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Directorate-General External Policies

Policy Department

NOTE
ON
THE POLITICAL AND ECONOMICAL SITUATION OF

SWITZERLAND

AND ITS RELATIONS WITH THE EUROPEAN UNION

Abstract:

Following a brief summary of Switzerland's unique political system, this paper outlines the current political situation, where increasing polarisation risks leading to legislative deadlock.

It then portrays the economic situation of the country, characterised by shrinking government deficit, but protracted slow growth of GDP.

Finally, the note reviews EU-Swiss relations, where numerous bilateral agreements have been concluded in order to reconcile the need for close integration with EU structures with the reluctance of the Swiss people to share sovereignty rights.

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1. POLITICAL SITUATION

Despite its official name of "Swiss Confederation", Switzerland is not a confederation, but a federal state, albeit decentralised to an unusual degree for Europe. Executive and legislative powers at the federal level are accordingly limited, and the 26 Cantons although the Cantonal administrations wield much greater day-to-day political power and enjoy a large degree of autonomy, in particular over public services and the taxation to finance them.

1.1. Background: the Political System

- **Parliament**: The ***Federal Assembly*** consists of two chambers:

- The ***Council of States*** (the upper house), 46 members, represents the Cantons: each Canton elects two members according to various electoral systems;
- The ***National Council*** (the lower chamber), made up of 200 members, represents the country as a whole rather than Cantonal interest. It is elected for a four-year term by proportional representation.

The two chambers have identical powers: a bill is only passed when they both consent . The Federal Assembly is divided into factions which consist of members of the same party or of members of parties with similar agendas. Therefore, a parliamentary faction is not necessarily the same as a party, and party affiliation is not strictly enforced in the Assembly. To form a faction, at least five members must band together.

- **Government**: The ***Federal Council*** consists of seven ministers of equal rank, individually elected by the Federal Assembly to serve four-year terms. Two seats are reserved for French-speaking Cantons. The Federal Council takes the lead in determining Switzerland's overall economic and political direction. Since 1959, a fixed distribution of seats among the main parties was meant to ensure political stability: two Christian Democrats (CVP), two Social Democrats (SP), two Radicals (FDP) and one member of the populist Swiss People's Party (SVP). This "magic formula" was upheld even after the SVP became the second-strongest party in the 1999 elections.

- **Head of State**: The office of ***President*** is relatively weak, confined to chairing meetings of the Federal Council and to various representative roles. The members of the Federal Council take the post in annual rotation. However, as Switzerland has become more internationally engaged (since, in particular, the successful referendum of 2002 concerning UN membership), the profile of the President is beginning to rise.

- **Direct democracy:** A long-standing characteristic of Switzerland's political system, decisions take directly by the people exist at the federal, cantonal and local level. At the federal level, laws and many international treaties passed by Parliament are submitted to a referendum if requested by eight cantons or 50 000 votes. There are also provisions for "people's initiatives" proposing changes to existing laws or even to the constitution. The number of both people's initiatives and referendums has increased significantly in the last years.

1.2 Current situation

Confirming the SVP's success of 1999, the 2003 elections saw the SVP emerge as the first party with 26,7 % of the vote against 23,3 % for the Social-Democrats (SP). The results of the main other parties were:

Radical Democratic Party (FDP)	17,3 %
Christian Democratic Party (CVP)	14,4 %
Green Party	7,4 %
Liberal Party	2,2 %

These results made maintaining the 'magic formula' untenable and when the Federal Council had to be renewed, the SVP obtained a second seat at the expense of the Christian Democrats. This makes for the following government line-up:

Federal President & Minister of defence: Samuel Schmid (SVP)

Vice-president and minister for environment, transport, energy & communications: Moritz Leuenberger (SP)

Minister for economic affairs: Joseph Deiss (CVP)

Minister of finance: Hans-Rudolf Merz (FDP)

Minister for foreign affairs: Micheline Calmy-Rey (SP)

