Accountability Report for the Federal Assembly

On 18 February, 2008, the Governing Board of the Swiss National Bank submitted its 2007 Accountability Report to the Federal Assembly in accordance with art. 7 para. 2 of the National Bank Act. The following Accountability Report is submitted to the Federal Council and the General Meeting of Shareholders for information purposes only, and does not require their approval.

Summary

In accordance with art. 7 para. 2 of the National Bank Act (NBA), the Swiss National Bank (SNB) submits an annual accountability report to the Federal Assembly in which it outlines how it has fulfilled its mandate. This report on the year 2007 is structured in line with art. 5 NBA, with a separate section devoted to each of the eight tasks listed there.

Monetary policy

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

In the year under review, the world economy continued to grow strongly, driven in particular by the European and Asian economies. Long-term interest rates remained low, and inflation was moderate overall. In the second half of the year, the mortgage crisis in the United States prompted a reassessment of financial market risks, which gave rise to an abrupt liquidity squeeze on money markets.

The economic upswing continued in Switzerland, too. Capacity utilisation was at a high level and the economy was close to full employment. Household consumption rose substantially due to rising incomes. Exports were driven by the vitality of the international economy and the exchange rate of the Swiss franc, and this stimulated equipment investment. The level of construction investment was slightly below that recorded in 2006.

SNB monetary policy was faced with an environment whose main features included the economic boom, a slowdown in growth in the US, rising oil prices, a falling Swiss franc and financial markets that were initially favourable but subsequently became unsettled. In view of the upswing in Switzerland, the National Bank initially continued its normalisation of monetary policy, raising the target range for the three-month Libor by a quarter of a percentage point in both March and June. In the second half of the year, the financial market crisis created a new situation. While, on the one hand, the upswing persisted and it was important not to jeopardise price stability, on the other hand, financial market developments created uncertainty as well as money market shortages accompanied by higher interest rates. In September, the SNB decided to calm the money market by bringing the three-month Libor back down from 2.90% to 2.75%, while simultaneously lifting the target range by 25 basis points to 2.25 – 3.25%. No further adjustment was required in December, with the inflationary indications demanding as much monetary policy attention as did those pointing to a slowdown in the global economy.

Liquidity supply

(2) The SNB provides the money market with liquidity. In this way, it implements monetary policy and acts as lender of last resort when necessary. In the second half of 2007, disruptions on the international money markets led to liquidity bottlenecks and a sharp rise in risk premiums. Initially, the SNB responded to the new situation with generous injections of liquidity, as and when needed. In September, it countered the increase in the three-month Libor caused by higher risk premiums by offering liquidity with a maturity of three months and charging lower repo rates. Fine-tuning operations were used frequently to stabilise short-term money market rates. From the beginning of December, the SNB provided funds to ensure that banks would be able to cover any financing requirements over the year-end period without strains. In addition, it took part in concerted liquidity measures organised by leading central banks (including US dollar auctions). In June, the Governing Board decided in favour of a substantial expansion in the list of collateral eligible for SNB repos while retaining strict requirements with respect to liquidity and credit rating.

Cash supply and distribution

(3) The National Bank holds the note-issuing privilege. Through the banks and the postal service, it supplies the economy with banknotes and coins, the latter on behalf of the Confederation. In 2007, it again focused on maintaining the quality of banknotes and of cash transactions, on further developing security features and on precautionary measures to prevent counterfeiting. As part of the project to develop a future series of banknotes, the bank authorities commissioned Manuela Pfrunder, a graphic artist from Zurich, to carry out further development work on her designs.

Payment systems

(4) In the area of cashless payments, the SNB is mandated to facilitate and secure the functioning of the appropriate systems. It operates accounts for the banks, guides the SIC interbank payment system and oversees payment and securities settlement systems. In the year under review, the SNB thoroughly evaluated the SIC, SECOM and SIS x-clear system operators for the first time and came to the conclusion that, fundamentally, they fulfil the requirements.

Currency reserves

(5) The National Bank manages Switzerland's currency reserves. Asset management is governed by the primacy of monetary policy and is carried out according to the criteria of security, liquidity and performance. In 2007, investments, most of them in foreign exchange, gold and Swiss franc claims from repo transactions, remained focused on liquid currencies and investment markets, and on the highest credit ratings. There was little change in the investment universe and portfolio breakdown. A large part of the 250 tonnes of the gold sales announced in 2007 have already been carried out. Again, earnings from currency reserves exceeded long-term return expectations, with earnings from gold being particularly outstanding. The return on foreign exchange reserves was reduced by exchange rate and share price losses. The price of gold and the dollar exchange rate remained the dominant risk factors.

Financial system stability

(6) The SNB is charged with helping to secure the stability of the financial system. It endeavours to identify risks to the system at an early stage and works to create an environment conducive to stability. In its financial stability report, the SNB judged the banking system and financial market infrastructure to be stable but drew attention to vulnerabilities. The disruptions on the financial markets emanating from the US mortgage market in the second half of the year had the potential to threaten the Swiss financial system, and caused the SNB and the Swiss Federal Banking Commission (SFBC) to monitor the big banks closely. Together with the SFBC, the SNB addressed the reform of liquidity controls at the big banks as well as the implementation of the new Basel Capital Accord (Basel II). In addition, a Memorandum of Understanding was signed with the SFBC relating to cooperation in the field of financial stability.

Monetary cooperation

(7) The National Bank participates in international monetary cooperation activities. Important bodies are the International Monetary Fund (IMF), the Group of Ten (G10), the Bank for International Settlements (BIS), the Financial Stability Forum (FSF) and the Organisation for Economic Cooperation and Development (OECD). The main activities of the IMF were the preventive surveillance of member states, the reform of the surveillance process, the reform of quotas and voting rights as well as its income. It conducted multilateral consultations on a coordinated strategy to reduce global imbalances. As part of the Financial Sector Assessment Program (FSAP), the IMF judged the Swiss banking sector to be shock-resistant. The BIS committees in which the SNB participated were concerned with banking supervision, payment transactions, the global financial system and financial markets. SNB technical assistance focused on the countries that belong to its IMF constituency.

Banker to the Confederation

(8) The SNB provides the Swiss Confederation with banking services in the areas of payment transactions as well as liquidity and securities management. In 2007, the SNB issued money market debt register claims and bonds for a total value of CHF 37.2 billion and carried out 122 000 payment transactions on behalf of the Confederation.

1 Monetary policy

Summary

Despite the turbulence experienced on financial markets during the second part of the year, conditions were favourable in the domestic and international economies in 2007. In order to manage monetary conditions, by ensuring that the buoyant economy did not jeopardise price stability, the Swiss National Bank (SNB) increased the three-month Swiss franc Libor target band on three occasions. Price stability was assured.

1.1 Monetary policy strategy

Constitutional and legal mandate

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

The SNB is thus charged with resolving in the best general interests any conflicts arising between the objective of price stability and consideration of the development of the economy, giving priority to price stability. The requirement to act in the "interests of the country as a whole" means that the SNB must gear its policy to the needs of the Swiss economy as a whole rather than the interests of individual regions or industries.

Significance of price stability

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

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

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

Taking economic activity into account ...

The economy is subject to numerous domestic and foreign shocks. These cause fluctuations in the business cycle which generate pressures on prices that are more or less pronounced. Such fluctuations are inevitable. Although monetary policy is medium and long term in nature, it can help to limit these fluctuations.

The SNB faces highly diverse situations. The most common cause of inflationary or deflationary phases is when aggregate demand for goods and services does not develop in line with the economy's production capacity. Such situations can arise, for example, as a result of unforeseen developments in the international economy, major fluctuations in exchange rates, serious government budget problems or inappropriate money supply levels in the past. Inflationary pressures increase in phases of economic overheating and decrease when production capacity is not fully utilised. Thus, the National Bank must gradually restore price stability by tightening monetary policy in the first case and easing it in the latter. Consequently, monetary policy that is geared to price stability has a corrective influence on aggregate demand and thus helps to smooth economic activity.

The situation is more complex when prices rise owing to shocks that increase corporate costs and cause companies to curb production. A continuous rise in the oil price is an example of such a shock. Under such circumstances, monetary policy must, on the one hand, make sure that the higher production costs do not result in an inflationary spiral, while, on the other hand, ensuring that the companies affected by the shocks are not excessively disadvantaged. An over-hasty restoration of price stability might have adverse effects on the business cycle and employment.

... despite numerous uncertainties

Even though the SNB takes economic developments into consideration when formulating its monetary policy, it cannot be expected to fine-tune them. There are too many uncertainties with respect to the cause and duration of the shocks that impair economic performance, as well as the transmission mechanisms, the time lag that elapses before monetary policy affects the business cycle and prices, and the extent of its impact.

Monetary policy approach

The monetary policy strategy in force since 2000 consists of the following three elements: a definition of price stability, a medium-term inflation forecast and – at the operational level – a target range for a reference interest rate, the three-month Libor (London Interbank Offered Rate) for Swiss francs.

Definition of price stability

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

The inflation forecast performs a dual function in the SNB's monetary policy strategy. While, on the one hand, it serves as the main indicator for the interest rate decision, on the other, it is also an important element in the National Bank's communication policy..

Functions of the inflation forecast

The SNB reviews its monetary policy on a regular basis to ensure that it is appropriate for the maintenance of price stability. With this in mind, it publishes a quarterly forecast on the development of inflation over the three subsequent years. The period of three years corresponds more or less to the time required for the transmission of monetary policy to the economy. Forecasts over such a long time horizon, however, involve considerable uncertainties. By publishing a medium to long-term forecast, the SNB emphasises the need to adopt a forward-looking approach and to react at an early stage to any inflationary or deflationary threats.

Quarterly publication of inflation forecast

The SNB's published inflation forecast is based on a scenario for global economic developments and on the assumption that the Libor determined at the time of publication of the forecast will remain constant over the entire forecasting period. The forecast published by the SNB thus maps the future development of prices based on a specific world economic scenario and an unchanged monetary policy in Switzerland. For this reason, it is not directly comparable with forecasts by other institutes which incorporate anticipated monetary policy decisions.

In the medium and long term, the price trend depends, essentially, upon the supply of money. The monetary aggregates and credit thus hold a relatively important position in the various quantitative models used for forecasting inflation. For shorter-term inflation forecasts, other indicators relating, for instance, to economic activity, exchange rates or oil prices, are generally of greater importance.

Indicators upon which the inflation forecast is based

The SNB regularly issues statements on the development of the principal monetary policy indicators factored into its inflation forecast. It provides details of the models it uses in several of its publications.

In view of the fact that the inflation forecast published by the SNB takes account of the interest rate decision taken by the Governing Board, the shape of the curve makes it possible for economic agents to deduce the probable future path of the Libor.

Communicating through the inflation forecast

If the inflation forecast indicates a deviation from the range of price stability, an adjustment of monetary policy could prove necessary. Should inflation threaten to exceed 2% on a longer-term basis, the SNB would thus consider tightening its monetary policy. Conversely, it would tend towards relaxation if there were a threat of deflation.

Review of monetary policy based on the inflation forecast

The SNB does not, however, respond mechanically to its inflation forecast; it takes account of the general economic situation when determining the nature and extent of its reaction. If inflation temporarily exceeds the 2% ceiling in extraordinary circumstances, for example following a sudden massive rise in oil prices or strong exchange rate fluctuations, monetary policy does not necessarily need to be adjusted. The same applies to short-term deflationary pressures.

Libor target range

The SNB implements its monetary policy by fixing a target range for the three-month Swiss franc Libor, which it publishes regularly. As a rule, this target range extends over one percentage point, and the SNB generally aims to keep the Libor in the middle of the range.

The SNB undertakes quarterly economic and monetary assessments at which it reviews its monetary policy. If circumstances so require, it will also adjust the Libor target range between these quarterly assessments. It sets out the reasons for its decisions in press releases.

1.2 International economic developments

Robust global growth despite slowdown in US

In 2007, global economic growth settled at around 5% for the third year in succession. The main reasons for this excellent performance were the continued economic momentum in emerging countries, particularly in Asia, as well as the favourable international financial conditions. Despite a progressive tightening in monetary policy, long-term real interest rates remained low, thereby supporting financial assets and the expansion in credit markets.

There was greater divergence between economic developments in different regions than there had been in 2006. While high growth levels persisted in emerging economies and the European economy continued growing at a rate higher than its long-term trend, the US economy slowed considerably.

Considerable increase in energy prices

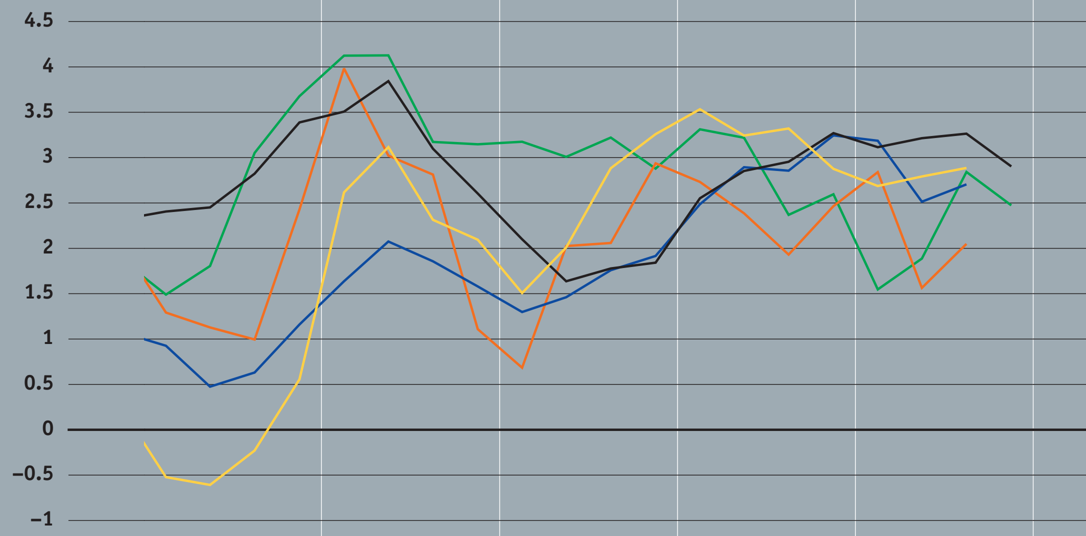
In 2007, oil prices rose substantially. The average price of a barrel reached USD 90 in the fourth quarter of 2007, which was the highest level ever attained, representing an increase of 50% over the same period in the previous year. A rise of this magnitude had not been observed since 2004. The main reasons were essentially the strong rise in demand from emerging economies and the lack of surplus capacities, in particular on the part of OPEC member states.

Turbulence on financial markets

Another dominant feature of the year was undoubtedly the strong increase in volatility on financial markets. The rise in the number of foreclosures and defaults in the US sub-prime mortgage market led, over the course of the summer, to a sharp revaluation of these assets and their derivative products. The uncertainty regarding the extent and distribution of losses dried up certain segments of the credit market and greatly increased the cost of interbank lending. The main stock market indices also declined in the wake of this credit market turmoil – dragged down by substantial corrections in the shares of financial institutions. Furthermore, the volatility of the stock market approached the levels reached when the technology bubble burst in 2000. Finally, investors' risk-aversion was reflected in a decline in yields on government bonds and an increase in risk premiums on corporate bonds. These developments resulted in a substantial tightening of financial conditions in developed economies in the second part of the year.

2003 2004 2005 2006 2007

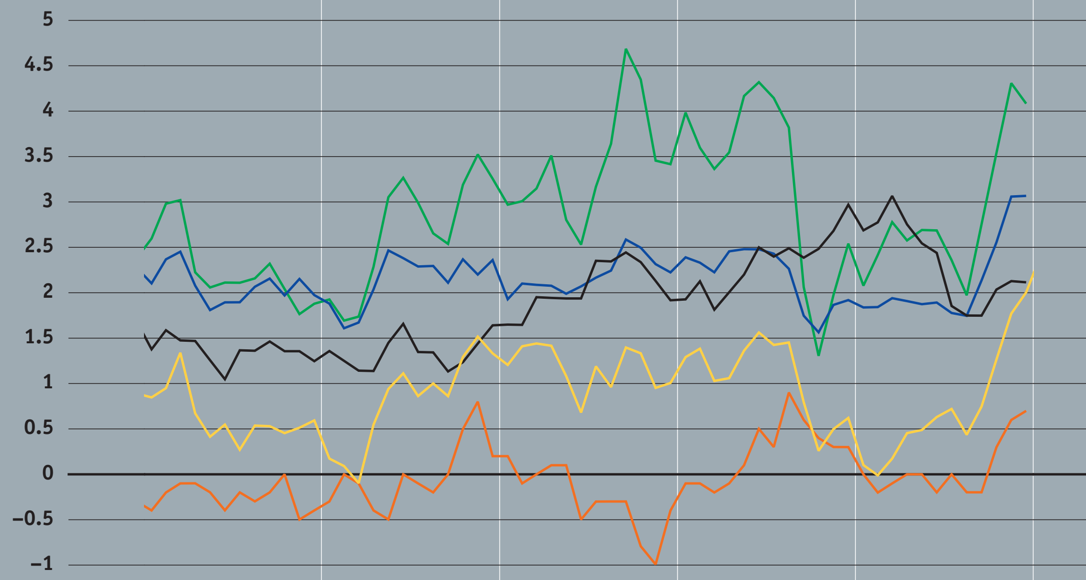
Gross domestic product



United States
Japan
Euro area
United Kingdom
Switzerland

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

Inflation



United States
Japan
Euro area
United Kingdom
Switzerland

In percent
Sources: Thomson Datastream, SFSO

2003 2004 2005 2006 2007

US growth impaired by decline in real estate market

The US economy continued slowing in 2007. At 2.2% (2.9% in 2006), annual GDP growth was distinctly below the long-term trend. This downturn reflected the substantial adjustment in residential investment. Between January and December 2007, house sales and new housing under construction declined by about 30%. The effect on house prices was striking, with certain indices recording a drop of almost 10% over the same period for the country as a whole.

