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Recent Economic Developments in
Switzerland: Annual Review

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Recent Economic Developments in Switzerland: Annual Review

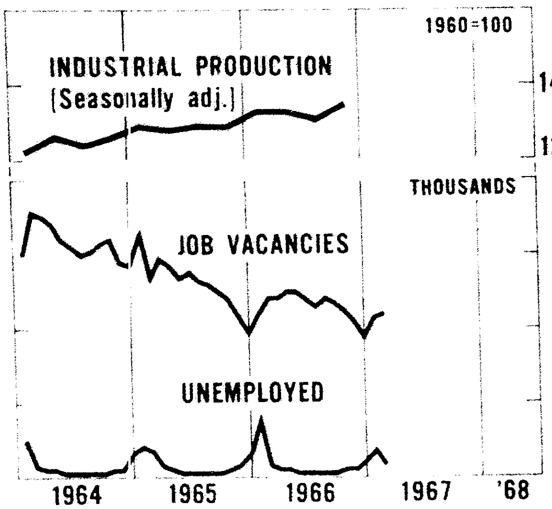
The Swiss economy grew only moderately in 1966--real GNP for the year as a whole advanced only 2.3 per cent over 1965, compared with 4.2 per cent in 1965 over 1964.[1/] But it continued to operate at a very high level, with no unemployment and only spotty unused plant capacity, which in some cases was caused by the shortage of labor rather than lack of demand. (See Chart and Table 1.) Reduced rates of expansion of demand--both domestic and foreign--were partly responsible for this slowdown in output. However, growth was also checked by official restrictions which curbed the availability of labor. These restraints even brought about an absolute decline in gross investment of 2 per cent. Public spending rose sharply, however, and a moderate rise in exports also took up some of the slack in domestic demand.

Consumer prices registered one of their sharpest increases this decade in 1966, reflecting a decline in agricultural subsidies, higher rents--resulting mostly from higher interest rates--higher import prices, and increased cost of services--reflecting rising wage rates. (See Table 1.) Wholesale prices, on the other hand, were stable. Wage rates--responding to tight labor market conditions--advanced over 5 per cent, an annual rate which has become typical of Switzerland in the sixties. (See Chart.)

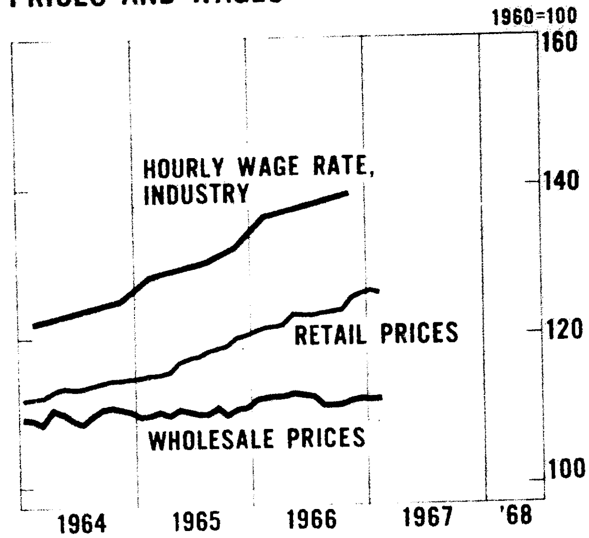
1/ For the previous review of Swiss economic developments see "Recent Economic Developments in Switzerland, December 1965 - May 1966," dated June 10, 1966.

