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Switzerland's Role as an International Financial Center

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Contents

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Tables

Charts

I. Introduction and Summary

1. Introduction

Switzerland has gradually, through history, developed into one of the major international financial centers. In several respects, its development has been unique. Because of the small size of the Swiss economy, it lacks the advantages offered by larger industrial countries as a natural center for international trade and finance. Furthermore, in contrast to other small economies, such as the Cayman Islands, Luxembourg, and Singapore, financial activities have not been promoted by deliberate policies concerning taxes, reserve requirements or bank supervision. On the contrary, international financial transactions have occasionally encountered political resistance in Switzerland, because they were seen as either competing with domestic transactions or because they were associated with disruptive capital movements. Equally, the fiscal authorities have introduced taxes on some financial transactions in order to raise revenue which have tended to hamper international competitiveness of Swiss financial markets.

In recent years, significant institutional changes have taken place in all major international financial centers. Deregulation of domestic banking abroad has reduced the traditional comparative advantage of Switzerland of having a universal banking system. The repeal of the withholding tax on interest income of nonresidents in the United States, France, and Germany in 1984 has also changed the competitive conditions. In addition, capital controls have been relaxed in several countries, including France and Japan, and measures taken in Germany in 1985 to foster the competitiveness of the financial markets in that country. The institutional changes in these countries have prompted a proliferation of new financial instruments which have also sharpened competitiveness in international banking.

The aim of this paper is to describe the characteristics and importance of financial transactions in Switzerland from an international perspective thereby continuing recent work in the Fund on Japan and Luxembourg and filling a gap in the economic literature on Switzerland. 1/ The paper does not deal with the significance of these transactions for the domestic economy in terms of growth and employment opportunities. The description is mainly confined to the financial markets located in Switzerland, i.e., it includes transactions by Swiss banks and foreign-owned banks within that geographical area but it touches only fragmentarily on the activities of Swiss-owned banks abroad.

1/ Eken, Sena, "Integration of Domestic and International Financial Markets: the Japanese Experience," IMF, Staff Papers, Vol.31, No. 3, September 1984; and "Banking and Financial Services Sector," Appendix II, Luxembourg - Recent Economic Developments, SM/85/157, 6/3/85.

2. Summary

The paper is divided into two parts. The first part describes the structure of the financial markets and international financial transactions in Switzerland while the second part focuses on three specific developments, namely (i) the relaxation of capital restrictions since 1979, (ii) the Swiss banking system since the second round of oil price increases, and (iii) the competitiveness of Switzerland as an international financial center. The first part of the paper concludes that Switzerland has developed into an international financial center because of long political stability and an excellent economic performance in terms of a low rate of inflation, a strong currency and external position, a high standard of living and sound government finances. In addition, the existence of a universal banking system permitting banks to engage in all kinds of transactions and some of the highest capital requirements in the world have provided a sound framework for development of financial transactions. The existence of strict bank secrecy and political neutrality of Switzerland, which have been preserved despite political pressure from abroad, have undoubtedly also played a crucial role.

Swiss financial institutions have specialized in portfolio management, foreign exchange and gold transactions. They have, de facto, a monopoly in bond issues in Swiss francs, as the Swiss National Bank has discouraged the emergence abroad of a Eurobond market in Swiss francs. Another characteristic of Swiss banking is off-balance-sheet fiduciary accounts which have grown rapidly in recent years and presently are of almost the same magnitude as banks' external balance sheet transactions. These accounts have reduced the risk of the Swiss banking system associated with international banking. With respect to market participants, the big banks in Switzerland have traditionally dominated international business. However, foreign banks established in Switzerland have increased their market share substantially in recent years, loosening up the cartel-like conditions. This has been encouraged by the Swiss monetary authorities in order to enhance competitiveness within Swiss borders.

The second part of the paper focuses first on the role played by capital restrictions during the 1970s in preventing capital inflows in exerting undue upward pressure on the Swiss franc or an excessive increase in domestic liquidity. It is argued that restrictions on capital movements were largely ineffective in insulating the Swiss economy from developments abroad. Indeed, since the gradual removal of capital control from 1979, there is no indication in terms of the difference between domestic and Euro-Swiss franc interest rates or the variability in exchange or interest rates that capital controls permitted the Swiss National Bank to pursue a more autonomous domestic policy than in the absence of controls. In addition, the removal of capital controls have not significantly increased the official reserve role of the Swiss franc.

The Swiss banking system has generally performed well during the debt crisis of the early 1980s. The exposure to high-risk countries has been smaller than that of many other countries and the high capital requirement and the existance of substantial hidden reserves have provided a buffer which have protected banks against losses. Swiss financial institutions appear to have benefited from its political neutrality and bank secrecy and the confidence in the Swiss banking system, in securing a marked increase in the share of deposits of some Latin American countries and Middle Eastern oil exporting countries during periods of political and economic crisis abroad.

With respect to the competitiveness of Switzerland as an international financial center, the traditional advantage of the Swiss banking system has been its universal banking system and few capital restrictions and other regulations compared to other countries. With the promotion of offshore banking operations and reduction in taxes on financial transactions in other countries, this comparative advantage has diminished in recent years. Market share calculations suggest a small decline in overall market shares of balance sheet transactions in 1982 and 1983, which, however, is partly related to a reduction in assets against high risk countries and to valuation effects in connection with the appreciation of the U.S. dollar. Moreover, in the case of Switzerland, it is particularly important to consider off-balance-sheet items, for which comparable data with other countries are not available. At present, the main policy question with respect to competitiveness is the level and structure of taxes levied on financial transactions in Switzerland and, in particular, the stamp duty which is a major reason for the lack of both a developed domestic money market and Eurobond trading in Switzerland. The stamp duty poses a particular disadvantage for Swiss banks compared to U.K. and U.S. banks.

II. Financial Markets

1. Development as an international financial center

a. Historical developments

In the 18th century, Swiss financiers and bankers were already actively engaged in international finance. As domestic savings exceeded domestic spending, Switzerland became a capital exporting country. This continued to the 20th century, with the exception of several periods during the 19th century, when domestic credit demand increased in connection with industrialization and the building of railroads. After World War I, Switzerland was also temporarily a capital importing country. But, after the mid-1920s, net capital exports resumed. The excess of domestic savings was partly related to the financial situation of the local governments in the Swiss cantons and cities. By contrast to governments in other European countries, where continuous wars resulted in massive financing needs, the Swiss governments were generally in a sound financial situation. The multi-confessional and multilingual character of the Swiss Confederation as well as the

location of Switzerland in the center of Europe made it imperative that Switzerland maintained its neutrality. 1/ Instead, the income from Swiss military service abroad through treaties concluded with foreign sovereigns provided for many years during the Middle Ages and until the 18th century one of the main sources of foreign revenue. In addition, Switzerland, as a neutral country, was able to maintain commercial trade with the belligerent countries.

While Switzerland had exported capital for centuries, it was not until the 20th century that Switzerland became a "safe haven" for foreign funds and began to intermediate between foreign savings and credit demand. After World War I, the currencies in Austria and Germany collapsed and the financial systems were in disarray. As Switzerland avoided hyperinflation, and was less affected by political unrest than other European countries, the country became attractive as a safe depository for funds during the 1920s and the 1930s. Before World War II, Swiss banks also received deposits on a massive scale, mainly from Germany. In order to protect depositors during the worldwide banking crisis of the 1930s, a new Banking Law was passed in 1934. As a side product, it also included rules on bank secrecy which prevented bankers from providing information on bank accounts to outsiders. This Banking Law created problems for the Swiss not only with the Germans during the War but also with the Americans after the War. The U.S. Government demanded German assets held in Swiss bank accounts and in other placements confiscated for the purpose of war reparations. Despite substantial political pressure, the Swiss Government did not succumb to these demands. Instead, a compromise was agreed, in which the Swiss consented to confiscate only part of German assets in Switzerland for war reparations. 2/

The ability of Switzerland to preserve a relatively stable and strong currency also increased the attractiveness of the Swiss banking system. The Swiss franc and the U.S. dollar were the only major currencies which were devalued only once (the U.S. dollar in 1934 and the Swiss franc in 1936) in the period from the end of World War I to 1971. Switzerland also maintained a very low rate of inflation by international standard. During the 1950s, the increase in consumer prices averaged 1 percent per annum. With the strong expansion in economic activity, prices accelerated to an annual rate of 3 percent during the 1960s and 4 1/2-5 percent in the period 1970-84, closely following the rate of inflation in Germany, but still low compared to other industrial countries (Chart 1).

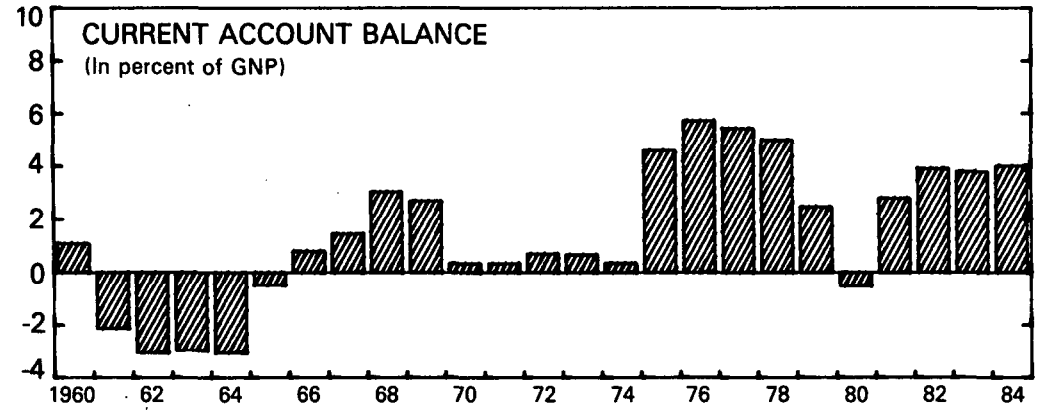
1/ Swiss neutrality as it exists at present developed through centuries. It was recognized formally by the European powers in the Vienna Congress (1815).

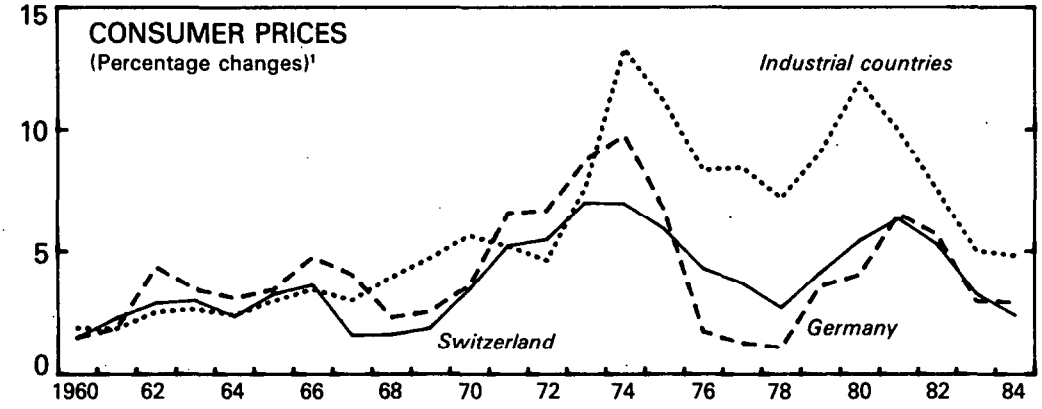
2/ In 1952, German firms which had their assets held in Switzerland confiscated were indemnified.

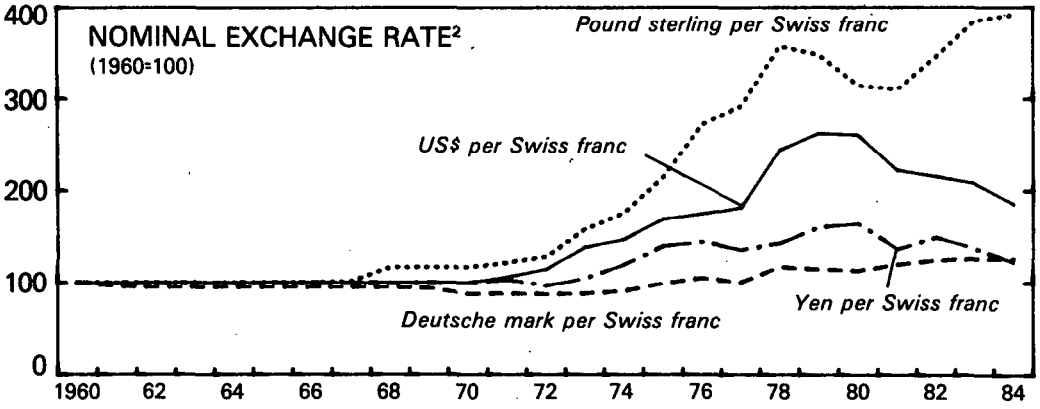
CHART 1

SWITZERLAND

ECONOMIC INDICATORS







Source: IMF, *Data Fund.*

[1]Compared to the same period of the preceding year.

[2]An increase (decrease) in the index indicates appreciation (depreciation) of the Swiss franc.

Since the early 1960s, international financial transactions have expanded strongly, with the convertibility of major currencies and liberalization of capital movements. In periods when monetary conditions at home and abroad differed considerably, Switzerland experienced substantial inflows of foreign capital which exerted an upward pressure on the Swiss franc. Political factors also accounted for occasional strong capital inflows. This was the case after the Suez crisis when Egypt's accounts in the United Kingdom and in the United States were temporarily frozen and again in the wake of the first major oil price increase in 1974 and the crisis in Iran in the late 1970s. Despite several attempts to discourage capital inflows the monetary authorities frequently had difficulties in controlling domestic liquidity without allowing a sharp appreciation of the Swiss franc (Chapter III).

Since the early 1980s, however, international capital flows have not been seriously in conflict with domestic policy aims. This is possibly explained by the sharp tightening in monetary policy in the United States and in other countries, which has permitted the Swiss authorities to pursue a monetary policy aimed at securing price stability without threatening external competitiveness (Charts 2 and 3). The high return on U.S. dollar and other foreign exchange assets is possibly also the explanation why the international debt crisis in the early 1980s led to an increase in foreign exchange denominated deposits with Swiss banks (especially fiduciary deposits) rather than Swiss franc deposits, thereby leaving the exchange rate unaffected (Chapter III).

b. Conditions for development as an international financial center

The history of Switzerland as an international financial center highlights some of the factors which have been important to its development. First, the Swiss economy has been characterized by political stability and a good economic performance in terms of a low rate of inflation, high standard of living, and sound government finances compared to other industrial countries. These factors have boosted confidence in its financial markets. Similar conditions have contributed to the development of other international financial centers, such as Singapore.

Second, Swiss capital exports developed because domestic savings exceeded domestic needs. Although a surplus on the external current account is not a necessary condition for a country to become an international financial center, it is certainly a boosting factor. Switzerland continues to have a high savings propensity compared to other industrial countries such as Germany, the United Kingdom, and the United States. During the last two decades, both the gross and net savings ratios in Switzerland have been exceeded only by that in Japan and have been substantially above that in Germany, the United Kingdom, and the United States (Chart 4). Among industrial countries, the current account surplus of Switzerland in 1984 (US$4 billion) was

exceeded only by that of Japan (US$35 billion), Germany (US$6 1/2 billion), and the Netherlands (US$5 billion). During the fixed exchange rate system which prevailed until 1973, current account surpluses and capital inflows resulted in massive exchange rate intervention by the Swiss National Bank which led to a strong official reserve position of Switzerland. The valuation of gold plays an important role for the ranking of countries. With gold valued at SDR 35 per ounce in all countries, official reserves of Switzerland (SDR 18 1/2 billion) were the seventh largest in the world at end-1984. But with gold valued at market value in all countries, official reserves of Switzerland (SDR 45 billion) were exceeded only by those of the United States (SDR 116 1/2 billion), Germany (SDR 74 1/2 billion), and France (SDR 50 billion). 1/

Third, the existence of a universal banking system in Switzerland has given Swiss banks a competitive advantage over countries in which specialized banking has prevailed. This is partly related to the federal structure of the country, which makes it important that banks in every canton and municipality are able to perform all kinds of banking transactions. The principle of universality was adopted in the Swiss Banking Law of 1934 at a time when a worldwide bank crisis induced other countries to impose restrictions on banking activity. For example, the 1933 Banking Act in the United States separated commercial banks from investment banks. In Europe, the Banking Law of 1935 introduced in Belgium prohibited banks from acting as both deposit banks and holding companies; in Italy, the Banking Law of 1936 drew a distinction between short- and long-term credit institutions. In addition to Switzerland, universal banking systems exist in Denmark, Germany, Luxembourg, and the Netherlands.

Fourth, the geographical position of Switzerland in the heart of Europe has played an important role. It was no coincidence that the first Swiss banking centers emerged in Geneva and Basle close to France and Germany. In addition, the use of three main European languages (French, German, and Italian) has also facilitated international banking. The hard working mentality of the Swiss people has also been a factor. Working hours in Switzerland continue to be high by comparison to other industrial countries.

Finally, the financial markets in Switzerland have benefited from the existence of bank secrecy. The purpose of bank secrecy is to protect banks' clients from misuse of confidential information relating to their financial transactions. Bank secrecy is not unique to Switzerland. However, bank secrecy is more protective in Switzerland

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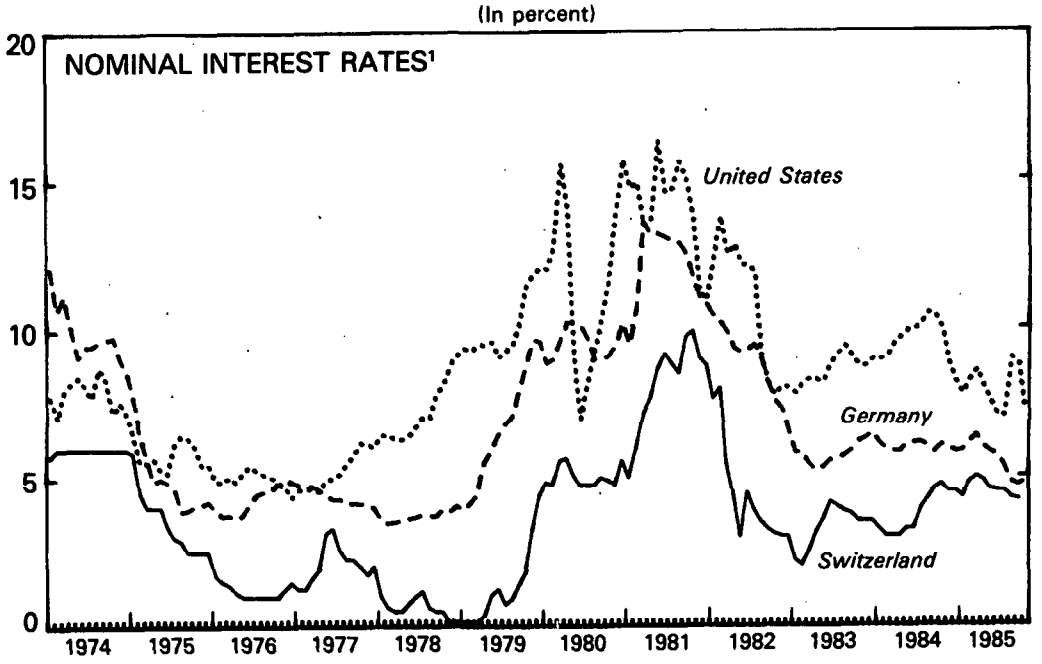
1/ IMF, International Financial Statistics; foreign exchange reserves include foreign exchange from swaps with the private banks. The market price for gold in London in 1984 on average (US$360 per fine ounce) has been used to calculate the value of gold holdings at end-1984.

