Accountability Report for the Federal Assembly

On 15 February 2006, the Governing Board of the Swiss National Bank submitted its 2005 Accountability Report to the Federal Assembly in accordance with art. 7 para. 2 of the National Bank Act of 3 October 2003. The following Accountability Report is provided to the Federal Council and the General Meeting of Shareholders for information purposes only, and does not require their approval.

Summary

In accordance with art. 7 para. 2 of the National Bank Act (NBA), the Swiss National Bank (SNB) submits an annual accountability report to the Federal Assembly in which it outlines how it has fulfilled its mandate. This report on the year 2005 is structured in line with art. 5 NBA, with a separate section devoted to each of the eight tasks listed there.

The SNB's main focus during the year under review was on monetary policy, investments and the distribution of the proceeds from the gold sales. Monetary policy remained expansionary because of the uncertainty about economic developments and the lack of any direct inflationary risk. However, the process of normalising the SNB's key interest rates, begun the previous year, was finally resumed. An accumulation of price and exchange rate movements – two parameters that normally move in opposite directions – gave rise to unusually large increases in the value of investments. The proceeds from the sale of gold no longer required for monetary purposes, amounting to CHF 21.1 billion, were distributed without affecting liquidity and without causing any disruption to the market. In all areas of its operations, the SNB consolidated the reforms initiated after the total revision of the NBA in the previous year.

(1) Monetary policy must serve the interests of the country as a whole. It must ensure price stability, while taking due account of economic developments. Monetary policy impacts on production and prices with a considerable time lag. Consequently, monetary policy is directed at future rather then current inflation. The monetary policy concept consists of three elements: the definition of price stability, a medium-term inflation forecast and an operational target range for the targeted money market rate.

Monetary policy

In the first half of the year, growth in the global economy was more modest and less steady than in the previous year. The substantial increase in commodity prices and the difficulties experienced by the large countries neighbouring Switzerland weighed on the economy. Later in the year, the economic impetus emanating from the US and Asia fed into the European economies, and they regained momentum. Incipient inflation gradually prompted less expansionary monetary policies.

Developments in Switzerland were similar. The initial weakness in the economy was due to falling exports, under-utilised capacity and general uncertainty. However, from the middle of the year, a recovery based on exports and construction became apparent. This boosted confidence and developed into a broad-based upswing that finally took in consumption, although little impetus was transmitted to employment. Prices remained steady, while capital yields were low and the value of the Swiss franc declined in step with the euro.

In December 2004, the National Bank suspended the normalisation of monetary policy commenced in the middle of that year. Interest rates remained extremely low and various monetary indicators showed that the course of monetary policy was clearly expansionary. However, the global economy remained unpredictable, while economic indicators for Europe and Switzerland were suggesting that the recovery would be weak. Moreover, recessionary second-round effects of the overheating in the oil market were just as possible as an inflationary impact. Consequently, caution was necessary, especially since no general inflationary pressure was evident despite the rise in oil prices. Towards the end of 2005, however, the upturn was clearly taking hold, and to some extent had even become established. The recovery became broader based and more sustained, and it was finally possible to raise the target interest rate range.

Liquidity supply

(2) Maintaining an adequate supply of liquidity to the money market goes hand in hand with the implementation of monetary policy. The NBA sets out the permissible central bank transactions, while the Guidelines on Monetary Policy Instruments specify the instruments and procedures, the eligible securities as well as the conditions for lending of last resort. The supply of money is ensured through a range of instruments, almost all of which are based on repo transactions. The new minimum reserve requirements applied from the beginning of 2005, while for liquidity-shortage financing, Lombard advances were available until the end of the year, alongside the new special-rate repo transactions.

Cash supply and distribution

(3) The National Bank holds the note-issuing privilege. Through the banks and postal service, it supplies the economy with banknotes and coins, the latter on behalf of the Confederation. In 2005, it again focused on maintaining the quality of banknotes and of cash transactions, on cash deposits held with third parties, on further developing security features and on precautionary measures to prevent counterfeiting. The development project for a new series of banknotes focused on the search for a suitable designer.

Payment systems

(4) In the area of cashless payments, the National Bank is mandated to facilitate and secure the functioning of the appropriate systems. It operates accounts for the banks, steers the SIC system for the settlement of interbank payments and oversees payment and securities settlement systems. In the year under review, the SNB's powers as the SIC steering body were extended and separated from its powers as the authority charged with the oversight of SIC. The National Bank specified the statutory minimum requirements for systemically important settlement systems.

Currency reserves

(5) The National Bank manages Switzerland's currency reserves. Its actions in this field are guided by the three criteria of security, liquidity and return. Guidelines laid down by the Governing Board define the investment principles and instruments, as well as the investment and risk control process. The SNB portfolio continued to focus on the most liquid currencies and markets, and on borrowers with the highest credit ratings. In the previous year, corporate bonds had been purchased for the first time and in the year under review, the investment universe was expanded to include foreign shares. Earnings were unusually high for all forms of investment, with gold and the dollar experiencing particularly strong value increases.

Financial system stability

(6) The National Bank is charged with helping to secure the stability of the financial system. This stability is both the result of and the condition for successful monetary policy and well-functioning financial markets. The SNB endeavours to identify risks at an early stage and to help create an environment conducive to stability through its monetary policy and other activities. In its Financial Stability Report, the SNB found the banking system and financial market infrastructure to be stable and well prepared to cope with disruptions. The National Bank helped to identify and initiate the implementation of measures for contingency planning and crisis management. It cooperated with domestic and foreign regulatory and supervisory authorities in various fields.

Monetary cooperation

(7) The National Bank participates in international monetary cooperation activities. Important bodies are the International Monetary Fund (IMF), the Group of Ten (G-10), the Bank for International Settlements (BIS) and the Organisation for Economic Cooperation and Development (OECD). The main activities of the IMF were surveillance of member states, crisis management, the financial problems of poorer countries and its own strategic direction. The interests of the G-10 included the impact of ageing on pensions and on financial markets. The BIS committees in which the SNB participates were concerned with banking supervision, payment transactions, the global financial system and financial markets. The National Bank's technical assistance focused on the countries that belong to its IMF constituency and involved the transfer of central bank knowledge alone.

Banker to the Confederation

(8) The National Bank provides the Swiss Confederation with banking services in the areas of payment transactions as well as liquidity and securities management. In the year under review, a new agreement with the Federal Finance Administration specified the details of services to be provided, as well as the remuneration for these services, as envisaged in the new NBA.

1 Monetary policy

Overview

The year 2005 was characterised by sluggish economic developments both in Switzerland and abroad. After a one-year interruption, the National Bank resumed the normalisation of its monetary policy, lifting its interest rates in December. Price stability was assured at all times.

Section 1.1 will discuss the legal basis underlying the National Bank's monetary policy, its mandate and its monetary policy strategy. Sections 1.2 and 1.3 will give an overview of economic developments abroad and in Switzerland. Section 1.4 will review the implementation of monetary policy in 2005 and the Governing Board's decisions in the context of the quarterly monetary policy assessments. Section 1.5 will describe the National Bank's statistical activities.

1.1 Monetary policy strategy

Constitutional and legal mandate

The Federal Constitution (FC) entrusts the National Bank, as an independent central bank, with the conduct of monetary policy in the interests of the country as a whole (art. 99 FC). The mandate is explained in greater detail in the National Bank Act (art. 5 para. 1), which requires the SNB to ensure price stability and, in so doing, to take due account of economic developments.

The National Bank is thus obliged to resolve as best as possible any conflicts arising between the objective of price stability and steady economic activity, while taking into consideration the interests of the country as a whole and giving priority to price stability. The requirement to act in the "interests of the country as a whole" indicates that the National Bank must gear its policy to the needs of the Swiss economy as a whole rather than to the interests of individual regions or industries.

Significance of price stability

Price stability contributes to economic growth. Stable prices are an important prerequisite for the smooth functioning of the economy. Both inflation and deflation disrupt decision-making by consumers and producers, and generate high social costs.

The National Bank's monetary policy aims at ensuring price stability in the medium and long term; in other words, it strives to prevent both sustained inflation and deflation. Short-term price fluctuations, by contrast, cannot be counteracted by monetary policy. By keeping prices stable, monetary policy creates an environment in which the economy can fully exploit its production potential.

To secure price stability, the National Bank must provide appropriate monetary conditions. If interest rates are too low for a lengthy period, the supply of money and credit to the economy is too high, thus triggering an inordinate demand for goods and services. Although this boosts production initially, bottlenecks occur in the course of time and economic capacity is stretched, thus causing prices to rise. By contrast, if interest rates are too high for a lengthy period, this reduces the supply of money and credit to the economy and consequently leads to a shortage of aggregate demand. This has a dampening effect on the prices of goods and services.

Economic activity duly considered

The economy is subject to numerous domestic and foreign influences. These cause fluctuations in the business cycle which generate, alleviate or increase the pressure on prices. Such fluctuations are inevitable, but although monetary policy takes a medium to long-term focus, it helps to reduce them. In this sense, the National Bank also takes economic activity into account when formulating its monetary policy.

The National Bank faces highly diverse situations. The most common cause of inflationary or deflationary phases is when aggregate demand for goods and services does not develop in line with the economy's production capacity. Such situations are caused, for example, by unforeseen fluctuations in the international economy, persistent exchange rate distortions, serious government budget problems or inappropriate money supply levels in the past. Inflationary pressures increase in phases of economic overheating and ease in phases in which production capacity is not fully utilised. The National Bank will thus tend to tighten monetary policy in the first case and ease it in the latter. Monetary policy that is geared to price stability has a corrective influence on aggregate demand and thus helps to smooth economic activity. The SNB's strategy must therefore aim at gradually restoring price stability.

The situation is more complex when prices rise owing to shocks that boost corporate costs and curb production. A continuous rise in the oil price is an example of such a shock. Under these circumstances, monetary policy must seek to ensure that the higher production costs do not result in an inflationary process, nor excessively disadvantage the companies affected by the shocks. A strategy aimed at the rapid restoration of price stability might have an adverse effect on the business cycle and employment.

Even though the SNB takes economic developments into consideration when formulating its monetary policy, it cannot be expected to fine-tune them. There are too many uncertainties regarding the cause and duration of the shocks that impair economic performance, the transmission mechanisms, the delay, and the scale with which monetary policy impacts on the business cycle and prices.

Monetary policy concept

The National Bank needs indicators to determine whether or not its chosen monetary policy is appropriate for its price stability objective. It bases its decisions on a broad range of real and monetary indicators. The monetary policy concept in force since the beginning of 2000 consists of three elements: a definition of price stability, a medium-term inflation forecast and – on an operational level – a target range for a reference interest rate, the three-month Libor (London Interbank Offered Rate) for Swiss francs.

Definition of price stability

The National Bank equates price stability with a rise in the national consumer price index (CPI) of less than 2% per annum. In so doing, it takes account of the fact that not every price movement is necessarily inflationary. Furthermore, it believes that inflation cannot be measured accurately. Measurement problems arise, for example, when the quality of goods and services improves. Such changes are not properly accounted for in the CPI; as a result, inflation, as measured by the CPI, will be slightly overstated.

Quarterly publication of inflation forecast

Each quarter, the National Bank publishes a forecast on the development of inflation over the three subsequent years. The period of three years corresponds more or less to the time required for the transmission of monetary stimuli to the economy. Forecasts over such a long time horizon are, however, fraught with considerable uncertainties. By publishing a medium to long-term forecast, the National Bank emphasises the need to adopt a forward-looking stance and to react at an early stage to any inflationary or deflationary threats.

The National Bank's inflation forecast is based on a scenario for global economic developments and on the assumption that the Libor will remain constant over the entire forecasting period. The forecast thus maps the future development of prices based on a specific world economic scenario and an unchanged monetary policy stance in Switzerland. It cannot therefore be compared with projections by other institutions, which usually incorporate expected monetary policy responses.

Indicators of relevance to the inflation forecast

In the medium and long term, price developments depend decisively on the supply of money. The monetary aggregates thus play a primary role in the quantitative models used to forecast inflation over the next two to three years. For shorter-term inflation forecasts, other indicators – mainly relating to economic activity and exchange rates – are important.

The National Bank regularly issues statements on the development of the principal monetary policy indicators factored into its inflation forecast. Moreover, the SNB has set out details of the models it uses to predict inflation in several of its publications.

Review of monetary policy based on the inflation forecast

If the inflation forecast indicates a deviation from price stability, monetary policy needs to be adjusted. Should inflation threaten to exceed 2% permanently, the National Bank would consider tightening its monetary policy. Conversely, it would loosen the monetary reins if there were a danger of deflation. The National Bank does not, however, react mechanically to the inflation forecast. To determine the nature and scale of its response, it also takes account of the general economic situation.

If inflation temporarily exceeds the 2% ceiling in extraordinary circumstances, for example following a sudden massive rise in oil prices or in phases of strong exchange rate fluctuations, monetary policy does not necessarily need to be adjusted. The same applies to short-term deflationary pressures.

Target range for the three-month Libor

The National Bank implements its monetary policy by influencing the interest rate level in the money market. It fixes a target range for the three-month Libor, which is the most important interest rate for short-term Swiss franc investments, and publishes it regularly. As a rule, this target range extends over one percentage point and the SNB keeps the Libor in the middle of the range.

The SNB undertakes quarterly economic and monetary assessments at which it reviews its monetary policy. If circumstances so require, it also adjusts the target range for the three-month Libor between these quarterly assessments. It sets out the reasons for any changes in a press release issued on the day the decision is made.

1.2 International economic developments

Moderate global economic growth in 2005

After an exceptional year in 2004, global economic growth was less robust in 2005. While Asia's emerging economies and the United States retained their lead positions, growth in Continental Europe lagged behind. The international economy was characterised by asynchronous growth cycles and pronounced regional differences.

Global economic developments were subdued in the first half of 2005; this trend was reflected in the manufacturing industry and in demand for equipment goods, where a flattening off in activity was observed. This was attributable in part to the massive rise in commodity prices, with fossil fuels and metals being particularly affected. The global economic recovery firmed, however, in the second half of the year.

Commodity prices hit record highs

On the back of the dynamic global economy, particularly in Asia's emerging countries, the price of crude oil stiffened by more than 50% between January and August 2005; the barrel price climbed from USD 40 to roughly USD 65. With parts of the US's energy infrastructure destroyed by Hurricanes Katrina and Rita, refined products such as petrol and diesel experienced yet another price spike in September. Most raw materials, particularly metals such as steel and copper, also recorded major price rises at the beginning of the year. The price of most energy products retreated towards the end of the year to a level which, although still high, was comparable to the level observed in mid-2005.

Inflation rises and core inflation is moderate

The strength of consumer prices in 2005 can be largely explained by the fluctuations in oil prices. Annual inflation in the US rose from 3.0% in the first quarter of 2005 to 3.7% in the fourth quarter, making it the highest rate since 1991. Inflation in the euro area grew from 2.0% to 2.3% in the same period. The indirect impact of the rise in energy prices on other consumer prices remained moderate, however.

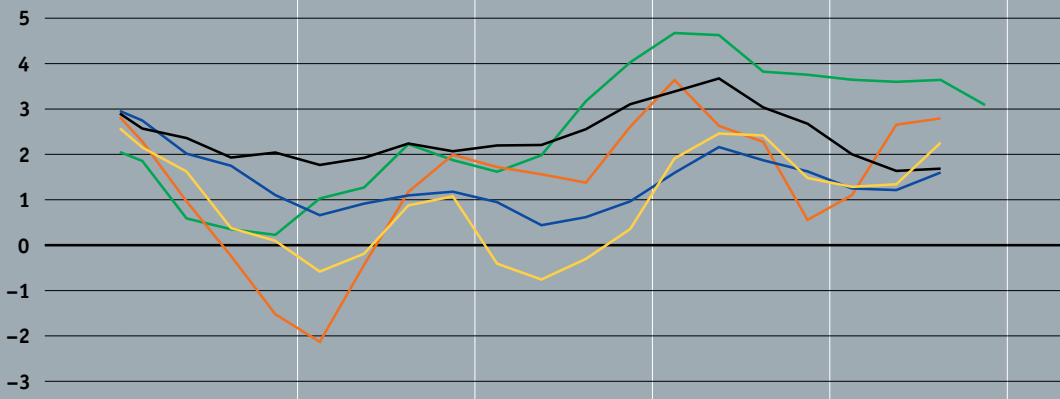
Measured by core inflation (which factors out energy and food prices), inflation in the US never exceeded 2.4% in 2005, while in Europe, it actually dropped from 1.8% in January to 1.5% in December.

The weak inflationary pressure was due, on the one hand, to the confidence of consumers and manufacturers in the ability of the monetary authorities to keep inflation in check in the medium term and, on the other hand, to the brisk international competition in the goods markets. This was underpinned by an important economic factor, namely the persistent unemployment in the majority of industrialised nations and the associated moderation in wage claims.

Vigorous demand in the US

The US economy was the major growth engine for industrialised countries. Although performance did not match that of 2004, GDP growth in the US considerably exceeded the average for OECD countries (2.7% according to OECD forecasts), with an increase of 3.5% (2004: 4.2%). Owing to this economic momentum, unemployment in the US fell by almost one percentage point between January 2004 (5.7%) and December 2005 (4.9%).