The other components of domestic demand, however, increased strongly. Household consumption was robust in the services and consumer durables sector, thereby compensating the loss of momentum in the current consumption goods segment, which was particularly affected by the increase in petrol prices. Corporate investment maintained its upward trend on the back of commercial and industrial construction. In part, this reflects the increase in production capacity needed to respond to a major increase in external demand. As opposed to previous years, the net contribution of foreign trade was positive in 2007 (0.6 percentage points). This was due to strong demand from Asia and Europe, the continued weakness in the dollar and the moderating effect which the increase in oil prices had on US demand for energy.

Conditions on the US labour market remained favourable. Employment slowed somewhat, leading to a slight growth in the rate of unemployment. However, at 4.8% in the fourth quarter of 2007 (4.5% in the fourth quarter of 2006), unemployment is still below the long-term average.

Apart from the real estate sector, the US economy performed well in 2007. This, however, should not obscure the deterioration in the macroeconomic indicators at the end of the year. The rapid increase in petrol prices and the financial market turbulence shook the confidence of households and businesses. In the fourth quarter, most confidence indices were at their lowest level for two years, and there was only a very small advance in the indices of activity for the manufacturing sector. Following the strong growth in the second and third quarters, there was a distinct slowdown in momentum in the three final months of the year.

European economic growth supported by investment

Although it varied from one country to another, the growth of economic activity in the euro area was again robust in 2007, attaining 2.7% (2.9% in 2006). The business cycle in the euro area followed a traditional pattern, with an upsurge in exports stimulating corporate investments and employment. Expenditure on equipment investment rose strongly in response to the high rate of capacity utilisation and corporate profits, both of which were at historically high levels. Growth in private consumption, however, remained moderate despite the continued decline in unemployment. This was due particularly to the increase in VAT in Germany and the rise in the price of petrol.

Conditions in the labour market continued improving. The rate of unemployment declined throughout the year, reaching 7.2% in December 2007, its lowest level since the official starting date for the series calculated by Eurostat (January 1993). This resulted from the strong demand for qualified workers, the moderate level of salary increases and the structural reforms in the labour market that have occurred in recent years, particularly in Germany.

As in the US, macroeconomic conditions in the euro area deteriorated at the end of the year. Most of the indices of business activity, in both manufacturing and services, declined in autumn, although they were still above their long-term average levels. In addition to the tightening of financial conditions related to the turmoil on credit markets, the strengthening in the euro also contributed to a deterioration in the outlook for exports.

Emerging Asian economies remain dynamic

Driven by the regional trade boom and the demand for investment, the emerging economies of Asia (China, Hong Kong, Singapore, South Korea and Taiwan) again recorded very strong growth in 2007. In China, GDP growth exceeded 10% for the fifth year in succession. The strong growth in investment was supported by increased corporate profits and favourable financial conditions. Strong exports gave rise to a substantial increase in the trade surplus.

The other emerging economies in the region also recorded growth rates above the average for the past ten years. They benefited from the upswing in global demand for information technology and from a revival in domestic demand following the improvement in labour market conditions.

Continued expansion in Japan

In Japan, the vitality of neighbouring economies and the weakness of the yen supported a growth rate of 1.9% in 2007 (2.4% in 2006). Investment in equipment continued to rise, due to the favourable financial position of businesses, whereas growth in private consumption remained weak as a result of limited increases in salaries.

Upward inflationary trend at end of year

In 2007, inflationary pressures in the developed countries increased. In terms of the overall consumer price index, inflation in December approached 4% in the US and 3% in Europe following the substantial increase in commodity prices, and in particular the rise in oil and food product prices in the second half of the year.

In the US, the rate of growth in the consumer price index, excluding food and energy products, slackened slightly during the course of the year to reach 2.4% in December 2007 (2.6% in December 2006). This was due, in particular, to a slowing in accommodation costs. In the euro area, the increase in the corresponding core index only slightly exceeded 2% at the end of the year, while in Japan the same index remained practically unchanged.

Monetary policies compromised

With sound economic advances recorded in the first half of the year, many central banks lifted their reference interest rates as part of medium-term inflation-combating measures. In the middle of the year, these policies were compromised by the turbulence experienced on financial markets and the uncertainties that ensued.

Consequently, the European Central Bank suspended the policy of gradually increasing its reference interest rate, after having lifted it by 50 basis points to 4% in the first part of the year. The Bank of Japan had not changed its reference interest rate from 0.5% since February. In order to address the problems caused by the severe correction on the US real estate market and the increase in the US refinancing rate, the Fed dropped its target for the federal funds rate by 100 basis points, taking it to 4.25% at the end of the year.

In addition, most central banks temporarily injected large amounts of liquidity in order to ensure that interbank refinancing markets did not run dry.

Uncertain outlook for 2008

Even though the global economy has moved into a phase of turbulence that adds considerable uncertainties to forecasts, the growth outlook for 2008 remains generally favourable. In the US, the large number of unsold homes suggests that residential investment will continue to contract in the next few quarters. Private consumption is also likely to slow, given the fall in the price of homes and the major increase in the price of petrol and food. The expected positive but modest increase in GDP in the US is likely to dampen exports and investment in Europe and Japan. Moreover, the increase in the value of the euro is likely to slow activity in the euro area. Nevertheless, in view of the continued improvement in employment, the European economy should continue growing. The vitality of emerging economies is likely to be a solid support for the developed economies.

Downside risks burdening global growth

However, there are several downside risks burdening the global growth outlook. First, the turmoil on financial markets could tighten credit conditions for households and businesses and cause them to cut back their expenditure. This applies particularly to the US and Europe. Second, the real estate crisis could spill over to other sectors of the US economy in a more serious manner than has happened to date. Third, current account imbalances continue to represent a major risk due to the fact that an abrupt correction could destabilise the global economy. Finally, the tensions on commodity markets could lead to new price increases that would impact on growth in developed economies and constitute a risk of inflation.

1.3 Economic developments in Switzerland

In 2007, the Swiss economy was in good shape and GDP growth remained at a high level, exceeding the forecasts made in 2006.

Healthy Swiss economy…

Following the lively developments in the previous year, 2007 saw a year of broad-based growth. Capacity utilisation was above the long-term average and the improvement in the labour market was substantial.

The main growth drivers included the strong global economy and the weakness of the Swiss franc with respect to the euro, which promoted net exports, although the contribution of exports to growth gradually declined during the course of the year. In addition, domestic demand was supported by advantageous financing conditions, as well as favourable developments in employment and income. For the first three quarters of 2007, GDP growth amounted to 2.8%. The turmoil on the financial markets barely affected the Swiss economy, which remained robust in the fourth quarter of 2007.

Real gross domestic product
Year-on-year change in percent

	2003	2004	2005	2006	2007[1]
Private consumption	0.9	1.6	1.8	1.5	2.0
Consumption by government and social security schemes	1.9	0.8	0.5	–1.4	–0.9
Investment	–1.2	4.5	3.8	4.1	3.4
Construction	1.8	3.9	3.5	–1.4	–2.6
Equipment	–3.6	5.0	4.0	8.9	8.3
Domestic demand	**0.5**	**1.9**	**1.8**	**1.4**	**0.2**
Exports of goods and services	–0.5	7.9	7.3	9.9	10.3
Aggregate demand	**0.2**	**3.8**	**3.6**	**4.3**	**3.8**
Imports of goods and services	1.3	7.3	6.7	6.9	6.0
Gross domestic product	**–0.2**	**2.5**	**2.4**	**3.2**	**2.8**

Sources: SFSO and SECO

1 Average of first three quarters.

Exports of goods and services recorded brisk growth during the first half of 2007 and exceeded the high volumes observed in 2006. Due to an increasing demand for investment goods and consumer goods originating mainly in Europe, south-east Asia and the oil-producing countries, exports to these countries remained particularly strong. Those to the United States, however, declined throughout the year.

… robust level of exports in first half of year…

In the second half of the year, the pace of growth in exports diminished. The downturn affected services somewhat more strongly than the goods sector, particularly with respect to financial services for clients abroad.

… and good results in second half

Gradual growth in imports throughout year

At the beginning of the year, the growth in imports of goods and services was below the long-term average. The second quarter of 2007 saw a slight acceleration, particularly in equipment goods, stimulated largely by corporate investment. However, it was not until the second half of the year that imports of goods and services began to grow more noticeably. Although the demand for imported equipment goods fell back slightly, the demand for durables acted as an import growth driver in the second half of 2007.

Strong growth in equipment investment

Given that capacity utilisation was above the long-term average, equipment investment continued rising. This advance was encouraged by advantageous conditions such as low interest rates, the good economic outlook and rising corporate profits. This growth in equipment investment meant that capital stock became better adjusted to production and this, in turn, was reflected in a decline in the rate of capacity utilisation in the second half of 2007.

Slowdown in construction

As opposed to equipment investment, construction investment showed a downward trend. This slowdown can be attributed, first and foremost, to a downturn in residential construction, which had already been at a high level following the strong developments of the preceding years. In the non-residential sector, growth in the construction of commercial premises advanced favourably in line with the general economic trend, while public works stagnated.

Employment increasing

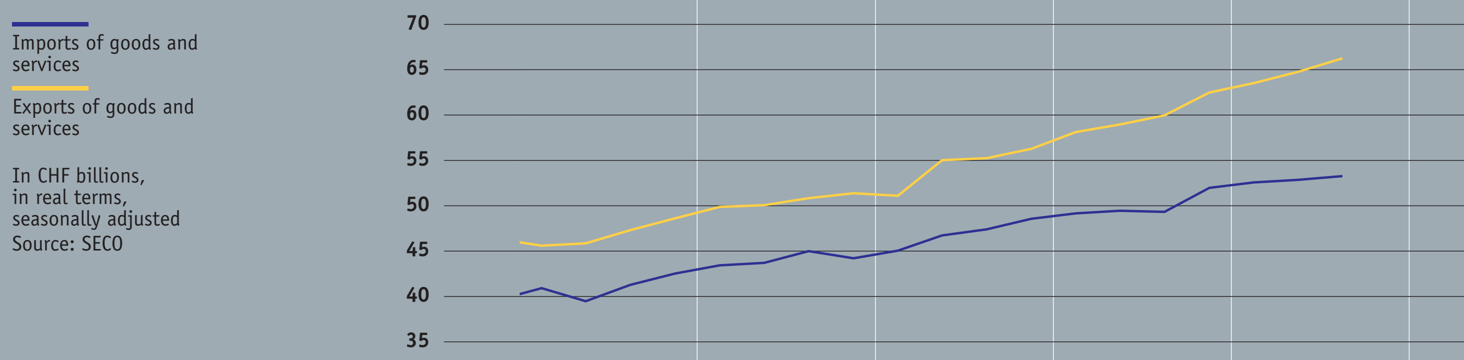
Benefiting from the strong economy, the labour market continued improving. In the first three quarters of 2007, some 82,000 new jobs were created. At the beginning of 2007, it was the manufacturing sector that served as the driver of employment growth. However, from mid-2007, employment growth in the services sector also picked up momentum. Despite a situation of near full-employment in 2007, excess demand for labour, measured in terms of job vacancies, never attained the levels achieved in 2000 – 2001. The opening up of the Swiss labour market to European Union nationals on the basis of the agreement on the free movement of persons has enabled employers to compensate part of the shortage of labour. The fact that approximately 40% of jobs created were taken up by non-Swiss employees is a partial reflection of this phenomenon.

Unemployment decreasing

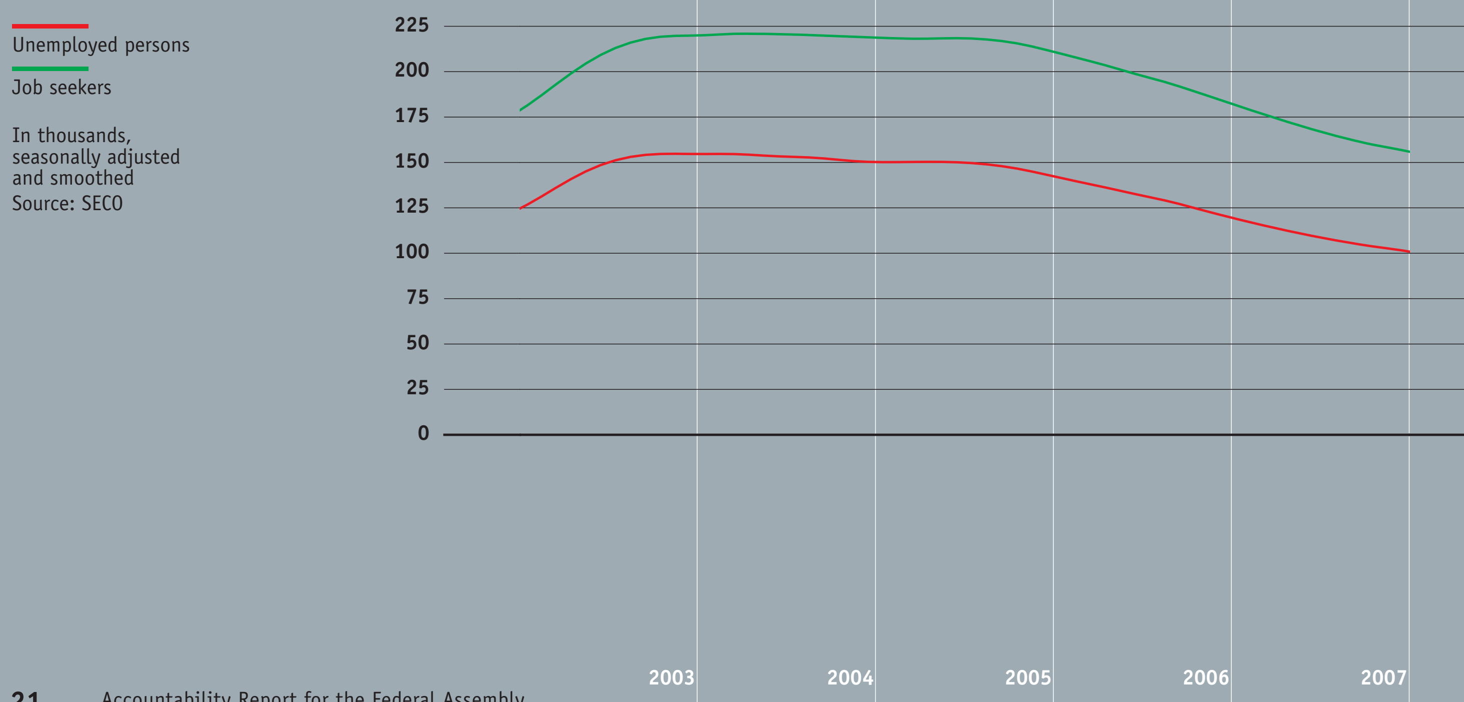
Alongside the vitality of employment, the rate of unemployment declined throughout the year, dropping from 3% in January to 2.6% in December in seasonally-adjusted terms. The rate of job seekers also continued falling, dropping from 4.6% in January to 4% in December. In addition to unemployed persons, this indicator includes people looking for jobs who are either temporarily engaged in employment or training programmes, or who receive temporary earnings.

Gross domestic product and components

Foreign trade



Labour market



Labour market

	2002	2003	2004	2005	2006	2007
Employment in terms of full-time equivalents[1, 2]	0.1	–0.9	0.0	0.2	1.4	2.6
Unemployment rate in percent	2.5	3.7	3.9	3.8	3.3	2.8
Number of job seekers in percent	3.8	5.2	5.6	5.5	5.0	4.3
Swiss nominal wage index [1, 2]	1.8	1.4	0.9	1.0	1.2	1.4
Total wage bill index[1, 2, 3]	5.4	1.5	0.7	2.6	3.9	5.5

1 Year-on-year change in percent.
2 Average of first three quarters of 2007.
3 Wage contributions to AHV/AVS.
Sources: AHV/AVS, SFSO, SECO

Expansion in real salaries and bonuses

In a labour market close to full-employment, real salaries certainly rose – but the increases were moderate. The Swiss wage index indicates an average increase in real salaries of about 1% in the first three quarters of 2007. However, this figure may be regarded as a minimum, since it does not take account of structural modifications in employment or bonuses. Using salary-based contributions to the Old Age and Survivors' Insurance (AHV/AVS), the increase in real average salaries amounted to around 2.5% in the first three quarters of 2007.

Healthy consumption figures

The healthy state of the labour market, with its favourable impact on employment, salaries and the climate of household consumption, provided strong support for private consumption, which, in 2007, attained the highest growth rate since 2001. All segments of private consumption benefited, with the demand for durable goods, such as sales of new cars, holding the pole position. By contrast, growth in the number of overnight stays, which is an important indicator for consumption of services, was relatively weak.

For the second year in succession, the rate of growth in real spending by the government sector was negative. This slackening in government spending slowed GDP growth.

Uncertainty on 2008 outlook

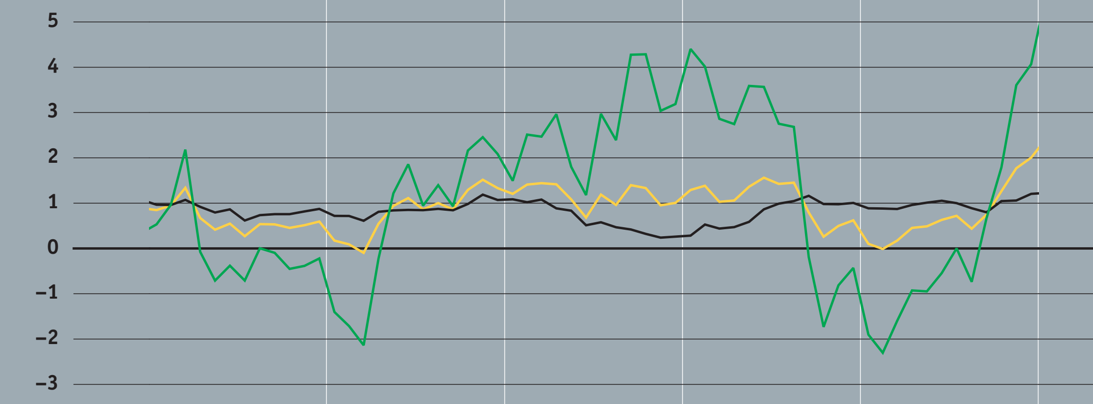
Although 2007 closed on a good note with respect to the economic situation, the turbulence on the financial markets in the second half of the year raised the level of uncertainty with respect to the economic forecast for 2008. Despite these risks, the economic outlook for Switzerland remains good. As compared to the strong growth experienced in the year under review, the increase in GDP is likely to slow a little in 2008, settling at around 2%.

