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December 21, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Switzerland - Staff Report for the 1993 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1993 Article IV consultation with Switzerland, which is tentatively scheduled for discussion on Wednesday, January 19, 1994.

Mr. Henry (ext. 38354) or Mr. Habermeier (ext. 38857) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the GATT Secretariat and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

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SWITZERLAND

Staff Report for the 1993 Article IV Consultation

Prepared by the Staff Representatives for the
1993 Consultation with Switzerland

Approved by Massimo Russo and Jan van Houten

December 20, 1993

I. Introduction

Discussions for the 1993 Article IV consultation with Switzerland were held with the Swiss authorities during October 18-28, 1993. 1/ The staff team met with Mr. Stich, Minister of Finance; Mr. Delamuraz, Minister of Economics; Mr. Lusser, President of the National Bank; and senior officials of the Ministry of Finance, Ministry of Economics, National Bank, and other agencies. Mr. Kaeser, Executive Director for Switzerland, participated in the discussions during October 25-28; Mr. Cippà (Advisor, OED), participated during October 20-22. Switzerland has accepted the obligations of Article VIII, Sections 2, 3, and 4.

The 1993 Article IV consultation discussions were the first held with Switzerland since it became a member of the Fund in May 1992. 2/

II. Background

Following almost a decade of expansion, the economy of Switzerland went into recession at the beginning of 1991, some two years earlier than other countries in Europe (Chart 1). This recession was initially brought about by a tight monetary policy adopted in mid-1988 to offset the inflationary consequences of the easing of monetary conditions that followed the 1987 stock market crash and, later, the introduction of regulatory and technical changes in the banks' clearing system. 3/ In 1992, when Switzerland was

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1/ The staff team consisted of Messrs. Russo (Head), Henry, and Habermeier (all EU1), Ms. Hargraves (RES), Ms. De Masi (EP, EU1), and Ms. Chuidian (EU1, assistant).

2/ See "Switzerland - Application for Membership" (EBD/90/174, 06/06/90), "Switzerland - Calculation of Quota" (EB/CM/Switzerland/90/1, 08/10/90), and "Switzerland - Accession to the Bretton Woods Institutions" (EBD/92/105, 05/18/92).

3/ The institutional innovations, notably the introduction of an electronic interbank payments system, caused a larger reduction in banks' demand for reserves than had been forecast.

poised for a recovery, activity began to contract elsewhere in Europe, weakening Switzerland's external markets and prolonging the downturn.

Although the Swiss recession is now in its third year, the downturn has not been especially deep, with real GDP in the second quarter of 1993 only 2 percent lower than at its peak at the end of 1990. The contraction of output has affected all sectors of the economy, although it has been most marked in the construction and service sectors. Unlike the recessions of 1975-76 and 1982, the current downturn was not caused primarily by a marked deterioration in export performance (Chart 2). Rather, tight monetary conditions contributed to a decline in domestic investment, which had reached an unsustainably high level, with considerable over-building in the commercial real estate sector.

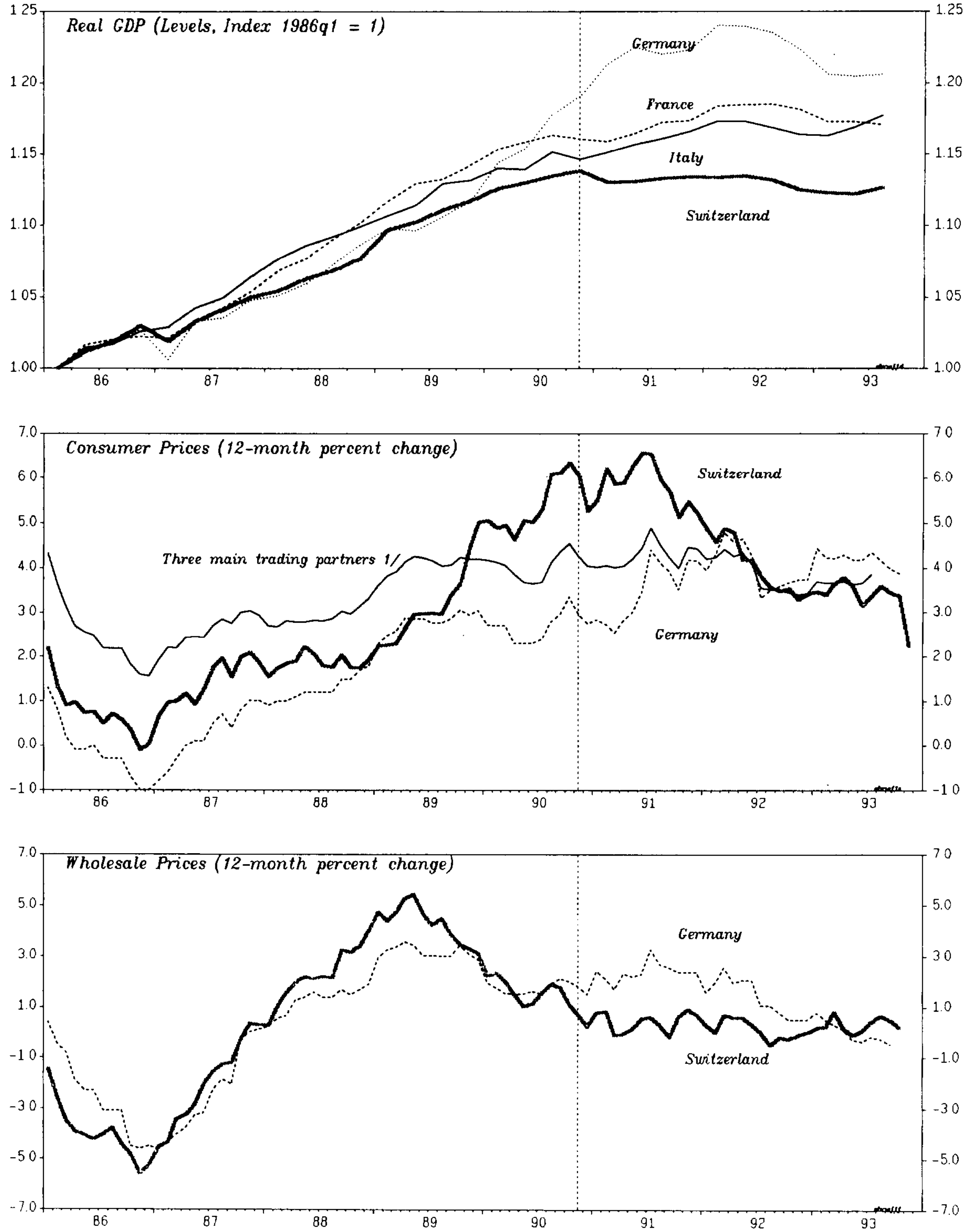
By the middle of 1992, private consumption had also begun to fall as consumers became more concerned about job security, real wages began to decelerate sharply, and the government decided to increase taxes and social security contributions. In contrast to previous recessions, the household savings ratio rose late in the downturn.

The external sector partly counteracted the decline in domestic demand, especially in 1992, when exports recovered from their temporary weakness in 1991 and imports fell by almost 4 percent, with an even more pronounced decline in imports of investment goods (Chart 3). The trade deficit diminished by about 2 percent of GDP and reached near balance in 1992. This has contributed to a pronounced but mostly cyclical increase in the current account surplus, which reached 6 1/2 percent of GDP in 1992 and continues to expand.

Employment has fallen by about 5 percent since activity reached its peak, and the decline has been much larger relative to the diminution in output than in earlier recessions (Chart 3). Employment declined first in the construction and industrial sectors, and later in the services sector, which had not been much affected in previous recessions. Structural changes in the labor market--especially more generous unemployment benefits and a reduced propensity of foreign workers and women to withdraw from the labor force in a downturn--further raised the number of workers registering as unemployed. Partly as a result, by late 1993, the unemployment rate had risen to 4 3/4 percent, an unprecedented level in Switzerland.

Consumer price inflation, which had remained below 3 percent until 1989, picked up sharply in 1990 and 1991 despite a deceleration in wholesale prices. After exceeding 6 percent in 1991, largely because of sharp increases in rents and other nontradables prices, the 12-month rate of increase in consumer price has been declining for some two years now. The decline was gradual at first but has accelerated since the second quarter of 1993 (Chart 1). The response of inflation to the monetary tightening has been slow compared to previous experience. This is partly attributable to the depreciation of the exchange rate in 1990-91, reflecting the concurrent tightening of monetary conditions elsewhere in Europe.