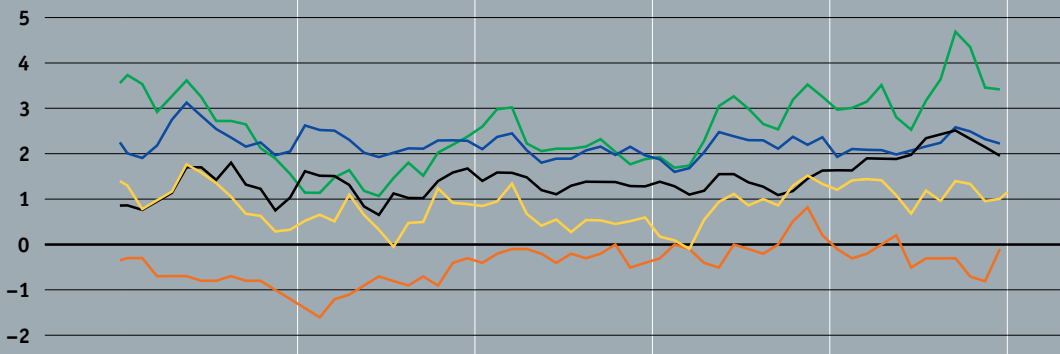
Gross domestic product



United States
Japan
Euro area
United Kingdom
Switzerland

Year-on-year change
in percent, in real terms
Sources:
Thomson Datastream, seco

Inflation



United States
Japan
Euro area
United Kingdom
Switzerland

In percent
Sources:
Thomson Datastream, SFSO

Domestic demand proved very robust on the whole. Despite the small rise in disposable income, consumer sentiment in US households remained upbeat – particularly with regard to cars – thanks to the considerable increase in the value of real estate. Consumer spending dropped in the fourth quarter, however. This was largely in response to the massive hikes in fuel prices at the beginning of the period. Government spending in the US also helped bolster growth.

Although demand for equipment goods in transportation and industrial machinery was slightly dampened by the high commodity prices, equipment investment (including information software) by companies continued the upward trend that has been observable since early 2003. The low interest rate levels, smaller risk premiums and the recovery of the stock exchange contributed considerably to shoring up investments.

Furthermore, 2005 was characterised by the fact that the net contribution from foreign trade was only slightly negative – a development that can be attributed to the robust demand from Asian trading partners, to the delayed knock-on effect of the weak dollar and to the decline in imports of petroleum products.

Slow recovery in European domestic demand

The European economy was rather lacklustre at the beginning of 2005. The slowdown in international trade in the first six months of the year particularly affected activities. The contribution to growth made by domestic demand did nothing to offset the decrease in exports. On the contrary, the steady deterioration in production prospects in industry actually curbed companies' equipment investment.

Private sector spending remained exceptionally low in the first half of 2005, particularly in Germany. The gloomy employment outlook – due in part to the rigid labour market and regulatory hurdles – led to this chronic weakness in household consumption in Europe. This situation consequently impaired the necessary redistribution of production factors. The inability to adapt became particularly obvious when major newly industrialised nations such as China and India came into the picture.

In the second half of the year, the domestic economy in Europe began to show clear signs of a recovery, however. Underpinned by the weak euro, exports boosted investments considerably. Owing to this improvement, the situation in the labour market relaxed slightly. For the first time in four years, unemployment decreased across the entire euro area.

Robust growth in Asia's emerging economies

Once again, the emerging economies of Asia reported extremely vigorous growth. The rapid expansion of China's manufacturing industry, in particular, buoyed international trade. Although the sharp rise of 9.9% in the country's GDP in 2005 primarily reflected the pronounced increase in exports, strong domestic demand was also a contributing factor. This notwithstanding, development in domestic demand was mixed – spending on equipment goods fell off slightly, while construction and private sector spending climbed.

China's economic upswing benefited the entire of Asia, particularly Japan. Despite the fact that its GDP fluctuated strongly from one quarter to the next, Japan's economy visibly went from strength to strength. Companies' high earnings shored up investment. The improved earnings situation stemmed from the far-reaching restructuring of production facilities in the 1990s. Consumer spending rose thanks to the brighter employment and wage prospects. Compared to previous recovery phases when it relied purely on developments abroad and government spending, Japan's growth should now be on firmer footing.

Stable recovery in Japan

The asynchronous economic cycles in industrialised countries are the reason for the differing monetary conditions. The European Central Bank (ECB) left its reference rate unchanged at 2% for the first eleven months of 2005. With uncertainties regarding the economic outlook partly assuaged and monetary indicators, such as the credit volume and the M3 monetary aggregate, pointing to continued growth, the ECB raised its key rate in December by 25 basis points.

Differing monetary policies

In the United States, meanwhile, the Federal Reserve (Fed) increased its key rate – the federal funds rate – in eight consecutive steps of 25 basis points each time, to 4.25% by the end of 2005. In the absence of inflationary pressure, Japan's central bank was able to maintain its policy of injecting the banking system with generous amounts of liquidity. Consequently, short-term interest rates remained at zero, as they have done for the past five years.

The US economy is set to remain robust in 2006. With employment clearly trending upwards, private sector spending should recover. This is all the more likely considering that the price of refined oil products retreated to a level far below that recorded at the end of summer 2005.

Global economic outlook remains bright for 2006

Domestic demand in Europe is expected to gain further momentum. The business climate indices for industry in most European countries – particularly in Germany – are set to return to their historical highs, thus encouraging companies to expand their production capacity. The situation in the service sector should improve together with consumer sentiment. Growth in China continues unabated and developments in the other Asian emerging markets suggest that activity will pick up pace once again. The likelihood is high, therefore, that the global economy will record robust growth in 2006. It can be expected that expansion of this kind will be accompanied by a tightening in monetary conditions in the majority of industrialised countries.

1.3 Economic developments in Switzerland

Hesitant start to the year

At the beginning of the year, the Swiss economy showed signs of weakness. Exports of goods declined and capacity utilisation in manufacturing dipped. Surveys of the economic situation increasingly reflected corporate diffidence about short-term movements in demand. Moreover, difficult weather conditions held back construction. In an initial estimate, seco projected GDP growth of an annualised 0.2% in the first quarter of 2005.

Signs of recovery from the second quarter onwards

Tangible indications of a recovery were evident in the second quarter. In spring, Swiss exports of goods had already returned to a strong growth path. The growth impetus came from the European Union, the US, Asia and the oil-exporting countries, the latter having benefited from increases in the price of oil. Construction recorded robust growth and made up the previous backlog. These two components – goods exports and investment in construction – were largely responsible for the vigorous advance in final demand in the second quarter.

However, GDP growth remained relatively modest, at 1.1%, since a reduction in inventories took up a large part of the increased demand. With the publication in September of GDP figures for the second quarter, seco also revised its first-quarter growth figures upwards. The new figures now showed that annual growth, originally estimated at 0.7%, had actually amounted to 1.2%.

... despite weak equipment investment

Although exports were again climbing, companies remained uncertain about short and medium-term growth in demand. This uncertainty, coupled with the decline in capacity utilisation in manufacturing, held back equipment investment until the middle of the year.

Vigorous private consumption from the beginning of the year

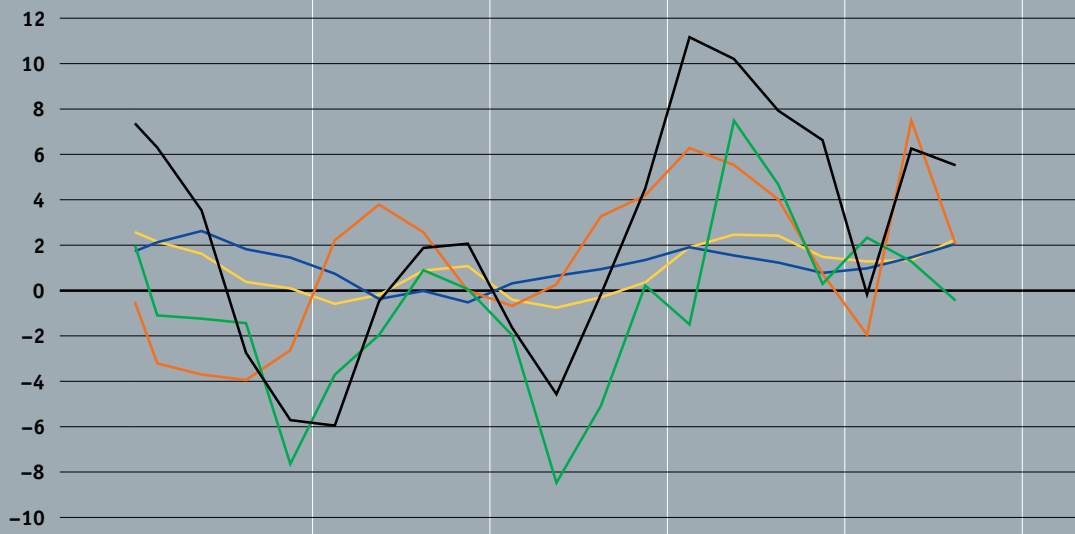
Favourable developments in private households' disposable income meant that overall private consumption was already robust in the first half of the year. Although basic salaries rose by only 1.2%, bonus payments had a positive impact on earned income.

Nevertheless, there were differences between the individual components of private consumption, in particular with respect to consumer durables. While retail sales in household furnishings continued to increase in line with construction investment, there was a decline in new car purchases. Moreover, the improvement in the consumer sentiment index petered out as the year progressed because of the increase in energy prices and the absence of any brightening in the labour market. However, this did not really affect the growth in private consumption. On the contrary, industries such as domestic tourism benefited from progressive increases in expenditure from one month to the next.

Annual growth due to dynamic second half

The recovery firmed in the second half of the year. The number of new orders increased and – once most stocks of finished products had been depleted – the rise in demand acted as a stimulus to production. From the third quarter onwards, capacity utilisation in manufacturing began to rise again, and corporate expectations improved considerably. An upturn in business activity and the renewed confidence in the demand outlook caused businesses to resume spending on equipment. In the third quarter, real GDP was up by 2.3% year-on-year. At the same time as it released its data for the third quarter, seco also revised its figures for the first and second quarters upwards.

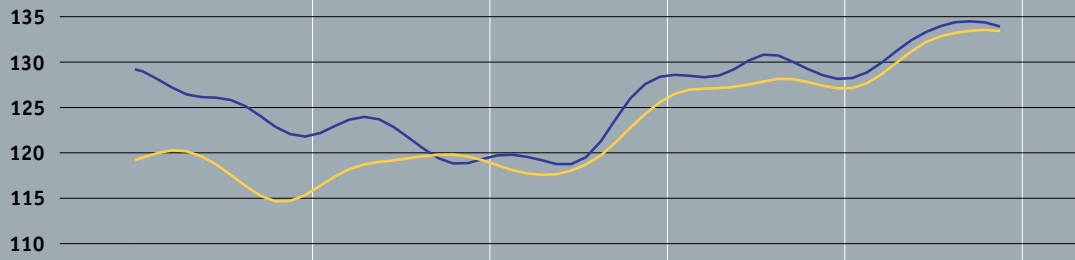
Gross domestic product and components



GDP
Private consumption
Investment in construction
Investment in equipment
Exports

Year-on-year change
in percent, in real terms
Source: seco

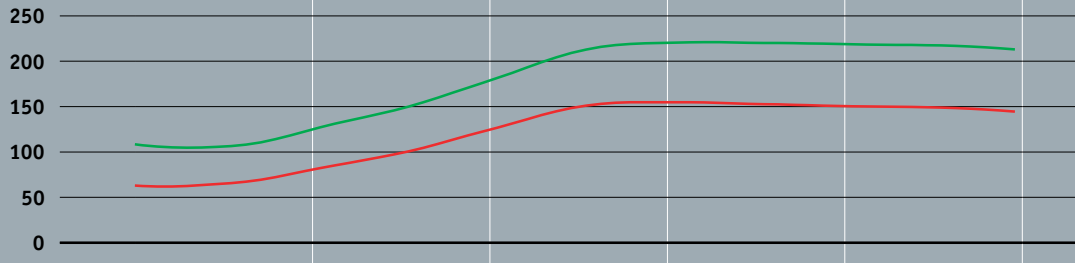
Foreign trade



Imports
Exports

Volume, seasonally adjusted
and smoothed
Index: 1997 = 100
Source:
Federal Customs Administration

Labour market



Unemployed persons
Job seekers

In thousands,
seasonally adjusted
and smoothed
Source: seco

Gross domestic product and components
Year-on-year change in real terms in percent

	2001	2002	2003	2004	2005[1]
Private consumption	2.0	–0.0	0.8	1.4	1.5
Government consumption	4.2	1.7	2.2	1.4	1.8
Investment in fixed assets	–3.1	0.3	–1.3	3.3	1.8
Construction	–3.4	2.2	1.8	4.1	2.5
Equipment	–2.9	–1.2	–3.8	2.7	1.1
Domestic demand	**2.3**	**–0.5**	**0.4**	**1.0**	**1.5**
Exports of goods and services	0.2	–0.7	–0.5	8.9	3.9
Aggregate demand	**1.7**	**–0.5**	**0.1**	**3.5**	**2.3**
Imports of goods and services	3.2	–2.6	1.3	7.4	4.0
Gross domestic product	**1.0**	**0.3**	**–0.3**	**2.1**	**1.6**

1 Average of first three quarters.

Sources: SFSO, seco

Stagnating employment

Business momentum was insufficient to bring about a noticeable improvement in the labour market. Many companies remained cautious about recruiting staff because of the continued uncertainty about the duration and extent of the economic recovery.

Overall, employment – calculated on the basis of full-time equivalents – stagnated in the first three quarters of 2005. Although there was a net rise in the number of jobs in manufacturing and construction, employment continued to drop in key areas of the service sector – in particular in financial intermediation, insurance and retailing.

Slight fall in unemployment

Over the year as a whole, there was only a very gradual decline in the number of unemployed persons, despite a stagnation in employment figures and an expansion in the number of jobs on offer. In December, the seasonally adjusted rate of unemployment stood at 3.7%, as compared to 3.8% at the beginning of the year.

The ratio of job seekers to persons in employment dropped slightly to 5.4%. In addition to unemployed persons, this indicator includes people looking for jobs who are either temporarily engaged in employment or training programmes, or who receive temporary earnings. The fact that it declined slightly, despite a larger number of jobs on offer, was because the number of persons who are either no longer eligible for benefits or have withdrawn from the labour market (and are therefore not recorded as job seekers) climbed. This latter development is reflected in a reduction in the participation ratio among people of working age.

Labour market

	2001	2002	2003	2004	2005
Employment in terms of full-time equivalents[1]	1.9	–0.2	–1.3	–0.4	–0.2[2]
Unemployment rate in percent	1.7	2.5	3.7	3.9	3.8
Number of job seekers in percent	2.8	3.8	5.2	5.6	5.5
Swiss nominal wage index[1]	2.5	1.8	1.4	0.9	1.1[2]
Total wage bill index, nominal[1,3]	2.2	5.4	1.5	0.7	2.5

1 Year-on-year change in percent.
2 Average of first three quarters.
3 Wage contributions to AHV/AVS.

Sources: AHV/AVS, SFSO, seco

Slight increase in real wages

The Swiss wage index compiled by the Swiss Federal Statistical Office (SFSO) shows that, in 2005, nominal wages rose in line with inflation, as they had done in the previous year. For the second year in succession, real wages stagnated in 2005, after having risen by an average 1% a year from 2001 to 2003. It is worth noting that the Swiss wage index takes no account of changes relating to the structure of employment (an increasing number of employees in higher-wage industries) or the qualification of employees. This means that the increase in wage levels tends to be underestimated.

The figures for contributions to the Old Age and Survivors' Insurance Fund (AHV/AVS) are closer to the total wage bill concept used in the national accounts, and provide a more complete picture. The average real wage per full-time equivalent job can be calculated on the basis of this total wage bill. Taking an average for the years 2004 and 2005, the real wage calculated in this manner rose by 0.8%. This was about the median value recorded over the past ten years. Thus, the real wage grew more strongly than in terms of the Swiss wage index, a fact that is attributable to changes in the structure of employment and employee qualifications, as well as to bonus payments.

Optimism for 2006

At the end of 2005, the growth outlook for the new year was still favourable. At its press conference on 15 December 2005, the National Bank forecast growth of a little more than 2% for the year 2006.

In a global environment that remains encouraging, exports of goods and services are likely to increase, while equipment investments will probably continue recovering. The rise in the demand for labour, the brighter outlook for the labour market and the improvement in real wages should allow consumption to grow at a rate somewhat above the long-term average. However, construction is unlikely to progress, following the strong increases recorded in 2003 to 2005. The easing in the housing market is likely to stabilise residential construction at a high level, while investment in commercial construction will probably stagnate due to substantial excess capacity.

Little fluctuation in import and producer prices

Throughout the year, the fluctuations in import and producer prices remained low overall. In a year-on-year comparison, the rate of change in the import price index slowed from 1.8% in January to 0.9% in June. The rise in producer prices also became less pronounced in the first months of 2005, with the rate of increase falling from 1% in January to a mere 0.3% in June. In the second half of the year, energy prices drove import and producer prices up again, although the rate of increase remained moderate. In December, the import price index was 1.5% above the year-back figure, while the index for producer prices rose 1.1%.

Inflation stable in 2005

The rate of growth in consumer prices recorded only little change during the course of the year. In December, it stood at 1%, slightly below the figure of 1.2% recorded for January. In general, the absence of any stronger inflationary pressure could be linked to the persistence of excess capacity in production. Nevertheless, despite the steadiness of the CPI, there were still substantial differences in the movements of prices for individual goods and services.

