Review of economic developments

1 International developments

1.1 Real economic performance

Crises in East Asia and Russia

In 1998, the world economy was dominated by the crises in East Asia and Russia. In East Asia, the financial crisis that broke out in mid-1997 triggered a very sharp downturn in growth. Russia's economic and political problems came to a head in the first half of 1998. International aid failed to prevent a further financial crisis. As investors took fright, large amounts of capital flowed out of the emerging markets. This also plunged a considerable number of Latin American countries into economic difficulties.

Tremors in the financial markets

The financial and economic crises in various parts of the world also sent tremors through the financial markets of the industrialised countries. In the summer, the Russian crisis triggered a huge fall in share prices. These price declines, the liquidation of speculative positions and the bailing-out of an American hedge fund that had come close to bankruptcy led to massive write-downs at international financial institutions. A measure of calm returned in the final quarter of the year, however. Interest rate cuts by the Federal Reserve Board helped in particular to ease the situation.

Slower growth in the industrialised nations

The economic crises and the turbulence in financial markets had a damaging impact to varying degrees on the industrialised countries. Japan was hardest hit. In most other industrialised nations, export growth tailed off perceptibly while general business sentiment worsened. Thanks to improving domestic demand, however, there was no drastic decline in overall growth rates. In the OECD countries, real gross domestic product (GDP) grew by an average of 2.2% in 1998, compared with 3.2% in 1997. The decrease can be ascribed in large part to the recession in Japan.

US economy still buoyant

The US economy grew by about 4% in 1998, roughly the same rate as in the previous year. Domestic demand was the main support for the economy, whereas export activity waned noticeably. Despite the upbeat economy, growth in industrial output slowed down during the course of the year. This was partly the result of the Asian crisis.

UK's upswing runs out of steam

Economic growth in the United Kingdom lost momentum in the past year. Consumer spending remained lively (though less so than in 1997) while investments and exports levelled off. The UK economy not only felt the effects of the Asian crisis, but also the restrictive monetary policy pursued by the central bank until mid-year in a bid to prevent the economy from overheating.

Recovery on the European continent

In Germany and France, the economic recovery initially gained fresh momentum in 1998. Domestic demand revived in both countries, thus helping to offset the effects of a flagging export industry. Towards the end of the year, however, signs of a slowdown began to increase. In contrast to Germany and France, Italy again failed to recover from its economic weakness in 1998. Growth rates in most of the smaller western European countries were much higher than those in the major economies. The decline in interest rates prior to the launch of the euro had a particularly beneficial effect. In the European Union (EU), at 2.8% on average, real GDP grew at roughly the same rate as in 1997.

Recession in Japan

At the end of 1997, the Japanese economy slipped into recession after the government's large-scale economic stimulation programmes had brought about a temporary revival in the preceding years. The crisis in the East Asian countries dealt a blow not only to the export sector but also to Japan's banking system, which has been faced with severe structural problems. The government launched another series of economic stimulation programmes while also deregulating various areas of the economy and taking steps to restructure the banking system.

Unemployment falls

A considerable number of jobs was created in the USA and the United Kingdom, thereby reducing unemployment. On the European continent, too, the situation on the labour markets improved: modest growth in the workforce was accompanied by the first fall in unemployment since 1994. The average unemployment rate for the EU as a whole, however, was still a substantial 10.6%. In Japan, unemployment rose to a record 4.1%.

Inflation still very low

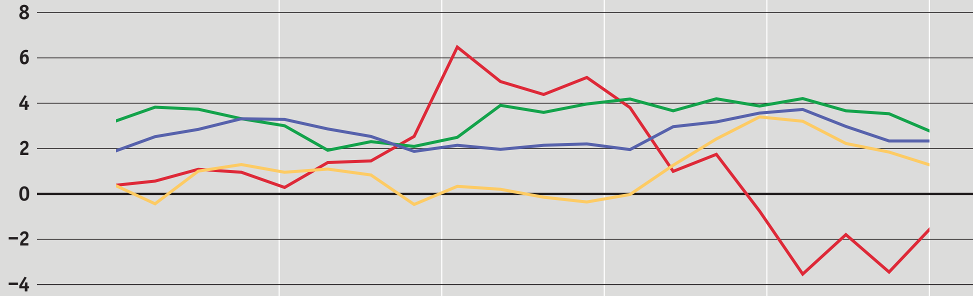
Consumer price inflation continued to decline in most OECD countries in 1998. This was due both to a sharp decline in commodities prices and to cheaper imports from East Asia. On average (and excluding high-inflation countries), inflation in the OECD dropped by 0.7 percentage points to 2% from the previous year's level. Of the major industrialised countries, only the United Kingdom witnessed a rise in inflation compared with the previous year.

1994 1995 1996 1997 1998

Real gross domestic product

USA
Japan
OECD Europe
Switzerland

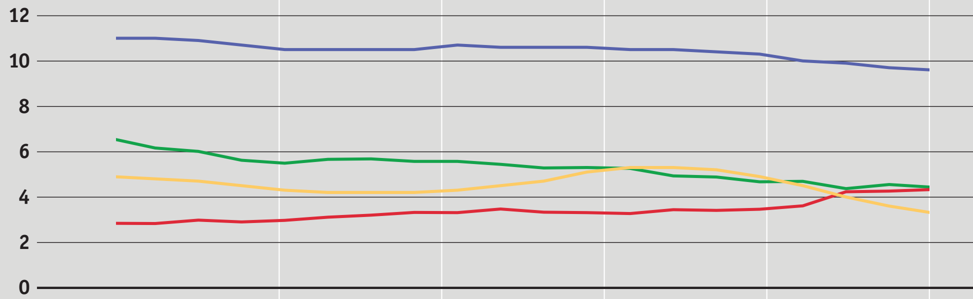
Change in percent
from previous year.
Source: OECD



Unemployment

USA
Japan
OECD Europe
Switzerland

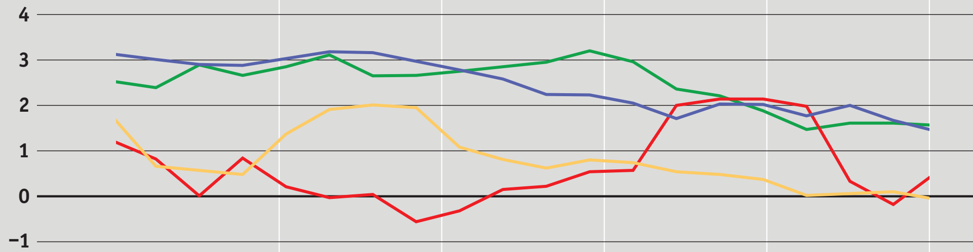
In percent of labour force.
Source: OECD



Inflation

USA
Japan
OECD Europe
Switzerland

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



Current account balance

USA
Japan
European Union
Switzerland

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

1994 1995 1996 1997 1998

Summary of data on economic activity

	1994	1995	1996	1997	1998
Real GDP Change from previous year in percent					
USA	3.5	2.3	3.5	3.9	3.9
Japan	0.7	1.4	5.2	1.4	−2.6
Germany	2.8	1.3	1.3	2.3	2.5
France	2.8	2.1	1.6	2.3	3.2
United Kingdom	4.4	2.8	2.6	3.5	2.0
Italy	2.2	2.9	0.7	1.5	1.5
EU	3.0	2.4	1.8	2.7	2.8
Switzerland	0.5	0.6	0.0	1.7	2.1
Unemployment in percent					
USA	6.1	5.6	5.4	4.9	4.5
Japan	2.9	3.2	3.4	3.4	4.1
Germany	9.6	9.5	10.4	11.5	11.1
France	12.3	11.6	12.3	12.5	11.8
United Kingdom	9.3	8.0	7.3	5.5	4.7
Italy	11.3	12.0	12.1	12.3	12.3
EU	11.5	11.2	11.3	11.2	10.6
Switzerland	4.7	4.2	4.7	5.2	3.9
Consumer price inflation in percent					
USA	2.6	2.8	2.9	2.3	1.6
Japan	0.7	−0.1	0.1	1.7	0.7
Germany	2.7	1.8	1.5	1.8	1.0
France	1.7	1.8	2.0	1.2	0.7
United Kingdom	2.5	3.4	2.5	3.1	3.4
Italy	3.9	5.4	3.9	1.8	1.7
EU	3.0	3.1	2.5	1.9	1.7
Switzerland	0.9	1.8	0.8	0.6	0.0
Current account balance in percent of GDP					
USA	−1.8	−1.6	−1.8	−1.9	−2.7
Japan	2.8	2.1	1.4	2.3	3.2
Germany	−1.0	−1.0	−0.6	−0.2	−0.5
France	0.6	0.7	1.3	2.7	2.6
United Kingdom	−0.3	−0.5	−0.3	0.6	−0.6
Italy	1.4	2.4	3.3	2.9	3.2
EU	0.3	0.6	1.0	1.4	1.4
Switzerland	6.7	7.0	7.2	8.2	8.1

Some 1998 figures are estimates.
Source: OECD

Crisis in East Asia ...

