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The Swiss Franc in the Cowpie?
Or: Thoughts on Switzerland in Europe and, in general, in the World

1. *Forced to come to Terms*

At the beginning of May, the EU-Summit sealed what has long been obvious and what financial markets are slowly ceasing to question with an "if, when, and how": A common European currency will be introduced as planned on the projected date, the circle of participating countries being set for some time. A generous, all-encompassing solution has crystallised, taking the financially weaker nations into consideration. Not even the question of who will lead the European Central Bank in the future could seriously endanger the harmony among the heads of government (a compromise was found which ethically stinks to high heaven, however, politically preserves domestic peace).

So few stumbling blocks, such harmony, a great degree of dignity and souplesse has astonished the skeptical observer and makes him even more suspicious, because he is observing that which, in his own view of the world, should not exist at all. But one thing is certain: The introduction of a common currency will not be easy for a continent which has seen only war and mutual destruction during the past millennia. A first-rate political power move, one can most closely compare it to a single blow to a Gordian Knot tied centuries before. In all honesty: Who has not expected much greater censure? For example, in the form of a tug of war of interest- and exchange-rate structures between the stronger and the traditionally weaker currencies of the member nations?

Do high unemployment rates and the hopelessly high debts of the individual European countries with lagging deregulations in major nations, such as France, suddenly pose no more serious problems? Shouldn't the financial markets intervene with penalties against risk, in order to steer the "Megastructure EU" back on to the virtuous path of political correctness?

It is this Non-Event with which we have to concern ourselves. And it is with this Non-Event particularly, that the previously reserved Swiss with his highly distinguished currency, must concern himself, for he has actually focused on the opposite. Being a result of past experiences, his self-imposed limitation of "not interfering in foreign quarrels" finds an end in its legitimacy when, surprisingly, "the foreign quarrel" fails to appear.

2. *Europe and Globalisation*

An inaccurate perception! This great European event did not happen totally isolated like an in-vitro fertilisation. The world does not only consist of Europe, and this is especially true with regard to the world of massive financial currents. A higher system exists for financial markets with its own rules and developments. Therefore, it is vital that megatrends can be found which form the framework of conditions under which the new Euro-currency can be introduced.

Presumably we are still too little aware of what globalisation really means. For some it is simply a term of abuse for a doomed phenomenon that puts established entitlements in question and, as a result, destroys jobs. For others, it is an incentive for each and everyone to go out in search of internationality, to relocate production, to build up and maintain international distribution channels and, unavoidably, to spend most of one's time in airplanes and airports, and producing enormous telephone bills. Both the fear of a too speedy structural change as well as an exaggerated and penetratingly visual mobility are mere symptoms of a much deeper process.

Globalisation in a greater economic sense has come to mean that economic creation of value has become comparable across all national boundaries and all continents. Earlier, standing under the pressure of world political coercion, one could hardly describe a political economy as being "open". Today, one cannot label a political economy as truly "closed". Of course, at the level of physical production and transportation of real goods, protectionism still exists to a considerable degree. Frankly, it is the European Union which often finds itself in the role of a cartel, justifying its actions with arguments in favor of internal markets and thereby isolating itself. However, at the level of *capital* this type of protectionism has all but disappeared. Daily hundreds of millions of dollars are allocated. Hundreds of millions are transferred out of investment objects that have become uninteresting or too risky. And, likewise, hundreds of millions of dollars are looking for new opportunities each day. Weighing returns and risks, every investment possibility is being examined constantly. The huge trading floors of the investment banks, often larger than several football fields together, exist for nothing other than the continuing evaluation of investment prospects.

One cannot overestimate the significance of this function. The efficiency with which capital nowadays seeks and finds its investment objectives cannot in any way be compared to the old-fashioned, almost locally organised stock exchanges of yesteryear. This development is not anywhere near its end. Trade exchanges have already set themselves up on the Internet, and employ other global communication channels as well. The trading floor has been elevated to virtual status.

In a world of investment possibilities constantly under examination, this means only one thing: that one must fight for one's money; one must allow oneself to be compared to other similar investment objects; that one can no longer hide one's entrepreneurial performance behind state structures and keep it on a low flame within cartel-like frames. Capital always seeks new alternatives. Opportunists are not tolerated in the long run. Where more can be earned by equal risk, there the money flows; the same can be said by equal returns with a lower risk. Capital is more fluid than water, and it has become even more fluid than mercury, always finding its own path. Modern information resources and high-tech communication are helping this development along.

