Mr Meyer gives a central banker's view from Switzerland

Speech given by Mr Hans Meyer, Chairman of the Governing Board of the Swiss National Bank, at the Swiss-American Chamber of Commerce, in New York on 1 October 1999.

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Environment

The Swiss will remember the last few years as a time of important economic and social challenges with mixed feelings.

If one attempts to put events into a larger context, the first thing that comes to mind is that in the course of time, there have always been periods of intense change which were followed by calmer ones. Such fluctuations can occur because different events, with their positive or negative consequences, may have a more or less coincidental cumulative effect. As a rule, however, there is a remarkable logic behind the way events unfold.

All things considered, it appears to be entirely logical that at the close of this century, we should have reached an economic and social turning point. An era is coming to an end, which – in a broad sense – we still associate with the post-war period.

During this period, our economic development was characterised by remarkably steady real growth. Especially during the first decades following the Second World War, pent-up demand created extraordinary dynamism. Economic output improved continuously not only in terms of quantity but also of quality, leading to unprecedented growth as well as more widespread prosperity.

In the course of this development, the public sector witnessed a remarkable expansion. Here too, an apparent backlog in demand had to be satisfied. Subsequently, developments became more complex. In the face of increasingly scarce resources, the question arose as to what the optimal role of government should be in terms of type, scope and implementation of its activities.

There is obviously also a dark side to this briefly outlined development. The pace of activities increasingly overwhelmed many contemporaries and thus led to new tensions. The social fabric has become less cohesive. Relations between individuals are more difficult. Environmental pollution is a problem which we tend to repress. Finally, we have come to realise that an increasing economic interdependence between individual countries entails opportunities as well as risks.

In short, we are today confronted with problems of a mature society. It is perhaps a small comfort, but nevertheless important, to point out that we find ourselves in a similar position as our neighbours and other comparable industrial states. Satisfaction with what has been achieved makes one forget all too easily what was needed to advance so far and what will be needed to maintain – if not increase – this level of prosperity. In the interests of innovation, flexibility and productivity, further adjustments are imperative. They must, however, take place in a manner that will not put at risk social cohesion. Demands should be made on the individual, but they should not be excessive.

The goal of our common effort is a development which assures security, freedom and general welfare in a balanced way. In the economic area, we must create the human and material conditions to promote appropriate growth, while keeping unemployment and inflation low. With regard to the human factor, the necessary qualification must be coupled with an adequate motivation. This motivation can be enhanced by an appropriate macroeconomic environment.

A gradual development of economic and social activities seems appropriate, since this is the only way to ensure the necessary identification of individuals with the community.

Economic situation

In the course of this year, prospects for economic recovery in Switzerland have been improving, bringing to an end an unusually long period of stagnation. The human and material costs of this stagnation are of course regrettable.

The causes for this period of stagnation are manifold. First, one has to bear in mind that it followed years of marked expansion. Other, more general reasons are the consequences of our past labour market policy, which helped to maintain existing structures, as well as of insufficient competition in the domestic economy. Last but not least, an already high level of achievement made it increasingly difficult to provide the necessary punch for change.

The need for structural changes as well as the necessity to tackle remaining problems from the past – notably in the construction sector, in agriculture and tourism – along with the repercussions of a weak global economy, have led to a temporary decline in growth.

A sustained process of adjustment, but also favourable monetary conditions have subsequently contributed to improve prospects. However, the impetus for take-off inevitably had to come from outside.

Our economic problems were, and still are, neither confined to a sector nor a region. The line separating positive and negative developments runs right across the economic landscape. It is still quality of performance, characterised by innovation, flexibility and productivity, which determines success.

Consolidating public finances remains important. Furthermore, efforts to promote competition must continue even though considerable progress has already been made. In this context, we have to realize that in many quarters, people are obviously sceptical about the concept of competition. The argument has not yet sunk in sufficiently that when it comes to allocating resources, the free play of market forces is well suited to achieve prosperity and economic welfare. This, however, is only possible within a framework of general economic stability.

One of the most gratifying recent developments is a steady decline of unemployment. Since imbalances in the labour market continue to exist, we must foster both know-how and motivation. Sufficiently flexible working conditions and greater mobility are also essential.

