THE CONTINUING ROLE OF SWITZERLAND AND THE SWISS FRANC IN INTERNATIONAL FINANCE

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ABSTRACT

Switzerland has had a long and unique role in international business and finance. Investors have historically been drawn towards Switzerland because of their trust in the stability of the Swiss currency. The Swiss economy attracts many international corporations because of its competitiveness on the tax front and its facilitated access to other European countries. This concentration of multinationals in Switzerland has a direct impact on the utilization of the Swiss franc in international finance. Furthermore, individual investors around the world are drawn to invest in Swiss banks, due in large part to the bank secrecy guaranteed in the Swiss Constitution along with special tax advantages offered in several Swiss cantons. The strong infrastructure that supports the Swiss banking system also adds to the attractiveness of Swiss franc investments.

However, the recent financial crisis may have a damaging impact on the reputation of the Swiss banking system. Increased scrutiny is being directed once again at the "Gnomes of Zurich". In addition, Switzerland's geographic and economic position within the heart of Europe has fostered speculation on Switzerland possibly joining the European Union. This article examines the past and present role that Switzerland and the Swiss franc have played in the high stakes world of global finance and postulates what its future involvement might be.

INTRODUCTION

Given the growth in globalization over the past few decades, international trade has become increasingly important. The use of foreign currencies is an unavoidable consequence of engaging in international trade in the highly-globalized and integrated world economy. For most of the twentieth century and beyond, the U.S. dollar has been THE leading international currency, both in terms of its role as the leading foreign reserve currency and its presence in international transactions.

Other currencies, most notably the British pound, Japanese yen, Deutsch (German) mark, and Swiss franc have also played significant roles in the global economy. Since 1999 the Euro has operated as the common currency within the European Monetary Union, thereby replacing the Deutschmark and other European currencies. (Seventeen nations have so far adopted the Euro: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, The Netherlands, Portugal, Slovakia, Slovenia, and Spain, while ten other members of the European Union – Bulgaria, Czech Republic, Denmark, Latvia, Lithuania, Hungary, Poland, Romania, Sweden and the United Kingdom – have chosen not to adopt it).

The Euro has consequently become the second most important currency in international trade and finance behind the U.S. dollar. Given its geographical proximity to various members of the European Union (EU) and economic ties to its neighbors, increased scrutiny has been directed at the likelihood of Switzerland joining the EU, as well as the possible future of the Swiss franc, vis-à-vis, the Euro. Switzerland has also come under a lot of political pressure with respect to its bank secrecy regulations. Such political affairs could have an impact on Switzerland's status as a leading economic power and concomitantly the use of the Swiss franc in global finance.

What follows is an examination of the Swiss economic system and the Swiss franc. Because the present situation cannot be understood without reviewing the past, we begin by offering an historic view of the Swiss economy, looking at major events that impacted the role of the Swiss economy and the Swiss franc. This includes an examination of factors that have led the Swiss economy, and more specifically, Swiss banking and the Swiss franc, becoming so dominant in world affairs. The conclusion will focus on what can be expected with respect to the future position of Switzerland and the Swiss franc in global finance.

SWITZERLAND AND THE SWISS FRANC

It is commonly acknowledged that "modern" Switzerland began in the 1840s with the acceptance and implementation of a new constitution. This constitution gave the country a more centralized administration, transforming the formerly independent canton regions into a single economic area. Important aspects of the constitution included the creation of a strong, unified banking system and the adoption of a common currency, the Swiss franc, for all of the Swiss cantons. The economy encountered some early difficulties, but overall Switzerland has flourished under the new constitution.

It did suffer through some unflattering times during and between the two World Wars. Switzerland did not take an active part in either of the wars, but some argue that Germany could have invaded Switzerland relatively easily and did not invade because it proved to be very useful as an independent state. For example, the Swiss National Bank bought gold from the German Reichsbank, with Germany then using the Swiss francs received in return as payment to buy raw materials from other countries that would not accept its gold. Swiss banks were also very heavily involved in providing financing to various German enterprises, as documented in the Bergier Report (Independent Commission of Experts Switzerland).