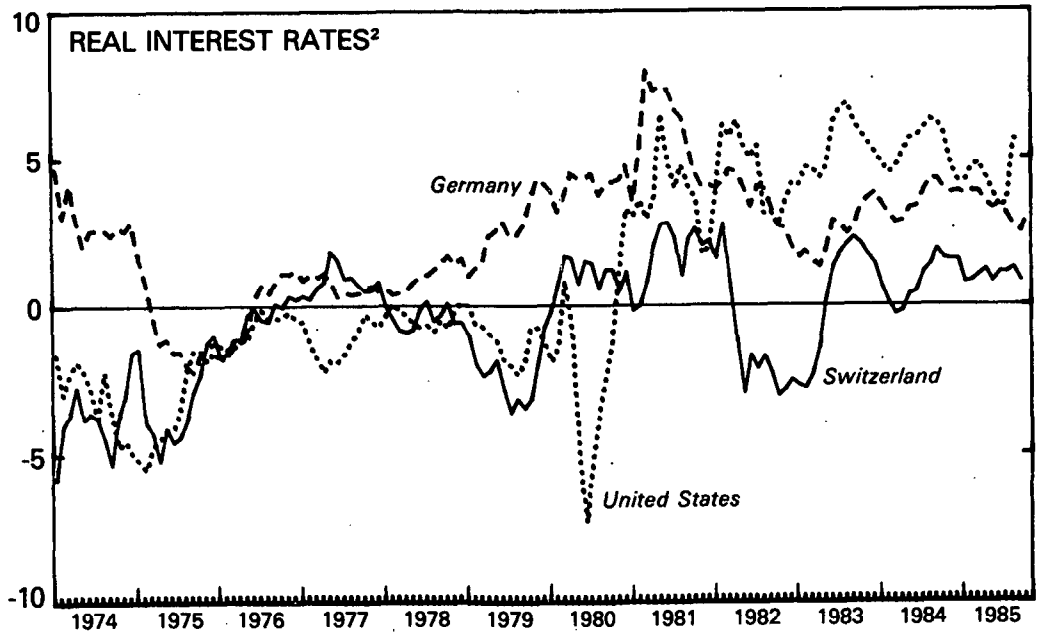
CHART 2

SWITZERLAND

NOMINAL AND REAL SHORT-TERM INTEREST RATES

(In percent)





Sources: IMF, *Data Fund;* and staff calculations.

[1]For Germany, 3-month interbank rates; for Switzerland, 3-month deposit rates with the big banks; for the United States, 3-month Treasury Bills.

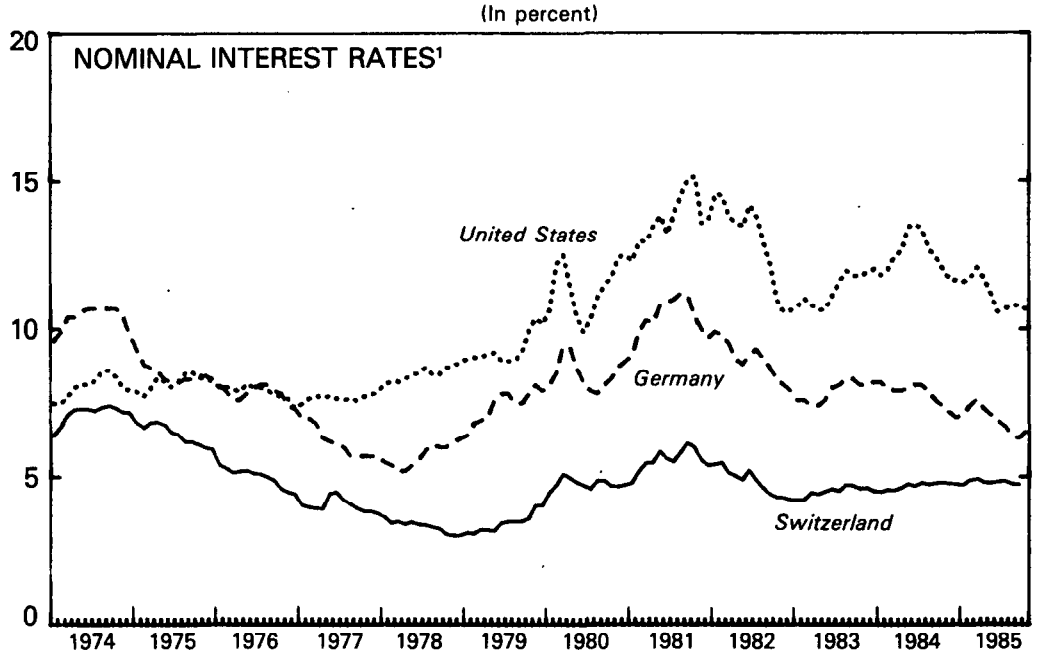
[2]Deflated by the increase in the consumer price index in a month compared to the same period of the preceding year.

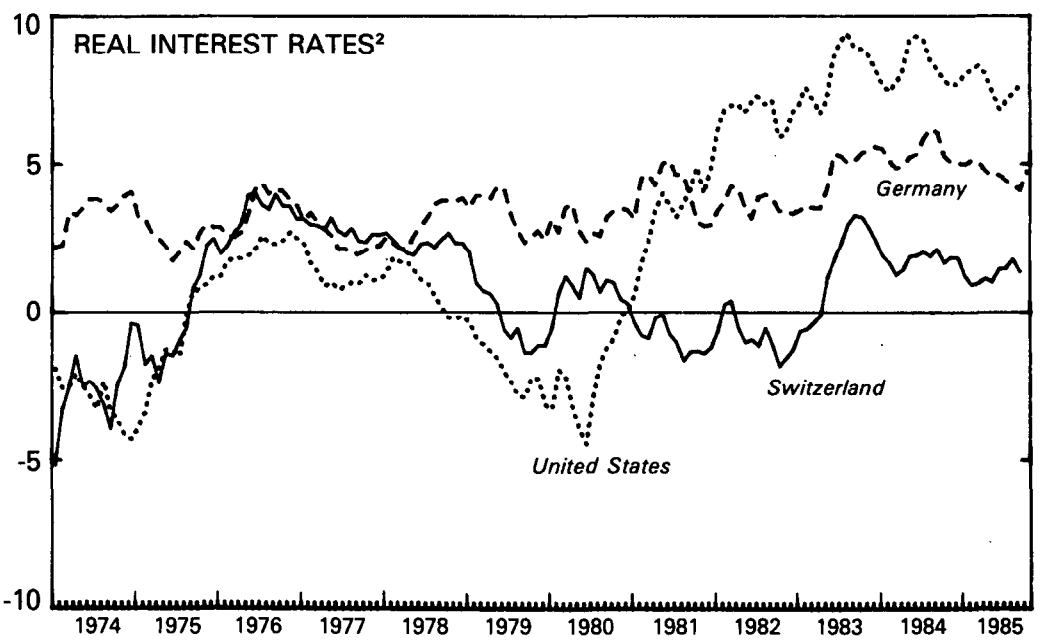
CHART 3

SWITZERLAND

NOMINAL AND REAL LONG-TERM INTEREST RATES

(In percent)





Sources: IMF, *Data Fund;* and staff calculations.

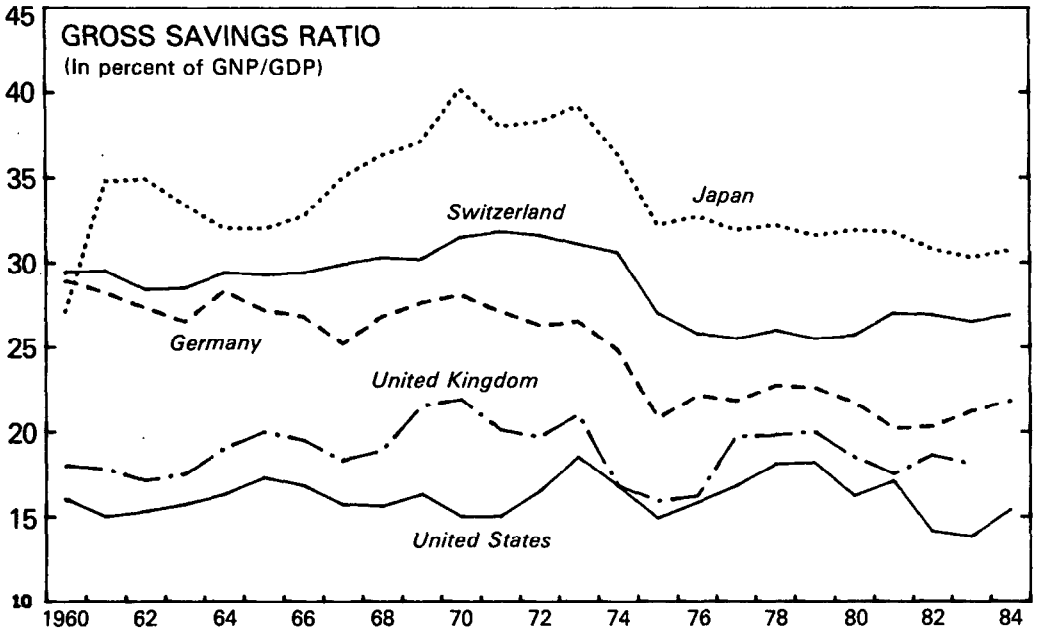
[1]Public bond yields.

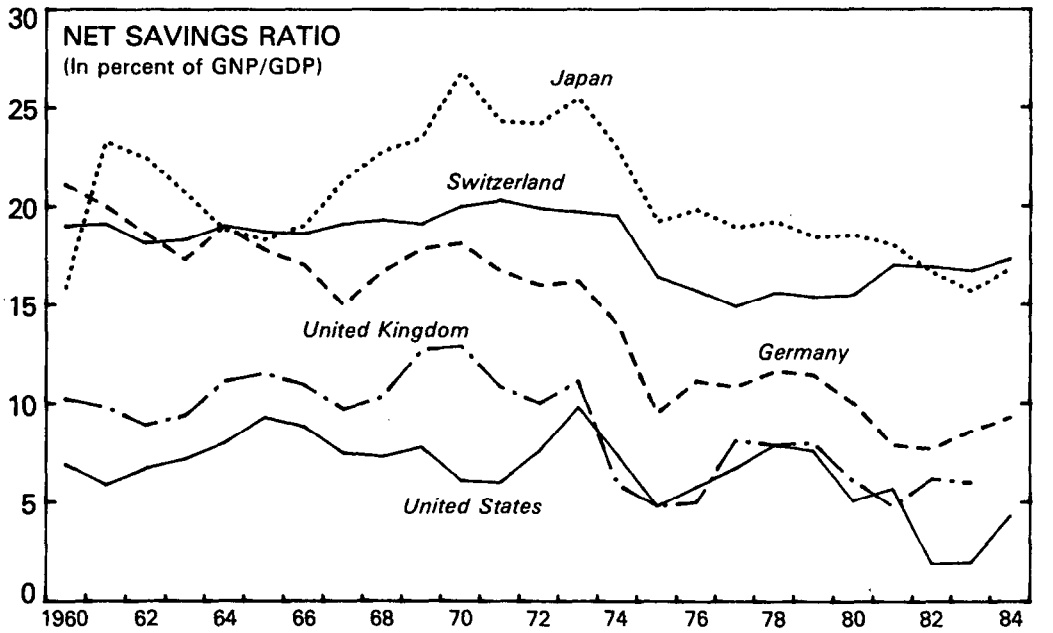
[2]Deflated by the increase in the consumer price index in a month compared to the same period of the preceding year.

CHART 4

SWITZERLAND

GROSS AND NET SAVINGS RATIOS[1]





Source: OECD, *National Accounts Statistics.*

[1]Net savings equal gross savings less depreciation.

than in most other countries. 1/ It differs in two major aspects. In the first place, the Banking Law prescribes severe penalties for breach of bank secrecy. 2/ Just as with violations of official secrecy, breach of banking secrecy is prosecuted ex officio by law, while violations of other professional secrecies (e.g., medical doctors, attorneys, and priests), are prosecuted only upon request of the injured party. In most other countries, bank secrecy is protected only by civil law; in a few cases (such as Austria, France, and the Netherlands) where breaches of bank secrecy are also prosecuted under criminal law, softer sanctions apply and prosecution is not ex officio.

In the second place, although banks are in certain cases obliged to provide information to the public authorities on clients' accounts, such requirement applies only to cases where criminal acts as defined under Swiss law are being investigated. For violations of domestic or foreign fiscal and foreign exchange laws, bank secrecy can be lifted and international judicial assistance granted under Swiss law only when fraud is involved. This is not possible for tax evasion which, although subject to administrative sanctions, is not prosecuted at criminal level in Switzerland. The legal treatment of tax evasion, however, is to be interpreted in connection with the 35 percent witholding tax on capital earnings, which limits the scope for tax evasion.

Bank secrecy and the rules for providing information to the authorities in case of criminal offense or inheritance apply equally to "numbered" and other accounts. However, "numbered accounts" differ from other accounts in the respect that the identity of the owner is known to fewer people within the bank. It is estimated that less than 10 percent of Swiss banking accounts are "numbered accounts." 3/ "Numbered accounts" are not a feature specific to the Swiss banking system but are applied also in countries such as Austria, Belgium, the Cayman Islands, France, Hong Kong, Luxembourg, and Singapore. In some of these countries, "numbered accounts" are truly anonymous in the sense that the identity of the account holder is not disclosed to the bank.

In recent years, Swiss bank secrecy has come under attack from abroad in connection with "insider trading" violations. The Securities and Exchange Commission (SEC) in the United States has demanded information from Swiss banks about their customers in order to investigate cases of insider trading. However, according to present

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1/ Since 1981, when a new law on bank secrecy took effect in Luxembourg, the regulations concerning bank secrecy in Luxembourg and Switzerland have been almost identical. However, in cases of inheritance, the Luxembourg banks are not allowed to disclose information on foreign-owned accounts to heirs, by contrast to Swiss banks.

2/ Violators may be punished by a prison term up to six months and a fine of up to SwF 50,000.

3/ Meier, Henri B., Swiss Capital Markets, 1983.

Swiss law, insider trading is not a criminal offense. Therefore, the bank secrecy could not be lifted and judicial assistance granted to foreign authorities. In retaliation, the SEC threatened to bar certain Swiss banks and their customers from the U.S. securities market. Consequently, in 1982 a compromise was reached, whereby the Swiss banks signed a Convention ("Convention XVI") specifying certain procedures to be followed. According to this Convention, a request by the SEC for information on a bank's customer in connection with insider trading investigations will be considered by a specially appointed Commission comprising Swiss citizens, who are independent of banks. The banks provide information to this Commission on customers' transactions, and if the case fulfills certain criteria, information will be forwarded to the SEC with the possibility of blocking the accounts in question. The "Convention XVI" is meant to be only a transitory solution. On May 1, 1985, a proposal was made by the Swiss Federal Government to Parliament concerning an amendment of the criminal law according to which insider trading would become a criminal offense. Such an amendment would enable the Swiss authorities to grant judicial assistance to foreign countries provided that the conditions mentioned in the bilateral treaties or the Federal Law concerning International Mutual Assistance in Criminal Matters are met.

2. The structure of the banking system

The Swiss banking system is characterized by the coexistence of privately and publicly owned banks. The publicly owned banks include the cantonal banks, which are owned by the cantons, as well as local savings banks, which are run with the capital of the municipalities. These public institutions accounted for about 16 percent of the total assets of Swiss banks at the end of 1984. The private banks are organized mainly as joint-stock corporations or as cooperatives. Although Swiss banks are organized as universal banks, the historical development has led to some specialization. Cantonal banks, regional banks, and savings and loans associations have specialized in savings deposits and long-term mortgage lending, while the so-called "big banks" 1/ have concentrated in company finance and international finance. However, during the last two decades, there has been a tendency for banks to engage in a broader field of transactions; the big banks have engaged more actively in mortgage lending through prolif-

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1/ The "big banks" in Switzerland, as defined in the Swiss banking statistics, consist of five banks. Three banks (Crédit Suisse, Swiss Bank Corporation, and Union Bank of Switzerland) clearly have the character of large, universal banks, while two others (Bank Leu and Swiss Volksbank) are smaller and engage in more limited activities.

eration of their domestic bank network, while the cantonal and regional banks have participated increasingly in portfolio management. 1/

Since World War II, a concentration has taken place in Swiss banking, as the big Swiss banks and foreign-owned banks have expanded at the expense of other banks. The main expansion occurred during the 1960s, when international operations grew strongly but the trend has continued through the 1970s and the early 1980s. Measured on the basis of both assets and fiduciary assets, 2/ the big banks increased their share in banking transactions from 42 1/2 percent in 1974 to 47 percent in 1984 (Chart 5). During the same period, foreign-controlled banks and finance companies expanded from 14 percent to 23 percent of the total. The gains in market shares of the big banks and foreign banks relative to "other banks" mirror the much more rapid expansion in international, compared to domestic, transactions.

Most foreign banks were established during the 1960s, when Switzerland gained importance as an international financial center (Chart 6). They comprise three major groups: (i) banks with more than 50 percent foreign ownership, (ii) finance companies, and (iii) branches of foreign banks in Switzerland. The establishment in Switzerland of foreign banks is permitted on a fairly liberal basis on condition that (i) the principle of reciprocity applies, i.e. that Swiss banks have equal access to establishment in the country of the foreign parent bank, (ii) the foreign banks comply with the Swiss Banking Law and rules and regulations of the central bank, (iii) the name of the foreign bank does not imply a Swiss character. 3/ In recent years many Japanese banks have established themselves in Switzerland. This has partly occurred through opening of branches but especially through finance companies (around 20 Japanese finance companies at end-1984). Finance companies in Switzerland are--by contrast to similar institutions in Japan--allowed to participate in underwriting of bond issues and in portfolio management.