CHART 1
Switzerland
Output and Inflation

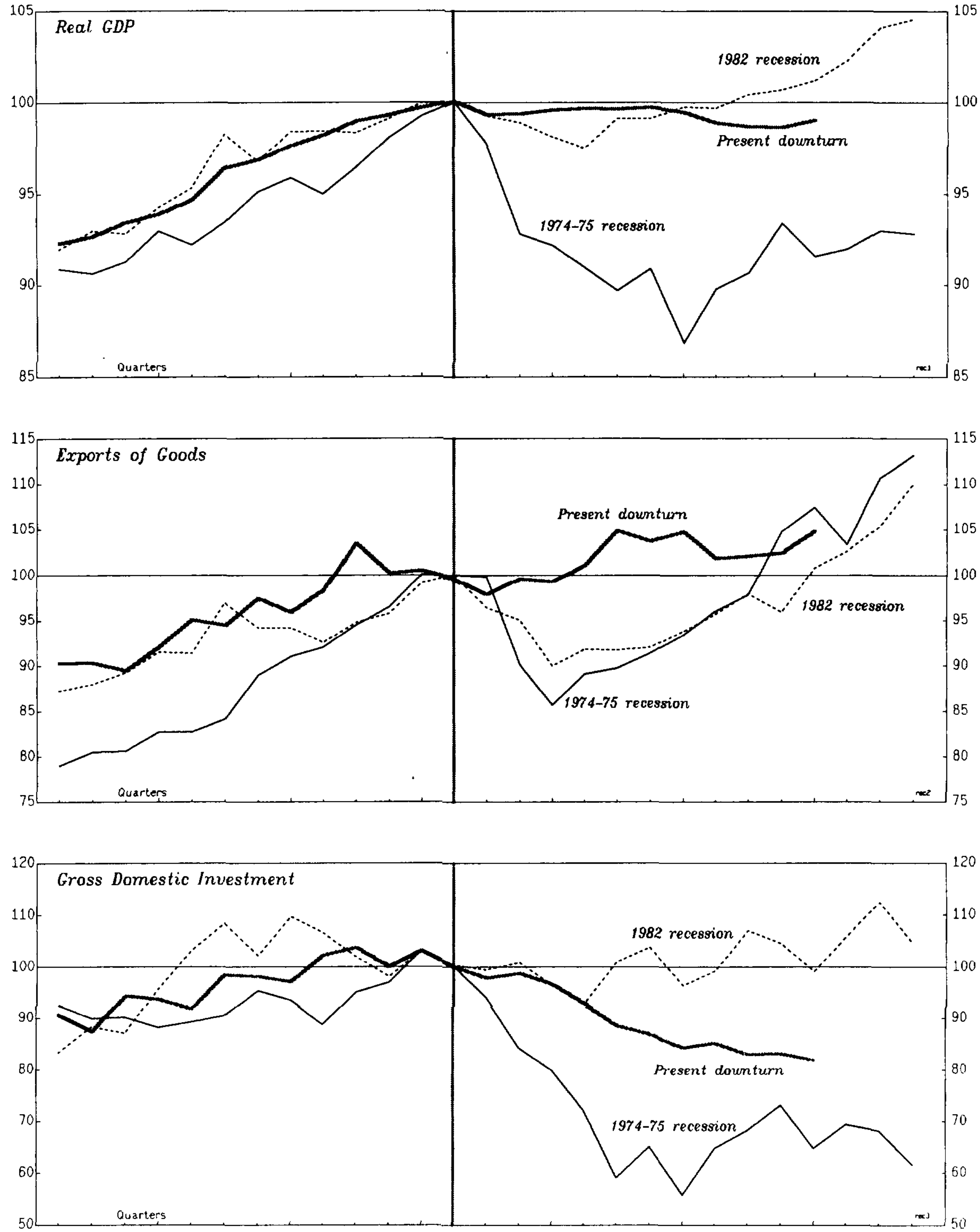


Sources: IMF, World Economic Outlook database; Swiss Institute for Business Cycle Research, data tape.
1/ Germany, France, Italy.

CHART 2
Switzerland

Comparison of GDP and of Components of Demand During Recessions 1/

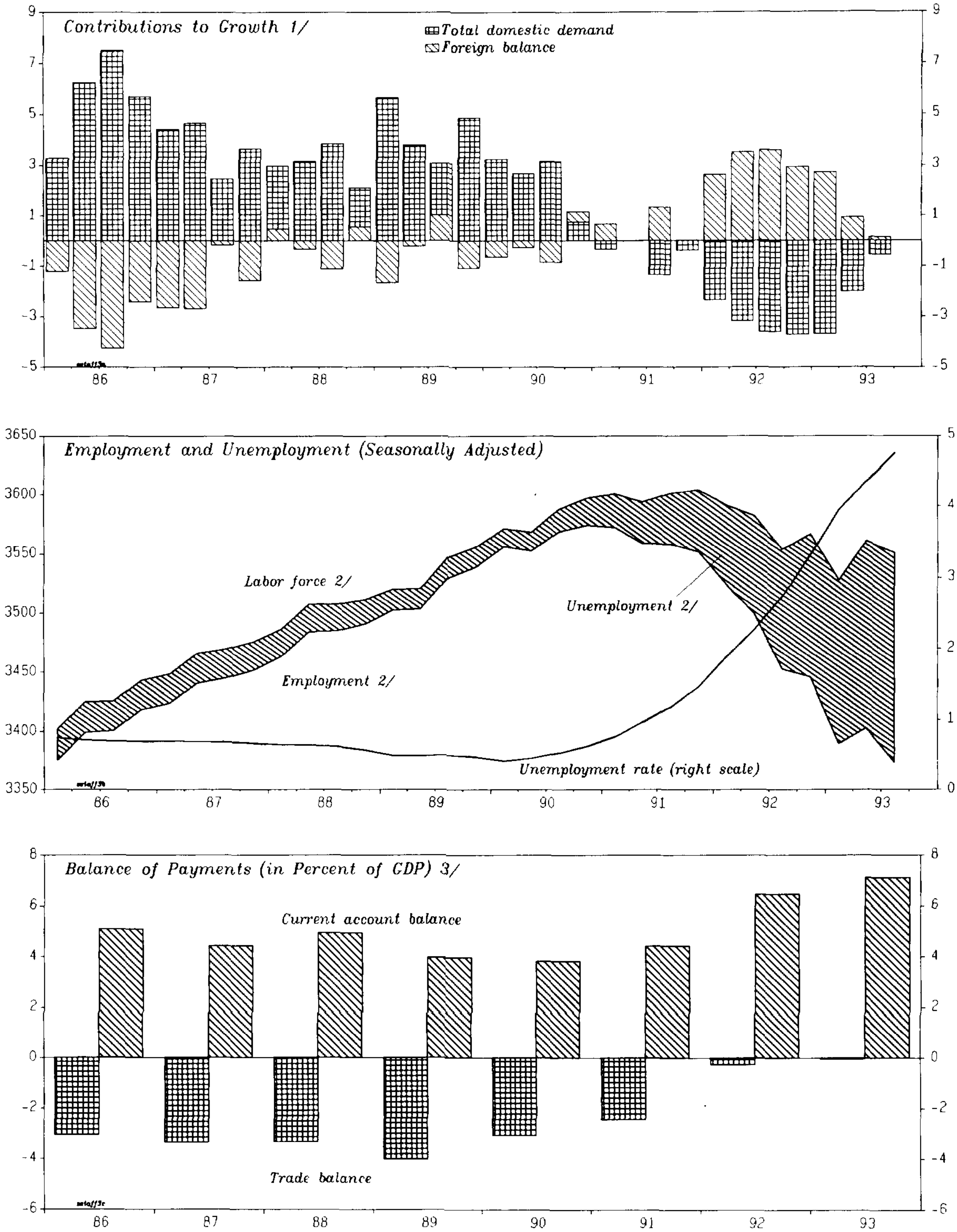
(Peak = 100)



Sources: Swiss Institute for Business Cycle Research, data tape.
1/ The peak preceding the 1991-93 recession is taken to be 1990, fourth quarter; the corresponding dates for the 1982 and 1974-75 recessions are 1981, fourth quarter and 1974, second quarter.

CHART 3
Switzerland

Growth, Employment, and Balance of Payments



Sources: IMF, World Economic Outlook database; Swiss Institute for Business Cycle Research, data tape.

1/ Change from the same quarter of the previous year as a percentage of GDP in the same quarter of the previous year.

2/ In thousands.

