The Competitiveness of Financial Centers: A Swiss View

Address by

Hans Meyer

Chairman of the Governing Board

Swiss National Bank

International Bankers Club Luxembourg

Luxembourg, March 23, 1998

Both Luxembourg and Switzerland are major financial centres in Europe. The performance and competitiveness of the financial services industry are thus of key economic and social importance to both countries. I should like to use this opportunity to say a few words on the subject from what may be a somewhat unusual perspective.

The factors which determine the competitiveness of an industry are basically the same as those determining the success of the entire economy. In both cases, we are looking at a multitude of quite diverse factors with varying degrees of importance. Today, I would like to single out just three of them which I believe are of particular significance: economic stability, social equilibrium (i.e. political stability), and the human factor. Although each of these elements could be dealt with separately, they should ultimately be viewed in a broader context.

Let's start with economic stability. I define this as a state of balanced development across the economy as a whole, characterised by steady growth, a modest inflation rate and low unemployment.

One of the main prerequisites for achieving such a state is the ability not only to create but to sustain an appropriate economic framework. This is primarily an objective for monetary policy, fiscal policy and competition policy. The main goal of monetary policy is to maintain price stability. This is of course not an end in itself, but a means to an end. A non-inflationary climate facilitates the free play of market forces and keeps socially damaging developments at bay. Fiscal policy must, basically, aim in the longer term to balance the public budgets. As with monetary policy, it is a question of steady, ongoing efforts. This should be no surprise, considering that the whole spectrum of public-sector activities is reflected in the public budgets. This in turn raises the question of what services the state should perform, who should pay for them and how public-services can most efficiently be provided. Where competition policy is concerned, the aim is to create conditions conducive to the free play of market forces. In recent decades, it has unfortunately not always been possible to gain consensus support for the idea of free competition, which is still regarded with scepticism and suspicion by many people. Provided that free competition is able to develop in a stable environment, there can be little doubt that it is the best means to assure optimal use of available resources. When things go wrong, it is generally due not to the principle of free competition itself but to the lack of a stable environment.

I would like to stress once again that the task of creating a stable economic framework is a never-ending one: it is a question of constantly working towards – but never actually reaching – the intended goal. Success in this endeavour is not just a question of thinking things through in a consistent way but, above all, of adopting a persevering and workmanlike approach.

Economic stability in the sense of a balanced development of the economy as a whole is the *sine qua non* for a financial centre. It is essential if investors are to gain sufficient confidence in the prospect of sustainable business success. Stable prices, low interest rates, modest rates of taxation and a solid currency are the crucial factors.

To what extent – if at all – is a financial centre reliant on its economic hinterland? This question is less easy to answer. Although a well-balanced interdependency might seem to be desirable here as well, this is not necessarily confirmed by experience. In fact, there never seems to have been any close correlation, and with modern technology enhancing the mobility of people, goods and services, the links have become even looser. Our two countries at least are proof of the fact that there need not be any close correlation between the importance of a country's economy and that of its financial sector.

Talking about economic stability, I referred to the need for perseverance. This is precisely where I see the link with social and political stability. The central task of any community is to provide its members with the greatest possible degree of security, freedom and general welfare. The last of these factors – the general welfare of the population – is dependent precisely on the creation of the appropriate economic framework I mentioned earlier. I should add that this task can only be accomplished if a sufficient number of citizens actively help in shaping developments. This is especially the case in the sphere of fiscal policy.

In the wake of extremely dynamic growth, public budgets have grown considerably in all developed countries over the past few decades. While the original purpose of this spending was to meet a pressing and legitimate need – such as in the area of social security – there has been a growing disparity between the claims made on the public purse and the willingness to generate the necessary resources. Today, we have reached a point where this trend needs to be reversed. However, neither rules and regulations nor government ordinances can achieve this alone. Instead, we have to take small but persistent steps to rectify the situation both from the spending and the revenues side, and – not least of all – to improve productivity. Because such ongoing measures need the backing of the community, the chances of success tend to be greater in smaller communities than in larger ones.

Our experience suggests that a federally structured society based on direct democracy is well suited to achieving the interaction between economic and political stability I have just outlined. Here again, though, I should add that we are always on the way towards our goals and will never actually meet them. Even in the conditions we enjoy, it is not easy to reach the necessary consensus.

This brings me to the "human factor". The background conditions I have been talking about are aimed in no small measure at enabling individuals to develop their own interests as well as those of society. This symbiosis is essential to the prosperity of the economy as a whole.

Where human resources are concerned, what is needed most of all is adequate training, motivation and the right mentality. Over the course of time, the development of the economy and the associated structural change have constantly thrown up new challenges for everyone involved. This can be seen, for example, in the phenomenon of structural unemployment, arising from an imbalance in supply and demand for specific skills. Although the need for continuous training and retraining is nothing new, it has now become an urgent concern. But qualifications alone are not sufficient. They only come into their own when the people in question are also motivated.

If we were to restrict ourselves purely to economic activities, we could leave it at that. But after what I said about the correlations between the economy and society, there is clearly more to it. In a democratic community, we don't just need "economic subjects" who contribute their skills in specific areas and with the right mentality. We also need citizens who are willing and able to concern themselves at all times with developments in the community and to help shape these developments.

If progress is to be made towards achieving balanced – and therefore stable – growth, it is especially important that individuals should be able to identify with the community as a whole. Clear interdependencies with the economy emerge here as a key aspect of social coexistence. Only if the individual members of society are assimilated into a balanced and flourishing economic environment will they identify with society to the extent that they work actively towards its goals – which in turn is essential to the successful shaping of the appropriate economic framework. The resulting social equilibrium, i.e. political stability, creates the necessary confidence in a stable and sustainable development that is so essential to a financial centre.