After the Second World War, the Swiss remained neutral but began to join international bodies such as the European Free Trade Association and the Council of Europe. Indeed, with Switzerland having limited natural resources and being landlocked, it depended heavily on foreign trade. However, Switzerland stayed out of the European Union to maintain its independence and strived to facilitate trade with its international partners. The Swiss government continues to maintain that its interests can be guaranteed without joining the European Union due to the various bilateral agreements it has with its neighbors, along with the benefits of operating under the Free Trade Agreement of 1972 (State Secretariat for Economic Affairs).

THE SWISS FRANC: TRADING, RESERVE, OR INVESTMENT CURRENCY?

The Swiss franc (internationally recognized as the CHF, from the Latin *Confoederatio Helvetica franc*) has been and continues to be a major international currency. But to what does the term "major international currency" refer? Indeed, one can look at currencies from at least three perspectives. First, one can examine the volume with which individual currencies are traded in the global markets. Only seven currencies, the U.S. dollar, Euro, Japanese yen, British pound, Australian dollar, Swiss franc, and Canadian dollar, make up the bulk (87.6 percent) of foreign exchange trading worldwide. The list is dominated by the U.S. dollar and the Euro, which make up approximately sixty percent of all foreign exchange trading. Currently the Swiss franc is currently the sixth most highly traded currency in the world, accounting for around 6.4 percent of daily transactions (Bank for International Settlements).

Second, one can look at the amount of currency held as bank reserves by foreign banks. For this perspective the Swiss franc is clearly not among the most widely held foreign reserve currencies. According to current statistics the Swiss franc comprises less than 0.1 percent of the total official foreign exchange reserves (International Monetary Fund). *Nonetheless*, given its historical importance, it is interesting to note that despite its relative lack of use, the IMF continues to list the Swiss franc within its statistical summary of international reserve currencies.

And third, one can focus on the amount of money invested in accounts labeled in a specific currency such as the size and scope of investments made by non-Swiss entities in Swiss securities accounts. It probably goes without saying that Switzerland is best known as a haven for foreign investment. However, investing in a country does not always mean investing in that country's currency so one usually refers to "assets under management" when examining the issue of investments managed within specific countries. The total volume of cross-border private banking at the end of 2009 was $7,400 billion with Switzerland being the global leader with approximately $2,000 billion under management, or 27 percent of the market. In comparison, the rapidly growing financial centers of Singapore and Hong Kong have only a 9% share ($700 billion) between them (Swiss Bankers Association). Although not all of the assets managed by Swiss banks are held in Swiss francs, the existence of vast holdings within the Swiss banking market indicates the important role that Switzerland maintains in global finance.

THE CONTINUING IMPORTANCE OF SWITZERLAND AND THE SWISS FRANC

The importance of Switzerland and the Swiss franc can be attributed to various factors. First and foremost, Switzerland offers a strong and stable economy. The Swiss have managed to foster steady economic growth while consistently maintaining low rates of inflation. Indeed, the stable Swiss economy is a key factor explaining why investors look to invest in Swiss francs. Even with the introduction of the Euro, the Swiss franc has lost little of its influence, thanks largely to its approach to monetary policy (Fischer). Furthermore, it has been noted that the volatility of the Swiss franc remains little changed since the introduction of the Euro, and in fact, the Euro appears to have had a stabilizing effect on the Swiss franc (Reynard).

A second factor helping the Swiss franc maintain its importance is the presence of many large and globally-diversified companies domiciled in Switzerland. Looking at the number of corporations headquartered in Switzerland and knowing that one-third of Swiss GDP comes from the activities of multinational corporations, one can see why Switzerland and the Swiss franc continue to play major roles in the global economy (Swiss American Chamber of Commerce).