3/ Data for 1993 are staff projections.

The recession has contributed to the emergence of sizeable fiscal deficits at all levels of government (Chart 4). Cyclical conditions, however, explain only part of the increase in fiscal deficits since 1989, and both staff and official estimates show that fiscal policy has been mildly expansionary since the early 1990s. At least half of the deficits expected in 1993 must be considered structural. Overall, the finances of the general government (including the public social security funds) moved from a position of near balance in 1990 to a deficit of 3 percent of GDP in 1992. At the federal level, the deficit amounted to Sw F 2.8 billion (0.9 percent of GDP) in 1992, compared with a budgeted shortfall of Sw F 1.3 billion (0.4 percent of GDP). The deterioration has continued in 1993, with the general government deficit expected to reach about 4 1/2 percent of GDP, and the deficit of the federal government expected, at more than 2 percent of GDP, to be twice as high as budgeted in the fall of 1992.

As indicated earlier, monetary policy was tightened markedly beginning in mid-1988, and the 3-month market interest rate rose from 3 percent at the beginning of 1988 to about 9 percent by the middle of 1989 (Chart 5). This was accompanied by a decline of almost 3 percentage points in the short-term interest rate differential vis-a-vis Germany, and Swiss short-term interest rates were higher than those in Germany in the second half of 1989. Long-term interest rates also increased over this period, but less sharply.

Monetary policy was eased slightly in late 1990, but tightened again around the middle of 1991 to counteract a depreciation of the Swiss franc (Chart 6). The strengthening of the Swiss franc during the period of turmoil in the EMS, and signs of declining inflation, permitted a progressive easing of monetary policy beginning in mid-1992. Scope for easing was also provided by the gradual decline of interest rates in Germany and elsewhere in Europe. Nevertheless, weak economic activity has meant that the monetary base, the aggregate targeted by the National Bank, has remained well below its medium-term target path (Chart 7).

III. Economic Outlook

At present, it appears that the downturn in economic activity may have bottomed out. A weak recovery is expected to begin in early 1994 and gradually gather strength. The upturn will be sustained by domestic impulses coming from private consumption, stockbuilding and investment, and by an improvement in export markets. Real GDP is projected to increase by only 1 1/4 percent in 1994, following a decline of 3/4 percent in 1993. In consequence, unemployment is likely to increase further to more than 5 percent by the end of 1994.

Inflation has already been reduced to 3 percent on a 12-month basis and the underlying rate over the last few months has been close to 2 percent. With the output gap at over 4 percent and rising, wage increases expected to average at most 2 1/2 percent in 1994, and broadly stable import prices, the twelve month rate of inflation is projected to decline further, to around

2 percent by the end of 1994, with higher administered prices accounting for perhaps 1/2 percentage point.

The most important risks to the outlook for 1994 come from the external environment. Economic activity in Switzerland's major European trading partners--Germany, France, and Italy--remains weak and the strength and timing of their recovery is unclear. Should the upturn in Switzerland be delayed or weaker than expected, inflation could decline more quickly than anticipated.

Beyond 1994, the staff assumes that real GDP will return gradually to potential, implying growth rates over the medium term of somewhat more than 2 1/2 percent, with potential GDP increasing by 2 percent per year. Inflation is projected to decline further and stabilize below two percent, although the introduction of the VAT at the beginning of 1995 would result in a once-off increase in the price level of about 1 percent.

IV. Policy Discussions

The key tasks for economic policy in Switzerland are to cope with the consequences of the recession currently affecting much of Europe, and to implement the structural reforms needed to compete effectively in an increasingly integrated European and global economy. Against this background, the discussions focused on the appropriate macro-economic policy stance to deal with short-term difficulties, and on the policies needed to enhance the prospects for balanced economic growth in the medium term.

Fiscal deficits have increased sharply over the last three years as policy-makers at all levels of government not only allowed automatic stabilizers to operate fully, but countenanced the further, rapid growth of both entitlement and discretionary expenditures. The discussions focused on the likely evolution of fiscal deficits in the absence of new measures and the appropriate extent and timing of fiscal consolidation given the current recession and the expected slow recovery in 1994. Monetary policy has already been eased in response to signs that inflation is coming under control. In the shorter term, the principal question for monetary policy is how quickly and how much further short-term interest rates could be reduced in light of weak economic activity and the prospects for lower inflation, while guarding against a resurgence of inflationary expectations. Finally, despite the large share of high technology industries in its tradable goods sector, Switzerland has not remained unaffected by mounting global competition, and employment has declined more sharply relative to output than during previous recessions. The discussions of structural policy centered on measures taken and planned by the authorities to enhance the efficiency of goods and factor markets.