Finally, it is important to remember that securing the right macroeconomic environment and its exploitation by people participating in the economy is an ongoing challenge. Consequently, there are no quick, simple or cheap solutions for the problems confronting us.

Monetary policy

The Swiss National Bank has the task of conducting a monetary policy in the interests of the country as a whole. It must contribute to creating a framework which promotes a balanced economic development, meaning adequate real growth, low unemployment and modest inflation.

Ensuring price stability is the primary goal of monetary policy. Our definition of price stability is a consumer price index below 2%. This is obviously not an end in itself, but a means to an end. An economic system which relies on the forces of the free market must be able to count on price stability for its smooth functioning. In particular, price stability prevents undesirable distortions in the social area.

Economic teaching and experience leave no doubt as to the connection between the money supply and price stability. As economists tend to say: money matters. Whether the supply of money is adequate depends on its relation to real economic development. Monetary policy is therefore able to make its best possible contribution if it succeeds in bringing the supply of money basically in line with real growth in the long term.

Three main problems have to be contended with in the conduct of monetary policy: the difficulty of assessing the economic situation, the limited knowledge of the way a modern economy works and foreign influences, over which we have little control. While knowing that these uncertainties exist should not paralyse our ability to make decisions, it should nevertheless lead us to exercise appropriate restraint. Both the basic interdependencies previously mentioned and current events, which are reflected in the relevant economic indicators, must be factors influencing the decision-making process.

As a small and open economy, Switzerland is highly integrated in international economic relations. By participating in international cooperation, the Swiss National Bank contributes to creating favourable conditions for an international division of labour. In this context, stable currency relations are crucial. Such relations are ultimately a result of sustained convergence of sound economic policies implemented by individual countries.

With an increasing international integration of individual economies, the awareness of mutual dependence has also grown. Accordingly, efforts to coordinate the behaviour of individual countries in the field of economic policy have been reinforced. In this context, it is important to realise that the stability of international economic and monetary relations is not primarily a matter of institutional regulations. What is of the essence is the conduct of individual countries.

These considerations are also relevant for an assessment of the European Monetary Union. Creating the Union at the beginning of this year meant a big step forward for the process of European integration. With the European Monetary Union, the participating Western European countries are trying to put their currency relations on a new footing in line with the changed environment.

If the European Monetary Union can be implemented according to plan, this will vastly improve the preconditions for a balanced economic development in Europe. Freedom of movement for persons will be facilitated along with the free flow of goods, services and capital. After what has been said, all will depend on whether the participating countries can muster the discipline indispensable for sustained and convergent stability-oriented policies.

In the context of the run-up to monetary union, significant progress has been made in individual countries. Inflation has been brought under control. Budgets have been brought in line with lasting effect. Both achievements did not fail to have a positive impact on the development of interest rates.

In view of the challenges that lie ahead, one must bear in mind that with the fixing of exchange rates, individual countries have forfeited an element of flexibility. In the past, imbalances in economic development were compensated with flexible exchange rates. Losing this possibility is significant, because many countries already lack the capacity to adjust.

We note with satisfaction that the monetary concepts of the European Central Bank are largely in conformity with our own. The chances are thus good that this will result in a sustained convergence of stability-oriented policies and, as a consequence, basically stable exchange relations between Switzerland and the new European currency area. Should, however, difficulties arise when the present goals are implemented, we would have to expect some turbulence. This would be likely to result in an upward pressure on the Swiss franc. The National Bank would, of course, have the possibility of relaxing monetary policy to counteract such a trend. This might, however, conflict with our policy's orientation towards stability.

The basic considerations on monetary policy outlined here also apply if we look beyond the European environment.

The crisis-like developments in East Asia, Russia and Latin America may have their characteristic features in individual cases. However, they also give rise to a number of comments of a more general nature.

Imbalances in economic development, weak financial systems and insufficient supervision of financial markets are merely symptoms of deeper-lying causes. In any case, most recent experiences tend to confirm the opinion that a sustained economic development is only possible on the basis of social coherence. Individual countries themselves bear the responsibility for creating this stability. In the long run, outside help can only be meaningful if it is granted as help towards self-help.