Minister for justice & police: Christoph Blocher (SVP)

Interior minister: Pascal Couchepin (FDP)

These changes have led to a greater emphasis on populist policies, greater tension between the main parties and an increased risk of legislative deadlock. Growing polarisation of the political system will probably make it more difficult to find sufficiently broad support, both in parliament and in potential referendums, for new legislation on economic reform, as exemplified by the referendum defeat of proposed tax and pension reforms in May 2004. Still, the recently elected leader of the "business party" FDP, Fulvio Pelli, has announced his determination to forge an alliance with moderate forces within the SVP and CVP in order to carry through reform programmes to revitalise the Swiss economy, working for fiscal sustainability, a reduction of state intervention, a strengthening of competition and a reform of the social welfare system.

With general elections not due before 2007, the SVP has experienced several setbacks in cantonal elections in recent months. The party definitely lost some of its punch since Mr Blocher joined the Federal Council, as he is now bound by the Council’s practice of collegiality when speaking in public. The SVP has yet to find a forceful leader who can match Mr Blocher’s appeal to the electorate. All this may indicate that the SVP has reached its peak in the German-speaking cantons, although there may still be potential for the SVP in francophone areas.

Meanwhile, during its March session, the National Council rejected, for the first time in History, the defence department’s arms procurement programme. The controversy arose from the planned purchase of two military transport planes for force projection outside Switzerland, with the SVP (opposed to such missions) and SP (seeking to cut expenditure) effectively combining to oppose the bill. The procurement programme is due to be presented again in the current (June) session.

2. THE ECONOMY

Switzerland's GDP contracted by 0.1% in the fourth quarter of 2004 and indicators point to only moderate expansion in 2005. Industrial output seems set to weaken and retail sales have already contracted substantially. The banking sector has performed reasonably well. Employment growth was flat in the fourth quarter. Although inflation has been boosted by high energy prices, core inflation has remained very low. The Swiss franc has strengthened in year-on-year effective terms. With a federal budget deficit in 2004 lower than planned (at 1.8% of GDP) and strong first-quarter fiscal revenue data, prospects for government finances are favourable.

2.1 Economic policy outlook

GDP growth, which reached 1.7% in 2004, is forecast slow down to 1.2% in 2005, before economic activity rebounds to 1.8% in 2006. Following two decades of poor growth, economic policymakers are paying greater attention to measures to improve the business environment through structural means. Progress in this field is expected to be slow, however, given the above-mentioned risk of political deadlock.

Discussions will be based on the government's growth package, the schedule of reforms it presented in February 2004 to boost trend growth. The package included measures to strengthen competition, market-oriented reforms of public healthcare and pensions insurance, and legislation to liberalise the electricity market and agriculture. Most of these measures will be subject to referendums, which past experience suggests will be difficult to win. Ultimately, reform legislation should be approved, but this will often require several attempts and a substantial watering down of initial proposals.

Eventually, these improvements are expected to go some way towards reducing the supply-side rigidities in product markets that have been identified as one of the main reasons for Switzerland's slow growth.

2.2 Monetary policy

The Swiss National Bank (SNB) raised its target for interest rates in two steps in 2004, first in June and then in September, by a total of 50 basis points to 0.75%. The SNB's most recent inflation forecast was published in March 2005 and predicts that, inflation will rise above 2%, the upper limit of the SNB's definition of price stability, in the third quarter of 2007. This is later than previous expected, but nevertheless a sign that the SNB expects inflationary pressures need to be dampened. To what extent this dampening will come from a more restrictive monetary policy will depend largely on exchange-rate movements, which have a strong impact on inflation in Switzerland.

The Swiss franc will continue to be subject to bouts of volatility, as a result of its status as a safe-haven. Concerns about global economic imbalances and geopolitical fears will lead to periodic flights into Swiss franc-denominated assets. Specifically, a drastic further appreciation of the Swiss Franc against the US dollar, over growing concern about the US current-account deficit, could even lead to a cut in interest rates or to interventions in foreign-exchange markets.