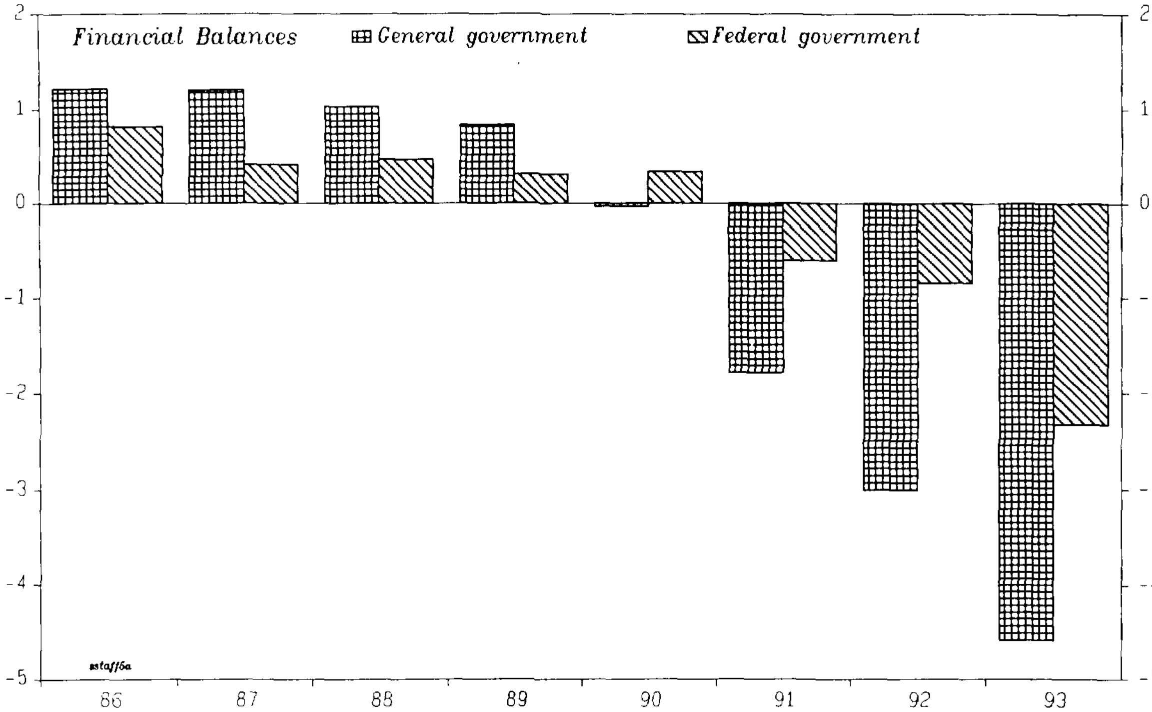
1. Fiscal policy

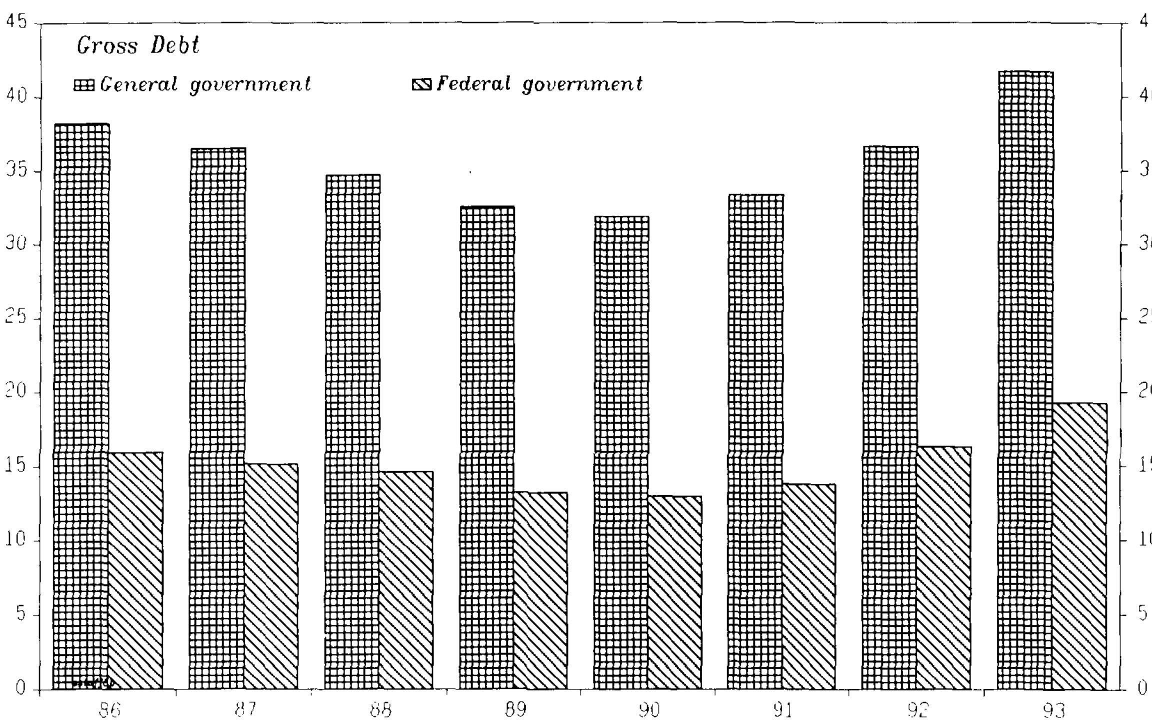
The authorities stated that the medium-term objective of fiscal policy in Switzerland was to achieve budget balance over the cycle. Since federal

CHART 4
Switzerland

Government Financial Balances and Debt 1/

(In percent of GDP)



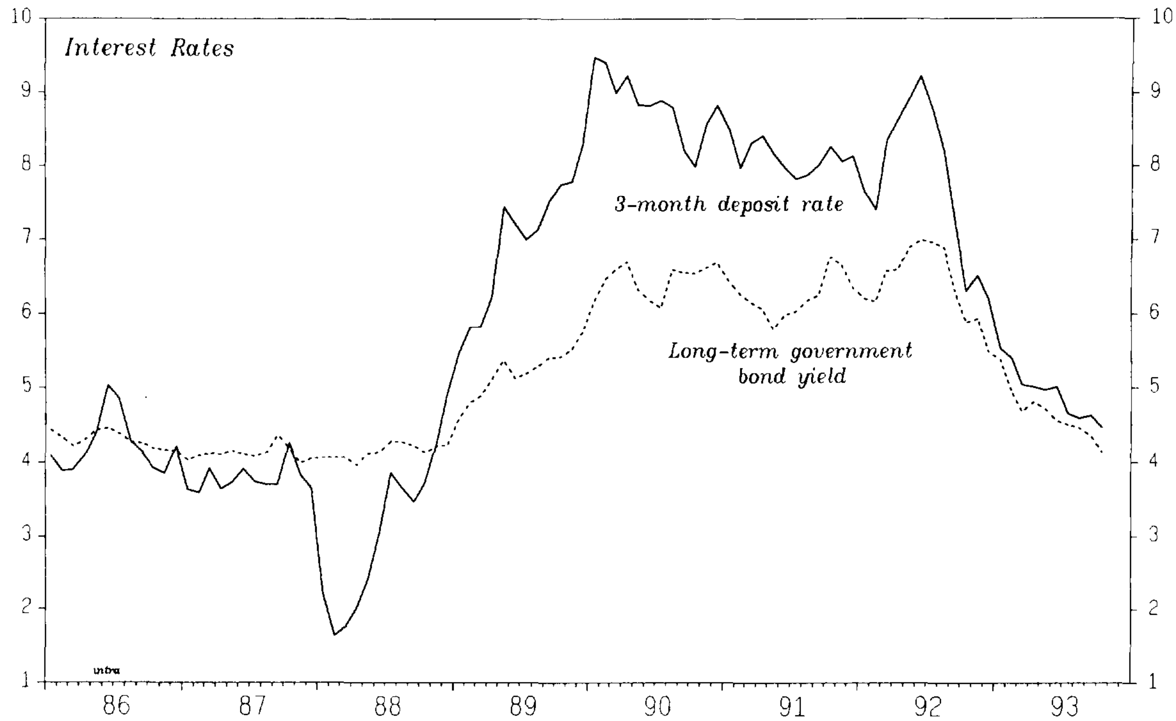


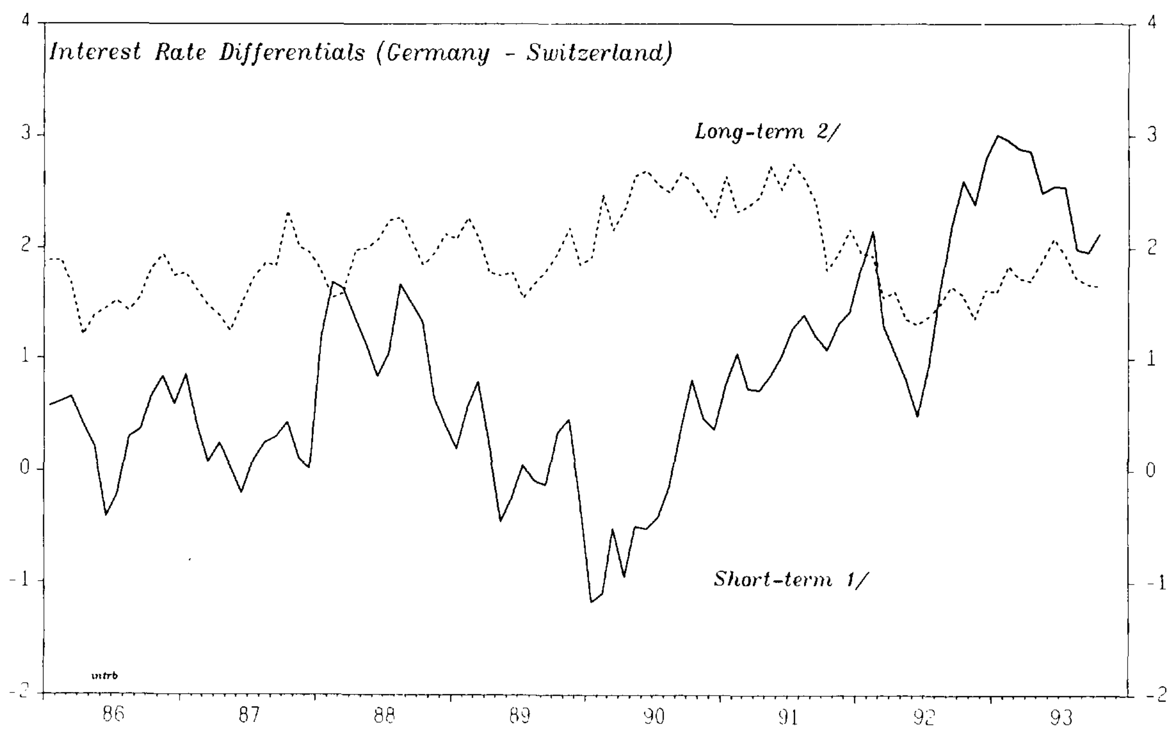
Source: IMF, World Economic Outlook database.
1/ Data for 1993 are staff projections.