A slackening in the pace of equipment investment and exports, together with the persistence of a relatively high level of imports, will probably have a negative impact on GDP. However, the vitality of the labour market and higher incomes in 2008 should result in a consolidation of private consumption and therefore support the economy.

Consumer prices
Domestic goods
Imported goods

Year-on-year change
in percent
Source: SFSO

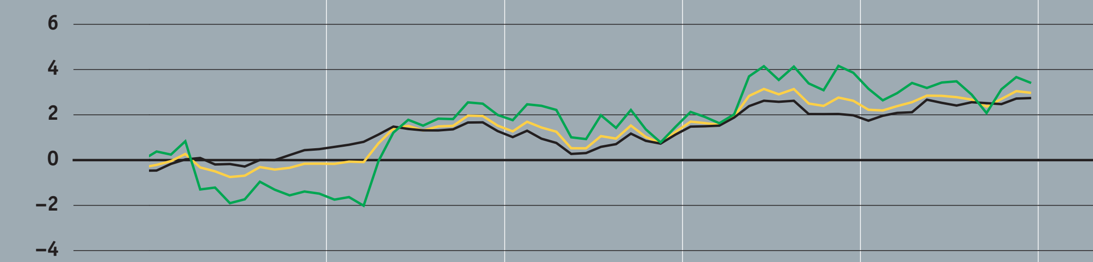
Consumer prices



Producer and import prices
Producer prices
Import prices

Year-on-year change
in percent
Source: SFSO

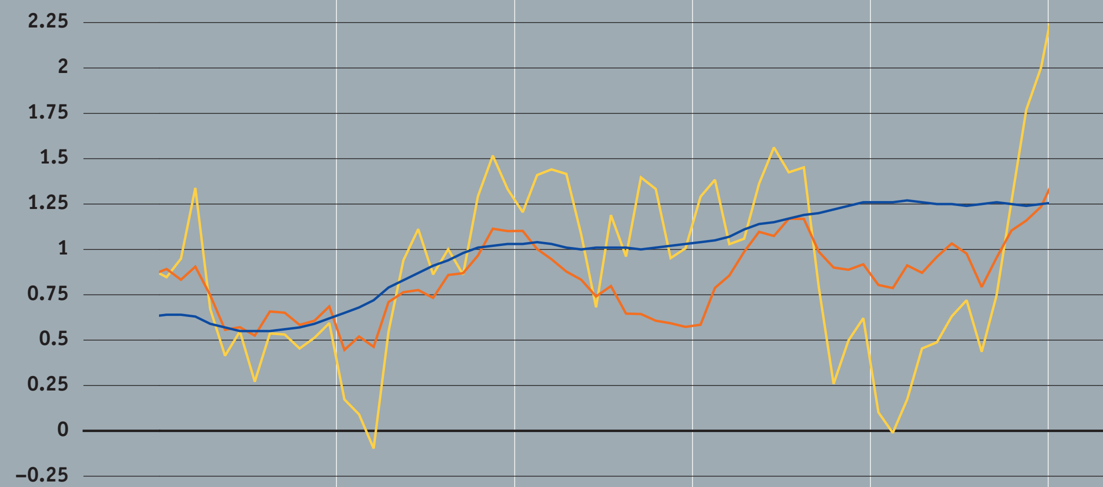
Producer and import prices



Consumer prices
Trimmed mean
Dynamic factor inflation

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

Core inflation



Price indices affected by energy prices

As in 2006, developments in import prices and production prices in 2007 were strongly affected by changes in energy prices, and particularly by movements in oil prices. The annual growth in import prices climbed from 3.2% to 3.5% between January and July, while the rate of increase in production prices crept up from 1.7% to 2.7% between January and May. Following a brief decline in September, the flare-up in oil prices led to a resurgence in import prices and production prices. While import prices advanced by 3.4% in the period from October to December, production prices increased by 2.6% in the same period. Apart from energy, prices of intermediate goods also grew strongly in the first half of the year, although this development was curbed in the second half. The terms of trade – in other words, the relationship between export and import prices – deteriorated over the course of the year as a result of the considerable increases in energy and commodity prices.

National consumer price index and its components
Year-on-year change in percent

	2006	2007	2007 Q1	Q2	Q3	Q4
Overall CPI	**1.1**	**0.7**	**0.1**	**0.5**	**0.6**	**1.7**
Domestic goods and services	0.8	1.0	0.9	1.0	0.9	1.1
Goods	–0.2	0.0	–0.5	–0.2	0.0	0.9
Services	1.1	1.2	1.3	1.4	1.1	1.2
Private services (excluding rents)	0.4	0.5	0.6	0.6	0.4	0.5
Rents	2.0	2.3	2.2	2.4	2.2	2.1
Public services	1.2	1.3	1.4	1.5	1.1	1.1
Imported goods and services	1.9	0.1	–1.9	–0.8	–0.0	3.2
Excluding oil products	0.4	–0.4	–1.3	–0.8	0.1	0.3
Oil products	9.3	2.4	–4.9	–1.0	–0.8	17.1
Core inflation						
Trimmed mean inflation	1.0	1.0	0.8	1.0	0.9	1.2
Dynamic factor inflation	1.2	1.3	1.3	1.3	1.3	1.2

Sources: SFSO and SNB

Inflation gradually rising ...

Inflation in 2007, measured in terms of the CPI, was moderate at the beginning of the year (0.1% in January), but increased over the year to reach 2% in December. The main reasons included the rise in the price of petrol and heating oil and the weakness of the Swiss franc against the euro, which pushed up the price of imports. The prices of services rose steadily throughout the year. Although the rate of growth in the price of goods rose over the course of the year, total average inflation amounted to 0.7%, which was 0.4 percentage points lower than in 2006.

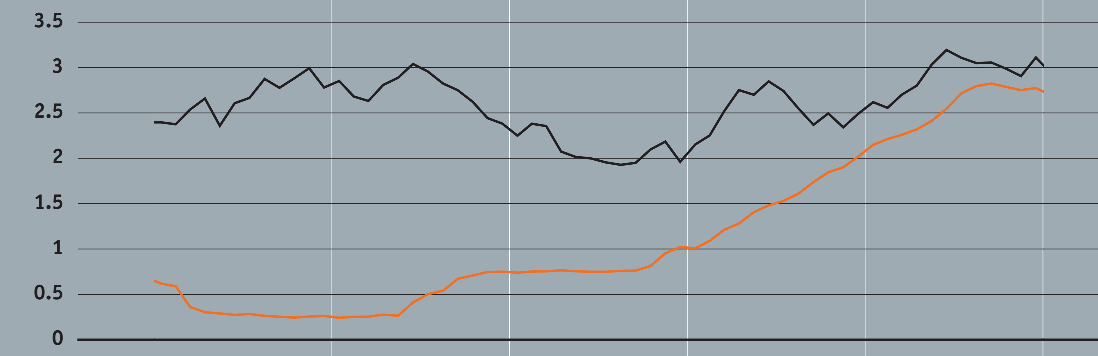
2003 2004 2005 2006 2007

Money and capital market rates

Three-month Libor

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

In percent

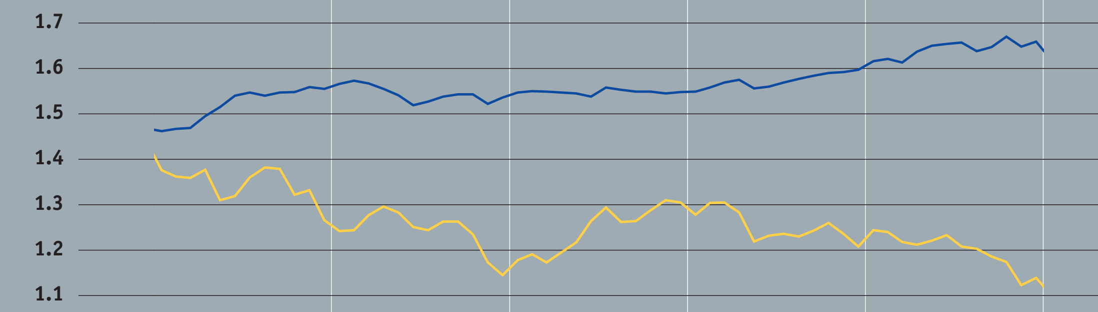


Exchange rates

CHF/USD

CHF/EUR

Nominal

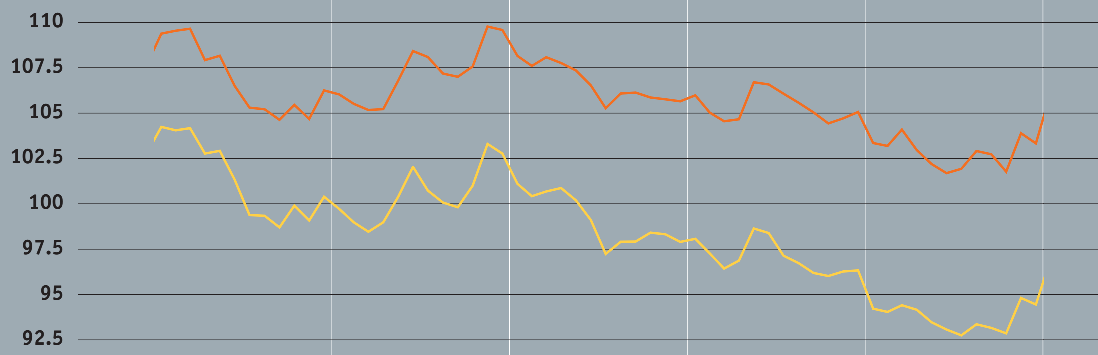


Export-weighted Swiss franc exchange rates

Real

Nominal

24 trading partners
Index: January 1999 = 100



2003 2004 2005 2006 2007

... but always under control

Numerous short-term fluctuations may have a significant impact on inflation, as measured by the CPI. The use of core inflation rates makes it possible to analyse inflationary trends. Between January and December, core inflation, as measured by the SNB using an average that excludes, for each month, all goods whose prices have recorded the greatest fluctuations (trimmed mean), rose gradually from 0.8% to 1.2%. In the same period, dynamic factor inflation – a form of core inflation that takes account of information contained in real and monetary variables and financial indicators in addition to price developments – remained relatively stable.

Libor rises in 2007

In the course of 2007, the Libor rose from 2.15% in January (average) to 2.77% in December (average). As a result of the normalisation of monetary policy, the Libor increased steadily during the first half of the year, reaching 2.5% in mid-2007. Although this advance continued in the second half of the year, it no longer followed the linear path of the first half. Increasing risk premiums caused the volatility of the Libor to rise, and just before the monetary policy assessment in September the rate reached around 2.9%. At the September assessment, the SNB therefore brought the Libor back to 2.75% with a view to calming the money market, and this level was maintained to the end of the year.

Increase in long-term yields and rise in volatility

In the first half of the year, ten-year Confederation bond yields – like other long-term interest rates – climbed 80 basis points to reach a level of 3.4% in June. However, from June onwards, in the wake of the turmoil on the financial markets, a major series of portfolio reallocations pushed down long-term interest rates. Consequently, ten-year Confederation bond yields slid to 2.8% in September. They then fluctuated around the 3% level for the remaining months of the year.

Swiss franc weak against euro

As in 2006, the Swiss franc was weak with respect to the euro. In 2007, the exchange rate fluctuated between CHF/EUR 1.60 and 1.68, reaching CHF/EUR 1.66 at the end of the year, as compared with CHF/EUR 1.60 at the end of 2006 (December average).

Swiss franc continues to strengthen against dollar

The picture was different as regards the US dollar exchange rate. The US currency remained relatively stable for the first six months of the year. Thereafter it plunged, in particular following the turmoil on the financial markets, reaching CHF/USD 1.14 at the end of the year, as compared to CHF/USD 1.21 at the end of 2006 (December average). Not since the mid-1990s has the level been so low.

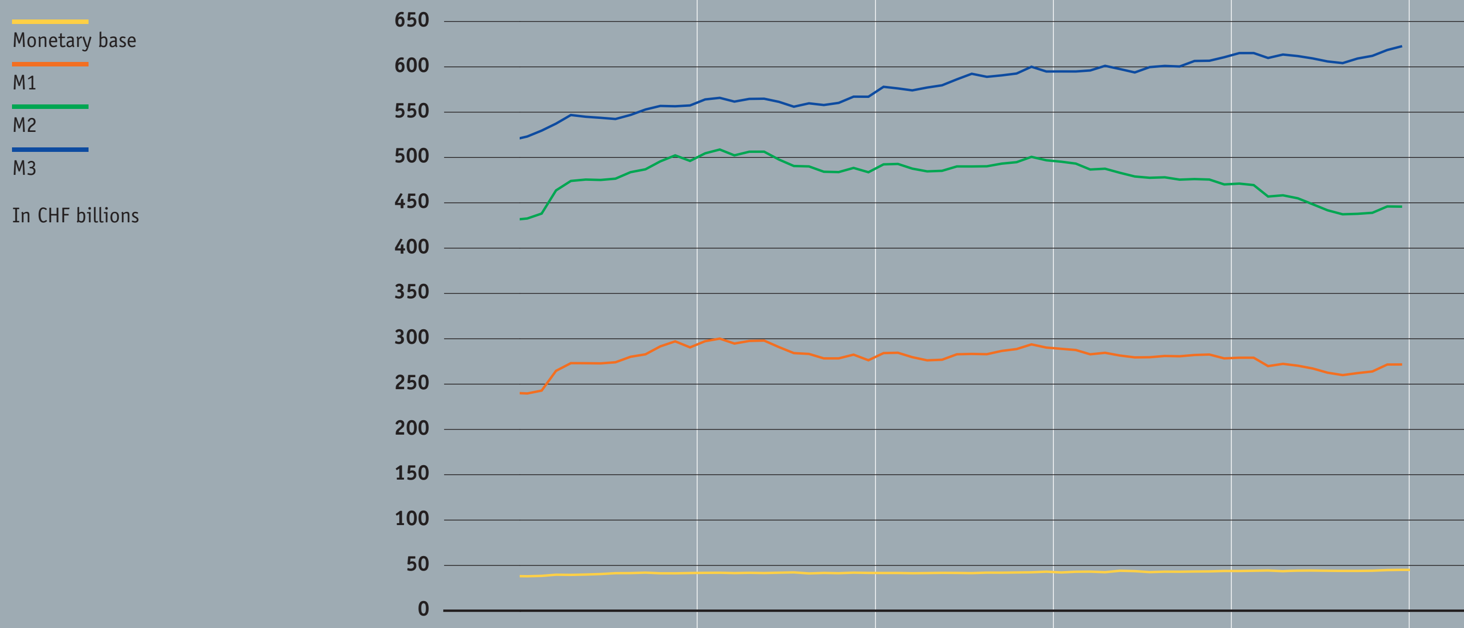
Both the nominal and the export-weighted real external value of the Swiss franc declined in the first half of the year but recovered in the second. In addition, these movements featured several periods of increased volatility.

Monetary overhang absorbed

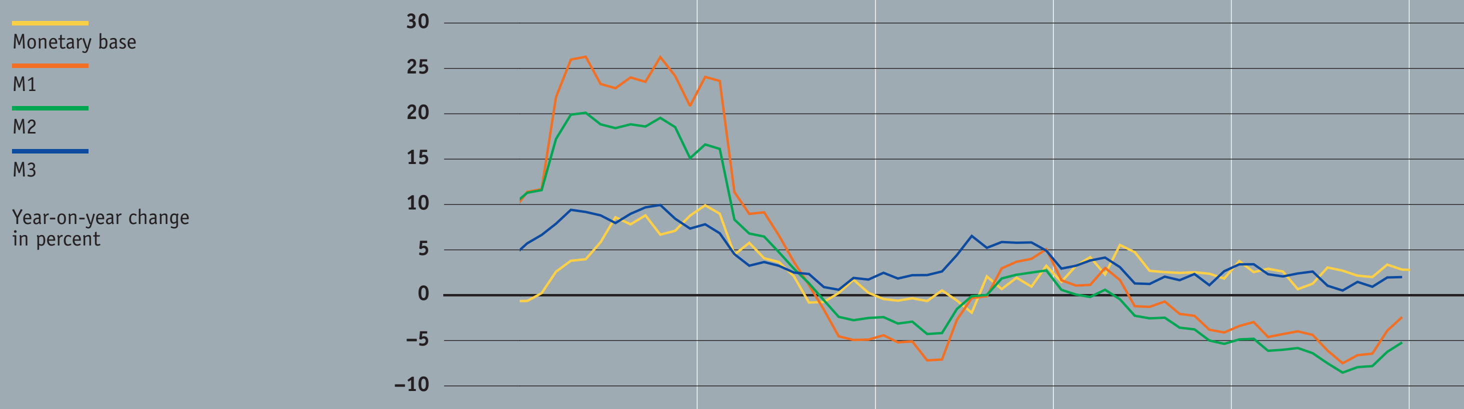
Since September 2004, when the process of normalising monetary policy was resumed, a substantial slowdown in the rate of growth of the monetary aggregates had been recorded as a result of the subsequent series of increases in the Libor. As in 2006, the rate at which M1 and M2 were falling picked up gradually over the course of 2007. Meanwhile, M3 continued growing, but at a relatively weak pace. The money overhang that had appeared in 2003 was absorbed in 2007.

2003 2004 2005 2006 2007

Level of monetary aggregates



Growth in monetary aggregates



2003 2004 2005 2006 2007

1.4 Monetary policy decisions

Four times a year, in March, June, September and December, the SNB's Governing Board conducts an assessment of the monetary policy situation. Each of these in-depth assessments results in an interest rate decision. In addition, if circumstances so require, the Governing Board also adjusts the target range for the three-month Libor in Swiss francs between regular assessment dates. In 2007, however, this was not the case.

Monetary policy challenges in 2007

In the first half of 2007, the SNB continued the policy of normalising the level of interest rates which it has been pursuing for the past three years. Consequently, it lifted the Libor target range in two steps to bring the interest rate to a level that was in line with the strength of the economy and that would ensure price stability in the medium term.

