Review of economic developments

1 International developments

1.1 Real economic performance

Stronger growth in the world economy – crises in East Asia

World economic growth accelerated in 1997. Real gross domestic product (GDP) in the OECD countries rose by 3% on average, up from 2.7% in the previous year. Growth was particularly pronounced in the United States and the United Kingdom. In Germany, France and Italy, the pace of business activity quickened, whereas the recovery in Japan suffered a setback. Outside the OECD, the situation improved in the transition economies of central Europe and in Latin America. Eastern Europe continued to grapple with huge economic problems. East Asia was shaken by financial crises, and several countries in this region had to resort to international financial aid.

Rapid expansion in the United States and the United Kingdom

In the United States and the United Kingdom the expansion continued with GDP rising substantially faster than in the previous year. In the United States, the growth was broad-based, with a particularly rapid increase in plant and equipment spending and in exports. The upswing in the United Kingdom was driven primarily by private consumption, though exports and investment in plant and equipment also contributed to the favourable outcome. The pace of expansion slowed in the second half of the year owing to higher interest rates and a stronger pound sterling.

Economic recovery in continental Europe

The economic recovery in Germany, France and Italy was driven mainly by strong export growth. Domestic demand, on the other hand, revived only hesitantly. Construction activity in particular remained sluggish, and government demand was dampened by restrictive fiscal policies. There was, however, an upturn in private consumption – in Italy partly also due to tax changes – and in expenditure on plant and equipment. Most of the smaller European countries enjoyed a lively pace of business activity, with growth rates of GDP exceeding the EU average of 2.5%.

Downturn in Japan

In Japan, the economic recovery lost momentum. The rise in value-added tax, lower public-sector investment activity and the collapse of major financial institutions in the second half of the year put a brake on domestic demand. After rising steeply at the beginning of the year, exports were throttled towards year-end by the financial crises in East Asia.

Uneven decline in unemployment

Vigorous economic growth in the United States and the United Kingdom gave a further boost to the demand for labour, and unemployment in these countries declined significantly. By contrast, the recovery in continental Europe brought little improvement in the labour market. Although the unemployment rate fell in a number of smaller countries, it continued to rise in Germany and remained at a high plateau in France and Italy. The average figure for the EU as a whole edged down to 11.1%. Japan showed relatively low unemployment.

Inflation still low

The inflation rate in the OECD area in general remained low. A notable decline was recorded in Italy, and the rate also fell in the United States, France and many smaller countries. Slight rises were recorded in the United Kingdom and Germany. In the EU as a whole, inflation receded from 2.5% on average to 2% whereas in Japan it moved up from 0.1% in the previous year to 1.7% on account of the increase in value-added tax.

Summary of data on economic activity

	1993	1994	1995	1996	1997
Real GDP change from previous year in percent					
USA	2.3	3.5	2.0	2.8	3.8
Japan	0.3	0.7	1.4	4.1	0.8
Germany	−1.2	2.8	1.9	1.4	2.4
France	−1.3	2.8	2.1	1.5	2.2
United Kingdom	2.1	4.3	2.7	2.3	3.4
Italy	−1.2	2.2	2.9	0.7	1.1
European Union	−0.5	2.9	2.5	1.7	2.5
Switzerland	−0.5	0.5	0.8	−0.2	0.7
Unemployment in percent of the labour force					
USA	6.9	6.1	5.6	5.4	5.0
Japan	2.5	2.9	3.2	3.4	3.4
Germany	8.9	9.6	9.5	10.4	11.5
France	11.7	12.3	11.6	12.3	12.5
United Kingdom	10.3	9.3	8.2	7.5	5.6
Italy	10.3	11.3	12.0	12.1	12.3
European Union	11.1	11.5	11.2	11.3	11.1
Switzerland	4.5	4.7	4.2	4.7	5.2
Inflation of consumer prices, in percent					
USA	3.0	2.6	2.8	2.9	2.3
Japan	1.2	0.7	−0.1	0.1	1.7
Germany	4.5	2.7	1.8	1.5	1.8
France	2.1	1.7	1.8	2.0	1.2
United Kingdom	1.6	2.5	3.4	2.5	3.1
Italy	4.2	3.9	5.4	3.9	1.8
European Union	3.5	3.0	3.1	2.5	2.0
Switzerland	3.3	0.9	1.8	0.8	0.5
Current account balance in percent of gross domestic product					
USA	−1.4	−1.9	−1.8	−1.9	−2.1
Japan	3.1	2.8	2.1	1.4	2.2
Germany	−0.7	−1.0	−1.0	−0.6	−0.3
France	0.8	0.6	0.7	1.3	2.3
United Kingdom	−1.6	−0.3	−0.5	−0.1	0.3
Italy	0.9	1.3	2.3	3.4	3.6
European Union	0.2	0.3	0.6	1.0	1.3
Switzerland	8.2	7.0	7.0	6.9	8.3

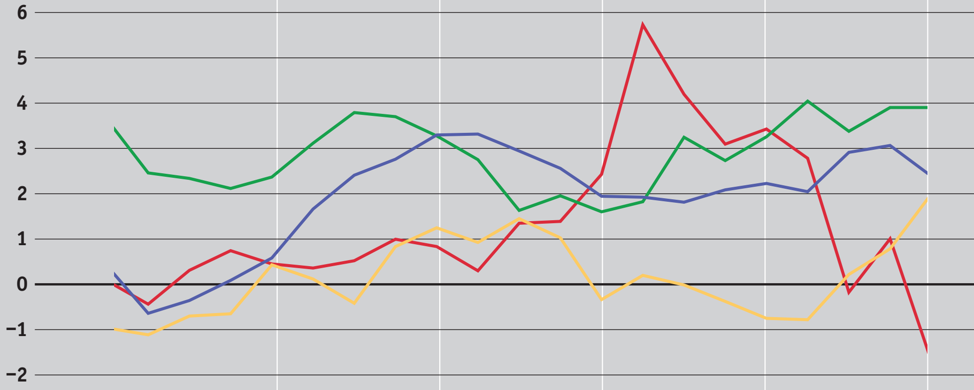
Some 1997 figures are estimates.
Source: OECD