These remarks are equally relevant for assessing the activity of the International Monetary Fund. The chief task of this important institution in the area of international monetary policy is advising its members in the conduct of economic policy. This is designed to create favourable preconditions for a positive development of international monetary relations and, of course, also the world economy. The second task is to provide credit facilities in order to support the necessary processes of adjustment. Since its inception, the International Monetary Fund has thus held an intermediate position between emphasising the self-responsibility of a country and granting adjustment aid. Its task is not made any easier by the fact that it has no possibility of enforcing recommendations.

Whenever difficulties arise in shaping international monetary relations, a call is made for introducing fundamental reforms. Experience has taught us, however, that bold visions hardly ever have a chance of being realised. It seems to make more sense to implement what has been recognised as appropriate in small, purposeful steps.

Reform of the monetary constitution

A monetary constitution comprises all regulations concerning the currency on a constitutional and statutory level. Our present monetary constitution still dates largely from the time of the establishment of the Swiss National Bank almost a hundred years ago. We are currently in the process of adapting it to modern requirements. These endeavours bear a direct relation to the reform of our fundamental law, the Federal Constitution, which was recently brought to an end.

A central issue of these reform efforts, to which I shall restrict myself in the following remarks, concerns the severance of the Swiss franc's link to gold. In actual practice, this link has been outdated for decades. It is, moreover, in direct contradiction to our commitments as a member of the International Monetary Fund. With the severance of the gold link, we will be free to act according to our own discretion with respect to the evaluation and utilisation of our gold holdings. The question therefore arises how to use this freedom of action.

In attempting to answer this question, one must bear in mind that monetary reserves are of course indispensable for a central bank in fulfilling its tasks. This is particularly true in the case of a small, open economy with a significant financial sector. Currency reserves consist primarily of freely disposable foreign exchange reserves and of gold holdings.

In retrospect, we have to remember that our freely disposable foreign exchange reserves have undergone a substantial increase, particularly after the transition to freely floating exchange rates a quarter of a century ago. At the beginning of the nineties, we therefore decided to limit future expansion to the extent of nominal economic growth. By international standards, we thus have a comfortable level of reserves.

As regards gold holdings, it must be decided what proportion will still be required for monetary policy purposes in future or, conversely, what proportion should become available for other public uses. This is basically a question of how an important part of our national wealth is to be usefully employed. Both fundamental considerations and a comparison with other countries may be helpful. However, in the final analysis there is a discretionary decision to take. We have come to the conclusion that it would be appropriate to maintain around half of today's gold holdings of approximately 2,600 tons as currency reserves.

In principle, we are in favour of removing the other half of this gold from our balance sheet. However, we are willing to accept that, in a broader perspective, it may not be appropriate to outsource. In such a case, the gold holdings would have to be managed according to special criteria by external specialists under the responsibility of the National Bank.

We have of course always been fully aware that any discussion of these problems is a sensitive issue. In consideration of the necessary legal adjustments on a constitutional and statutory level, we had no other choice but to lay bare the situation in detail.

I should like to underline once more that we do not underestimate the significance of abundant currency reserves. The sky, however, cannot be the limit. It will be in our own interest to exercise the necessary diligence when converting part of our gold holdings into interest-bearing assets. This includes close contacts with institutions with which we entertain friendly relations.

Financial centre

Let me conclude with a few reflections on Switzerland as a financial centre.

A financial centre is by definition the location in which the various financial market players combine their efforts. Conforming to more recent developments, we no longer talk about regional centres in Switzerland. We rather refer to the Swiss financial centre. In the forefront are of course activities of banks and insurance companies. To these must be added a growing number of further providers of financial services. In keeping with international developments, the dividing lines are gradually becoming blurred.

The decisive criteria for assessing the substance of a financial centre are integrity, stability and quality. These depend on various factors of a human and material nature.

On a human level, these factors are know-how and mentality. Integrity, loyalty, reliability and a willingness to serve must go hand in hand with specialist knowledge as well as urbanity and a gift for languages. Our social environment and our educational system basically provide a good starting point. Nevertheless, gaps in specialised training and international experience are still cause for complaint.

On a material level, the primary factors are political and economic stability. Both are guaranteed to a high degree. It cannot be overlooked, however, that other countries have made considerable progress in this respect.