CHART 5

Switzerland

Interest Rates



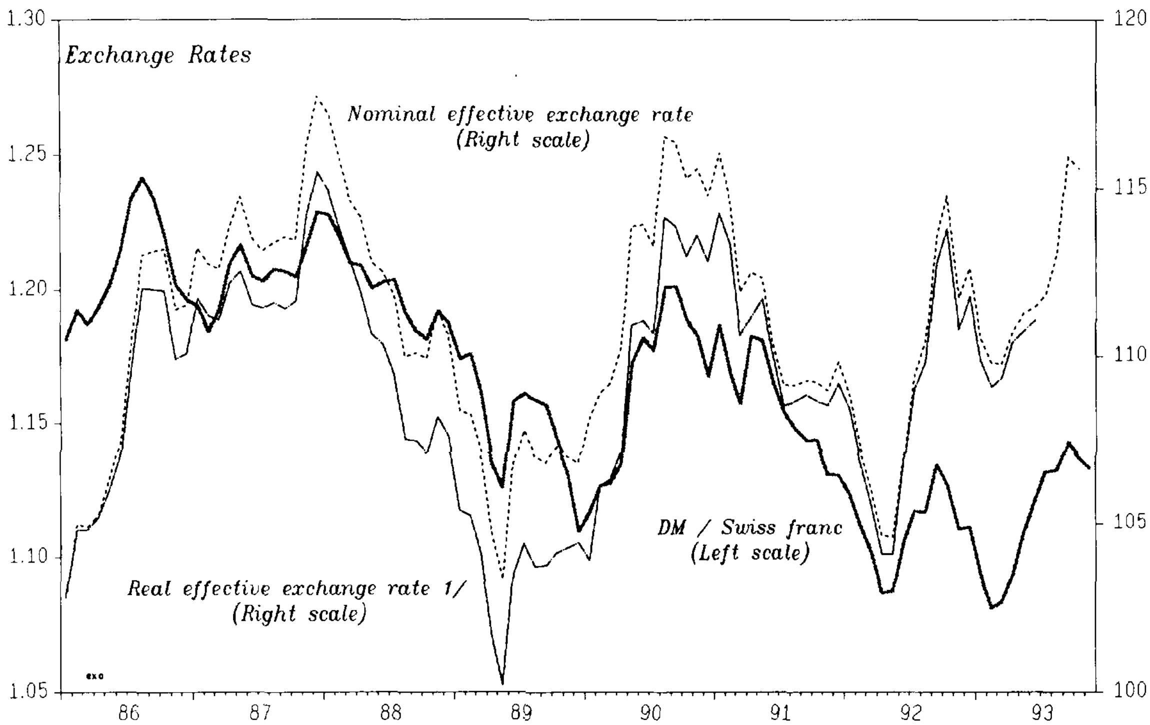


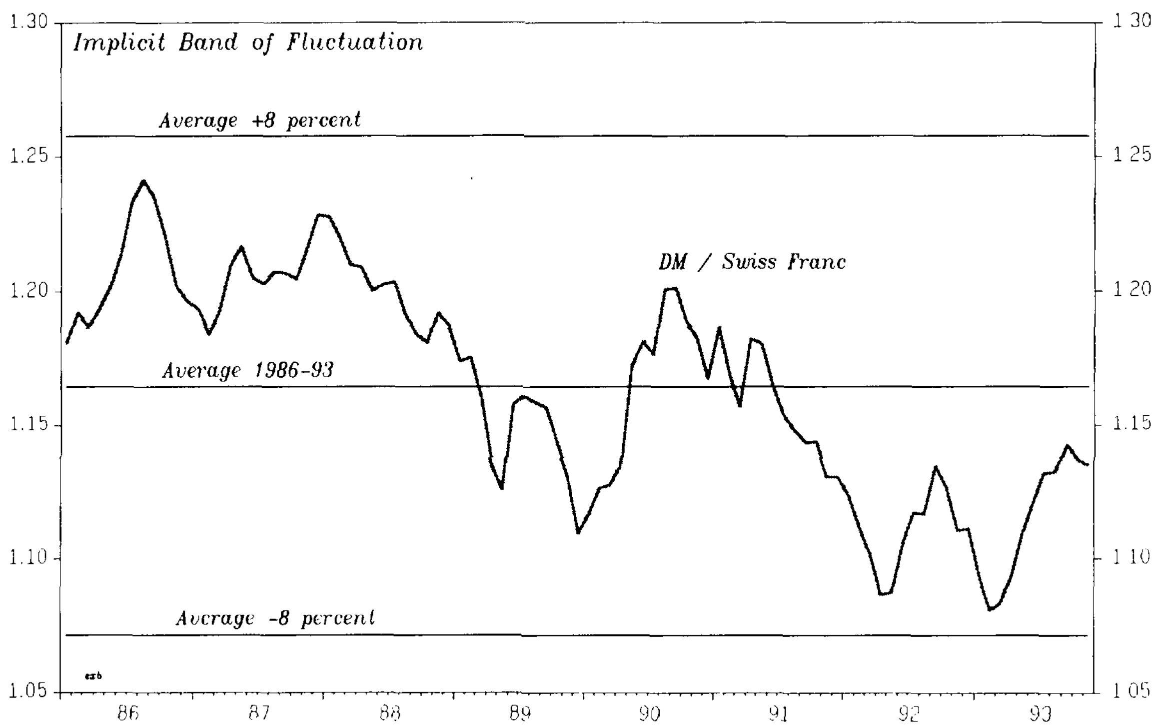
Source: IMF, International Financial Statistics database.

1/ 3-month deposit rates.

2/ Weighted average of long term government bond yields.

CHART 6
Switzerland
Exchange Rates





Source: IMF, International Financial Statistics database.
1/ 1977 = 100. Based on relative consumer prices.

government finances were only one third of general government, the authorities believed that there was little room for active countercyclical measures. The government also intended to contain the share of the public sector in the economy in order to avoid adverse effects on incentives.

Although fiscal policy had been expansionary at all levels of government since the recession began in 1991, there had been no conscious decision to adopt stimulative measures. Rather, expenditure had been allowed to drift upward, and some new programs had been introduced in the areas of social security, foreign relations, and transport. As a result, the structural deficit of the general government had increased in 1992-93 and, despite the recession, the authorities had decided to adopt a number of consolidation measures, notably the increase in the gasoline tax that went into effect in March 1993.

The authorities expected that the general government deficit would reach more than 4 percent of GDP in 1993, a level that was uncomfortable but not unmanageable, as the ratio of debt to GDP was, at about 40 percent, still relatively low. The deficit of the federal government was expected to increase to about Sw F 7 1/2 billion (2 1/4 percent of GDP), compared with Sw F 3.45 billion in the budget. The 1993 federal budget had assumed that nominal GDP would increase by 5 percent and real GDP by 1 1/2 percent; both figures would now need to be revised downward by at least 2 percentage points. Revenues would consequently be about Sw F 3 billion lower than budgeted, while expenditure would be perhaps Sw F 1 1/2 billion higher, largely as a result of increased borrowing on behalf of the unemployment insurance fund. Although the gross debt of the federal government was expected to increase to almost 19 percent of GDP by the end of 1993, the government's financial assets were considerable, leaving a net debt of only 13 percent of GDP.

With regard to the 1994 federal budget, the authorities noted that there was considerable public debate on whether consolidation measures ought to be postponed in light of the anticipated fragility of economic recovery, or whether early action should be taken to reduce fiscal deficits. In the event, the draft budget submitted to parliament in October proposed a federal deficit of about Sw F 7 billion (2 percent of GDP), implying little change in the fiscal stance. This draft envisaged an increase in expenditure by about 5 percent and in revenue of almost 9 percent, assuming nominal and real GDP growth of 3 1/2 percent and 1 percent, respectively. In the course of the parliamentary discussions, revenue projections have been revised downward by 0.2 percent of GDP and expenditure has been reduced commensurately.

Precise information on the fiscal policy intentions in 1994 of lower levels of government was not yet available. It was noted that the cantons were largely autonomous in their fiscal policy decisions; in particular, the federal government had no power to restrict their borrowing. Nevertheless, the authorities anticipated that fiscal policies at the cantonal and local levels would remain conservative. Some cantons had of their own accord adopted legal limits on borrowing and provisions mandating automatic tax increases to finance emerging deficits. As tax increases were unpopular and could in most cases not pass a popular referendum, these cantonal governments faced considerable pressure to reduce spending.

In the medium term, the federal deficit was expected to persist at a level of about 2 1/4 percent of GDP in the absence of new measures, implying an increase in the structural deficit as the output gap narrowed. This outlook reflected the relatively low elasticity of the tax system (somewhat below unity) and increases in expenditure, especially entitlement outlays, on the basis of existing legislation. Expenditure measures already proposed in connection with the 1994 budget would reduce the deficit by 0.4 percent of GDP by 1997. The approval of the introduction of a value added tax in the November 1993 referendum will reduce the deficit by a further 0.4 percent of GDP. The authorities maintained that these policy changes would be sufficient to forestall additional increases in the structural deficit.

The staff supported the authorities' medium-term target of achieving budget balance over the cycle. However, the staff noted that the structural component of the fiscal deficits could well be greater than estimated by the authorities, and that it was likely to grow further as interest payments on the public debt increased. Consolidation measures beyond those currently envisaged by the authorities would therefore be necessary if the official target was to be achieved. In light of the uncertain growth outlook for 1994, it would be desirable to undertake the bulk of this adjustment in 1995 and 1996. Nevertheless, the long lead time involved in changing the course of fiscal policy in Switzerland's system of direct democracy made it advisable to establish a firm legal basis for the needed consolidation measures as early as possible. In this regard, the staff also encouraged the authorities to work closely with lower levels of government on a new system of revenue and burden sharing. Under the current system, a considerable portion of the funds transferred to cantonal and local governments were earmarked for specific purposes, limiting the ability of those levels to control and contain their expenditure.