1993 1994 1995 1996 1997

USA
Japan
OECD Europe
Switzerland

Change in percent
from previous year.
Source: OECD

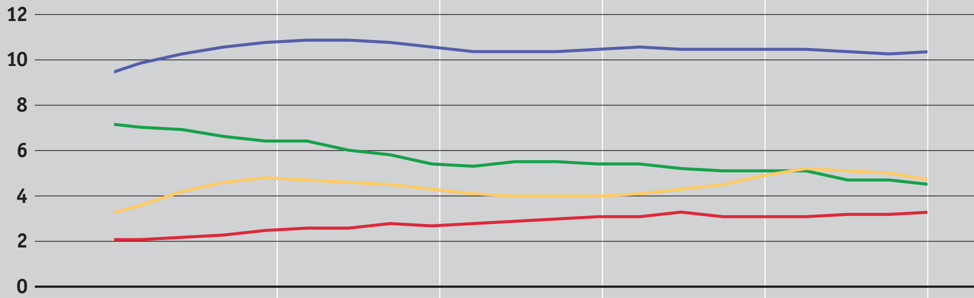
Real gross domestic product



USA
Japan
OECD Europe
Switzerland

In percent of labour force.
Source: OECD

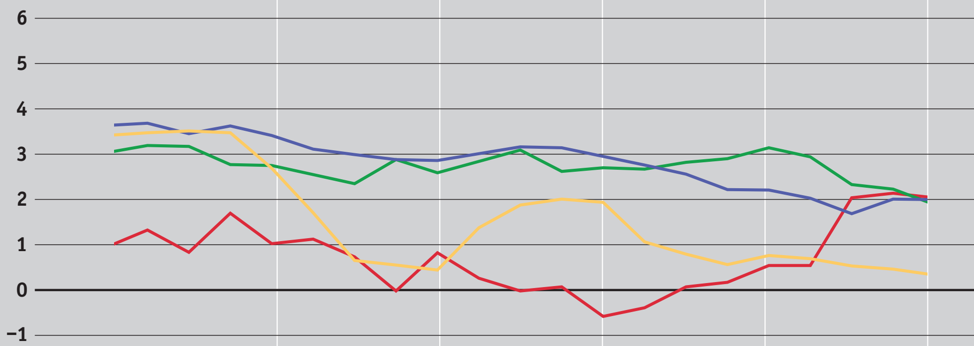
Unemployment



USA
Japan
OECD Europe
Switzerland

Percentage change in consumer
prices from previous year.
Source: OECD

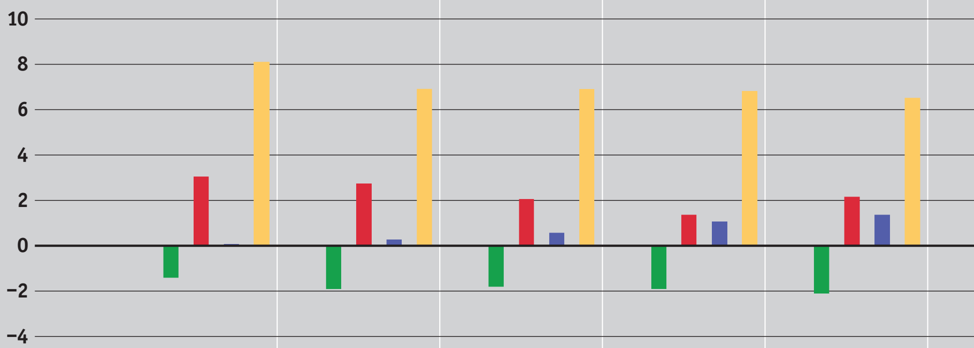
Inflation



USA
Japan
European Union
Switzerland

Net balance in percent
of gross domestic product.
Source: OECD

Current account balance



1993 1994 1995 1996 1997

Mixed developments in central and eastern Europe

In most countries of central and eastern Europe, further progress was made with economic reforms in 1997. Economic growth strengthened, and inflation receded. The exceptions were the Czech Republic and Slovakia, which reported a drop in output, as well as Bulgaria and Romania, where the recession worsened. In Russia, the decline in production was halted for the first time since 1991, while in Ukraine it fell less steeply than in the previous year against a background of lower inflation.

Financial crises in East Asia

In the course of 1997, various countries in East Asia suffered from increasing structural imbalances. The situation was aggravated by the rise in the US dollar, as many of the region's countries had pegged their currencies to the dollar. During the second half of the year, Thailand and later Indonesia, Malaysia, the Philippines and South Korea were forced to abandon the dollar peg. The result was a massive devaluation of these currencies. In an attempt to bring the financial crisis under control, various countries asked international organisations (notably the International Monetary Fund) and foreign governments for financial assistance. By the end of 1997, such assistance was granted to Thailand, Indonesia and South Korea. The crises, along with the measures being taken to combat the structural imbalances, are likely to substantially slow the region's hitherto strong growth.

Continued recovery in Latin America and Africa

The economic situation in Latin America improved steadily. The rate of inflation continued to decline. However, the financial crises in East Asia attracted attention to Latin America's structural weaknesses. This in particular prompted the Brazilian government to institute strong measures to curb the country's mounting current account and government deficits. As a result, the Brazilian currency stabilised. In Africa, particularly south of the Sahara, economic recovery continued, and inflation declined further.

Growth in world trade

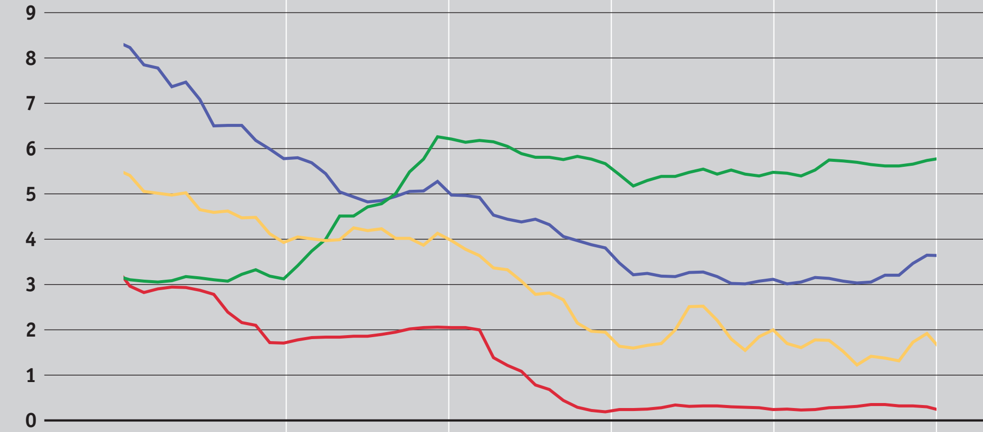
World trade expanded substantially in 1997. Real exports were up 9% compared with a 6% rise in the previous year. This was due mainly to the improvement in the economies of the OECD area as a whole.

1.2 Monetary policy

Small rise in US interest rates, substantial tightening of monetary policy in the United Kingdom

In 1997, the central banks of the OECD countries continued their efforts to maintain price stability. At the end of March, the Federal Reserve Board in the United States raised its benchmark interest rate (federal funds rate) by 0.25 percentage points to 5.5% after having lowered it at the beginning of 1996. Owing to the favourable inflation outlook, no further interest rate increase was deemed necessary in 1997. By contrast, the Bank of England was compelled – in view of the growing threat of inflation – to tighten its monetary policy considerably in the course of the year. To reduce the strength of domestic demand, the base lending rate was raised in several steps by a total of 1.25 percentage points to 7.25%.