The increasing importance of foreign banks, finance companies and branches of foreign banks has become especially evident in international transactions. They accounted for 37 1/2 percent of total foreign assets and fiduciary assets by end-1984 compared to 31 1/2 percent at end-1974 (Chart 5). During the same period, the big Swiss banks registered a

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1/ Many cantonal banks are prohibited from engaging actively in international finance by cantonal laws.

2/ Fiduciary accounts are explained in Section 4a (2) below.

3/ At end-1984, the Federal Banking Commission reported that reciprocity was guaranteed by the following countries and states: Austria, Belgium, Canada, Denmark, France, Germany, Hong Kong, Israel, Italy, Japan, Lebanon, Luxembourg, the Netherlands, Spain, the United Kingdom, and in the United States: the States of California, Connecticut, Florida, Illinois, Indiana, New York, Ohio, Pennsylvania, and Wisconsin.

decline in market shares of foreign business from 58 percent to 52 1/2 percent, while the share of "other banks" was almost unchanged at 10-11 percent.

With respect to the currency denomination of banks' external transactions, at end-1984, 21 percent of total external assets and fiduciary assets of Swiss banks were expressed in Swiss francs, of which, external assets accounted for 17 percentage points and fiduciary accounts 4 percentage points. The remainder, 79 percent, was denominated in foreign exchange, equally divided among external assets and fiduciary assets. The Swiss franc share of external assets has been very stable over the last decade (Chart 6).

3. Bank supervision

The Swiss banking system is supervised by the Federal Banking Commission, which is independent of both the Swiss National Bank and the Federal Government. 1/ A characteristic of the Swiss banking supervision is the fact that the Federal Banking Commission--although legally entitled to audit the banks directly--in practice has delegated this responsibility to external auditors. 2/ Similar systems are applied in a few other countries. For instance, in Belgium, each bank appoints two external auditors, one selected by the general assembly of shareholders and the other by the Banking Commission to provide information to that organization. In Germany, external auditors are obligated to report irregularities to the Supervisory Office which may also insist on the appointment of a special auditor. In many other countries, however, e.g., Italy, Japan, and the United States, direct inspection by the supervisory authorities are carried out with no formal contacts with banks' auditors. The United Kingdom constitutes an exception, inasfar as supervisors both refrain from inspecting directly and also from relying formally on banks' external auditors, which are under no obligation to furnish information to the supervisory body.

All banks which are located in Switzerland are subject to supervision. The same applies to foreign-owned banks. However, since July 1984--in line with recommendations by the Cooke Committee--branches of foreign banks are not subject to Swiss capital requirements, if the

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1/ Separate supervisory organizations exist also in Belgium, Canada, France, Germany, and Sweden. The central bank has the responsibility for bank supervision in Italy, the Netherlands, and the United Kingdom, and in Luxembourg, the monetary institute (in the absence of a central bank) exercise supervision. In Japan, bank supervision is divided between the central bank and the Ministry of Finance, which has the formal responsibility. In the United States, bank supervision is shared between federal and state authorities, the Federal Reserve System, and special federal agencies.

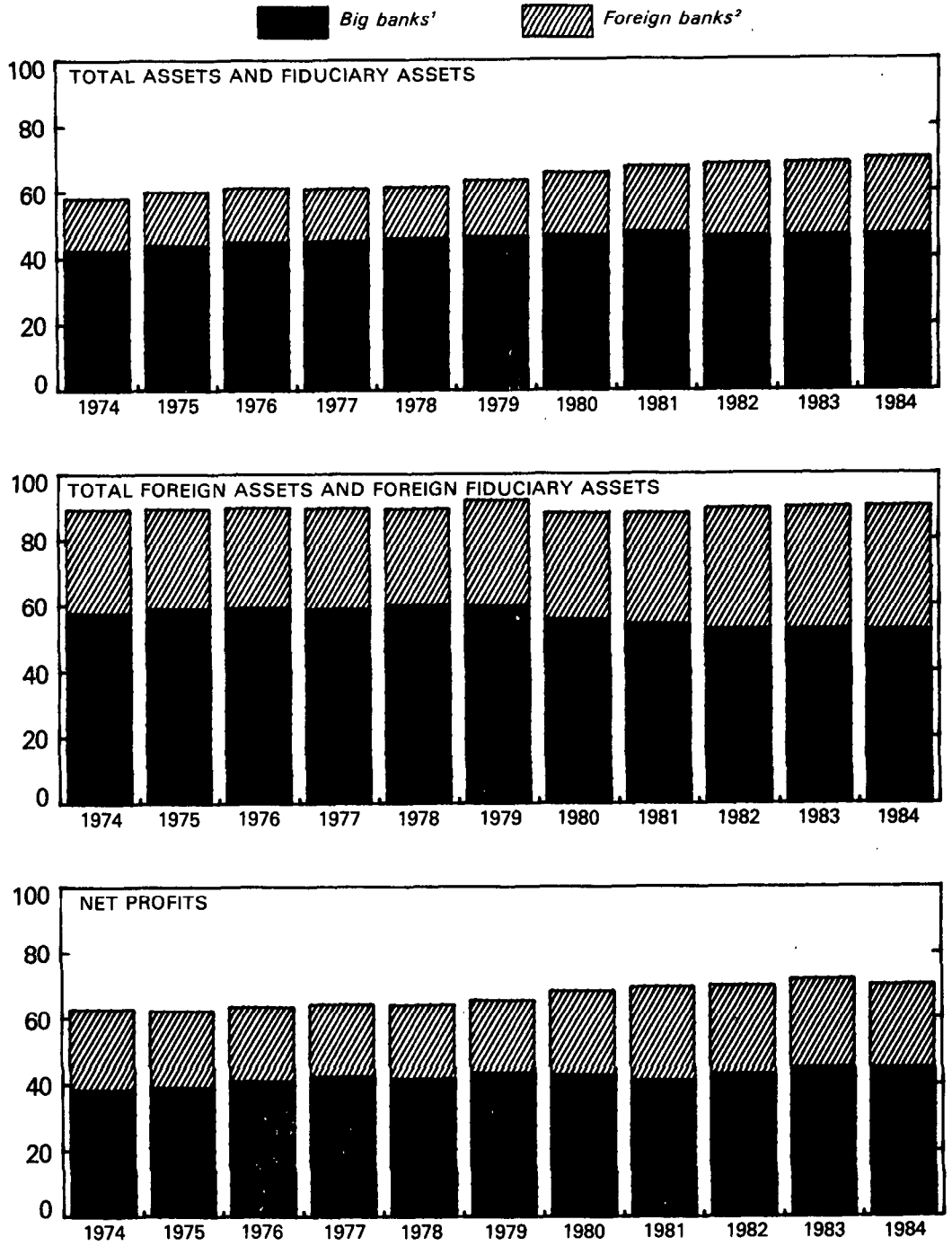
2/ Federal Banking Commission, 50 Jahre Eidgenössische Bankenaufsicht, 1985.

CHART 5

SWITZERLAND

MARKET SHARES IN BANKING

(In percent)



Source: Swiss National Bank, *Das Schweizerische Bankwesen.*

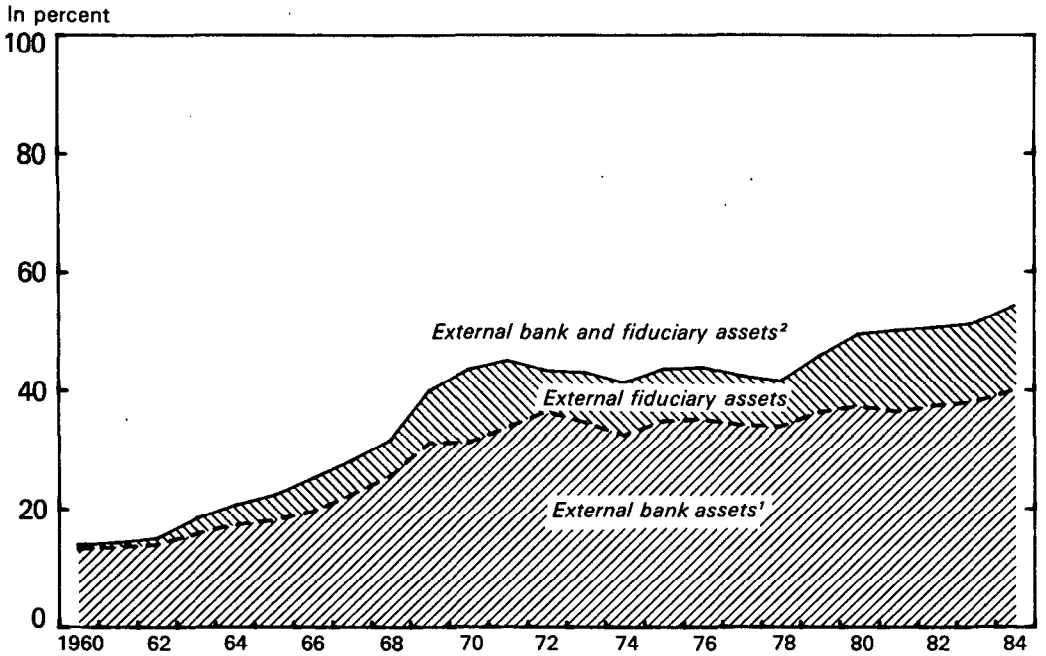
[1]Big five banks.

[2]Foreign-controlled banks in Switzerland, foreign-owned finance companies, and branches of foreign banks in Switzerland.

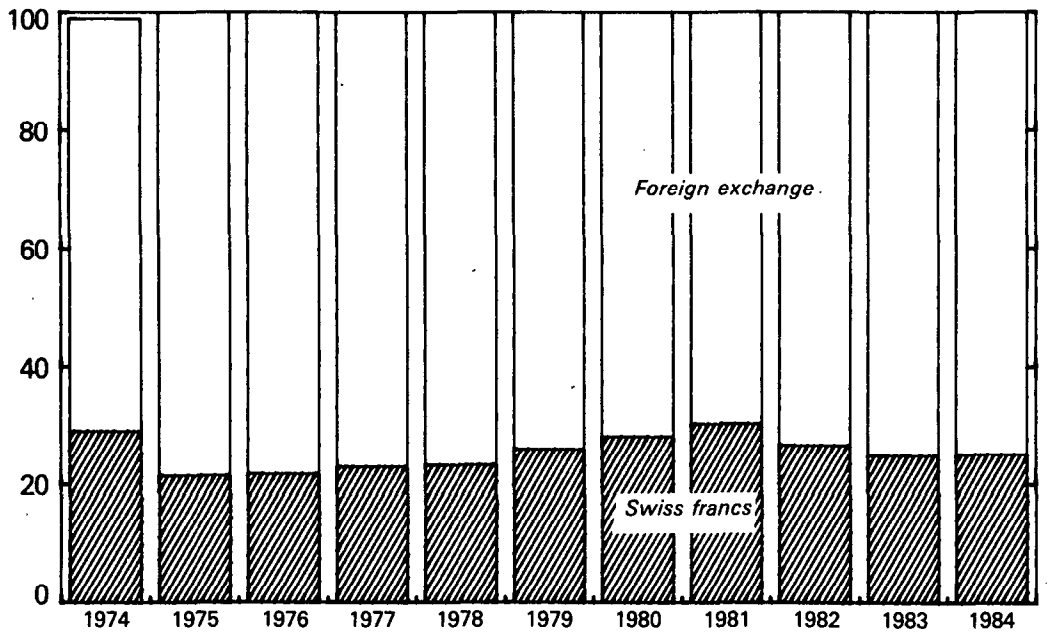
CHART 6

SWITZERLAND

EXTERNAL ASSETS AND FIDUCIARY ASSETS OF BANKS



CURRENCY DENOMINATION OF EXTERNAL ASSETS AND FIDUCIARY ASSETS



Source: Swiss National Bank, *Das Schweizerische Bankwesen.*
[1]External assets in percent of total bank assets.
[2]External bank and fiduciary assets in percent of total bank and fiduciary assets.

country of the parent bank exercise surveillance of the banks located in Switzerland. With respect to liquidity, however, branches of foreign banks are obliged to place at least 10 percent of their assets in Switzerland. Bank supervision applies also to finance companies if they solicit deposits in public. In practice, however, among the 110 finance companies which presently engage in capital exports, only 4 are subject to the Banking Law and banking supervision, among them no foreign-owned company. With the rapid increase in the number of finance companies in recent years, this exception to bank supervision has gained in importance.

In December 1980, the Swiss Banking Law was amended so as to link more closely the capital requirements to the specific asset portfolio of banks. In Switzerland, the so-called weighted capital/risk asset approach is applied which differentiate capital requirements according to the risk associated with various assets. An alternative approach is the capital/asset requirement which relates capital requirements to the total balance sheet without regard to the difference in the riskiness of assets. In most European countries, a capital/risk asset approach is used. In the United Kingdom, a combination of both requirements is applied. In Germany, however, a capital/asset requirement is in force. In Japan, the capital requirement does not apply to total bank assets but only to foreign assets. In the United States, there exists a capital/assets requirement, which varies according to the size of the banks; bank supervisors, however, judge the adequacy of banks' capital by using a capital/risk asset approach.

The revision of the Banking Law in 1980 in Switzerland also introduced the principle of consolidated balance sheets for capital requirements. The consolidation is to encompass all banks and subsidiaries in Switzerland or abroad, in which the parent bank holds at least 50 percent of the capital or exercises a controlling influence in some other manner. The principle of consolidation also applies to the rules for maximum exposure to a single customer. Switzerland was one of the first countries which applied consolidated balance sheets to capital requirements.

Capital is defined to include (1) paid-in capital, (2) published reserves, (3) a portion of hidden reserves (if set aside on particular account), and (4) certain subordinated loans. 1/ The actual capital ratios have normally exceeded the required ones:

1/ At end-1984, the composition of banks' capital was: 37 percent as paid-in capital, 45 percent as published reserves, 13 percent as hidden reserves, and 5 percent as subordinated loans.

Capital Ratios for Swiss Banks 1/

(In percent of total assets)

	1981		1982		1983		1984	
	Required	Actual	Required	Actual	Required	Actual	Required	Actual
Big banks	7.0	7.4	6.7	7.3	6.7	7.1	6.8	7.1
All banks	6.4	7.5	6.2	7.5	6.2	7.3	6.3	7.4

Source: Swiss National Bank, Das Schweizerische Bankwesen.

1/ Nonconsolidated basis.

The capital ratios in Switzerland both on a capital/asset basis and a weighted capital/risk asset basis are among the highest in industrial countries. However, international comparisons of these ratios are difficult because of different compositions of asset portfolios and difficulties in evaluating the riskiness of various assets. Moreover, the definitions of equity and reserves and the application of consolidation of balance sheets and of hidden reserves vary among other countries. 1/

In the case of Switzerland, the Banking Law provides for the creation of hidden reserves, which goes beyond the practice in most other countries. The actual capital ratios for Swiss banks are therefore probably much higher than disclosed in the above-mentioned figures. While the creation and use of hidden reserves are not known to the public, the Banking Commission receives information from the banks about such transactions. Hidden reserves serve as a buffer against unexpected losses which can be absorbed without appearing in the publicized bank balances. This has the advantage of preventing a decline in customers' confidence and--in severe cases--a run on the bank. However, it also conflicts with the objective of providing an accurate picture of a bank's performance during an accounting period. In the early 1980s, the Swiss news media reported on substantial losses by specific banks, which were never reflected in the banks' balance sheets. In December 1981, however, the Banking Commission in a circular to the banks revoked the right of the banks to use hidden reserves to

1/ IMF, Publication of Occasional Paper on International Capital Markets, Developments and Prospects, SM/85/332, 12/6/85.

cover losses without limitation. Since then, the use of hidden reserves to camouflage losses of a bank has been restricted. 1/

The Swiss banks are obligated to make capital provisions for certain contingent liabilities and off-balance sheet transactions, such as open positions in foreign currency (10 percent) and precious metals (20 percent) as well as guarantees and floating rate liabilities. However, no provisions are required for portfolio management and underwriting obligations which also entail risks. 2/ Capital requirements do not apply to fiduciary accounts. Because the Swiss Banking Law is phrased in terms of general principles rather than detailed rules, innovations in financial markets have not given rise to an immediate need for a revision of the Banking Law, as has been the case in some other countries.

The Federal Banking Commission has refrained from imposing limits on country exposure in banks' international lending. The Commission's position is that country risks should be assessed individually by the banks and that each bank should take the responsibility for its lending policy. Nevertheless, with the emergence of the international debt crisis in the early 1980s, the monitoring of country risks has increased. At the end of 1982, the Commission requested banks to provide detailed country breakdown of their international transactions and information on their write-off practices and risk provisions for countries identified by the Banking Commission as problem countries. On this basis, it required that banks, in addition to regular capital requirements, made 20 percent provisioning for those problem countries (Chapter III).

4. International capital transactions

a. Short-term transactions

(1) Money market transactions

The international money market transactions of Swiss banks serve partly as a substitute for a domestic money market and partly as a connection between the various segments of domestic and international financial transactions, including the Euro-Swiss franc market. The domestic money market is characterized by its thinness in terms of limited money market instruments and few participants. The lack of a developed money market is mainly attributable to fiscal impediments, especially the stamp duty which amounts to 0.15 or 0.30 percent--independent of maturity--depending on whether the debtor is a resident

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1/ Federal Banking Commission, "50 Jahre Eidgenössische Bankenaufsicht, 1985.

2/ Lusser, Markus, Die Geld -und Kapitalmärkte in einer Zeit raschen Wandels, April 1985.

or a nonresident, respectively. 1/ This is a prime reason for the of short-term instruments and for the fact that existing paper is often held to maturity. The existence of the stamp duty is also one of the reasons why less than 15 percent of the marketable debt of the Federal Government consists of short-term liabilities; there exists no market for Treasury bills like in many other countries. In addition, Swiss banks have not issued certificates of deposits to attract funds, in part because of resistance, in the past, from the Swiss National Bank which has feared that this instrument would compete with savings deposits with low interest, thereby raising the overall level of banks' costs. Furthermore, Swiss industry has covered their short-term financing needs through bank credits rather than through commercial paper. Finally, export and import financing have normally not been associated with issuance of bankers' acceptances, partly due to the stamp duty but also in order to protect customer relationships. 2/

In the absence of domestic short-term paper, Swiss banks have invested surplus funds abroad. The bulk of interbank transactions of Swiss banks is with foreign banks (78 percent of assets and 53 percent of liabilities at end-1984). The smaller Swiss banks typically adjust their liquidity position through the big banks which, together with foreign banks in Switzerland, are the main transactors on the international money market.