The staff also noted that any fiscal consolidation program would need to make allowance for unfunded and contingent future obligations and for risks to the economic outlook. In the short-term, the principal risk was that the recovery might be delayed or substantially weaker than anticipated. If the economic downturn were sufficiently protracted, it might even prove necessary to assume a lower level and growth rate for potential output, implying an increase in the portion of the deficit to be considered as structural. Looking further ahead, trade liberalization under the GATT would most likely necessitate further restructuring of the agricultural sector, with a shift from market intervention to direct income support. This might cost 1 percent of GDP or more. Finally, in the longer term, there was a need for measures to cover the unfunded liabilities of the public pension funds. Although these funds were more highly capitalized than in many other countries, the expected present value of their expenditure was greater than that of their receipts on current policies.

According to staff calculations, the structural deficit of the general government will persist in the medium term principally due to increased interest payments, and the debt ratio will continuously increase from its presently modest level. If the recovery were postponed a further year, the staff estimate that the effect would be to raise the deficit of the federal government by about 1/2 percent of GDP in the medium term. The structural deficit would also increase somewhat, again reflecting higher interest payments. 1/

2. Monetary policy

The authorities explained that monetary conditions had been gradually eased since the middle of 1992, allowing the 3-month market interest rate to decline from about 9 1/4 percent in June 1992 to 4 1/2 percent in October 1993. Scope for this easing was provided by a lessening of inflationary pressures, and the continuing slow growth in the monetary target. The decline in interest rates elsewhere in Europe, and the strengthening of the Swiss franc in mid- to late-1992 were also considered helpful. Inflation had been on a downward trend for well over a year and would continue to subside in 1994, although it was not yet expected to reach the National Bank's target of 1 percent. As the economy recovered, it was also expected that the monetary base would return to the target path.

The authorities did not see much room in the near future for further reductions in official short-term interest rates. Monetary policy would need to proceed cautiously in order to maintain the credibility acquired in the course of decades and which had already been placed somewhat at risk by the inadvertent loosening of monetary policy in 1988. 2/ Although inflation was still higher than its target, it was not expected to be a major concern in the immediate future; the authorities believed that on present policies their target would be reached in the medium term. In their view, reducing short-term rates much below their current level might signal to markets that the National Bank was targeting activity rather than inflation. Such a perception could lead to a resurgence of inflationary expectations and higher inflation in the medium term, and adversely affect the stability of the exchange rate. A further danger was an increase in Swiss long-term real interest rates, which had for many years been substantially lower than elsewhere in Europe. It was all the more necessary to guard against this risk in light of the sharp increase in public sector borrowing since 1992.

1/ Details of the fiscal scenarios are given in Chapter III of the paper on Economic Developments and Issues.

2/ For a full discussion of the conduct of monetary policy and its credibility, see Chapter IV of the paper on Economic Developments and Issues.

The staff welcomed the progress that had already been made in reducing inflation and noted that the easing of monetary policy since mid-1992 had been appropriate. They also noted the high degree of credibility Swiss National Bank policies had achieved by keeping inflation low over the longer term, a success that had contributed to relatively low interest rates, on average the lowest in Europe. Nevertheless, with a basically flat yield curve at present and little risk of renewed inflationary pressures, there appeared to be some scope for a further relaxation of monetary policy without jeopardizing the medium-term target for inflation. Monetary conditions elsewhere in Europe were also expected to ease. This should allow Swiss rates to decline without entailing a depreciation of the exchange rate.

The authorities agreed that the outlook for inflation in 1994 was largely favorable. Nonetheless, increases in administered prices and the introduction of the VAT at the beginning of 1995 might keep the headline rate relatively high. If monetary conditions elsewhere in Europe were allowed to ease more than was justified by lingering inflationary pressures, the Swiss National Bank would be faced with the difficult task of deciding whether to follow foreign interest rates down or allowing the exchange rate to appreciate, at a time when the recovery had not yet firmed. This tendency of the exchange rate to rise could be accentuated by the large current account surplus.

On the conduct of monetary policy, the authorities pointed out that Switzerland had used targets for the monetary base since 1980. Although these were first explicitly set for the medium term in 1990, a medium term outlook had always been at the foundation of the earlier, annual, targets. In the shorter term monetary policy was conducted with a degree of pragmatism, taking into consideration developments in other variables, notably interest rates in Switzerland and abroad, other monetary aggregates, and the exchange rate.

In the view of the authorities, monetary targeting reinforced the credibility of the National Bank's commitment to price stability. This in turn accounted for the stability of the exchange rate between the Swiss franc and countries similarly dedicated to maintaining low inflation in the longer term (Chart 6). The Swiss experience suggested that countries elsewhere in Europe now seeking to acquire a reputation for stability would need to successfully pursue an independent anti-inflationary policy for a considerable time, perhaps for as much as a decade. In the authorities' view, a sustained commitment of this kind was more important to establishing credibility than a hard-currency policy.

The choice of central bank money as the target variable and nominal anchor was motivated by its stability, direct controllability, and the timely availability of data. The use of central bank money allowed the National Bank to integrate the short-term management of bank liquidity with its medium-term target. The National Bank was watching closely for any signs of renewed instability in this aggregate that might be caused by financial innovation. Further problems in judging the stance of monetary policy similar to what occurred in 1987-88 were thus highly unlikely. 1/

The authorities noted that the main component of central bank money--banknotes in circulation--had remained stable despite the institutional changes (Chart 7). Reserves, which now accounted for only 10 percent of the aggregate, had stabilized in the course of 1989. This had prompted the National Bank to choose the fourth quarter of that year as the base for its current medium-term target. 2/

The staff concurred that the stability of demand for central bank money had apparently been re-established. Nevertheless, they expressed some doubts about conducting monetary policy on the basis of such a narrow aggregate. Even though an unusually large proportion of transactions were made in cash in Switzerland, the transmission of monetary policy affected a wider range of monetary variables. In particular, the close substitutability of banknotes in M0 and transactions accounts in M1 made the case for M0 difficult to understand. More generally, as financial innovation proceeded and substitutes for cash became increasingly important, the relationship between the M0 and economic activity was likely to shift. 3/

3. Structural issues

The authorities emphasized that Switzerland would need to rely on structural reforms and a liberal trade policy to strengthen conditions for growth in the medium term. Joining the European Economic Area (EEA) was seen as an opportunity to remove structural rigidities and expand trade. Following the rejection of the EEA agreement in the referendum of December 1992, the government had decided unilaterally to adopt most of the relevant structural reforms. Discussions took place under three broad headings; the "revitalization program," labor market issues, and trade policy.

a. The "revitalization program"

The "revitalization program" announced in early 1993 would strengthen competition by more vigorously combating cartels and anti-competitive practices, which are now widespread. It would strengthen the "internal

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1/ Chapter IV of the paper on Economic Developments and Issues provides further details.

2/ The target calls for a rate of increase in central bank money by 1 percent per year on average, over a three- to five-year period. The decision to set the fourth quarter of 1989 as the base period was announced at the end of 1992. The 1 percent average growth target for central bank money is based on an inflation target of 1 percent, and assumes growth in potential output of 2 percent and a trend increase in velocity of 2 percent.

3/ Indeed, the authorities acknowledged that the introduction and intensive use of electronic point of sale facilities had already affected this relationship.

market" in Switzerland by eliminating regulatory barriers to trade and improving labor mobility among the cantons, for example by opening up locally segmented markets for public procurement, setting uniform standards for the introduction of new products and services, and by assuring mutual recognition of professional and small business licenses. The program would also reorient immigration policy by facilitating the entry of highly skilled workers.