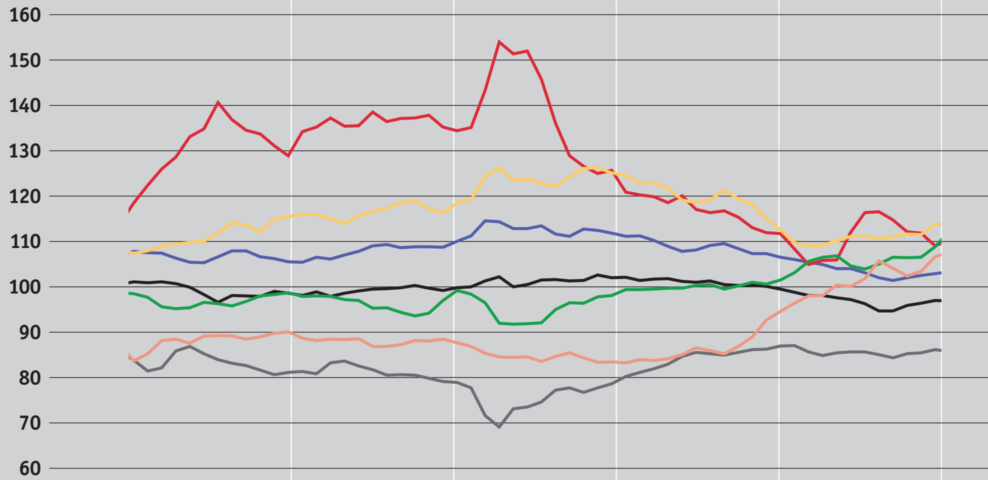
Short-term interest rates



Eurodollar
Euroyen
Euro-DM
Euro-Sfr

Three-month Euromarket rates.
Source: BIS

Real exchange rates



Dollar
Yen
D-Mark
French franc
Pound sterling
Lira
Swiss franc

Trade-weighted real exchange rate indices; 1990 = 100.
Source: OECD

Modest interest rate increase in Germany and some of the neighbouring countries

In October, the German Bundesbank raised its repurchase rate from 3% to 3.3% after having left it unchanged for over a year. The discount and Lombard rates were not altered. The Bundesbank justified its move by citing its intention to counter a build-up of inflationary potential in the runup to European Monetary Union (EMU). The M_3 money supply aggregate, which had exceeded the target corridor in the first half of the year, expanded less rapidly in the course of the year and was back within the corridor in the second half. In step with the Bundesbank, the central banks of various neighbouring countries also raised their key interest rates by a small margin.

Substantial easing in Italy

In Italy, the sharp reduction in inflation and the lira's readmission to the European Monetary System's exchange rate mechanism (ERM) at the end of 1996 allowed the central bank to ease its monetary stance very substantially: it lowered the discount rate from 7.5% to 5.5% and the Lombard rate from 9% to 7%.

No change in Japan's low rates

As in the previous year, the Japanese central bank left the discount rate unchanged at 0.5%. Its policy took account of the ailing economy and the problems of the financial sector.

1.3 Fiscal policy

Improved public-sector finances

The public-sector finances of all the major industrial countries improved in 1997. In the United States and the United Kingdom, this was due mainly to the favourable economic conditions, while in Japan and in continental Europe it resulted from a tighter fiscal stance.

Restrictive fiscal policy in Japan

In Japan in particular, the government adopted a restrictive fiscal policy in order to curb the public-sector deficit which had mushroomed in the preceding years owing to measures taken to revitalise the economy. With a rise in value-added tax and cutbacks in public investment the total government deficit declined by 1.5 percentage points to approximately 3% of GDP.

Smaller government deficits in the United States and the United Kingdom

In the United States, tax revenues were well over budget owing to the strong economic growth. In fiscal 1996–97, the deficit was down to $ 22.6 billion or 0.3% of GDP (compared with a budgeted figure of $ 125.6 billion). The United Kingdom's budget deficit was also reduced, dropping to 1.5% of GDP for the 1997–98 fiscal year. Both the American and British governments are aiming to balance their budgets within the next few years.

Government deficits down to about 3% of GDP in Germany, France and Italy

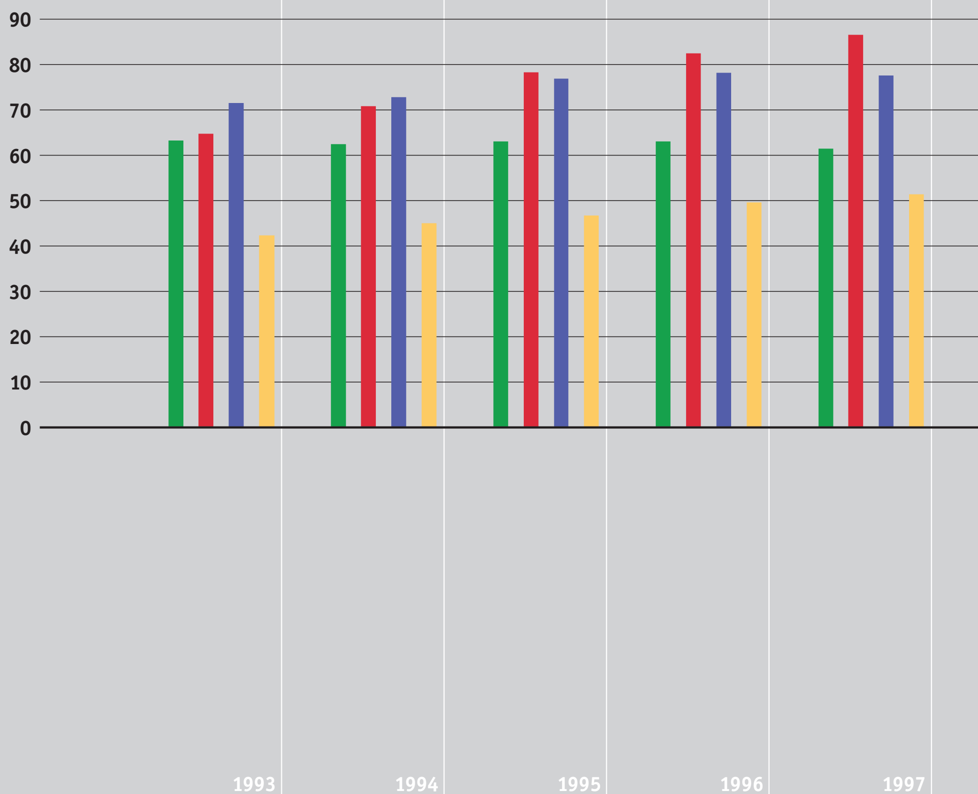
Germany, France and Italy reduced their budget deficits to approximately 3% of GDP in 1997. This was the result of strenuous efforts on the part of the respective governments: spending cuts were implemented in all three countries, and, in addition, in France and Italy taxes were raised. These three governments are predicting a further deficit reduction in 1998.

Public-sector financial balances

USA
Japan
European Union
Switzerland

Public-sector financial balances (all levels of government including social insurance) in percent of GDP.
1997: budget forecasts.
Source: OECD

Government indebtedness



USA
Japan
European Union
Switzerland

Aggregate public-sector debt (all levels of government including social insurance) in percent of GDP.
1997: budget forecasts.
Source: OECD

1.4 Foreign exchange markets

Sharp appreciation of the dollar

The US dollar rose steeply in 1997. In the course of the year it appreciated by 15.9% against the D-mark, by 12.2% against the yen and by 8.1% against the Swiss franc. In December the dollar's trade-weighted real exchange rate was 10.5% above its level 12 months previously.

Weak D-mark

The D-mark trended downwards against the other currencies outside the ERM. It depreciated by 11.6% against the pound sterling and by 6.8% against the Swiss franc, but showed little change against the continental ERM currencies. Its trade-weighted real exchange rate declined by 3.0% in the course of the year.

ERM remains calm

There was little change in the ERM parities during the year under review. By and large, the spread between the weakest and the second strongest currency did not exceed 4%. The mechanism's strongest currency – the Irish punt – did appreciate more sharply at first, but eased again in the fourth quarter.