The rate of growth in import goods prices (a component of the CPI) climbed from 1.5% to 3%. This increase was mainly attributable to the prices of petrochemical products, index components that shot up by 18.8% year-on-year to December 2005, while the prices of other import goods and services stagnated.

Domestic inflation amounted to 1.1% at the beginning of the year, and 0.3% in December. Throughout the year, stronger competition in the domestic market held down the prices of goods; in food and electricity, in particular, there was a drop in prices. Although the rate of inflation in the area of services remained positive, it tailed off from one month to the next. Growth in the prices of public sector services slowed to 1.3% in December (January: 2%). Rents increased, but the rate of increase subsided from 2.1% in January to 1% at the end of 2005. The prices of other private services held steady in December, as compared to the beginning of the year when they were still rising at a rate of 1%.

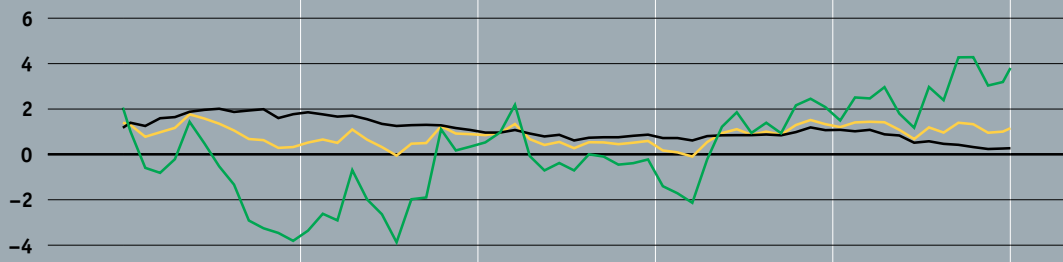
National consumer price index and components

Year-on-year change in percent

	2004	2005	2005 Q1	Q2	Q3	Q4
Overall CPI	**0.8**	**1.2**	**1.4**	**1.1**	**1.2**	**1.1**
Domestic goods and services	0.9	0.6	1.1	0.7	0.5	0.3
Goods	0.4	–0.4	–0.2	–0.4	–0.4	–0.7
Services	1.0	1.0	1.5	1.1	0.8	0.6
Private services (excluding rents)	0.6	0.5	1.1	0.7	0.3	0.1
Rents	1.2	1.4	1.9	1.6	1.2	1.0
Public services	1.9	1.5	1.9	1.3	1.5	1.3
Foreign goods and services	0.6	2.7	2.2	2.0	3.2	3.5
Excluding oil products	–0.9	–0.3	0.0	–0.4	–0.8	–0.0
Oil products	9.3	18.5	14.0	14.7	23.5	21.0
Core inflation						
Core inflation (SNB)	0.8	0.8	1.0	0.8	0.7	0.6
Core inflation 1 (SFSO)	0.5	0.5	0.9	0.6	0.3	0.3
Core inflation 2 (SFSO)	0.3	0.3	0.8	0.4	0.0	0.1

Sources: SFSO, SNB

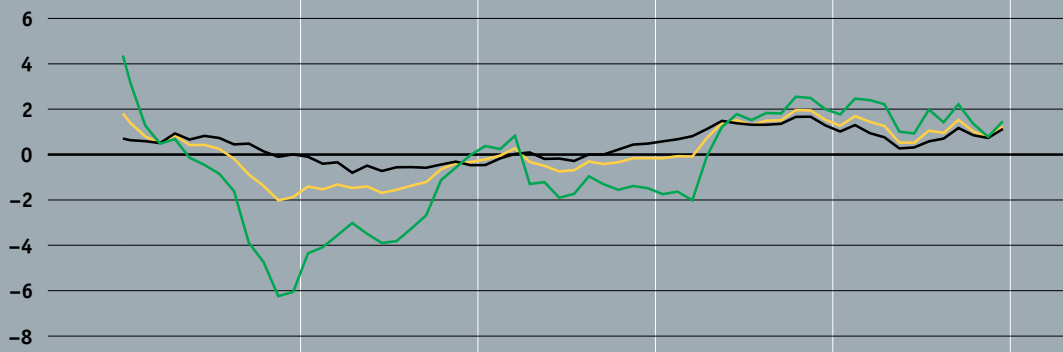
Consumer prices



Consumer prices
Domestic goods
Imported goods

Year-on-year change
in percent
Source: SFSO

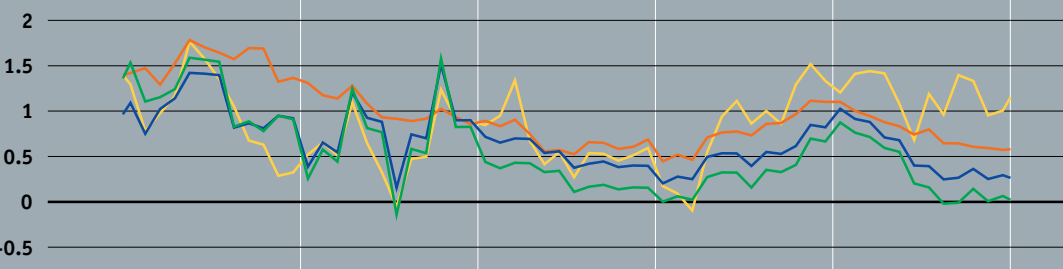
Producer and import prices



Producer and import prices
Producer prices
Import prices

Year-on-year change
in percent
Source: SFSO

Core inflation



Consumer prices
Core inflation (SNB)
Core inflation 1 (SFSO)
Core inflation 2 (SFSO)

Year-on-year change
in percent
Sources: SFSO, SNB

The SNB measure of core inflation, which excludes the strongest price fluctuations, declined from 1.1% in January to 0.6% in December, thus mirroring the generally quiet situation on the inflation front.

Libor lifted in December

During the first nine months of the year, the three-month Libor remained stable at 0.75%. Financial markets were anticipating an increase in the rate of interest at the end of the year. Consequently, the three-month Libor rose gradually, arriving at around 1% in the weeks before the December monetary policy assessment. Following the decision reached at this final quarterly assessment for 2005, to raise the target range for the key rate by 25 basis points, the Libor stabilised at 1%, i.e. in the middle of the new target range (0.5–1.5%).

Capital market yields stable

While most interest rates in the capital market had declined in the second half of 2004 – thus also including those for Swiss Confederation bonds – this trend appeared to have been halted at the beginning of 2005. In the first few months of 2005, there was actually a reversal of the former trend, but by spring, yields had already reverted to the downward trend of 2004. Swiss Confederation bonds reached their lowest level in September, at 1.8%. In autumn, there was another reversal in the trend, so that the yield on these bonds again amounted to 2% at the end of December. Consequently, looking at 2005 as a whole, yields on Swiss Confederation bonds dropped only 40 basis points.

In autumn, there was a rise in long-term interest rates which also affected securities with a term of less than ten years. Thus, we may assume that international financial markets were anticipating a normalisation in the monetary policies pursued by several countries. The good economic outlook in the second half of the year and the slight upturn in inflation contributed to this development.

Dollar recovery, euro stability

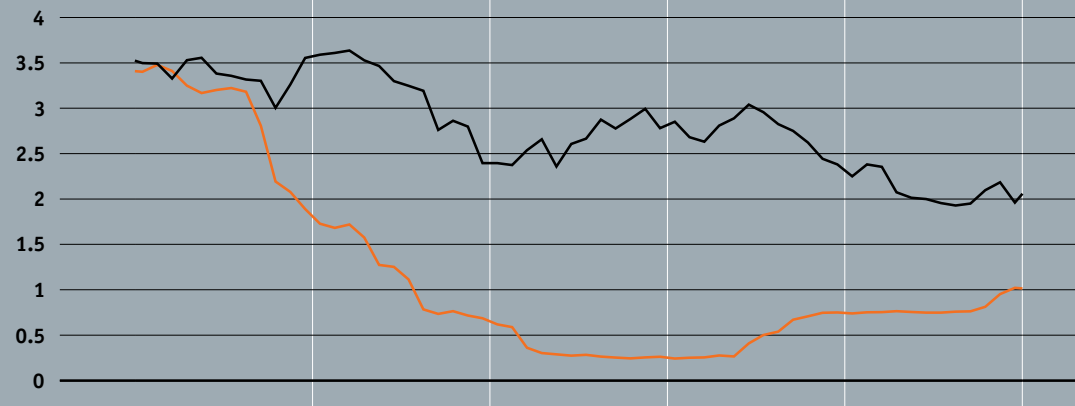
In 2005, the Swiss franc moved within a relatively narrow band against the euro, with exchange rates ranging from 1.53 CHF/EUR to 1.57 CHF/EUR. The US dollar, however, was less static, recording an increase in value against both the Swiss franc (from 1.13 CHF/USD in January to 1.31 CHF/USD in December) and the euro. The dollar appreciation followed many years of decline, and was linked to interest rate increases by the Fed as well as expectations – maintained throughout the year – that the process of monetary policy normalisation in the US would continue.

In the first half of the year, both the nominal and the real export-weighted external value of the Swiss franc declined. This was attributable to the robust US economy and the strengthening in the US currency. At the end of the year, the Swiss franc firmed slightly.

Continued reduction in money overhang

The monetary aggregates expanded strongly due to the National Bank's expansionary monetary policy, in place since 2001. A money overhang – as measured by the M3 aggregate – already existed as early as 2003. The monetary aggregates reacted rapidly to the increase in the Libor in June and September 2004, and until mid-2005, M1 and M2 declined, while M3 grew only slightly. Along with the improvement in the economic situation, the three monetary aggregates began to expand again in the second half of 2005, and from September the rate of increase gained momentum. Despite the renewed growth in money stocks, the money overhang that had existed since the beginning of 2003 receded further in the year under review.

Money and capital market rates

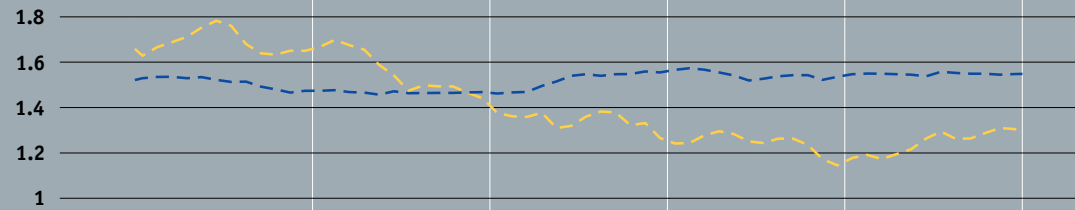


Three-month Libor

Yield on ten-year Swiss Confederation bonds (spot interest rate)

In percent

Exchange rates

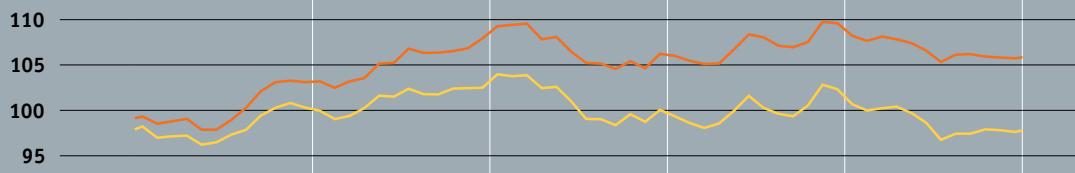


CHF/USD

CHF/EUR

Nominal

Export-weighted Swiss franc exchange rates



Real

Nominal

24 trading partners
Index: January 1999 = 100

1.4 Monetary policy decisions

Four times a year – in mid-March, June, September and December – the National Bank's Governing Board conducts a regular assessment of the monetary policy situation. Each of these assessments results in an interest rate decision. If circumstances so require, the National Bank also adjusts the Libor target range for three-month investments in Swiss francs between regular assessment dates. In 2005, however, this was not the case.

Monetary policy challenge in 2005

Despite the decision taken on 15 December to raise the three-month Libor by 25 basis points, monetary policy remained expansionary throughout 2005. The normalisation of interest rates that began in summer and autumn of 2004 was suspended in 2005. On many occasions the National Bank had indicated that the interruption in interest rate increases, maintained since December 2004, would only be temporary. However, the major challenge in 2005 was to determine the moment when the interest rate should be lifted again.

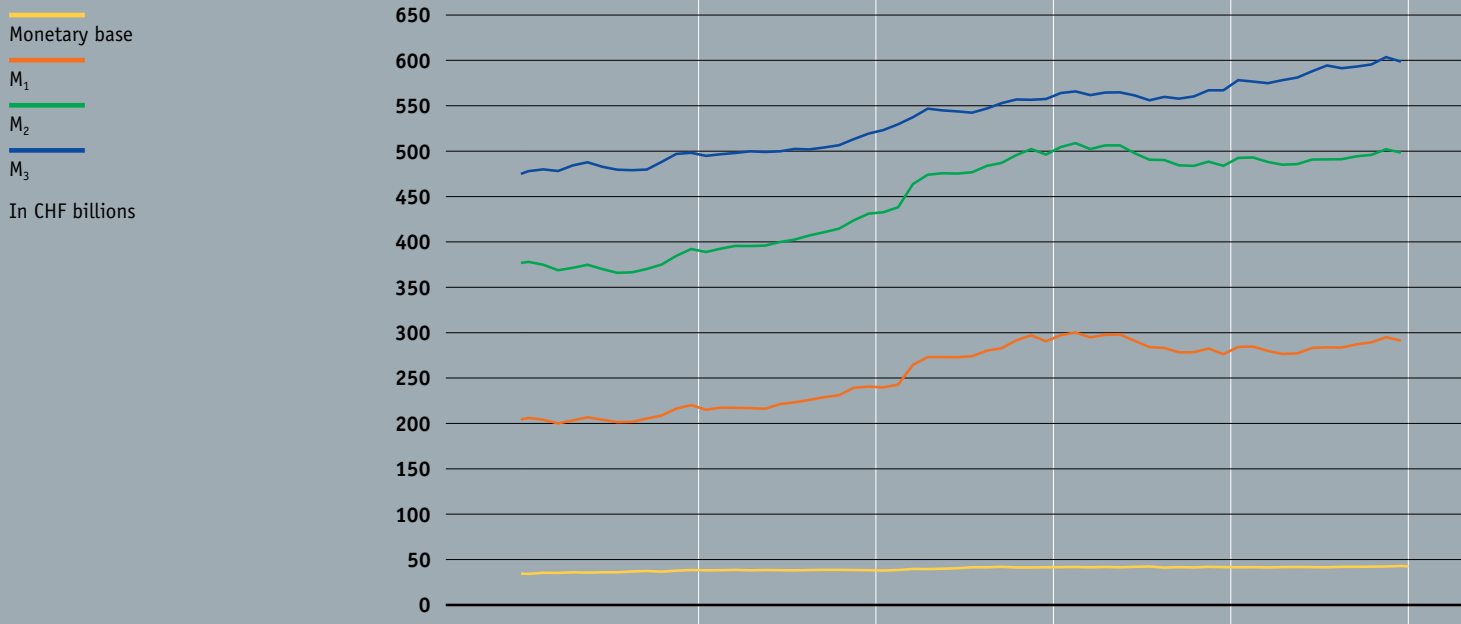
Temporary stability

The first signs of a vigorous recovery in the Swiss economy were already evident in spring 2004, when the National Bank initiated the process of raising its interest rates. However, the upswing faltered at the end of 2004 and economic activity grew only hesitantly in the first half of 2005. In view of a global economy rendered erratic and unpredictable due – in particular – to the listless economy in Europe and the record levels of oil prices, growth forecasts for Switzerland were adjusted downwards during the course of 2005. The slowdown, while linked to a favourable inflation outlook, caused the National Bank to maintain the Libor at the level of September 2004 throughout the first three quarters of 2005.

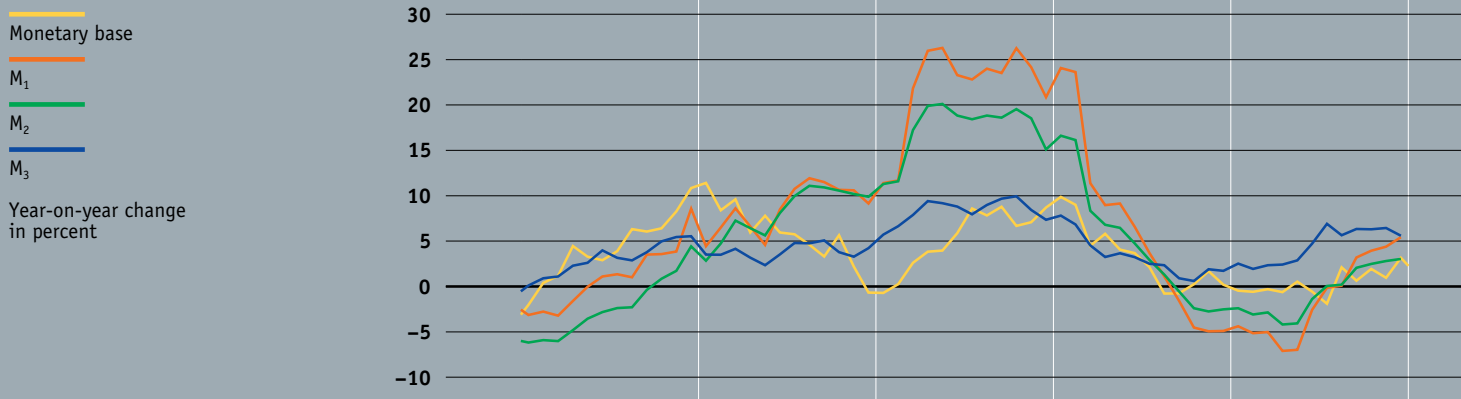
... and increase in Libor in December

The National Bank raised its interest rates in December, at the final monetary policy assessment of the year. By making this one-year break, the SNB had demonstrated its flexibility. Taking account of the declining long-term inflation risks, it had utilised the greater degree of leeway available to it for maintaining an expansionary monetary policy. Nevertheless, it had monitored developments carefully throughout the year, as is evident in the monetary policy assessments undertaken in March, June and in particular September. It acted promptly once the indications of a robust and sustained economic recovery had finally consolidated.

