Background

The economy has performed impressively. Growth has exceeded the euro area average in each of the past four years, employment has surged and inflation has remained relatively muted. This favorable outcome can be traced to a strong external environment that has led to an increase in high value-added manufacturing, and in financial sector income flows which reinforced Switzerland's role as a major global financial center.

Global credit strains, however, have had an impact on the financial sector. While Credit Suisse and Swiss Re have reported losses, UBS has been particularly hard hit, reflecting its high exposure to U.S. subprime assets. Subprime losses at UBS have amounted to US$38 billion, and have led to writedowns by the main rating agencies, as well as two capital injections of about US$28 billion. Still, while deleveraging at the big banks is ongoing, domestic lending has remained on a surprisingly steady pace.

The economy gathered speed in 2006 and into the first half of 2007, resulting in a positive output gap of about 1 percent. GDP growth accelerated to 3.1 percent in 2007, as private consumption was supported by a very favorable labor market, and investment

[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.

was underpinned by strong corporate profitability and tightening capacity constraints. So far, leading indicators have remained surprisingly positive. Demand of manufactured goods from Europe and Asia is steady and consumer-related industries, such as retail trade and tourism, have performed particularly well. Economic growth, however, is expected to moderate to 1.4 percent in 2008 as the worsening external environment takes its toll on goods exports and financial sector inflows, and financial tensions lower consumer confidence, gradually weakening consumption.

Headline inflation averaged 0.7 percent in 2007, while core inflation was 0.6 percent. CPI inflation has recently picked up due to fuel and food price increases but is expected to moderate by the end of the year. For 2008, inflation is projected to average 2 percent and fall to 1.4 percent in 2009. Foreign labor, in particular, has helped to keep wage pressures in check, and has bolstered competitiveness.

The Swiss National Bank (SNB) continued to normalize interest rates in the first half of 2007, but has since relaxed monetary policy when necessary. The SNB's target range for the 3-month Libor has been increased by 200 basis points since mid-2005 (to 2.25-3.25 percent) as the Swiss franc weakened. Since September, however, repo rates have been reduced to accommodate emerging credit strains which placed upward pressure on Libor rates.

The state of public finances continued to improve in 2007. The general government achieved a surplus of 2.2 percent of GDP aided by strong cyclical revenues and surpluses at lower levels of government. Debt to GDP ratios have fallen below 45 percent but aging-related expenditures are expected to reverse this trend in the medium-term.

Executive Board Assessment

Executive Directors welcomed Switzerland's impressive growth performance over the last four years, and commended the authorities on their strong macroeconomic policies and structural reform efforts. Directors noted that the financial turbulence of the past year—and the continued tensions, especially in the interbank markets—have generated risks for the Swiss financial sector. Although the economy has weathered well these challenges, Directors considered that, along with the slowdown in U.S. activity and the prospect of slower growth in Europe, these developments are projected to decelerate Swiss growth in the period ahead.

Against this background, Directors observed that the key policy priority is to maintain domestic financial stability, which, given Switzerland's strong international linkages, would contribute also to international stability. They commended the authorities for their vigorous response to date to limit the fallout from the financial turbulence. In particular, Directors welcomed the authorities' well-timed injections of liquidity into the banking system in concert with other major central banks, and their enhanced oversight of the major banks and insurance companies. They also praised the authorities for their proactive sharing of information and lessons learned with other regulators, and their smooth coordination of supervisory activities, while calling for continued work on measures that will further enhance financial sector stability. This work should focus on the following four areas: better risk assessment and risk management; increased capital buffers; more liquidity; and greater disclosure.

Looking ahead, Directors noted the importance of stronger buffers to protect the financial system. They noted that recent developments will likely lead to higher capital requirements under the Basel II framework, and that additional capital may be needed to cushion against unforeseen risks. In this regard, most Directors considered that a leverage ratio approach envisaged by the authorities could serve as a useful complement to the existing regime, if implemented alongside Basel II and with appropriate safeguards. Directors also welcomed Switzerland's development of a stronger stress testing framework to improve liquidity risk management and a more active review of banks' contingency plans and liquidity management policies. In the insurance sector, Directors noted progress in implementing the Swiss Solvency Test for insurance companies, and welcomed the strengthened on-site supervision and international supervisory cooperation.

