I Introduction

Switzerland, through a long tradition of banking and finance, has developed into a major center for international financial transactions. In recent years, however, significant institutional changes in most large capital centers have challenged Switzerland's traditional role as a financial center. Deregulation of domestic banking in other countries has reduced its comparative advantage of having a universal banking system. The creation of new offshore banking facilities and the repeal of the withholding tax on interest income of nonresidents in the Federal Republic of Germany, France, and the United States in 1984 have changed the competitive environment. In addition, capital controls have been relaxed in several countries, including France and Japan, while Germany and the Netherlands have taken measures to strengthen the international competitiveness of their financial markets.

This study describes the characteristics and importance of financial transactions in Switzerland from an international perspective and the structural changes which have taken place in recent years. It also adds to the recent work in the Fund on banking and financial markets and fills a gap in the economic literature on Switzerland.[1] The significance of these transactions for the domestic economy in terms of growth and employment opportunities is not discussed. The description is mainly confined to the financial markets located in Switzerland; that is, it includes transactions by Swiss banks and foreign-owned banks within that geographical area but touches only fragmentarily on the activities of Swiss-owned banks abroad.

Section II explains the reasons why Switzerland has developed into an international financial center. Its long political stability and 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 have been major factors. In addition, the existence of a universal banking system that permits banks to engage in all kinds of transactions, as well as some of the highest capital requirements in the world, has provided a sound framework for development of financial markets. Political neutrality and strict bank secrecy—preserved despite political pressure from abroad—have undoubtedly also played a crucial role.

Section III describes the banking system, including the financial institutions and bank supervision. The big three banks in Switzerland have traditionally dominated international financial business, but foreign banks established in Switzerland have increased their market share substantially in recent years, loosening the cartel-like conditions. The Swiss monetary authorities have encouraged this development to enhance competitiveness within Swiss borders.

Section IV explains the specialization of Swiss financial institutions 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 are at present of almost the same magnitude as banks' external balance sheet transactions. These accounts—characterized by anonymity and exemption from withholding tax on interest income—have attracted short-term deposits from abroad while reducing the risk of the Swiss banking system associated with international banking.

Section V focuses on three specific developments, namely (i) the relaxation of capital restrictions since 1979, (ii) the Swiss banking system in the early 1980s, and (iii) the competitiveness of Switzerland as an international financial center. First, it describes the role played by capital restrictions during the 1970s in preventing capital inflows from 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 controls 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

[1] Eken (1984).

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 has not significantly increased the official reserve role of the Swiss franc.

The Swiss banking system generally performed well during the debt crisis of the early 1980s. The exposure to high-risk countries was smaller than that of many other countries, and the high capital requirement and the existence of substantial hidden reserves have provided a buffer that protected banks against losses. Swiss financial institutions appear to have benefited from the political neutrality and bank secrecy and the confidence in the Swiss banking system; for example, they have secured 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 with other countries. The promotion of offshore banking operations and the reduction in taxes on financial transactions in other countries have diminished this comparative advantage in recent years. Market share calculations suggest a small decline in overall market shares of balance sheet transactions in 1982 and 1983 and stagnation thereafter; the decline is partly related, however, 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 with banks in Luxembourg and the United Kingdom.