In the second half of the year, the SNB was operating in a new environment. Management of monetary conditions consisted of ensuring, on the one hand, that the healthy state of the economy did not jeopardise price stability in the medium term, and, on the other hand, that the turbulence on the financial markets did not result in a liquidity shortage. Consequently, the aim of monetary policy was to relax monetary conditions sufficiently to ensure that interbank market nervousness did not jeopardise the growth and stability of the Swiss economy, but to do so without any relaxation of vigilance in the matter of price stability.

Monetary policy in 2007 facing numerous risks ...

As in previous years, monetary policy in 2007 was exposed to numerous risks in the short, medium and long term. The SNB regularly evaluates the probability of such risks, their consequences for the economy and their implications for monetary policy.

... in the short term ...

Although the vagaries of oil prices represented a major risk to the economy and to price stability throughout 2007, the principal risk capable of dampening economic activity in the second part of the year was the crisis on the credit market, which deeply shook the financial markets and rocked the banking world. Although the volatility in energy prices did not cause the SNB to adopt any particular measures, the fear that money markets might dry up, however, encouraged it to relax monetary conditions in the second half of 2007.

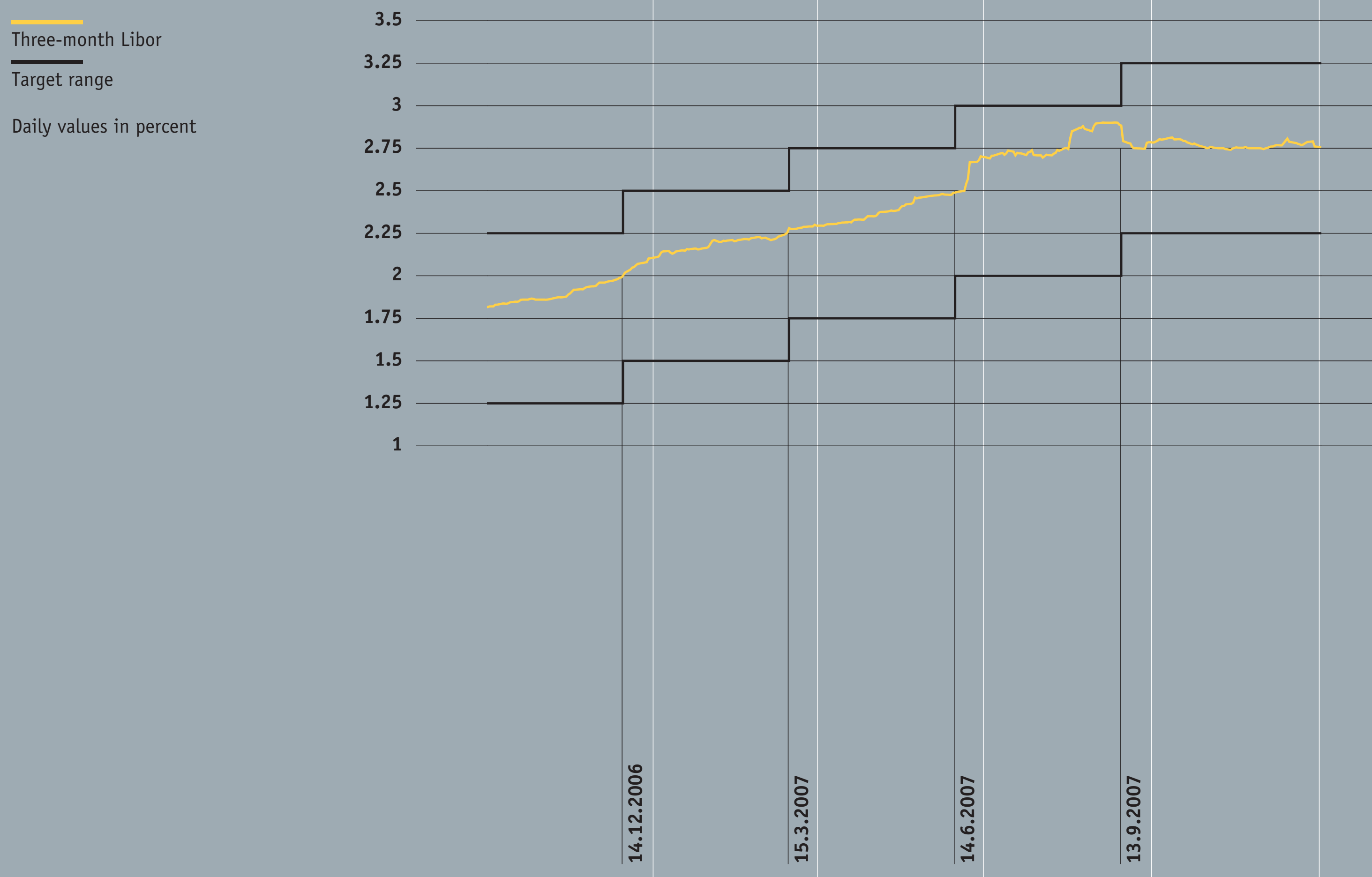
... in the medium term ...

Uncertainties with respect to the outlook for the global and Swiss economies remain the principal risks in the medium term. Although the European and Swiss economies grew in line with expectations in 2007, in the second half of the year there were an increasing number of indications of a considerable slowdown in the United States as a result of the substantial corrections on the real estate and financial markets. In addition, the weakness of the Swiss franc against the euro constituted an additional risk to price stability throughout the year.

Q4 2006 Q1 2007 Q2 Q3 Q4

Three-month Libor

Daily values in percent



Q4 2006 Q1 2007 Q2 Q3 Q4

... and in the long term

The outlook for inflation in the long term would have deteriorated if the SNB had not maintained the normalisation of its monetary policy. Thus, raising interest rates in 2007 was necessary if favourable perspectives for price stability were to be maintained.

Quarterly assessment of 15 March

As at each monetary policy assessment, the SNB bases its inflation forecast on the global economic scenario it regards as most likely. The economic trends that had emerged in the course of 2006 – a slowdown in the US and sustained growth in Europe – were confirmed at the first quarterly assessment of 2007. Consequently, the SNB predicted growth for 2007 of 2.8% in the US and 2.3% in Europe, and for 2008 of 3.1% in the US and 2.2% in Europe. It also expected that the decline in oil prices would continue to dampen inflation in the months following the assessment.

At the time of the assessment, the business cycle in Switzerland was solidly established. During the course of the following quarters, most components of domestic demand as well as exports would further consolidate growth. Moreover, the healthy economy would stimulate the labour market and promote a further decline in unemployment. Consequently, the National Bank continued to forecast GDP growth of approximately 2% for 2007.

At the time of the quarterly assessment, the Swiss franc had strengthened a little against the euro, following a period of weakness whose effect on inflation had not been significant.

In this context, the evaluation of the inflation outlook at the time of the assessment involved a greater level of uncertainty. Although foreign competition and the opening up of the labour market continued moderating price increases, there was a risk that, to an increasing extent, the rise in production costs would be passed on to prices due to the high level of capacity utilisation. Consequently, the Governing Board decided to lift the Libor target range by 25 basis points, with the new range being set at 1.75 – 2.75%.

According to the graph shown at the end of the assessment, the path of the inflation forecast based on an unchanged Libor of 2.25% was below that of December 2006 for a large part of 2007, due in particular to the drop in oil prices. The acceleration that followed, in which the new forecast overtook that of December, was more marked than previously, due to the weakening in the Swiss franc, which neutralised the impact of the increase in the interest rate. For 2009, the path of the forecast again fell below the December forecast, as the effects of the higher interest rate once again predominated. Expected inflation amounted to 0.5% for 2007, 1.4% for 2008 and 1.6% for 2009. Even though inflationary forces were muted overall, they picked up slightly at the end of the forecast period.

Quarterly assessment of 14 June

At the time of the June assessment, the US economy, although satisfactory, was a little less strong than expected. Consequently, the SNB reduced its growth forecasts for the US, setting them at 2.2% for 2007 and 3% for 2008. By contrast, the European economy was better than previously expected. The forecast for 2007 was lifted to 2.6% while that for 2008 remained unchanged at 2.2%.

2006 2007 2008 2009 2010

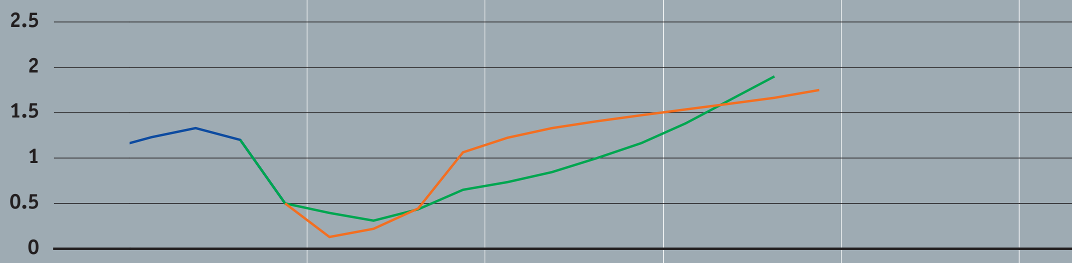
Inflation forecast of 15 March 2007

Inflation

December 2006 forecast:
three-month Libor 2.00%

March 2007 forecast:
three-month Libor 2.25%

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



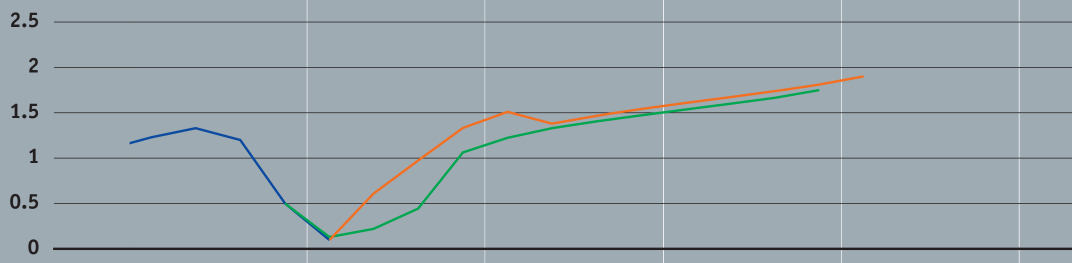
Inflation forecast of 14 June 2007

Inflation

March 2007 forecast:
three-month Libor 2.25%

June 2007 forecast:
three-month Libor 2.50%

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



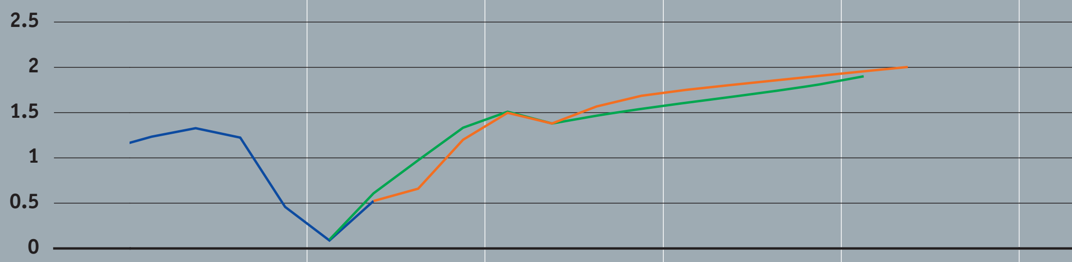
Inflation forecast of 13 September 2007

Inflation

June 2007 forecast:
three-month Libor 2.50%

September 2007 forecast:
three-month Libor 2.75%

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



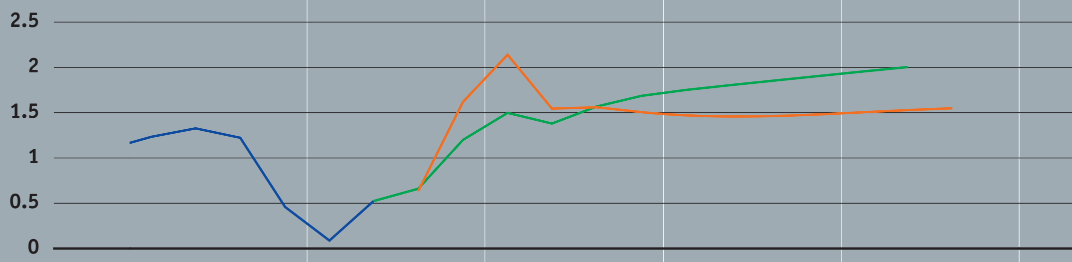
Inflation forecast of 13 December 2007

Inflation

September 2007 forecast:
three-month Libor 2.75%

December 2007 forecast:
three-month Libor 2.75%

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



2006 2007 2008 2009 2010

The Swiss economy was in good shape at the time of the assessment, due in particular to demand from neighbouring countries and exchange rate developments. In addition, since the March assessment, the strength of the economy had continued to support improvements in the labour market. Consequently, unemployment numbers had declined further, with the rate slipping below 3%. As a result, the SNB forecast GDP growth close to 2.5% for 2007.

In the foreign exchange market, the Swiss franc had continued giving ground to the euro and appreciating against the US dollar. In export-weighted terms, it had depreciated by 1.7%. This relaxation in monetary conditions continued to work against the effects of Libor increases and threatened to stimulate inflationary pressures in an economy operating at a high level of capacity utilisation.

In this situation, price stability was exposed to several risks, the first of which was the high price of oil. The second risk was that global demand was growing at too rapid a pace in relation to the development in production capacity. The third risk was related to the decline in the value of the Swiss franc against the euro. To ensure that medium-term price stability was not jeopardised by the strong economy, the Governing Board decided to raise the Libor target range once again by 25 basis points, thereby taking it to 2.00–3.00%.

On the assumption of an unchanged Libor of 2.50%, the published forecast put average annual inflation at 0.8% for 2007, 1.5% for 2008 and 1.7% for 2009. The combined effect of high oil prices, strong economic developments and a weakening Swiss franc resulted in a deterioration in the inflation outlook during the course of the months following the assessment. However, from mid-2008, inflation moved up to a level slightly above that forecast three months previously, approaching 2% at the end of the forecast period.

Quarterly assessment of 13 September

The international environment at the time of the September assessment was dominated by the mortgage loans crisis in the US, a major correction on the stock market and the liquidity shortfalls on the money market. For the time being, the global economy did not appear to have been affected. Growth in the US economy was only very slightly weaker than expected, but the risks of a slowdown at the end of 2007 had risen. Moreover, after having fallen back between mid-July and mid-August, oil prices were heading upwards again.

In Switzerland, GDP had grown strongly in the first half of the year and employment was still improving. Consequently, capacity utilisation would remain high. The SNB, therefore, retained its GDP growth estimate for 2007 close to 2.5%, subject to any unexpected moderating effect arising from the uncertainties related to the financial markets.

As against the previous assessment, however, the inflation outlook had worsened somewhat. Oil price developments constituted the main risk. In addition, capacity utilisation remained high and the Swiss franc was still relatively weak. Nevertheless, it was possible that certain factors, such as a possible economic slowdown attributable to the turmoil on the financial markets, might limit the inflationary risks. In the meantime, since the turmoil on the money market had lifted the Libor from 2.5% to 2.9%, the tightening in monetary conditions was considered excessive with respect to the outlook for inflation. In this situation, the Governing Board decided in favour of relaxing money market conditions by bringing the Libor back to 2.75% while simultaneously lifting the target range by 25 basis points to 2.25–3.25%. From this assessment onwards, the SNB aimed for a Libor of around 2.75%.

Despite the higher level of the Libor, the inflation forecast published in September was almost identical to that of June. On the assumption of an unchanged Libor of 2.75%, the SNB forecast average annual inflation of 0.6% for 2007, 1.5% for 2008 and 1.8% for 2009. Inflation rose to the first quarter of 2008 and then flattened slightly from the second quarter onwards. In essence, this forecast was based on recent oil price developments. From mid-2008, a slight increase in inflation was expected, with figures even reaching 2% at the end of the forecast period.

Quarterly assessment of 13 December

For the final assessment of the year, the SNB assumed that US economic growth – affected simultaneously by the unfavourable developments on the real estate and credit markets and by the rise in oil prices – could weaken in 2008 (forecast: 2.4%). At the time of the assessment, Europe did not appear much affected by the rise in the euro and the turmoil on the financial markets, and its growth outlook was likely to remain good, even though the SNB adjusted it slightly downwards for 2008 (forecast: 2%).

Swiss growth was strong in the third quarter, with GDP growing at an annualised rate of 3.3%. Simultaneously, in the months preceding the assessment, employment had continued increasing in practically all sectors. As a result of these developments, the growth outlook remained good for the quarters ahead, and therefore the SNB was forecasting GDP growth of some 2% in 2008, a lower figure than that recorded in 2007. This relaxation in the pace of economic activity should allow for some reduction in the level of capacity utilisation.

The inflation outlook remained good, even though it encompassed even more uncertainties than the previous assessment. Although price stability would be supported by the expected slowdown in the growth of the Swiss economy and the reduction in the rate of increase of the monetary aggregates, there were other elements capable of disturbing this stability. Examples of such inflationary factors were the rise in oil prices, should it persist, as well as the continued weakening in the Swiss franc. In this uncertain situation, the Governing Board decided to retain the Libor target range at 2.25 – 3.25%, aiming for a Libor of 2.75%.

On the assumption of an unchanged Libor of 2.75%, the inflation forecast indicated a surge in inflation in the first half of 2008. This advance, in which expected inflation temporarily rose above 2%, was mainly due to the increase in the price of oil. From mid-2008 to the end of the forecast period, however, inflation settled at around 1.5%. The sudden correction to the forecast in the middle of the year was due to a baseline effect, and the downturn of the path at the end of the forecasting period was to be seen within the context of the expected slowdown in the international economy.

1.5 Statistics

The SNB collects the statistical data it requires to fulfil its statutory tasks on the basis of art. 14 NBA. It collects data for the conduct of monetary policy and the oversight of payments and securities settlement systems, for safeguarding the stability of the financial system and preparing both the balance of payments and the statistics on the international investment position. Statistical data compiled for purposes relating to international monetary cooperation are transmitted to international organisations.

Purpose of activities in the field of statistics

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

Institutions required to provide data

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

Survey activity kept to a minimum

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

Confidentiality and exchange of data

The SNB manages a database containing 3.7 million time series and publishes the results of its surveys. Statistical information is made available primarily in the *Monthly Statistical Bulletin* and the *Monthly Bulletin of Banking Statistics*, as well as *Banks in Switzerland*, which is published annually. These publications are supplemented by reports on the balance of payments, the international investment position, direct investment and the financial accounts. The SNB's publications are available in German, French and English and are accessible on the SNB website, www.snb.ch, along with other data series.