Massive currency depreciations in East Asia

Owing to the financial crises in East Asia, some of this region's currencies underwent massive depreciation in the second half of 1997. By the end of December, the Thai baht had plunged by 46% against the dollar, the Indonesian rupiah by 56%, the Malay ringgit by 35% and the Philippine peso by 26%. The Singapore dollar fell by 15% against the dollar, the currencies of South Korea and Taiwan by 47% and 15% respectively.

1.5 Financial markets

Decline in long-term interest rates

In 1997, long-term interest rates in the OECD countries declined again slightly on balance. In the United States and in Japan they rose in the first half of the year but eased again in the second half. In Europe, interest rates in the various countries converged. Whereas in France and Germany long-term rates edged down only slightly, in Italy they fell sharply. The convergence of long-term interest rates indicates that the financial markets are expecting EMU to materialise.

Booming stock markets in North America and Europe, collapse in East Asia

In the first half of 1997, share prices climbed rapidly on many stock markets. The crises in East Asia triggered sharp falls around the world, however. Although the market indices in North America and Europe recovered by the end of the year, on East Asian stock exchanges the decline continued.

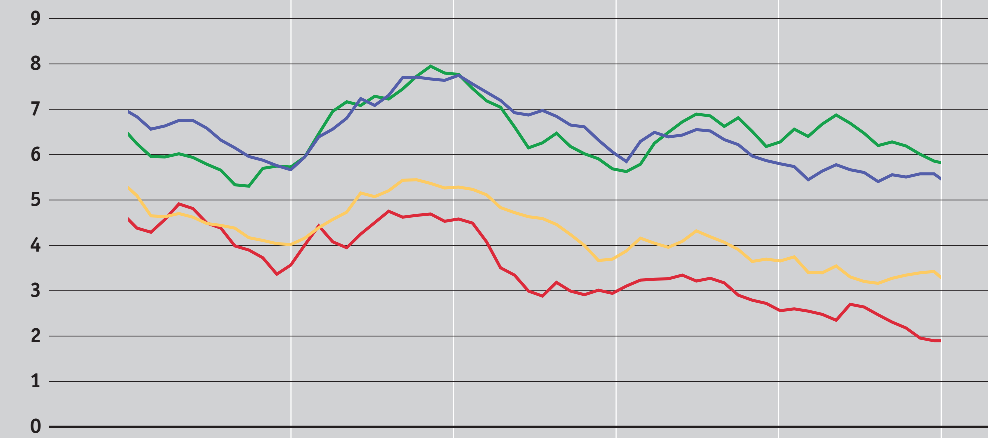
Growing volume of new issues on the international financial markets

Gross borrowing on the international financial markets rose by 12.5% year-on-year to $ 1,769 billion. The portion accounted for by bonds rose to 30.8%. Variable-interest securities, convertible bonds and equities also increased their market share, whereas issuing programmes for notes contracted slightly and those for money market paper quite considerably. The relative importance of the various issuing currencies also shifted, with the dollar, D-mark, lira and sterling gaining at the expense of the yen and – to a lesser extent – the French franc, Swiss franc and guilder.

Rise in US banks' earnings

The economic expansion and the favourable development of the capital markets gave a boost to the financial services industry. In the United States in particular, the banks' earnings rose. Profits were lifted by trading income as well

Long-term interest rates



Dollar

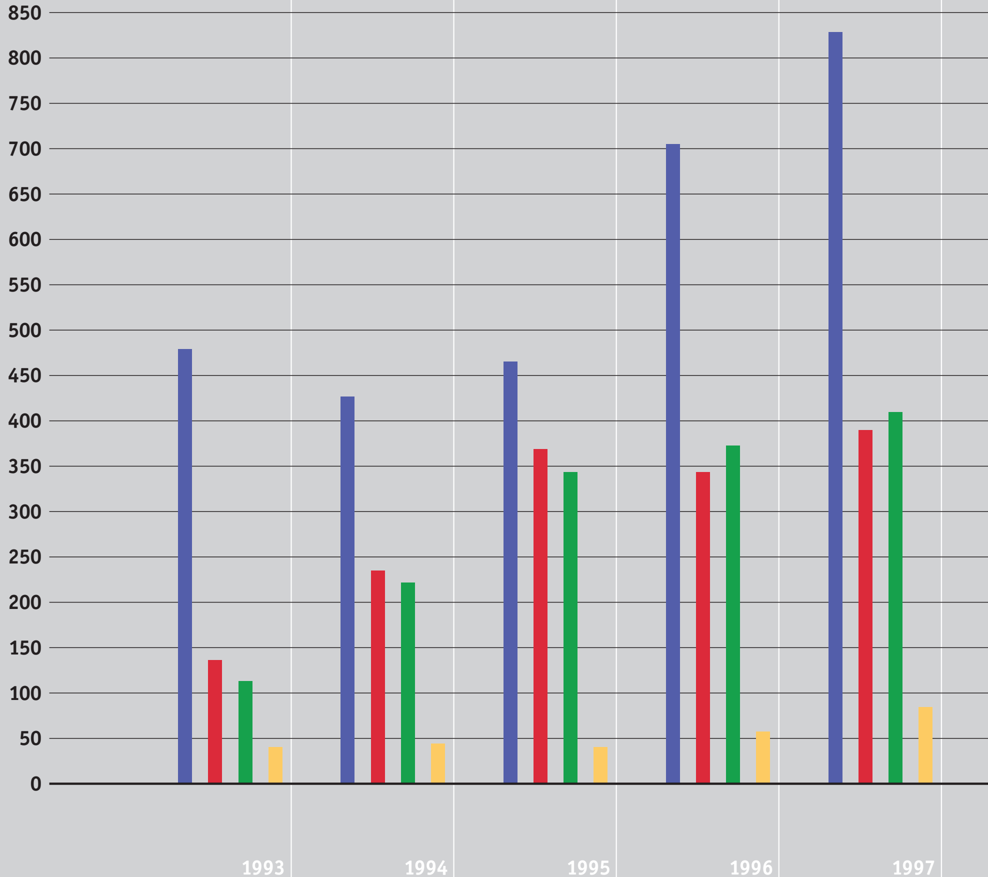
Yen

D-Mark

Swiss franc

Yield on long-term government bonds, percent per annum.
Source: BIS

Borrowing in the international financial markets



Bonds

Bank loans

Medium-term notes

Shares

Billions of dollars.
Source: OECD

as by net interest earnings since lending activity was strong. At the same time, most banks also made larger provisions for doubtful loans. The Federal Reserve Board raised the share from 10% to 25% which a securities subsidiary of a bank holding company is permitted to have in its parent company's total earnings. The result was a wave of takeovers, particularly among securities houses.

West European banks more profitable

The banks in most western European countries also improved their profitability in 1997. This can be ascribed to the rise in share prices, the reduced need for provisions and the larger volume of loans. Only in Italy did the banks fail to achieve any substantial increase in profitability, as they were still preoccupied with restructuring their balance sheets. In the United Kingdom, the government transferred responsibility for banking supervision (previously incumbent upon the central bank) to an independent body, the Financial Services Authority.

Situation in Japan's financial sector worsens

The situation in Japan's banking sector deteriorated substantially. Owing to a decline in the quality of the banks' assets, provisions for bad and doubtful loans had to be strengthened. The price decline on Japan's stock markets exacerbated these problems, and a number of large banks had to close down. The Japanese government made public funds available for shoring up the financial sector and announced that reforms would be set in train. In future, it will be permissible to found holding companies. Banking supervision will pass from the Ministry of Finance to an independent body.