Today, there is a tendency for people to retreat into the role of the pure economic subject. I see this as a worrying development, and indeed as posing a threat to both the economy and society. Based on what I said earlier, the economy and society can only flourish in a balanced environment. But this balance can only be achieved if the citizens are aware of their dual responsibility and act accordingly.

We have talked about economic stability, political stability and the human factor. These are the elements which define the substance of a financial centre, and the necessary symbiosis between them hinges on the actions of the individual. But we should not forget the importance of other major aspects such as a clearly defined legal system and a properly functioning technical and organisational infrastructure.

I would also like to address another aspect that is of particular importance to a central bank: the stability of the system. Maintaining stability in the financial sphere should not be viewed in isolation, as it is closely interlinked with the human and economic factors discussed earlier.

Political and economic stability, the quality of the human contribution, a clearly defined legal order and an efficient infrastructure are the keys to the success of a financial centre. To this, we should add a reputation which is founded upon a sound attitude and a good track record, going beyond the criteria we have enumerated.

Stability of the financial system is a concern primarily for the market participants themselves. Furthermore, it comes within the remit both of the bank supervisors and of the central bank, which is responsible for monetary policy. As you know, responsibilities and powers are kept separate in my country, the task of supervising the banks being assigned to an independent body, the Federal Banking Commission. Discussion about whether it would be preferable to unite the two institutions under one roof has been going on for a long time.

Both solutions clearly have their advantages and disadvantages, each of which may be weighted differently depending on the requirements of society. Consequently, the debate must be pragmatic and not dogmatic. We believe that our approach has proved its worth and do not see any need for radical change. It is clear, though, that the separation of responsibilities and powers can only function on a basis of close cooperation and trust.

I should like to touch upon two areas in which fundamental changes are needed. First, the financial systems have obviously been becoming more complex with regard to the roles played by their major participants. The traditional approach of focusing supervisory activities on the banks thus seems less and less appropriate. A more comprehensive supervisory system, covering the financial markets as a whole, would be preferable, with particular attention being paid to the transparency of market activities.

Moreover, bank supervision should take account of the increasingly international nature of the financial markets. There would appear to be good reason to call for a globalisation of the supervisory system. But globalisation is one of those "in" words that has to be treated with caution. As a matter of fact, individual financial markets are still embedded in a national economic and social environment. What we need is for cooperation between the national supervisory bodies to be gradually intensified – which is in fact happening. True supranational supervision is still a long way off, as the necessary economic and social framework is lacking.

For this reason, I should now like to focus on the role that an individual central bank has to play in helping to safeguard the stability of the financial system.

I have already spoken about the general prerequisites needed for a financial market to flourish. Within the scope defined by the operating conditions mentioned, market players are basically responsible themselves for what they do or don't do. Their prime concern is to stay solvent at all times by adopting sound business practices and putting an effective organisation in place. To prevent problems from occurring, the responsible bodies at the individual banks must be able at all times, and with a minimum of delay, to accurately assess their risk situation and to take rapid and appropriate action.

Of course, it is never possible to rule out the possibility of an individual bank running into difficulties. In such cases, a solution must first be sought through the market. Solidarity among the other market players should provide a "first line of defence". Seeking funds from the central bank can only be contemplated in the last instance – hence the expression "lender of last resort". Obtaining credit from the central bank presupposes that the liquidity requirements are only temporary. If the solvency of a bank is in peril because of a threat to its capital, the problem is a matter for the supervisory authorities and possibly for the state itself. In practice, the boundary between liquidity and solvency problems can be a fluid one.

In my view, it is important for everyone involved not to lose sight of these principles – which are in fact quite simple. It should not be assumed that the central bank might take action beyond the limits outlined. But this does not mean that it cannot assist in the search for solutions, as far as they do not involve extending further credit.

If the problems of individual banks multiply, there is a danger that liquidity may dry out throughout the entire system. In such a case, the central bank would basically be able to supply the market with the necessary liquidity. However, it may then come into conflict with the requirements of a policy geared to economic stability. Consequently, the short-term benefits of an easing of monetary policy should be weighed against the longer-term risks.

I would like to sum up my thoughts as follows:

1. Three factors are of prime importance to the competitiveness of a financial centre: economic stability, political stability and the "human factor" (i.e. professionalism, motivation and mentality). Although these factors can each be viewed separately, it is the interaction between them that really counts.

2. Economic stability, in the sense of a balanced development of the economy as a whole, is made possible by the existence of an appropriate economic framework. This is created first and foremost by monetary policy, fiscal policy and competition policy. Economic stability provides the financial services industry with a favourable climate in terms of low inflation and interest rates, moderate tax levels and appropriate exchange rates.

3. Favourable economic conditions are planned and implemented as part of the process of social coexistence. This can best be achieved when the largest possible number of the community's members are involved.

4. Individuals are at the same time citizens and economic subjects, thereby creating a crucial interdependency. Proper integration into a balanced economic environment is an important prerequisite for developing a sense of common purpose – in other words, identifying with society and thus also displaying a willingness to actively help shape its progress. This ultimately means that economic and social development can only progress in a sustainable and balanced way if an appropriate equilibrium can be maintained between them.

5. Even at a time when global economic and social developments are becoming more and more closely intertwined, being an integral part of a national community still plays an important role. It is still essential that these national communities should strive first and foremost to keep their own house in order – a house, though, which should not just be stable but open as well.

6. Ensuring the stability of the financial system is one of the core tasks of the supervisory authorities and of the central bank in its capacity as lender of last resort. However, the market players' sense of individual responsibility is also of key importance. If a third party is to offer assistance in a system run on free market principles, this can and should be seen as nothing more – nor less – than helping the others to help themselves.