Publications and database

In connection with its centenary celebrations, the National Bank began a new series of publications with historical time series in 2007. They cover topics of importance for the formulation and implementation of past and present monetary policy. In the course of the year, brochures were published on the following topics: *The monetary base and the M1, M2 and M3 monetary aggregates*, *Capital and stock markets*, *Swiss National Bank – Balance sheets and income statements* and *Interest rates and yields*.

New publication series

New surveys

At the end of 2007, the SNB introduced a new monthly survey on the interest rates for various banking products published by the banks. This rounded out its information on the level of Swiss interest rates. A complete and up-to-date overview of the SNB's statistical surveys is contained in the appendix to the revised NBO, which came into force on 1 July.

Collaboration

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

... with the SFBC

Under the agreement with the SFBC on the reciprocal exchange of data in the financial sector, the SNB has, since 2007, been collecting the new capital adequacy statement data in accordance with Basel II, for the SFBC.

... in the banking statistics committee

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

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

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

... with the Principality of Liechtenstein

Since 2007, the SNB has conducted surveys of Liechtenstein-based companies when preparing its balance of payments figures and statistics on its international investment position. It has worked together with the relevant authorities in Liechtenstein – the Office of Economic Affairs and the financial market supervision authority.

... with foreign agencies

The SNB works closely with the Bank for International Settlements (BIS), the OECD, the EU statistical office (Eurostat) and the IMF in the field of statistics. This collaboration is aimed at harmonising statistical survey methods and analyses. In 2007, the SNB participated for the seventh time in the global survey on foreign exchange and derivative markets coordinated by the BIS. This survey is conducted every three years in over 50 countries. On 1 January 2007, the bilateral statistics agreement between Switzerland and the EU came into force. Among other things, this covers Switzerland's financial accounts, which are drawn up by the SNB in cooperation with the Swiss Federal Statistical Office.

2 Supplying the money market with liquidity

Mandate

It is the task of the Swiss National Bank (SNB) to provide the Swiss franc money market with liquidity (art. 5 para. 2 (a) National Bank Act (NBA)). Art. 9 NBA defines the framework within which the SNB may conduct transactions in the financial market. Based on art. 9 para. 1 (e) NBA, the National Bank also acts as lender of last resort (LoLR).

Guidelines on monetary policy instruments

The Guidelines of the Swiss National Bank (SNB) on Monetary Policy Instruments contain more explicit information with regard to art. 9 NBA and describe the instruments and procedures used by the National Bank for the implementation of its monetary policy. They also define the conditions under which these transactions are concluded and what securities can be used as collateral for monetary policy operations. In principle, all banks domiciled in Switzerland as well as international banks abroad that meet the conditions stipulated by the National Bank are accepted as counterparties. The guidelines are supplemented by instruction sheets.

Liquidity

Well-functioning money markets are of fundamental importance in ensuring that financial market participants can adjust their positions according to their liquidity needs. In order for a bank to maintain its solvency, it must have sufficient liquidity at all times. The most liquid assets are sight deposits held at the SNB, since they can be used for payment transactions immediately and are deemed to be legal tender. In addition, banks hold sight deposits at the National Bank to satisfy minimum reserve requirements and as liquidity reserves.

Disruptions on international money markets

At the beginning of August, the problems in the US mortgage market diffused like a shock wave into the money markets of the most important currencies. Rumours and reports of losses and write-offs at international financial institutions led to a sudden loss of mutual confidence among banks and to uncertainty with regard to their own level of liquidity. As a result, banks began hoarding liquidity and became very cautious about granting credit to one another. The crisis of confidence led to a significant rise in risk premiums in the international money markets. The market for unsecured interbank loans shrank considerably and at times the market for foreign exchange swaps dried up. Banks were unable to obtain unsecured funds for terms of more than a few days or weeks – or able to do so only by paying substantial interest premiums. Initially, the liquidity bottleneck became apparent in the US dollar money market and subsequently spread to money markets of other currencies. On the Swiss franc money market, the disruptions were modest by international standards as was the concomitant rise in risk premiums and their volatility.

2.1 Regular instruments for steering the money market

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

Open market operations include main financing, liquidity-absorbing and fine-tuning operations. In the case of open market operations, the SNB takes the initiative in the transaction. The standing facilities comprise intraday and liquidity-shortage financing facilities. For these facilities, the SNB merely sets the conditions under which commercial banks can obtain short-term liquidity to meet their requirements.

Main financing and liquidity-absorbing operations

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

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

Fine-tuning operations

Fine-tuning operations are used to smooth the impact of exogenous factors on both liquidity supply and liquidity demand and thus to stabilise short-term money market rates. By setting prices for repo transactions on the electronic market place, the National Bank can influence price formation in the banks' call money trading at any time. As a rule, a transaction has an immediate impact on liquidity after it has been concluded. Fine-tuning transactions can be used both for providing and withdrawing liquidity.

Intraday facility

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

The National Bank provides a liquidity-shortage financing facility to bridge unexpected liquidity bottlenecks. In order for the SNB's counterparties to obtain liquidity through this facility, the National Bank must grant a limit to be covered by collateral eligible for SNB repos at all times. Each counterparty has the right to obtain liquidity up to the limit granted until the following bank business day. This limit is utilised in the form of a special-rate repo transaction. The Special rate for obtaining liquidity provided through this facility is two percentage points above the Repo Overnight Index (SNB) of the previous bank business day. The interest premium is intended to prevent commercial banks from using the facility as a permanent source of refinancing. At the end of 2007, 72 banks had been granted a limit under the liquidity shortgage financing facility. During the period under review, banks requested that their limits be increased from a total amount of CHF 12.1 billion to CHF 33.7 billion. This put them in a considerably better position to hedge their liquidity risk.

Liquidity-shortage financing facility

2.2 Liquidity supply

The SNB reacted swiftly to the tensions in the money market and, on 9 August 2007, was the first central bank to inject additional liquidity by means of fine-tuning measures. During the subsequent months, the National Bank provided the banking system with generous funds, as and when needed. Excess liquidity was absorbed consistently in each case so that the banks' sight deposits held at the National Bank remained largely unchanged on average. As a result of the measures taken to calm the money market, the SNB was able to maintain the restrictiveness of monetary policy at the targeted level.

Measures to calm the money market

By mid-September 2007, higher risk premiums for unsecured money market transactions had led to an increase in the three-month Libor for Swiss francs to approximately 2.90%. It was thus clearly above the middle of the target range, which was at 2–3% at the time. While, with its monetary policy decision of 13 September 2007, the National Bank raised the target range to 2.25–3.25%, it stated its intention of calming the money market. To this end, on the day of the monetary policy assessment, banks were offered repo transactions for three-month maturities. At the same time, the interest rate for one-week repos was slashed, from 2.29% to 2.08%. The higher risk premiums on the three-month Libor were therefore offset by a lower repo rate. The desired reaction ensued within a few days and the three-month Libor dropped from approximately 2.90% to 2.75% – the middle of the new target range.

After the monetary policy assessment of September 2007, the three-month Libor was held in the middle of the target range. The National Bank supplied the money market mainly with liquidity via regular weekly transactions at a rate of 2.05%. Fine-tuning operations were used increasingly to stabilise short-term money market rates. To counter any year-end tension on the money market, the SNB supplied the banks with liquidity over the year-end period as early as the beginning of December 2007.

Regular monetary policy instruments in CHF billions

	2006 Holding Average	Turnover	2007 Holding Average	Turnover
Repo transactions				
Liquidity-supplying transactions	**20.82**	**1 069.47**	**21.73**	**1 071.99**
Maturities				
ON/TN/SN	0.13	40.66	0.13	23.64
1 week	18.91	980.19	18.41	969.41
2 weeks	1.50	39.11	0.71	28.50
3 weeks	0.00	0.00	0.22	5.80
Other[2]	0.27	9.50	2.26	44.63
Intraday facility	**7.07**[2]	**1 773.94**	**7.76**[2]	**1 955.90**
Liquidity-shortage financing facility	**0.01**	**1.72**	**0.01**	**1.82**
Liquidity-absorbing transactions	**0.00**	**0.16**	**0.13**	**38.58**

1 Comprises 1-month, 3-month and short-term transactions with non-standardised maturities.
2 Amount drawn down per bank business day.

Repo transactions in detail

The daily presence of the SNB in the money market allows flexible and effective steering of the three-month Libor. This steering was mainly carried out by means of one-week repo transactions at variable interest rates. Along with the increases in the target range for the three-month Libor, the repo rates were adjusted to take account of the latest monetary policy developments. Between January and mid-August 2007, the one-week repo rate was lifted from 1.90% to 2.43% and subsequently gradually lowered to 2.05%. The average difference between the three-month Libor rate and the one-week repo rate was 26 basis points between January and July and 64 basis points between August and December. The rise is primarily a reflection of the higher risk premiums on unsecured money market transactions compared with secured ones.

In 2007, the average volume of the National Bank's repo transactions from main financing and fine-tuning operations outstanding at the end of the day grew slightly by approximately CHF 900 million to CHF 21.7 billion. The turnover – in other words, the sum of all of these repo transactions – reached CHF 1,072 billion. Roughly 90% of total turnover was achieved with transactions with one-week maturities.

Banks' daily bids at National Bank repo auctions fluctuated between CHF 0.6 billion and CHF 178.6 billion, with the average being CHF 31.4 billion. The amount of liquidity allocated see-sawed between CHF 0.6 billion and CHF 9.0 billion and the annual average amounted to CHF 3.9 billion. Of this amount, 58.95% was allotted to domestic banks, the remainder to international banks abroad. The allocation rate fluctuated between 2.80% and 100%, with the average rate amounting to 12.52%.

Average use of the intraday facility by banks rose from CHF 7.1 billion in 2006 to CHF 7.8 billion in the year under review.

In 2007, banks again made use of the liquidity-shortage financing facility only in individual cases and to a limited extent. The annual average use of this facility was less than CHF 10 million.

2.3 Further monetary policy instruments

In addition to the regular monetary policy instruments, the National Bank has a number of other instruments at its disposal, as provided for in art. 9 para. 1 NBA. These are foreign exchange spot and forward transactions, foreign exchange swaps and the SNB's own interest-bearing debt certificates; it can also purchase or sell securities in Swiss francs. Moreover, it can create, purchase or sell derivatives on receivables, securities, precious metals and currency pairs. In 2007, such instruments were not used in the context of monetary policy.

2.4 Emergency liquidity assistance

Liquidity assistance conditions

Within the context of the emergency liquidity supply facility, the National Bank may provide liquidity assistance to domestic banks if they are no longer able to refinance their operations in the market (Lending of Last Resort). The institutions requesting credit must be systemically important and solvent. In addition, the liquidity assistance must be fully covered by sufficient collateral at all times.

Systemic importance of a financial institution

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

In 2007, no emergency assistance of this kind was required.

2.5 Minimum reserves

Main features of the regulation

The duty to hold minimum reserves (arts. 17, 18, 22 NBA) ensures that a bank's demand for base money reaches a minimum level. It thus fulfils a monetary policy objective. Eligible assets in Swiss francs comprise coins in circulation, banknotes and sight deposits held at the National Bank. The minimum reserve requirement is 2.5% of the short-term liabilities in Swiss francs (up to 90 days) and 20% of the liabilities vis-à-vis customers in the form of savings and investments.

If a bank fails to fulfil the minimum reserve requirement, it is obliged to pay interest to the National Bank for the number of days of the reporting period for which there was a shortfall. The interest rate is four percentage points higher than the average Repo Overnight Index (SNB) over the reporting period in question. In connection with the partial revision of the National Bank Ordinance (NBO) which entered into effect on 1 July 2007, the provision on the application of sanctions, in particular the calculation of interest, was spelled out in more detailed terms, and a minimum charge of CHF 500 was fixed.

Minimum reserves (20 December 2006 to 12 December 2007)
in CHF millions

	2006 Holding Average	**2007 Holding** Average
Sight deposits at the SNB	5 003	5 261
Banknotes	4 715	4 850
Coins in circulation	93	97
Eligible assets	9 811	10 208
Requirement	8 158	8 650
Amount in excess of requirement	1 653	1 558
Requirement in percent	120%	118%

In 2007 (from 20 December 2006 to 19 December 2007), the average minimum reserves required by law amounted to CHF 8.7 billion. This is a 6% increase year-on-year. Eligible assets amounted to an average of CHF 10.2 billion. As a result, banks surpassed the requirement by an annual average of CHF 1.6 billion and the liquidity ratio was 118% on average over the year. In the previous year, the three corresponding values were CHF 9.8 billion, CHF 1.7 billion and 120%.

In 2007, the statutory minimum reserve requirements were met by the approximately 300 banks, with a few exceptions. Nine banks infringed the requirements for one reporting period, two banks for two reporting periods. The amount of the shortfalls was insignificant, amounting to 0.01% of total required assets. The total amount in interest that the contravening banks were required to pay amounted to CHF 24,600.

2.6 Collateral eligible for SNB repos

To carry out its monetary policy operations, the SNB only accepts collateral that meets certain requirements. In so doing, the SNB protects itself against losses and ensures equal treatment of counterparties. In 2007, the National Bank redefined the criteria for collateral eligible for SNB repos. When these criteria entered into effect on 1 October 2007, the list of collateral eligible for SNB repos was expanded considerably. The inclusion of bonds by issuers domiciled in a member state of the European Union (EU) or the European Economic Area (EEA) was the main feature of the expansion. The SNB accepts securities denominated in Swiss francs and euros and for the first time also in US dollars, pounds sterling, Danish kroner, Swedish krona and Norwegian krone. Individual securities are subject to stringent requirements with regard to liquidity and to credit rating. The potential of securities qualifying as eligible collateral at the National Bank rose from approximately CHF 6,000 billion to nearly CHF 11,000 billion. Securities denominated in foreign currency accounted for 96% of this total. The SNB is one of the few central banks that accepts securities in foreign currency for its monetary policy operations.

To secure the liquidity of the internationally oriented Swiss banking system, a wide range of collateral eligible for SNB repos is paramount. Banks with sufficient securities that qualify as eligible at the central bank may obtain liquidity, even in difficult conditions, since these securities can be transformed into liquid assets at central banks or in the interbank market through repo transactions.

2.7 Concerted liquidity measures by the central banks

In the fourth quarter 2007, the Bank of Canada (BoC), the Bank of England (BoE), the European Central Bank (ECB), the US Federal Reserve Bank (Fed) and the Swiss National Bank acted in unison to restore calm in the international money markets. Together with the Fed, the ECB and the SNB provided liquidity in US dollars over the year-end period via auctions. On 17 December 2007, the Swiss National Bank alloted US dollar liquidity amounting to USD 4 billion to the banks (for the period from 20 December 2007 to 17 January 2008). This measure enabled the SNB's counterparties to gain easier access to US dollar liquidity. The auction was held in the form of a variable rate tender with a minimum bid rate. Collateralisation took the form of securities eligible for SNB repo transactions. The Fed supplied the SNB with US dollars on the basis of a swap agreement.

3 Ensuring the supply of cash

3.1 Organisation of cash distribution

Mandate

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

Role of the SNB

The National Bank offsets seasonal fluctuations in the demand for cash and replaces notes and coins that are unfit for circulation. The role of retailer, which includes the distribution and redemption of coins and banknotes, is assumed by commercial banks, Swiss Post and cash processing operators.

Turnover at offices

In 2007, the National Bank's offices registered currency turnover amounting to CHF 127.4 billion, as compared with CHF 126.9 billion a year earlier. They received 426.1 million banknotes (2006: 405.0 million). The value of incoming coins stood at CHF 317.5 million (previous year: CHF 360.3 million), their weight at 1,600 tonnes (previous year: 1,802 tonnes). The SNB examined the quality, quantity and authenticity of the notes and coins.

... agencies

The agencies' turnover (incoming and outgoing) reached a level of CHF 14.5 billion in the year under review, compared with CHF 14.9 billion a year earlier. Agencies are cash distribution services operated by cantonal banks on behalf of the SNB. They are responsible for the distribution and redemption of cash in the regions. In order to do this, the agencies have access to cash belonging to the National Bank.

... domestic correspondents

The SNB can grant banks the authority to act as correspondents in areas where it does not have its own operations. Together with the post offices, these banks perform local cash redistribution transactions. The domestic correspondents supplied 1.9 million banknotes (previous year: 2.2 million) with a total value of CHF 314.9 million (previous year: CHF 340.0 million).

3.2 Banknotes

Mandate

Pursuant to art. 7 of the Federal Act on Currency and Payment Instruments (CPIA), the SNB issues banknotes commensurate with demand for payment purposes and takes back any banknotes which are worn, damaged or have been returned owing to seasonal fluctuations. It also determines the denomination and design of the notes. Particular attention is paid to their security. Given the speed at which counterfeiting technology is advancing, it has become absolutely essential that the effectiveness of the security features on the banknotes be continuously checked and, if necessary, adapted. New security features are developed in cooperation with third parties. This makes it possible to update the security features on current banknotes and to protect new ones.

Banknote circulation

In 2007, banknote circulation averaged CHF 38.9 billion (previous year: CHF 38.2 billion). This increase is primarily attributable to a rise in the number of 1,000-franc notes, which are often held as a store of value. The number of banknotes in circulation amounted to 292.0 million (previous year: 283.4 million). The increase is principally attributable to GDP growth and the greater use of the 20-franc notes in ATMs.

Issue and disposal

In 2007, the SNB put 93.5 million (previous year: 111.5 million) freshly printed banknotes with a face value of CHF 7.7 billion into circulation (previous year: 7.8 billion), and destroyed 85.9 million (previous year, 97.0 million) damaged or recalled notes with a nominal value of CHF 5.5 billion (previous year, CHF 6.4 billion).

Counterfeits

Roughly 2,800 counterfeit banknotes were confiscated in Switzerland in 2007 (previous year: 2,600). The National Bank's offices alone discovered 83 counterfeit notes (previous year: 108). By international standards, 10 seized counterfeit notes per million Swiss franc notes in circulation is a relatively low figure.