1.6 European integration

Further progress towards monetary union

The EU continued to work towards the introduction of the euro. The preparatory tasks included drafting the monetary policy and designing the instruments to be placed at the disposal of the future European Central Bank (ECB). The EU laid the foundations for the exchange rate system which will link the countries participating in the single currency to the "outsiders" currencies. In June 1997, a stability and growth pact was signed.

Stability and growth pact

The purpose of this pact is to ensure that the countries participating in EMU continue to pursue stability-oriented policies even after the launch of the euro. Accordingly, these countries are committed to keeping their budget deficits permanently below 3% of GDP. This limit may be exceeded only in exceptional situations, such as during a deep recession. Any country whose deficit rises above this ceiling will be required to rectify the situation within a given period of time. If it fails to do so, it will have to deposit an interest-free loan which will be converted into a fine if the deficit is not brought within the limit by a particular deadline.

Programme for monetary policy

The planned ECB monetary policy gives the central bank a choice of two strategies, one geared to inflation targets and the other to money supply targets. The ECB can also adopt a combination of the two strategies. Regardless of which strategy is chosen, monetary policy must take the following five requirements into account:

– announcement of a definition of price stability in order to improve the transparency and credibility of monetary policy;
– publication of targets enabling the public to assess the ECB's performance;
– use of a broad spectrum of indicators providing information about possible inflationary threats;
– priority given to money supply aggregates in the formulation of monetary policy;
– development of techniques for forecasting the inflation rate and other important economic factors.

Basis of exchange rate system

The exchange rate system for the member countries not participating in EMU must contain the following elements:
– definition of central rates against the euro;
– fluctuation band of +/–15% around the central rates, as in the ERM today;
– generally automatic and unlimited interventions at the upper/lower edge of the fluctuation band;
– the option of discontinuing interventions if they jeopardise the paramount goal of monetary policy, i.e. price stability;
– voluntary participation in the exchange rate mechanism.

Legal basis for the introduction of the euro and efforts to harmonise the financial sector

The European Council has passed Regulations dealing with the introduction of the euro and an amended proposal for Regulations concerning the denominations and technical features of the single currency coins. Furthermore, a Directive has been drafted concerning the finality of payments and rights of lien which would become applicable to EU payment systems not later than on the commencement of EMU. Besides its work relating to the launch of the euro, the EU continued its efforts to harmonise the financial services sector. The European Parliament and Council passed a Directive stipulating a minimum degree of protection for investors in the event of securities houses becoming insolvent. The Commission also proposed that new Directives be issued for the recognition of internal models for calculating capital adequacy requirements for market risks.

The financial sector's preparations for the single currency

The financial sector has stepped up its preparatory work for the introduction of the single currency. Above all, this includes the development of a euro interbank interest rate, the introduction of forward contracts in euros and the harmonisation of market conventions for euro bonds.

2 Switzerland

2.1 Real economic performance

Signs of a cyclical upturn

The Swiss economy began to show signs of a revival in 1997. After a decline in real GDP in the first quarter, the spring saw the beginnings of a recovery which subsequently strengthened in the second half of the year. Over the year as a whole, real GDP increased by 0.7%, compared with a 0.2% drop in the previous year. The upturn was driven mainly by exports, which were boosted significantly by faster economic growth abroad and by the Swiss franc's depreciation in the previous year. Private consumption revived in the course of 1997. Plant and equipment investment rose once more while building investment and government consumption continued to contract.

Higher industrial output and capacity utilisation

The activity level in manufacturing improved on account of higher demand. Order intake, which had declined in the previous year, increased significantly during 1997, though the rise in domestic orders was easily outstripped by growth in demand from abroad. Output went up markedly after having been virtually unchanged in 1996. Accordingly, capacity utilisation advanced from 83% at the end of 1996 to 86% by the end of 1997.

Moderate rise in consumer spending

Consumer spending rose again only moderately by a mere 0.9% on average. However, it did accelerate as the year went on. While demand for durables and services improved, sales of non-durable goods continued to contract. Domestic tourism began to pick up: overnight stays rose for the first time since 1991. The increase in private consumption was combined with a fall in the savings rate, as disposable household income remained close to the previous year's level.

Marked fall-off in construction activity

Building investment was 4% below the 1996 result. Both in residential and commercial/industrial construction, recovery was held back by the large number of vacant properties. By contrast, the situation in the civil engineering sector improved owing to increased public sector orders. This upturn was due in large part to the "impulse" programme passed by Parliament in spring 1997.

Continued rise in plant and equipment investment

Investment in plant and equipment increased by 1.5%, similar to the previous year.

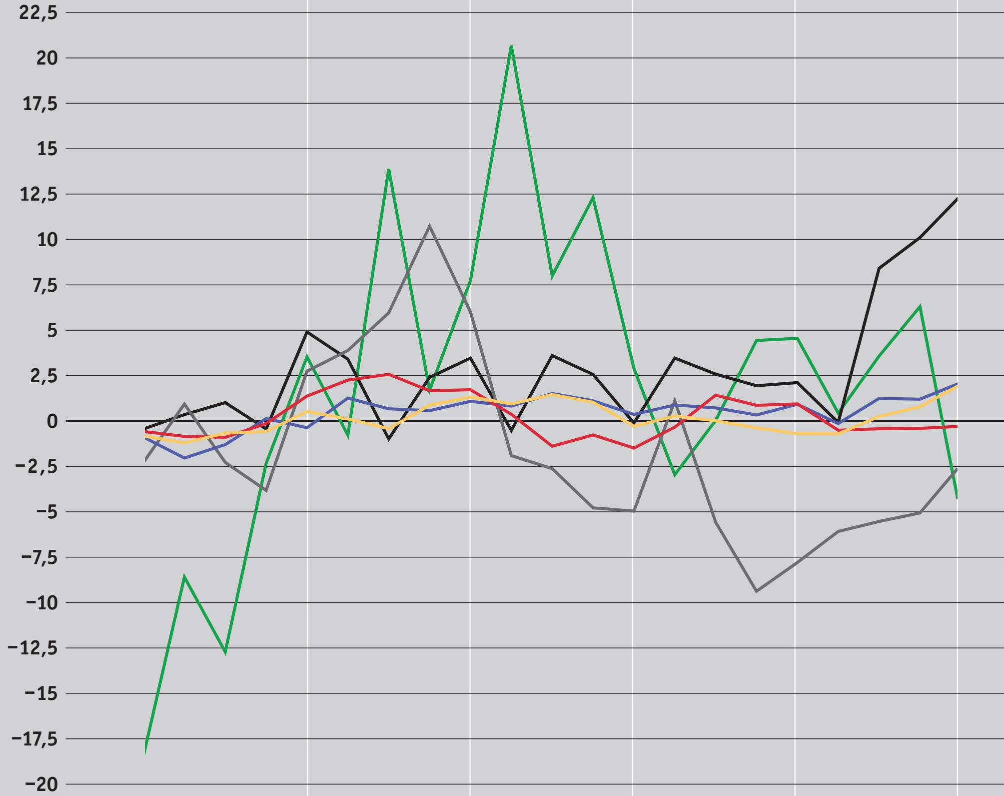
Large increase in exports

Buoyed by the cyclical upturn in the EU, strong economic growth in the United States and the depreciation of the Swiss franc (the currency was still moving downwards at the beginning of 1997), Switzerland's total exports rose substantially during the year under review. In real terms, they increased by 8%, compared with a 2% rise in the previous year. Exports of raw materials and semifinished goods showed above-average growth. Shipments of capital goods abroad also rose significantly, whereas consumer goods exports recorded only a modest advance.