The financial crisis had grave repercussions in East Asia. In Thailand and South Korea, GDP contracted by approximately 8% each in 1998, in Indonesia even by approximately 15%. Malaysia and Hong Kong (China), which were initially spared the worst of the crisis, also suffered a serious downturn in economic activity in the first half of the year. In mainland China, too, economic growth eased off. In many countries – notably Thailand, South Korea and Indonesia – the crisis exposed structural weaknesses in the banking sector and insufficient supervision of the financial sector. Towards the end of the year, the economic downturn moderated in all three countries. This improvement was due in part to financial support from the International Monetary Fund (IMF) and steps towards structural reform. Gradual exchange rate stabilisation following sharp depreciation in the previous year allowed all three countries to lower their interest rates.

... and in Russia

The economic situation in Russia deteriorated rapidly in the first half of the year. The government was unable in particular to rein in its budget deficit. As the markets became increasingly nervous, interest rates on government paper soared. Despite financial aid from abroad, the rouble (which had been pegged to the dollar) came under strong pressure in the summer. The government announced that it would be restructuring its short-term rouble-denominated debts and imposed a moratorium on the repayment of private-sector debt to private creditors abroad. This accentuated the downward pressure on the rouble. Once allowed to float freely at the beginning of September, the rouble spiralled downwards. Inflation subsequently accelerated and the recession worsened.

Eastern Europe resists the crisis

The Russian crisis had little impact on most of the other East European countries. In Poland, Hungary and Slovakia, economic growth slowed only slightly while inflation continued to fall. The Czech economy drifted into a mild recession after monetary and fiscal policies had been tightened in response to the spring 1997 currency crisis. In Romania, the economy continued to contract while inflation fell off markedly.

Problems in Latin America – international financial aid for Brazil

The crises in Asia and Russia also had repercussions on Latin America. Export earnings were hit by declining commodity prices as well as by the Asian crisis. In Brazil, the large current account deficit coupled with a deterioration in government finances dealt a particularly severe blow to investor confidence. This triggered a large-scale exodus of capital. In the late summer, the Brazilian real – which was pegged to the dollar – came under pressure. A financial crisis was headed off (for the time being at least) by large injections of foreign money and the adoption of more stringent monetary and fiscal policies. Whereas Argentina, Chile and Mexico experienced only a moderate downturn, Venezuela plunged into recession.

African growth continues

Economic growth in the developing countries of Africa picked up slightly in 1998 despite the adverse effect of sharply declining commodity prices. Inflation continued to fall.

1.2 European integration

Beginning of the third stage of European Monetary Union

1 January 1999 marked the beginning of the third stage of European Monetary Union (EMU). From the same date, the European Central Bank (ECB) – which had begun operating on 1 June 1998 – took charge of monetary policy in the EMU. Also on 1 January 1999, the euro was introduced as a currency in its own right. Since then, the ECB has used the euro for all its transactions. Newly issued government debt of the participating countries is now denominated in euros, and a large proportion of existing government bonds have been redenominated in the new currency.

Participating countries

Eleven countries participated in the third stage of EMU from the start: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. The European Council had recognised in May 1998 that these countries fulfilled the conditions for membership (notably the convergence criteria). Of the four other EU countries, Greece and Sweden failed to meet all the prerequisites while Denmark and the United Kingdom decided for the time to opt out of the third stage of the European Monetary Union.

Fixing of the conversion rates

The bilateral exchange rates between the currencies of the participating countries which were fixed in May 1998 corresponded to the central rates in the exchange rate mechanism of the European Monetary System. These rates, as well as the market rates applicable on 31 December 1998, formed the basis on which the national currencies were to be converted into euros. In this way it was possible to ensure that the external value of the ECU – which, according to the Maastricht Treaty, was to be converted into the euro at a ratio of 1:1 – would not be changed by the introduction of the euro.

Monetary policy of the European Central Bank

The ECB's monetary policy strategy has three main elements: a quantitative definition for price stability, a reference value for the rate of growth of the money stock M_3, harmonised for the euro area, and an estimate of future inflation. The ECB defines price stability as a rise in the harmonised consumer price index not exceeding 2% per annum. For the growth of the M_3 aggregate in 1999, a reference value of 4.5% was fixed. The ECB pointed out that deviations from the reference value would not automatically trigger interest rate changes. And finally, the estimate of future inflation was to be based on an analysis of numerous economic and financial factors.

Instruments of monetary policy

Open market transactions constitute the ECB's chief instrument of monetary policy. These consist mainly of short-term repurchase agreements with a two-week maturity which are concluded at weekly intervals, longer-dated (three-month) repos concluded at monthly intervals, and fine-tuning operations. In addition, the ECB made two standing facilities available: a marginal lending facility and a facility allowing banks to deposit their liquidity surpluses. Moreover, all credit institutions within the meaning of the EU's First Banking Directive are subject to the minimum reserve requirement. The minimum reserves bear interest at the ECB's rate for its main refinancing operation.

The European Council issued three regulations governing the introduction of the euro, the last of which took effect on 1 January 1999. As a result, the national currencies – which continue as sub-units of the euro until 2002 and can be used until that year – were superseded by the euro at the defined conversion rates. In the transitional period, financial obligations have in principle to be met in the currency in which they are denominated unless otherwise agreed by the contractual parties. From the beginning of 2002, banknotes and coins denominated in euros will be put into circulation. Not later than six months afterwards, the national banknotes and coins will cease to be the legal tender of the member countries participating in the third stage of European Monetary Union.

Legal basis for the introduction of the euro

The EU continued its efforts to harmonise the financial sector. ECOFIN (the EU's council of economics and finance ministers) passed a directive allowing banks and investment houses to calculate the equity needed for covering market risks using internal models. Another directive issued by ECOFIN revises the capital adequacy standards applying to derivative financial instruments and permits an extensive exchange of information with supervisory bodies in third-party states.

Continued harmonisation of the financial sector

1.3 Monetary policy

After a number of central banks had tightened the reins slightly in the previous year, monetary policy was left largely unchanged in the major industrialised countries throughout the first three quarters of 1998. In the last few months of the year, the Federal Reserve Board gradually eased its monetary stance to counter the effects of the turbulence in the financial markets and to take account of the more subdued growth prospects. On the European continent, interest rate convergence continued in the run-up to the euro launch. In December, as a downturn in the business cycle began to look more likely, all eleven countries in the euro area reduced their key interest rate to 3%.

Unchanged monetary policy in the first three quarters – easing in final quarter

Between end-September and mid-November, the Federal Reserve Board lowered its Fed Funds rate in three steps from 5.5% to 4.75% and reduced the discount rate from 5% to 4.5%. The Bank of England followed suit, cutting its base lending rate three times by a total of 1.25 percentage points to 6.25% in mid-December. This was a response to flagging economic activity and an easing of inflationary pressures. In June it had raised the lending rate in order to prevent the economy from overheating.

US and UK interest rates lowered

Up to the end of November, the German and French central banks left their key interest rates (repo rates) unchanged at 3.3%. Meanwhile, the central banks of Italy, Spain, Portugal and Ireland brought their key interest rates gradually in line with the German and French rates. On 3 December, all countries in the euro area with the exception of Italy simultaneously lowered their key interest rates to 3%. Italy initially reduced its discount rate from 4% to 3.5%, subsequently lowering it to 3% at the end of December. The final round of interest rate cuts prior to the euro launch ranged between 0.2 percentage points (Austria) and 1 percentage point (Italy). The ECB confirmed that the 3% rate was to

Euro area key interest rates converge at 3%

be seen as the European benchmark and that it intended to hold it at this level for the foreseeable future. A year previously, key interest rates in the future euro area had averaged 4.1%.

Interest rate cuts in Japan

In September, the Bank of Japan lowered its call money rate from 0.5% to 0.25% to prevent any further worsening in the economic situation and to head off deflationary trends.