(2) Fiduciary accounts

Fiduciary accounts constitute an increasingly important element of short-term transactions of Swiss banks and especially of external transactions. They accounted for 24 percent of total assets and fiduciary assets (domestic and external) and for 44 percent of total external assets and external fiduciary assets at the end of 1984. They emerged during the 1960s and grew particularly rapidly after the second oil price shock with the emergence of sizeable OPEC funds. In the period between end-1979 and end-1984, foreign fiduciary assets grew by 24 percent per annum in Swiss franc terms compared to 14 percent per annum of banks' external assets.

Fiduciary accounts are off-balance-sheet deposits and loans of a bank for the account of and at the risk of the customer with respect to the currency, transfer and credit risk. To qualify for preferential fiscal status (exemption from withholding tax), a written contract between the bank and the customer has to exist. The maturity of deposits is normally 1-3 months, but, in practice, the deposits are

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1/ This implies an annualized interest cost of, for instance, 0.6 or 1.2 percent for transactions of 3 months' maturity, and 8.1 or 16.9 percent for transactions of one week's maturity, when the debtor is a resident or nonresident, respectively.

2/ Corti, Mario, Switzerland: Banking, Money, and Bond Markets, 1983.

often rolled over so that they resemble medium-term placements. The banks perform no maturity or currency transformation but act solely as intermediaries, especially in the international money market. Notwithstanding the fact that the customer carries the full risk of a fiduciary transaction, the customer does not always know where the funds are placed. Equally, if the funds are placed with a foreign bank that bank is usually not aware of the underlying fiduciary transaction but considers it a normal transaction with a Swiss bank.

Fiduciary accounts are mainly denominated in foreign currencies (especially U.S. dollars) and the bulk of the customers are nonresidents, although Swiss residents are free to hold fiduciary assets (also without witholding tax) and receive fiduciary loans. At the end of 1984, 90 percent of all fiduciary accounts were denominated in foreign currencies (68 percent in U.S. dollars) and the remainder in Swiss francs. At the same time, 84 percent of banks' fiduciary liabilities and 99 percent of their fiduciary assets were against nonresidents.

The advantages for the customer of fiduciary deposits are (1) the exemption from the 35 percent withholding tax which apply to domestic deposits, (2) small bank fee, (3) the discrete character of fiduciary operations compared to a direct placement in the international money market, and (4) the higher return available on Eurodeposits compared to domestic deposits. These benefits, however, have to be weighed against the risk associated with a fiduciary account compared to a bank deposit. The risks are two-fold; the depositor has the full risk associated with the bank where the fiduciary deposits is redeposited abroad. In addition, the depositor has the risk with the Swiss bank, where the deposit is placed because the foreign bank which holds a liability against a Swiss bank does not distinguish it from any other liability against that bank and therefore might use that liability to cover outstanding claims against the Swiss bank, in case of default of the Swiss bank. For the Swiss banks, the advantages of fiduciary accounts are (1) a commission of 0.25-0.5 percent per annum, (2) no risks and, consequently, (3) no liquidity or capital requirements.

From an economic point of view, the fiduciary business is close to other bank transactions, where the banks act as pure intermediaries. They affect capital movements in the same way as other bank transactions. If the Swiss banks act solely as intermediaries between two nonresidents, no net capital movements take place in Switzerland. In practice, however, Swiss residents have been providing funds for fiduciary lending to nonresidents, giving rise to capital outflows, cumulating to SwF 34 billion by end-1984. For the Swiss economy as a whole, the fiduciary business results in current receipts (commissions) from abroad amounting to SwF 1/2-1 billion per annum (1/4-1/2 percent of GNP) (estimated by the staff on the basis of outstanding fiduciary accounts at end-1984). To the extent that only nonresidents are involved, the fiduciary transactions imply no risk to the Swiss economy. However, the legal issues involved are rather complex.

Suppose, for instance, that Swiss banks although not legally obliged, are de facto willing to cover a default connected to placements abroad. In this case, fiduciary transactions should be included in liquidity and capital requirements. There is no disclosed information about any default of a fiduciary business and the Swiss banks' response to it. Another issue which has been of relevance in recent years is the treatment of fiduciary business in negotiations about "new money" to debtor countries. Swiss banks have argued that fiduciary accounts should not be included in calculations of the Swiss banks' share in package deals, despite the fact that to foreign banks there is no difference between a balance sheet transaction and a fiduciary transaction of a Swiss bank.

b. Medium and long-term transactions

(1) General characteristics

The comparative advantage of Swiss financial markets in international transactions has traditionally been in medium- and long-term operations, particularly public bond and note issues. 1/ The importance of Swiss markets derives, in part, from the substantial placing power of Swiss banks both with private and institutional Swiss investors associated with the high domestic savings ratio and with foreigners who rely on Swiss banks for portfolio management. For borrowers, the low nominal interest rate on Swiss franc issues, compared to issues in U.S. dollars, deutsche mark, Netherlands guilders, and pound sterling has also been attractive, although the exchange rate appreciation of the Swiss franc wiped out any interest rate advantage during the 1970s. A low nominal interest rate for an appreciating currency might be attractive to a borrower compared to a high nominal interest rate for a currency with a tendency to depreciate because of the reduced liquidity requirement, insofar as the appreciation of the currency is reflected in payments--other than interest--only at the time of redemption of the loan. In this respect, it resembles an indexed liability.

Bond issues denominated in Swiss francs constitute a significant proportion of the international bond market. In 1984, they accounted for 47 percent of all recorded foreign bond issues in the world, thereby being the most important currency of denomination for these issues (Table 1). The share of Swiss franc issues in total international bonds, which comprise both foreign bonds and Eurobonds, amounted to 12 percent in 1984 with the Swiss franc being the second most important currency of denomination after the U.S. dollar which accounted for 63 1/2 percent of international bond issues. The value of Swiss franc issues was roughly twice the value of issues denominated in each deutsche mark, pound sterling, and yen and about three times the value

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1/ The difference between public bond issues and notes is explained in Sections (2) and (3) below.

Table 1. International Bond Issues

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
	(In millions of U.S. dollars)										
Eurobonds	3,396	8,743	14,705	18,724	14,961	18,691	20,394	31,294	50,329	50,098	81,717
U.S. dollar	1,991	3,379	9,390	11,573	6,767	10,360	13,649	25,761	42,228	39,205	65,334
Deutsche mark	639	2,918	2,789	5,219	6,478	5,881	3,457	1,396	3,253	4,042	4,324
Pound sterling	24	--	--	221	287	291	975	535	846	2,153	3,965
Yen	--	10	--	111	79	184	301	410	598	233	1,190
ECU	--	--	--	--	--	--	--	153	823	2,191	2,938
Other	742	2,418	2,526	1,600	1,350	1,975	2,012	3,039	2,581	2,274	3,966
Foreign bonds	5,243	11,217	18,413	16,263	20,713	20,308	17,924	20,514	25,199	27,050	27,801
U.S. dollar	3,587	6,712	10,801	7,868	6,358	4,365	2,709	6,856	6,025	4,735	4,294
Deutsche mark	--	353	1,171	1,407	1,431	2,690	4,951	1,196	2,109	2,618	2,419
Pound sterling	--	33	--	--	--	--	178	911	1,129	859	1,649
Swiss franc	972	3,414	5,381	4,959	7,406	9,718	7,470	8,118	11,325	13,500	13,120
Yen	--	67	226	1,276	4,388	2,671	1,543	2,723	3,317	3,851	4,873
Other	684	638	834	753	1,130	864	1,073	710	1,294	1,487	1,446
Total international bonds	8,639	19,960	33,118	34,987	35,674	38,999	38,318	51,808	75,528	77,148	109,518
	(In percent)										
Foreign bonds	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
U.S. dollar	68.4	59.8	58.7	48.4	30.7	21.5	15.1	33.4	23.9	17.5	15.4
Deutsche mark	--	3.1	6.4	8.7	6.9	13.2	27.6	5.8	8.4	9.7	8.7
Pound sterling	--	0.3	--	--	--	--	1.0	4.4	4.5	3.2	5.9
Swiss franc	18.5	30.4	29.2	30.5	35.8	47.9	41.7	39.6	44.9	49.9	47.2
Yen	--	0.6	1.2	7.8	21.2	13.2	8.6	13.3	13.2	14.2	17.5
Other	13.0	5.7	4.5	4.6	5.5	4.3	6.0	3.5	5.1	5.5	5.2
Total international bonds	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
U.S. dollar	64.6	50.6	61.0	55.6	36.8	37.8	42.7	63.0	63.9	57.0	63.6
Deutsche mark	7.4	16.4	12.0	18.9	22.2	22.0	21.9	5.0	7.1	8.6	6.2
Pound sterling	0.3	0.2	--	0.6	0.8	0.7	3.0	2.8	2.6	3.9	5.1
Swiss franc	11.3	17.1	16.2	14.2	20.8	24.9	19.5	15.7	15.0	17.5	12.0
Yen	--	0.4	0.7	4.0	12.5	7.3	4.8	5.3	4.4	5.0	5.5
ECU	--	--	--	--	--	--	--	0.3	1.1	2.8	3.6
Other	16.4	15.3	10.1	6.7	6.9	7.3	8.1	7.9	5.9	5.2	4.0

Source: OECD, Financial Statistics.

of issues in ECUs (European Currency Units) (Table 1). The share of the Swiss franc increased sharply from 11 1/2 percent of international bond issues in 1974 to a peak of 25 percent in 1979. However, since then the share declined following the strong expansion of Eurobonds denominated in U.S. dollars in recent years.

The Swiss bond market for foreign issues is primarily confined to issues denominated in Swiss francs while Eurobond issues in other currencies are very few. The main reason for limited Eurobond activity in Switzerland is the stamp duty on every security transaction. This stamp duty applies also to transactions of security dealers. Moreover, a large number of investors in bond issues are Swiss residents who have a preference for investments in Swiss francs compared to other currencies. There are no official data on investors in foreign bond issues on the Swiss market but it is estimated by private Swiss banks that more than half of public issues and about half of the notes are placed with Swiss residents. Swiss banks, however, participate actively through their foreign branches in Eurobond trading and issues abroad. 1/

Another feature of the Swiss bond market is that Swiss banks established in Switzerland have, de facto, monopoly in bond issues in Swiss francs as the Swiss National Bank has prevented the emergence of a Eurobond market in Swiss francs for fear of an uncontrolled internationalization of the Swiss franc. Legally, the Bank has not been in a position to prevent foreign banks outside Switzerland from issuing bonds denominated in Swiss francs. In practice, however, the Bank has made its position clear both publicly and directly to foreign banks which have considered to issue Swiss franc bonds or bonds with a Swiss franc link abroad. As long as the operations in Swiss francs remain in Switzerland, the central bank is in a position to supervise and, if necessary, to control bond issues. The nonexistence of a Eurobond market in Swiss francs has given Swiss banks a kind of monopoly which has resulted in relatively high fees and commissions for Swiss franc issues compared to issues in other currencies. For instance, the fees and commissions on an 8-year public bond issue in Swiss francs amount to about 3 1/4 percent compared to about 2 percent for a Eurodollar issue with a similar maturity. This difference can probably be attributed to the absence of a Euro-Swiss franc bond market. For note issues in Swiss francs, however, the fees and commissions are similar (1 7/8 percent) to public bond issues in the Eurodollar market.

The competition within the Swiss capital market seems to have increased somewhat in recent years. This is partly due to the removal of capital export regulations and the liberal implementation of the

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1/ In 1984, Credit Suisse First Boston, which is owned, in part, by one of the big Swiss banks, was by far the most dominant lead manager in Eurobond issues, accounting for 16 1/2 percent of the total value of Eurobond issues. In the second and third place, were a U.S. bank and a German bank accounting each for 7 1/2 percent of total issues.

authorization practice of bond issues by the Swiss authorities, including the attitude toward swaps, which have been one of the driving forces in international capital transactions in recent years. As pointed out by the Deutsche Bundesbank in its Monthly Report of July 1985, the liberal authorization practice is evidenced by the fact that gross issues of Swiss franc bonds and notes of nonresident borrowers were twice as many (US$38 billion) as issues of foreign deutsche mark bonds (US$19 billion) in the same period, while Switzerland's GNP was only 15 percent of that of Germany.

Total gross medium- and long-term capital exports which comprise public bonds, medium-term notes and bank credits totalled SwF 40 1/2 billion in 1984 (Table 2). 1/ Capital exports have expanded at an annual rate of 22 percent (measured in Swiss franc terms) during the last decade. While bank credits accounted for the strongest expansion between 1974 and 1981, public issues and, in particular, notes, have grown faster since 1982. This development is partly a result of the relaxation of restrictions on foreign bond issues, especially secondary market trading in notes, since 1982. In addition, the increasing importance of bond issues reflect the general trend in international lending in recent years toward securities rather than bank credits which is, in part, related to the debt crisis of the early 1980s. Another recent development has been the gradual disappearance of the boundaries between the various categories of capital exports. For instance, notes which used to be private placements now resemble public bond issues. Moreover, foreign bond issues comprise an increasing share of banks' asset portfolio. The share of foreign bond issues in total foreign assets of Swiss banks has risen from 4 1/2 percent in 1974 to 8 1/2 percent in 1983. Similar blurring of boundaries between traditional bank lending and capital market transactions is observed in other countries. (BIS, Annual Report, 1985.)

The Swiss capital market has traditionally been accessible only to first class borrowers. Industrial countries accounted for 73 1/2 percent of medium- and long-term capital exports in 1984, while non-oil developing countries made up only 9 percent and state trading countries and OPEC countries together accounted for 3 1/2 percent (Table 2). The emergence of the debt crisis in the early 1980s prompted Swiss banks to adopt a more cautious lending policy, leading to a concentration of lending to industrial countries rather than developing countries. Indirectly, however, developing countries have benefited from the tapping of the Swiss capital market by the development organizations (e.g., IBRD, ADB, and the IDB), which accounted for 14 1/2 percent of medium- and long-term borrowing in 1984.

1/ The figures mentioned in this and the following sections apply to "authorized" medium- and long-term capital exports, which comprise all transactions of SwF 10 million and above of more than 12 months' maturity.

Table 2. Switzerland: Medium- and Long-Term Capital Exports (Authorized) 1/

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1978	1984
	(In millions of Swiss francs)											(In percent)	
By instrument:													
Public issues	1,011	2,490	3,510	3,684	4,430	5,206	5,486	7,575	9,975	10,292	11,150	20.2	27.4
Notes	2,769	7,162	10,483	9,319	8.996	11,319	9,438	11,846	17,709	20,685	19,337	41.1	47.6
Bank credits	1,876	2,482	5,167	5,263	8,464	10,345	8,398	12,784	9,849	9,205	10,137	38.7	25.0
Total	5,656	12,134	19,160	18,266	21,890	26,869	23,322	32,205	37,532	40,181	40,625	100.0	100.0
By borrower:													
Industrial countries	...	...	...	...	14,012	19,892	16,024	22,902	28,030	31,620	29,902	64.0	73.6
Non-oil developing countries	...	...	...	...	3,259	2,885	3,430	4,508	3,711	3,438	3,596	14.9	8.9
State trade countries	...	...	...	...	745	1,473	834	1,443	539	435	916	3.4	2.3
Of which:													
Eastern Europe	...	...	...	...	(655)	(1,423)	(722)	(1,341)	(539)	(435)	(756)	(3.0)	(1.9)
Other	...	...	...	...	(90)	(50)	(112)	(102)	(--)	(--)	(160)	(0.4)	(0.4)
OPEC countries	...	...	...	...	662	706	434	467	127	233	386	3.0	1.0
Development Organizations	...	...	...	...	3,213	1,914	2,600	2,885	5,125	4,456	5,826	14.7	14.3
Of which:													
IBRD, ADB, IDB	...	...	...	...	(2,360)	(1,185)	(1,694)	(1,993)	(4,026)	(3,590)	(4,936)	(10.8)	(12.2)
Other	...	...	...	...	(853)	(729)	(907)	(892)	(1,099)	(867)	(891)	(3.9)	(2.2)
Total	5,656	12,134	19,160	18,266	21,890	26,869	23,322	32,205	37,532	40,181	40,625	100.0	100.0

Source: Swiss National Bank, Monthly Report.

1/ Capital exports which are subject to authorization from the Swiss National Bank comprise public issues of at least SwF 10 million, credits or participation in credits, which amount to SwF 10 million and above and have a maturity of at least 12 months and emissions of notes amounting to SwF 3 million and above and with a maturity of 12 months and above.

Among industrial countries, Japan has figured prominently in recent years. According to the Swiss National Bank, more than half of the notes in 1983 and 1984 were issued by Japanese borrowers, implying that they accounted for at least one fourth of total medium- and long-term capital exports. 1/ This also helps explain the proliferation of Japanese-owned banks and, especially, finance companies in recent years. The bulk of the notes were issued as convertible notes, i.e., with the option of conversion to equity. Frequently, these convertible notes are converted into equity 6-8 weeks after the issue date and the equity is bought by Japanese investors. The early conversion practice also implies that the issues of notes constitute short-term Swiss capital exports and that the statistics therefore overstate the extent of medium- and long-term capital exports. The advantages for the Japanese borrower of this "roundtripping" via the Swiss capital market is to secure funds at lower costs than through issues in Japan, and for the Swiss economy, to receive fees, commissions and fiscal duties (e.g., stamp duty).

The Swiss capital market has also been attractive to international development organizations, especially the International Bank for Reconstruction and Development (IBRD). In its fiscal year 1985 (July 1, 1984-June 30, 1985), 25 percent of gross borrowings of the IBRD (including swap transactions) was denominated in Swiss francs, followed by 20 percent in yen, 17 percent in deutsche mark, and 8 percent in U.S. dollars. Thus, Swiss franc borrowings reached the maximum limit agreed between the IBRD and the Swiss National Bank. The IBRD converts the Swiss franc proceeds with the Swiss National Bank and the latter replenishes its foreign exchange reserves through foreign exchange purchases in the market according to market conditions. In this way, the conversion requirement serves mainly to prevent disorderly conditions in the foreign exchange market resulting from large transactions.

Since 1982 the IBRD has made extensive use of currency swaps in Swiss francs because its credit rating on that market is affected by an already high amount of outstanding debt in Swiss francs. 2/ The distribution between direct borrowings in Swiss francs and swaps has been:

1/ Swiss National Bank, Monthly Bulletin.

2/ A typical currency swap transaction consists of, for instance, a U.S. company borrowing in Swiss francs on the Swiss capital market and the IBRD simultaneously borrowing in U.S. dollars on the U.S. market. The IBRD and the U.S. company then swap the liability and interest payments so that the IBRD incurs a liability in Swiss francs and the U.S. firm a liability in U.S. dollars.