Level of monetary aggregates



Growth rates of monetary aggregates



Monetary policy risks in 2005

As in previous years, monetary policy in 2005 was subject to numerous short, medium and long-term risks. The probability of such risks occurring, their consequences for the economy and their impact on monetary policy are analysed regularly by the National Bank.

... in the long term

The low interest rate of the past three years was incompatible with a recovering economy. The inflation forecasts made in 2005 clearly showed that medium and long-term price stability could not be guaranteed at the interest rates prevailing in the year under review. It was evident, therefore, that the normalisation initiated in 2004 had not been concluded; an excessively long interruption in this process would have entailed a substantial inflation risk. The National Bank's awareness of these interconnections led to the interest-rate decision in December.

... in the medium term

In the medium term, the biggest risk was posed by the many uncertainties associated with the economic situation in the world and in Switzerland. The US economy maintained a strong rate of growth despite the environmental disasters experienced in the southern states. However, in Europe, the situation was unsatisfactory since domestic demand was slow in picking up. Moreover, it was considered possible throughout 2005 that the global economy might pursue a different course. Switzerland's growth engines – investments and exports – are largely dependent on international conditions. Consequently, there was considerable uncertainty with regard to economic developments in Switzerland in 2005, and this created additional difficulties when deciding on the timing for a resumption of normalisation.

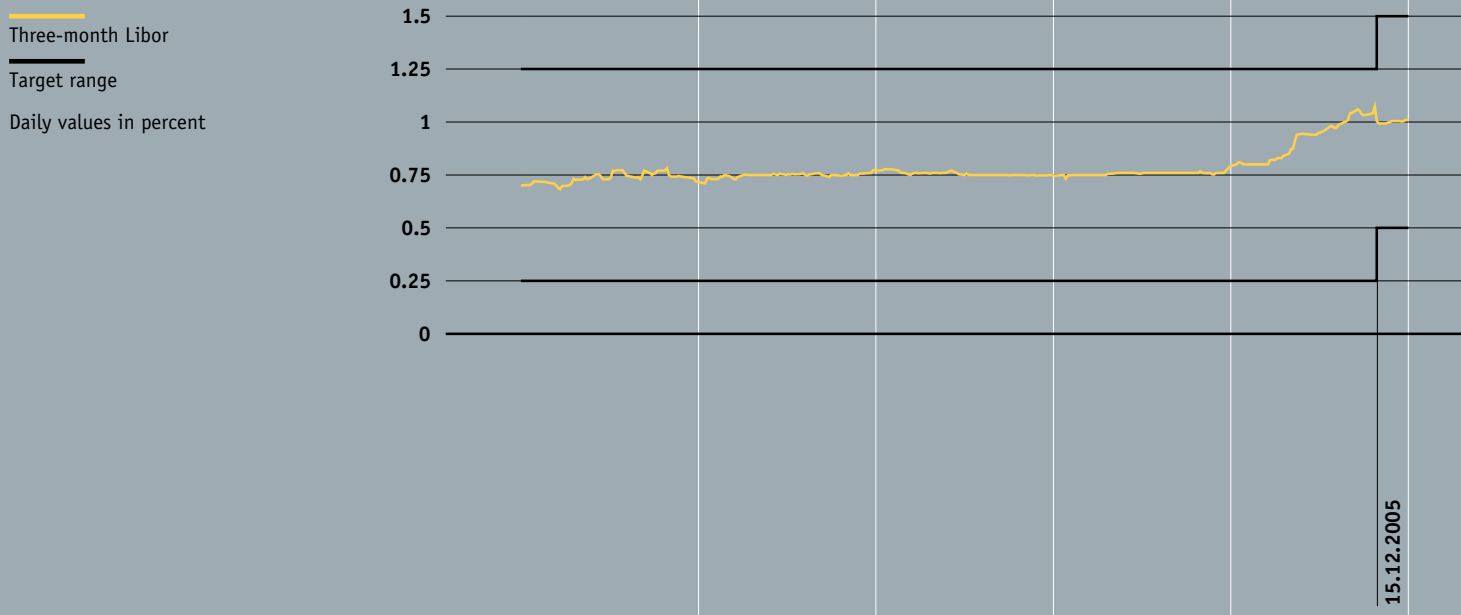
... and in the short term

In the short term, oil price fluctuations were again the focus of attention. There were no further inflation risks. Oil prices persisted at a high level, but there were no significant second-round effects. On the one hand, the high oil prices had a dampening effect on demand and growth (even if this effect was limited), while on the other hand, strong competition in numerous markets helped to moderate price and wage developments, thereby reducing the risk of spiralling inflation. Even though the situation was worrying, it did not require the National Bank to take any special action during the course of 2005.

Initial situation: final quarterly assessment in 2004

The National Bank's inflation forecast on 16 December 2004 was based on a Libor of 0.75%. At that time, the SNB forecast annual inflation of 1.1% for 2005, taking account of an increase in oil prices as well as a higher valuation of the Swiss franc against the dollar. The stronger Swiss franc meant a tightening in monetary conditions and thus a lower inflationary impact from the increase in oil prices. For 2006 – in the medium term – the SNB now predicted a lower inflation rate of 1.3% averaged out over the year and 2% at the end of the year. This adjustment to the previous quarterly assessment was due to the expectation that the closure of the output gap would be delayed. In the longer term, finally, the forecast reflected lower inflationary pressure than had been assumed for the same period during the course of 2004. The easing in the situation was mainly due to the absorption of the liquidity surplus that had begun in summer 2004.

Three-month Libor



After raising the Libor twice, in June and September 2004, the Governing Board decided in December to leave the target range unchanged at 0.25–1.25%, and to keep the Libor at 0.75%. Since inflationary pressure was expected to lessen, the National Bank did not see any need to take a further step towards the normalisation of interest rates. Apart from these considerations, monetary conditions were already tighter because of a stronger Swiss franc. Despite this, monetary policy at the beginning of 2005 remained expansionary. The National Bank nevertheless noted that, in view of the inflation anticipated in the long term, the normalisation of interest rates begun in mid-2004 had not been completed.

Quarterly assessment of 17 March 2005

At each monetary policy assessment, the National Bank bases its inflation forecast on the global economic scenario it regards as most likely. In the quarter preceding the March 2005 assessment, the US economy was strong and broad-based, giving rise to expectations that this would continue in the following quarters of 2005, with an annual growth rate of 3.4% for 2005. In the European Union, by contrast, growth rates in the final two quarters of 2004 were below expectations. The recovery during the course of 2005 foreseen in the scenario of December 2004 was still anticipated, although it would be a little delayed. For 2005, the National Bank forecast about 1.9% growth in Europe. With a renewed increase in fossil fuel prices, it predicted that prices would remain high for the next few quarters.

For Switzerland, the National Bank forecast real GDP growth of about 1.5% in 2005, as compared with 1.5–2.0% in the September 2004 assessment. Even though it might be modest, a continuation of economic recovery was linked with the foreseeable stimulus provided by exports and investments. Renewed strength was also evident for 2005 in private consumption, which had slowed markedly in 2004. However, the SNB did not expect that production capacity would be fully utilised until the second half of 2006. With respect to monetary aggregates, there was a drop in M1 and M2, while M3 grew only slightly. Aware that its monetary policy was still expansionary, the National Bank paid particular attention to the real estate sector and in particular to the rapid and continuous rise in mortgage lending.

The inflation forecast published in March 2005 was based on a Libor of 0.75% and showed consistently lower rates of inflation than the December 2004 forecast. At 0.7%, forecast inflation would have reached its low point in the fourth quarter of 2005. The expectation of a marked decline in the rate of inflation right through the year was essentially the result of a statistical effect. On average, inflation would amount to 1% for the year. In the medium term, from 2006, it was likely to creep up because of higher utilisation of production capacity. An inflation rate of 2.6% was expected for the end of 2007. Consequently, at the end of the forecast period the 2% mark – the upper limit of the range the National Bank equates with price stability – would have been clearly exceeded. On the basis of the inflation forecast, therefore, it was clear that the rate of interest could not remain unchanged in the long term, and that it would be raised by the SNB when the production gap began to close.

Despite this situation, the Governing Board decided to leave the target range for the three-month Libor unchanged at 0.25–1.25%. The reasons for this decision were two-fold. First, inflation prospects had improved slightly since the last monetary policy assessment on 16 December 2004. As a result, there was more leeway for monetary policy action. Second, the National Bank had lowered its forecast for the Swiss economy. In addition, there had been disturbing developments in a number of possible scenarios since the December assessment. For instance, the persistence of high oil prices could have held back the global economy more severely than had been assumed.

By leaving the target range for the three-month Libor unchanged, the National Bank maintained its expansionary monetary policy. It made use of the monetary policy leeway available to it in order to support the economic recovery, but without jeopardising medium and long-term price stability.

Quarterly assessment of 16 June 2005

Since the beginning of the year, repeated increases in the price of oil had put a brake on the global economy. The situation was particularly unsatisfactory in Europe because, in addition to expensive oil, the rise in the value of the euro in the fourth quarter of 2004 was also curbing economic activity. Consequently, the National Bank lowered its growth assumptions for Europe to 1.5% for 2005 and 2.1% for 2006. By contrast, the US economy seemed to be only mildly affected by the difficulties in the oil markets and growth estimates there were maintained at 3.4% for 2005 and 3.6% for 2006.

As usual, international conditions had a strong impact on the Swiss economy. Contrary to the expectations of the National Bank at its previous monetary policy assessment, economic activity in Switzerland remained sluggish in the first quarter of 2005. Real GDP was unchanged from the previous quarter, although domestic demand increased slightly. This disappointing result was mainly attributable to weak exports and investments. In view of the low level of demand, companies curtailed investment, and this, in its turn, affected employment. The uncertain labour market situation had a dampening impact on consumer spending. Although private consumption rose, the rate of increase was below the historical average.

In these circumstances, the Swiss economy could no longer be expected to grow by approximately 1.5% in 2005, as forecast by the National Bank in March. Consequently, the forecast for real GDP growth in 2005 was adjusted down to about 1% at the June assessment. Assuming that exports recovered, the National Bank was still expecting the economy to record a moderate improvement over the course of the year.

The incentive for consumers and producers to hold liquid investments remained strong due to the persistence of a low interest rate. In the view of the SNB, there was still an excess of liquidity in the economy. Although the M3 monetary aggregate was still rising slightly, excess liquidity was no longer increasing. Financial conditions remained favourable in real estate. Mortgage lending had risen by an average of over 5% a year since the beginning of 2003, and even though mortgages granted to private households had slowed towards the end of 2004, the rate of growth still exceeded that of previous years. Since the beginning of 2005, corporate mortgage lending had also increased, after having declined in the five previous years.

The SNB did not change its inflation forecast for 2005 from that published at the March assessment, continuing to expect a 1% increase in prices for the year. The projected decline in the rate of inflation over the course of the year was attributable to the assumed stabilisation in the oil price. At the June assessment, inflation levels for the period after the end of 2005 were expected to be substantially lower than those forecast in March. Given a Libor of 0.75%, inflation for 2006 was forecast at 0.5% and for 2007 at 1.4%. Consequently, the medium-term inflation outlook was more positive than at the previous monetary policy assessment (2006: 1%, 2007: 2.1%). The expected low level of inflation for 2006 was attributable to the fact that the economy was likely to be sluggish. For 2007, however, the rate of inflation was set to increase faster as a result of better utilisation of production capacity and a high level of liquidity. At the end of the forecast period, inflation would reach 2.4%. As at the previous monetary policy assessment, the outer limit of the range which the National Bank equates with price stability would have been exceeded. However, the amount by which this limit was exceeded would not have been quite as great due to the fact that the liquidity surplus was gradually receding.

Once again, the Governing Board decided to leave the target range for the three-month Libor unchanged at 0.25–1.25%. The reasons for this decision were three-fold. First, the National Bank had lowered its forecast for the Swiss economy. Second, the medium-term inflation outlook associated with this slow economic development was improved, and an increase in the target range for the three-month Libor appeared less urgent. Third, there was more uncertainty with regard to international developments. It was harder to judge the economic outlook for Europe than it had been in March 2005. While oil prices had dropped in April and May, they had risen again in June and there was a risk of them persisting at a high level for a long period to come. In addition, the decline in long-term interest rates observed in numerous international markets was difficult to reconcile with a recovery in the economy.

By leaving the Libor unchanged, the National Bank maintained the monetary policy course pursued up to then. It continued to use the available leeway to support the economy without jeopardising medium and long-term price stability.

Quarterly assessment of 15 September 2005

In the previous monetary policy assessment, the SNB had assumed that, although the price of oil would remain high, it would gradually edge downwards. However, contrary to this assumption, oil prices had continued to rise sharply. Consequently, the forecast drawn up in September was based on a very high price for oil. This would be even more detrimental to the recovery in Europe, and the growth forecast for 2005 was cut back to 1.4%, while that for 2006 fell to 2%. In the US, by contrast, the rise in oil prices was more than compensated by other factors, in particular the high level of consumption. For this reason, the SNB was a little more optimistic about US growth than in June, and adjusted its forecasts upwards for 2005 and 2006, to 3.6% for both years.

Inflation forecast of 17 March 2005

Inflation

December 2004 forecast: three-month Libor 0.75%

March 2005 forecast: three-month Libor 0.75%

Year-on-year change in national consumer price index in percent

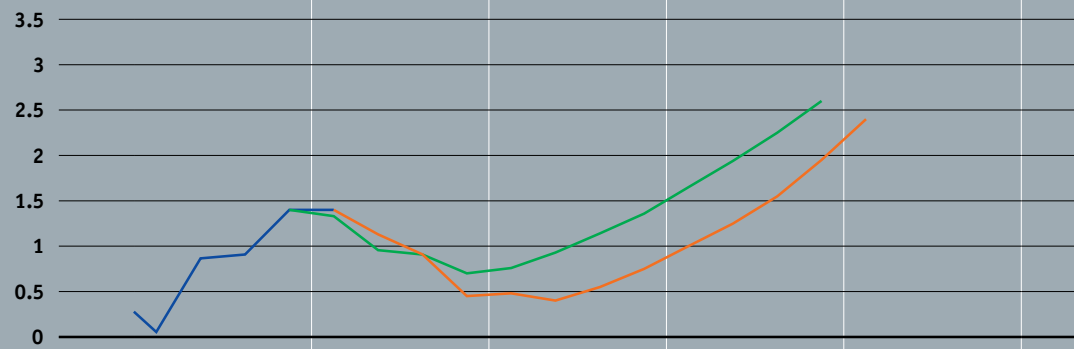
Inflation forecast of 16 June 2005

Inflation

March 2005 forecast: three-month Libor 0.75%

June 2005 forecast: three-month Libor 0.75%

Year-on-year change in national consumer price index in percent



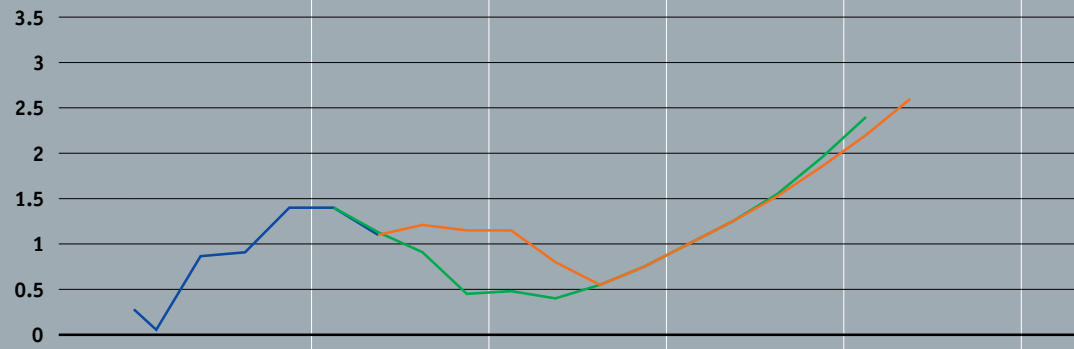
Inflation forecast of 15 September 2005

Inflation

June 2005 forecast: three-month Libor 0.75%

September 2005 forecast: three-month Libor 0.75%

Year-on-year change in national consumer price index in percent



Inflation forecast of 15 December 2005

Inflation

September 2005 forecast: three-month Libor 0.75%

December 2005 forecast: three-month Libor 1.00%

Year-on-year change in national consumer price index in percent

For Switzerland, the National Bank was still forecasting real GDP growth of about 1% in 2005. Both investments and private consumption had already picked up before September. Growth was now broader-based, and a continuation of this trend appeared probable for the second half of 2005. It was assumed that exports and construction would provide the major impetus, while consumption continued to suffer from the high oil prices and the persistence of unemployment. The economic recovery expected in 2006 would bring with it an improvement in the labour market, and thus also stronger growth in consumption in the medium term. Full utilisation of production capacity was likely to be achieved towards the end of 2006.