1.4 Fiscal policy

Budget situation improves

With the exception of Japan, the leading industrial nations saw a continued improvement in their budget situation in 1998. Government debt as a proportion of GDP also declined in most countries. The contraction in government deficits was due to economic growth and declining interest rates; in a number of countries, the situation was improved by the fact that governments were adhering to tight fiscal policies.

Budget surplus in the USA

In the USA, the government posted a budget surplus in fiscal 1997–98 – the first for thirty years. Equivalent to 1.7% of GDP, the surplus was mainly the result of a surge in tax revenues, which was due in turn to the economic uptrend. As business activity is expected to slow down, the budget surplus is likely to contract slightly in fiscal 1998–99.

Improved budget situation in Europe

In the United Kingdom, the government recorded a slight budget surplus of an estimated 0.6% of GDP in 1998, compared with a deficit of 1.5% in the previous year. As in the USA, vigorous economic growth was a major factor contributing to this growth. 1998 also saw a decline in budget deficits in most countries participating in the third stage of European Monetary Union as of 1 January 1999: in Germany and France, the deficit was still 2.1% and 2.9% respectively of GDP, while in Italy it remained at 2.7%. The governments of all three countries plan to trim back their deficits further in 1999.

Drastic deterioration in government finances in Japan

In Japan, expansionary fiscal policies implemented by the government in an attempt to boost economic activity caused the budget deficit for fiscal 1998–99 to balloon to an estimated 6% of GDP. Public debt rose to approximately 100% of GDP.

1.5 Foreign exchange markets

Large fluctuations in dollar exchange rate

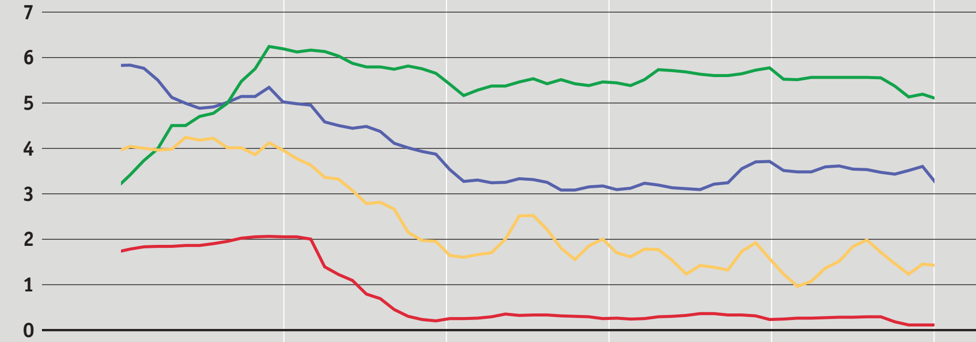
Between January and August, the dollar performed strongly against the European currencies. It was buoyed up by economic growth in the USA and an ample flow of money into American investments from East Asia and other emerging markets. Owing to Japan's economic problems, the dollar made particularly large gains against the yen. At the end of August, turbulence in the financial markets caused the dollar to plunge against the European currencies and the yen. It then fluctuated substantially up to the end of the year. Between January

1994 1995 1996 1997 1998

Short-term interest rates

Eurodollar
Euroyen
Euro-DM
Euro-Sfr

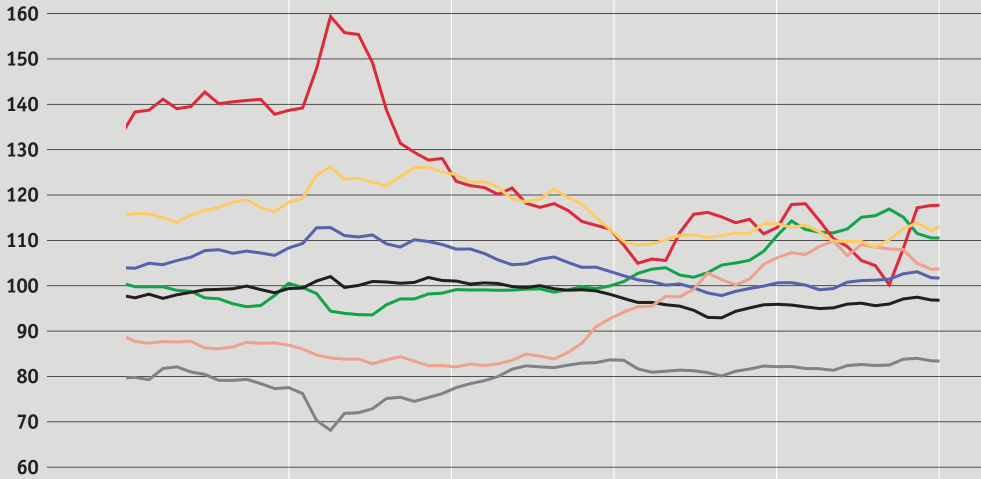
Three-month
Euromarket rates.
Source: BIS



Real exchange rates

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

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



1994 1995 1996 1997 1998

and December, the dollar lost a total of 7.3% against the D-mark, 14.5% against the yen and 6.2% against the Swiss franc. Nevertheless, the real trade-weighted dollar exchange rate in December was 1.6% higher than a year previously.

D-mark holds steady

The D-mark held steady against most European currencies in 1998. The only noticeable gain was a 6.8% rise versus the pound sterling. In relation to the Swiss franc, it showed a modest appreciation year-on-year. The real trade-weighted exchange rate of the D-mark fell by 2.5% in the 12 months to end-December 1998.

Calm in the European Monetary System

The situation in the European Monetary System (EMS) remained calm in the run-up to the launch of the euro. This was a reflection of the growing confidence in the new single currency. In March, the Greek drachma was admitted to the System's exchange rate mechanism (ERM). With the exception of this new member, all ERM currencies moved within narrow bands.

EMS II

For those EU currencies remaining outside the euro area, an "EMS II" was set up. The main difference compared with the original EMS is that the central rates of the participating currencies are fixed in relation to the euro rather than bilaterally. Intervention in support of a currency is, in principle, unlimited but may be suspended if price stability – the primary goal of the ECB's monetary policy – is jeopardised. Denmark and Greece have been members of EMS II since the beginning of 1999. Their respective currencies are pegged to the euro within a bandwidth of +/–2.25% (Danish krone) and +/–15% (Greek drachma). The United Kingdom and Sweden have not joined EMS II.

1.6 Financial markets

Continued fall in long-term interest rates

Long-term interest rates in the OECD countries underwent a further decline in 1998. This development was assisted by the continuing downtrend in inflation and low inflationary expectations. In the summer, moreover, sharp price falls on the equity markets prompted many investors to switch their assets increasingly into high-grade government bonds. This brought about a steep drop in the yields on government paper issued by western industrialised countries, thus widening the spread versus corporate bonds. By December, long-term US bond yields had fallen to 4.6%, 1.2 percentage points lower than a year previously.

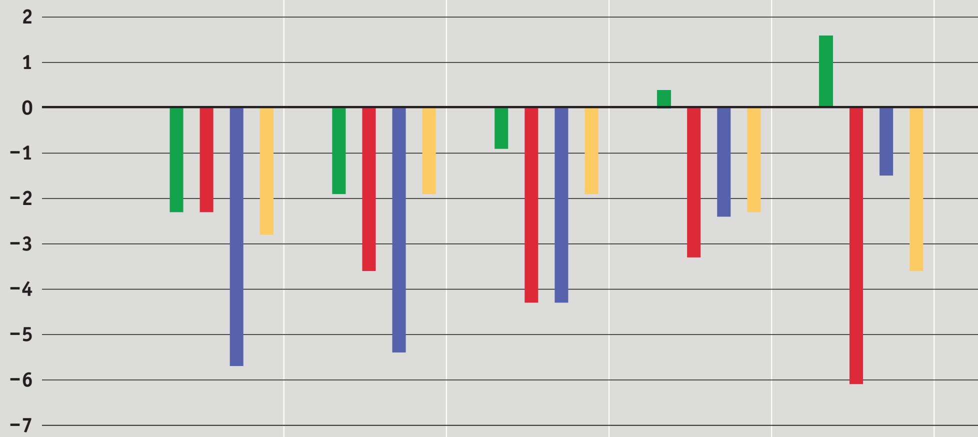
Long-term European rates converge

In the euro-area countries of the EU, long-term interest rates had converged to a large extent even before the new single currency was launched. By the end of the year, the average yield on ten-year government bonds in the eleven EMU countries was 4.1%. The spread between the country with the highest yield (Italy) and that with the lowest yield (Germany) had shrunk to 0.3 percentage points.