SWITZERLAND: MAIN ECONOMIC INDICATORS

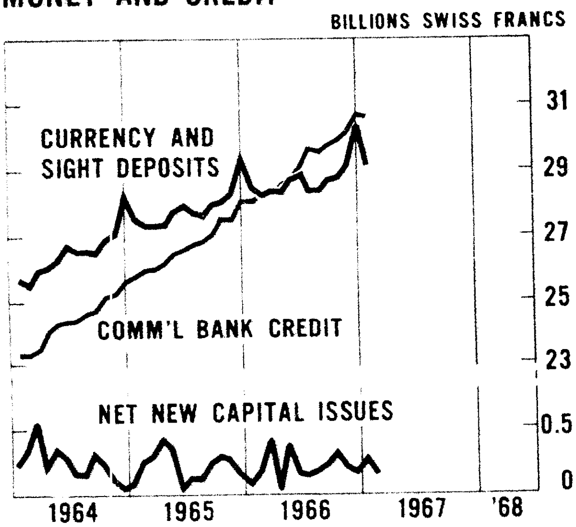
INDUSTRIAL PROD. AND UNEMPLOYMENT



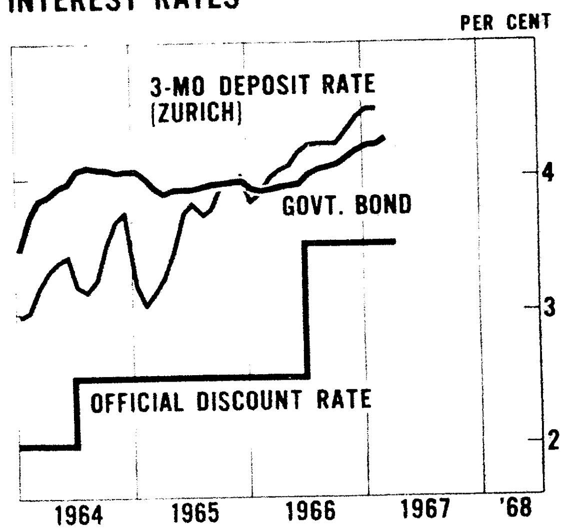
PRICES AND WAGES



MONEY AND CREDIT

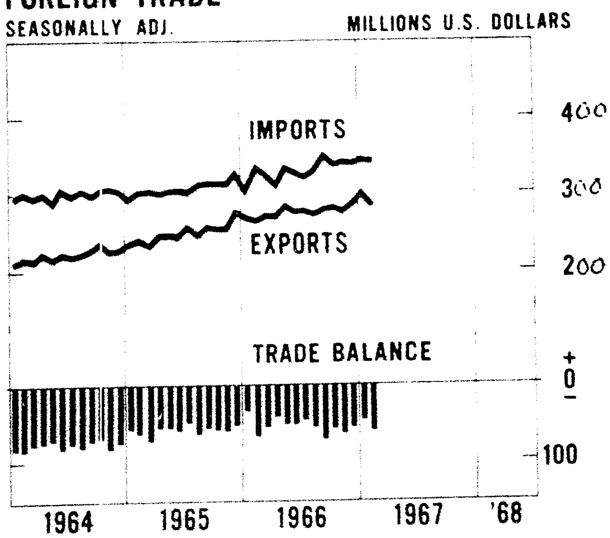


INTEREST RATES



FOREIGN TRADE

SEASONALLY ADJ.



FOREIGN EXCHANGE

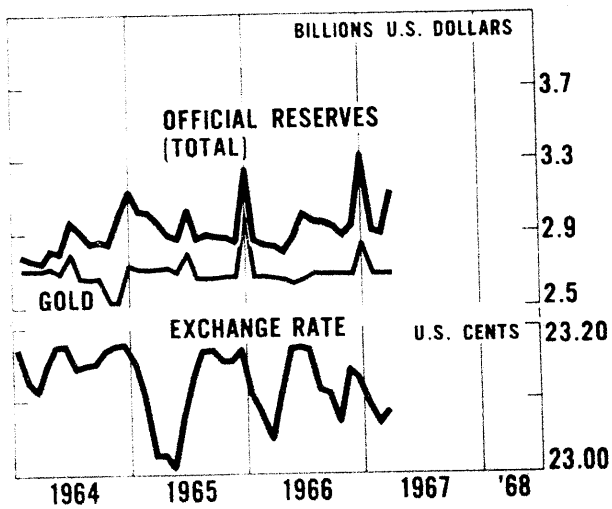


Table 1. Switzerland: Selected Economic Indicators

Annual Increases
(per cent per annum)

Year	Real GNP	Consumer Prices	Wholesale Prices	Wage Rates (industry)
1960	5.8	1.8	-.90	4.1
1961	7.3	3.5	2.00	5.0
1962	5.0	3.3	3.25	5.7
1963	4.6	3.8	4.19	6.2
1964	5.1	2.4	1.01	5.0
1965	4.2	4.9	.73	5.6
1966	2.3	4.6	.90	5.3

Source: OECD, Main Economic Indicators.