Imports also rose strongly

Owing to the economic recovery – and despite higher import prices – imports increased by a full 6.7% compared with 2.5% in the previous year. Particularly strong growth was recorded by imports of raw materials and semi-finished goods, which had declined in 1996. Incoming shipments of investment goods also grew, though consumer goods imports declined.

Gross domestic product and components



Real GDP

Private consumption expenditure

Government consumption expenditure

Building investment

Plant and equipment investment

Exports

Change from previous year in percent.
Source: Federal Office for Economic Policy

Decline in employment accelerates

The past year saw no improvement on the Swiss labour market, which generally recovers more slowly than output. According to the employment index, the decline in employment actually accelerated: it dropped by 1.6% in total, compared with a 0.6% fall in 1996. In manufacturing it was down by 2.8% and in construction by 3%. The smallest sectoral drop in employment, by 1%, occurred in services. Increased employment was reported by wholesale distribution, information technology, research and development as well as insurance and public administration.

Decline in unemployment overstated

The seasonally-adjusted number of unemployed, which until March had increased to 194,900, fell to 175,100 in December. However, the fall was due in large part to the cantons' job creation programmes, which were introduced in connection with the recent revision of Swiss labour law. Persons participating in work or training programmes were not registered as unemployed. The annual unemployment rate was 5.2% compared with 4.7% in the previous year. The highest regional rate was recorded in the Canton of Ticino at 7.8%, followed by French-speaking Switzerland at 6.9% while German-speaking Switzerland averaged 4.5%. Whereas the unemployment rate was stable in Ticino, it tended to decrease in the other two regions from the second quarter onwards. The number of people out of work for up to six months began to fall in February. In June, a similar turnaround was reported for the category of persons unemployed for between six and twelve months. By contrast, the number of long-term unemployed rose continually up to year-end; in December, this group accounted for 34% of unemployment, compared with 28% in January. The proportion of unemployed foreign nationals in relation to total unemployment was approximately 45%, as in the previous year. The share of women was 42%, as against 58% for men.

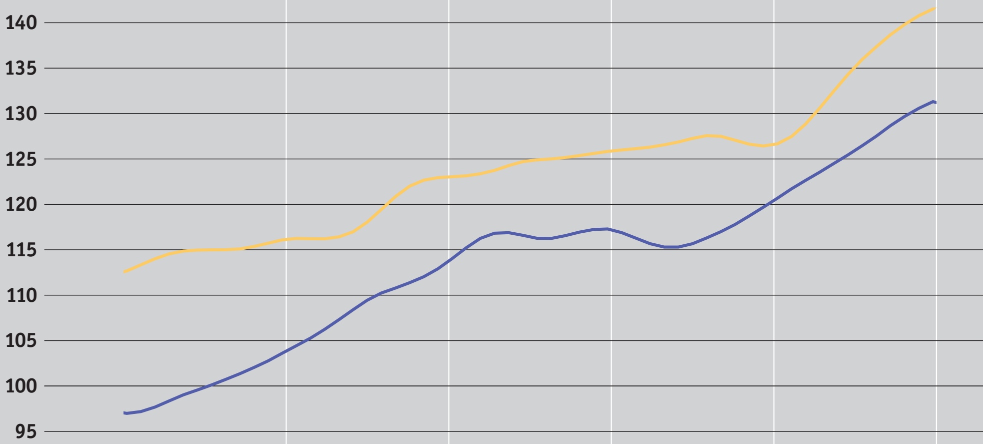
Survey results indicate decline in labour force

The deterioration in the Swiss labour market was also reflected in the results of the "SAKE" labour force survey. These showed that in 1997 the number of persons in employment declined by 0.4% to 3,766,000, compared with a 0.5% increase in the previous year. Unlike the employment index, this figure also includes persons working less than 50% of full time. A slight increase in employment was recorded in this "under 50%" category, with a more substantial 5.6% rise in the "50–89% of full time" category. The number of persons in full-time employment, however, was down by 1.6%. Between 1991 and 1997, the share of this group in total employment decreased from 74.6% to 71.7%. The number of women with jobs rose in 1997 by 0.4%, while the number of employed men fell by 1%. The percentage of the total labour force without gainful employment rose from 3.7% to 4.1%, a decline in the rate for women being offset by a rise in the rate for males.

Foreign trade

Imports
Exports

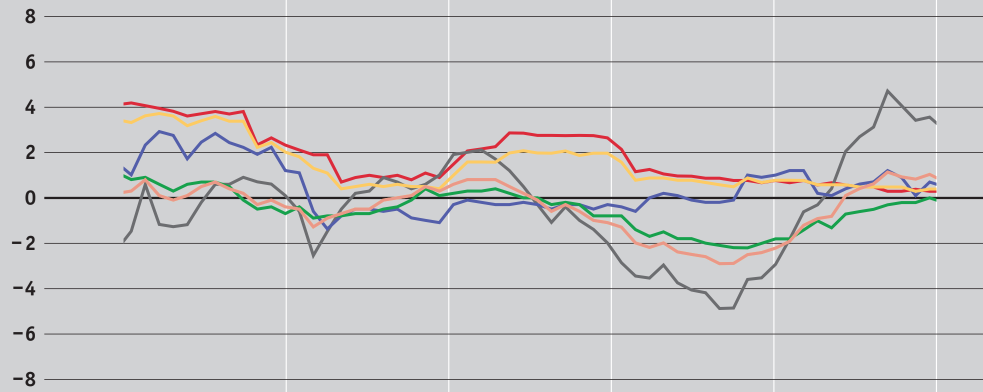
Volume, adjusted for seasonal and exceptional factors.
Index: 1988 = 100.
Source: General Directorate of Customs



Price developments

Consumer prices
Consumer prices for domestic goods
Consumer prices for imported goods
Producer and import prices
Producer prices
Import prices

Percent change from previous year.
Source: Federal Statistics Office



Wages and salaries

Nominal
Real

Wage and salary earnings of employed persons: percent change from previous year (1997: estimate).
Source: Federal Department of Economic Affairs

Rays of hope in the labour market

The development of the "Manpower job offer index" points to a likely future improvement on the labour market. The index, which measures the amount of space occupied by job advertisements in Swiss newspapers, began rising in March 1997 after having fallen steadily since July 1995. Moreover, the decline in employment slowed in the course of the year, and the number of people on short working hours fell markedly.

Employment and unemployment

	1993	1994	1995	1996	1997
Number of persons in employment (SAKE survey) change in percent	−0.8	−1.7	1.5	0.5	−0.4
Full-time employment change in percent	−2.7	−1.4	−0.5	−1.0	−1.8
Full- and part-time employment[1] change in percent	−2.9	−0.4	0.0	−0.6	−1.6
Unemployment rate in percent	4.5	4.7	4.2	4.7	5.2
Number of unemployed thousands	163.1	171.0	153.3	168.6	188.3
Number on short working hours thousands	42.0	22.6	9.9	13.1	6.6
"Manpower job offer index" change in percent	−27.7	27.2	18.4	−19.8	0.6

1 between 50% and 89%

Data not seasonally adjusted
"Manpower job offer index": space occupied by job advertisements in Swiss newspapers
Sources: Federal Statistics Office, Federal Office for Industry and Labour, Manpower

Continued price stability

Inflation, as measured by the national consumer price index, receded again in 1997. It fell from 0.8% in January to 0.4% in December, averaging 0.5% over the year as a whole. This was the smallest rise in the CPI since 1959. The corresponding figure for 1996 was 0.8%.