The M1 and M2 monetary aggregates were no longer receding, while M3 was advancing at an even faster rate. Although the supply of liquidity to the economy remained abundant, it did not present any direct threat to price stability. Mortgage lending in the real estate market continued to grow strongly.

Due to the high oil prices, the rate of inflation forecast for the period to mid-2006 was higher in September than it had been in June. A high level of inflation was expected to persist for a number of quarters. It could be assumed that the increase in oil prices would not trigger spiralling inflation since it was probable that the level of economic activity would be relatively moderate and the recovery in the labour market very slow. However, in view of the recent developments in oil prices, the National Bank revised upwards its forecast of average inflation for the year 2005 to 1.2%. Assuming a stabilisation in oil prices, it forecast that inflation would recede in the first half of 2006, due to a statistical effect. Thereafter, given full utilisation of production capacity and a persistently high level of liquidity, higher rates of inflation could be expected from the end of 2006. At 0.8%, average inflation for 2006 was slightly higher than at the previous assessment, while the 2007 figure was unchanged at 1.4%. By the end of the forecast period, inflation would amount to 2.6%, still above the limit of the range that the SNB equates with price stability.

The National Bank decided to leave the target range for the three-month Libor unchanged at 0.25–1.25% and to maintain its expansionary monetary policy course. There were two factors that gave rise to this decision. First, the curve for projected inflation remained low until mid-2006, despite the fact that, in real terms, oil prices had reached the highest level for twenty years. This afforded the National Bank a certain amount of leeway which it could use without jeopardising price stability.

Second, there was a degree of uncertainty with regard to the development of economic activity in Switzerland. Nevertheless, a growth rate of 1% for 2005 could be assumed, as at the previous monetary policy assessment. Consequently, the National Bank decided to maintain the level of interest rates, while also making it clear that, as soon as the recovery in the economy was confirmed, it would change the monetary policy course which had been expansionary for a long time.

Quarterly assessment of 15 December 2005

Although the growth forecasts for the euro area and the US were almost unchanged from the September monetary policy assessment, the SNB expressed confidence on the outlook for the global economy. For 2005, it continued to work on the basis of a European growth rate of 1.4%, and for 2006, 2%, while its growth assumptions for the US were lowered slightly, to 3.5% for 2005 and 3.6% for 2006. In view of the vitality of the US economy, the National Bank forecast growth of about 3.5% in 2007. The SNB was also optimistic about developments in the euro area, projecting a growth rate of 2.4% in 2007. As compared to the situation at the previous monetary policy assessment, world oil markets had eased somewhat. Consequently, the National Bank no longer regarded oil prices as having the potential to hold back the industrialised economies, although it assumed that the price level would remain high over the next few quarters.

Unlike the September monetary policy assessment, when the SNB was still expecting the Swiss economy to grow by only 1% in 2005, at the December assessment it revised its forecast upwards to just over 1.5%. First, seco's revised GDP growth rates for the first two quarters supported a more optimistic evaluation. Second, both consumption and equipment investment were strong in the third quarter, and positive developments could be expected in the next few quarters. This scenario would not be affected by the levelling off in construction investment expected in 2006. Economic activity at the end of the year was a further factor supporting the National Bank's confidence in the outlook for 2006. Given this situation, the SNB forecast GDP growth of a little more than 2%.

Monetary indicators also pointed to an improvement in the economic situation. The trends that had emerged at the September assessment were further reinforced shortly before the December assessment. There was an additional acceleration in the movement of the M1 and M2 aggregates that had persisted since August. M3 grew even more strongly. In October 2004, its rate of growth was just 1%, while at the monetary policy assessment it came to more than 6%. The SNB also devoted special attention to real estate, an area which remained very active.

As at the previous monetary policy assessment, the National Bank forecast inflation of 1.2% for 2005. On the assumption of an unchanged Libor of 0.75% in the following three years, the December forecast for inflation in 2006 was revised upwards from the rate forecast at the September assessment. By the end of the forecast period, inflation would amount to 3%, considerably above the limit of the range that the SNB equates with price stability.

Given this situation, the Governing Board decided to increase the target range for the three-month Libor by 25 basis points, to 0.50–1.50%, and to hold the Libor in the middle of the target range for the time being. At the beginning of the year, with the considerable improvement in the medium and long-term inflation outlook, the National Bank had suspended the normalisation of its interest rates. At the monetary policy assessment in September 2005, it had again decided against increasing the interest rate. While the improvement in the inflation outlook appeared to be petering out, a sudden rise in the oil price created uncertainty with respect to economic prospects. In December, the need for action became more urgent with the upturn in the global and Swiss economies. As a result, the SNB resumed normalisation of its monetary policy course.

Assuming an unchanged three-month Libor of 1% for the next three years, the Governing Board forecast annual inflation of 0.8% in 2006, 1.2% in 2007 and 2.7% for the end of the forecast period. This would still be above the limit of the range that the National Bank equates with stability. Thus, monetary policy remained expansionary and continued to support economic recovery.

1.5 Statistical activities

Purpose of statistical activities

Since 1 May 2004, a uniform legal basis (art. 14 NBA) has governed the collection of statistics that the SNB requires in order to fulfil its statutory tasks. Statistical data are needed for the conduct of monetary policy, the oversight of payment and securities settlement systems, for helping to maintain the stability of the financial system, for preparing both the balance of payments and statistics on the international investment position, for international monetary cooperation and for analyses by international organisations.

Institutions required to provide data

Banks, stock exchanges, securities dealers and fund managers of Swiss and foreign investment funds are required to provide the National Bank with statistical data on their activities (art. 15 para. 1 NBA). Where necessary to analyse trends in the financial markets, to obtain an overview of payment transactions or to prepare the balance of payments or the statistics on Switzerland's international investment position, the National Bank may collect statistical data from other private individuals or legal entities on their business activities. This applies in particular to insurance companies, occupational pension schemes, investment and holding companies, and operators of payment and securities settlement systems such as the postal service (art. 15 para. 2 NBA).

The National Bank limits the number and type of surveys to what is strictly necessary (art. 4 National Bank Ordinance (NBO)). It seeks in particular to minimise the demands placed on those required to provide information.

Confidentiality and exchange of data

The National Bank is required to ensure the confidentiality of the data it collects and may only publish them in aggregated form. However, the data collected may be exchanged with the competent supervisory authorities for the Swiss financial market (art. 16 para. 4 NBA).

Publications and database

The National Bank manages a database containing 1.7 million time series and publishes the results of its surveys. The most important publications containing statistical information are the Monthly Statistical Bulletin and the Monthly Bulletin of Banking Statistics, as well as Banks in Switzerland, which is published annually. These publications are supplemented by reports on Switzerland's balance of payments, the international investment position and direct investment. All publications are also accessible on the internet (www.snb.ch), along with other data series. The two monthly publications are now available in English.

New surveys

The National Bank has extended its test phase for the collection of data on the terms and conditions of new loans extended to companies (lending rate statistics). This will make it easier for reporting banks to ensure that the data can be provided at the level of data required. The extension of the test phase will also allow the National Bank to conduct additional investigations and, consequently, to modify the form used for reporting. The test phase will terminate in mid-2006 and normal data collection will begin immediately thereafter.

At the beginning of the year under review, the National Bank began collecting data on the new minimum reserve requirements, thereby implementing the relevant provisions in the NBA and the NBO. It ceased collection of data on banks' cash liquidity at the start of the same year.

In the third quarter, the National Bank began collecting data for the revised investment fund statistics. The revisions were needed because data collection did not fully reflect developments in funds business over the past few years. The new statistics contain more detailed data and have made it possible to arrive at an appropriate definition of the boundaries of the Swiss investment fund market.

Financial accounts published for the first time

For the first time, the National Bank has published financial accounts for Switzerland. The accounts set out the scope and structure of the financial assets and liabilities of the different economic sectors. The published stock data cover the period 1999–2003. The financial accounts provide information for monetary policy and close a gap in the system of national accounts, as well as enabling Switzerland to meet a requirement under the bilateral statistical agreement with the EU.

Collaboration

In compiling statistical data, the National Bank cooperates with the competent federal government bodies, notably the Swiss Federal Statistical Office (SFSO) and the Swiss Federal Banking Commission (SFBC), the competent authorities of other countries and international organisations (art. 14 para. 2 NBA). With regard to organisational and procedural issues, and when introducing new surveys or modifying existing ones, the reporting institutions – together with their associations – are given the opportunity to comment (art. 7 NBO).

... with the SFBC

As part of the agreement on the reciprocal exchange of data for the financial sector, the National Bank assisted the SFBC secretariat with the revision of supervisory reports processed by the National Bank.

... with the banking statistics committee

The National Bank consulted the banking statistics committee on the content of its banking surveys (art. 7 NBO). The committee comprises representatives of the Swiss commercial banks, the Swiss Bankers' Association, the SFBC and the Liechtenstein banks.

... with the group of experts on the balance of payments

A group of experts under the direction of the National Bank participates in the drawing up of the balance of payments. It comprises representatives from industry, banking, insurance, various federal agencies and the Swiss Institute for Business Cycle Research at the Swiss Federal Institute of Technology.

... with the Principality of Liechtenstein

The National Bank stepped up its collaboration with the Liechtenstein authorities. A trial collection of data from manufacturing companies and within the services sector was conducted in order to complete the balance of payments and statistics on the international investment position.

... with foreign agencies

In the area of statistics, the National Bank works closely with the Bank for International Settlements (BIS), the Organisation for Economic Cooperation and Development (OECD), the Statistical Office of the European Communities (Eurostat), and the International Monetary Fund (IMF). This collaboration is aimed at harmonising statistical survey methods and analyses.

2 Supplying the money market with liquidity

Mandate

It is the task of the Swiss National Bank (SNB) to provide the Swiss franc money market with liquidity (art. 5 para. 2 (a) National Bank Act (NBA)). The transactions that the National Bank may conduct with financial market participants are listed in art. 9 NBA. Based on art. 9 para. 1 (e) NBA, the National Bank also acts as lender of last resort.

Guidelines on monetary policy instruments

The "Guidelines of the Swiss National Bank (SNB) on Monetary Policy Instruments" dated 25 March 2004 contain more explicit information with regard to art. 9 NBA and describe the instruments and procedures used by the National Bank for the implementation of its monetary policy. They also define the conditions under which these transactions are concluded and what securities can be used as collateral for monetary policy operations. In its transactions, the National Bank only accepts securities that fulfil its currency, liquidity and credit-rating criteria. Basically, all banks domiciled in Switzerland as well as internationally active banks abroad that meet the conditions stipulated by the National Bank are accepted as counterparties. The guidelines are supplemented by five Instruction Sheets which are primarily intended for the counterparties. Since May 2004, the National Bank has been publishing a weekly report containing important monetary policy data.

2.1 Regular instruments for steering the money market

All regular monetary policy instruments of the SNB, with the exception of Lombard advances (abolished with effect from the end of 2005), are based on repo transactions. In a repo transaction, the cash taker sells securities spot to the cash provider. At the same time, the cash taker enters into an agreement to repurchase securities of the same type and amount from the cash provider at a later point in time. The cash taker pays interest (the repo rate) for the duration of the transaction. From an economic perspective, a repo is a secured loan.

Main financing and liquidity-absorbing operations

The purpose of the National Bank's main financing operations is to provide the banking system with liquidity, while that of liquidity-absorbing operations is to withdraw surplus liquidity from the system.

Where main financing operations are concerned, transactions are concluded by way of auction. The auctions in turn are conducted by volume tender – in other words, the National Bank's counterparties request a certain amount of liquidity at a fixed price (repo rate). The repo rate, the size of the individual operations and their maturities depend on monetary policy requirements. The maturity of repo transactions varies from a day (overnight) to several weeks. In exceptional circumstances, contracts may even run for several months. The SNB sets the maturity of repo transactions in such a way that the commercial banks have to request liquidity on an almost daily basis to ensure they have the sight deposits required to meet minimum reserve requirements.

Fine-tuning operations

Fine-tuning operations are used to smooth the undesired impact of exogenous factors on liquidity supply as well as sharp fluctuations in short-term money market rates. Fine-tuning is carried out through bilateral repo transactions that are concluded when necessary. The conditions for these repo transactions may vary from those applying to main financing operations.

Intraday facility

During the day, the National Bank provides its counterparties with interest-free liquidity (intraday liquidity) through repo transactions so as to facilitate the settlement of payment transactions via Swiss Interbank Clearing (SIC) and foreign exchange transactions via Continuous Linked Settlement (CLS), the multilateral payment system. The cash amounts must be repaid by the end of the same bank working day at the latest. These funds do not qualify when evaluating compliance with minimum reserve requirements or liquidity requirements under banking law.

Liquidity-shortage financing facility

The National Bank provides a liquidity-shortage financing facility to bridge unexpected liquidity bottlenecks. The interest rate for liquidity provided through this facility is two percentage points above the call money rate. The basis upon which the rate is calculated is the Overnight Repo Index (SNB) for the previous bank working day. The interest premium is intended to prevent commercial banks from using the facility as a permanent source of refinancing.

In 2005, there were still two instruments available for this purpose: conventional Lombard advances and special-rate repo transactions. However, since the beginning of 2006, the only way of accessing the liquidity-shortage financing facility has been via special-rate repo transactions. The precondition for concluding special-rate repo transactions is that a limit be granted by the National Bank and that this limit be covered by collateral eligible for SNB repos. The limit determines the maximum amount of liquidity that a counterparty may obtain, and it is utilised in the form of an overnight repo transaction. The securities are held by the counterparty in a Custody Cover Account "SNB" at SIS.

Most banks had begun or completed the changeover before the end of 2005. At CHF 11.1 billion, these banks' limits exceeded the Lombard credit limits granted under the old system by some 25%. As of 1 December 2005, the procedure for obtaining liquidity through the liquidity-shortage financing facility was simplified. Before the end of the day, banks are requested to report their liquidity requirements through the repo trading platform.

2.2 Liquidity supply with the different facilities

Monetary policy instruments in CHF billions

	2004 Holding Average	2004 Turnover	2005 Holding Average	2005 Turnover
Repo transactions				
Main financing and fine-tuning operations	**22.31**	**1 087.15**	**21.08**	**1 066.53**
Maturities of				
less than 1 week	0.48	95.42	0.10	18.38
1 week	16.06	852.12	19.16	993.15
2 weeks	4.42	115.59	1.63	42.90
3 weeks	1.07	13.52	0.00	0.00
Other	0.28	10.50	0.19	12.10
Liquidity-absorbing operations	**0.00**	**0.00**	**0.03**	**7.50**
Intraday facility	**6.19**	**1 584.13**	**6.34**	**1 610.62**
Liquidity-shortage financing facility	**0.00**	**0.52**	**0.01**	**1.02**

Repo transactions in detail

During the course of the year, the SNB allocated liquidity to banks at differing prices, depending on monetary policy criteria and the situation in the money market. In the period to mid-December, repo rates fluctuated between 0.54% and 0.67%. Along with the increase in the target range for the three-month Libor in December 2005, the SNB raised its repo rates by a moderate amount, to 0.74%.

In 2005, the average volume of the National Bank's repo transactions still outstanding at the end of the day fell by CHF 1.2 billion to CHF 21.1 billion. The turnover – in other words the sum of all of these repo transactions – fell by CHF 12.6 billion to CHF 1,075.1 billion. Almost all of this turnover was achieved with a maturity of one week. Fine-tuning operations were only used in exceptional cases.

In the year under review, banks' daily bids at National Bank repo auctions fluctuated between CHF 1.3 billion and CHF 98.3 billion, averaging CHF 34.6 billion. The amount of liquidity allocated varied from CHF 1.3 billion to CHF 8.5 billion, averaging CHF 4.0 billion over the year. The allocation rate fluctuated between 3% and 100%, with the average rate amounting to 16.8%.

Average use of the intraday facility by banks rose moderately in 2005, from CHF 6.2 billion to CHF 6.3 billion.

In 2005, banks again made only occasional use of the liquidity-shortage financing facility for bridging unexpected liquidity bottlenecks.

2.3 Further monetary policy instruments

In addition to the regular monetary policy instruments, the National Bank has a number of other instruments at its disposal, as provided for in art. 9 para. 1 NBA. These are foreign exchange spot and forward transactions, foreign exchange swaps and the SNB's own interest-bearing debt certificates; it can also purchase or sell securities in Swiss francs. In addition, it can create, purchase or sell derivatives on receivables, securities, precious metals and currency pairs. In 2005, these instruments were used within the context of asset management and the distribution of proceeds from gold sales.

2.4 Distribution of proceeds from gold sales (with no effect on liquidity)

In 2005, between the beginning of May and mid-July, the National Bank transferred the proceeds from the sale of gold no longer required for monetary purposes to the Confederation and the cantons. The amount of CHF 21.1 billion was paid out in ten weekly tranches, and the SNB credited the Confederation's account with CHF 2.1 billion on each occasion. Following each of these payments, CHF 1.4 billion was forwarded to the cantons the same day. Prior to each distribution, foreign currency and Swiss franc investments into which gold proceeds had originally been channelled were liquidated. The timing was chosen to match the ten payment dates. With effect on these same dates, Swiss francs were purchased with the proceeds from the sale of foreign currency investments. Hedging transactions were also timed to mature on these dates. In this way, the Swiss franc inflow to the SNB arising from the liquidation of the investments neutralised the liquidity effects of the Swiss franc outflow resulting from the distribution. Regular monetary policy instruments were used to offset short-term liquidity fluctuations. As a result of this continual neutralisation of outflows, the distribution had no significant impact on the money and foreign exchange markets, despite its historical proportions.