World Bank Swiss Franc Borrowings

(In millions of Swiss francs)

IBRD fiscal years	1981	1982	1983	1984	1985
Borrowings	1,832	3,235	2,971	3,590	4,926
Swaps	--	1,097	2,364	1,906	2,212
	1,832	4,332	5,335	5,496	7,138

Source: IBRD.

In agreement with the Swiss National Bank, swap transactions have not exceeded 40 percent of total gross borrowings of the IBRD in Swiss francs. 1/ The Swiss monetary authorities have generally shown a more liberal attitude than some other central banks (e.g., in Germany, Japan, and the Netherlands) to the use of swap transactions for both international development organizations and other borrowers. At the beginning of the 1980s, the Swiss authorities feared that borrowings on the Swiss market through swap transactions would increase the amount of borrowings on the market and drive up Swiss interest rates. However, as no disorderly conditions have occurred in the capital market, the official attitude has become more liberal. The Swiss authorities have recognized that they could not prevent the proceeds from loans in Swiss francs from being swapped against other currencies at some point in time.

(2) Notes

Notes are medium-term bond issues which accounted for nearly half of total medium- and long-term capital exports in 1984. The maturities range from a minimum of 18 months to a maximum of 8 years (requirements of the Swiss authorities), with 5-7 years being the normal maturity. Notes are usually paid back in full at maturity (bullet maturity) although other repayment schedules are permitted. Early redemption is allowed only after 18 months or after the expiration of half of the maturity. These restrictions have been imposed to prevent early repayments and thereby increased demand for Swiss francs in periods when the Swiss franc was appreciating. Note issues picked up strongly in 1982 after the lifting of restrictions on secondary market trading.

1/ The Swiss National Bank has requested information on swap transactions by international development organizations.

Comparison of Notes and Public Issues

	Notes	Public Issues
Syndication	"Ad hoc" syndicate or through a single bank	Lead management by major three banks (two thirds of issues) or "ad hoc syndicates"
Amount	No limit	No limit 1/
Maturity	SNB: min. 18 months max. 8 years Standard: 3-7 years	SNB: min. 8 years Standard: 8-12 years
Denomination	SNB: min. SwF 50,000 in bearer form	No legal requirement SwF 5,000 and SwF 100,000 in bearer form
Interest payments	Mostly annual; in case of convertibles, mostly semiannual	Mostly annual; in case of convertibles, mostly semiannual
Repayment schedule	Standard: bullet 2/	Standard: - After 5th year, borrower makes annual purchases in secondary market of up to 5 percent of issue amount if prices are at par or below. Amounts which cannot be purchased automatically become due at maturity - bullet 2/
Documentation	(a) Underwriting agreement or paying agency agreement (b) Short memorandum distributed to interested clients	(a) Underwriting agreement or paying agency agreement (b) Short prospectus published in three major newspapers. (c) Full-length prospectus for investors
Listing	No listing	Zürich, Geneva, Basle, Lausanne, Berne
Secondary market	Active	Active

	Notes	Public Issues
Investors	Private and institutional investors	Private and institutional investors
Physical delivery	SNB: not permitted; compulsory safe custody deposit account with underwriter or SEGA (Swiss Clearing Organization).	Possible
Withholding tax	None	None
Approvals	SNB	SNB and Admission Board of Swiss Stock Exchanges
Costs		
Underwriting Commission	1 1/2 percent for 5 years plus 1/8 percent for each additional year	2 1/4 percent for 8 years plus 1/8 percent for each additional year
Management fee	--	1/2 percent up to SwF 100 million, 1/4 percent exceeding amounts
Listing commission	--	1/4 percent
Taxes 3/	0.315 percent	0.315 percent
Turnover tax (paid by investor)	0.3 percent	0.3 percent
Paying agent fee	1/4 percent on annual interest payments, 1/8 percent on repayment of principal	3/4 percent on annual interest payments, 0.3 percent on repayment of principle.
Printing costs	about SwF 20,000	about SwF 30,000
Admission and quotation fees for stock exchange listings	--	SwF 1,600 and about SwF 2,300 per annum

Sources: Credit Suisse, Swiss Capital Market, July 1985; and Swiss National Bank, Monthly Bulletin.

1/ On January 1, 1984, the maximum limit on public issues was raised from SwF 100 million to SwF 200 million. On May 15, 1985 the ceiling was completely lifted.

2/ Full repayment at expiration of term.

3/ Calculated on issue price less underwriting commission and management fee.

Until the early 1980s, notes used to be placed with a limited number (around 10-15) of institutional investors without any publicity. Similarly, they were not listed on Swiss Stock Exchanges, and no public prospectus for investors was required. However, since secondary market trading was permitted in 1982 (Chapter III, Section 1), the character of note issues has changed, and the boundaries to public issues are disappearing. Both the amounts and the name of the borrower are now disclosed and trading in the secondary market is very active (especially in convertible notes). Consequently, the Swiss National Bank has raised the question in 1985 whether note issues should be considered "public issues," requiring a public prospectus. On the federal level, there is no supervision of the securities markets such as, for instance, the Securities and Exchange Commission in the United States. On the cantonal level, there is supervision only of stock exchanges.

The Swiss National Bank which has opposed Eurobond issues in Swiss francs has also prevented a secondary Eurofranc note market from developing abroad. It has required that notes be held physically in custody in Switzerland with the bank of issue or (since January 1984) with a Swiss Clearing Organization (SEGA) from issue to maturity. The significance of this regulation seems mainly to be to provide information to the Swiss authorities on trading in notes and make the notes subject to the stamp duty. While this rule may discourage secondary trading in notes among nonresidents, it does not prevent it from taking place. For instance, an investor in London is free to sell a Swiss franc note to an investor in New York. The note would physically remain in Switzerland and, in principle, the transaction would be registered in Switzerland, and be subject to the stamp duty. However, in practice, there is a market in Euro-clear and CEDEL with certificates, which replace the original notes and thereby permit secondary market trading abroad without any Swiss taxes. 1/

(3) Public foreign bond issues

Public foreign bonds comprise foreign bonds issued with a minimum maturity of 8 years and average maturities of 8-12 years. In order to avoid additional exchange rate pressure during currency unrest, early repayment is allowed only after 5 years. The bulk of the issues are denominated in Swiss francs, but since mid-1982 dual currency issues have appeared. Their share in total public issues rose from 4 percent in 1982 to 12 percent in 1983 and then declined to 9 percent in 1984. Typically, the principal of a dual currency issue has been expressed in U.S. dollars and interest payments in Swiss francs. They cater both to U.S. borrowers who have been able to borrow at interest rates 1-2 percentage points lower than on straight U.S. dollar issues and to Swiss investors interested in receiving interest payments in Swiss francs.

1/ Euro-clear and CEDEL are international securities clearing houses formed by banks and securities dealers for the collective custody and book entry transfer of securities, notably Eurobonds.

Floating rate issues are allowed but remain the exception. Issues with variable interest rates are in demand especially by banks in need of matching their assets and liabilities. However, the bulk of investors in Swiss franc issues prefer fixed interest rates. In the spring of 1985, the first zero coupon bond issue was floated in Switzerland.

Since 1980, the restrictions on public bond issues have gradually been lifted. Foreign issues are no longer subject to obligatory conversion of the Swiss franc proceeds with the Swiss National Bank. 1/ Equally the queuing system has been removed effective January 1, 1984. Before then, the queuing system served to prevent the bunching of foreign bond issues and thereby erratic increases in interest rates on the bond market. De facto, this led to a quota system among market participants, insofar as bond issues were approved according to existing market shares of the various banking groups leading the issues. The system worked to the advantage of the established big banks but to the disadvantage of smaller domestic banks and foreign-owned banks. 2/ The Swiss National Bank was interested in increasing the competition among banks, because banks located in Switzerland were the only issuers of Swiss franc bonds. Partly as a consequence of the elimination of the queuing system, the market shares of the big banks as lead managers has declined from about three fourths in the late 1970s and early 1980s, to about two thirds in 1984.

Public issues by foreigners exceeding SwF 10 million still remain subject to the permission of the Swiss National Bank which, however, is granted on a liberal basis. The Swiss National Bank has also gradually eliminated the ceiling on individual public bonds. In January 1983, the ceiling was raised from SwF 100 million to SwF 200 million and in May 1985, the ceiling was eliminated altogether. 3/

1/ However international development organizations are still converting their borrowing proceeds with the Swiss National Bank.

2/ Lusser, Markus, Die Geld und Kapitalmärkte in einer Zeit raschen Wandels, speech presented in SEGA Schweizerische Effekten-Giro - AG, April 1985.

3/ The existence of a ceiling on public issues compared to no ceiling on notes had probably led to a switch from issues in public issues to note issues. The lifting of the ceiling was not expected to increase significantly the total value of foreign bond and note issues.

III. Recent Developments in the International Financial Markets

1. The relaxation of capital restrictions

a. Introduction

Under a floating exchange rate system, the monetary authorities are faced with the dilemma of whether to target the growth in the money supply or the exchange rate. This dilemma is even more acute for an international financial center, where domestic residents have easy access to foreign currency deposits, which might render the demand for domestic money volatile. In addition, the demand for a reserve currency--such as the Swiss franc--reflects the portfolio choices of foreign asset holders and, therefore, might fluctuate with major shifts in world savings, e.g., increases in OPEC funds in the first years following the second oil price episode and, more recently, large net savings in Japan. The demand for a reserve currency is also subject to erratic changes as a result of political events. In this respect, the Swiss franc is possibly more sensitive than other reserve currencies due to the neutrality and bank secrecy of the country. It can also be argued that the small size of the Swiss economy and the money supply makes the Swiss franc exchange rate more sensitive to capital flows than the exchange rate of major currencies such as the deutsche mark.

During the fixed exchange rate system, capital controls were used as an instrument to dampen capital inflows and the resulting increase in domestic liquidity and, thereby, in part, insulate monetary developments in Switzerland from developments abroad. With the advent of the floating of exchange rates, the Swiss National Bank shifted its policy target to the money supply. The setting of monetary targets began in 1975, the same year as in Germany. The shift from fixed to floating exchange rates did not resolve the conflict between exchange rate and monetary policies, as the Swiss franc appreciated strongly in real effective terms until 1978, deteriorating Swiss external competitiveness (Chart 7). 1/ Therefore, during the first years of floating the Swiss National Bank continued to rely on capital restrictions to limit foreign capital inflows. But these restrictions were not effective in preventing strong capital inflows in 1978 from forcing the authorities to abandon the monetary target for that year. Consequently, from 1979, the Bank began gradually dismantling nearly all capital restrictions and embarked on a controlled internationalization of the Swiss franc. Since 1980, the authorities have reintroduced monetary targeting as the main policy instrument to secure price stability.

1/ During the same period, the deutsche mark also appreciated significantly.

The following sections describe, first, the background of capital restrictions and, second, try to evaluate the effects of the removal of capital restrictions on monetary and exchange rate developments and the official reserve role of the Swiss franc. The conclusion is that capital controls were largely ineffective during the 1970s and their removal has not given rise to problems in monetary or exchange rate management. This outturn, however, was crucially a result of the sharp tightening in monetary policy abroad during the same period as capital restrictions were removed. Finally, the more liberal access to holdings in Swiss francs has not significantly increased the official reserve role of the Swiss franc.

b. Recent history of capital restrictions

During the 1970s, the Swiss franc was frequently exposed to strong upward pressure. In addition to reducing official interest rates and intervening in the foreign exchange market, the Swiss authorities tried to limit capital inflows through capital controls, while promoting capital exports through a liberal authorization practice. The choice of instruments, however, was greatly impaired by an almost complete lack of information on capital flows. 1/

In August 1971, when the Swiss franc came under strong upward pressure during the U.S. dollar crisis, the Swiss National Bank ceased its intervention in the exchange market and imposed, inter alia, a 100 percent minimum reserve requirement on any increase after July 31, 1971 in banks' net liabilities to nonresidents and prohibited interest payments on any increase in Swiss franc deposits of nonresidents after July 31, 1971. 2/ When the pound sterling began floating in June 1972 and the Swiss franc again came under upward pressure, a new series of control measures was introduced. Nonresidents were not allowed to buy Swiss franc-denominated bonds or other securities or purchase real estate in Switzerland. Furthermore, foreign borrowing by Swiss nonbanks was made subject to authorization. At the same time, a penalty in the form of a commission charge of 2 percent per quarter was levied on all net increases in Swiss franc deposits of nonresidents. This so-called "negative interest rate" was temporarily suspended in October 1973.

After the floating of the Swiss franc in January 1973, the control measures were initially retained. In November 1974, when funds from oil exporters were shifted to Switzerland, the ban on interest payments and a "negative interest rate" of 3 percent per quarter was reintroduced. In the period from mid-1975 to mid-1977 when exchange rate pressure

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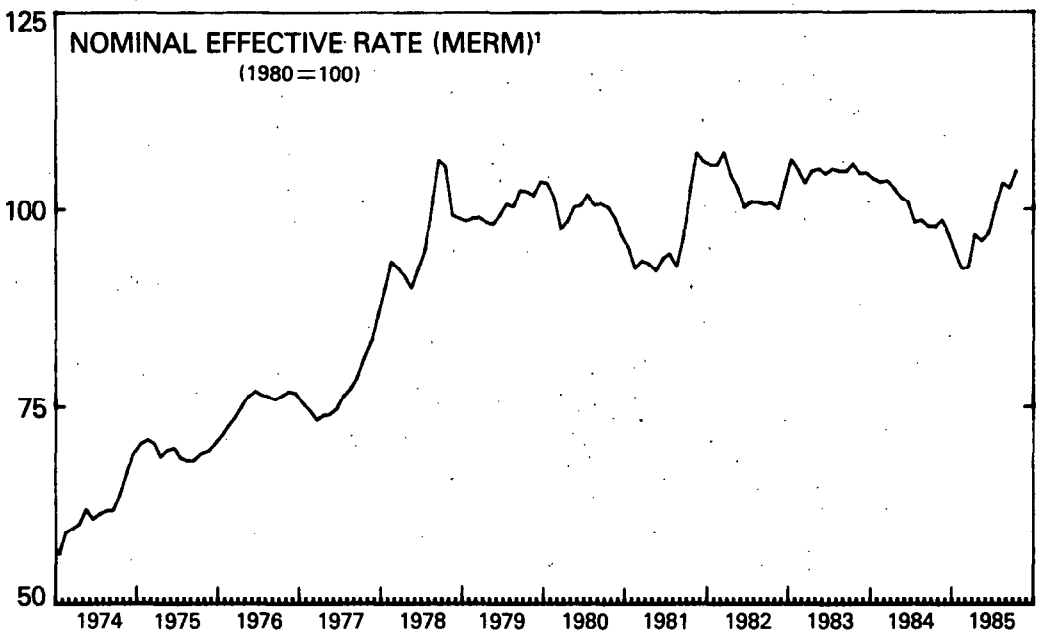
1/ Swiss National Bank, 75 Jahre Schweizerische Nationalbank, Die Zeit von 1957 bis 1982, p. 230; see also Appendix I on "Statistical Coverage."

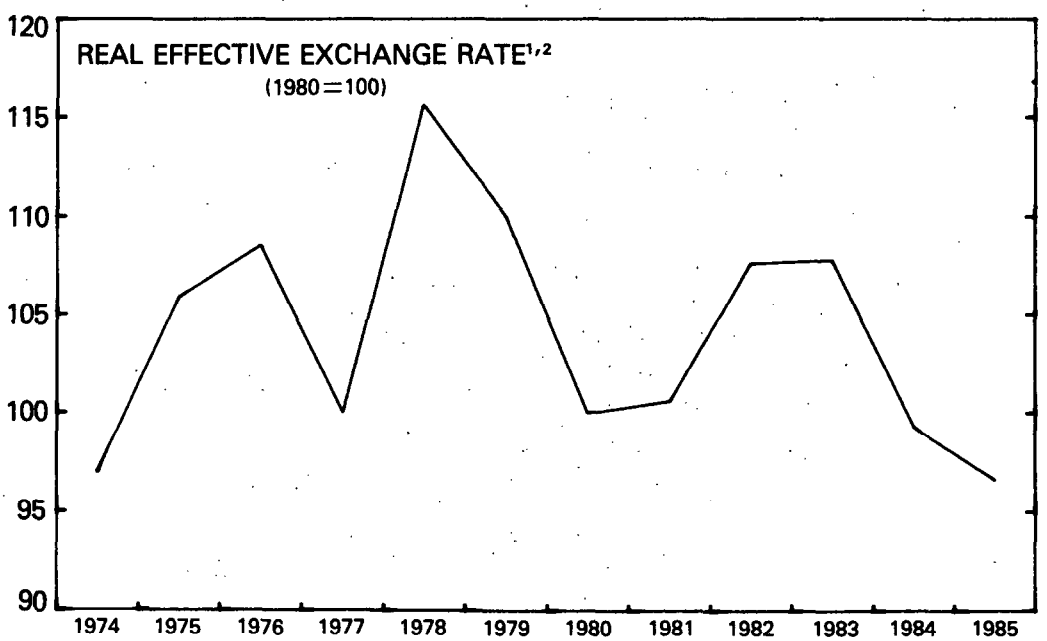
2/ Capital controls during the period 1971-76 in Switzerland are described in greater detail in Baumgartner, Ulrich, Capital Controls in Three Central European Countries, DM/77/12 (2/1/1977).

CHART 7

SWITZERLAND

EXCHANGE RATE DEVELOPMENTS





Source: IMF, *International Financial Statistics.*
[1]An increase (decrease) in the index indicates an appreciation (depreciation) of the Swiss franc.
[2]Relative unit labor cost.

subsided, capital restrictions were temporarily relaxed. However, in the second half of 1977, the upward pressure on the Swiss franc intensified. Consequently, in February 1978, imports of foreign banknotes were restricted, the "negative interest rate" on increments in nonresidents' deposits raised to 10 percent per quarter, and the ban on interest payment was extended to deposits of foreign monetary authorities, which had hitherto been exempted. Finally, as the Swiss franc had appreciated by 26 1/2 percent in real effective terms between the second quarter of 1977 and the third quarter of 1978 (Chart 7) the Swiss National Bank abandoned its monetary target in October 1978. Instead, the Bank announced a temporary exchange rate target against the deutsche mark, declaring its intention to intervene in the exchange markets to achieve a rate well above SwF 0.80 per deutsche mark.

The difficulties in preventing capital inflows and the appreciation of the Swiss franc gave rise to a reassessment of policies from 1979. The Swiss National Bank recognized that the main determinants of capital movements were monetary and other economic policies pursued in Switzerland and abroad. Adjustments in asset portfolios to reflect changes in economic conditions could not for a prolonged period be prevented by capital restrictions because there was ample scope for circumvention.