The staff welcomed this program, which would help Swiss producers to compete more effectively in the wider European market and would benefit consumers by leading to greater competition and lower prices. Unlike many other countries, there was little public ownership of industry and only limited protection was offered to declining industries through subsidies and trade restrictions. Nevertheless, serious structural rigidities remained in a number of areas, most notably in agriculture, the labor market, and the tertiary sector. 1/

The staff noted that the level of agricultural support remained among the highest in Europe and relied largely on border measures and price supports. As a result, food prices in Switzerland were about twice as high as in the EC. The authorities replied that progress had begun to be made in reducing trade and other market distortions by cutting support prices for some agricultural products while placing greater emphasis on direct payments to agricultural producers. They stressed that pressure for further cutbacks in support prices would be greatly increased if the GATT negotiations were successfully concluded before the end of 1993. Although some reduction in the overall level of agricultural support was desirable, if only for budgetary reasons, it would prove difficult to implement.

b. Unemployment and labor market issues

The authorities observed that in the past, unemployment had been masked by the tendency of women and foreign workers to withdraw from the labor force when the demand for labor declined. Over the 1980s, as more foreign workers attained permanent resident status and the labor force participation of women rose, labor supply became less responsive to cyclical downturns. At the same time, more comprehensive and generous unemployment benefits provided a greater incentive to register as unemployed. As a result of these changes, frictional and cyclical unemployment had become visible. Nevertheless, the Swiss labor market was relatively flexible. Wage setting was largely a competitive process, and wages responded to changes in labor demand.

The staff suggested that the sharp increase in the number of unemployed might indicate the emergence of some structural unemployment, although its extent was admittedly difficult to gauge. In the event, a number of

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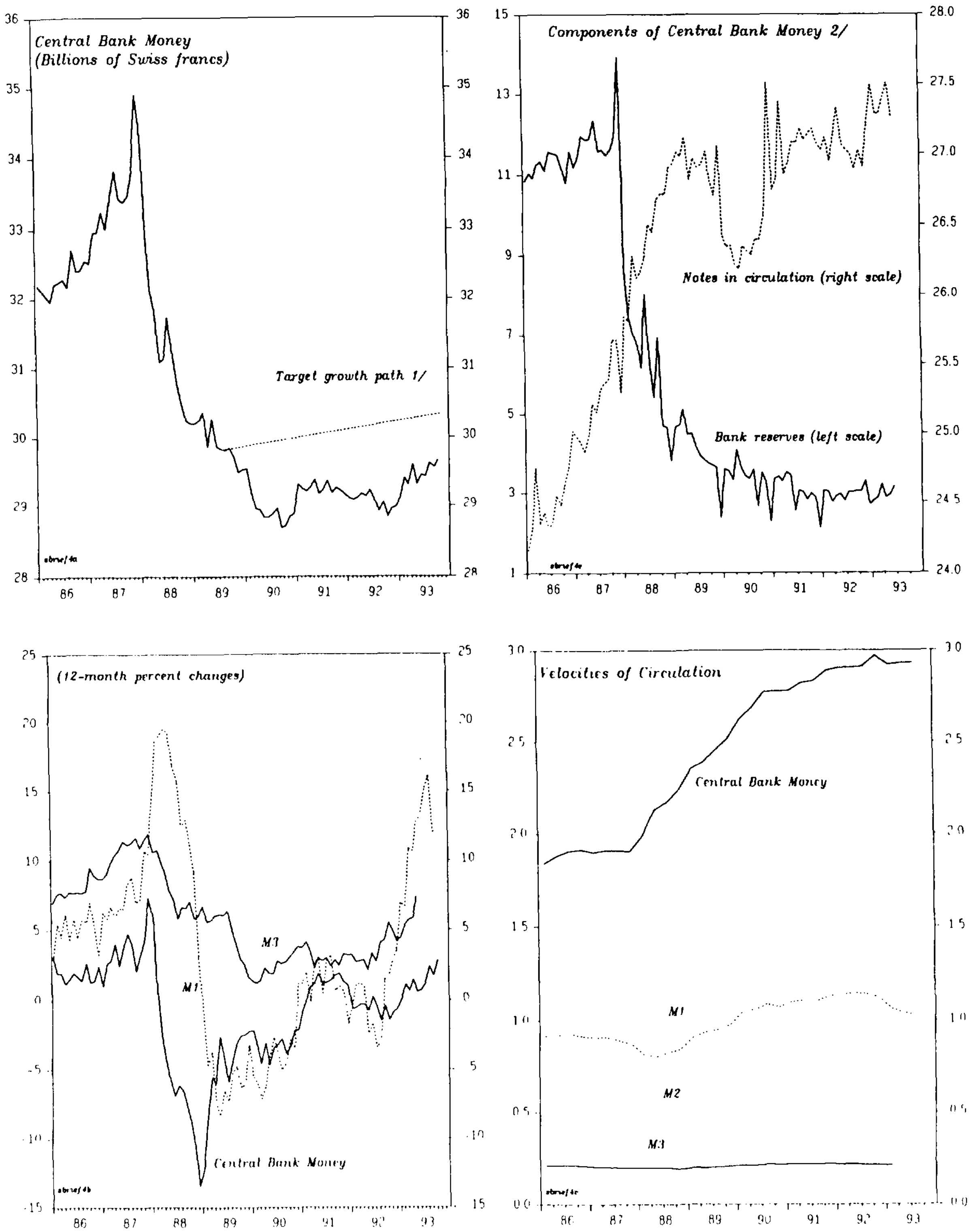
1/ Chapter V of the paper on Economic Developments and Issues provides further detail.

CHART 7
Switzerland
Monetary Aggregates



Sources: IMF, World Economic Outlook database; Swiss National Bank, Monthly Bulletin.
1/ One percent per annum from the 1989, fourth quarter.
2/ Seasonally adjusted; in billions of Swiss francs.

rigidities in the Swiss labor market impeded the efficient allocation of labor. First, unemployment benefits were high relative to other countries and did not decrease over the payment period. Second, relatively few resources were now allocated to active labor market policies such as retraining programs for the unemployed. Third, labor mobility would be facilitated by improving the transferability of pensions and reducing regulation in the rental housing market.

The authorities agreed on the need to adopt more active labor market policies and to reform the unemployment insurance system. However, lifting rent controls was politically difficult and would do little to increase labor mobility, as it was feasible to commute to most areas of the country.

c. Trade policy

On trade policy, the authorities actively supported a successful conclusion of the Uruguay Round. A well-functioning multilateral trade system was of great importance to a small open economy like Switzerland that did not belong to one of the major trading blocks. Although Switzerland was prepared to reform its support system for agriculture to reduce trade distortions, it agreed with at least one member of the EC on the need for greater reciprocity in this area.

The authorities noted that Switzerland had concluded trade agreements with a number of countries in transition in central and eastern Europe. Switzerland was unique among western European countries in providing duty-free access for all industrial products. Some restrictions were maintained, however, on processed agricultural products and on ferrous waste and scrap.

Finally, the authorities expressed the hope that bilateral negotiations with the EC in areas such as air and road transport, education, and rules of origin, where Switzerland was currently at a disadvantage relative to members of the EEA, would be brought to a mutually beneficial conclusion.

4. Official development assistance

Disbursements of official development assistance amounted to US$ 1.1 billion in 1992, or 0.46 percent of GDP, a temporary increase of almost 50 percent over 1990 and 1991. This largely reflected Switzerland's first contribution to the World Bank group. In 1993, official development assistance is expected to amount to only 0.31 percent of GDP, less than the 1990 level and below the OECD average.

V. Staff Appraisal

The first Article IV consultation finds Switzerland in unaccustomed economic difficulties. Following economic performance during most of the 1980s that ranked among the best in Europe, with high and growing per capita income, low inflation, small fiscal deficits, and virtually zero unemployment, the early 1990s have been marked by higher inflation, a protracted recession, the emergence of substantial fiscal deficits, and increasing unemployment. Although monetary policy has succeeded in bringing inflation under control, a weak external environment and numerous structural rigidities cloud the prospects for an early recovery in output and robust growth in the medium term.

Restoring stability to the fiscal accounts presents the greatest challenge. Although almost half of the present deficit is cyclical in origin, a continuation of current policies would result in a gradual increase of the structural deficit over the medium term. The measures that have already been announced or decided upon--introduction of the VAT and small expenditure cuts--may not be sufficient to counteract this tendency. The structural deficit would increase further if the economic recovery proves to be weaker than presently anticipated. Further determined action will therefore be required at all levels of government.

While Switzerland's past record of credible financial policies and a debt ratio that is still relatively low strengthen the case for allowing automatic stabilizers to operate fully in 1994, a detailed consolidation program sufficient to reduce the structural deficit of the general government by at least 2 percent of GDP in 1995-96 should be announced as soon as possible. This would enhance the credibility of fiscal policy and make it more likely that Switzerland will continue to enjoy lower long-term interest rates than other economies in Europe. The long lags involved in changing the stance of fiscal policy in Switzerland's system of direct democracy also argue for the early announcement of the necessary consolidation measures.