The demand for credit and capital was very heavy during 1966. In the capital market, the authorities modified the impact on interest rates by sharply restricting new issue flotations--keeping the volume of new capital raised through bond issues at roughly one-half that requested by borrowers. Even so, interest rates, under foreign as well as domestic pressure, rose to their highest levels since the twenties. Short-term deposit rates rose to 4.50 per cent, and yields on long-term government bonds to 4.31 per cent.

Although interest rates have not advanced further in 1967, they have not declined decisively as in other industrial countries. (See Chart.) This situation reflects the continuing advance in economic activity and the maintenance of monetary restrictiveness in order to minimize further price increases.

In the fourth quarter (1966), there was some renewal of expansion in the economy--centered around an upturn in industrial activity--but the vigorous expansionary trend that many observers were counting on had not yet materialized through May. At the turn of the year, order books in industry were relatively comfortable, and the inflow of new orders was about equal to deliveries. There are early indications that consumer demand might be more buoyant this year--retail sales appear to be expanding--but it looks as if overall investment, and especially private investment, will be dampened by continued credit stringency. Early 1967 trade figures do not give much clue to what exports might do this year, although trade circles are guardedly optimistic because of the way the very specialized Swiss exports held up last year in the face of a general weakening of import demand in other countries. (See Chart.)

The Swiss balance of payments was in equilibrium last year, as measured by official reserve changes, and is expected to continue in near balance this year (abstracting from flows of flight capital). In the absence of any international currency uncertainty, little net capital inflow is foreseen this year. Some observers feel, however, that the traditional Swiss deficit on current account may increase some from the estimated $70 million in 1966.

Economy less expansive in 1966

Economic activity in Switzerland registered its slowest rate of expansion this decade in 1966, although, operating at a very high level, there was little slack in the economy. (See Table 1.) Private domestic demand--consumer and investment together--showed little increase. Gross investment declined 2 per cent from 1965, the decline occuring almost entirely in industrial construction. Public spending, on the other hand, was especially buoyant and export demand held up well.

Industrial output for the year was slightly more than 3 per cent greater than 1965, about the same rate of advance as the previous year. Most of the increase occurred in the first and fourth quarters and was mainly the result of good performance in export-oriented industries. Output of chemicals and pharmaceuticals grew 19 per cent, and watch production, which also includes sophisticated timing and control mechanisms, advanced 14 per cent. In contrast, output in some other major industries--textiles and metal-processing in particular--actually declined.

The volume of new construction declined slightly in 1966 from the previous year (although in terms of market prices the value of new building was up slightly from 1965). Residential building--in terms of the number of new residences completed--was roughly equivalent to 1965. Industrial building projects declined. Construction of public buildings, on the other hand, reached a new peak and took up some of the slack capacity in the industry.

Labor productivity in industry continued to advance nicely, although investment in industry was slack. The 3 per cent increase in industrial output took place with a 2 per cent dip in industrial employment. However, as was pointed out in a recent Bulletin of the Swiss Credit Bank, "it is important to recognize that there are definite limitations on the extent that Switzerland can carry out automation in manufacturing because the economy is heavily dependent on its exports of high-quality, specialized production."

Wages and cost-of-living continue advance

The easing impact on labor conditions normally expected when the pace of economic activity slows has not occurred in Switzerland because the government has continued its policy of reducing the number of foreign workers. This program has resulted in a 10 per cent decline (about 72,000 individuals, mainly Italians) in the foreign labor contingent since 1964, and a further 2 per cent reduction during the first seven months of 1967 has been ordered. (These regulations apply generally to firms with more than 10 employees, except for certain industries where there is a critical need for skilled labor.)