As a consequence, since 1979 the Swiss National Bank has lifted practically all restrictions on capital inflows. This change was facilitated by the depreciation of the Swiss franc stemming, in part, from a tightening of monetary policy abroad, especially in Germany and the United States. The steps in liberalization are described in detail in Appendix II. In summary, the most significant changes were the permission, in January 1979, for nonresidents to buy securities denominated in Swiss francs; the elimination of the limit on forward sales of Swiss francs in March 1980; the gradual removal in the period to August 1980, of the ban on payment of interest and the levy of "negative interest rates" on increases in Swiss franc deposits of nonresidents; and the removal of license requirement for borrowing abroad by Swiss residents. The only restriction which remained on capital inflows was the requirement of approval by the Cantons for real estate investment by nonresidents in Switzerland. This restriction, however, was not motivated by exchange rate considerations.

c. Impact of relaxation of capital restrictions

In this section, the impact of the removal of capital restrictions since 1979 is discussed in terms of (1) the monetary target, (2) exchange rate and interest rate volatility, and (3) the official reserve role of the Swiss franc.

During the first three years of monetary targeting the annual targets were, by and large, observed (text table below). However, in 1978 M1 expanded by 16.2 percent against a target of 5 percent. As

mentioned above, the upward pressure on the Swiss franc subsided in 1979 and a monetary target was again set for 1980. In both 1980 and 1981, however, actual monetary growth fell substantially short of the targets, with the monetary base declining by 7 percent and 0.5 percent, respectively, against an announced target rate of 4 percent for each year. This was partly a result of the reversal of capital flows, but it also reflected a deliberate policy change during the target period to tighten monetary policy in the wake of the inflationary impact of the second round of oil price increases and the sharp tightening in monetary policies abroad. Since 1982, however, the targets have almost been realized, with only limited fluctuations in monetary aggregates.

Monetary Targets in Switzerland

(Percentage change)

	M1		Monetary Base	
	Target	Actual	Target 1/	Actual
1975	6.0	4.4	...	7.4
1976	6.0	7.7	...	4.3
1977	5.0	5.5	...	2.6
1978	5.0	16.2	...	15.3
1979	...	8.5	...	6.9
1980	...	-9.4	4.0	-7.0
1981	...	-3.6	4.0	-0.5
1982	...	3.0	3.0	2.6
1983	...	7.6	3.0	3.6
1984	...	2.7	3.0	2.5
1985	...	...	3.0	2.2 2/

Sources: Swiss National Bank, Annual Report and Monthly Report.

1/ The target for 1980 referred to the increase in the monetary base from mid-November 1979 to mid-November 1980. For the other years the target refers to annual average growth rates (average of monthly growth rates).
2/ Estimate.

From the beginning of 1979 to the end of 1984, the Swiss franc has depreciated by 37 1/2 percent against the U.S. dollar but appreciated by 8 percent against the deutsche mark. While the Swiss franc depreciated almost continuously against the U.S. dollar it fluctuated against the deutsche mark (between SwF 78 and SwF 91 per deutsche mark during the same period). 1/ In real effective terms (relative unit labor costs), the Swiss franc has depreciated by 14 percent from 1978 to 1984, thereby reversing the appreciation which took place in the earlier part of the 1970s.

1/ The bilateral exchange rate to the deutsche mark is of particular relevance for Switzerland, as Germany accounts for about 30 percent of Swiss merchandise imports and 20 percent of Swiss merchandise exports.

Monetary and exchange rate developments since 1979 have clearly been influenced by the tightening in monetary conditions in the United States and the sharp appreciation of the U.S. dollar. As these developments have coincided with the removal of capital restrictions, it is difficult to distinguish between the effects of the separate events. However, movements in the spread between domestic interest rates and Euro-interest rates for a currency may be looked to as evidence of effectiveness of capital restrictions. 1/ Changes in the spread between the two rates might indicate changes in transaction costs associated with capital restrictions or other impediments to interest rate parity. As Chart 8 shows, with the exception of 1974, there is no indication of significant changes in the difference between domestic and Euro-Swiss franc interest rates. The two rates follow each other closely, pointing to the existence of free capital movements both before and after the removal of capital controls. Statistical testing of the two subperiods in terms of the means and standard deviations of the difference in interest rates also confirm that the difference has not diminished since the elimination of restrictions. This would seem to confirm the view that capital restrictions in place before 1979 were ineffective. A similar experience of unsuccessful application of capital controls was made in Germany, which also experienced massive capital inflows during the 1970s despite the attempt to prevent them through extensive administrative measures. 2/

If capital restrictions had achieved their aim of insulating monetary developments from events abroad, it might be expected that the variability in exchange rates would be smaller during the period, when capital restrictions were in force. A comparison between the period with restrictions (1974-78) and without restrictions (1979-84), however, seems rather to indicate the opposite, although firm conclusions of causality should be avoided. Since 1979, there has been a decline in the variability in the nominal effective exchange rate of the Swiss franc, while the variability in interest rates has remained unchanged. The variability in the nominal effective exchange rate (MERM), measured as the standard deviation of changes in the natural logarithm of monthly exchange rates, declined on an annual average basis from 1974-78 to 1979-84. A similar development occurred for the deutsche mark, while the variability rose for the pound sterling, the U.S. dollar, and the yen (Table 3). The latter period, however, coincides with the introduction of the European Monetary System, which might also have reduced the variability of the exchange rate of the Swiss franc through its perceived link to the deutsche mark.

1/ Otani, Ichiro, and Siddharth Tiwari, "Capital Controls and Interest Rate Parity: The Japanese Experience 1978-81," IMF, Staff Papers, Vol. 28, No. 4, December 1981.

2/ Deutsche Bundesbank, "Freedom of Germany's capital transactions with foreign countries," Monthly Report, July 1985.

Table 3. Switzerland. Variability of Nominal Effective Exchange Rates and Short- and Long-Term Interest Rates

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1974-78	1979-84
												Annual average	
Variability of nominal effective exchange rates 1/													
Germany	18.6	11.3	11.4	9.8	14.8	6.8	8.9	18.9	7.6	9.4	12.0	13.2	10.6
Japan	17.1	9.6	9.7	15.1	31.9	19.6	29.6	20.7	29.7	14.3	12.1	16.7	21.0
Switzerland	20.6	12.8	9.3	18.5	35.0	9.7	16.5	28.3	16.0	12.7	9.1	19.3	15.4
United Kingdom	8.1	8.8	24.1	9.4	17.6	20.8	10.5	21.8	17.5	22.6	9.5	13.6	17.1
United States	13.3	16.4	5.2	8.3	15.9	11.2	21.8	21.9	23.2	12.9	19.4	11.8	18.4
Variability of short-term interest rates 2/ 3/													
Germany	66.7	50.0	22.1	8.6	16.8	38.6	49.6	104.3	30.2	31.7	17.7	32.8	45.4
Japan	55.0	56.7	28.0	41.1	28.8	34.0	95.0	29.8	19.2	26.0	28.3	41.9	38.7
Switzerland, domestic deposits	9.7	40.8	27.4	48.4	36.8	53.2	42.7	74.4	99.1	43.1	28.0	32.6	56.8
Euro-SwF deposits	116.7	101.7	59.1	76.0	55.3	63.6	61.6	92.6	123.2	42.1	30.6	81.8	69.0
United Kingdom	16.3	50.8	92.4	91.6	70.6	79.2	46.0	79.3	59.2	32.5	73.0	64.3	61.5
United States	64.1	50.0	24.9	19.0	28.3	44.2	215.6	136.7	116.7	29.5	46.6	37.3	98.2
Variability of long-term interest rates 2/ 4/													
Germany	27.6	20.5	19.0	16.1	17.3	25.0	43.7	42.3	25.4	19.6	13.5	20.1	28.3
Japan	14.7	19.5	13.4	22.8	9.5	31.0	61.0	32.5	30.7	15.9	23.3	16.0	32.4
Switzerland	16.2	14.2	15.3	21.4	8.3	14.2	21.9	27.5	18.7	10.7	7.0	15.1	16.7
United Kingdom	41.7	73.4	56.2	56.7	28.2	75.3	39.8	34.8	55.8	31.8	35.3	51.2	45.5
United States	21.7	20.8	14.4	9.7	12.9	27.4	74.8	66.4	60.6	23.8	39.9	15.9	48.8

Sources: IMF, International Financial Statistics; and staff calculations.

1/ Standard deviation (multiplied by 1,000) of the change in the natural logarithm of the average monthly MERM exchange rates.

2/ Standard deviation (multiplied by 100) of changes in monthly interest rates.

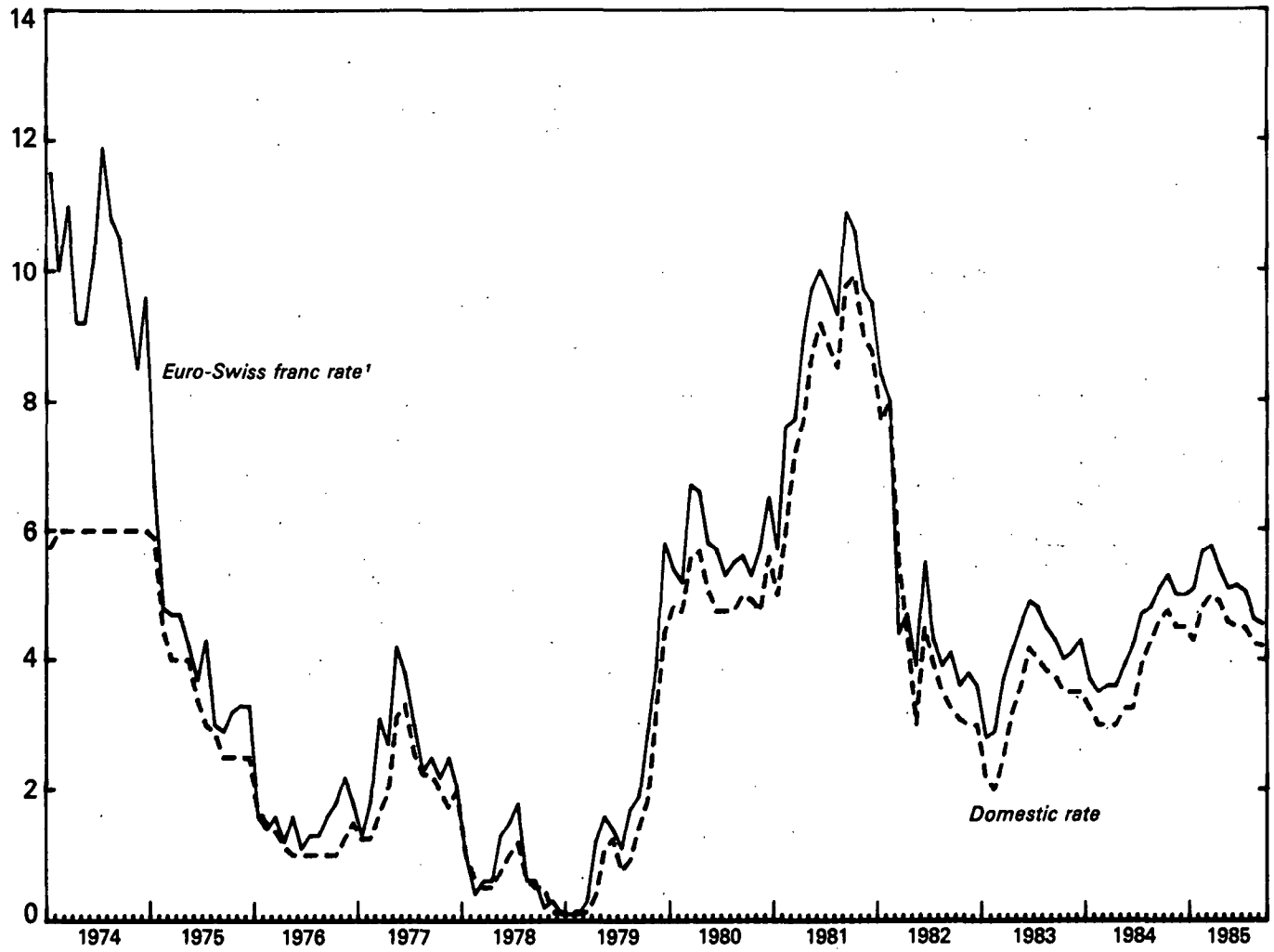
3/ Domestic 3-month rates, except for Japan, where call money rates have been used.

4/ Public bond yields.

CHART 8

SWITZERLAND

THREE-MONTH DOMESTIC AND EUROSWISS FRANC DEPOSIT RATES



Source: Swiss National Bank, *Monthly Bulletin.*

[1]3 month deposit rates in London.

The decline in variability of the Swiss franc exchange rate does not appear to have taken place at the expense of higher variability in interest rates. Thus, the variability in long-term interest rates has remained practically unchanged in Switzerland between the two periods, notwithstanding a sharp increase in the variability in Japan and the United States and a notable rise in Germany. For short-term interest rates, the evidence is mixed, with a clear decline in the variability of Euro-Swiss franc rates, but a significant increase of domestic rates. In both Germany and the United States, the variability in short-term rates rose significantly in the years 1979-84 compared to 1974-78, while it remained almost unchanged in Japan and the United Kingdom.

The more liberal access to holdings of Swiss francs has not increased the role of the Swiss franc as an official reserve currency. The share of the Swiss franc in total identified official holdings of foreign exchange--as estimated by the IMF staff--rose from 2.1 percent at end-1978 to a peak of 3.2 percent by end-1980 and subsequently declined to 2.0 percent by end-1984 (Table 4). During the same period, the share of the yen rose almost continuously from 3.3 percent to 5.2 percent, partly reflecting an easing of capital controls in Japan. However, the share of "unspecified currencies," which especially relate to holdings of oil exporting countries, has risen substantially during the same period (from 4.3 percent at end-1978 to 11.0 percent at end-1984). This implies that the overall official reserve role of the Swiss franc might be underestimated by the identified reserve holdings. The small effect on the official reserve role of the Swiss franc after the removal of restrictions is probably explained, in part, by the limited effectiveness of capital controls before 1979 in satisfying the demand of official Swiss franc holders and, therefore, no pent-up demand for Swiss franc holdings and, in part, by the increase in real returns on U.S. dollar assets after 1979.

2. The Swiss banking system since the second round of oil price increases

a. Introduction

Since 1979 there have been major shifts in world savings. In the period 1979-81, oil exporting countries experienced substantial net savings which had their counterpart in net dissavings of non-oil developing countries and industrial countries. In the years 1982-84, the external current account surplus of oil exporting countries dwindled, the deficit of non-oil developing countries declined and industrial countries, excluding the United States, showed growing external surpluses.

This section describes first the changes in liabilities of banks in Switzerland after the second oil price episode, especially to oil exporting countries and some Latin American countries and second, the lending exposure of Swiss banks and the intensified supervision by the Federal Banking Commission. The main conclusions are that while the

Table 4. Share of National Currencies in Total Identified Official Holdings of Foreign Exchange (end period)

(In percent of total)

	1978	1979	1980	1981	1982	1983	1984	Memorandum: 1984 ECUs treated Separately 2/
All countries								
U.S. dollar	75.6	72.9	66.8	69.8	68.7	68.5	65.1	57.0
Pound sterling	1.7	2.0	3.0	2.1	2.4	2.6	2.9	2.6
Deutsche mark	10.9	12.5	15.0	12.9	12.3	11.2	12.0	11.0
French franc	1.2	1.3	1.7	1.4	1.3	1.1	1.1	1.0
Swiss franc	2.1	2.5	3.2	2.7	2.7	2.3	2.0	1.9
Netherlands guilder	0.9	1.0	1.3	1.1	1.1	0.8	0.8	0.7
Japanese yen	3.3	3.6	4.4	4.1	4.5	4.7	5.2	4.8
Unspecified currencies	4.3	4.2	4.6	5.8	7.7	8.7	11.0	21.1
Industrial countries								
U.S. dollar	86.2	83.5	77.6	78.7	77.0	77.6	73.6	57.0
Pound sterling	0.7	0.8	0.8	0.7	0.8	0.9	1.6	1.4
Deutsche mark	7.9	9.7	14.4	13.0	12.5	13.1	15.2	12.9
French franc	0.4	0.6	0.5	0.5	0.4	0.3	0.4	0.4
Swiss franc	1.2	1.5	1.8	1.8	1.8	1.5	1.4	1.2
Netherlands guilder	0.5	0.6	0.7	0.8	0.7	0.5	0.7	0.6
Japanese yen	2.3	2.6	3.5	3.7	4.5	5.2	6.3	5.3
Unspecified currencies	0.8	0.6	0.6	0.7	2.3	0.9	0.8	21.3
Developing countries 3/								
U.S. dollar	61.7	62.3	56.2	61.1	60.6	59.7	57.0	57.0
Pound sterling	3.0	3.2	5.0	3.5	4.0	4.3	4.1	4.1
Deutsche mark	14.8	15.2	15.7	12.8	12.1	9.4	8.8	8.8
French franc	2.2	2.1	2.9	2.3	2.1	1.8	1.7	1.7
Swiss franc	3.4	3.5	4.6	3.6	3.6	3.1	2.6	2.6
Netherlands guilder	1.4	1.5	1.9	1.4	1.5	1.2	0.9	0.9
Japanese yen	4.6	4.5	5.2	4.5	4.6	4.3	4.1	4.1
Unspecified currencies	9.0	7.8	8.5	10.8	11.4	16.2	20.8	20.8

Source: IMF, Annual Report 1985.

1/ Starting with 1979, the SDR value of the ECUs (European currency units) issued against U.S. dollars is added to the SDR value of U.S. dollars, but the SDR value of ECUs issued against gold is excluded from the total distributed here.

2/ This column is for comparison purposes and indicates the currency composition of reserves when holdings of ECUs are treated as a separate reserve asset, unlike the earlier columns starting with 1979 as is explained in the preceding footnote. The share of ECUs in total foreign exchange holdings was 11 percent for all countries and 20.6 percent for the industrial countries.

3/ The calculations here rely to a greater extent on Fund staff estimates than do those provided for the group of industrial countries.

overall share of Swiss banks' liabilities in BIS reporting banks' liabilities declined somewhat between 1979 and 1984, a significant increase was observed in their share in deposits of the Middle Eastern oil exporting countries and Argentina and Brazil. This was probably related to the perceived stability of the Swiss banking system during the international debt crisis. On the lending side, Swiss banks have experienced less exposure to high-risk countries than banks in BIS reporting countries. The Swiss banks reduced, in time, their large exposure to Mexico.

b. Bank liabilities 1/

After the second round of oil price increases, net assets of oil exporting countries rose from US$257 billion at end-1979 to US$380 billion by end-1983, according to Bank of England estimates. 2/ The financial assets of oil-exporting countries were initially concentrated in liquid assets, such as bank deposits and short-term money market instruments. Subsequently, they were diversified into longer-term placements in bonds, equities, properties and loans, often on concessional terms, to other developing countries.

