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The potential for capital controls in Switzerland

Summary

Switzerland's Finance Minister has said that Switzerland is examining capital controls and/or negative interest rates as a way of controlling capital inflows. This note looks at the possible options.

In summary, we think that some re-introduction of capital controls/negative interest rates is possible in extremis. Of the various options available, we take the view that unlocking the ability of the market to set negative interest rates is the option most likely to be effective, and to be acceptable to residents and non-residents alike. We explore the history of capital controls in Switzerland, and in view of this, we pick one scenario as our 'most likely'. Any actual imposition of capital controls is very unlikely to look like our 'most likely', but we present it as a way of stimulating thought.

Introduction

In this note we look at the possibility of the imposition of capital controls (or other restrictions) on movements of capital in and out of the Swiss Franc.

Switzerland imposed restrictions on interest payments and charged 'fees' on foreign-held bank accounts in the 1970s (see below). For much of the 20th century, however, Switzerland chose to offer 'safe-haven' bank accounts to all comers. It offered high levels of confidentiality to its international customers, and in the 1930s, it instituted laws which made breaching bank confidentiality a criminal offence. Switzerland has recently modified somewhat its secrecy provisions (under pressure, *inter alia*, from the US).

However, Swiss Finance Minister Eveline Widmer-Schlumpf said, in evidence to a committee in the Swiss Upper House on 7th December 2011, that her Government was actively considering "capital controls and negative interest rates". She did, however, say at the same time that "other countries haven't had only good experiences with capital controls and negative interest rates".

Possible Alternatives – capital controls

The alternatives divide first into the ***constituency*** which is targeted in a capital control environment, and secondly into the ***instrument(s)*** which are targeted. Controls can take the form of ***quantitative restrictions***, or ***price restrictions*** (in effect – taxes of one sort or another).

The Swiss face a particular problem – namely the demand for Swiss Franc-denominated investments (including cash) from non-residents. Hence, it is very likely indeed that the constituency targeted will be non-residents.

Non-resident persons are, by definition, outside normal Swiss legal jurisdiction, so any capital controls would have to target the money, not the person.

For Switzerland, a country whose principal export is the provision of investment services to non-residents, it must be of overriding importance that the Swiss maintain an attractive offering to their foreign customers. This would preclude draconian measures (like freezing or expropriating in some way existing accounts), even though the first sniff of such action would undoubtedly dramatically reduce international demand for Swiss Francs.

In the current very integrated financial world, the identification of beneficial owners of Swiss Francs would be difficult (how can you know who is making a forward purchase of Swiss Francs against the Euro in London?), and require a level of bureaucratic intervention (and bureaucracy) which would most likely be unacceptable or impracticable for the Swiss authorities. Thus, in my view the establishment of two regimes, 'onshore Swiss Francs' (i.e. for residents) and 'offshore Swiss Francs' (for non-residents) is less likely than measures that apply generally, although it is possible that the spot might most likely remain fully deliverable, while residents might be exempted from action that applied to non-residents in the interest rate/forward market.

If measures are to apply generally, they must be acceptable to the Swiss electorate; and they must have some chance of being effective.

On instruments, capital controls could target the process of *buying* (or selling) Swiss Francs versus other currencies, or they could target the *holding* of Swiss Franc-denominated assets (cash; bonds; equities; property). In the present situation, it may have more impact to target the *holding*, since this provides a time-related penalty for so doing, rather than just a cost for one action. Taxing or controlling single actions can have perverse effects – non-residents could still exchange Swiss Francs between each other offshore without penalty if the authorities could not see the transaction. This is how the Eurodollar market developed in Europe in the 1960s after the US authorities imposed a series of taxes and restrictions on US-originated debt issuance – an action which seriously damaged the development of the New York financial services industry (and similarly boosted London's position).

History

The 1970s were the last occasion in the post-war period when the Swiss Franc was subjected to such intense buying from international investors that the Swiss authorities intervened with capital controls.

Much of the backdrop was very different – an oil-mediated commodity price boom, serious international inflation, and a recent breakdown of a fixed exchange rate regime. But the symptom was the same – unwanted appreciation of the Swiss Franc through international capital inflows.

The chosen methods for capital controls then were

(a) A ban on interest payments to non-resident Swiss bank balance increases (*increases* so as not to penalise existing holders)

(b) A quarterly charge on non-resident Swiss bank balance increases. The charge varied during 1971-79 between 0% per quarter and 10% per quarter, depending on the capital inflow pressure

(c) Prohibition on the purchase of Swiss Franc denominated bonds, property and other securities by non-residents

(d) Restrictions on non Swiss-denominated borrowing by Swiss residents.

All of these measures were very difficult to apply in a consistent and effective way – the Swiss Franc was already so widely held by 1971 that they were found to have little practical effect on the exchange rate (which still appreciated strongly over this period), and by the end of 1979, the Swiss authorities decided that capital controls had been largely ineffective, and potentially damaging to Swiss financial services exports. So by August 1980, all substantive exchange controls were removed, and the SNB decided that monetary and fiscal measures were the only ones able to regulate demand effectively for Swiss Francs – in effect alignment with the Deutsche Mark.

With the exception of SNB FX market intervention, this has remained the position until today.

Our Guesses

We think that when the Swiss Finance Minister says "'other countries haven't had only good experiences with capital controls and negative interest rates", she may be obliquely referring to the Swiss experience from the 1970s. Few other countries have ever imposed negative interest rates on investors.

Given this experience, we think that the Swiss will embark on capital controls only in extremis. But since the SNB laid down 1.20 CHF/EUR as the floor for the Euro (ceiling for the Swiss Franc), extremis may be just round the corner if the Euro is plunged, yet again, into a serious currency crisis.

Since the world of the 2010s is very different indeed from the world of the 1970s, we think that several of the restrictions applied in the 1970s would be entirely ineffective. In our view, the most effective instruments would be:

a) negative interest rates on cash balances for all investors – not a tax, but the ability of Swiss Franc sellers (shorts) to be paid an interest rate, and Swiss Franc buyers to pay an interest rate. The interest rate would be set by the market.

b) restrictions on the issue, holding and movement of Swiss Franc bank notes by non-residents (and possibly everyone)

c) an exemption (in a limited amount) from negative interest rates for resident persons who come forward with Swiss tax identification, and a law that obliges Swiss banks not to charge negative interest rates to such self-declared residents. Domestic companies would probably not be able to use such exemption (too much leakage), but domestic savings institutions, like pension funds, might be able to. This provision is designed to placate the electorate, and limit round-tripping with bank notes. The limit on the exemption is to restrict round-tripping from new borrowing at negative interest rates by residents.

d) A commitment from the SNB to take deposits from the banks at zero (or a fraction above) to ensure residents' deposits are not loss-making to the banks.

e) An announcement to the effect that the SNB expects the markets to adjust the interest rates/forwards to equate supply and demand, wheresoever it arises. So non-residents will have no identification or qualifications demanded, and there will be one (deliverable) forward market, as at the moment.

Obviously, the leakage will be in SNB bank notes, which are zero coupon. But given the fixed supply of these, and some controls on their export and supply, it is likely that the leakage will be modest. Non-residents would have the option of converting Swiss-based accounts into any other currency, and no extra charges would be incurred on such funds remaining in Switzerland under their banking regulations.

The above is pure speculation, but given the Swiss prior experience, and their desire to remain friendly and supportive to their long-term clients, this is our best guess of the possible route that the Government/SNB might take.