Development of a new banknote series

In 2007, the bank authorities commissioned Manuela Pfrunder, a Zurich graphic artist, to take forward the preliminary work already done on a new series of banknotes. Manuela Pfrunder was one of the prizewinners in the artistic design competition in 2005. In the subsequent design work and technical refinements, she submitted drafts that were particularly well tuned to the requirements for banknotes that are to be put into circulation.

Number of banknotes in circulation
In millions

CHF 10s: 62

CHF 20s: 66

CHF 50s: 36

CHF 100s: 76

CHF 200s: 30

CHF 1,000s: 22

Annual average

3.3 Coins

Mandate

The SNB is entrusted by the Confederation with the task of coin circulation. Its role is defined in art. 5 CPIA. It takes over the coins minted by swissmint and puts into circulation the number required for payment purposes. Coins that are surplus to requirements are taken back – without restriction – against reimbursement of their nominal value. The National Bank's coinage services are not remunerated, as they constitute part of the mandate to supply the country with cash.

Coin circulation

The average value of coins in circulation was CHF 2.5 billion (previous year: CHF 2.5 billion) or 4,407 million coins (previous year: 4,295 million). This increase reflects the steep increase in the demand for small coins observed since the spring of 2006. There are a multitude of reasons for this, but the most important factors are the healthy economic situation and – especially – the lively tourist industry.

4 Facilitating and securing cashless payment transactions

Mandate

In accordance with art. 5, para. 2 (c) of the National Bank Act (NCA), the National Bank facilitates and secures the operation of cashless payment systems. Art. 9 NBA empowers the SNB to keep accounts (SNB sight deposit accounts) for banks and other financial market participants.

4.1 Facilitating cashless payment transactions

The banks and other selected financial market participants conduct a high proportion of their mutual payment transactions through the Swiss Interbank Clearing (SIC) system, which is steered by the SNB. Having an SNB sight deposit account is a prerequisite for participating in the SIC system.

SIC: a real-time gross settlement system

SIC is a real-time gross settlement system. Such systems settle payments individually – and only if there is sufficient cover for the transaction – through the accounts of the system participants. Once executed, transactions are irrevocable and final; they have the character of cash payments. SIC is operated by Swiss Interbank Clearing AG, a subsidiary of Telekurs Group, on behalf of the SNB.

SNB steers SIC

The National Bank steers the system. It transfers liquidity from the sight deposit accounts at the SNB to clearing accounts in the SIC system at the start of each clearing day and transfers the balances from the clearing accounts back to the sight accounts at the end of the clearing day. Legally, the two accounts form a unit. The clearing day in the SIC system starts at 5.00 pm and ends at 4.15 pm the following day. The SNB monitors operations and ensures that there is sufficient liquidity by granting, when necessary, intraday loans to banks against collateral. In addition, the National Bank is responsible for crisis management.

SIC agreements

An agreement concluded between the SNB and SIC AG entrusts the latter with providing data processing services for the SIC system, while the relationship between the SNB and the holders of sight deposit accounts is governed by the SIC giro agreement.

Participation in payment system bodies

The SNB influences the development of the SIC system also on a conceptual level. Based on the SIC master agreement, the National Bank authorises changes and additions to the system. It made use of this authority in connection with the project – initiated in 2006 – to merge the IT infrastructure of the two service providers, SIS Systems AG and Telekurs Services AG, in a joint organisation. The amalgamation of the data processing centres of the two institutions had a major impact on the operation of the SIC system, both in technical and organisational terms. In 2007, therefore, the SNB commissioned external auditors to establish whether the new structure complied with its requirements for the operation of the SIC system. Overall, the results of the examination were positive, although the question of a backup computer centre outside the Zurich region remains to be investigated. The SNB also exerted an influence on the Board of Directors of SIC AG (on which it has a seat) and in a number of technical working groups.

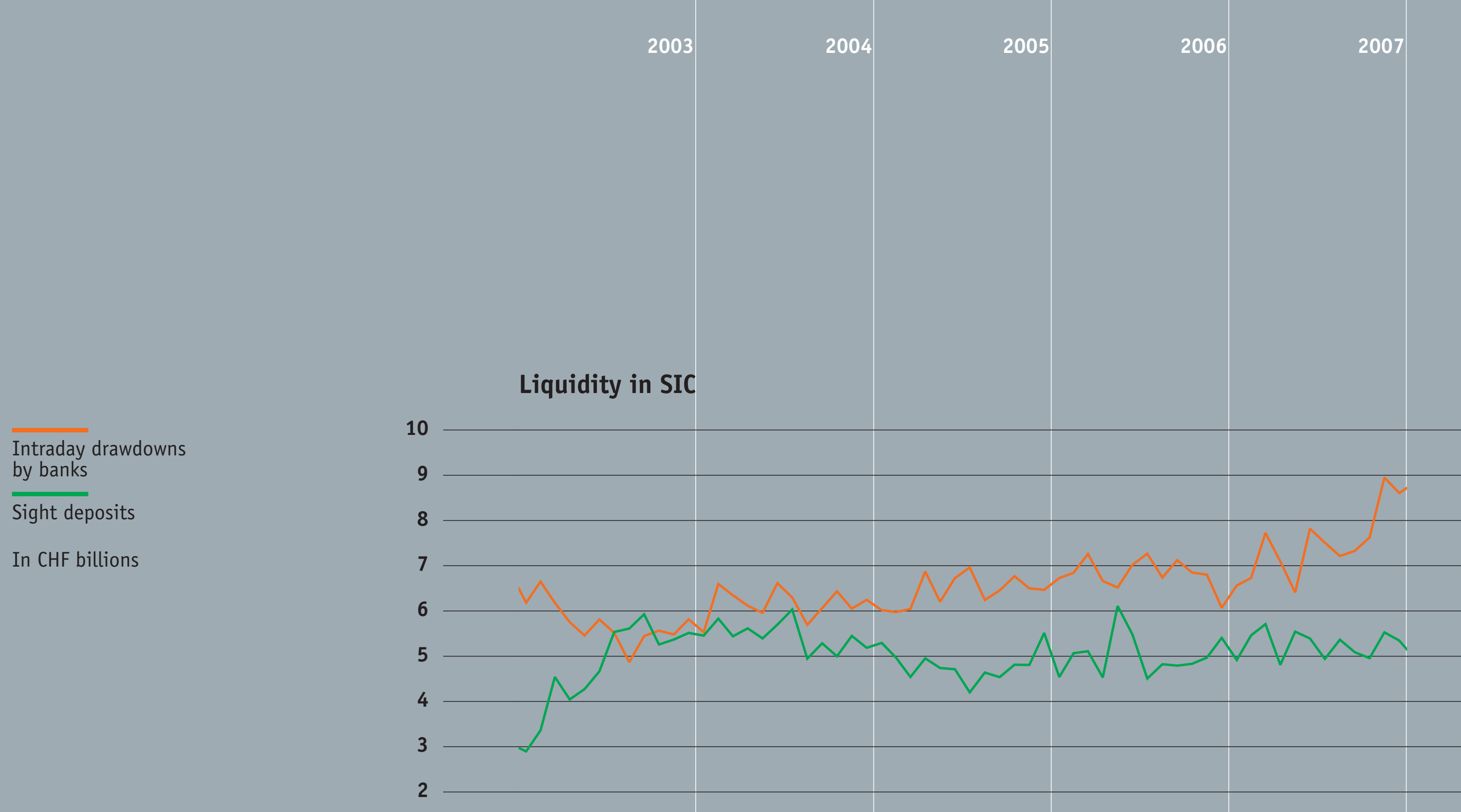
Key figures on SIC

At the end of 2007, 347 participants were connected to SIC, as compared with 330 the previous year. The Swiss Interbank Clearing AG processing centre settled approximately 1.4 million transactions amounting to CHF 208 billion each day. On peak days, up to 4.2 million transactions and volumes of up to CHF 337 billion were processed. The total number of transactions handled by the SIC system increased by around 12.5% and turnover was up roughly 16.6%.

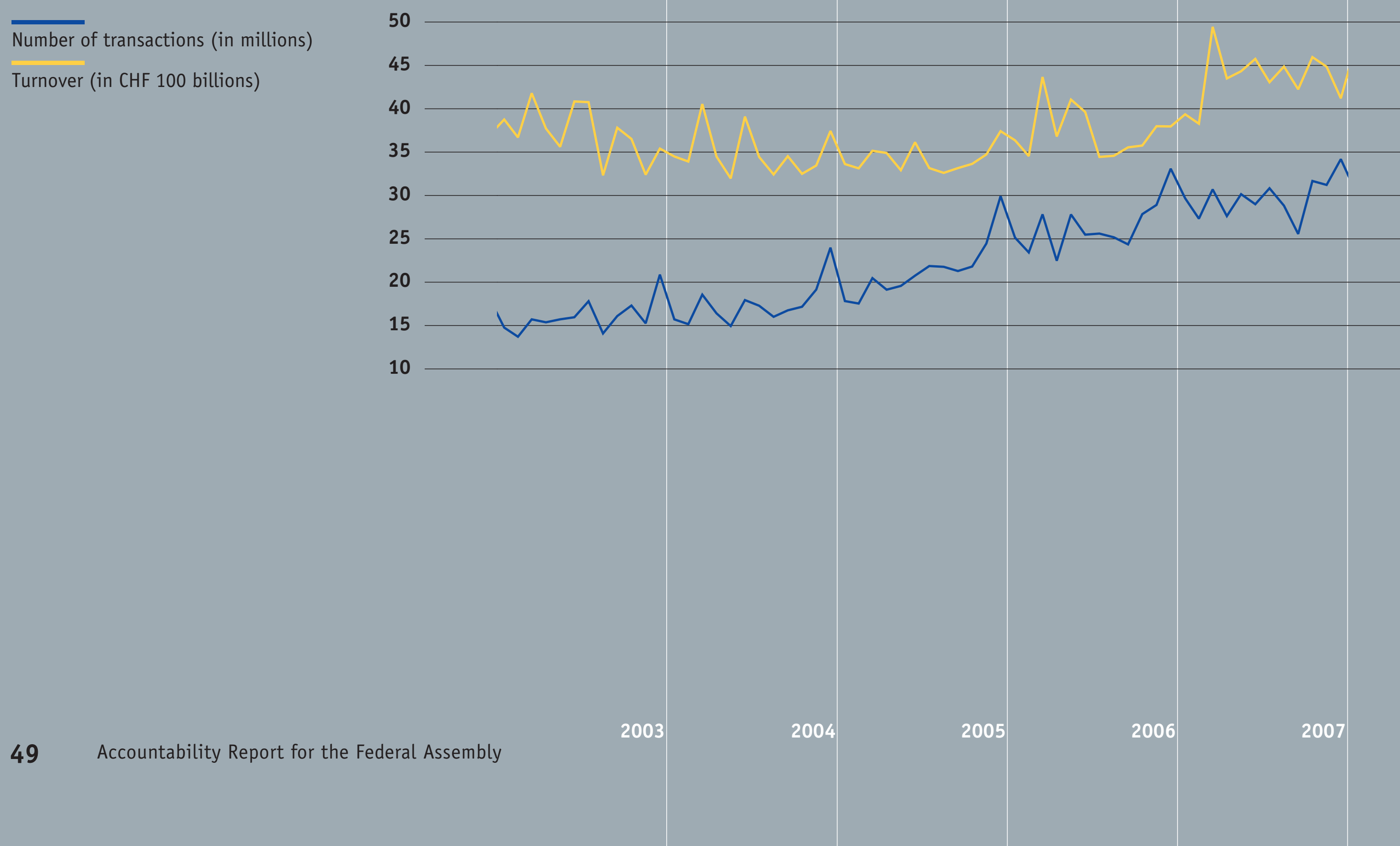
SIC – key figures

	2003	2004	2005	2006	2007
Transactions (in CHF thousands)					
Daily average	768	816	1 009	1 264	1 421
Peak daily value for the year	2 145	2 215	2 690	3 844	4 167
Volume (in CHF billions)					
Daily average	178	163	161	179	208
Peak daily value for the year	284	273	247	318	337
Amount per transaction (in CHF thousands)	232	200	160	141	146
Average liquidity (in CHF millions)					
Sight deposits, end of day	4 811	5 339	4 831	5 217	4 872
Intraday liquidity	5 972	6 188	6 340	7 070	8 828

Liquidity in SIC



Transactions and turnover in SIC



Other bodies responsible for the cashless payment system

In addition to the banks, non-banks, i.e. “other financial market participants” have SNB sight deposit accounts and are thus able to participate in the SIC system. “Other financial market participants” are companies that operate commercially on the financial markets. Sight deposit account holders in this category currently include PostFinance, securities dealers and institutions that are of importance either for the implementation of National Bank policies or for handling payment transactions (at present there are five cash-processing institutions). Not all sight deposit account holders participate in the SIC system. SNB figures show a total of 457 sight deposit account holders as at 31 December 2007 (previous year: 459). Of these, 306 were domiciled within Switzerland (previous year: 302). Of the account holders, ten were non-banks (previous year: ten).

Establishment of Swiss Financial Market Services (SFMS)

In May 2007, the SWX Swiss Exchange Association, the SWX Group, the SIS Swiss Financial Services Group AG and the Telekurs Holding AG announced their intention of forming a joint financial centre holding called Swiss Financial Market Services (SFMS) at the beginning of 2008. The SNB fulfills important tasks for most areas of SFMS business. For instance, payment streams in the SIC interbank clearing system – a key element in the Swiss Value Chain – pass through SNB sight deposit accounts. Moreover, the National Bank provides the liquidity required for the smooth functioning of the Swiss financial market infrastructure. In addition, the SNB makes major contributions with respect to the design and planning of installations and processes.

4.2 Oversight of payment and securities settlement systems

Mandate

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

Focus on systemically important systems

At present, the systems that could harbour risks for the stability of the financial system include the Swiss Interbank Clearing (SIC) system, the SECOM securities settlement system and the central counterparty, x-clear. The operators of these systems must meet the minimum requirements set out in arts. 22–34 NBO. The SNB has provided further details on these minimum requirements in its system-specific control objectives. Other systems of importance for the stability of the Swiss financial system are the Continuous Linked Settlement (CLS) system for foreign exchange transactions, whose operator is based in the US, and the central counterparty, LCH.Clearnet Group Limited (LCH), domiciled in the UK. CLS and LCH are exempted from the obligation to meet the minimum requirements because they are already subject to adequate oversight by their local regulators and there is a smooth exchange of information with the SNB.

Cooperation with the SFBC

SIS SegaInterSettle AG and SIS x-clear AG, which operate the securities settlement system SECOM and the central counterparty x-clear respectively, hold banking licences and are subject to prudential supervision by the Swiss Federal Banking Commission (SFBC) as well as to system oversight by the SNB. While prudential supervision primarily aims at protecting individual creditors, system oversight focuses on the risks to which the financial system is exposed as well as the system's functioning. Although the SFBC and the SNB exercise their supervisory and oversight powers separately, they coordinate their activities as stipulated by law so as to avoid duplication (cf. art. 21 para. 1 NBA and art. 23bis para. 4 Banking Act). This applies in particular to the collection of information required for the supervision of institutions and the oversight of systems. When assessing whether a system operator complies with the minimum requirements, the SNB relies – as far as possible – on the information already gathered by the SFBC.

Cooperation with authorities abroad

The SNB cooperates with authorities abroad in the oversight of cross-border payment and securities settlement systems. In the case of CLS, the Federal Reserve Bank of New York – which is the authority with primary responsibility for its oversight – involves all central banks whose currencies are settled via this system. As regards the central counterparties LCH and x-clear – the latter holds the status of Recognised Overseas Clearing House (ROCH) in the UK – the SNB and the SFBC cooperate with Britain's Financial Services Authority (FSA) and the Bank of England. The details of this cooperation between the British and Swiss authorities are set out in a Memorandum of Understanding.

Finally, the SNB participates – together with the other central banks in the Group of Ten (G10), and under the leadership of the Belgian central bank – in the oversight of the Belgium-based Society for Worldwide Interbank Financial Telecommunication (SWIFT), which operates a global network for the transmission of financial information. Oversight focuses on those activities of SWIFT that are of significance for financial stability in general and for the functioning of financial market infrastructure in particular. It does not extend to compliance-related issues at SWIFT.

Good marks for corporate governance and risk management

2007 was the first year in which the SNB awarded ratings for compliance with its system-specific requirements by the bodies operating the SIC, SECOM and x-clear systems. These ratings, based on the SNB's control objectives, focused on corporate governance, on the systems' contractual basis and on the analysis, management and control of systemic credit and liquidity risks by the operators. Overall, the system operators received good marks from the SNB; with one exception, the National Bank found that all the control objectives investigated had been met either for the most part or in full. The SNB judges the system operators to have an appropriate corporate governance system overall. The instruments they are using for the ongoing capture, limitation and monitoring of their credit and liquidity risks are adequate. The rules and methods applied by the individual systems, as well as the interfaces between these systems, contribute significantly to minimising settlement risks. In the statements it sent to the system operators, however, the SNB referred to certain areas that may require attention. This applies in particular to the management of x-clear's risk positions vis-à-vis LCH. The SNB thus requested SIS x-clear to seek and implement improvements together with LCH as soon as possible. They were able to find a solution by the end of the year under review. In addition, the SNB asked all system operators to include a number of minor clarifications or additions in their contractual documents. One system operator was requested to check that its internal audit unit had appropriate resources.

Check on IT and information security

To assess compliance with control objectives that relate to the systems' IT and information security, the National Bank relies mainly on the results of audits conducted by external auditors. The SNB closely monitors their work, from the definition of the audit's scope through to acceptance of the concluding reports. The totality of IT-related control objectives is assessed as part of a three-year cycle. One such cycle was initiated in the year under review. The audit work was aimed on the one hand at protecting the information-processing infrastructure against physical threats and, on the other hand, on ensuring secure and continuous operation of the individual systems. The report completed by the external auditors towards the end of 2007 stated that compliance with the defined control objectives is very good and thus contains only a small number of (medium to low-priority) recommendations. Based on the report's findings, the SNB will issue a statement to the system operators at the beginning of 2008.