Investment objects: Without a doubt, this term brings to mind businesses whose refinancing titles (shares and bonds) are placed on financial markets. However, the significance of the rising efficiency of capital allocation reaches considerably beyond. Entire nations, states and currencies are also open to continual examination and incessant screening. Not one second goes by in which someone somewhere in the world is not reflecting on the economic value of the Mark, or the justification of the interest rate of the Italian Lira, or about Belgium's credit risk.

When we now ponder the introduction of the Euro, respectively, the Non-Event at its definite and formal consecration, then we must do this with Globalisation in mind. This means, it must be totally clear to us that this Event/Non-Event has occurred in a system which with its numerous highly-complex "checks and balances" constantly self-stabilises and for this purpose continually sets rates and imposes premiums.

3. *A World of Convergence*

In nature such feedback mechanisms are well-known. Algae and fish so balance themselves, invasive bacteria are kept in check in the human body, wolves and reindeer control their population growth in relation to each other, all these things happen unintentionally.

This *self-organizing* phenomenon is what we must concern ourselves with. The aforementioned constant surveillance of each and every market member and investment object for the purpose of better capital allocation remains not without consequences. To the contrary: *Because*, even though continuously monitored, controlled and supported, *because* capital always seeks out the most attractive investment object, and *because* modern high-tech communication systems function more efficiently (cheaper!), investment objects must conform more or less to certain principles. Once again: Investment objects are any economic element which requires capital; enterprises, countries and their currencies, supranational organisation and unions.

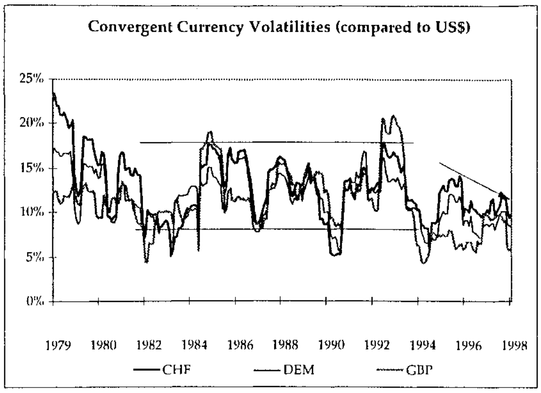
At times of higher nominal interest rates, we have pointed to the more efficient control mechanisms of the bond markets and, based thereon, have forcasted a drop in interest rates. A look at major economic giants shows that the self-organising effect of the financial markets has led to an unimaginable degree of convergence. Total Return varies only by a few basis points among the important currencies, as one can see from the table below. The same trend is exhibited by the inflation rates of the respective countries. Likewise, economic growth has also adjusted itself.

	Bond yield (Total Return)	Inflation (annual rates)	Economic (annual rates)
USA	5.64	1.4	3.6
Great Britain	6.06	4.0	2.9
Germany	4.58	1.4	2.5
France	4.58	1.0	3.0
Holland	4.55	2.5	3.8
Italy	4.84	1.8	2.8

Source: Bloomberg

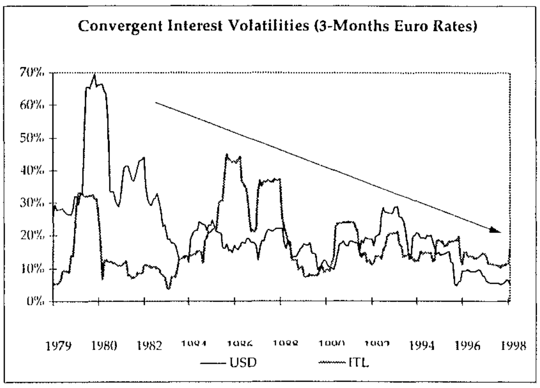
Nations and international economic regions, who ignore the demands and the desires of global capital distributors and who persistently disappoint them, are steered back to the path of virtue through brutal market eruptions. At the moment Southeast Asia is experiencing this pressure. Whether the feedback mechanism functions in every case, that the desired results are achieved, including a pleasant, politically correct and socially fair resolution, cannot be answered here. One also finds disheartening conditions in nature, for example incurable diseases.

Generally speaking, capital markets, which have become better, faster, and more cost-effective, have led to a reduction of volatility and fluctuations in major world economies. Annual economic growth in the United States has moved within a narrow band of 2% - 4% within the last five years. In Europe, economic growth is lower, however, notably constant. Inflationary jumps, as seen in the seventies, no longer occur. Central Banks are forced, due to the feedback mechanism of bond markets, to keep their money policies more or less uniform. Because currency fluctuations have been reduced to such an extent, several of the larger forex houses have seriously considered closing up shop. With such small fluctuational spreads, there is no longer much money to be made with foreign exchange trades.