Directors welcomed the recent appointment of the board and senior management of the new financial regulator (FINMA), and emphasized the need to ensure that the agency has the appropriate level of supervisory capabilities and resources. Directors recommended further strengthening of on-site supervision capabilities, with appropriate reliance on external auditors to monitor regulatory compliance. They also stressed the importance of building on existing cross-border supervisory arrangements for global groups, and securing more active support of host supervisors in maintaining the stability of global operations.

Directors agreed that the calibration of monetary policy has correctly balanced the risks to inflation and economic growth. They indicated that the effective easing of monetary policy has been appropriate given the potentially serious downside risks to the economy and the projected decline of inflation. Looking ahead, Directors welcomed the authorities' commitment to continue to monitor developments carefully. A number of Directors considered that the relatively contained inflation outlook provides some scope for further easing. A number of other Directors believed that the current monetary stance remains appropriate at the present juncture. Regarding the operational framework, Directors noted that its flexibility has served the economy well, and looked forward to further analysis of its signaling and substantive effects.

Directors commended the authorities for the strong fiscal performance. They emphasized that, following the small fiscal stimulus anticipated in 2008, further progress toward long-term fiscal sustainability will require continued fiscal prudence and structural reforms. In this regard, Directors welcomed the *Long-Term Sustainability Report* as an important step in raising awareness of the needed actions, and looked forward to the early formulation of specific policy measures. Directors noted that savings could be achieved through a consolidation of governmental responsibilities as outlined in the *Task Evaluation Program*. They also welcomed the proposal to extend the debt-brake rule to incorporate “extraordinary” expenditures.

In reviewing the factors behind Switzerland’s large external current account surplus, Directors considered that the surplus largely reflects structural factors, notably the country’s high per capita income, its aging population, and its position as a major financial center. They also noted that accounting norms and the specificities of the investment flows tend to overstate the surplus relative to other countries. Taking into account these considerations, Directors generally agreed that the exchange rate appears to be broadly in line with fundamentals.

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 2008 Article IV Consultation with Switzerland is also available.

Switzerland: Selected Economic Indicators

	2004	2005	2006	2007 1/	2008 1/
Real economy					
Real GDP	2.3	2.5	3.2	3.1	1.4
Real total domestic demand	1.6	1.9	1.4	0.2	2.2
CPI (year average)	0.8	1.2	1.0	0.7	2.0
Unemployment rate (in percent of labor force)	3.5	3.4	3.3	3.1	3.1
Gross national saving (percent of GDP)	34.0	34.9	36.9	38.6	36.6
Gross national investment (percent of GDP)	21.0	21.4	22.2	21.8	22.5
Public finances (percent of GDP)					
Confederation budget balance 2/	-0.6	-0.2	0.5	0.9	-0.4
General government balance 2/ 3/	-1.0	-0.2	1.9	2.2	0.8
Gross public debt	53.4	50.5	45.9	44.0	42.3
Balance of payments					
Trade balance (in percent of GDP)	1.5	0.6	1.0	1.9	1.4
Current account (in percent of GDP)	14.0	13.5	14.7	16.9	14.1
Official reserves (end of year, US$ billion) 4/	55.5	36.3	38.1	42.7	…
Money and interest rates					
Domestic credit (annual average)	2.3	4.0	5.5	7.5	…
M3 (annual average)	3.2	4.2	2.5	2.0	…
Three-month Libor rate (in percent)	0.5	1.5	1.6	2.2	…
Government bond yield (in percent)	2.6	2.1	2.5	2.9	…
Exchange rate					
Exchange rate regime				Managed float	
Present rate (May 14, 2008)				SwF 1.05 per US$1	
Nominal effective exchange rate (1990=100)	110.4	109.8	108.4	106.0	…
Real effective exchange rate (1990=100) 5/	105.6	104.0	101.7	98.0	…

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/ Based on consumer prices.