Unemployment continues practically non-existent and, under these tight labor market conditions, negotiated wage rates in industry advanced over 5 per cent in 1966, compared with 5.6 per cent in 1965, and 5 per cent in 1964. This wage rate advance was an important factor through its effect on the cost of services in the 4.6 per cent increase in the consumer price index in 1966. Reduced food subsidies, rising rents, and higher fuel costs were also important in raising the cost of living. In contrast, the wholesale price index showed only a slight rise--reflecting equally increased prices in both domestic and imported items.

More recently, prices have continued to show an upward trend, and the outlook for better price-wage stability is not considered good over the near-term. Between October 1966 and March 1967 consumer prices rose about 2 per cent, although in February-March there was some levelling off of the index because of lower food prices.

<u>Interest rates rise sharply in 1966; credit conditions remain tight</u>

The higher cost and scarcity of financing was one of the most important factors moderating economic expansion in Switzerland in 1966. Swiss financial markets were under pressure throughout the year, reflecting the general world-wide stringency in credit conditions as well as heavy domestic demand for credit. Interest rates in all market sectors climbed to their highest levels since the early twenties, and there has been little indication so far in 1967 that they will recede very much in the near future. (See Table 2.)

Table 2. Switzerland: Selected Financial Indicators

	1966 Jan.	1966 March	1966 June	1966 Sept.	1966 Dec.	1967 Jan.	1967 March	1967 Apr.
Money supply[a/] (billions SF, seas. adj.)	28.43	28.49	28.77	28.93	29.50	29.17	29.37[c/]	---
Com'l bank credit[a/] (billions SF)	28.03	28.28	29.09	29.75	30.65	30.61	30.66[c/]	---
Interest rates[b/]								
3-month yields:								
Zurich banks	3.81	4.00	4.19	4.25	4.50	4.50	4.50	4.25
Euro-dollars	4.44	5.21	6.12	6.25	6.12	4.87	4.98	4.81
Deposit certificates (3 to 8 years)								
12 cantonal banks	4.36	4.36	4.36	4.61	4.61	4.86	4.86	4.86
5 large banks	4.39	4.39	4.39	4.64	4.64	4.88	4.88	4.88
Long-term govt. bonds	3.90	3.92	3.95	4.08	4.23	4.23	4.31	4.29
Stock prices[b/] (1958=100)	242	234	220	198	187	198	211	215

a/ End-of-month figures.
b/ Last Friday of month.
c/ February.

The increase in commercial bank credit in 1966 was kept to just over 9 per cent by the credit control ceilings. In contrast, money supply rose only 2.5 per cent, reflecting not only the slowdown in the pace of economic activity but, more importantly, the increased attractiveness of holding other forms of liquid assets.

Money market rates increased steadily in the first half of 1966, levelled off, and then rose sharply in the final quarter. By the end of the year, the Zurich three-month deposit rate was 4.50 per cent, up from 3.81 per cent twelve months earlier. Several factors worked to reduce domestic liquidity during the first half of the year: A greater-than-seasonal loss in official reserves reduced the resources of the commercial banking system and was only slightly offset by the central bank. Less credit availability in foreign markets and the demand from U.S. firms for foreign credits in line with the U.S. balance-of-payments program increased the demand for Swiss loanable funds. Also, the domestic demand for credit was unusually robust.

In the fall, funds were attracted to foreign money centers by the rising yields there. This factor, together with the loss of speculative funds as the position of sterling turned for the better, put pressure on domestic bank liquidity. At about the same time, a spurt of industrial activity increased the domestic demand for credit. Finally, the inability of public authorities to raise needed funds in the capital market to finance projects that were already under way led them to shift to short-term bank financing. The extent of the strain on the banking system was reflected in the unprecedented volume of domestic currency resources drawn from the central bank in December--mainly through its foreign currency swap arrangements with the commercial banks--when the currency drain on banks and their need for year-end window-dressing funds were at a peak.1/

1/ During the last few years, the foreign currency swap arrangement with commercial banks--i.e., providing the banks with Swiss francs against foreign currencies and agreeing to reverse the operation at a future date at a guaranteed rate--has become the Swiss National Bank's major instrument of supplying bank liquidity at times of stringency. Until recently this arrangement has been reserved for year-end periods of stringency. Other means available to the Swiss central bank to provide the banking system with funds are (1) normal discounting arrangements and (2) the purchase of special Confederation notes. These instruments, usually used first when the need to provide commercial banks with funds arises, however, have limited potential because of the small volume of assets available for operations. On the other hand, the major Swiss money market banks have vast foreign currency resources, giving foreign currency swap operations a large potential.