Convergent Currency Volatilities (compared to US$)

Source: Bloomberg/



Convergent Interest Volatilities (3-Months Euro Rates)

Source: Bloomberg/

This is the world in which politicians are now planting the Euro. And this world explains the Non-Event. The convergence between currencies, interest rates, inflation rates, and economic growth have historically become so small, that, in principle, much will not be changed by the introduction of a common currency. It is believed that in the future European companies dealing within internal markets will be liberated from foreign exchange risks. True. However, since for quite a while, due to the convergence, exchange rate risks no longer exist!

This is not to say that the Euro's situation is now safe for the next five to ten years. Not at all! It is quite possible that out of the Non-Event a real happening could arise. For the markets will watch the European Central Bank with a sharp eye, just as they do Thailand's Baht (perhaps even more sharp-eyed).

Only: the European Central Bank knows this and will behave accordingly (hopefully).

4. *Politics Overrated*

Naturally one now will object that it was precisely the ever more possible prospect of the currency union which brought about this inner-European convergence. From our point of view, hiding behind the clarification of this contention is more than just the question whether the chicken or the egg came first. Similarly one may perceive the discussion concerning deregulation and openness: is it a political desire which gives rise to this metamorphosis, or is it not rather sheer necessity, because the globalised world forces it? Whoever is attracted to the media and its sensationalism, believes in brains like Kohl, in doers like Blair and in machos like Chirac.

Meanwhile it has been demonstrated that fundamental megatrends govern what comes to pass. We have pointed to the reduction of the role of the independent states many times over as a result of the end of bipolar threats. With the definite and permanent introduction of global communications and trading systems, this territorial hierarchy gains in significance again. Who can today pinpoint exactly where a certain process has taken place: which laws apply, where taxes are due, where a reciprocal action is called for?

A major portion of the world economy is no longer based on the principle of territory. As before, politics, in comparison, rests on territorial bodies. At the most, politics is at most a source of annoyance for the economy which needs to be considered in one's calculations. Politics is no longer a contributory factor.

With this in mind, interpreting the Non-Event at the EU-Summit last May, the market believes the matter remains *despite* (and not as a result of!) politics, which reflects the behavior supporting the argument of the feedback mechanism of the distribution of capital.

5. *The Cowpie really exists*

The future can't be so rosy for this politically created entity "EU". Firstly, the evil of a very high unemployment rate reigns. The remedy for this problem which is most preferred by politicians lies dormant in the dusty old chest of socialistic doctrine ("new distribution of work", of course under the management of a welfare-friendly state, as if such an utopia has ever existed!). Furthermore the Socialists so strongly dominate what currently happens in Europe, that any freedom gained is a result of determined actions managing to slip by tight controls. The treasury of most countries wallows in financial fiasco, meanwhile the state's quota is set so high that the tax screw cannot be tightened any further. Pressured by criteria set at Maastricht, bookkeeping tricks are being used for, e.g., the elimination of pension promises by the state. At some time or other these commitments will rise to the surface again as debts in Francs and Cents, respectively (better yet), in Euro and Cents. One will never spot a similar situation in a comparable economic block, for example the USA, having such extreme contrasts existing between cultures, languages and mentalities, as one finds within the EU. What will happen when these large and clumsy distribution operations begin to meet resistance?

This is one well-known viewpoint. The other far less visible side projects a considerably more positive picture. Not to expect anything else – this point was made in the previous chapter – globalisation has definitely influenced the business sector in Europe. Neither German, nor French, nor Italian corporations are able to distance themselves from a global presence, and to be scrutinised and compared in economic performance. The restructuring has begun to bear fruit, with a few years delay, first in America, now also in Europe. The most recent example, illustrating that executives are starting to think differently all over Europe: What about a merger between Daimler and Chrysler? Forced to bring higher, more stable returns, corporate balance sheets will have to be cleaned up on both the asset and liability sides.

Through an increase in productivity the unit labor costs will decrease. For quite awhile they have already been sinking in Germany, in spite of labor unions and record-high social costs. This will have an effect. Especially in a country where the unit labor costs are extremely high in general. The percentage of the reduction appears especially attractive when viewed in actual numbers. Correspondingly corporate profit expectations increase as well. Therefore, the bullish stock market in Germany is not without grounds...