2.5 Emergency liquidity assistance

Liquidity assistance conditions

Within the context of the emergency liquidity supply facility, the National Bank may provide liquidity assistance to domestic banks if they are no longer able to refinance their operations in the market (lender of last resort). However, the bank requiring credit must be systemically relevant and solvent, and the liquidity assistance must be fully covered by collateral at all times.

Systemic importance of financial institutions

A bank or group of banks is of systemic importance if its inability to pay would seriously impair the functioning of the Swiss financial system or major parts thereof, and have a negative impact on the economy. To assess the solvency of a bank or group of banks, the National Bank obtains an opinion from the Swiss Federal Banking Commission (SFBC). The National Bank determines what collateral is sufficient.

In 2005, no emergency assistance of this kind was required.

2.6 Minimum reserves

New minimum reserve regulation

Under the new National Bank Act, the former cash liquidity provisions based on the Banking Act were replaced by the minimum reserve regulation in the NBA (arts. 17, 18, 22). This regulation came into effect on 1 January 2005 and was first applied in the reporting period from 20 January to 19 February 2005. The purpose of the minimum reserves is to secure a minimum level of demand for base money, thus fulfilling a monetary policy objective. Both eligible assets and relevant liabilities have been redefined. Eligible assets in Swiss francs now comprise only coins in circulation, banknotes and sight deposits held at the National Bank. With respect to liabilities towards banks, minimum reserves are now obligatory only in the case of liabilities towards banks that are not themselves subject to minimum reserve requirements. If a bank fails to fulfil the minimum reserve requirement, it is required to pay interest to the National Bank with respect to the 30-day period for which there was a shortfall. The interest rate is three percentage points higher than the one-month Libor for Swiss franc investments averaged over the reporting period in question.

Minimum reserve volumes in 2005

In 2005 (from 20 January to 19 December), the average minimum reserves required by law amounted to CHF 7.6 billion. This was CHF 1.0 billion below the figure required under the old cash liquidity requirements. The decline was mainly due to the fact that minimum reserves no longer need to be held for short-term liabilities towards banks that are themselves subject to minimum reserve requirements. Existing eligible assets amounted to an average CHF 9.3 billion. Consequently, surplus liquidity averaged CHF 1.7 billion over the year and the liquidity ratio was 122%.

In 2005, all of the 300 or so banks fulfilled the statutory minimum reserve requirements, with very few exceptions. Ten banks infringed the requirements, in each case for one reporting period. The amount involved was insignificant, amounting to 0.1% of total required assets. The punitive interest that the contravening banks were required to pay totalled about CHF 24,000.

3 Ensuring the supply of cash

3.1 Organisation of cash distribution

Mandate

Pursuant to art. 5 para. 2 (b) of the National Bank Act (NBA), the National Bank is charged with ensuring the supply and distribution of cash in Switzerland. In conjunction with the commercial banks and their jointly operated organisations, as well as Swiss Post, it works to ensure an efficient and secure payment system.

Role of the SNB

The National Bank works with the head and regional offices of the commercial banks, Swiss Post, Swiss Federal Railways (SBB/CFF) and the cash processing operators. It offsets seasonal fluctuations in the demand for cash and replaces notes and coins that are unfit for circulation. The role of retailer, which also includes the immediate redistribution of cash, is assumed by the bodies mentioned above.

Closure of the cash office in Lugano

The cash office at the SNB branch in Lugano is to be closed at the end of 2006. This decision, reached by the Bank Council in October, but still to be approved by the Federal Council, is the consequence of structural changes involving the commercial banks, Swiss Post and cash processing operators. These organisations are important business partners of the SNB and are concentrating their processing of banknotes and coins in a small number of Swiss cities. As a result, the cash office in Lugano no longer has the processing volume needed for rational and secure operations. In future, cash processing operators in Ticino will take care of all cash distribution needs there.

Cash deposit facilities

Since 2003, cash processing operators have been able to request the National Bank to provide them with cash deposit facilities, which comprise stocks of banknotes and coins. The National Bank retains ownership of these facilities. The cash processing operators obtain and deposit cash by exchanging cash deposit holdings for their sight deposits at the SNB. In the second year after the cash deposit facilities were set up, the National Bank again recorded a drop in its own number of incoming and outgoing banknotes, as well as in the number of transports made by the operators of cash deposit facilities. Consequently, the supply and distribution of cash have become more efficient.

Turnover at offices

In 2005, the National Bank's offices registered currency turnover amounting to CHF 121.4 billion, as compared with CHF 124.4 billion a year earlier. They received 391.4 million banknotes (previous year: 407.0 million). The value of incoming coins stood at CHF 257.3 million (previous year: CHF 289.2 million), their weight at 1,373 tonnes (previous year: 1,498 tonnes). The National Bank examined the banknotes and a number of the coins with regard to quantity, quality and authenticity.

... agencies

The agencies' currency turnover (incoming and outgoing) rose in the year under review to CHF 15.2 billion, compared with CHF 14.3 billion a year earlier. Agencies are cash distribution services operated by cantonal banks on behalf of the National Bank. They are responsible for the distribution and redemption of cash in their region. In order to do this, the agencies have access to cash belonging to the National Bank. In previous years, the reorganisation of Swiss Post and the emergence of cash processing operators had led to a steady decline in the agencies' turnover.

... domestic correspondents

The National Bank can grant banks the authority to act as correspondents in areas where it is not active. Together with the post offices, these banks perform local cash redistribution transactions. In 2005 the domestic correspondents supplied 2.3 million banknotes (previous year: CHF 2.6 million) for a total value of CHF 353.6 million (previous year: CHF 407.1 million). Here too, turnover is highly dependent on the activity of the cash processing operators.

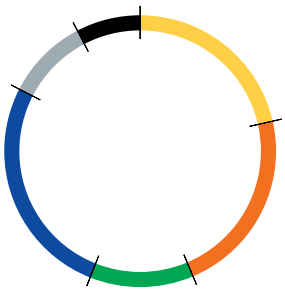
3.2 Banknotes

Mandate

Pursuant to art. 7 of the Federal Act on Currency and Payment Instruments (CPIA), the National Bank issues banknotes commensurate with demand for payment purposes and takes back any banknotes which are worn, damaged or no longer needed. It also determines the denomination and design of the notes. Particular attention is paid to their security. Given the speed at which counterfeiting technology is advancing, it has become absolutely essential that the security features on the banknotes be continuously checked and, if necessary, adjusted, as was the case for example with the perforated number (known as Microperf) on the small notes. New security features are developed in cooperation with third parties.

Banknote circulation

In 2005, banknote circulation averaged CHF 37.1 billion (previous year: CHF 36.2 billion). This increase is primarily attributable to a corresponding development in the 1,000-franc notes, which are often held as a store of value. The number of notes in circulation amounted to 276.2 million on average (previous year: 271.9 million). The rise is attributable to GDP growth, the increased use of the 20-franc note in ATMs, and the generally growing demand for 10-franc notes.



Number of banknotes in circulation
In millions

CHF 10s: 59

CHF 20s: 61

CHF 50s: 34

CHF 100s: 73

CHF 200s: 27

CHF 1,000s: 21

Annual average

Issue and disposal

In 2005, the National Bank put 107.8 million (previous year: 108.6 million) freshly printed banknotes with a face value of CHF 7.7 billion into circulation (previous year: 8.7 billion), and destroyed 99.9 million (previous year: 112.7 million) damaged or recalled notes with a nominal value of CHF 7.0 billion (previous year: CHF 8.2 million).

Counterfeits

Roughly 4,000 counterfeit banknotes were confiscated in Switzerland in 2005. The National Bank's offices alone discovered 142 counterfeit notes (previous year: 244). By international standards, 14 seized counterfeit notes per million Swiss franc notes in circulation is fairly negligible. Moreover, the counterfeits are by and large of poor quality.

Development of new banknote series

In 2004, initial preparatory work was done on a new banknote series, and in early 2005 the National Bank invited twelve artists to take part in a competition for the artistic design of the new banknotes. The theme of the designs was "Switzerland open to the world", and the participants were asked to use the six denominations to present Switzerland as a centre for sport, for culture, for tourism and recreation, for human rights, for education, research and development, and as an economic centre. Portraits are no longer to be used, although the denominations and basic colours used in the current series are to remain unchanged. A jury chaired by Jean-Christophe Amman, an art historian, exhibition organiser and former director of the Museum of Modern Art in Frankfurt am Main, Germany, awarded the first prize for the designs submitted by Manual Krebs and equal second for those by Manuela Pfrunder and Martin Woodtli. In 2006, the National Bank will decide on who should be given the mandate to further develop the submissions.

3.3 Coins

Mandate

The National Bank is entrusted by the Swiss Confederation with the task of coin circulation. Its role is defined in art. 5 CPIA. In essence, the SNB must put the number of coins required for payment purposes into circulation and take back those coins that are surplus to requirements – without restriction and against reimbursement of the nominal value. The National Bank's coinage services are not remunerated, as they constitute part of the mandate to supply the country with cash.

Withdrawal of the one and five centime coins

In a submission made as part of a Federal Department of Finance consultation procedure, the National Bank concurred in principle with the department's considerations regarding a withdrawal of the one and five centime coins, and drew special attention to the importance of providing businesses with early and comprehensive information. Elaborate rounding-off procedures will need to be programmed into equipment such as cash registers and vending machines.

Coin circulation and minting

At CHF 2.4 billion, average coin circulation in 2005 remained at the year-earlier level. The number and denomination of coins in circulation depend greatly on the prices of items sold in vending machines.

In 2005, demand for new coins amounted to 32 million coins (previous year: 32 million), with a nominal value of approximately CHF 10.6 million (previous year: CHF 13.7 million). A large proportion of these coins replace those taken out of the country by tourists.

4 Facilitating and securing cashless payment transactions

In accordance with art. 5 para. 2 (c) of the National Bank Act (NBA), the National Bank facilitates and secures the operation of cashless payment systems.

Mandate

4.1 Facilitating cashless payment transactions

Art. 9 NBA empowers the SNB to keep interest-bearing and non-interest-bearing accounts (SNB sight deposit accounts) for banks and other financial market participants. These accounts are the core of the Swiss Interbank Clearing (SIC) system, through which the banks and PostFinance conduct their payment transactions with each other. SIC is a real-time gross settlement system. Such systems settle payments individually – and only if there is sufficient cover for the transaction – through the accounts of the system participants. Once executed, transactions are irrevocable and final; they have the character of cash payments. SIC is operated by Swiss Interbank Clearing AG, a subsidiary of Telekurs Group, on behalf of the National Bank.

Bodies responsible for the cashless payment system

The National Bank steers the system. This includes the transfer of liquidity from the sight deposit accounts to the clearing accounts in the SIC system at the beginning of each clearing day. At the end of the day, the SNB transfers the balances from the clearing accounts back to the sight deposit accounts. Legally, the two accounts form a unit. The clearing day in the SIC system starts at 5.00 pm and ends at 4.15 pm the following day. Over the course of the day, the SNB monitors operations and ensures that there is sufficient liquidity by granting, when necessary, intraday loans to banks against collateral.

National Bank steers SIC

An agreement concluded between the SNB and SIC AG entrusts the latter with providing data processing services for the SIC system. This agreement had to be revised as the new NBA commissioned the SNB to oversee systemically important payment and securities settlement systems. The stability of the financial market and the implementation of monetary policy hinge on the smooth functioning of the SIC system. Under the NBA, this system is thus deemed to be systemically important and is subject to oversight by the SNB. The new "Agreement with regard to the SIC system" (SIC agreement) has been in force since June 2005. While it does not contain any fundamental changes, the SNB's steering powers are defined in a more comprehensive manner than before and are more clearly geared towards monetary policy requirements and towards the SNB's efforts to facilitate and secure the payment system. This distinguishes the SNB's powers as the SIC steering body from its statutory powers as oversight authority. Moreover, the SNB created the internal organisational and institutional conditions required to prevent conflicts, duplications and overlaps that could result from its double mandate of steering and overseeing.

New SIC master agreement

New SIC giro agreement

The SNB also modified the SIC giro agreement, which governs the relationship between the SNB and the holders of sight deposit accounts, and which refers to the SIC agreement. The revised giro agreement takes the changing needs of the market (outsourcing) and the SNB's longstanding experience with SIC into account.

Participation in payment system bodies

Moreover, the National Bank influences the further development of SIC at a conceptual level and, therefore, has an indirect impact on the entire payment system in Switzerland. Based on the SIC master agreement, the SNB is the final approval body for upgrades and enhancements to SIC. It also exerts influence through the Board of Directors of SIC AG, in which it is represented, as well as through various technical working groups. In addition to contingency planning, standardisation and harmonisation problems were the main focus in 2005. The principal goal was to develop technical and organisational solutions for straight-through processing, i.e. to automate the settlement process from the sender of payment orders to the recipient as far as possible, thus eliminating the need for manual intervention.

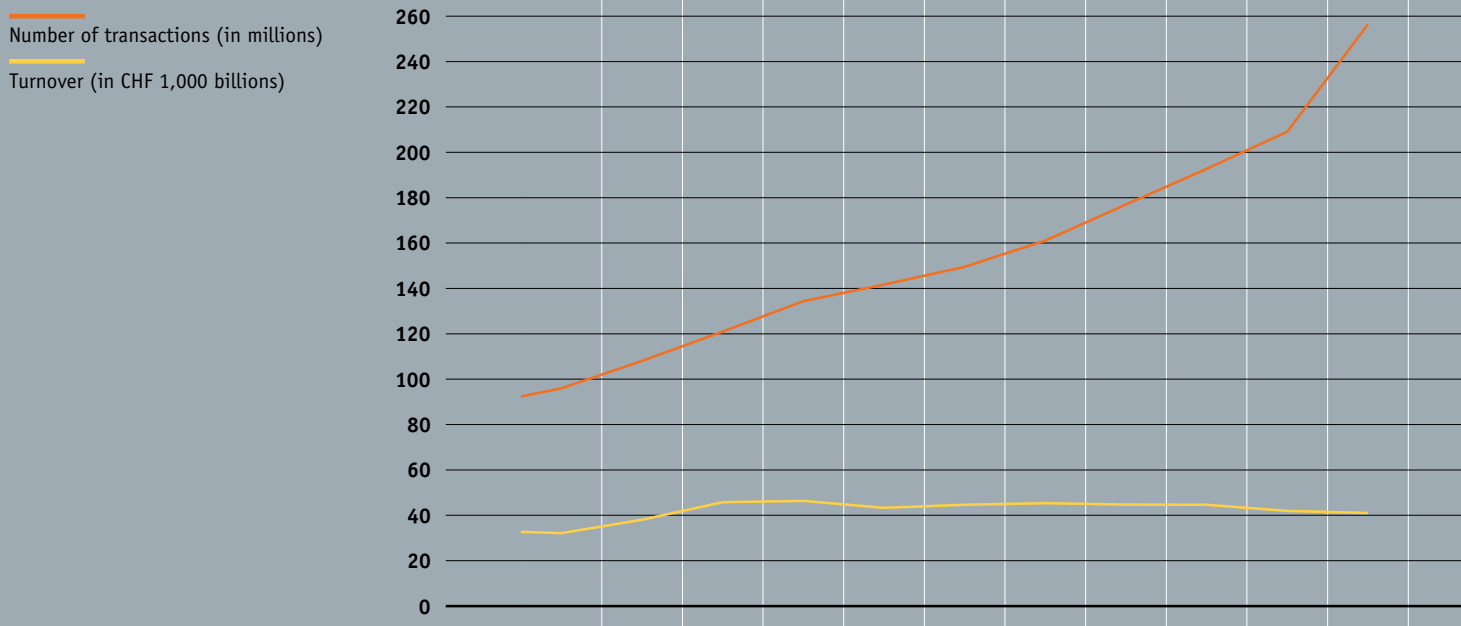
Adoption of European standards

To this end, the EU is in the process of implementing a concept for uniformly structuring the identification numbers of banks and bank accounts. A new standard, the International Bank Account Number (IBAN), was created to identify the beneficiary's account. The already existing Bank Identifier Code (BIC) of SWIFT (Society for Worldwide Interbank Financial Telecommunication) identifies the beneficiary's bank. From the beginning of 2006, cross-border euro payments within the European Economic Area (EEA) must have an IBAN and a BIC. During 2006, a fee will be charged for euro payments not carrying the IBAN and BIC. As of 2007, the EEA financial institutions will be entitled to reject such non-conforming payments. This also applies to payments from Switzerland. The Swiss payment system bodies recommend that IBAN be used not only for euro payments but also for domestic payments in Swiss francs so as to exploit the rationalisation and cost reduction potential of the standardisation also within Switzerland. Where reasonable, the SNB adjusted its account codes to the European standard.