By end-1983, about 60 percent of oil exporting countries' assets in all industrial countries were invested in the United Kingdom, the United States, and in Germany. A significant proportion of the remaining 40 percent was probably invested in Switzerland, but it is not possible from available data to make a precise estimate.

1/ The country breakdown of Swiss banks' assets and liabilities comprise assets and liabilities with banks located in Switzerland, thereby including assets and liabilities with Swiss banks' branches abroad.

2/ Oil exporting countries, as defined by the Bank of England, comprise the 13 members of OPEC plus Bahrain, Brunei, Oman, and Trinidad and Tobago; Bank of England, Quarterly Bulletin, March 1985.

Oil Exporting Countries' Investment in Industrial Countries

	1974	1979	1983
United Kingdom			
In billions of U.S. dollars	28.3	57.5	63.1
(In percent)	(45)	(28)	(22)
United States			
In billions of U.S. dollars	15.0	47.8	85.9
(In percent)	(24)	(24)	(30)
Germany			
In billions of U.S. dollars	8.1	15.6	21.6
(In percent)	(13)	(8)	(7)
Other industrial countries			
In billions of U.S. dollars	11.4	80.1	117.3
(In percent)	(18)	(40)	(41)
Total industrial countries			
(In billions of U.S. dollars)	62.8	201.0	287.9
(In percent)	(100)	(100)	(100)

Source: Bank of England, Quarterly Bulletin, March 1985.

Thus, there is no information about the amount of Swiss franc-denominated bonds which have been bought by these countries. Equally, there are no data on purchases of equities and properties by oil-exporting countries in Switzerland. Information on oil exporting countries' placements in Switzerland is largely confined to data on bank deposits and fiduciary deposits by Middle Eastern oil exporting countries with Swiss banks. 1/ Those countries--as defined in the Swiss banking statistics--include Iraq, Iran, Jordan, Kuwait, Oman, Qatar, United Arab Emirates, Bahrain, Saudi Arabia, Syria, People's Democratic Republic of Yemen, Yemen Arab Republic, Libya, and Egypt.

Bank deposits of Middle Eastern oil exporting countries with Swiss banks rose from SwF 8 billion at end-1978 to SwF 14.9 billion by end-1984. The most striking development, however, was the expansion of fiduciary deposits of oil exporting countries with Swiss banks from

1/ It has also been reported that an OPEC country bought promissory notes issued by the Swiss National Bank for the amount of SwF 500 million in mid-1981 at two-year maturity.

SwF 6.3 billion at end-1978 to SwF 34.8 billion at end-1984 (Table 5). The increase was particularly strong between 1982 and 1984. As a large part of the fiduciary accounts is denominated in U.S. dollars, the increase in Swiss franc terms reflects, in part, the appreciation of the U.S. dollar in that period.

The Swiss banks' share of total BIS reporting banks' liabilities (including Swiss banks' fiduciary liabilities) to Middle Eastern oil exporting countries stayed at about 12 percent from end-1978 to end-1981. However, in 1982 it rose to 14 1/2 percent and in 1983 to about 17 percent. This suggests a shift of bank deposits to Swiss banks from other banks. A study made by the Bank of England 1/ shows a sharp reduction in Eurocurrency deposits in the United Kingdom in both 1982 and 1983, while bank deposits in Germany declined only slightly and even rose in the United States (measured in U.S. dollar terms). Although the coverage of oil-exporting countries is more comprehensive for the Bank of England data than the Swiss data, it seems plausible that oil exporting countries have shifted funds from the United Kingdom to Swiss banks and U.S. banks. In Switzerland, the increase related only to fiduciary deposits, which are mainly denominated in U.S. dollars. Therefore, there might not have been a currency switch but only a shift from Eurodollar placements in the United Kingdom to Switzerland. The increase in Swiss banks' share of oil exporting countries' deposits did not reflect an increase in the total market share of Swiss banks in liabilities of BIS reporting banks.

In recent years, Switzerland has also increased its share of deposits of Argentina and Brazil. The share of Swiss banks in total identified bank deposits of Argentina has risen from 12 1/2 percent at end-1979 to 33 percent at end-1983 (Table 6). The increase continued slightly in 1984, corrected for change in the coverage of BIS statistics. The share of deposits of Brazil has followed an almost identical development, rising from 12 percent in 1979 to nearly 30 percent in 1983 followed by a small decline in 1984. For Argentina, the jump occurred in 1982, the year of severe debt crisis and when the U.K Government froze Argentinian assets after the invasion of the Falklands. For Brazil, the rise was particularly large in 1980 and in 1982. For both countries, the largest increase in deposits has occurred in fiduciary accounts. The increase in the Swiss share of deposits of Argentina and Brazil might be related to shifts in deposits of private residents of those countries fearing the seizure of their funds in other countries to match banks' claims on borrowers from those countries.

1/ Bank of England, Quarterly Bulletin, March 1985.

Table 5. Switzerland: Swiss Banks' and BIS Banks' Liabilities to Oil Exporting Countries

(End period)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983 3/ A	1983 3/ B	1984 3/ A	1984 3/ B
	(In millions of Swiss francs, unless otherwise indicated)												
Swiss Banks													
Swiss bank liabilities to Middle-Eastern oil exporting countries 1/	6,311	9,394	9,115	8,990	7,951	10,582	13,991	13,740	13,090	12,420	...	...	...
Of which:													
Sight deposits	(2,842)	(3,352)	(2,434)	(2,283)	(1,980)	(3,026)	(4,163)	(3,770)	(4,567)	(4,209)	(...)	(...)	(...)
Time deposits	(3,469)	(6,042)	(6,681)	(6,707)	(5,971)	(7,556)	(9,828)	(9,970)	(8,523)	(8,211)	(...)	(...)	(...)
Swiss banks' fiduciary liabilities to Middle-Eastern oil exporting countries 1/	...	...	6,593	5,328	6,321	8,905	14,105	16,073	23,728	28,947	...	34,832	...
Total, in millions of SwF	...	...	15,708	14,318	14,272	19,487	28,096	29,813	36,818	41,367	...	49,723	...
Total, in millions of US$	...	...	6,410	7,159	8,810	12,334	15,932	16,577	18,460	18,980	...	19,235	...
	(In millions of U.S. dollars)												
BIS Reporting Banks													
BIS reporting banks' liabilities to Middle-Eastern oil exporting countries 1/	36,285	42,705	53,954	66,791	69,276	98,068	126,545	126,932	116,729	103,135	125,111	120,888	127,901
BIS reporting banks' liabilities plus Swiss banks' fiduciary liabilities to Middle-Eastern oil exporting countries 1/	...	...	56,652	69,440	73,202	103,701	134,565	135,907	128,626	116,416	138,392	134,363	141,376
	(In percent)												
Swiss banks' share of total BIS reporting banks' liabilities to Middle-Eastern oil exporting countries 2/	...	...	11.3	10.3	12.0	11.9	11.8	12.2	14.4	16.3	13.7	14.3	13.6
	(In millions of U.S.dollars)												
Memorandum item:													
BIS reporting banks' liabilities to OPEC countries 2/	43,503	51,494	64,292	77,915	82,876	121,003	160,678	157,662	135,307	120,336	141,884	139,938	146,952

Sources: Swiss National Bank, Schweizerische Bankwesen and BIS, International Banking Statistics, 1973-83, and International Banking Developments and Financial Market Developments.

1/ The coverage of Middle-Eastern oil exporting countries follows that of the Swiss National Bank's statistics; they include Iraq, Iran, Jordan, Kuwait, Oman, Bahrain, United Arab Emirates, Qatar, Saudi Arabia, Syria, Yemen, Libya and Egypt.

2/ OPEC countries comprise Kuwait, Lybia, Oman, Qatar, Saudi Arabia, United Arab Emirates, Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Nigeria, and Venezuela.

3/ The coverage of BIS reporting banks was substantially widened at end-1983, and again changed at end-1984, as presented in column B. Data on the old basis is presented in column A.

Table 6. Switzerland: Deposits of Argentina and Brazil

	1979	1980	1981	1982	1983 1/ A	1983 1/ B	1984
	(In millions of U.S. dollars)						
Deposits with Swiss banks							
Argentina	616	626	479	719	833	...	949
Brazil	592	624	467	631	826	...	997
Fiduciary deposits with Swiss banks							
Argentina	385	639	978	1,716	1,680	...	1,569
Brazil	426	707	978	994	966	...	1,119
Total deposits with Swiss banks							
Argentina	1,001	1,265	1,457	2,435	2,513	...	2,518
Brazil	1,018	1,331	1,445	1,625	1,792	...	2,116
Deposits with BIS reporting banks							
Argentina	7,603	6,605	6,565	5,730	5,881	8,643	8,379
Brazil	8,075	4,719	4,805	4,255	5,090	11,364	17,307
Total deposits with BIS reporting banks including fiduciary deposits with Swiss banks							
Argentina	7,988	7,244	7,543	7,446	7,561	10,323	9,948
Brazil	8,501	5,426	5,783	5,249	6,056	12,330	18,426
Total deposits with Swiss banks in percent of total deposits with BIS reporting banks	(In percent)						
Argentina	12.5	17.5	19.3	32.7	33.2	24.3	25.3
Brazil	12.0	24.5	25.0	31.0	29.6	14.5	11.5
Memorandum items:							
Official foreign exchange reserves							
Argentina	8,858	6,057	2,586	2,406	1,172	...	1,242
Brazil	8,342	5,042	5,488	3,641	4,355	...	11,507

Sources: Swiss National Bank, Das schweizerische Bankwesen; BIS, International Banking Statistics, 1973-83, April 1984 and International Banking Developments and Financial Market Developments; and IMF, International Financial Statistics.

1/ The coverage of BIS reporting banks was substantially widened at end-1983, which is reflected in data in column B. Data on the old basis is presented in column A.

c. Lending exposure 1/

Even before the debt crisis of the early 1980s, external assets of Swiss banks were composed of a relatively high proportion of claims on low-risk industrial countries. At end-1979, 69 percent of Swiss banks' external assets (76 percent including fiduciary assets) were to industrial countries compared to only 56 percent for BIS reporting banks (Table 7). This difference became more marked during the early 1980s, as the share of industrial countries in Swiss banks' external assets increased to 74 1/2 percent by end-1984 (81 1/2 percent including fiduciary assets) while it remained almost constant at 56 percent for BIS reporting banks.

The exposure of Swiss banks to Latin American countries, which peaked at 10 1/2 percent of total external assets at end-1980, was almost as large as that of BIS reporting banks (11 1/2 percent at end-1980). However, by contrast to BIS reporting banks, which maintained their relative exposure up to end-1984, Swiss banks reduced their lending in both nominal and relative terms, especially in 1981 and 1982, to 6 percent of external assets by end-1984 (Table 7). Lending to Central America (e.g., Mexico) was cut sharply in those years, but exposure to other Latin American countries, including Argentina and Brazil, was also reduced somewhat.

In line with the overall trend in BIS bank lending, the Swiss exposure to Eastern European countries was halved from 3 1/2 percent to 1 1/2 percent of their total external assets between end-1979 and end-1984. The exposure of Swiss banks in Africa, at about 3-3 1/2 percent of the external assets, was almost the same as the exposure of BIS reporting banks. No significant change has taken place in this share in recent years.

The debt crisis of the early 1980s prompted the Federal Banking Commission to intensify its supervision of banks' country risk. In its Annual Report of 1983, the Commission described a selected survey conducted among Swiss banks at end-1982 on country risk measured on a consolidated basis. It concluded that Swiss banks had lower risk exposure and better capital coverage than banks in several other countries. At end-1982, the exposure to 60 high-risk countries amounted to SwF 23 billion (US$11 1/2 billion at end-1982 exchange rate); about 60 percent of this lending was to Latin American countries. High-risk lending was concentrated in the big banks and in foreign-owned banks which were most heavily engaged in foreign lending. On average, risky lending was below the own capital of the banks. However, for a number of foreign-owned banks, high-risk lending exceeded substantially their own capital.

1/ The figures in this section (unless otherwise indicated) relate to exposure of banks located in Switzerland and not to Swiss banks on a consolidated basis.

Table 7. Switzerland. External Assets and Fiduciary Assets of Swiss Banks and BIS Reporting Banks 1/

(In percent)

	Swiss Banks' External Assets						Swiss Banks' External Assets and Fiduciary Assets						BIS Reporting Banks' External Assets					
	1979	1980	1981	1982	1983	1984	1979	1980	1981	1982	1983	1984	1979	1980	1981	1982	1983	1984
Industrial Countries 2/	69.0	68.5	71.0	71.7	72.7	74.5	75.9	77.0	79.2	79.3	80.4	81.6	56.2	56.5	56.2	56.3	55.5	55.9
Other Western Europe 3/	4.3	4.6	4.3	4.0	4.0	2.2	3.2	3.2	3.1	3.1	2.7	1.4	2.5	2.6	2.4	2.4	2.0	2.0
Eastern Europe	3.4	3.1	2.6	2.1	1.7	1.3	2.3	1.9	1.4	1.2	1.0	0.8	5.0	4.5	3.9	3.1	2.5	2.2
Latin America	9.2	10.3	6.8	5.9	5.7	5.9	7.6	6.9	4.3	3.8	3.7	3.8	11.2	11.7	11.9	11.6	11.5	11.2
Central America	4.6	4.8	2.0	1.5	1.5	1.5	4.0	3.1	1.2	0.9	0.9	0.9	2.9	3.2	3.7	3.6	3.6	3.4
Argentina	0.9	1.4	1.2	1.1	1.1	1.1	0.7	1.0	0.8	0.9	0.8	0.8	1.2	1.4	1.5	1.3	1.3	1.2
Brazil	1.6	1.7	1.4	1.4	1.4	1.6	1.2	1.1	0.8	0.9	0.9	1.0	3.3	3.3	3.2	3.3	3.4	3.6
Other	2.1	2.4	2.2	1.9	11.7	1.7	1.7	1.7	1.5	1.2	1.2	1.2	3.7	3.7	3.5	3.4	3.3	3.0
Africa	3.3	3.0	3.5	3.4	3.5	3.2	2.6	2.3	2.3	2.2	2.1	2.0	3.4	3.1	3.0	3.1	2.8	2.5
South Africa	1.1	0.8	1.3	1.3	1.6	1.7	0.8	0.5	0.8	0.8	0.9	1.0	0.6	0.5	0.6	0.8	0.9	0.8
Other	2.2	2.3	2.2	2.1	1.9	1.5	1.8	1.8	1.6	1.4	1.2	0.9	2.8	2.6	2.4	2.3	1.9	1.7
Middle East	3.1	3.1	2.8	2.8	2.6	2.6	2.4	2.1	2.3	1.9	1.7	1.7	3.0	2.7	2.4	2.5	3.2	2.8
Asia	2.9	2.9	3.0	3.4	3.9	4.5	2.1	2.1	1.9	2.2	2.3	2.7	6.0	6.6	7.0	7.4	9.7	10.1
Singapore	0.8	0.7	1.1	1.5	1.8	2.3	0.6	0.6	0.7	0.9	1.1	1.4	1.4	1.6	2.1	2.2	2.5	2.8
Other	2.1	2.1	1.9	1.9	2.1	2.3	1.5	1.5	1.3	1.3	1.3	1.4	4.6	4.9	4.9	5.1	7.2	7.4
Caribbean 4/	4.9	4.4	6.1	6.6	5.8	5.8	4.1	4.6	5.5	6.3	6.1	1.4	12.7	12.2	13.1	13.8	12.9	13.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: BIS, International Banking Statistics, 1973-83, 1984 and International Banking Developments and Financial Market Developments; and Swiss National Bank, Das schweizerische Bankwesen.

1/ The categories in the table have been adapted to the published statistics of the Swiss National Bank.

2/ Industrial countries follow IMF definition of industrial countries, excluding Ireland for Swiss data but including Ireland for BIS data, (United States, Canada, Australia, Japan, New Zealand, Austria, Belgium, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom).

3/ From end-1984, Swiss banks' assets and fiduciary assets vis-a-vis Liechtenstein are considered as domestic rather than external assets.

4/ Caribbean include residual for BIS statistics.

On the basis of information on the risk evaluation and provisioning of some Swiss banks with long-lasting experience in international business, the Federal Banking Commission formed a judgment on evaluating country risk by Swiss banks. In early 1983, it requested that Swiss banks make 20 percent provisioning for lending to countries which were defined as risky and that this percentage be reached in the course of two to three years for the banks which were currently below that ratio. In its Annual Report of 1984, the Commission concluded that by the end of 1984, all Swiss banks were following that recommendation. 1/

3. The competitiveness of Switzerland as an international financial center

Switzerland has never competed with other major international financial centers in terms of the overall volume of transactions. Its strength has been specialization, especially in the international bond market, in porfolio management, and trade with precious metals. In recent years, competitiveness has increased in international banking. Capital restrictions have been reduced in France, Germany, and Japan; deregulation in major financial centers has shifted part of international business to domestic markets, reducing the traditional comparative advantage of Switzerland of having a universal banking system. The repeal of the withholding tax on interest income from securities of nonresidents in the United States in mid-1984 followed by similar moves in France and Germany have also reduced the competitive advantage of Switzerland as a financial center. Moreover, recent trends in international banking show a move away from expansion of balance sheet transactions toward fee and commission generating off-balance-items, another traditional specialty of Swiss financial business. At the same time, new financial instruments have proliferated, including floating rate notes, note issuance facilities, Euro-commercial paper, and interest and currency swaps. These developments in combination with increased use of advanced telecommunications and computers have undoubtedly exposed Swiss financial institutions to increased competitiveness.

A market share analysis for international financial transactions is only possible to a limited extent. Table 8 shows the share of Swiss banks' external assets (including fiduciary assets) in BIS reporting banks' assets. From 1974 to 1981, the share of Swiss banks' assets in BIS reporting banks' external assets remained almost unchanged at 13-14 percent if adjustment is made for a widening in the coverage of BIS data. However, in 1982 and 1983 the Swiss market share declined by some 1 1/2 percentage points and stayed roughly unchanged in 1984 (also corrected for changes in BIS data coverage). The question is whether this decline is to be interpreted as a deterioration in competitiveness. The figures, by nature, indicate only the magnitude

1/ The fiscal authorities at both the federal and cantonal level have accepted the 20 percent provisioning as tax deductible.