Revision of the National Bank Ordinance

Owing to the experience gained from these audits, the amendments to the National Bank Ordinance were extended to include the provisions regarding minimum requirements, their verification and implementation. Operators of systemically important institutions are now no longer required to have their procedures and technical concepts audited at least once a year by an external body, but only periodically. In addition, the provision stipulating that a system operator must have the effectiveness and enforceability of its basic contractual documents assessed regularly by an expert, in the case of foreign law being applicable, was relaxed. Finally, system operators are no longer required to have the SNB approve amendments to the basic contractual documents where these changes concern systemically relevant aspects; they now only need to inform the National Bank.

Other principal areas of systems oversight

The merger of the infrastructure operators SWX Swiss Exchange, SIS Swiss Financial Services Group and Telekurs Holding at the beginning of 2008 to form Swiss Financial Market Services (cf. p. 50) – a merger that also affected the SIC, SECOM and x-clear systems – does not have any immediate implications for the conduct of system oversight. Nevertheless, the SNB will pay particular attention to its effects on the system operators' corporate governance.

During the year under review, the SNB continued to exert pressure on the system operators to quickly set up an additional national data processing centre which could be brought into service in an emergency. The project was initiated in the second half of 2007 and the data processing centre is scheduled to become operational by the end of 2008.

The central counterparty x-clear had to undertake a number of changes to its risk management arrangements owing to its plan to extend its business activities to the clearing of securities traded on the London Stock Exchange (LSE) as of the first quarter of 2008. The likely future participants of x-clear will access the system not simultaneously but over a period of several months. The SNB examined the proposals drafted by SIS x-clear and formulated a response in conjunction with the SFBC.

5 Asset management

5.1 Basic principles

Mandate

Under art. 5 para. 2 of the National Bank Act (NBA), the Swiss National Bank is responsible for managing the currency reserves. Asset management is governed by the primacy of monetary policy and is carried out in accordance with the criteria of security, liquidity and performance. The SNB's own Investment Policy Guidelines define the scope for its investments and for the investment and risk management process. Within this framework, investments are made in line with the principles of modern asset management. Diversification of investment aims at achieving an appropriate risk/return profile.

Function of assets

The SNB's assets essentially consist of foreign exchange, gold and financial assets in Swiss francs (securities and claims from repo transactions). They fulfil important monetary policy functions. Their composition is determined mainly by the established monetary order and the requirements of monetary policy. Some of the assets, including claims from repo transactions, are used directly for the implementation of monetary policy. Using repo transactions, the SNB supplies commercial banks with liquidity in the form of base money by purchasing securities from them. The SNB holds currency reserves – in the form of foreign exchange and gold – in order to ensure it has room for manoeuvre in monetary policy at all times. These reserves also serve to build confidence and to prevent and overcome potential crises.

5.2 Investment and risk control process

Responsibilities of Bank Council and Risk Committee, ...

The NBA defines the SNB's responsibilities and describes in detail its mandate with regard to asset management. The Bank Council is charged with the integral oversight of the investment and risk control process. Its role is to assess the underlying principles and monitor compliance with them. The Risk Committee – which is composed of three members of the Bank Council – supports the Bank Council in this task. In particular, it monitors risk management. All internal risk management reporting is addressed directly to the Governing Board and the Risk Committee. To avoid conflicts of interest, operational responsibilities for monetary policy and investment policy operations are largely kept separate.

The Governing Board defines the requirements with regard to the security and liquidity of – and income from – the investments, as well as the eligible currencies, investment categories, instruments and debtors. It decides on the composition of the currency reserves and other assets, and normally sets the investment strategy once a year. The investment strategy encompasses the allocation of total assets to the different portfolios and the guidelines for their management, in particular the allocation to different currencies and investment categories, and the leeway for active management at the operational level.

... Governing Board, ...

An internal Investment Committee determines the tactical allocation of the assets at the operational level. Within the strategically prescribed range, it adjusts the following parameters to changing market conditions: currency weightings, maturities and allocations to the different investment categories. The management of the individual portfolios is the responsibility of Portfolio Management. The majority of investments are managed by internal portfolio managers. External asset managers are used to obtain efficient access to special investment categories and for conducting performance comparisons with internal portfolio management.

... Investment Committee and Portfolio Management, ...

The investment strategy is based on quantitative specifications relating to risk tolerance and liquidity of the investments, and on comprehensive risk/return analyses. Risk management and limitation is carried out by means of a system of reference portfolios, guidelines and limits. All relevant financial risks on investments are identified, assessed and monitored continuously. Risk measurement is based on standard risk indicators and procedures. While market risk is mainly assessed by means of sensitivity and Value-at-Risk (VaR) analyses, credit risk is appraised using information from major rating agencies, market indicators and in-house analyses. Credit limits are based on these indicators and are adjusted whenever the assessment of counterparty risks changes. Risk indicators are aggregated over all investments. Compliance with the guidelines and limits is monitored systematically. Quarterly risk reports for the attention of the Governing Board and the Bank Council's Risk Committee document the results of risk management activities.

... and Risk Management

5.3 Breakdown of assets

Composition of assets

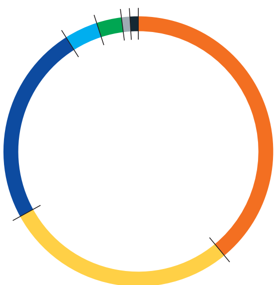
The SNB's currency reserves totalled CHF 85 billion at year-end 2007. Gold accounted for CHF 35 billion of this amount and foreign exchange reserves for CHF 50 billion. In addition, the SNB held assets of approx. CHF 35 billion in the form of claims from repo transactions and bond investments on the capital market. Due to seasonal factors, claims from repo transactions at the end of the year were – as usual – several billion Swiss francs higher than the average for the year. At the end of 2007, claims from monetary-policy-related repo transactions in US dollars were outstanding for the first time.

Gold holdings

On 14 June 2007, the SNB announced its intention to sell 250 tonnes of gold by the end of September 2009. The proceeds are being used to increase the foreign exchange reserves. By rearranging its assets in this way, the SNB is seeking to attain a more balanced allocation of its currency reserves. Such reallocation has become necessary because the sharp rise in gold prices in recent years had steadily increased gold's weighting in relation to foreign exchange reserves. The gold sales are being conducted within the framework of the second Central Bank Gold Agreement of 8 March 2004. Between 15 June 2007 and the end of the year, a total of 145 tonnes of gold were sold. Even so, the value of the gold holdings rose year-on-year, as the soaring price of the metal more than offset the disposals.

Investments

The bulk of the assets consisted of fixed-income investments. Of these, claims from repo transactions in Swiss francs accounted for CHF 31 billion, claims from repo transactions in US dollars for CHF 5 billion, Swiss franc bonds for CHF 4 billion, claims from gold lending operations for CHF 4 billion and foreign exchange reserves for CHF 44 billion. The remaining foreign exchange reserves consisted of equities.



Breakdown of National Bank assets
In percent

Foreign exchange reserves 39

Gold reserves 28

Claims from repo transactions in Swiss francs 24

Claims from repo transactions in US dollars 4

Securities in Swiss francs 3

Monetary institutions 1

Other assets 1

Total: CHF 127 billion
At year-end

Breakdown of foreign exchange reserves and Swiss franc bond investments

	2006 Foreign exchange reserves	2006 CHF bonds	2007 Foreign exchange reserves	2007 CHF bonds
Currency allocation, incl. derivative positions				
CHF	–	100%	–	100%
USD	27%	–	28%	–
EUR	48%	–	47%	–
JPY	10%	–	10%	–
GBP	10%	–	10%	–
Other (CAD, DKK)	5%	–	5%	–
Investment categories				
Money market investments	3%	–	2%	–
Government bonds[1]	58%	48%	61%	44%
Other bonds[2]	29%	52%	25%	56%
Equities	11%[3]	–	12%	–
Risk indicators				
Duration of bonds (years)	4.2	5.4	4.1	5.0
Value-at-Risk (1 year, 95%) in CHF billions	2.5	0.1	3.7	0.0

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

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

3 Including share index futures: 12%

At the end of 2007, the foreign exchange reserve bond portfolios and the Swiss franc bond portfolio comprised government and quasi-government bonds as well as bonds issued by international organisations, local authorities, financial institutions and other companies. In the case of foreign exchange reserves, secured and unsecured money market investments were also made at banks, to a limited extent. The equities were managed on a purely passive basis, with broad market indices in euros, US dollars, yen, pounds sterling and Canadian dollars being replicated. To avoid any conflicts of interest with monetary policy, only corporate bonds and equities issued by foreign companies were held. Slightly more than one-quarter of the gold holdings were kept available for lending transactions.

Debtor categories and instruments

Exchange rate and interest rate risks were managed using derivative instruments such as interest rate swaps, interest rate futures, forward foreign exchange transactions and foreign exchange options. In addition, futures on equity indices were used to manage the equity investments.

Changes in investment allocation

The currency allocation of the foreign exchange reserves changed only marginally compared with the previous year. Taking share futures into consideration, the proportion of equities was unchanged. Owing to the higher level of reserves held and increased volatility, the Value-at-Risk of the foreign exchange reserves rose by roughly CHF 1 billion to CHF 3.7 billion.

5.4 Investment risk profile

Risk profile ...

The main risk to investments is market risk, i.e. risks relating to the gold price, exchange rates, share prices and interest rates. Market risks are managed primarily through diversification. The SNB counters liquidity risks by holding a considerable part of its investments in the world's most liquid currencies and investment markets. To a limited extent, it also enters into credit risks.

... of currency reserves

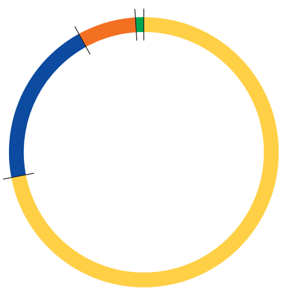
The adjustments made in recent years, especially the more even distribution of currencies within the foreign exchange reserves and the inclusion of equities, have improved the risk-return profile of the currency reserves. The average duration of fixed-income investments in 2007 was approximately four years. The price of gold and the US dollar exchange rate were still the dominant risk factors. By contrast, equity, interest rate and credit risks contributed only marginally to the overall risk. The higher level of foreign exchange reserves and greater volatility increased the overall risk on currency reserves.

… and of Swiss franc investments

The Swiss franc bonds were managed passively. Their structure in terms of maturities and credit ratings was generally in line with the Swiss Bond Index for rating categories AAA and AA across the entire maturity spectrum. Duration at year-end was approximately five years. Monetary policy repo transactions were almost free of risk; owing to their very short maturities, there was no interest rate risk. Moreover, they posed virtually no credit risk since the claims were secured by first-class collateral. The collateral was re-valued twice daily and any shortfall was covered immediately. As of 1 October 2007, the range of instruments accepted as collateral by the SNB was supplemented by additional currencies and borrower categories.

Credit risks

The SNB was exposed to credit risk by purchasing bonds of various debtors and debtor categories. These included bonds of public and supranational issuers as well as mortgage bonds and similar instruments. Portfolios of corporate bonds (totalling CHF 2.3 billion) and US mortgage-backed securities (CHF 1.3 billion) were also held. These MBS consisted entirely of securities issued and guaranteed by the agencies Ginnie Mae, Fannie Mae and Freddie Mac. Such Agency MBS were only marginally affected by the crisis on the American mortgage market. Although the risk premiums for MBS (as for corporate bonds) rose versus government bonds, the MBS still generated a positive yield of about 7% in USD in 2007. Moreover, credit risk vis-à-vis banks existed in the form of time deposits (CHF 0.9 billion) and replacement values of derivatives (CHF 0.0 billion). Gold lending (CHF 4.2 billion) did not entail any significant credit risk, as these operations were secured by bonds with above-average credit ratings. Although credit risk tolerance has increased in recent years, the average rating of the SNB's investments was high. 72% of its investments had the top AAA rating. As in 2006, the lowest rating category still eligible for investment – BBB – accounted for approximately 1% of total investments at year-end.



Rating allocation of investments[1]
In percent

AAA 72

AA 20

A 7

BBB 1

At year-end
1 Excluding shares and repo transactions

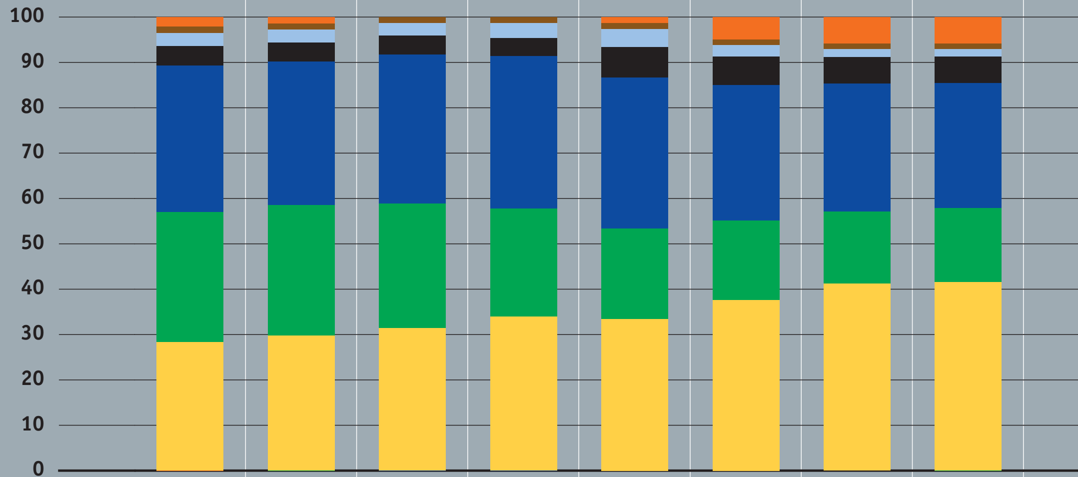
2000 2001 2002 2003 2004 2005 2006 2007

Breakdown of foreign exchange reserves

Gold
USD
EUR
GBP
DKK
CAD
JPY

In percent

Excluding surplus gold and interim investment of the corresponding sales proceeds (formerly 'free assets')



2000 2001 2002 2003 2004 2005 2006 2007

Liquidity risk

The SNB's requirements for the liquidity of its investments are high. More than 70% of the foreign exchange reserves were denominated in the two major currencies, euro and US dollar, with highly liquid government bonds accounting for a large proportion of these.

Overall risk

The overall risk of investments can be estimated – among other methods – by a VaR analysis. This indicator is applied both to the total assets and to various sub-portfolios. The VaR shows the loss that – based on a prescribed probability level – will not be exceeded within a specific period of time. Given the SNB's long investment horizon, the VaR is calculated for a one-year period. Consequently, a figure for the expected return is factored into the calculation. Probability is set at 95%. Based on this calculation method, the VaR indicates the loss threshold which should only be exceeded once in every twenty years. Taken separately, the VaR came to roughly CHF 8.4 billion for gold and CHF 3.7 billion for foreign exchange reserves. Owing to diversification effects, the VaR for total assets was – at CHF 9.4 billion – significantly lower than the sum of the VaRs for the sub-portfolios.

Due to the limited explanatory power of the VaR – for example, it provides no information on possible extreme losses and tends to underestimate the risk of major losses – further risk analyses are required. Therefore, the SNB also used stress and scenario analyses. The National Bank's comparatively long-term investment horizon was taken into account in all of these calculations.

5.5 Investment performance

The SNB's investment performance is calculated across all asset categories (foreign currency assets, gold and Swiss franc assets including, repo transactions). In 2007, it amounted to 8.0%, which was above the long-term return expectations. The above-average performance was the result of an unusually sharp increase in the price of gold (21.6%). By contrast, foreign exchange reserves (3%) and CHF bonds (–0.1%) produced below-average returns. The return on the foreign exchange reserves was reduced by exchange rate and share price losses on dollar investments.

Return on investments in Swiss francs[1]

	Foreign exchange reserves	Gold	CHF bonds	CHF repos	Total return[2]
1999	9.7%		0.7%	0.9%	
2000	5.8%	–3.1%	3.3%	2.7%	2.2%
2001	5.2%	5.3%	4.3%	2.9%	4.0%
2002	0.4%	3.4%	10.0%	1.0%	3.0%
2003	3.0%	9.1%	1.4%	0.2%	4.2%
2004	2.3%	–3.1%	3.8%	0.3%	0.9%
2005	10.8%	35.0%	3.1%	0.6%	12.8%
2006	1.9%	15.0%	0.0%	1.3%	5.2%
2007	3.0%	21.6%	-0.1%	2.2%	8.0%

1 Sum of direct income and realised and unrealised price changes on holdings.
2 Figures for 2000 – 2005 include the return on free assets.

6 Contribution to financial system stability

6.1 Monitoring of the financial system

Analysis of banking sector and financial market infrastructure

In June 2007, the SNB published its fifth *Financial Stability Report*, a publication that looks at developments in the banking sector and in the financial market infrastructure. Individual banks are only mentioned if this is relevant for the overall assessment.

Banking sector as a whole in good shape

According to the report, the banking sector was in good shape in a generally favourable macroeconomic and financial environment. Owing to their high profits, the banks were able to improve their capital adequacy and thus their resilience to shocks. The market also found the level of banks' robustness to be high.

Weakness of the banking sector

The Financial Stability Report also revealed a number of vulnerabilities: first, an increased risk appetite – mainly by the two big banks – in lending and securities trading; second, a relatively high leverage of the two big banks – particularly by international standards; third, a lack of transparency by the banks with regard to risks and resilience in stress situations. Relating to the macroeconomic and financial environment, the Swiss National Bank mentioned the unusually low risk premiums and very high real estate prices in countries like the US. The report emphasised that these two factors posed a large risk to the macroeconomic and financial environment and could cause the situation to deteriorate. Moreover, the report pointed out that the problems that emerged in the US in connection with the sub-prime mortgage credits could be a first sign of such deterioration.

Vulnerability and serious turmoil in the second half of the year

The vulnerability of the financial system became obvious in the second half of 2007 and caused turmoil. From July onwards, the situation of the sub-prime borrowers took a clear turn for the worse, mainly due to falling demand in the US real estate market. The rating agencies considerably downgraded some mortgage-backed securities. Consequently, their prices dropped and liquidity in the related markets dried up. Liquidity problems also affected other segments, such as the leveraged finance business. These developments prompted investors to make higher risk assessments. As a result, risk premiums increased in most segments of the financial market.