The important role that commerce plays can be explained from several perspectives. First, Switzerland’s business-friendly legal and fiscal environment is commonly cited by many international firms as factors in moving their world or regional headquarters to Switzerland. The Swiss-American Chamber of Commerce reports that remaining competitive on the tax front is among the key steps necessary to ensure that multinationals move to and then stay in Switzerland. Second, the stability of the Swiss economy and of the Swiss franc is attractive to multinational corporations looking at investment locations. Third, Switzerland has geographical benefits as it is centrally situated within the European Union area and has easy access to the major European markets. Furthermore, the Swiss proclivity toward maintaining high standards results in it being a very good test market for businesses hoping to introduce products in Europe (Parsons). Using Switzerland as a base for operations often leads companies to rely on the Swiss franc as a trading currency. This use of the Swiss franc is bolstered by Swiss accounting standards that are specially adapted to facilitate the currency translation process.

Switzerland is well known as a location that attracts wealthy investors from around the world. This can be explained by various aspects of the Swiss constitution that appeal to rich investors (Federal Department of Finance). For example, bank secrecy is a policy under which the identity and amount of money invested by people in Swiss financial institutions are kept private. Likewise, there are specific Swiss cantons that are known to target wealthy investors. These cantons offer tax breaks specifically designed to benefit the wealthiest from around the world (Kirchgassner). The number of wealthy individuals who have emigrated to Switzerland over the years is a testament to their success.

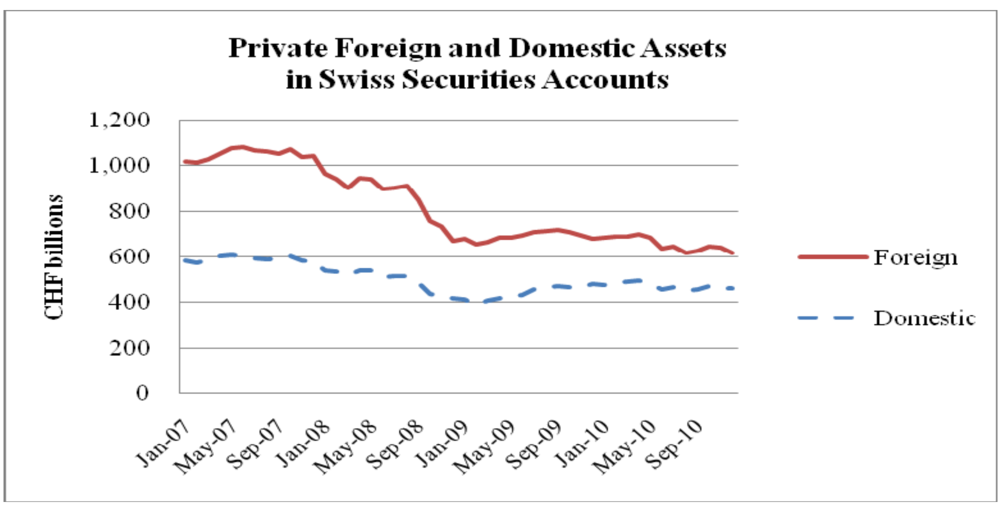
Furthermore, Switzerland has a state-of-the art banking infrastructure. It is likely that Swiss banking know-how, together with its technological expertise, are leading criteria for global investors looking to transfer money. Investors trust the Swiss banking system as one of the safest places to invest money. It is impossible to know to what extent the quality of the Swiss bank infrastructure accounts for Switzerland's success in banking. But Switzerland has always been known for its use of the most modern facilities and technologies and has always been able to anticipate market demands in terms of financial products and technologies.

The stature of private banking within the Swiss economy has been well summarized in comments attributed to Swiss private banker Hans J. Baer who declared that private banking is the full range of services that a client may wish to obtain and this therefore extends way beyond wealth management. Swiss private banking starts at the three international airports at Zurich, Geneva and Basel and continues via the railway stations and luxury hotels of our country right up to the doors of Sprüngli's cake shop. Swiss private banking encompasses our hospitals, cultural institutions, media, lawyers, shops, schools, universities and, of course, our banks and asset managers (Geiger & Hürzeler).