The life cycle of a cowpie was scientifically examined not too long ago. If the blow-fly is not present shortly after production, then no maggots will develop, and the cowpie will become rock hard. The grass growing underneath it can not breath and the grass dies. In a living cowpie, thousands of new organisms find a basis for growth, changing its compact structure, little by little decomposing it and breaking it up, resulting in a healthy environment conducive to support new life.

This comparison may seem rather obtuse and in any event out of place. For the sake of clarity, however, nothing is too low, and so the liberty is taken: The cowpie is Europe, politicised and hopelessly mired in its socialistic roots. The blow-flys are the global market powers who, albeit uncoordinated, but none the less systematic, breathe life into the entire macrocosm. Whether the cowpie likes it or not – other powers also exert their influence, and in the end the cowpie's importance is diminished.

6. The Reverse Side of the Silver Coin

Let's return back to Switzerland. The story about the cowpie and the silver coin stems from our bank's backyard, and has been told to illustrate the situation involving the two half-cantons of Appenzell which are totally surrounded by the canton of St. Gall. The silver coin represents cleanliness, order and maintenance of value, the cowpie in the sense of dirt, stench, and unworthiness.

Switzerland's situation in Europe, and above all Swiss existence in general, has been compared with the silver coin until today. Of course a touch of arrogance is present, defining the alpine nation's special situation for ages. Evoking these memories, a ballot over guest (then "foreign") laborers comes to mind, or the Swiss world traveler in other cultures.

In a sense, the silver coin does present an accurate picture: there is no land in the world with such a high living standard, no country with higher currency reserves, no nation with more international industry, no political entity with a better system of justice and less corruption, and so forth. But the times have changed. It will become increasingly more difficult for the Swiss to maintain this special status as a sparkling ornament, and it will be hard to join in amid the tumult of maggots in the cowpie.

The silver coin has always held its value and been admired in the world. For this reason an interest rate difference of 1 ½ % to 3% between the Swiss Franc and the major European currencies has prevailed for years. This means nothing other than the Swiss business community, the Swiss state, as well as (indirectly) the enormously high number of renters, are able to refinance at more favorable rates. The average Swiss citizen is not aware of the meaning of this interest rate advantage.

Today Switzerland finds itself under pressure. On the one hand, the Swiss feel isolated in many ways by the EU. Switzerland fluctuates between wanting and not wanting to reach an agreement on fundamental points and therefore to enter into bilateral negotiations. Neither over transportation disputes (a wonder due to the central position of Switzerland) nor in questions concerning residency rights is there a political consensus in sight. On the other hand, problems are piling up relating to the disposition of undetermined assets in particular and the neutral role of Switzerland during World War II, in general.

In view of the above, an existence as the world's jewelbox appears suddenly to have lost its glance.

7. The Great Strategy Deficit

It is not at all astonishing given that Switzerland could manage to avoid any discussions concerning its identity, its function in the world, or its special position during the fifty year Cold War. Here, in the heart of Europe, remaining neutral and accumulating wealth, no one ever has shown an interest in destabilising Switzerland, who has been occupying a geographically and politically sensitive position.

Switzerland used this time to its own advantage. As well as chalking up good results in international industrial operations (such as Nestlé, Roche, Sandoz, Ciba-Geigy, ABB, Holderbank, etc.), this alpine nation has also managed to take advantage of bank secrecy laws to become the largest investment administrator in the world. International enterprise *and* off-shore business found a spot in one and the same country, such services could only originate and flourish in a location where priorities are set to deal with the serious conflicts between East and West.

With the turn-around of 1989, and the disintegration of the Soviet empire, Switzerland was forced to initiate strategic discussions to explore options concerning "What's next?", which means what chances and risks are to be expected in a world which no longer needs Switzerland's stability. Unexpectedly, this nation is now finding itself in an apparent ghetto-situation.

In principle, this situation has not yet even been defined. Some do not realise that Switzerland, in its present form, is in jeopardy, others are delighted, this feeling stemming from exaggerated over-confidence, and still others react with temper tantrums, often colored by racial undertones. But does this mean the end!

First, one must identify what type of conflict is involved. Discord (war and its special vocabulary and strategic plans) helps little to form opinions. War is a form of conflict always involving political power plays. In the case of Switzerland, this dispute concerns something totally different. It involves money. So obviously legitimate various claims may effectively be, so clearer the objective: Money! This is true in all sectors: Banks, insurance companies, industry, and of course, for the National Bank.