Share prices highly volatile

Share prices on most stock markets continued to soar in the first half of 1998, but a massive downturn set in at the end of July. The sea change in sentiment was triggered by the outbreak of the financial crisis in Russia. This induced market players to reassess the risks inherent in numerous emerging markets. In addition, investors were increasingly worried about the growth prospects for the

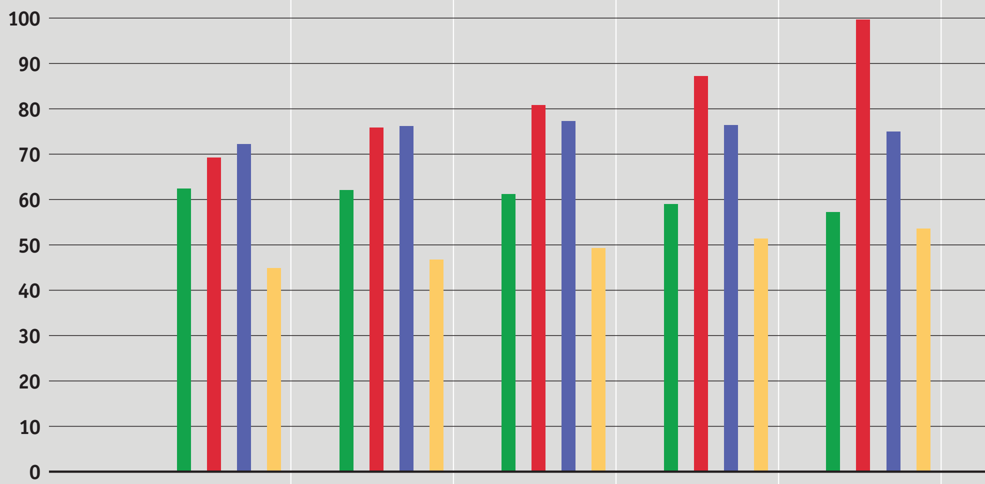
Public-sector financial balances



USA
Japan
European Union
Switzerland

Public-sector financial balances (all levels of government including social insurance) in percent of GDP.
1998: 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.
1998: budget forecasts.
Source: OECD

1994 1995 1996 1997 1998

industrialised countries. In the fourth quarter, share prices in most industrial nations recovered. The recovery was due in large part to the interest rate cuts implemented by central banks in the USA and Europe.

Decline in net borrowing on the international financial markets

Net borrowing on the international financial markets declined by 12% compared with 1997 to a total of $ 912 billion. Of this total, international bank loans accounted for $ 320 billion, money market instruments for $ 7 billion and net sales of medium- and long-term bonds for $ 585 billion. The volume of floating-rate and equity-linked issues increased at the expense of fixed-interest instruments. The currency breakdown changed substantially: while the percentage of issues denominated in dollars rose from 50% to 55%, the share accounted for by EU currencies increased from 32% to 38%. Swiss franc issues took a market share of 1.5%, up from 0.8% in 1997. These increases in market share contrasted with a decline in the relative importance of yen-denominated issues.

Bank earnings fall

The sharp fall in share prices coupled with the effects of the financial crises diminished the earnings of the commercial banks. A major American hedge fund became insolvent and was saved from collapse by a group of large international banks mediated by the Federal Reserve Board.

US and European banks set aside large provisions

The financial debacle in East Asia and Russia compelled internationally active banks in the USA and Europe to greatly increase their provisions for loan losses in the crisis-hit regions. This had a considerable impact on earnings from international business. On the other hand, margins in domestic business were boosted by the economic upswing. The process of concentration in the financial services industry continued. Numerous mergers and acquisitions took place between financial institutions, notably in North America. The German and Swiss futures exchanges entered into an alliance, and a number of other foreign stock exchanges agreed on closer cooperation.

Banking crisis in Japan

In Japan, the situation in the banking sector continued to deteriorate. Having posted large write-downs, the majority of financial institutions reported substantial losses. Two big banks were nationalised, and two regional banks had to cease operating. The government issued a restructuring plan for the banking sector. A fund to provide protection for investors was set up with the help of public money. The government also provided finance for state-run banks, as well as for financial institutions that are continuing to operate as autonomous entities.

Bank failures and government aid in East Asia and Russia

In Thailand, Indonesia, South Korea and Malaysia, numerous banks encountered solvency problems. They either had to close down or were recapitalised with the help of public funds. In Russia, the banking sector had to contend with massive liquidity problems. As a result, one major bank went out of business. The Russian central bank provided short-term loans to shore up the banking sector. Most of the countries affected by the financial crisis announced that they would be subjecting their banking sectors to tighter capital adequacy and provisioning requirements while also creating a more stringent system of banking supervision.

1994 1995 1996 1997 1998

Dollar

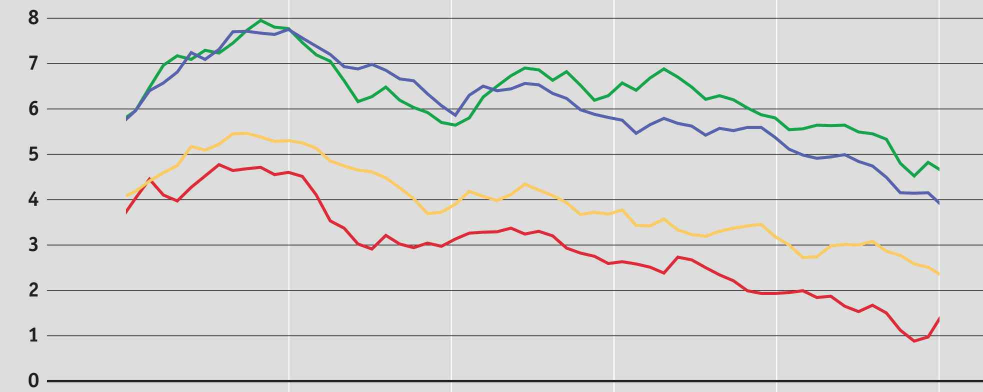
Yen

D-mark

Swiss franc

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

Long-term interest rates



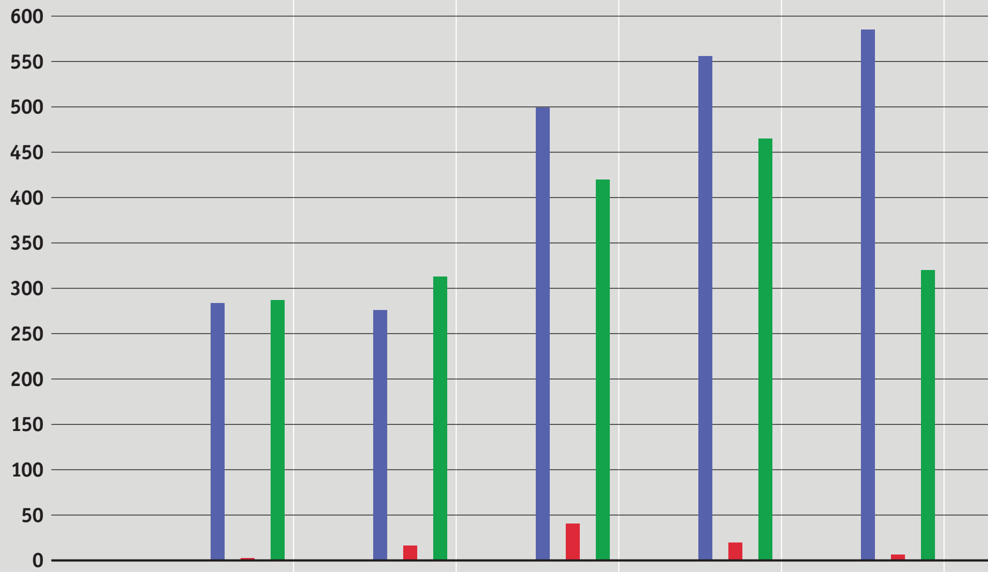
Bonds and medium-term paper

Money market paper

Bank loans

Billions of dollars.
Source: BIS

Net borrowing in the international financial markets



1994 1995 1996 1997 1998

2 Switzerland

2.1 Real economic performance

Firmer support for economic upswing

In Switzerland, the economic upswing that had begun in the previous year gained more solid support in 1998. Real GDP expanded on average by 2.1%, compared with a rise of 1.7% in 1997. As export growth – which had powered the early stages of the recovery – eased off, domestic demand took over as the driving force. Private consumption made particularly gratifying progress. Investment in the construction sector posted its first (if still hesitant) advance since 1994, while investment in plant and equipment continued to surge ahead.