Prices of services rising more slowly than those of goods

While price rises for goods fluctuated between 0.1% and 1% during the year and averaged out at 0.6%, service-sector inflation declined steadily and averaged 0.5% for the year as a whole. Private-sector services were influenced chiefly by the minimal rent increases, whereas in the public sector costs were driven down mainly by lower charges for postal and communications services.

Exchange-rate-related price rise of imported goods and services

At the consumer level, the cost of foreign goods and services rose by 0.7% on account of the depreciation of the Swiss franc, whereas domestic inflation receded to 0.5%. The combined producer and import price index edged up by 0.1% during the course of the year, as slightly declining producer prices were outweighed by a marked upturn in the cost of imported goods. The rise was particularly pronounced for imported raw materials.

Rising current account surplus

During 1997, the current account surplus grew by Sfr 3.9 billion to Sfr 30.3 billion, i. e. to 8.3% of nominal GDP. While the balance of trade (special trade) showed a surplus of Sfr 0.3 billion, the surplus from services rose by Sfr 2.1 billion to Sfr 17.7 billion. Income from personal travel rose for the first time in three years, and the banks' commissions income soared on account of high stock market turnover. The surplus from employee compensation and investment income grew from Sfr 14.3 billion to Sfr 17.5 billion. This was due to higher net income from direct investment and, above all, to the banks' net interest earnings. The deficit from current transfers decreased slightly to Sfr 4.4 billion.

Current external transactions account balances in billions of Swiss francs

	1993	1994	1995 revised	1996 preliminary	1997 estimated
Goods trade	2.4	2.2	1.0	1.1	−0.5
of which special trade	3.5	3.2	1.8	1.9	0.3
Services trade	16.8	15.6	15.2	15.6	17.7
of which personal travel	2.4	2.7	2.4	1.8	1.8
Employee compensation and investment income	13.5	10.7	13.9	14.3	17.5
of which investment income	20.7	17.6	20.8	21.3	24.2
Current transfers	−4.0	−4.7	−4.8	−4.7	−4.4
Total current account	28.8	23.9	25.3	26.4	30.3

2.2 Fiscal policy

Federal deficit slightly below the budget

In 1997, the federal deficit amounted to Sfr 5.3 billion, i.e. 1.2% of GDP. This was Sfr 0.5 billion below the budget figure. For the first time, credits to the Swiss Federal Railways were included in the calculation while surpluses in the federal pension fund were excluded. Restated on the same basis, the previous year's deficit comes to Sfr 6.4 billion instead of Sfr 4.4 billion. Using the new accounting method, the 1997 deficit is thus Sfr 1.1 billion lower than in the previous year. Whereas revenues notably from direct federal tax and from stamp duty were higher than budgeted, expenditure on loans to the unemployment insurance fund were (as in the previous year) higher than expected. A deficit of Sfr 7.6 billion or 1.7% of GDP is budgeted for 1998.

No improvement in cantonal finances

Preliminary data put the cantons' aggregate deficit at Sfr 3.1 billion, i.e. roughly in line with the budget figure. It was Sfr 0.9 billion higher than in 1996. Most cantons were expecting personnel and transfer expenditures to remain stable and outlays on goods and services as well as for interest payments to fall, but were predicting higher revenues from fees. On the other hand, actual loans to the unemployment insurance fund will probably exceed the planned credits by Sfr 0.9 billion. Moreover, many cantons expect corporate tax revenues to fall below budget.

Balanced aggregate communal accounts

As in the previous year, the communes (municipalities) are likely to post in aggregate more or less balanced accounts for 1997. A deficit of Sfr 0.5 billion had been forecast. While the smaller cities and towns generally reported balanced results or even surpluses, the financial situation of the large cities deteriorated markedly.

Further rise in indebtedness

The debt ratio (i. e. debt as a percentage of GDP) for the Confederation, cantons and communes rose during 1997 from 48% to 49% (the corresponding figure for 1990 had stood at 31%). Almost half of the total was attributable to the Federal Government, about 30% to the cantons and 20% to the communes.

Cut in the federal deficit urgently needed

The development of government finances over the last few years shows that the cantons and communes have been more successful than the Federal Government in cutting their deficits. As a result, government debt at the federal level has risen by a particularly wide margin. Unless the annual deficit is reduced, the deterioration in the Confederation's financial position could undermine confidence in the government's capacity for action. Even if the emerging economic recovery were to result in higher tax revenues and offer relief on the income side, the defects in the structure of the federal budget system still require urgent attention. According to estimates published by the International Monetary Fund, this structural component accounts for about half of Switzerland's total government deficit.

2.3 Financial markets

Low capital and money market rates

The steady slide in long-term interest rates – which had begun in mid-1996 – continued in the first half of 1997. In June, the average yield on Confederation bonds dropped to 3.1%. It initially rose slightly in the second half, but by December it had fallen back to the June figure. Short-term rates followed a similar path: the yield on three-month money market debt register claims issued by the Confederation fell to 1.2% by June. They firmed up in the second half of the year but dropped back to 1.4% by December.

Swiss franc lower than in the previous year

In export-weighted real terms, the Swiss franc weakened by 6.9% on average in 1997 compared with a 3.2% decline a year earlier. In the course of the year, the franc's real exchange rate firmed against the main continental European currencies. It initially softened against the dollar, sterling and the yen but firmed again in the fourth quarter.

Rise in net capital market borrowing

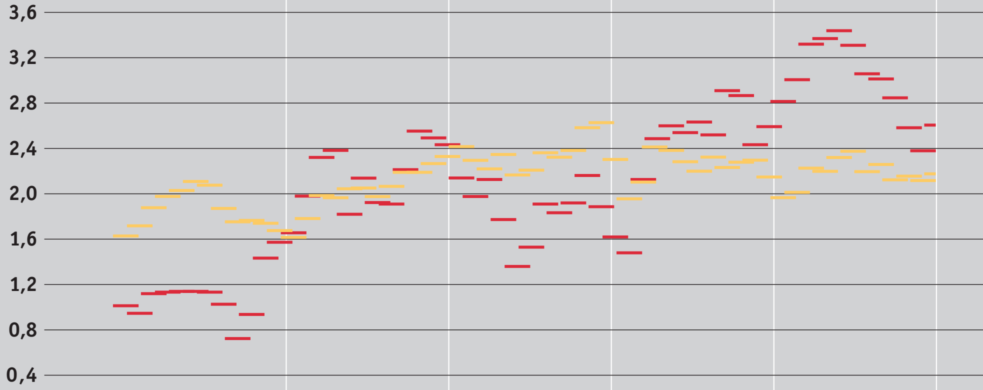
Net borrowing on the Swiss capital market (i. e. issues of bonds and shares less redemptions) rose substantially from the previous year's depressed level. However, the total of Sfr 28.8 billion was still well below the average for the last few years. Net borrowing by domestic debtors came to Sfr 6.7 billion, versus Sfr 0.4 billion in the previous year. Owing mainly to lower redemptions, the net issuing volume of domestic bonds increased by Sfr 0.6 billion to Sfr 6.8 billion year-on-year. Where domestic share issues are concerned, repurchases exceeded new issues by Sfr 0.1 billion – in the previous year, too, buybacks had exceeded flotations. Foreign borrowers tapped the bond market for Sfr 22.1 billion in net terms, roughly in line with the average for the last few years but considerably more than in 1996.