The domestic demand for credit has remained strong so far in 1967, and the Swiss money market has received little benefit from falling foreign interest rates since, even at lower levels, foreign rates are still above Swiss rates. Switzerland is the only major financial center where interest rates have not yet moved decisively lower this year.

In mid-April, however, there were signs of possible easing, reflecting in part assistance from the central bank. Foreign currency swaps were again made available to the banks at the end of March--in the past these swaps have been used only at year-end--and in late April the National Bank released sizable amounts of funds to the commercial banks from blocked accounts. (These blocked accounts, amounting to SF 1,035 million, were established in 1961 to sterilize some of the heavy flow of funds into Switzerland arising out of the international currency uncertainty at the time.)

In the long-term capital market, the authorities moderated the impact of heavy demand by limiting the total volume of funds raised in 1966 to about the same level as the previous year. To slow rising interest rates, new issue quotas were reduced successively each quarter--limiting the total volume of funds raised to about one-half of the total volume reportedly applied for. Also to moderate interest rate pressures, the National Bank supported the government bond market until mid-year; after this support was lifted, yields on long-term government bonds rose from 3.95 per cent in June (1966) to 4.31 per cent in March (1967).

Strong demand for long-term financing continued in the first quarter this year and kept yields firm at their higher level. The total of public and privately placed loans in January-March (1967) was SF 1,052 million, compared to SF 855 million in the same period of 1966. Most issues have been easily marketed although most have been made more attractive by an increase in coupon rates. More recently investor interest has been shifting increasingly to long-term securities, indicating an expectation that interest rates in Switzerland have probably peaked out and will edge downward.

External position stable

Switzerland's overall foreign payments were virtually balanced in 1966. Although estimates for the Swiss current account, the only part of the Swiss balance of payments for which data are produced, are not yet available for the year, it is believed that the balance will be somewhat improved from the slight $70 million deficit of 1965.

The Swiss foreign trade position improved last year as exports grew faster than imports. The foreign trade deficit was $651 million, down from $714 million in 1965, and the lowest deficit since 1960.

Exports grew 10.4 per cent in 1966, compared to a 12 per cent increase in 1965. The sharpest increase occurred in shipments to the Western Hemisphere (+21 per cent), particularly the United States and Canada. Exports to Asia increased 11 per cent and to EFTA trading partners, almost 10 per cent. Sales to EEC countries were fairly weak, increasing slightly more than 5 per cent.

Reduced internal demand had its impact entirely on domestic production and did not dampen Swiss demand for foreign products. Imports advanced almost 7 per cent in 1966, compared to 2.5 per cent in 1965, reflecting an across-the-board demand increase in all import categories.

The Swiss National Bank's (BNS) reserves of gold and foreign exchange reflected the relative equilibrium in the country's capital accounts in 1966. From January 1966 to January 1967 official reserves increased only $52 million.

In the February-April period (1967) the usual seasonal drain on official Swiss reserves was slightly greater than in 1966 and amounted to $72 million. However, in May and the first week of June large flows of flight capital to Swiss banks in response to, first, political tensions and then war in the Middle East led to large scale official intervention in the foreign exchange market. The BNS' reserves increased $403 million during the period.