Weaker export industry but domestic economy forges ahead

The cooling of the world economy had a serious impact on the export sector. A steady decline set in at the end of 1997: foreign orders had already started tailing off in the autumn of 1997, and by the second half of 1998 even the absolute figures were declining. Owing to the robust domestic economy, however, industrial output grew overall, albeit less markedly than in the previous year. The end-1998 capacity utilisation figure of 86% was the same as a year earlier even though technical capacity had been increased substantially during the year.

Private consumption revives

Private consumption gained further momentum, exceeding the year-back level by 1.8% in real terms. The improvement in the labour market and an increase in real disposable income had a stimulating effect. Both are reflected in the index of consumer sentiment, which reached its highest level for eight years in July and is thus back in the positive zone. Demand for consumer durables strengthened markedly, and the situation in the domestic tourism market continued to improve.

Downslide of building investment arrested

The crisis that had afflicted the construction sector since 1991 finally eased in 1998. Investment in construction rose 0.7% year-on-year, compared with a 1.5% drop in 1997. The upturn was assisted by the federal government's "Impulse" programme and by a number of major transportation projects, which particularly benefited civil engineering. Although the number of vacant properties remained stubbornly high, construction activity in the private residential segment also picked up slightly. Commercial construction revived, albeit on a very low level.

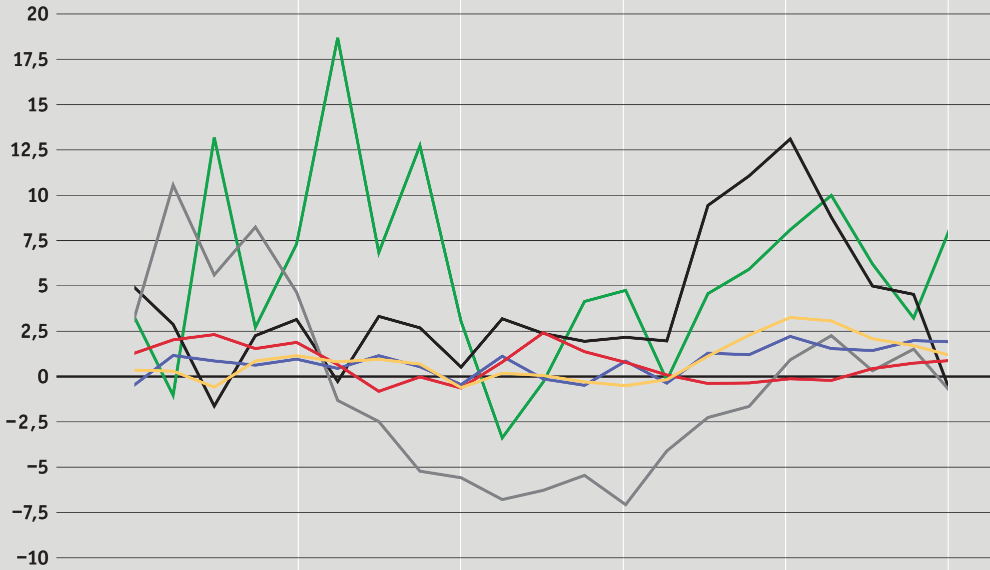
Strong growth in plant and equipment investment

Already growing strongly in the previous year, investment in plant and equipment continued to rise in 1998 (up 7.1% as against 5% in 1997). The steady fall in prices for imported capital goods provided an incentive. As a result of this brisk investment activity, technical capacity was expanded considerably.

Export growth slows

In real terms, growth in goods exports lost momentum during the year. On average over 1998, exports of goods rose by a real 4.9%, as against 7.7% in the previous year. Flagging demand from Japan and crisis-hit East Asia had a particularly strong impact. Shipments to this region fell by 26.1% year-on-year, and their share of total exports declined from 10.3% to 5.6%. Thanks to the European economic revival, exports to the EU rose faster than in 1997, and this helped to offset the decline in Asia. Exports of both capital goods and consumer goods as well as raw materials and semi-manufactures grew at a slower pace on an annual average. Export prices were below the year-back level after having firmed in 1997.

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

1994 1995 1996 1997 1998

Rapid growth in imports

With the domestic economy expanding, merchandise imports grew strongly again in real terms, climbing by 8.1%. Imports of consumer goods showed particularly dynamic growth. Imports of capital goods also rose faster than in the previous year, though imports of raw materials and semi-manufactures levelled off. Following a marked rise in the previous year, import prices declined in 1998. This was largely a reflection of the sharp fall in oil prices.

Improved employment situation

The economic recovery had a pronounced effect on the labour market. On average, employment in 1998 rose by 1.2% after having declined by 1.6% in the previous year. Total employment was still 6.4% below its 1991 peak, however. The improved situation is due for the most part to growth in the service sector. The workforce in this sector rose by 1.6%, with all segments except transport and communications and also the banking industry contributing to the growth. In manufacturing industry, however, employment figures rose only marginally. While the number of people employed in the chemical, electronics and metalworking/machine-building industries rose, employment in other sectors – notably the garment and footwear industry and publishing and printing – declined. The construction sector saw a slight rise – by 0.8% – in employment after the workforce had contracted by approximately 15% compared with its previous peak.

Decline in unemployment quickens

Higher demand for manpower accelerated the decline in unemployment: the seasonally-adjusted unemployment rate dropped from 4.8% in December 1997 to 3.2% in December 1998, and the number of persons without jobs declined by 57,000 to 116,500 in the space of a year. As in 1997, part of the decline in unemployment was due to statistical factors. For one thing, there was an increase in the number of long-term unemployed (i.e. persons no longer eligible for unemployment benefits) and, for another, cantonal work creation programmes also helped to improve the figures. Only about half the long-term unemployed feature in the statistics, while persons taking part in job creation schemes are not included. Even so, the drop in unemployment attributable to cyclical factors was more pronounced than in the previous year. The number of job seekers – comprising both unemployed persons and participants in a cantonal job creation scheme – declined from 241,600 in December 1997 to 198,200 in December 1998. The regional discrepancies remained: unemployment averaged 6.3% in Ticino, 5.3% in French-speaking Switzerland and 3.3% in German-speaking Switzerland. However, the rate declined at a similar pace in all three regions. Foreign nationals as a percentage of the total number of unemployed persons rose slightly to 48%. Short-time working remained low after having declined significantly in the previous year.