Table 8. Switzerland. Swiss Banks' Market Shares in BIS Reporting Banks
(End of period)

	Total External Assets of BIS Reporting Banks (1)	Total External Assets and Fiduciary Assets of Swiss Banks (2)	Of which, Fiduciary Accounts (3)	BIS Reporting Banks' Liabilities to Switzerland (4)	(2) in percent of (1)	(4) in percent of (1)
	(In billions of U.S. dollars)				(In percent)	
1974	362.1	52.2	15.6	53.2	14.4	14.7
1975 A	442.6	62.5	19.6	55.0	14.1	12.4
1975 B	442.3	62.5	19.6	55.0	14.1	12.4
1976	548.0	72.5	22.7	61.6	13.2	11.2
1977 A	657.1	90.7	27.8	75.0	13.8	11.4
1977 B	689.8	90.7	27.8	76.9	13.1	11.1
1978 A	904.8	116.8	33.6	95.2	12.9	10.5
1978 B	893.2	116.8	33.6	93.5	13.1	10.5
1979	1,110.0	144.8	49.7	121.9	13.0	11.0
1980	1,321.9	176.9	67.7	144.9	13.4	11.0
1981 A	1,541.4	200.2	86.8	162.3	13.0	10.5
1981 B	1,550.2	...	...	163.0	12.9	10.5
1982	1,694.5	197.5	82.5	161.5	11.7	9.5
1983 A	1,757.1	197.7	82.7	165.9	11.3	9.4
1983 B	2,097.9	...	...	175.2	9.4	8.4
1984 A	2,151.5	200.4	88.6	183.8	9.3	8.5
1984 B	2,160.4	...	...	183.8	9.3	8.5

Sources: BIS, International Banking Statistics, 1973-83, and International Banking Developments and Financial Market Developments; Swiss National Bank, Das schweizerische Bankwesen.

1/ Two sets of figures for BIS reporting banks (A and B) refer to a break in the statistical coverage.

but not the quality of the transactions. As mentioned in Chapter III, Section 2, Swiss banks reduced sharply their exposure to Latin American countries in 1981 and 1982 in contrast to BIS reporting banks. The decline in the market share of Swiss banks' external assets might therefore reflect withdrawal by Swiss banks from lending to high-risk countries. The period of observed decline in market share also coincides with the large appreciation of the U.S. dollar against the Swiss franc and other currencies and might therefore, in part, reflect valuation changes of external assets. In addition, these figures fail to capture the substantial amounts of off-balance-sheet transactions (except fiduciary accounts), which are highly important for Swiss banks and for which comparable data are not available. 1/

Swiss financial institutions have traditionally catered to portfolio management of private persons rather than institutions. In recent years, however, there has been a significant shift in savings from individuals toward institutions (e.g., social security funds) in both Switzerland and abroad. As individuals and institutional investors have different needs for portfolio management, a reorientation in the services offered by Swiss financial institutions has been required. The turnover in the portfolio of institutional investors is usually relatively high. In that case, taxes on financial transactions play a crucial role for the attractiveness of Switzerland compared to other centers.

The repeal in several countries of the withholding tax on interest income on securities held by nonresidents has fuelled the debate in Switzerland on taxation of securities transactions. The taxation takes two forms: a withholding tax on interest income and a stamp duty on all securities transactions. These taxes have been introduced for fiscal reasons rather than to prevent capital inflows. The withholding tax on interest income, at 35 percent, is high by international comparison (Appendix III). It applies to all capital earnings, including interest income on domestic bond issues (i.e., the borrower is a Swiss resident) and on bank deposits. However, interest income on foreign bond issues in Switzerland (i.e., the borrower is a nonresident) and on fiduciary deposits is exempt from the withholding tax. 2/ The different treatment of financial transactions with respect to withholding tax has led to a shift from regular bank deposits to fiduciary deposits and presumably also to a shift in demand from domestic to foreign Swiss franc issues. However, as foreign bond issues

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1/ Off-balance-sheet transactions accounted for about 57 percent of earnings of the big banks in 1984.

2/ A Swiss peculiarity is that interbank deposits with a maturity of above 12 months are also subject to withholding tax on interest. However, the withholding tax is refunded quarterly, thereby implying an administrative cost rather than a significant tax.

are exempted, it does not constitute a competitive disadvantage for foreign bonds issues in Switzerland compared to issues in other countries.

The stamp duty is one major reason for the lack of a developed money market in Switzerland (as described in Chapter II). It has also prevented Swiss banks from participating actively in trading in Eurobonds in Switzerland; those transactions have been conducted via their branches and affiliates abroad. As shown in Appendix III, the stamp duty is a particular disadvantage compared to the United Kingdom and the United States, where no taxes on Eurobond trading exist. Security transactions by dealers in Switzerland are also subject to the stamp duty while dealer transactions are exempted from security taxes in many other countries. The Swiss Government may consider a change to the stamp duty in a way to secure a neutral impact on federal revenue. 1/ In that case, the Government would have to weigh the relative merits of maintaining a secure source of fiscal revenue, which, however, impairs international competitiveness of the Swiss financial market against the possibility of reducing the stamp duty, which might attract international business to Switzerland and generate increased tax liabilities of financial institutions and private persons, thus compensating, in part, for the shortfall in revenue from the stamp duty.

1/ The share of the stamp duty in total federal revenue has increased from 4.8 percent in 1980 to a projected 7.5 percent in 1985 (budget figure).

Statistical Coverage

The analysis of international financial transactions of Switzerland is constrained by the lack of statistics. A particular shortcoming is the nonexistence of historical data on the capital account of the balance of payments. Estimates on flows of the banking sector have been derived from the stock figures of the annual balance sheets of banks. The derived flow data give an imprecise picture because of valuation adjustments, etc. Capital flows for the nonbank sector have been derived as a residual from the estimates of the current account, changes in stock figures for banks, and changes in official reserves. Any error in these magnitudes would therefore be mirrored in the residual.

In 1983, the Swiss National Bank began publishing quarterly current account estimates. At the same time, it started the preparation of capital account statistics after the legal foundation had been established in 1980 and 1982 permitting the Swiss National Bank to collect information on financial transactions of the private sector. The capital account of the balance of payments was published for the first time in October 1985 with data beginning from 1983. 1/ The statistics have improved considerably the scope for analyzing international capital transactions. The errors and omissions, however, are still sizeable (4-5 percent of GNP), suggesting that the current account surplus is underestimated and/or net capital inflows are underrecorded.

The main source for external capital transactions used in the present report is the annual balance sheets of banks and finance companies, which provide a detailed breakdown of banks' foreign assets and liabilities by type of asset and, in part, maturity and currency. In addition, a country breakdown of foreign assets and liabilities as well as of fiduciary accounts is published. Another important source of information is the monthly statistics on approved medium- and long-term capital exports comprising (a) banks' export and finance loans, (b) foreign bond issues, and (c) notes, which amount to SwF 10 million and above.

1/ Kommission für Konjunkturfragen, Die Zahlungsbilanz der Schweiz im Jahre 1984, October 1985.

APPENDIX I

The Balance of Payments

(In millions of Swiss francs)

	1979	1980	1981	1982	1983	1984
Current account balance	4.1	-0.9	5.4	8.0	8.1	8.9
(In percent of GNP)	(2.5)	(-0.5)	(2.5)	(3.9)	(3.8)	(4.0)
Capital account balances	...	...	...	...	-17.4	-15.2
Of which:						
Direct investment					-0.4	-1.5
Portfolio investment					-8.4	-7.0
Banks					-4.0	-3.5
Other long-term capital					0.8	0.6
Other short-term capital					0.1	-4.3
Precious metals					-5.5	0.5
Errors and omissions					10.1	9.8
Valuation adjustment of net foreign assets of Swiss National Bank					1.0	2.7
Changes in net foreign assets of Swiss National Bank					-1.8	-6.2

Sources: Swiss National Bank, Das Schweizerische Bankwesen, and Monatsbericht.

Chronology of Restrictions on Capital Flows
(Position on January 1, 1979, and subsequent changes)

I. Restrictions Concerning Capital Inflows

1. Decree of July 5, 1972 and April 16, 1973 subjecting borrowing abroad to license

Position on:

January 1, 1979: Borrowing abroad by Swiss residents (non-banks) is subject to license.

May 31, 1979: Lifted.

2. Decree of July 5, 1972 (with later amendments) concerning foreign exchange positions of the banks

Position on:

January 1, 1979: Total foreign exchange liabilities of banks has to equal the total of foreign exchange assets by the end of each day.

May 31, 1979: Lifted.

3. Decree of November 20, 1974 (with later amendments) concerning inflow of foreign capital

a. Ban on interest payments

Position on:

January 1, 1979: Bank deposits and fiduciary accounts of nonresidents (including foreign official monetary institutions) denominated in Swiss francs are not permitted to carry interest rate.

Exception: deposits outstanding as of October 31, 1974 and new deposits up to a maximum of SwF 20,000.

February 21, 1980: The Federal Government lifts the ban on the payment of interest on nonresidents' Swiss franc time and savings deposits (including fiduciary accounts in Swiss francs) with a maturity of at least three months. In addition the National Bank authorizes interest payments on foreign central banks' deposits with maturities of at least six months.

March 11, 1980:	The Federal Government permits the payment of interest on Swiss franc deposits of nonresidents with maturities of at least three months.
August 31, 1980:	Lifted.

b. Negative interest rate

Position on: January 1, 1979:	A 10 percent negative interest rate per quarter is levied on all deposits in Swiss francs of nonresidents exceeding the balance of October 1974 plus SwF 100,000. Exemption: deposits below SwF 100,000 for nonbanks and SwF 250,000 for banks.
November 1, 1979:	The negative interest rate is reduced to 2.5 percent per quarter.
December 1, 1979:	The penalty is reduced to zero.
August 31, 1980:	Cancelled.

c. Ceiling on forward sales of Swiss francs to nonresidents

Position on: January 1, 1979:	The ceiling on forward sales of Swiss francs with a maturity of up to 10 days to nonresidents is 20 percent of the outstanding amounts of October 31, 1974. For forward sales with a longer maturity the ceiling is 40 percent of the amounts outstanding on October 31, 1974.
September 18, 1979:	The ceiling on forward sales of Swiss francs with a term of at least 11 days to nonresidents is raised from 40 to 50 percent of the amounts outstanding on October 31, 1974.
February 21, 1980:	The ceiling on forward sales of Swiss francs to nonresidents is raised from 20 to 40 percent of the amounts outstanding on October 31, 1974 for contracts with a term of up 10 days and from 50 to 80 percent for contracts with a term of 11 days or more.
March 11, 1980:	The National Bank removes limits on the forward sale of Swiss francs to nonresidents introduced in November 1974.

4. Decree of January 22, 1975 concerning the sterilization of the proceeds from intervention on the foreign exchange market of January 22, 1975

Position on:	
January 1, 1979:	The National Bank is entitled to neutralize the Swiss franc proceeds from intervention in the foreign exchange market by blocking the proceeds to the account of the selling partner without interest payment.
May 31, 1979:	The decree is lifted without having been ever used.

5. Decree of February 27, 1978 concerning imports of foreign banknotes

Position on:	
January 1, 1979:	Imports of foreign banknotes of more than the equivalent of SwF 20,000 per person and per quarter is not allowed, except by special authorization of the National Bank.
January 24, 1979:	Lifted.

6. Decree of February 27, 1978 concerning foreign acquisition in domestic securities

Position on:	
January 1, 1979:	Private persons or companies residing in Switzerland are not allowed to sell domestic securities to nonresidents. A nonresident is only allowed to buy domestic securities from a bank for an amount equivalent to the proceeds of sales of domestic securities.
January 24, 1979:	Lifted.

II. Restrictions Concerning Capital Outflows

1. Articles 7 and 8 of the Banking Law of November 8, 1939/March 11, 1971

Position on:

January 1, 1979:	Public bond issues, notes and bank credits to nonresidents are subject to approval by the Swiss National Bank, if the amount exceeds SwF 10 million (notes: SwF 3 million) and the maturity is one year and above. Short-term foreign lending of banks and capital exports of Swiss nonbanks are liberalized. Nonresidents are allowed to buy a maximum of 50 percent of the proceeds from borrowing by other nonresidents. Half of the proceeds which is denominated in Swiss francs has to be converted to dollars at the National Bank and the other half converted to convertible currencies in the private market. A maximum of SwF 100 million per public bond issue is in force, while there is no limit for notes.
January 29, 1979:	Quota regulation of placement is lifted.
June 8, 1979:	The obligation to convert the proceeds from borrowings in Swiss francs into other currencies is terminated.
September 1, 1980:	Revision of conditions for capital exports: liberalization of rules for placement of notes; easier access to the use of multicurrency clause; permission of foreign central banks to buy notes and participate in credits.
January 1, 1982:	The National Bank stops making an issue program for foreign bond issues but continues coordinating the issues.
July 1, 1982:	Liberalization of secondary market trading for notes. This trading, which was confined to banks participating in emission syndicate is made completely free.
November 11, 1982:	Foreign investors are allowed to participate as sub-underwriters, if they are not mentioned publicly.

APPENDIX II

January 1, 1984:	The queuing system under which a limit of three issues per week was imposed on foreign bond issues is eliminated and the maximum amount of an issue is raised from SwF 100 to SwF 200 million. The National Bank informs, on request, the leading issuing banks about the number, magnitude, and dates for approved borrowings in order to avoid bunching of issues.
January 18, 1984:	The deposit requirement for medium-term notes is modified. In addition to the issuing bank and the members of the syndicate, SEGA (Swiss Clearing Organization) can now act as a custodian for notes.
May 15, 1985:	The ceiling on the amount of public bond issues (SwF 200 million) is lifted.

APPENDIX III

Taxes Affecting International Portfolio Movements

	Germany	Japan 1/	Switzerland	United Kingdom 2/	United States
			(In percent of interest income)		
Withholding tax for nonresidents 3/					
Shares	25	20	35	5 or 15 6/	--
Domestic bond issues	--	20	35	30 7/	--
Foreign bond issues 4/	--	20	--	30 8/	--
Bank deposits	--	20	35	30	--
Fiduciary deposits	N.A.	N.A.	-- 5/	N.A.	N.A.
			(In percent of transaction value)		
Other taxes on transactions on securities					
Stamp/turnover tax	0.25 9/0.01-0.55		0.15 or 0.30 10/	Bearer's bonds: -- (e.g. Eurobonds) Shares and registered bonds (mainly convertibles) : 1 11/	-- 12/

Source: National sources.

1/ Since August 9, 1984, nonresidents' interest income from Japanese corporate Euroyen bonds has been exempt from the withholding tax.

2/ For withholding tax, the general rule is a tax rate of 30 percent, unless the borrower is exempt (e.g. development banks and the European Commission) or there exists a double taxation treaty.

3/ Lower rates apply where tax conventions exist.

4/ Foreign bond issues exclude Eurobonds.

5/ The exemption from withholding tax of 35 percent requires that a written contract between the bank and the customer exists, specifying that the bank has no risk involved in the transaction.

6/ Depends on the amount of share holdings.

7/ Some gilt-edged stocks as designated by the Treasury are free of tax to non-residents.

8/ There is no withholding tax on interest from Eurobonds.

9/ The tax does not apply to initial purchases, nor does it apply to dealer transactions.

10/ Applied to issue, sale and resale of securities of any maturity. The lower rate of 0.15 percent applies to securities where the debtor is a Swiss resident, while the higher rate of 0.30 percent applies to securities where the debtor is a nonresident. The tax applies also to dealer transactions.

11/ Exemptions from the 1 percent tax: (i) gilt-edged stocks; (ii) collections closed within the two weeks' account period; (iii) purchases by stock exchange; others; (iv) provisions for relief for market makers over the counter trading.

12/ No taxes at the federal level.

Restrictions on Foreign Bond Issues

	Germany 1/	Japan	Switzerland 3/	United Kingdom 4/	United States
Unit of denomination					
National currency	N.R.	N.R.	N.R.	N.R.	N.R.
Foreign currency	N.R.	N.R.	N.R.	N.R.	N.R.
Composite units (e.g. ECU, SDR)	N.R.	N.R.	N.R.	N.R.	N.R.
Minimum required maturity					
Public bonds	5 years for DM issues	7-15 years for yen issues	8 years	5 years	N.R.
Private placements	3 years for DM issues	...	18 months	5 years	N.R.
Early permitted repayment					
Public bonds	N.R.	...	after 5 years	after 5 years	N.R.
Private placements	N.R.	...	after 18 months but not before half of the maturity has elapsed	after 5 years	N.R.
Maximum limit on individual issue					
Public bonds	N.R.	Y 10-30 billion for private issues 2/	N.R.	N.R.	N.R.
Private placements	N.R.	...	N.R.	N.R.	N.R.
Authorization requirement	Regional and int. development banks	Authorization is required	Issues at and above SwF 10 million	Sterling and Euro-sterling issues are subject to timing consent by the Bank of England	N.A.
Institutions operating in securities market					
New issues	Banks	Securities Firms	Banks, Finance companies, Other	Banks	Investment banks
Secondary market	Banks	Securities Firms	Banks, Finance companies Brokers, Other	Brokers, Jobbers	Brokers, Dealers
Futures, Options and Swaps	Banks	N.A.	Banks, Finance companies	Brokers, Banks	

Sources: National sources.

1/ In Germany, under a "Gentlemen's Agreement" between the Bundesbank and the major banks, any bank, including Germany subsidiaries of foreign banks, domiciled in Germany may lead manage foreign deutsche mark bond issues and private placements. In the case of foreign currency bonds with a deutsche mark option or dual currency bonds, where interest or redemption are made in deutsche marks, it is sufficient if a German bank (including foreign bank subsidiaries) is a co-leader. However, the authorities will apply tests of reciprocity in determining whether foreign affiliated banks can lead manage new issues. This raises currently problems with respect to Japan, where regulations prohibit banks from engaging in new issues, which are undertaken by securities houses.

2/ In Japan, there are no maximum limits on foreign issues by Governments, or international organizations, or AAA private borrowers.

3/ In Switzerland, both Swiss-domiciled banks and branches of foreign banks in Switzerland can lead manage foreign bond issues. With respect to issues denominated in Swiss franc, the authorities make sure that the issues are kept in Switzerland. Although authorization of issues at or above SwF 10 million is required, this is given on a liberal basis. With respect to issues in foreign currencies, the Swiss authorities check that there are no objections from the foreign monetary authorities concerned.

4/ In the United Kingdom, the Bank of England will allow issues in foreign currencies only if the foreign monetary authorities have no objections. Capital market issues are administered according to the Control of Borrowing Order 1958 with guidance notes of November 1980, July 1982 and March 1985. The last of these guidance notes reduced the maturity to one year minimum subject to certain requirements.

Notation: N.R. = no restrictions
N.A. = not applicable

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