2.3 Fiscal policy

The federal government deficit in 2004 came in substantially below target, at Swfr1.7bn (US$1.4bn), compared with the budget projection of Swfr3.5bn. The target for the federal government budget deficit for 2005 is Swfr1.8bn, which seems realistic; a better result also appears possible.

In 2005, the Swiss National Bank will transfer the proceeds of the sale of 1,300 tonnes of gold, which is no longer needed for reserve purposes, some Swfr21.1bn (about 4.7% of GDP), to the federal and cantonal governments. However, its use and statistical treatment has not yet been decided on, although it is generally assumed that a substantial share will be used for debt repayment.

In April 2004 a package of measures was introduced to improve the federal government's fiscal position by Swfr2.7bn per year in 2006; a further package is currently passing through the legislative process. Overall, these measures, along with the return of GDP growth broadly towards the line of potential growth, will lead to a gradual narrowing of the underlying federal government deficit, from an estimated 1.8% of GDP in 2004 to 0.9% of GDP in 2006.

3. EU - SWITZERLAND RELATIONS

EU/Switzerland cooperation has been both long-lasting and intensive. Geographically fully surrounded by the EU since 1995, Switzerland shares culture, language and economic integration with its neighbouring countries. With over 70 bilateral agreements currently in place, the first dating back to the early days of the European Coal and Steel Community (1956), no other third country has as many agreements with the EU as Switzerland.

In a referendum held on 6 December 1992, the Swiss people rejected the ratification of the EEA agreement previously negotiated by their government. As a consequence, the Swiss Government decided to suspend negotiations for EC accession, which had begun that year, until further notice. Switzerland retains observer status at the EEA however, allowing it to follow the evolution closely.

3.1 Bilateral Trade

In 2002 Switzerland's main trading partner was the EU, which absorbed 61% of its exports and supplied 77.5% of its imports. On the other hand, Switzerland is currently the third largest trading partner of the EU. Trade figures in 2003 show €58.7 billion in imports and €71 billion in exports. In terms of imports, Switzerland was the EU's 5th most important trading partner in 2003, after the USA, China, Japan and Russia. Regarding exports, Switzerland was the 2nd after the USA in the same period.

The Swiss economy is highly integrated internationally, capitalising on an open trade regime for industrial products but with a protected and heavily subsidised agricultural sector. Tariffs on manufactures are generally low, and in principle there are no quantitative restrictions, anti-dumping, countervailing or safeguard actions. However, in a number of sectors, the market entry has long suffered from "private" or "informal" barriers, which can be attributed to a legacy of weak anti-cartel legislation, specific and protective technical regulations, certain investment restrictions, and exclusive rights under intellectual property legislation.

Swiss merchandise exports are concentrated on a few sectors, particularly chemicals and medicinal products, machinery, instruments and of course watches. Switzerland represents 29.8% of EU's total imports of chemical products and 15% of total imports of power generating machinery. In 2002, Switzerland was also the EU's second partner for trade in commercial services, with about 25% originating in the financial sector.

Developed countries are the main partners for foreign direct investment in Switzerland, but the outflow towards Central and Eastern European countries has recently increased. The United States is the main investor as well as the main destination, in terms of FDI stock. Inward stock is more concentrated, with only three investors accounting for almost 70% (USA, the Netherlands, Germany). The most important destinations of Swiss FDI are the USA, UK and Germany.

3.2 Bilateral Agreements

In order to minimise the negative consequences of the rejection of the EEA agreement, negotiations on a first package of bilateral agreements ("Bilateral I")began in 1994. They covered seven sectors: Free Movement of Persons, Trade in Agricultural Products, Public Procurement, Conformity Assessments, Air Transport, Transport by Road and Rail, Swiss Participation in the 5th Framework Programme for Research. Negotiations were concluded in 1999, and the agreements entered into force on 1st June 2002. They are linked by a termination clause, which means that all the agreements came into force together and will also come to an end together if any one of them is terminated. The on-going implementation of these agreements obliges Switzerland to take over relevant Community legislation in the covered sectors.