Key figures on SIC

At the end of 2005, 325 participants were connected to SIC, as compared with 306 the previous year. The SIC AG data processing centre settled approximately 1 million transactions amounting to CHF 161 billion each day. On peak days, up to 2.7 million transactions and a volume reaching CHF 247 billion were processed. Total transactions processed in the SIC system rose substantially. Commercial clients increasingly used the bank/SIC system to settle their retail payments, which were previously settled via the data carrier exchange (DTA) application. DTA bundles the payments submitted on data carriers into batches. They are then credited or debited to the corresponding bank accounts via the SIC system. As this procedure is not very transparent and requires various manual interventions, DTA is no longer available as of 2006.

Transactions and turnover in Swiss Interbank Clearing per year



Key figures on SIC

	2001	2002	2003	2004	2005
Transactions (in thousands)					
Daily average	644	705	768	816	1 009
Highest daily value of the year	2 078	1 874	2 145	2 215	2 690
Volume (in CHF billions)					
Daily average	182	180	178	163	161
Highest daily value of the year	274	270	284	273	247
Amount per transaction (in CHF thousands)	282	253	232	200	160
Average liquidity (in CHF millions)					
Sight deposits at the end of the day	3 339	3 327	4 811	5 339	4 831
Intraday liquidity	2 566	3 897	5 972	6 188	6 340

4.2 Oversight of payment and securities settlement systems

Mandate

The NBA (art. 5 para. 2 (c) and arts. 19–21) obliges the National Bank to oversee systems for the clearing and settlement of payments (payment systems) and transactions involving financial instruments, in particular securities (securities settlement systems). It entitles the SNB to impose minimum requirements on the operation of systems that might be a source of risks to the stability of the financial system. The National Bank Ordinance (NBO) lays down the details of system oversight (arts. 18–39 NBO).

Focus on systemically important systems

Oversight focuses on those systems from which risks for the stability of the financial system may emanate, namely the Swiss Interbank Clearing (SIC) payment system, the securities settlement system SECOM, the central counterparty x-clear and Continuous Linked Settlement (CLS), the system for foreign exchange settlements.

Minimum requirements spelled out

The minimum requirements for the operators of systemically important payment and securities settlement systems are the core of system oversight. These requirements are quite abstract, however. In the year under review, the National Bank therefore adopted so-called control objectives that set out in more specific terms the minimum requirements for each individual system that is subject to oversight. For the system operators, these control objectives enhance the transparency and comprehensibility of the regulatory requirements. At the same time, they facilitate the review of compliance with the minimum requirements. Like the minimum requirements, the control objectives are formulated in a target-oriented manner and cover three areas. The first includes general requirements regarding corporate governance and the contractual basis of a system. The second covers requirements relating to the analysis, management and control of risks. The third and largest area contains requirements in the field of IT security. Before adopting the control objectives, the SNB consulted the Swiss Federal Banking Commission (SFBC) and invited submissions from the system operators subject to oversight.

Cooperation with the SFBC

SIS SegaInterSettle AG and SIS x-clear AG, which operate the securities settlement system SECOM and the central counterparty x-clear respectively, both hold a banking license and are supervised by the SFBC (institutional supervision) as well as the SNB (system oversight). While institutional supervision primarily aims at protecting the individual creditor, system oversight deals with systemic risks and the functioning of the financial system. Although the SFBC and the SNB exercise their supervisory and oversight powers separately, they coordinate their activities as stipulated by law so as to avoid duplication (cf. art. 21 para. 1 NBA and art. 23bis para. 4 Banking Act). This applies in particular to the collecting of information required for the supervision of institutions and the oversight of systems. The SFBC and the SNB have agreed that the SNB will, as far as possible, rely on the information already compiled by the SFBC when assessing whether a system operator complies with the minimum requirements.

Cooperation with authorities abroad

The National Bank cooperated with authorities abroad in overseeing internationally active payment and securities settlement systems. Where CLS is concerned, the US Federal Reserve system – the authority with primary responsibility for oversight – involves all central banks whose currencies are settled via this system. As regards the central counterparty x-clear, which holds the status of Recognised Overseas Clearing House (ROCH) in the UK, the National Bank and the SFBC cooperated with the British Financial Services Authority (FSA). Moreover, the SNB participates in overseeing the Society for Worldwide Interbank Financial Telecommunication (SWIFT), a company domiciled in Belgium. SWIFT operates a global network for the secure transfer of financial information. The smooth functioning of the SWIFT network is essential for the payment and securities settlement systems of many countries and, notably, also for cross-border payment transactions. SWIFT is overseen by the central banks of the Group of Ten (G-10), with the National Bank of Belgium coordinating the oversight activities.

Strengthening the financial market infrastructure

In the year under review, the operators of the systemically important payment and securities settlement systems initiated a range of measures to enhance the resilience of Switzerland's financial market infrastructure to major disruptions. These measures include the evaluation of risk profiles of the data processing centres and the formulation and implementation of operational concepts which take due account of the shortage of competent staff to be expected in the event of a crisis. These measures were initiated as a result of the analyses and recommendations of a working group consisting of representatives from the entire financial sector; this working group reviewed and assessed the contingency planning and crisis management of the major companies in the financial sector.

5 Asset management

5.1 Basic principles

Mandate

Under art. 5 para. 2 of the National Bank Act (NBA), the National Bank is responsible for managing the currency reserves. Asset management is governed by the primacy of monetary policy and is implemented according to the criteria of security, liquidity and return. Within these parameters, investments are made in line with the principles of modern asset management. Diversification of investment aims at achieving an adequate risk/return profile. In view of the extended investment possibilities under the new NBA, the National Bank issued Investment Policy Guidelines in 2004 which define the scope of investment activity as well as the investment and risk control process.

Asset classes

The National Bank's assets essentially consist of foreign currency, gold and financial assets in Swiss francs (securities and claims from repo transactions). They fulfil important monetary policy functions. Their composition is determined mainly by the established monetary order and the requirements of monetary policy. Part of the assets, including claims from repo transactions, are used directly for the implementation of monetary policy. The National Bank uses repo transactions to supply commercial banks with liquidity in the form of base money by purchasing securities from them. By setting the terms for such transactions, the SNB influences the interest rate level in the money market. The National Bank holds currency reserves – in the form of foreign currency and gold – in order to have room for manoeuvre in monetary policy at any time. Currency reserves serve to prevent and overcome potential crises.

5.2 Investment and risk control process

Responsibilities of Bank Council and Risk Committee

The NBA, which entered into force in 2004, defines the SNB's responsibilities and describes in detail its mandate with regard to asset management. The Governing Board decides on the composition of the currency reserves and other assets. The Bank Council is charged with the integral oversight of the investment and risk control process. It assesses the principles of the process and monitors compliance with them. The Risk Committee – which is composed of three members of the Bank Council – supports the Bank Council in this task and monitors risk management in particular. All internal reporting carried out is addressed directly to the Governing Board and Risk Committee. To avoid conflicts of interest, the responsibilities for monetary policy and investment policy operations are largely separated on the operational level.

... Governing Board

The Governing Board defines the requirements with regard to the security and liquidity of the investments as well as the eligible currencies, investment categories, instruments and debtors. It generally decides on the investment strategy once a year. The investment strategy encompasses the allocation of total assets to the different portfolios and the guidelines for their management, in particular the allocation to different currencies and investment categories, as well as the leeway for active management on an operational level.

An internal Investment Committee determines the tactical allocation on an operational level. Within the strategically prescribed range, it adjusts the currency allocations, duration or allocation to the different investment categories to changing market conditions. The management of the individual portfolios is the responsibility of Portfolio Management. The majority of investments are managed by internal portfolio managers. In order to facilitate access to investment categories such as US mortgage-backed securities or indexed equity portfolios, the SNB uses external asset managers. For performance comparison purposes with internal portfolio management, other mandates are outsourced.

... Investment Committee and Portfolio Management

The investment strategy is based on the quantitative specifications as to risk tolerance and liquidity of the investments, and on comprehensive risk/return analyses. Risk management and risk limitation are carried out by means of a system using reference portfolios, guidelines and limits. All relevant financial risks on investments are continuously compiled, assessed and monitored. Risk measurement is based on standard risk indicators and procedures. While market risk is mainly assessed by means of sensitivity and Value-at-Risk (VaR) analyses, credit risk is appraised using information from major rating agencies. Risk indicators are aggregated over all investments. Compliance with the guidelines and limits is monitored on a daily basis. A quarterly risk report for the attention of the Governing Board and the Bank Council's Risk Committee documents the results of risk management activities.

... Risk Management

5.3 Development of the asset structure

The National Bank manages currency reserves of a little over CHF 70 billion, two-thirds of which are held in foreign exchange reserves and one-third in gold. In addition to this are approximately 30 billion Swiss franc assets in the form of claims from repo transactions and bond investments in the domestic capital market.

Composition of assets

With the entry into force of the new NBA in May 2004, former legal restrictions regarding eligible investment categories and debtors were dispensed with. This opened up the possibility to broaden the investment universe, thus improving the risk/return profile of investments. The National Bank acted on this already in 2004, adding corporate bonds to its asset mix. It also lowered the required minimum rating for bond investments from A to BBB – the lowest investment grade category. Then, for the first time, the SNB invested part of its foreign exchange reserves in a well-diversified equity portfolio in early 2005. The equities are managed on a purely passive basis, whereby broad market indices in euros, US dollars, yen, pounds sterling and Canadian dollars are replicated. In order to avoid any conflict of interest with monetary policy, only corporate bonds and equities from foreign companies are held. At the end of 2005, 5% of the foreign exchange reserves were invested in corporate bonds and 10% in equities.

Broader investment spectrum

Most of the investments were fixed-income ones, with roughly CHF 40 billion in foreign exchange reserves, CHF 26 billion in claims from repo transactions, CHF 6 billion in Swiss franc securities and CHF 3 billion in claims from gold lending transactions. At the end of 2005, the bond portfolios consisted of government and quasi-government bonds as well as bonds of international organisations, local authorities, financial institutions and other companies. To a limited extent, secured and unsecured money market investments were also made at banks. Exchange rate and interest rate risks were

Debtor categories and instruments

managed by derivative instruments, such as interest rate swaps, interest rate futures and forward foreign exchange transactions. In addition, futures on equity indices were also used to manage the equity share.

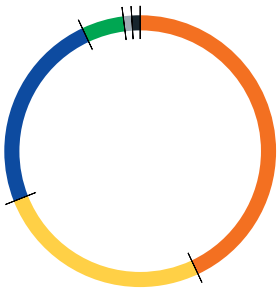
Investment structure at the end of 2005

	Foreign exchange reserves	Swiss franc securities
Currency allocation, incl. derivative positions		
Swiss francs	–	100.0%
US dollars	28.3%	–
Euros	47.4%	–
Pounds sterling	9.9%	–
Other (yen, Canadian dollars, Danish kroner)	14.4%	–
Investment categories		
Money market investments	3.2%	–
Government bonds[1]	62.9%	48.3%
Other bonds[2]	25.2%	51.7%
Shares	8.7%[3]	–
Risk indicators		
Duration of bonds (years)	3.8	5.1
Value-at-Risk (1 year, 95%) in CHF billions	2.1	0.1

1 Government bonds in their own respective currencies, and – in the case of Swiss franc investments – bonds issued by Swiss cantons and municipalities.

2 Government bonds in foreign currencies, bonds issued by foreign local authorities and supranational organisations, Pfandbriefe, US mortgage-backed securities (MBS), corporate bonds, etc.

3 Including share index futures not backed by money market investments: 9.8%.



Structure of National Bank assets
In percent

Foreign exchange reserves 43

Gold reserves 26

Claims from repo transactions 24

Securities in Swiss francs 5

Monetary institutions 1

Other assets 1

Total: CHF 109 billion
End of 2005

Reduction of US dollar share

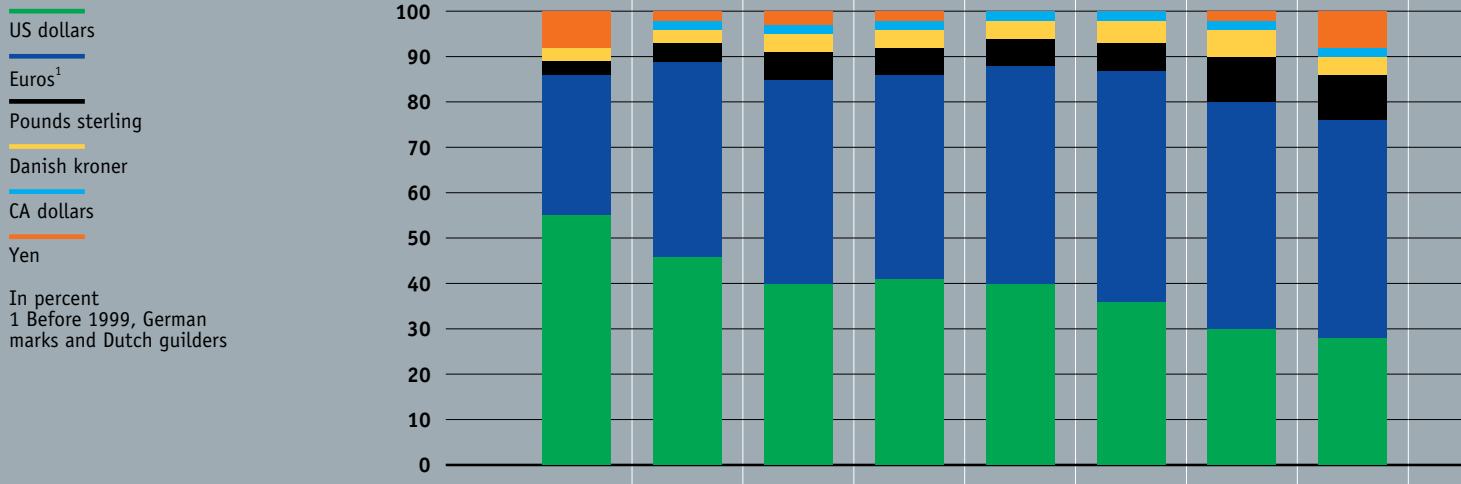
The US dollar share in the foreign exchange reserves was scaled back yet further in 2005. Having been largely reduced in favour of the pound sterling in 2004, this year saw the share of yen increased. This move brought the SNB another step closer to achieving a balanced and diversified currency allocation.

Distribution of free assets

The sale of the gold no longer required for monetary purposes was completed at the end of March. A total of 1,300 tonnes of gold was sold between 2000 and 2005. The proceeds were invested on an ongoing basis in fixed-income investments, in accordance with a separate investment strategy. The proceeds from the sale were distributed to the Swiss Confederation and the cantons between the beginning of May and mid-July 2005 (cf. 2.4, p. 42).

The investment income was not included in this distribution. A percentage of the earnings were already distributed in 2004 and 2005 as part of the annual result. Following the distribution, the remainder – around CHF 1.5 billion – was transferred to the portfolios of the foreign exchange reserves and Swiss franc securities.

Currency breakdown of foreign exchange reserves



In percent
1 Before 1999, German marks and Dutch guilders

5.4 Investment risk profile

Risk profile

The main risk to investments is market risk, i.e. gold price, exchange rate, share price and interest rate risks. These risks are managed primarily by diversification. The National Bank counters liquidity risk by holding a considerable part of its investments in the world's most liquid currencies and markets. In addition, it also takes some credit risk. Compared with the market risk, this is insignificant, however.

... of currency reserves

The addition of equities to the currency reserves and the improved currency allocation contributed to enhancing the risk/return profile of the foreign exchange reserves. The average duration of fixed-income investments was decreased from five to four years, with the result that the interest rate risk was also slightly reduced. The price of gold and the US dollar exchange rate were still the dominant risk factors of currency reserves. By contrast, equity, interest rate and credit risks contributed only marginally to the overall risk. With the exception of gold lending, gold was not actively managed. Slightly more than one-quarter of the gold holdings are available for gold lending. At the end of 2005, approximately 134 tonnes of gold had been lent to different financial institutions against remuneration. Roughly 90% of the gold lending was secured by bonds with above-average ratings.

... and of Swiss franc investments

Swiss franc securities are managed passively. The maturity and credit structure largely correspond to that of the Swiss Bond Index. Duration at year-end was 5.1 years. Monetary policy repo transactions pose virtually no credit risk, since the claims are secured by first-class collateral. These collateralised securities are re-valued daily, and shortfall is covered immediately. Given the very short maturities, there is no interest rate risk.

Credit risks

The National Bank was exposed to credit risk by purchasing bonds from different debtors and debtor categories. Moreover, credit risk vis-à-vis banks existed in the form of time deposits, replacement values of derivatives, and gold lending. Even though credit risk tolerance has been somewhat higher since 2004, the SNB's fixed-income investments had a very high average rating. Overall, 77% of the investments were graded AAA, the highest possible rating. The lowest still eligible rating category – BBB – accounted for approximately 1% of these investments.

Overall risk

The overall risk of investments can be estimated – among other methods – with the VaR analysis. This indicator illustrates the SNB's risk tolerance and is applied both to the total assets and to all sub-portfolios. The VaR shows the loss that – based on a prescribed probability level – will not be exceeded within a specific period of time. In view of the long investment horizon, the VaR for the SNB is calculated for a period of 12 months. The probability level is set at 95%. Based on this calculation method, the VaR indicates the loss threshold which should only be exceeded one in every twenty years. Taken separately, the VaR for gold came to a little over CHF 6 billion and to approximately CHF 2 billion for foreign exchange reserves. Owing to diversification effects, the VaR for total assets was – at roughly CHF 6 billion – significantly lower than the sum of the VaRs for the sub-portfolios.