Employment figures up

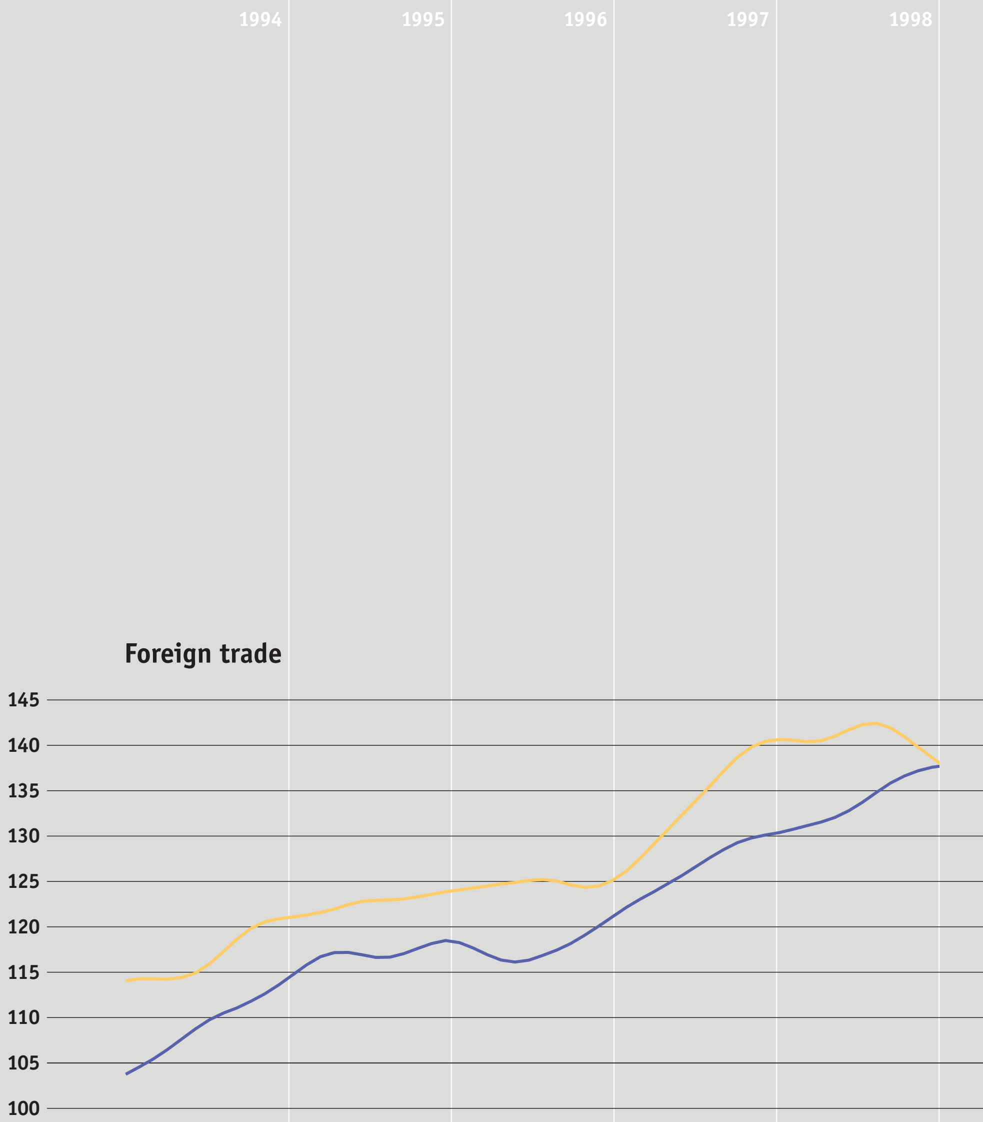
The improved employment situation is reflected in the results of the "SAKE" Swiss labour force survey, which is conducted once a year (in the second quarter). This showed a 1.8% rise in the workforce to 3,833,000 persons, compared with an 0.4% decline in the previous year. While the number of persons in full-time employment rose only slightly (up 1.4%), there were more substantial rises in part-time employment (2.5% in the 50–89% category and 3.2% in the under 50% category). The proportion of "part-timers" as a percentage of the total workforce thus advanced further from 25.4% at the beginning of the 1990s to 28.5%. The percentage of the potential labour force without gainful employment decreased from 4.1% to 3.6%. While the rate for men declined, it rose

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

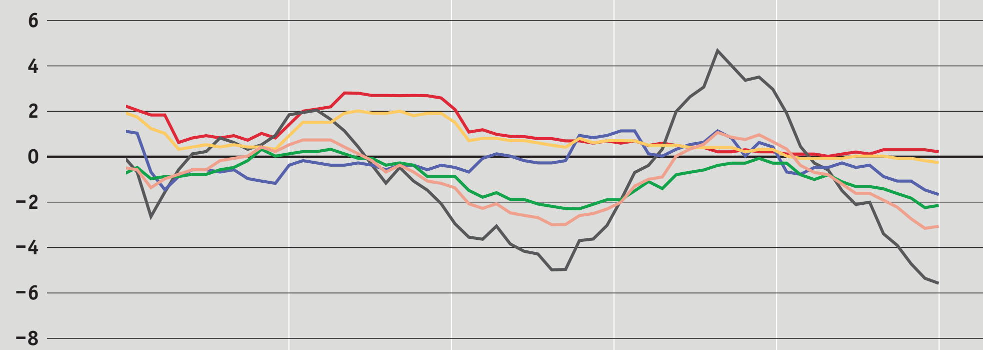
Consumer prices for imported goods

Producer and import prices

Producer prices

Import prices

Percent change from previous year.
Source: Federal Statistics Office

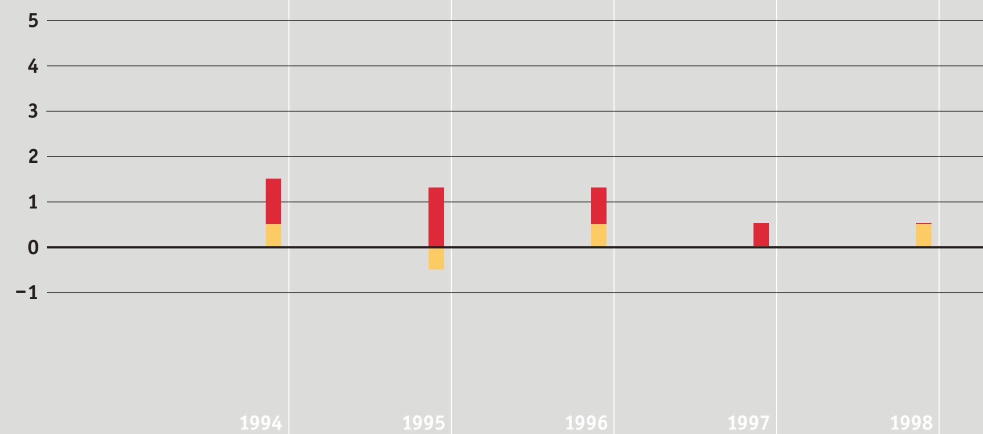


Wages and salaries

Nominal

Real

Wage and salary earnings of employed persons: percent change from previous year (1998: estimate).
Source: Federal Department of Economic Affairs



slightly for women. However, the number of women in employment rose faster (by 2.3%) than the equivalent figure for men. This illustrates that the proportion of women represented in the workforce has grown once more.

Employment and unemployment

1 according to employment statistics

2 according to the SAKE survey

3 space occupied by job advertisements in Swiss newspapers

Sources: Federal Statistics Office, Federal Office for Industry and Labour, Manpower

	1994	1995	1996	1997	1998
Full-time employment[1] change in percent	−1.4	−0.5	−1.0	−1.8	0.8
Full- and part-time employment[1] change in percent	−1.1	0.1	−0.3	−1.6	1.2
Persons in employment[2] change in percent	−1.7	1.5	0.5	−0.4	1.8
Unemployment rate in percent	4.7	4.2	4.7	5.2	3.9
Number of unemployed thousands	171.0	153.3	168.6	188.3	139.7
Number of part-timers thousands	22.6	9.9	13.1	6.6	3.1
"Manpower job offer index"[3] change in percent	27.2	18.4	−19.8	0.8	36.1

Consumer prices stable

Inflation, as measured by the national consumer price index, was 0% in 1998, compared with 0.5% in 1997. The cost of services rose by 0.2% compared with an 0.5% increase in the previous year. The renewed fall in inflation was due in large part to the sharp drop in telecommunications charges resulting from deregulation. The price of goods declined by 0.3% year-on-year after having risen 0.2% in 1997.

Prices of domestic goods rise faster while imported goods become cheaper

Inflation for goods and services produced in Switzerland averaged 0.3%. By contrast, prices of imported goods and services declined by 0.7% (largely due to a sharp fall in the oil price).

Lower prices across the board

The past year saw a decline in both producer prices and import prices, the fall being particularly pronounced for raw materials and semi-manufactures. Producer prices were 1.2% below their year-back level while prices of imported goods – which had risen by 2% in 1997 – declined by 2.2%.

Declining current account surplus

Switzerland's current account surplus fell by Sfr 2 billion to Sfr 31.1 billion in 1998. This latter figure is equivalent to 8.1% of GDP. In value terms, exports of goods rose by 3.2% and imports by 5.2%. The balance of trade (special trade) showed a deficit of Sfr 1.8 billion. The surplus from services contracted by Sfr 0.3 billion to Sfr 18.5 billion over the year. A further rise in revenue from personal travel was recorded while the banks' commission earnings diminished substantially. The surplus from employee compensation and investment income increased by Sfr 0.3 billion to Sfr 20 billion. Investment earnings from abroad rose more markedly overall than the corresponding payments remitted to foreign countries. This was due principally to higher net earnings from direct investment. The deficit from current transfers amounted to Sfr 4.8 billion, slightly less than in 1997.