Negotiations on a second bilateral package ("Bilateral II") were opened soon after, and concluded in 2004. These cover a total of nine areas: agreements on Processed Agricultural Products, Statistics, Pensions, Environment, Media, Schengen/Dublin, Fight against Fraud, and Savings Taxation, plus a declaration of intent on Education/Vocational Training/Youth.

Within this second package, a referendum was only requested on the Schengen/Dublin agreement. This was duly held on 5 June 2005, and confirmed the agreement by a margin of 54.6% to 46%. The campaign on this referendum had seen Mr. Blocher paying lip service to the government line in favour of the accord, while leaving little doubt as to his party's and his personal opposition to what they see as a threat to Switzerland’s neutrality and independence.

3.3 Impact of EU Enlargement

The recent EU enlargement has had consequences for a number of existing arrangements between the EU and the Swiss Confederation. As an EFTA member, Switzerland has committed to contribute CHF 1 billion over a period of five years towards lessening the economic and social gap between the old and the new member states of the EU. Under this cohesion scheme, Switzerland shall support specific projects in different areas, which it will choose and carry out autonomously.

The adaptation of existing bilateral agreements has been in principle a technical question. However, for the ***Agreement on Free Movement of Persons***, a mixed agreement containing transitional provisions, formal negotiations to the ten new Member States have been concluded in mid 2004 to undertake such an adaptation. These negotiations were concluded in July 2004, and the resulting agreement will be subject to a referendum scheduled for 25 September of this year.

Given that the margin of success in the June referendum was much smaller than the 62% forecast, success in this new vote appears far from assured. The SVP is campaigning against the initiative, playing on the fear of job losses by domestic workers if foreign workers flood the country. On the other hand, Mr Blocher has indicated that as a businessman, he is personally in favour of extending the accords (in contrast to his views on Schengen). The other three major political parties are in favour of ratifying the extension, the Social democrats after pushing through legislation that will help to prevent "wage dumping"—although they might still face opposition from many left-wing voters.

The consequences for Switzerland of a “No” vote in September are potentially far-reaching. Commissioner Ferrero-Waldner has already warned that discrimination against certain EU Member States would not be tolerated. If the EU therefore were to cancel the whole Accord on the Freedom of Movement, all the remaining accords in the first set of bilateral agreements would also fall into abeyance. Although a deal might be reached to allow co-operation to continue, the EU could use the opportunity to step up pressure on Switzerland’s banking secrecy rules. For that reason alone, the Swiss government will be worried about been forced to return to the negotiating table.

3.4 The Accession Question

Put on hold in 1992 after the failed referendum on EEA membership, Switzerland's application for EU accession technically remains open. The government still pursues a policy of long term Swiss integration into EU, to the point of having established an Integration Office under the Department of Foreign and Economic Affairs. However, with the SVP once again likely to portray the extension of the Free Movement Agreement as a step towards EU membership in the run-up to the September referendum, there is speculation that the EU membership application may actually be formally withdrawn in order to draw the sting out of the party’s attack.

In its Foreign Policy Report of 15 November 2000 the government set out its long-term aim of taking Switzerland into the EU as well as the three preconditions for the commencement of accession negotiations:

- Switzerland wishes first to gather experience with the seven bilateral agreements of 1999 (as well as the second bilateral package of 2004). It wants to see how these agreements work out in practice.

- The effects of joining the EU on central areas of Swiss statehood must be thoroughly clarified and convincing answers found to any outstanding questions. The Federal Council will publish a report on the pros and cons of EU membership in the second half of this legislative period (i.e. before 2007), outlining the consequences for the country's federalism, popular rights, neutrality, system of government organisation, finances, economic and monetary policy, agriculture, migration policy, not to mention its foreign and defence policy.
- Finally, there needs to be broad domestic support for the aim of EU accession.