Statement by Thomas Moser, Executive Director for Switzerland
May 23, 2008

1. On behalf of my Swiss authorities, I would like to thank the staff for the stimulating and constructive discussions. In light of the global financial market turmoil and the importance of Switzerland's financial sector, and in line with the refocusing of the Fund's activities on macro-financial linkages, the staff report rightly focuses on financial sector stability issues and policies, including on regulatory questions. Many issues that the report highlights are at the forefront of international policy discussions and thus of relevance beyond Switzerland. My authorities welcome the overall positive assessment of their policy responses in this regard, and the staff report will be very helpful in strengthening the support for these measures.

Growth Outlook

2. The Swiss economy has enjoyed four years of solid, broad based growth, at a rate above its long-term average growth rate. For 2008 and 2009, a slowdown is expected, given the deterioration in the international economic and financial environment, but at the time being there is still little concrete evidence of a marked slowdown. The Swiss authorities expect GDP growth to slow to about 2 percent in 2008 and to 1-1.5 percent in 2009.

3. As pointed out by the staff, Switzerland's openness and its large and international financial sector expose Switzerland's economy to exogenous shocks, but thanks to its flexibility the Swiss economy should be well capable of handling such shocks. The lower growth prospects for the U.S. economy and, to a lesser extent, for Europe will undoubtedly have an adverse affect on Swiss exports, but this is partially compensated by continuing strong growth in Asia and the Gulf region. It should also be pointed out that higher oil prices do not only have an adverse impact on the Swiss economy, as higher income in oil-exporting countries stimulates demand for the Swiss investment and luxury goods industries.

4. As to financial sector linkages, Switzerland's two major international banks are undoubtedly affected by the international financial turmoil, by and large through their investment banking arms. However, the Swiss banking sector as a whole has continued to be very profitable, and there is little evidence of a tightening in credit conditions in Switzerland. It should also be noted that the very solid financial footing of Swiss households and companies would help to cushion such a tightening.

Maintaining Financial Sector Stability

5. My Swiss authorities fully share staff's views on measures to further enhance financial sector stability. They would like to emphasize three main priorities that will support

the stability objective: (i) enhanced international cooperation, (ii) the close monitoring of the two large banks, and (iii) the launch of the financial supervisory authorities (FINMA).

6. On international cooperation, the Swiss National Bank (SNB) participated from the outset of the financial market turmoil in international cooperation and continues to coordinate with the Federal Reserve and the European Central Bank in providing dollar liquidity. The SNB and the Swiss Federal Banking Commission (SFBC) are also actively involved with their respective foreign counterparts in enhancing the exchange of information and policy response. Switzerland is fully engaged in the international efforts to strengthen regulatory standards in the Basel Committee and other relevant for a, and is ready to actively contribute to multilateral efforts aimed at maintaining financial sector stability, including in the IMF and the FSF.

7. Switzerland is well aware of the systemic importance of its two large banks. Both the SFBC and the SNB are implementing pragmatic steps to improve the supervision and regulation for risks and liquidity management at the large banks, and to raise capital requirements. For example, a regular, mandated stress testing exercise with the two large banks has been introduced. The Swiss authorities are also well on track for the launch of FINMA; the remaining board members and its director were appointed on May 21. The independence of FINMA is a prerequisite for the agency to be able to fulfill its supervisory duties. It is also an objective of FINMA to enhance Switzerland's input to international cooperation.

8. As to the insurance sector, the Swiss authorities concur with staff that the insurance supervisor should focus on the consistent implementation of the Swiss Solvency Test (SST), and on monitoring companies that show SST ratios of less than 100 percent. Based on the integrated approach, the SST will be complemented by a focus on corporate governance, risk management, and internal controls.

9. On pension funds, it should first be noted that with an asset volume of comfortably over 100 percent of GDP, the (mandatory) occupational benefit plan system in Switzerland is well endowed. 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. Many pension funds have in fact significantly increased the latter. 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. Also, one fifth of the pension fund liabilities are insured with private insurance companies who have to meet strict coverage and solvency requirements at all times.