Economic policy

Because of the more moderate pace of economic expansion and recognizing that interest rates at their higher levels are having a greater restraining effect than three years ago, the Swiss

National Bank has dismantled the last of its program of legally enforceable monetary controls adopted early in 1964 and has taken a more neutral policy stance.[1/]

On March 17 this year the last vestiges of the controls on foreign money inflows were abolished--the prohibition against banks paying interest on foreign deposits and the requirement that banks receiving net inflows of foreign-owned funds must pay them into a frozen account at the central bank. (Previously these restrictions on foreign money inflows--which virtually eliminated any net inflow of foreign-owned funds--had been modified in various stages throughout 1966 in face of changing economic and financial conditions.) At the end of 1966 the central bank's mandatory credit ceilings were allowed to lapse. However, in view of the continued heavy demand for credit, which the authorities felt could generate inflationary pressures and cause further disruption in the Swiss interest rate structure, these mandatory ceilings were replaced with a voluntary credit restraint program which takes the form of guidelines, rather than ceilings, and will be administered by the

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1/ In an effort to restrain the inflationary pressures which were threatening to get out of hand in the spring of 1964, Swiss Federal authorities submitted to Parliament and got approval for a four-point emergency anti-inflationary program. (This program was later approved by a popular referendum for extension through March 1967 at the government's discretion.) Under this program (1) new restrictions were placed on all types of construction; (2) domestic capital issues were placed under the control of a capital issues committee; (3) mandatory ceilings were clamped on bank credit; and (4) comprehensive, legally enforceable controls were placed on the inflow of new foreign funds.

Swiss Bankers' Association, rather than the central bank. These guidelines limit credit expansion to 7 per cent, slightly less than that which actually occurred in 1966.

The Capital Issues Committee which was operated by the central bank under the old Credit Decree was also abolished at the end of 1966 and replaced by a voluntary program, again administered by the Swiss Bankers' Association. This program will continue to limit new bond flotations on a quarterly basis but will be less restrictive in that only issues valued at more than SF 8 million require approval compared with the former ceiling of SF 5 million.

In the realm of fiscal policy, the Federal authorities are also attempting to be as neutral as possible. When it became apparent that the 1967 Federal budget deficit would be the largest since 1945 because of lower receipts from the biennial Federal defense tax, the Federal Council trimmed proposed spending sharply. (See Table 3.) Budgeted expenditures for 1967 are up only 2.5 per cent from 1966 expenditures, which were cut SF 185 million from budgeted amounts in an attempt to reduce the inflationary pressures of government spending.

The Swiss Federal government is faced with a major revenue problem because of its dependence on import duties. Receipts from import duties will amount to roughly 40 per cent of the projected revenues in the 1967 budget. Since duties are being lowered, this

Table 3. Switzerland: Surpluses and Deficits in Public Agency Spending a/
(millions SF)

	Confederation	Cantons	25 largest cities	Total
1960	715	54	n.a.	---
1961	139	138	n.a.	---
1962	432	106	n.a.	---
1963	126	56	18	200
1964	420	-17	13	416
1965	31	-65	16	-18
1966	5	-160c/	-8b/d/	-163
1967b/	-412	-152e/	-8d/	-572

\+ Surplus.
\- Deficit.

a/ Balance of actual receipts and expenditures in ordinary administrative budgets.
b/ Approved budgets only.
c/ Final accounts for all cantons except Basel-Stadt and Schaffhausen for which budget figures have been included because of unavailability of accounts.
d/ Twenty largest cities only.
e/ Does not include budgets for cantons of Schaffhausen and Geneva which have not yet been reported.

will become a declining source of Federal income. (It is estimated that abolition of duties among the EFTA countries on industrial products this year will cost the government SF 225 million in revenues.) Although the Federal Council has requested an increase in income and turnover tax rates, they are not expected to be approved by Parliament in time to help finance this year's deficit, which puts the Council in a dilemma. If they turn to the already tight capital market, it will only aggrevate conditions there;

and if they use some of the Confederation's sterilized resources--built up from past surpluses--it will add to the money supply.

Beyond this year, however, the problem of government finance at all levels will have to be tackled. Swiss public agencies have just recently moved from a period of surplus operation to one of deficit spending. (See Table 3.) New ways of raising funds will have to be provided, and the contest between the Confederation and cantonal and local governments over division of the country's tax potential is already warming up.