The Swiss franc in an international environment

Prof. Bruno Gehrig

Member of the Governing Board

Swiss National Bank

Lunch Briefing at The "Swiss Plus" Conference,
London, 20.4.1999

Since the beginning of this year, Switzerland is entirely surrounded by Euroland. Not surprisingly therefore, many people wonder whether not only the Swiss financial sector, but also the Swiss franc, will have a future or not. As a central banker, I would here like to focus on the Swiss currency and on how it has been affected by the drastic changes in the financial markets that we have experienced in the recent past. Moreover, I shall elaborate on what the future probably holds for the Swiss franc.

In looking back, we can distinguish two distinct and important trends in the development of the financial markets:

The first is what may be called "the success of markets". By this, I mean the gradual but steady growth of financial markets. The process started many years ago with the liberalisation of trade in goods and services. Later on, the regulators also began to remove the barriers against the mobility of capital. Today, goods, services and capital can flow fairly freely among most countries. In step with the movement towards free trade, widespread deregulation has occurred. The domestic financial markets used to be embedded in a dense network of market regulations. Market participants made constant - and in most cases, successful - attempts to try and circumvent these regulations with innovations. Not least due to these market forces, many countries saw no alternative to far-reaching deregulation. In the area of foreign exchange, markets have also grown at an impressive rate. First, we witnessed the introduction of the convertibility of currencies. Then, in the seventies, with the transition to flexible exchange rates, the growth accelerated even more.

The second major trend observable in the financial markets is the rapid progress in communication technologies. This development made it possible to transmit information at a much higher speed and at much lower cost. Thanks to new information technologies, geographical and national borders have become increasingly irrelevant. Not only did information technology lead to new financial products, but it has also profoundly altered the platforms of the exchanges as well as the architecture of payment and settlement systems.

For a long time, Switzerland enjoyed a comparative advantage in terms of political, social and economic stability. The Swiss National Bank contributed to this stability by providing an environment of low inflation. These factors of stability, coupled with the growth of the markets, in large measure supported the development of Switzerland's banking sector. In absolute terms, the SFR markets are modest in size. But relative to the size of the real sector of the economy, they are huge. In 1997, the share of SFR transactions in foreign exchange was 5%, somewhat smaller than the weight of the pound Sterling. In terms of equity market capitalisation in Europe, Switzerland is fourth behind the UK, Germany and France. Relative to GDP, however, equity market capitalisation amounted to 261% at the end of last year, which is the highest figure world-wide.

Market Size - Equity and Foreign Exchange					
	Switzerland	**US**	**UK**	**Germany**	**Japan**
Equity market capitalisation as of 30/12/98					
• Bill USD	715	11'276	2'263	1'094	2'467
• in % of GDP (CS)	261	132	162	54	63
Share of global forex market in % (1997, BIS)	5	44	6	14	6

Yet there were times when the internationalisation of our currency posed a considerable threat to the objectives of the Swiss National Bank. In autumn 1977, for instance, international demand for our currency was so strong that the appreciation of the Swiss franc was getting out of control. The exchange rate was seriously jeopardising the balanced growth of the Swiss economy. In an attempt to reduce the demand for Swiss francs in foreign exchange markets, the Swiss National Bank saw no other way but to introduce a series of regulatory measures such as negative interest rates on Swiss franc deposits held by foreigners.

Over time, Switzerland's comparative advantages based on its tradition of stability became fewer. Several countries had pushed down their inflation rate to levels similar to that of Switzerland. In this changed environment, the financial sector had to make new efforts in order to remain successful. One of these efforts was directed at developing an efficient and safe infrastructure for trading stocks, settling securities transactions and for interbank payments, and it has - as we can see today - achieved its aims to a large extent.

These market developments and technological advances did not fail to have an influence on the Swiss National Bank. They concerned us most immediately in the following three areas:

First, the risk of an excessive appreciation of the Swiss franc - like that experienced in 1977 - has become much smaller. While at times the overvaluation of the franc may still be a problem, it no longer poses the same existential threat to our economy. In the last few years we have been able to avoid exchange rate distortions by means of purely market-oriented measures without building up inflation. We are confident that we will succeed in continuing this flexible policy. Our policy approach is clearly based on the view that we will best achieve our targets if we rely on truly open markets, a sound infrastructure and instruments that utilise - rather than restrict - market processes.

The second example to demonstrate how internationalisation and technology have affected the Swiss National Bank is the implementation of monetary policy. Last year, we switched from foreign exchange swaps to repos as the main form of liquidity provision. Thanks to a new technological platform at the central securities depository SEGA, repos can now be settled in a safe, fast and inexpensive way. The implementation of monetary policy by means of repos instead of foreign exchange swaps has two decided advantages: a) repos bear fewer credit and settlement risks, and b) we are able to transact this form of business with more counterparties. Instead of just three or four, we now deal with some twenty partners. Starting this summer, our range of counterparties will include banks abroad, which underlines our willingness to operate as broadly as possible.

Third, we support the financial sector in developing competitive, state-of-the-art trading, payment and settlement systems. Our main payment system, the twelve-year old Swiss Interbank Clearing system (SIC), was one of the first Real-Time Gross Settlement systems to be developed. Later, we were among the first to implement a Delivery-versus-Payment scheme that settled both the money and the securities leg on a transaction-by-transaction basis. Just recently, we added a new and also unique feature to our settlement infrastructure. Today, Switzerland offers a direct link between the stock exchange, securities settlement and the payment system. At the same time, we provide remote access to all three institutions, which, of course, includes a National Bank account. We thereby invite as many market players as possible to participate directly in our markets. We are convinced that the promotion of direct access enhances system stability.

Thanks to these efforts and to the modern financial infrastructure they have produced, I am confident that the financial industry has good prospects for the future. But we know that innovation and flexibility are the key to success in today's dynamic markets. They have to be the industry's guiding principles independent of any future developments in the relationship between our country and the European Union, and also independent of the question of whether or not the Swiss franc will be replaced by the euro some day.