Aside from the inadvertent loosening of monetary policy in 1987-88, the Swiss National Bank has on the whole been successful in conducting an independent monetary policy and in keeping inflation low; this in turn has contributed to relatively low interest rates--indeed the lowest in Europe. The institutional changes in reserve requirements and in the payments system appear to have been absorbed by late 1989 and the stability of the demand for central bank money re-established. The greater emphasis now given to the medium-term framework for monetary policy, with its reliance on central bank money as the target and with the exchange rate also playing a significant role in the short run, is to be welcomed. In the future, the conduct of monetary policy may need to be guided by a wider range of indicators. While the demand for currency is apparently stable, such a narrow aggregate may not adequately capture the way monetary policy affects the economy. Financial innovation is in any event likely to diminish its reliability as an indicator of monetary policy.

The easing of monetary policy since mid-1992 has been appropriate, and has brought interest rates down considerably. However, prospects for recovery in 1994 are uncertain, as evidenced by a flat yield curve, and the output gap is likely to grow further. With both wage and price increases rapidly coming under control and little risk of renewed inflationary pressures, the staff believe that there is still some scope for a further easing of monetary conditions. Interest rates elsewhere in Europe are also expected to decline further, a development that should lessen the risk of a persistent depreciation of the exchange rate.

The authorities have taken notable steps to reduce structural rigidities in the economy. Among the most important are the proposed reform of the competition law, which will speed the breakup of the numerous cartels that still dominate many sectors, the unilateral adoption of EC legislation, which will help to counteract the adverse consequences of the rejection of the EEA agreement in December 1992, and the creation of an "internal market" in Switzerland, which will increase the mobility of products and factors within the country. These reforms will help Switzerland to benefit from an increasingly integrated European economy and more successfully face the challenges of greater global competition.

Nevertheless, there remains considerable scope for efficiency improvements in other sectors. In the labor market, there is a need to pursue a more active labor market policy and to improve work incentives by scaling back and phasing unemployment benefits. Regional labor mobility should also be fostered by phasing out rent control and improving the portability of pensions and other benefits. Potential efficiency gains in the railways and the telecommunications sector need to be vigorously pursued, possibly through privatization.

Switzerland is to be commended for its generally liberal trade policies. In particular, its support for a successful conclusion of the Uruguay Round is to be welcomed, as is the market access it has granted to the products of economies in transition. However, the staff notes with regret that there has been little progress so far towards reducing severe trade distortions in the area of agriculture. Swiss agricultural producers are among the most highly protected in the world, a policy that is costly both to consumers and the public finances.

The staff encourages the Swiss authorities to increase official development assistance to their target level of 0.4 percent of GDP as a first step, and to augment it further as soon as possible.

The Executive Board has placed Switzerland on an annual consultation cycle. It is proposed that the next Article IV consultation be held within 12 months after the current one has been completed.

Switzerland: Basic Data

Area and population	
Total area	41,293 square kilometers
Total population (1992)	6.9 million
GNP per capita (1992)	$32,053

	1990	1991	1992 1/	1993 2/	1994 2/
			(Percentage changes at 1985 prices)		
Demand and supply					
Private consumption	1.5	1.5	-0.2	-0.3	1.3
Public consumption	4.7	1.5	0.5	1.1	1.2
Gross fixed investment	2.6	-2.5	-5.0	-3.4	0.2
Construction	1.9	-3.1	-2.3	-2.0	--
Machinery and equipment	3.7	-1.2	-9.6	-6.0	0.5
Total domestic demand	2.3	-0.5	-3.0	-1.1	2.0
Exports of goods and nonfactor services	3.0	-0.7	3.4	-0.5	1.8
Imports of goods and nonfactor services	2.9	-1.7	-3.8	-1.5	3.5
Foreign balance 3/	-0.1	0.5	3.2	0.5	-0.8
GDP	2.3	-0.0	-0.1	-0.7	1.2
Manufacturing output	2.7	0.5	-1.0	-2.1	1.2
Contribution to the growth of real domestic product 3/					
GDP	2.3	-0.0	-0.1	-0.7	1.2
Foreign balance	-0.1	0.5	3.2	0.5	-0.8
Total domestic demand	2.4	-0.5	-3.2	-1.2	2.0
Exports of goods and nonfactor services	1.2	-0.3	1.4	-0.2	0.8
Imports of goods and nonfactor services	1.4	-0.8	-1.8	-0.7	1.6
Private consumption	0.9	0.9	-0.1	-0.2	0.8
Gross fixed investment	0.8	-0.7	-1.5	-0.9	0.0
			(In millions)		
Employment and unemployment					
Labor force	3.6	3.6	3.6	3.6	3.6
Employment (percent change)	1.3	-0.1	-2.2	-2.8	0.1
Unemployed	0.0	0.0	0.1	0.2	0.2
(In percent of labor force)	0.5	1.1	2.6	5.1	5.3
			(Percentage changes)		
Prices and incomes					
GDP deflator	5.7	5.5	2.6	2.3	1.9
Consumer price index	5.4	5.8	4.0	3.4	2.3
Average hourly earnings (industry)	6.1	7.4	2.3	2.3	3.3
Unit labor costs (total economy)	6.4	7.4	3.4	1.4	1.4
Real disposable income 4/	2.9	2.4	-0.1	-0.4	0.6
Personal saving ratio	12.2	13.0	13.1	13.0	12.4

1/ Preliminary.
2/ Staff projections.
3/ Change as percent of previous year's GDP.
4/ Deflated by the national accounts deflator for private consumption.

Switzerland: Basic Data (continued)

	1990	1991	1992 1/	1993 2/	1994 2/
			(In billions of SwF)		
Public finances					
General Government					
Financial balance	-0.1	-5.9	-10.2	-15.8	-15.8
(In percent of GDP)	-0.0	-1.8	-3.0	-4.6	-4.4
Gross debt	100.1	110.5	124.3	143.7	163.1
(In percent of GDP)	31.9	33.4	36.6	41.7	45.9
Balance of payments					
Trade balance (f.o.b./f.o.b.)	-9.5	-8.0	-0.9	-0.1	-1.9
Services balance	24.8	26.4	27.1	29.0	29.8
Net private transfers	-3.0	-3.6	-4.2	-4.2	-4.5
Net official transfers	-0.2	-0.2	-0.2	-0.2	-0.4
Current account	12.0	14.6	21.9	24.5	23.1
(In percent of GDP)	3.8	4.4	6.5	7.1	6.5
			(Percentage changes in annual averages)		
Monetary data					
Central bank money	-3.4	1.3	-0.9	1.3 3/	...
Money (M1)	-4.2	1.2	0.1	9.1 3/	...
Broad money (M3)	2.4	3.0	3.6	...	...
Domestic credit	8.9	3.9	2.4	1.8 3/	
			(Period averages in percent)		
Interest rates					
Three month deposit rate	8.3	7.6	5.5	4.4 4/	...
Yield on government bonds	6.7	6.3	5.5	4.6 4/	...
			(Levels)		
Exchange rates					
SwF per US$ (end of period)	1.30	1.36	1.46	1.47 5/	...
SwF per US$ (annual average)	1.39	1.43	1.41	1.48 4/	...
Nominal effective rate (1972=100)	113.0	111.1	109.2	115.6 6/	...

Source: International Monetary Fund, World Economic Outlook database.

1/ Preliminary.
2/ Staff projections unless otherwise noted.
3/ First six months compared with same period a year ago.
4/ Average January-November.
5/ As of December 9, 1993.
6/ October 1993.

Switzerland: Fund Relations
(As of October 31, 1993)

I. Membership Status: Joined 5/29/92; Article VIII.

II. General Resources Account:	SDR Million	% Quota
Quota	2,470.40	100.0
Fund holdings of currency	1,873.04	75.8
Reserve position in Fund	597.36	24.2
Operational budget transfers (net)	32.80	

III. SDR Department:	SDR Million	% Allocation
Holdings	18.51	N/A

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: (SDR Million; based on existing use of resources and present holdings of SDRs): None

VII. Exchange Rate Arrangement:

The Swiss National Bank does not maintain margins in respect of exchange transactions. However, the Swiss National Bank has intervened when warranted by the circumstances. Switzerland's exchange system is free of restrictions on current international transactions. Switzerland continues to apply exchange restrictions vis-à-vis the Federal Republic of Yugoslavia (Serbia/Montenegro), which were notified to the Fund under Decision No. 144-(52/51) on 9/1/92.

VIII. Article IV Consultations:

Switzerland is on a 12-month consultation cycle.

IX. Technical Assistance: None

X. Resident Representatives: None