In the context of the legal order, banking secrecy is currently at the centre of attention. Applying it is, and remains, a tightrope walk. What is basically undisputed is an adequate protection of the private sphere. This should not, however, lead to such protection being exploited for dubious business deals. In an international context, valid law takes account of this problem in the form of regulations on mutual judicial assistance in criminal matters, which include insider transactions and money laundering. One way or another, it cannot be overlooked that legal regulations must be supported by an appropriate business mentality. Problems in the grey area between business as usual and unlawfulness can also affect the integrity of a financial centre.

The relevant environment is, of course, also influenced by fiscal regulations. Here, too, one might refer to a tightrope walk. The implications of subjecting financial transactions to fiscal charges and of spreading the tax burden evenly must be weighed against each other. Aside from economic and operational efficiency, exercising political discretion is indispensable. At the same time, it is clear that growing international involvement restricts the room for manoeuvre.

More recently, endeavours by the European Union to close loopholes by taxing interest earnings on capital invested in countries other than the tax domicile have gained attention. Under discussion is a choice between a withholding tax and a reporting obligation. At this juncture, a consensus within the EU is not yet foreseeable. Clearly, a convincing solution would have to include all major financial as well as off-shore centres. If that becomes possible, we would hardly be able to refuse to cooperate in the field of withholding tax. In the event of a comprehensive solution, the effects should be within acceptable limits from a general economic perspective.

Finally, attention must be drawn to the organisational and technical infrastructure as an element of the general environment. In this respect, conditions in Switzerland are favourable. Technologically advanced and in some areas pioneering solutions guarantee quick, safe and cost-effective business transactions. This is of great value for the integrity, stability and quality of the financial centre even if the respective activities are largely hidden from the public eye.

Apart from the relevant factors already mentioned, the development of financial transactions will be influenced to a considerable degree by changing customer needs and technological innovations.

As regards customer needs, changes in savings and investment habits of private and institutional customers must be pointed out. To this must be added the changing financing requirements and practices of enterprises. Such changes depend on economic developments, but also on trends of which it is difficult to say if they will prove to be of lasting influence.

In the technological field, the primary concern is continued development in data processing and communications. These have implications for the design of products, the conduct of business, international integration and the development of costs and prices. The resulting consequences, for example for the ideal size of an enterprise, are a matter of controversy.

As has already been pointed out, the dividing lines between individual suppliers are becoming increasingly blurred. Moreover, new suppliers, notably among wholesale distributors and in the consumer goods industry, are pressing into the financial area.

As regards retail banking, it may be assumed that the population of a highly developed industrial country will still require financial services in the future. Straightforward transactions tied to a particular location will be of primary importance. These should be carried out rapidly, reliably and cost-effectively. For economic and technological reasons, there will be an increase in providers, and this, in turn, will strengthen competition.

Trading and advisory services with their strong international orientation have shown an impressive development in recent years. Experience has been that this is a line of business which not only offers opportunities, but also involves considerable risks and is very much centred on people. It seems quite remarkable that all major banks in industrial countries are currently concerned with their strategy in this field.

The future development in portfolio management is of particular significance to us. This is the core business of the Swiss financial industry. Further progress will depend in large measure on what the outlined background conditions will look like in future. In this context, it is the overall situation that counts rather than conditions in a certain area.

Outlook

At the turn of the century, Switzerland is economically and socially in good condition. Following years of frequently painful adjustments to a changing environment, preconditions for a balanced development are favourable. The quality and scope of these adjustments bear witness to the flexibility of our economy and society. The years ahead will continue to be characterised by constant change. It is therefore important to remain vigilant. On the basis of overall economic as well as social stability, innovative power and flexibility must be preserved. In a mature society, this represents a particular challenge.

By keeping our own house in order, we also make the best possible contribution to international solidarity. In the narrower European context, our bilateral agreements with the European Union will form a good basis for cooperation in the coming years. In Europe and beyond, Switzerland traditionally has an extensive network of international relations which we shall continue to cultivate in the future. As far as these relations are of a political nature, an appropriate social consensus is necessary for doing so.

The further development of our financial centre will depend on whether we succeed in continuing to guarantee the attributes mentioned earlier on: integrity, stability and quality. This requires efforts both on an individual and on an overall economic level. A sustained commitment in both spheres will permit existing opportunities to be used.