The situation in the financial markets became more serious and uncertainties increased, leading to significantly higher demand for liquidity by banks. In addition, banks were more cautious in lending to other banks, mainly regarding unsecured loans and loans with maturities of more than one month. A subsequent liquidity shortage in the interbank market caused central banks to react with substantial and concerted injections of liquidity.

Liquidity shortage in the interbank market

The turmoil in the second half of 2007 had a considerable negative impact on the Swiss big banks, largely because of their exposure to the market for mortgage-backed securities (MBS) and leveraged finance commitments. As regards UBS, the annual loss was substantial and drastic measures had to be taken to strengthen the capital base. The reduced robustness of the Swiss big banks was also reflected in a number of market indicators.

Considerable impact on the big banks

In view of the turmoil and its impact on the Swiss big banks, the Swiss National Bank stepped up its monitoring of the financial system, working closely with the Swiss Federal Banking Commission (SFBC) as well as major central banks and foreign supervisory authorities.

Stronger monitoring

The Swiss National Bank continually monitored the changes in market indicators, which were most affected by the turmoil. In addition to traditional indicators, such as those of the equity and bond markets, the SNB also monitored MBS prices, risk premiums of international big banks as well as reports on their quarterly results and their provisioning requirements directly related to the turmoil. The Swiss National Bank regularly submitted the results of this monitoring to the SFBC and other federal offices.

Market monitoring

Under the auspices of and in close cooperation with the SFBC, the Swiss National Bank also intensified its monitoring of the two big banks, focusing on the following three aspects: first, projections on profits, capital adequacy and liquidity trends; second, compilation of exposures in those financial instruments that played a central role in the crisis; third, description of internal valuation methods for positions without representative market prices. Such information helps the Swiss National Bank to be optimally prepared in case it needs to provide emergency liquidity assistance. The conditions for the provision of emergency liquidity assistance by the SNB are outlined in section 2.4.

Monitoring of big banks, together with the SFBC

Lessons learned

In many areas, the developments in the second half of the year resulted in corrections of imbalances and excesses that had accumulated in previous years. Thus, increased risk premiums in the major markets largely reflected a normalisation of the compensation for such risks. At the same time, the turmoil that resulted from this correction revealed and confirmed vulnerabilities requiring reactions by banks and authorities. First of all, it became apparent that a problem which only seemed to affect a small part of the US mortgage market triggered a serious crisis of confidence in the international banking sector. The very high leverage of international big banks and their lack of transparency had probably accelerated the spread of the turmoil. Moreover, risk measurement and management systems of the international big banks seemed to have partially failed. In particular, liquidity and credit risks had been underestimated.

From the SNB's point of view, adjustments are necessary mainly regarding legal requirements for capital and liquidity as well as for the banks' risk measurement and management systems. The SNB, together with the SFBC, intends to support the implementation of such adjustments at a national and international level. The coordination at an international level will primarily take place in the Financial Stability Forum (FSF).

6.2 Revision of liquidity regulation for big banks

Regulation attuned to critical situations

In spring 2007, the SFBC and the SNB initiated a reform project aimed at regulating the big banks' liquidity. The current liquidity requirements do not take sufficient account of the complexity of risk profiles and the way in which banks manage risks. Considering the systemic consequences that illiquidity of a big bank would have, these weak points must be eliminated. The reform project mainly aims at the following: First, the authorities define stress scenarios regarding liquidity; second, the banks implement these scenarios in accordance with their risk profiles; third, they prove that they are able to cope with them. The SFBC and the SNB are managing this reform project in close collaboration with the two big banks.

6.3 Capital adequacy requirements

At an international level, the SNB, as a member of the Basel Committee on Banking Supervision, was involved in implementing the new Basel Capital Accord (Basel II). The implementation of Basel II was the main focus of the Basel Committee in 2007.

Credit risks in the trading book

In addition, the Basel Committee worked intensively on the introduction of an incremental default risk charge for complex credit exposures listed in the trading book. Banks which use internal value-at-risk models to calculate capital adequacy requirements for market risks and also apply them to model specific risks would be required to measure default risks exceeding those included in the value-at-risk models and back them with equity capital. With this measure, the Basel Committee wants to take due account of exposures in credit-related and often illiquid products which have increasingly become trading book items. Their actual risk is not sufficiently reflected in the value-at-risk approach which is based on a holding period of only ten days and a confidence interval of 99%. In December, the Basel Committee carried out an impact analysis with the banks concerned. The definitive guidelines are scheduled to be issued in spring 2008.

First conclusions from the crisis in the credit markets

The Basel Committee also dealt with the conclusions from the crisis in the credit markets. Basel II resulted in several improvements in the areas of equity capital regulation, risk management and oversight as well as valuation and transparency. In addition, the Basel Committee has drawn first provisional conclusions with regard to its future thrust. First, the Accord should be selectively checked for any need for improvement. In this context, higher capital requirements for securitisation and – related to this – an analysis of the actual risk transfer have been discussed. Under Basel II, short-term liquidity facilities must be backed by equity capital; however, capital adequacy requirements for securitisation tranches that have recently been downgraded by the rating agencies have been reduced markedly. Second, a clearer delineation should be made between the trading and the banking book, and instruments that cannot be sold in the market should not be included in the trading book, in which capital adequacy requirements are lower. Third, an exchange of information regarding the appropriate organisation of stress tests should take place between the supervisory authorities and the banking sector.

In Switzerland, the new capital adequacy requirements based on Basel II entered into effect – in January 2007 for those banks (mostly small and medium-sized institutes) that use the standardised approach and in January 2008 for those banks that use a more complex approach. In 2007, the Swiss National Bank continued to participate in the implementation of the new capital adequacy requirements, namely those in connection with the second pillar of Basel II. The regulations of this pillar require the supervisory authority, together with the bank in question, to thoroughly analyse the bank's risk profile, the quality of its risk management and its capital adequacy. Subsequently, the supervisory authority may – if necessary – demand corrective measures and impose additional capital requirements. The results of the stress test – as well as other factors – will play an important role in deciding whether equity capital should be increased. The SNB supported the SFBC in drawing up a concept for a stress test that ensures sufficient transparency and is suitable for making comparisons between different banks.

Implementation of Basel II in Switzerland

6.4 Memorandum of Understanding with the Swiss Federal Banking Commission

In autumn 2006, the SNB launched the idea of a Memorandum of Understanding (MoU) between the Swiss National Bank and the Swiss Federal Banking Commission (SFBC) in the area of financial stability. In view of the increasing significance of the Swiss big banks and the responsibility of the SNB as lender of last resort, it became apparent that cooperation with the SFBC needed to be intensified. In May 2007, the MoU, which had been drawn up by the two authorities together, was signed and published.

Need for increased cooperation

The MoU mainly defines the tasks of the two authorities and specifies the terms of their cooperation. In particular, it contains details on information exchange and opinion sharing as well as cooperation in regulation projects. In addition, the MoU deals with cooperation in the area of crisis prevention and management.

Content of the Memorandum of Understanding

The MoU reflects the increasing importance authorities attach to financial stability. It strengthens the relationship between the SFBC and the SNB, and defines the framework for increased cooperation. For the first time, this cooperation has proven its worth during the turmoil in the second half of 2007.

Role and first assessment

7 Involvement in international monetary cooperation

7.1 International Monetary Fund

Swiss interests

The IMF works to promote stable monetary conditions worldwide and support free trade and international payment flows. As an open economy with a globally important financial sector, Switzerland is particularly committed to these aims.

Responsibilities

The Chairman of the Swiss National Bank sits on the Board of Governors of the IMF, the Fund's highest decision-making body, while the Head of the Federal Department of Finance (FDF) leads the Swiss delegation that takes part in the IMF meetings. Switzerland holds one of the 24 seats on the Executive Board, the IMF's most important operational body. In this function, it represents one constituency, which also includes Azerbaijan, the Kyrgyz Republic, Poland, Serbia, Tajikistan, Turkmenistan and Uzbekistan, and actively participates in formulating IMF policy. Montenegro, which attained its independence from Serbia on 3 June 2006, became an IMF member in its own right on 18 January 2007 and is no longer part of the Swiss constituency. The Swiss seat on the Executive Board is held alternately by a representative of the SNB and of the FDF. The National Bank and the FDF determine Switzerland's policy in the IMF and support the Swiss executive director in his activities.

Principal activities in 2007

In 2007, the Executive Board was concerned mainly with monitoring the member states' economic situation, the reform of the surveillance process, the reform of the system of quotas and voting rights, and the IMF's income situation. The volume of loans granted by the IMF continued to decline. Furthermore, discussions were held on the suggestions brought by an external commission on improvements to the division of work between the IMF and the World Bank.

Surveillance

In addition to the IMF's regular surveillance work, the year 2007 saw the so-called multilateral consultations take place for the first time. The aim of these consultations was to work together with systemically important countries to develop a coordinated economic policy strategy for reducing global imbalances. In June 2007, the regulations for surveillance of individual countries were revised. The new rules establish principles for bilateral surveillance, thus facilitating a more focused and effective economic policy dialogue between the IMF and its member states. According to the new rules, surveillance is focused mainly on external stability. What is new, in particular, is the principle of avoiding exchange rate policies that might give rise to external instability.

Quota and voice reforms

The purpose of the quota and voice (voting rights) reforms, which are due for completion by autumn 2008, is to ensure that representation of the member countries reflects the emerging countries' growing economic importance. As a first step, the quotas for four countries (China, Mexico, South Korea and Turkey) were increased. As a result, Switzerland's quota dropped from 1.62% to 1.59%. In a second step, a new quota formula will be negotiated, an across-the-board increase in quotas implemented and the member states' basic votes raised in favour of the smaller and lower-income countries.

IMF's income situation

With the volume of loans decreasing, the IMF is confronted with a decline in income. To ensure that it can continue its activities, the Fund thus needs new sources of income. In January 2007, an external committee presented a number of recommendations aimed mainly at expanding the IMF's investment activities. In the committee's view, this means that additional resources should be made available. It saw two ways of achieving this goal: using portions of the quotas for financial market investments, and sales of gold. Many member states insisted that to improve the IMF's budget situation costs should also be cut.

Participation in the FSAP

In 2006, within the framework of the IMF's bilateral economic-policy surveillance activities, Switzerland participated not only in the annual Article IV Consultation process but also in the Financial Sector Assessment Programme (FSAP). Participation in the FSAP is voluntary, but is recommended for financial centres as it entails a detailed examination of the financial sector's health and stability. In Switzerland's case it meant updating the first evaluation, which was carried out in 2001. The results were published in spring 2007. Despite certain risks, the IMF confirmed the resilience of Switzerland's banking sector to various macroeconomic shocks. It also gave a positive verdict on the improvements to financial market oversight and regulation that have been made in recent years.

Switzerland's reserve position

The IMF's equity consists of the quotas of its member states. Total quotas in the IMF amount to 217 billion Special Drawing Rights (SDRs) (CHF 387 billion), with Switzerland's quota coming to 3,458 million SDRs (CHF 6,163 million). The Swiss quota is financed by the National Bank. The portion of this quota that is paid out corresponds to Switzerland's reserve position in the IMF. For the SNB, this represents a currency reserve that it can draw down at any time. At the end of 2007, Switzerland's reserve position amounted to 227.8 million SDRs, compared with 303.4 million SDRs a year earlier. At the end of 2007, one SDR was equivalent to CHF 1.78. This figure is calculated from the weighted exchange rates of the US dollar, euro, yen and pound sterling.

Contributions to PRGF and interim PRGF

The National Bank also finances the Swiss contribution to the loan account of the IMF's Poverty Reduction and Growth Facility (PRGF). The PRGF funds, in which Switzerland participates with a loan commitment of 151.7 million SDRs, were fully drawn down by the end of 2001. Since the PRGF could not be maintained as a self-supporting facility, interim financing (interim PRGF) was necessary. Switzerland contributes 250 million SDRs towards the capital of the interim PRGF. This amount is provided by the National Bank. The Swiss Confederation guarantees the National Bank the timely repayment of both the PRGF and interim PRGF loans, including interest payments.

Renewal of GAB and NAB

In November 2007, the Federal Council voted in favour of renewing Switzerland's participation in the IMF's General Arrangements to Borrow (GAB) and New Arrangements to Borrow (NAB). Renewal of the GAB requires the approval of parliament. These two types of borrowing arrangements enable the IMF – at times of crisis or in the event of its own resources being in short supply – to draw on credit lines totalling a maximum of 34 billion SDRs. Switzerland's contribution – a maximum of 1,540 million SDRs – would have to be provided by the SNB as a participant in the Arrangements.

7.2 Group of Ten

On 20 October, the finance ministers and central bank governors of the Group of Ten met in Washington. The topic of the meeting was "Highly Leveraged Institutions." In addition, delegates voted in favour of renewing the IMF's General Arrangements to Borrow (GAB). The GAB have been renewed nine times in their 45-year history; the last time they were activated was in 1998, when the IMF had granted a loan to Russia.

7.3 Bank for International Settlements

BIS bodies

Since spring 2006, the SNB has held the chairmanship of the BIS's Board of Directors. The central bank governors of industrialised countries and emerging economies meet every two months at the BIS for an exchange of information. In addition, the National Bank participates in four standing committees of the BIS: the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System and the Markets Committee.

Committee on Banking Supervision

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

The Committee on Payment and Settlement Systems (CPSS) monitors and analyses the developments in national and international payment and securities settlement systems. It issued two reports in 2007. The first addressed the clearing and settlement of over-the-counter (OTC) derivatives, the volume of which has risen sharply in recent years. The second was a consultative report on the progress achieved in reducing settlement risks in foreign exchange transactions.

Committee on Payment and Settlement Systems

The Committee on the Global Financial System (CGFS) monitors and assesses developments on the international financial markets and draws up recommendations which support central banks in their responsibilities with regard to the stability of the financial system. In 2007, the CGFS published two reports. The first investigated the factors influencing institutional investors when determining portfolio structures, and the implications for the global financial system. The second examined the extent to which the development and growth of local-currency bond markets in many emerging countries over the last few years has reduced these countries' vulnerability to financial crises.

Committee on the Global Financial System

The Markets Committee serves as a discussion forum for the G10 central bank staff members responsible for financial market operations. The discussions dealt with the developments on the foreign exchange and other financial markets and the impact of individual events on the overall functioning of these markets. In 2007, talks focused on the financial market crisis triggered in the summer by developments on the US mortgage market.

Markets Committee

7.4 Financial Stability Forum

At the beginning of the year, Switzerland became a member of the Financial Stability Forum (FSF). The Federal Department of Finance has delegated the task of representing Switzerland on the FSF to the Chairman of the SNB Governing Board.

The forum, which combines in one single body the national authorities responsible for financial stability, international financial institutions, international groups representing regulatory and supervisory authorities, and the central banks' committees of experts, enables Switzerland to strengthen cooperation and coordination in the oversight of the international financial system and to contribute to the reduction of systemic risks. Membership in the FSF gives Switzerland the opportunity to actively participate in international dialogue on the early identification of issues relevant to stability, in particular in the areas of financial market regulation and supervision, and international financial systems.

In the year under review, the turbulence on the international financial markets was the main topic of discussion for the FSF.

7.5 OECD

Switzerland is a member of the OECD. On the Organisation's intergovernmental committees, it works to promote the development of economic relations, particularly among industrialised countries and major emerging economies. The National Bank, together with the Federal Administration, represents Switzerland in several OECD bodies.

The Economic Policy Committee (EPC), its Working Parties, WP1, WP3 and STEP, deal with structural policies and the global economic outlook on a political and scientific level. The Committee on Financial Markets (CMF) analyses current developments and structural problems in international financial markets. The Statistics Committee (CSTAT) drafts standards for the National Accounts in association with other supranational organisations.

In September 2007, Switzerland's economic policies were assessed by the Economic and Development Review Committee (EDRC). In its report, the OECD confirmed that Switzerland had emerged from its period of low growth. It praised the SNB's monetary policy: in its view, this policy provides a prudent monetary framework for Switzerland's growing production potential. However, it considered that without further domestic market reforms, Switzerland would not be capable of transforming the current healthy economy into a sustained upswing.

7.6 Monetary assistance loans

No new monetary assistance loans were extended in 2007. In October 2007, Bulgaria repaid the balance-of-payments loan of EUR 14.3 million that had been extended to it. By the end of 2007, no claims under the Monetary Assistance Act were outstanding.

7.7 Technical assistance

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

In 2007, the SNB continued providing assistance to the National Bank of Azerbaijan in matters relating to cash and internal auditing. A new feature of this support was the SNB's assistance in setting up a monetary policy research department and a central statistics database for the central bank. In Serbia, the SNB continued providing the central bank with assistance in investing currency reserves. The National Bank of the Kyrgyz Republic again received advice on security issues and in matters concerning cash, controlling and financial market operations. Support was given in the area of risk management and monetary policy research for the first time. Cooperation with the National Bank of Tajikistan in monetary policy matters was also continued.

For the fourth time, the SNB – together with the Polish central bank – organised a seminar for central banks in the Swiss IMF constituency as well as other countries on the territory of the former Soviet Union or in southeast Europe. This seminar, on "Financial Systems and Monetary Policy," was held at Gerzensee in May 2007.

Outside of the Swiss constituency within the Bretton Woods institutions, the SNB provided support for the central banks of Mauretania and Peru. Furthermore, the National Bank received delegations from the Chinese and Taiwanese central banks.

8 Banking services for the Confederation

Mandate

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

Remuneration for banking services

These services are provided in return for adequate compensation. However, they are provided free of charge if they facilitate the implementation of monetary policy. Services subject to remuneration comprise: payment transactions, liquidity management, the custody of securities and the issue of money market debt register claims (MMDRC) and Confederation bonds. The details of the services to be provided and the remuneration are laid down in an agreement concluded between the Swiss Confederation and the National Bank.

Issuing activities

In 2007, the SNB issued both MMDRCs and bonds on behalf of and for the account of the Confederation. MMDRCs amounting to CHF 53.1 billion were subscribed, of which CHF 33.5 billion was allocated. The corresponding figures for Confederation bonds were CHF 5.5 billion and CHF 3.7 billion respectively. The auction procedure was used for these issues.

Payments

In the area of payment transactions, the SNB carried out roughly 82,000 payments in Swiss francs on behalf of the Swiss Confederation and approximately 40,000 payments in foreign currencies.