Current account
balances in billions of Swiss francs

	1994	1995	1996 revised	1997 provisional	1998 estimated
Goods trade	2.2	1.0	1.1	−0.5	−2.7
of which special trade	3.2	1.8	1.9	0.3	−1.8
Services	15.6	15.2	15.4	18.8	18.5
of which personal travel	2.7	2.4	1.6	1.5	1.5
Employee compensation and investment income	10.7	13.9	15.6	19.7	20.0
of which investment income	17.6	20.8	22.4	26.2	26.4
Current transfers	−4.7	−5.0	−5.0	−4.9	−4.8
Total current account	23.9	25.2	27.2	33.1	31.1

2.2 Fiscal policy

Budget surplus at the federal level

In 1998, the federal surplus amounted to Sfr 0.5 billion or 0.1% of GDP. This was Sfr 8.1 billion higher than budgeted, exceeding the previous year's figure by Sfr 5.8 billion. Extraordinary revenues were mainly responsible for this positive result. First, the contribution emanating from the National Bank's profits (Sfr 400 million) was double the projected figure and, second, proceeds from the sale of Swisscom shares were posted to the financial accounts as an extraordinary one-off revenue item. This income led to a better financial result in accounting terms by Sfr 2.9 billion. In addition, the favourable economic situation caused revenues from stamp duty and direct federal tax to outstrip the budgeted figures. On the expenditures side, unused credit lines for the unemployment insurance scheme and lower interest expenses improved the result by Sfr 1 billion compared with the budgeted figure. For 1999, a deficit of Sfr 4 billion or about 1% of GDP is budgeted.

Deficit at the cantonal level ...

Interim figures put the aggregate cantonal deficit at Sfr 3.2 billion, compared with Sfr 3.1 billion in 1997. This is Sfr 1 billion below budget. The improvements vis-à-vis the budgeted figures are due mainly to the National Bank's higher transfer of profits. By contrast, most cantons expect tax revenues to fall short of the projected figures. With regard to expenditures, loans to the unemployment insurance scheme and interest expenses are likely to have fallen.

... and at the communal level

According to the available figures, the communes (municipalities) are expected to have posted a deficit of Sfr 0.3 billion overall in 1998, compared with a budgeted deficit of Sfr 0.6 billion. While most smaller towns and villages reported balanced budgets or even surpluses, the large towns and cities recorded deficits again.

Rise in indebtedness

Total debts of the Confederation, cantons and communes rose – according to estimates – to approximately 53% of GDP. Almost half the debts were attributable to the Federal Government, rather more than 30% to the cantons and just under 20% to the communes.

Programme to reduce the federal deficit

The Federal Council's efforts to tackle the federal budget deficit led to the drafting of a constitutional bill, "Budget Target 2001", which was approved by a referendum in June. The draft legislation lays down binding targets and deadlines for reducing the deficit and imposes sanctions in the event of their being missed. A maximum permissible deficit of 2% of revenues (i.e. approximately Sfr 1 billion) is defined for the year 2001. The interim targets for 1999 and 2000 are deficits not exceeding Sfr 5 billion and Sfr 2.5 billion respectively.

Stabilisation Programme 1998

To comply with Budget Target 2001, a "Stabilisation Programme 1998" was agreed at round-table talks held by representatives of the cantonal governments, the coalition partners, industry and employee organisations; this programme was subsequently submitted to parliament. The economy programme, which comprises revenue-boosting measures and spending cuts resulting in savings of about Sfr 2 billion, focuses mainly on social benefits, transfer payments to the cantons and defence spending. It also lays down savings targets for the Federal Railways and stipulates credit ceilings. The programme plans to boost government revenues by closing a number of tax loopholes.

2.3 Financial markets

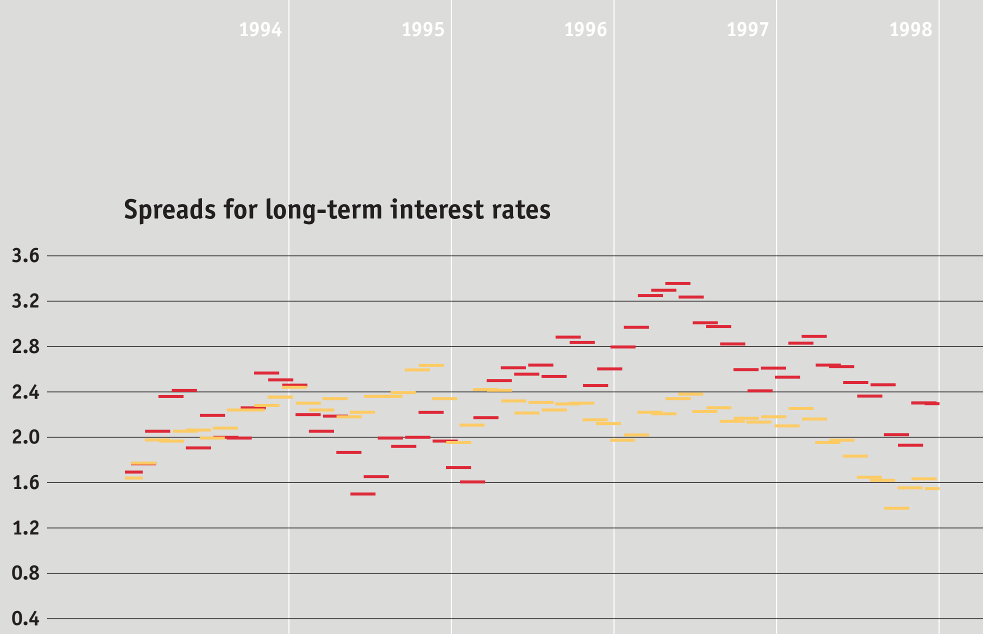
Low interest rates

The downtrend in interest rates, already observable since 1995, continued through to February 1998. By the end of February, the average yield on federal bonds had slipped to 2.6%, while the yield on three-month money market debt register claims issued by the Confederation had dropped below 1%. Both short- and long-term rates climbed back again by the summer, the rise being more pronounced at the short end of the market. The international financial crisis pushed interest rates lower again in the second half of the year. By December, the average yield on federal bonds had dropped back to 2.3%, i.e. lower than they had been in February. The growing nervousness on the markets that resulted from the international financial crisis caused the yield spread between Confederation and other paper to widen.

Financial crisis pushes up the Swiss franc's exchange rate

At the beginning of the year, the Swiss franc appreciated in the wake of the financial market turbulence in East Asia. From March onward, the Swiss franc lost ground – particularly against the European currencies – as the market gained confidence in a timely euro launch and in the new currency's stability. As of end-August, however, the international financial crisis pushed the Swiss franc up again. Over the year as a whole, the Swiss franc's exchange rate remained virtually unchanged both in real and export-weighted terms.

Spreads for long-term interest rates

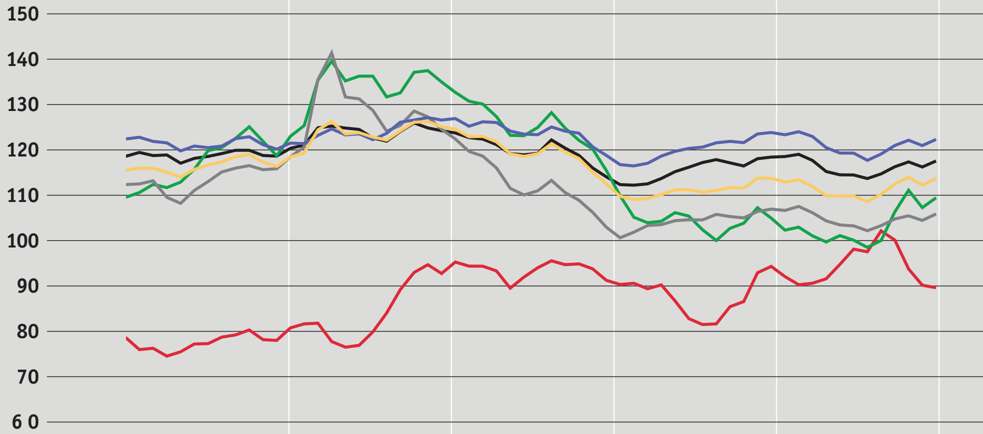


Germany – Switzerland

United States – Switzerland

Spread in
percentage points.
Source: BIS

Swiss franc real exchange rates



Total (15 countries)