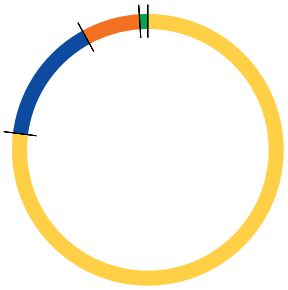
5.5 Investment performance

The National Bank's investment performance is calculated across all asset categories (foreign currency assets, gold, Swiss franc assets including repo transactions). In 2005, it amounted to 12.8%, which, in contrast to 2004, was considerably higher than the long-term return expectations. Gold and exchange rate gains in particular, as well as share profits, contributed to the above-average result. With a 35% increase, the Swiss franc gold price recorded an exceptionally strong rise over the course of the year. Both the value of gold in US dollars and the value of the dollar in Swiss francs increased significantly. This is a rare occurrence. In previous years, both of these values tended to develop in opposite directions. On the whole, changes in the interest rate level had no major impact on performance. The generally low interest rate level resulted in low current interest earnings in all investment currencies.

Return on investments in Swiss francs[1]

	Foreign exchange reserves	Gold	Swiss franc securities	Total return[2]
1999	9.7%		0.7%	
2000	5.8%	–3.1%	3.3%	2.2%
2001	5.2%	5.3%	4.3%	4.0%
2002	0.4%	3.4%	10.0%	3.0%
2003	3.0%	9.1%	1.4%	4.2%
2004	2.3%	–3.1%	3.8%	0.9%
2005	10.8%	35.0%	3.1%	12.8%

1 Sum of direct income and realised and unrealised price changes on holdings.
2 Including the return on monetary policy repo transactions and on free assets.



Rating allocation of fixed-income investments
In percent

AAA 77

AA 15

A 7

BBB 1

End of 2005

6 Contribution to financial system stability

Mandate

Pursuant to art. 5 para. 2 (e) of the National Bank Act (NBA), the National Bank is obliged to contribute to the stability of the financial system.

Stability as important condition

Stability-oriented monetary policy makes a significant contribution towards a stable financial system which, in turn, inspires confidence in a balanced economic development and helps consumers, savers and investors to make long-term decisions. A stable financial system is also a prerequisite for properly functioning financial markets and is thus indispensable for a successful implementation of monetary policy. The National Bank makes every effort to identify any potential risks to stability at an early stage. It also plays an active role in creating an operational environment that promotes stability. To this end, the National Bank collaborates closely with the Swiss Federal Banking Commission (SFBC) and other federal offices.

6.1 Publication of a financial stability report

Analysis of banking sector and financial market infrastructure

In June 2005, the National Bank published its third Financial Stability Report. The report looked at developments in the banking sector and in the financial market infrastructure with regard to stability. The individual banks were analysed solely in terms of their systemic importance.

Stable banking sector

According to the report, the banking sector raised its profits substantially in 2004 in a generally favourable macroeconomic and financial environment. This increase led to an overall rise in capital, thus improving the banking sector's capability to absorb shocks. No major imbalances which might trigger a crisis were identified. Consequently, the National Bank judged the Swiss banking system to be stable. Moreover, the economic environment in which the banks operate remains favourable.

Secure and efficient financial market infrastructure

With regard to the settlement and processing of payments, securities transactions and transactions using other financial instruments, the report stated that the Swiss financial sector has a smoothly functioning financial market infrastructure that also compares favourably with that of other countries. The architecture of the payment and securities settlement systems that are integrated in the Swiss value chain reduces settlement risks significantly. The Swiss financial sector is also well prepared for severe disruptions. An analysis, lead-managed by the National Bank, examined the existing contingency planning and crisis management measures of the key financial market infrastructures and the major system participants and presented a generally positive picture. Various measures to increase the resilience of the financial system were identified, and a start has been made on implementing them.

6.2 New Basel Capital Accord

SNB supports Basel II

As a member of the Basel Committee on Banking Supervision, the National Bank continued to participate in the revision of the Basel Capital Accord. The Committee modified the 2004 Accord (Basel II, original version), notably with regard to counterparty risk of derivatives and illiquid positions in the trading book. The National Bank supports the direction in which Basel II is headed. Substantial and risk-adequate capital cushions strengthen the stability of the banking system. They protect banks from solvency problems and thus also from crises of confidence that may lead to liquidity shortages. Only well-capitalised banks can fulfil their macroeconomic task of granting credit, also in difficult economic times.

SNB's role in implementation

In autumn 2003, a working group lead-managed by the SFBC began to implement the new Capital Accord in the Swiss banking regulatory framework. The National Bank, together with the commercial banks and auditing companies, participated in this task, concentrating on areas related to the stability of the banking system and the smooth functioning of the credit market. In the first half of 2005, the working group drafted the ordinances and circulars on the new capital adequacy requirements. The drafts were approved by the SFBC in autumn and then submitted for consultation. The new provisions are likely to be passed in mid-2006, and the new capital adequacy regulation could then enter into force at the end of 2006, at the earliest. For the advanced calculation method of capital adequacy requirements (internal ratings approach), Swiss standards will be based strongly on the Basel Capital Accord. With regard to the standard approach, which is better suited to smaller banks, differences will remain, however, particularly in relation to risk weighting.

SNB's concerns regarding implementation

The National Bank supports the direction in which the Swiss implementation of Basel II is headed. From the SNB's point of view, three issues are particularly important. The first relates to the reliability of the advanced methods used by large banks to calculate capital adequacy requirements. The second relates to the necessity of restricting the procyclical potential of the new capital adequacy requirement; the SNB places great emphasis on the careful conduct of stress simulations by the banks. The third concerns the need to reduce the potential for contagion in the Swiss banking sector; the SNB is calling for stricter regulation and diversification of interbank claims.

6.3 Legislation relevant to the financial market

Legislation on financial market supervision

The National Bank contributed in various ways to legislative projects that are important for the Swiss financial centre. As part of a government working group headed by the Federal Department of Finance (FDF), it helped to finalise the Federal Act on Financial Market Supervision (FINMA Act) and draw up the corresponding message (cf. 97th Annual Report 2004, p. 60). The draft law provides for the establishment of a Federal Financial Market Supervisory Authority (FINMA) integrating the SFBC, the Federal Office of Private Insurance and the Money Laundering Control Authority. The independence and corporate governance of the future financial market supervisory body will be strengthened. The statutory instruments for supervision and the system of sanctions will be unified as far as possible. Furthermore, the draft obliges FINMA to estimate the follow-up costs of regulation projects.

Reform of securities legislation

On behalf of the FDF, the National Bank continued to actively support the reform of the securities act. The SNB had contributed substantially to drawing up the draft legislation on the custody and transfer of uncertificated securities (Uncertificated Securities Act), which updates the legal basis for the safekeeping of securities by financial intermediaries. The draft law was met with broad approval in an informal consultation procedure. The Federal Council mandated the FDF to revise the draft based on the comments received and to submit a message by mid-2006.

On an international level, the National Bank assumed the chair of a committee of government experts at the International Institute for the Unification of Private Law (Unidroit), which is preparing an agreement on the harmonisation of the law on securities held with intermediaries. Work is scheduled to be concluded by 2007.

7 Involvement in international monetary cooperation

Mandate

Art. 5 para. 3 of the National Bank Act (NBA) stipulates that the National Bank shall participate in international monetary cooperation.

On an international level, the National Bank primarily cooperates with the International Monetary Fund (IMF), the Group of Ten (G-10), and the Bank for International Settlements (BIS) and the Organisation for Economic Cooperation and Development (OECD). It also provides technical assistance.

7.1 International Monetary Fund

Swiss membership since 1992

Switzerland has been a member of the IMF since 1992. The IMF works to promote stable monetary conditions worldwide and support free trade and payment flows internationally. As an open economy with a globally important financial sector, Switzerland shares these aims.

The Chairman of the National Bank is a governor on the Board of Governors of the IMF, the Fund's highest decision-making body, while the Head of the Federal Department of Finance (FDF) leads the Swiss delegation that takes part in the IMF meetings. Switzerland holds one of the 24 seats on the Executive Board, the IMF's most important operational body. As a representative of a constituency, which also includes Azerbaijan, the Kyrgyz Republic, Poland, Serbia and Montenegro, Tajikistan, Turkmenistan and Uzbekistan, it participates in formulating IMF policy. The Swiss seat on the Executive Board is held alternately by a representative of the FDF and the SNB. The FDF and the SNB determine Switzerland's policy in the IMF together and support the Swiss executive director in his activities.

Important activities in 2005

In addition to its surveillance of the economic situation in member countries (crisis prevention), the Executive Board's main activities in 2005 addressed crisis management, the IMF's medium-term strategic direction and its activities in favour of poor nations. Significant progress has been made in recent years in the area of surveillance. As regards crisis management, the focus was on countries with loan packages. The IMF's medium-term strategy is devoted to the challenges posed by globalisation. In so doing, the focus is on more effective country surveillance, better assistance with regard to institution and capacity building as well as structural reforms of the Fund. Together with other international financial organisations, the IMF reduced the burden on Heavily Indebted Poor Countries (HIPCs) by cancelling debt. An Exogenous Shocks Facility (ESF) was set up for the poorest member countries. An additional Policy Support Instrument (PSI) provides assistance to low-income countries without balance of payments problems when implementing a sustainable economic policy.

SNB finances reserve position

The IMF finances its activities with the member countries' quotas, i.e. capital subscriptions. Quotas in the IMF amount to SDR (Special Drawing Rights) 213 billion (approx. CHF 400 billion), with Switzerland's quota coming to SDR 3,458.5 million (roughly CHF 6,505.4 million). The portion of the Swiss quota drawn by the IMF – the reserve position – is financed by the National Bank. For the National Bank, it represents a currency reserve and may be used by it at any time. At the end of 2005, Switzerland's reserve position amounted to SDR 571.2 million, compared with SDR 1,153.9 million at the end of 2004. At the end of 2005, one SDR was equivalent to CHF 1.88. The value of the SDR is calculated on the basis of weighted exchange rates for the US dollar, euro, yen and pound sterling.

Contributions to PRGF and interim PRGF

The National Bank also finances the Swiss contribution to the loan account of the IMF's Poverty Reduction and Growth Facility (PRGF). The PRGF funds in which Switzerland participates with a loan commitment of SDR 151.7 million were completely drawn down by the end of 2001. Owing to the fact that the PRGF cannot be established as a self-supporting facility before 2006, interim financing (interim PRGF) was necessary. The National Bank made a contribution of SDR 250 million to the interim PRGF's capital. The Swiss Confederation guarantees the National Bank the timely repayment of both the PRGF and interim PRGF loans, including interest payments.

7.2 Group of Ten

Study on implications of ageing populations

The National Bank participates in meetings of the finance ministers and central bank governors of the G-10 countries and in various working groups. In 2005, a G-10 group of experts prepared a report entitled "Ageing and pension system reform: implications for financial markets and economic policies". Funded pension schemes were the main focus of the analysis. In addition to the problems of private (funded) pension schemes – still in their infancy in many countries – three areas of reform were identified: firstly, a regulatory and supervisory framework should be set up to support a more rigorous risk management, adequate governance, as well as transparency and comparability between the return achieved by different pension funds. Secondly, financial instruments must be made available that are specially tailored to institutional investors and pension funds so as to better coordinate their investments and obligations. Thirdly, protection of pension beneficiaries must be enhanced and their knowledge in financial matters improved. Informed and critical pension beneficiaries are in a better position to assess risks and to make more careful decisions.

7.3 Bank for International Settlements

BIS bodies

The central bank governors of industrialised countries and emerging economies meet every two months at the BIS for an exchange of information. In addition, the National Bank participates in the four standing committees of the BIS: the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System and the Markets Committee.

Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision serves as a platform for regular cooperation in banking supervision matters. Its tasks are described in more detail in the chapter on the National Bank's contribution to the stability of the financial system.

Committee on Payment and Settlement Systems

The Committee on Payment and Settlement Systems (CPSS) monitors and analyses the developments in national and international payment and securities settlement systems. The CPSS issued two reports in 2005. The first report provides an overview on the developments and innovations in high-value payment systems in the last few years. The second report discusses the oversight of payment and securities settlement systems. It concludes that oversight practices of the G-10 central banks are very similar and contains principles on effective oversight.

Committee on the Global Financial System

The Committee on the Global Financial System (CGFS) monitors and assesses the developments in the international financial markets and draws up recommendations which support central banks in their responsibilities with regard to the stability of the financial system. In 2005, the CGFS published two reports. The first report on the role of ratings in structured finance examined the rapidly expanding markets for structured financial instruments, the critical importance of rating agencies and the ensuing implications for people responsible for financial stability. The second report is a survey of the use of stress tests in major financial institutions and clearly illustrates the crucial role of such tests within risk management.

Markets Committee

The Markets Committee serves as a discussion forum for the G-10 central bank staff members responsible for financial market operations. Topics addressed in the discussions included the developments in the foreign exchange and other financial markets, as well as the impact of individual events on the overall functioning of these markets.

7.4 OECD

Switzerland is a member of the OECD. In the OECD committees, it works to promote the development of economic relations, particularly among industrialised countries. The National Bank, together with the Federal Administration, represents Switzerland in several OECD bodies. The Economic Policy Committee (EPC), its Working Parties, WP1 and WP3, and their working groups deal with the global economic outlook on a political and scientific level. The Committee on Financial Markets (CMF) discusses current developments and structural problems in international financial markets. In November 2005, the OECD's country survey on Switzerland was discussed with the experts of the Economic and Development Review Committee (EDRC).

7.5 Monetary assistance loans

No new monetary assistance loans were extended in 2005. One balance-of-payments loan remained outstanding at the end of the year – EUR 14.3 million to Bulgaria, expiring in 2007.

7.6 Technical assistance

Transfer of central bank-specific expertise

The National Bank fosters good relations with the central banks of those countries Switzerland works with in the International Monetary Fund. With their support, Switzerland is able to head a constituency in the IMF and claim one of 24 seats on the Executive Board. The National Bank primarily provides the central banks of these countries with technical assistance, with a particular focus on the transfer of central bank-specific expertise. The SNB provides no financial support.

... to countries in its IMF constituency

The Swiss National Bank is assisting the National Bank of Azerbaijan in the introduction of a new banknote series and advising it on the im-plementation of monetary policy. Work on these projects continued in 2005, including the successful introduction of liquidity planning in the money market. Moreover, an already existing project on the investment of currency reserves was pursued further. The National Bank of Azerbaijan began receiving assistance in personnel matters for the first time. In Serbia and Montenegro, assistance to their respective central banks in investing currency reserves continued. The National Bank of the Kyrgyz Republic again received technical support in the area of cash management and now also receives advice on securities issues. The project assisting the National Bank of Tajikistan in the preparation of monetary policy decisions was continued. Finally, staff members of the National Bank held a seminar on investment strategy and risk controlling at Turkmenistan's central bank.

Furthermore, the National Bank provided topic-related technical assistance to several countries. In May 2005 – together with the National Bank of Poland – it organised a conference on exchange rate regimes and monetary policies in Zurich. The conference addressed in particular participants from central banks whose countries are members of the Swiss constituency at the IMF as well as other countries of the former Soviet Union and Southeast Europe.

... and to other countries

Outside of the Swiss constituency within the Bretton Woods institutions, the National Bank advised the National Bank of Kazakhstan with regard to investment strategy and risk controlling.

8 Banking services for the Confederation

Mandate

Based on art. 5, para. 4 and art. 11 of the National Bank Act (NBA), the National Bank provides provide banking services to the Swiss Confederation.

Remuneration for banking services

The services are to be provided by the National Bank for an adequate consideration. However, the services are provided free of charge if they facilitate the implementation of monetary policy. Remunerable services include payment transactions, liquidity management and custody of securities. The details of the services to be provided and the remuneration are to be laid down in agreements concluded between the Federal Finance Administration (FFA) and the National Bank.

New agreements with the FDF

On 1 January 2005, an agreement with the Federal Department of Finance (FDF) on the remuneration for banking services provided to the Swiss Confederation entered into force. At the same time, the modalities for the provision of services in connection with the Confederation's liquidity management were laid down in a provisional agreement and a declaration of intent. In the year under review, the SNB and the FFA agreed to combine all concerns in connection with the provision of banking services to the Confederation in one single agreement. Consequently, the agreement on the remuneration for banking services has been an integral part of this new agreement since the beginning of 2006.

Liquidity management

An important change in the agreement concerned the level of interest-bearing sight deposit accounts with the SNB which was lowered from CHF 600 million to CHF 200 million. A limit of CHF 10 billion was set for time deposits with the SNB and the maximum maturities were restricted from two years to six months. These new regulations are likely to have the effect that the FFA will aim to keep sight deposits with the SNB within the interest-bearing level and to invest any surplus liquidity in the banking system. The fluctuations in market liquidity will therefore be less pronounced and the volatility of call money rates will tend to go down.

Issuing activity

In 2005, the National Bank issued money market debt register claims (MMDRC) and bonds on behalf of the Confederation via the auction system of the Eurex Repo electronic trading platform. A total of CHF 99.5 billion MMDRCs were subscribed, of which CHF 51.9 billion were allocated. Market participants subscribed Swiss Confederation bonds in the amount of CHF 8.5 billion. Bonds totalling CHF 5.5 billion were allocated. In the area of payment transactions, the SNB carried out 51,600 foreign payments and 57,100 domestic payments on behalf of the Confederation (incl. the Swiss Federal Institute of Technology).