Big advances in share prices

The Swiss Performance Index (SPI) soared by 55% during 1997, easily exceeding the already sizeable gains in share prices recorded in the two preceding years. After sharp price rises in the first half of 1997, the SPI exhibited wide fluctuations but little net change in the second half.

1993 1994 1995 1996 1997

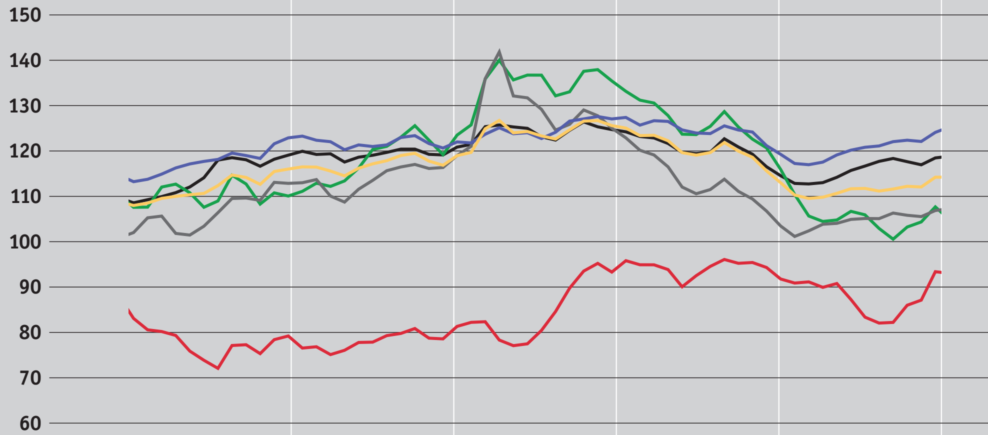
Spreads for long-term interest rates



Germany – Switzerland
United States – Switzerland

Spread in
percentage points.
Source: BIS

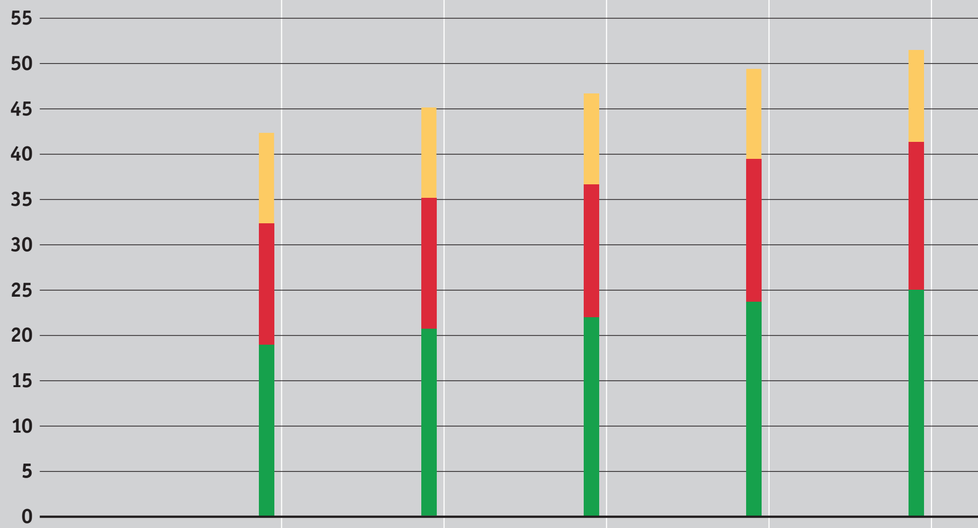
Swiss franc real exchange rates



Total (15 countries)
Dollar
D-Mark
Yen
French franc
Lira

Consumer-price deflated
real value of the Swiss
franc in foreign currencies.
Total: export-weighted.
Index November 1977 = 100

Public-sector indebtedness



Communes
Cantons
Confederation

In percent of GDP.
(1997: estimate).
Source: Federal Department
of Economic Affairs

1993 1994 1995 1996 1997

Banks' domestic business stagnated while foreign business grew strongly

Owing to the generally sluggish domestic economy, the banks saw little growth in domestic lending. By contrast, loans to foreign customers expanded markedly. At the same time, the banks' financial assets rose vigorously and by year-end accounted for approximately 40% of the balance sheet total. Overall, the aggregate balance sheet total of the Swiss banks grew substantially by almost 20%, though part of this large rise was due to exchange rate changes.

Mergers in financial services industry

In Switzerland, as in other countries, growing international competition has given rise to mergers between large financial services companies. At the beginning of December, the Credit Suisse Group merged with Winterthur Insurance. The same month, Union Bank of Switzerland and Swiss Bank Corporation announced that they would be merging to form the United Bank of Switzerland, one of the world's largest financial institutions.

Improved annual results

The Swiss banks reported better results than in the preceding years, when loan loss provisions had featured prominently in their financial statements. The "big three", as well as the banks specialising in asset management such as private banks and foreign banks, posted particularly large increases in their operating results. This was due in large part to commissions from securities trading and to earnings from derivative transactions.

Selected bank interest rates

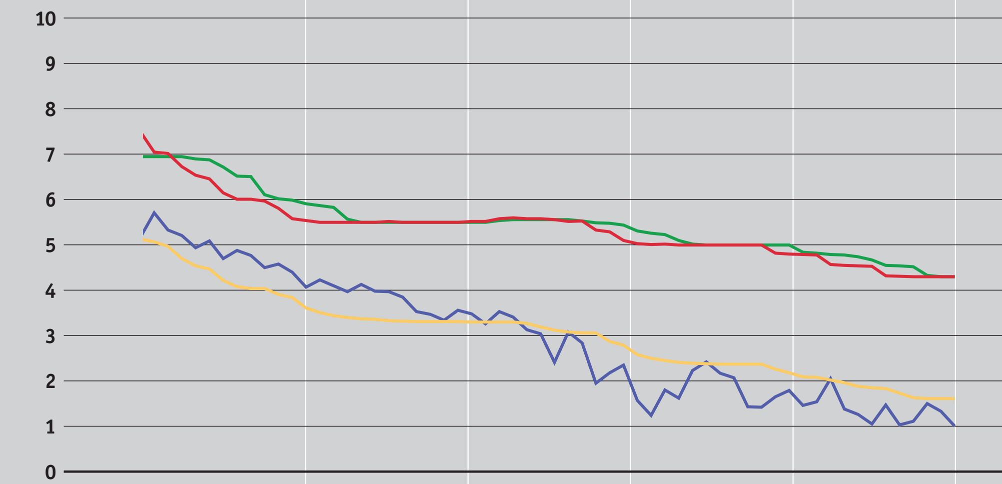
Existing mortgages
at cantonal banks

New mortgages
at cantonal banks

Savings deposits
at cantonal banks

Three-month time deposits
at big banks

Quarterly averages,
percent per annum



Share prices

Total

Banks

Industry

Swiss Performance Index.
Source: Swiss Stock Exchange