Dollar

D-mark

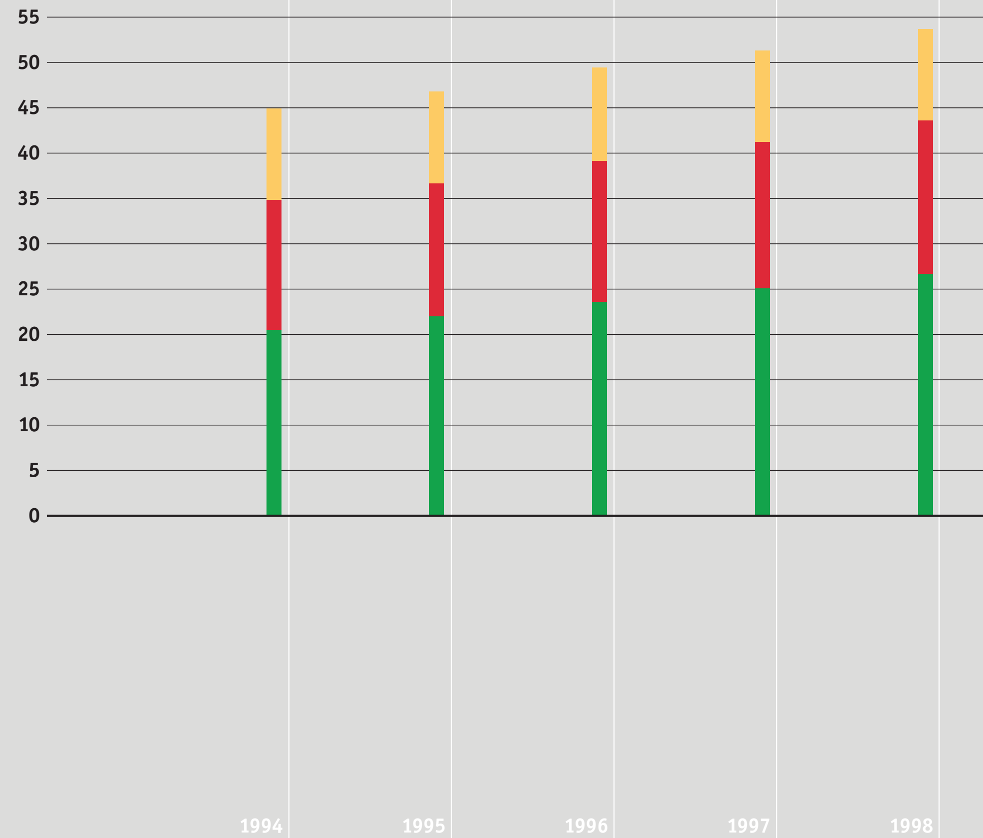
Yen

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
(1998: estimate).
Source: Federal Department
of Economic Affairs

Capital market borrowing

Borrowing on the Swiss capital market increased considerably in 1998 by comparison with the previous year. Net borrowing on the Swiss capital market (i.e. new issues less redemptions) amounted to Sfr 42 billion, as against Sfr 28 billion in 1997. Net borrowing by domestic debtors totalled Sfr 14 billion, twice the previous year's figure. Bond issues accounted for the bulk of these domestic borrowings, whereas share issues were counterbalanced by an almost equal volume of redemptions. Foreign borrowers tapped the capital market for Sfr 28 billion.

Highly volatile equity market

In the first half of the year, the bull market for equities continued. The Swiss Performance Index (SPI) gained 32% between January and end-July, climbing to a peak of over 5200 points. By October, however, it had dropped below 3400 points in the wake of the international financial crisis. While industrial stocks lost about 24% of their value on average, service-sector shares declined by over 51%. The main losers were bank shares, which plummeted on average by 55%. The SPI recovered by year-end, however, considerably exceeding its level at the beginning of 1998.

Banks adopt cautious stance on domestic lending

As in the preceding years, the banks' domestic lending business virtually stagnated in 1998, whereas their foreign business grew substantially. The aggregate balance sheet total of the Swiss banks increased by 25% overall, though this significant rise was due in large part to a new accounting method for repo transactions.

Banks' annual results unchanged

The banks' annual results were influenced positively by operating profits from domestic business and by the expansion of their private banking business around the world. Their results were adversely affected, however, by the stock market slide in the late summer, losses from derivatives business and the big banks' problems with loans to crisis-ridden emerging countries.

Merger of big banks

The merger of Union Bank of Switzerland and Swiss Bank Corporation, announced in December 1997, was completed by end-June 1998 in legal terms with the formation of UBS LTD. The Competition Commission approved the merger, subject to various conditions being met. Even before the merger, the Federal Banking Commission had released plans to tighten up the regulation of the big banks, and in autumn 1998 it set up a special office to monitor these banks' activities.

The repo – an innovation in the Swiss financial market

In April 1998, a new financing instrument – the repurchase agreement, or "repo" – was introduced in the Swiss financial market (cf. page 32). Switzerland's repo market was developed jointly by SEGA (Swiss Securities Clearing Corporation), the commercial banks, the Swiss Exchange and the National Bank. It allows unsecured credits between banks to be superseded by secured loans, thus reducing counterparty and market risks. In addition, the simultaneous "delivery versus payment" system guaranteed by SEGA eliminates settlement risk. Repo transactions are almost fully automated. This also applies to the selection of the securities in the borrowers' custody account serving as collateral and to the margin transfers.

Selected bank interest rates

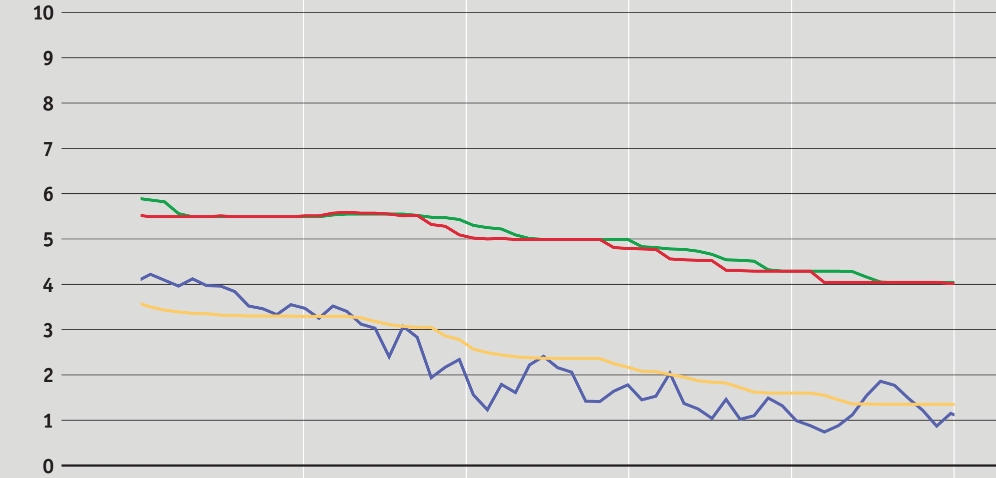
Existing mortgages at cantonal banks

New mortgages at cantonal banks

Savings deposits at cantonal banks

Three-month time deposits at big banks

Quarterly averages, percent per annum.



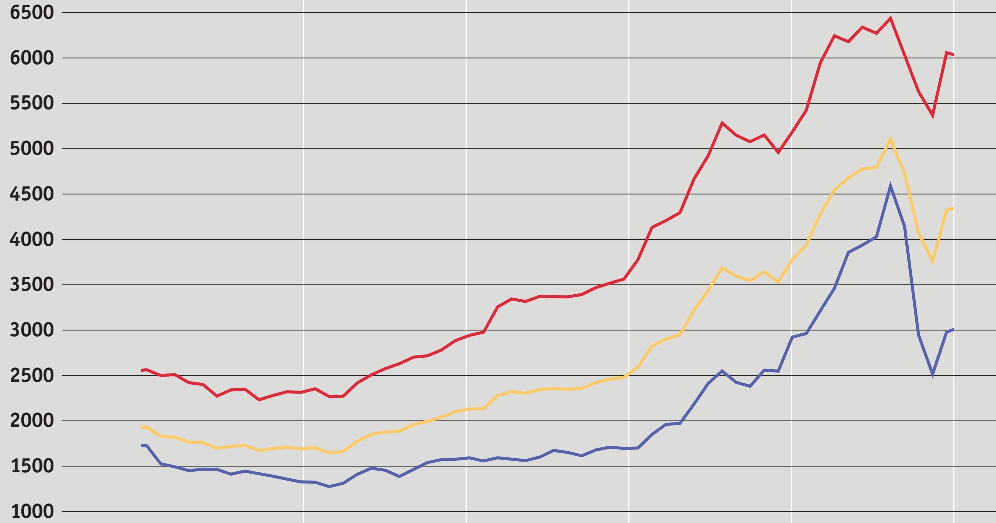
Share prices

Total

Banks

Industry

Swiss Performance Index.
Source: Swiss Stock Exchange



1994 1995 1996 1997 1998