And it doesn't necessarily just have to be jingling coins in one's own pocket. Rather, what is sought is the "full monty". That's why bank secrecy laws are under pressure. The OECD has demanded that Switzerland open its bank books in foreign treasury affairs. It is well known that the American government is hiding behind this OECD initiative. Certainly the assault on the bank secrecy laws has been supported in part by the endorsements for the defense out of New York.

The motivation for this attack on the Swiss bank secrecy laws is presumably many-sided, and typically American: A mixture of missionary zeal to destroy all evil, via global control of all databanks, on one hand, and pure greed, tied to imperialistic thinking, on the other.

In history this situation is not new: a sudden and concentrated attack on a people who are more or less defenseless, but due to their uniqueness and diligence have collected considerable wealth in their ghetto. This story also teaches that at no time has legitimisation failed to prove this precedence.

It is much too simple to view political leadership in a situation of weakness and loss of orientation. The big bank's judgment policy of alignment of individual freedom is too hasty and shabby. But who can hold it against them that they want to be welcome again in the US and the rest of the world, and likewise be in a position to be able again to go on the acquisition tour?

The strategic *Ghetto-Situation* in Switzerland is *sui generis,* and characterises itself such, that no other option remains for the victim other than to offer a sacrifice. In other words there is no good or better solution, rather one must be satisfied when can find a second worst solution in place of the worst.

8. *Approaching the EU*

The newest developments accelerate a process that for Switzerland alone as a nation, would have taken much longer or would not have come to pass at all. America is finally chasing Switzerland into the arms of the EU. The only question existing in our opinion is under which conditions such an approach would and could be favorable.

Residency and transportation questions aside, the most important issue concerns the maintenance of Switzerland's global off-shore status and how to save its reputation as an important international financial center. The answer to this question is tied closely to that of whether the Swiss Franc will exist in the future and, if so, what privileges it has over the Euro. We could imagine to interpret the interest rate advantage of our national currency as sort of a bonus, which would reflect a higher creditworthiness. And this low credit risk, in turn, would stand in direct relationship to the managed investment funds, as these are not dormant, but dynamically add to "wealth creation".

An ethical component is always tied to offshore business. The avoidance of taxes may seem in some cases to be unethical, but in cases of high, confiscating tax levels, it plays the moral role of a guardian angle protecting property and hindering the draining of honestly earned money to a greedy state; respectively, the bank secrecy laws can be highly problematic, or absolutely necessary.

Switzerland will not be able to avoid confronting these problems concerning bank secrecy when drawn toward approaching the EU. An answer to the OECD, which would tie the opening of the bank secrecy laws to the tax percentage quotas of the petitioning countries, would most likely bring demands to a halt: Who could object to opening the bank secrecy to nations whose withholding taxes lie under the limit of, say, 30%? Not the OECD, because it has fought for lower quotas for years. Finance center Switzerland? Also not, because no other nations exist with lower quotas and because, if they did, they would definitely not start treasury investigations.– We have recently submitted these admittedly quite daring suggestions on to the proper Swiss authorities. Perhaps courage will be needed in the near future to try out some of these bold, but nevertheless accurate liberating blows.

9. *Restructuring continued*

Meanwhile as Switzerland licks its wounds and especially suffers because of a decade long absence of knocks, the restructurisation proceedings are running at high speed in the world as well as now also in Europe. We have already referred to the sinking unit labor costs in Germany, a clear sign that the extensive investments of the last few years have begun to bear fruit. The frame for continuing economic growth is given, despite all Europe-specific iniquities such as unemployment and inflexible social legislation. We are expecting for 1998 a growth rate between 2 ½% and 3% (real) for Germany. As in the USA, we are not expecting a new consumer and building boom in the near future. Rather growth will be carried by export and investments in equipment. The same applies to the other industrialised countries of Europe.

For the investor, times of speedy restructuring has always been interesting. Also even when the greatest market fans from
in St. Gall bristle when facing considerable increases in exchange rates, we see very clearly that the values of corporations have risen due to stable interest rates and notably higher outlooks. And there is no reason to expect that there will be any changes to this view in the future. Why should the world be worth less tomorrow than today?

Naturally we know that set-back risks exist, and we would be lousy investment advisors if we were not aware of them. And we adjust ourselves to each individual client and balance their risk-taking abilities and preferences. And we remain confident that until further notice the dynamic powers of the markets have more say than the politicians. And, therefore, we watch the continuing development of the world with great interest and a healthy measure of positive thinking, from now on.

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