FUTURE ROLE OF SWITZERLAND AND THE SWISS FRANC

What will become of Switzerland and the Swiss franc? This is a complex issue that can be examined from many perspectives. We have noted that Switzerland offers a complex mix of factors than explain why investors have historically looked there for investment purposes. However, in the near term, the current financial crisis has likely had and will likely continue to have a negative impact on the Swiss banking system. This may reduce the prominence of Switzerland and the Swiss franc in the global marketplace. We find that since 2007 there has been a significant outflow of funds from Switzerland. As seen in Exhibit 1, foreign investments in Swiss securities accounts have declined by almost 40 percent since the peak in 2007 (a loss of some $460 billion) while domestic investments are down only around 25 percent (a loss of $145 billion).

Exhibit 1



Source: Swiss National Bank, Monthly Statistical Bulletin February 2011

Similarly, Swiss economic policies have come under fire, most notably from the U.S. but also from some of its European neighbors. The main target has been UBS (the Union Bank of Switzerland), probably the largest manager of private wealth assets in the world. For example, the U.S. Treasury department has recently negotiated the transfer of names of many American customers who allegedly had illegal investments in UBS bank accounts. The crucial importance of bank secrecy is therefore being pierced with unknown consequences for the future role of Swiss banks managing the financial affairs of foreign investors.

The long-term fortunes of Switzerland likely revolve around whether or not Switzerland would be willing to join the European Union and the ability of the Swiss franc to remain independent of the Euro. We have shown that Switzerland offers unique advantages in promoting itself as a financial center, advantages that can only be maintained if it remains neutral and stays outside of the EU. Indeed, joining the EU would force the Swiss to abide by its requirements. Even if, as with the British, Switzerland joined the EU without joining the currency union, a variety of costly adjustments might endanger the role Switzerland plays as a leading economy and the role of the Swiss franc as a major international currency.

But what is the likelihood of Switzerland to join the Euro? Joining the euro would likely benefit the Swiss economy in two key areas: lower transactions costs from not having to exchange currencies and less uncertainty in valuing transactions, as the majority of business activities would be denominated in Euros. However, adopting the Euro would cause Switzerland to lose a significant amount of seigniorage that it currently exploits due to some of the boutique value placed on Swiss francs. Investors may not be as willing to look at Switzerland if some of the unique benefits of the Swiss franc and Swiss banking system are negated by a move to the Euro.

SUMMARY AND CONCLUSION

This paper highlights the importance of Switzerland in international trade and finance. The Swiss franc is among the most widely traded currencies and has a very distinct role in international money management. Four explanations for the level of importance placed on Switzerland were given. First, investors trust the stability of the Swiss economy and the Swiss franc. Second, Switzerland attracts many multinationals due to its competitiveness on the tax front and its facilitated access to nearby European countries, which has an impact on the commercial utilization of the Swiss franc. Third, wealthy individuals look at Swiss banks because of their famous bank secrecy laws as well as the special tax benefits offered by specific cantons. Fourth, the quality of the Swiss banking infrastructure has a positive impact on the overall level of trust in the banking system.

The continued role of Switzerland and the Swiss franc has been questioned due to the current financial crisis that has damaged some of the reputation of the Swiss banking system. Even as the Swiss franc continues to be heavily traded in the global foreign exchange markets, we observe massive capital outflows from Switzerland, particularly from foreign private investors. Although still viewed as one of the safest financial markets in the world, it does not exist in isolation and is not sheltered from global contagions, which may have caused Switzerland to lose some of its stellar reputation. It is difficult to say if this drop in confidence in the Swiss financial markets will last long term, but if it would, the survival of Switzerland as a major, independent player in the global financial markets will be in jeopardy.

If this happens, Switzerland might need to consider joining the EU. If it would join, even without adopting the Euro as its currency, Switzerland will likely suffer from losing some of its comparative advantages in making itself relevant in the global marketplace. The Swiss banking system and the Swiss franc might therefore become nothing more than components necessary for maintaining well-diversified international portfolios rather than as significant players attractive to corporate and private investors alike.

The Swiss banking market is fully aware of the challenges it faces. In a recent study, Swiss bankers overwhelmingly acknowledged the need to become more tax and regulatory transparent (KPMG). While some resent the imposition of outside regulatory pressures that can put pressures on their profitability, the majority appear to be willing to let their historical competitiveness in providing financial solutions to global customers adjust to the new realities; they look forward to adapting their business strategies to thrive in the new global financial marketplace.

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