Monetary Policy

10. At slightly over 2 percent in 2008, inflation is now expected to be somewhat higher than assumed in the staff report, i.e., slightly above the rate which the SNB regards as compatible with price stability. However, inflation is expected to ease again toward the end of the year and no further action from the SNB is required. But vigilance remains necessary as it cannot be excluded that inflation will prove more persistent than expected. The scope for easing, mentioned in the staff report, needs to be qualified accordingly.

11. My Swiss authorities would like to point out that increasing integration with international markets in general, and Europe in particular, has not eliminated the scope for independent monetary policy responses. Both in 2001 and 2002 the SNB moved faster and more forcefully than the ECB. In 2003, it stopped reducing interest rates earlier than the ECB, and in 2004 again, the SNB acted before the ECB. It is true, however, that growth and inflation in Switzerland are closely correlated developments in the euro zone, but it should also be mentioned that inflation in Switzerland is significantly and permanently lower than in the euro area.

12. As the staff report rightly notes the SNB’s operational framework differs from the operating procedures of other central banks: the SNB targets the three-month Swiss-franc Libor, whereas other central banks set the overnight or the one-week repo rates. The staff seems to see little value in this Swiss particularity, but the concept has served the SNB and the Swiss economy well, particularly during the recent financial market turmoil. The Libor – and not the repo or the overnight rate – is an important reference interest rate for the Swiss economy. By targeting a three-month market rate rather than a risk-free overnight rate, the SNB has been able to largely offset the gyrations in the risk premium over the recent months, and thus been able to isolate the non-financial sector of the Swiss economy from the turmoil on financial markets. By incorporating what could be termed an “automatic monetary stabilizer,” this operational framework has led the policy stance to be more accommodative – or less restrictive – than it would have been otherwise. We agree with staff, however, that these issues deserve further theoretical and empirical analysis.

Public Finances

13. Fiscal performance in 2007 was again better than budgeted for all levels of government. Thanks to buoyant revenues stemming from strong economic growth, the general government surplus in 2007 increased further to 2.2 percent of GDP from 1.9 percent in 2006. The authorities are particularly satisfied that expenditure control was maintained despite strong revenues. The surpluses over the past years have also allowed a significant reduction in public debt. At around 44 percent of GDP, the current level of gross debt is over 10 percentage points below the historical peak in 2003.

14. As staff notes, long-term fiscal sustainability has also improved over the past years. The authorities are aware of the fiscal challenges stemming from an aging population. By introducing the Long-Term Sustainability Report as a regular feature of the medium-term budget planning, an important step was made to inform and sensitize policy makers and the public of the order of magnitude of costs related to demographic change. A crucial message of the report is the speed with which adjustment costs increase, if concrete measures to reduce costs are delayed. The authorities are confident that the report will help in the implementation of structural changes in the areas of social security and health care.

15. At the federal level, the authorities remain committed to the two main goals that have anchored fiscal policy over the last years: stabilizing federal gross debt in nominal terms and reducing expenditure growth to a sustainable level. The debt brake, introduced in 2003, has been the main instrument in this respect. To further strengthen this fiscal rule, the Federal Council has proposed an amendment of the budget law, which would ensure that also extraordinary expenditure is taken into account by the debt brake. At present, extraordinary spending under exceptional circumstances is exempted from the fiscal rule and can lead to an increase of debt, thereby undermining the original spirit of the fiscal rule. The amendment of the budget law introduces the obligation to compensate extraordinary expenditure over a period of six years with additional spending cuts over and above those required by the debt brake for maintaining the balance in the ordinary accounts. At present, the proposal is in a broad public consultation process. The Federal Council plans to submit the bill to Parliament in September 2008.

16. As regards the reduction of expenditure growth to a sustainable level, the Task Evaluation Program remains the main instrument to define specific measures and structural reforms across all areas of the federal government. The Federal Council recently reconfirmed the specific medium-term expenditure growth rates for the different tasks, which ensure a stabilization of the current expenditure-to-GDP ratio. It also submitted a report to Parliament, outlining 50 possible reform areas, which are currently being specified by the respective ministries.