Zurich in these times

The center of global capital flow remains an island for global investors

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Almost a day does not go by when there is not some headline in the news about the latest financial crisis. Governments around the world are rushing to respond with very little effect. They are frantically demanding significant new regulations for the most regulated industry on earth. Will all this really help?

Something much greater is afoot that governments and the financial industry do not fully understand and really cannot change. The change is so dramatic and so pervasive within the culture, that it is now being likened by many to the impact of the Reformation, which was so important for Zurich. The wave directly hit the rigid structures in the financial world. It has had an enormous impact on the major centers of the financial industry and will continue to do so for years to come. Financial centers around the world have tied their fate to those changes and perhaps at the epicenter is Zurich, a city that in recent years can legitimately claim the title of global capital metropolis.

While manufacturers have spread globally, communicating and doing business in ways never before seen, the financial community could do little to structurally change. It was always limited by government regulation and its own comfort with the existing structures not to adapt to the new world. Bankers may scoff and say that this trend has already been out there for a long time. Unfortunately their structures and the way they are required to do business are much older.

The change is not just about how to do business, it is where to do business. Does anyone remember the NYSE marketing line, “The world puts its stock in us”? New Yorkers in 2007 were saying they were the gold standard of the world, when the government put even more burdens on them via Sarbanes-Oxley. However, like the auto industry permanently changed Detroit, the world changed New York, opening the door for Zurich and other financial centers.

The decline of New York as a financial center

For New York, there is a new realization that it is no longer the dominant player of years past. Billions of dollars in capital have left the U.S. As it was leaving, few thought of the real impact. Less money means less need for money managers. Fewer managers means fewer companies to manage money. It is simple supply and demand. One could say that the downfall of Bear Stearns was really the first plant closing in New York. Steel mills in cities like Pittsburgh and Youngstown lost far more jobs than the loss of Bear Stearns. So why the big headlines?

Where did the money go? It went to the world. Zurich and Geneva are two of the largest locations. In fact, there was a boomtime in Zurich and Geneva shortly before the problems with UBS surfaced. Switzerland is really one of the biggest beneficiaries of the current changes in the financial world. Approximately 35% of the offshore wealth for the world resides in Switzerland. Why is it that such a huge percentage is in Switzerland? Some say it is the bank privacy protection. That law and tradition of Swiss banking are under major pressures. Some fear the loss of privacy means the loss of the Swiss advantage. In fact, a certain portion has left. Perhaps it is time. What is revealed behind the bank secrecy law is the tremendous infrastructure for capital formation, investment and management. New York, London and Frankfurt may have the largest markets to trade assets, but Zurich has the capital and decides where that capital goes. Singapore advertises to be the “Switzerland of Asia”. Switzerland is the standard for comparison.

With the global capital flow, there are, in effect, two worlds at play, the regulated world and the “economic” world. The financial world is very focused on the first world. Decisions are based on tax laws and securities laws of a certain country. As countries compete for business, they change their laws and regulated entities follow. Malta and Cyprus are rapidly growing locations for the financial world. Switzerland does not live in a vacuum. If taxes or the cost for formation and management of capital are too high to stay in Switzerland, the capital will disappear.

Taxes and the “economic” world

The “economic” and unregulated world is free of the tax and regulatory trap. Decisions are made based on what makes the best economic sense. Decisions based on tax laws and the like are inherently non-economic, lead to inefficient structures and are prone to collapse in tough economic times. In this world, security, infrastructure for investment, quality of life, availability of an educated workforce and good housing take priority over taxation and regulation. Taxes and regulation play a role, but the investors do not get lost in chasing the lowest tax rate. Simply, you get what you pay for.

Switzerland: At the top in both worlds

Fortunately for Switzerland, the country is at the top in both worlds. The difficulties with European countries on tax issues only magnifies the fact that Switzerland can operate all the services of a government at a fraction of the cost of governments in countries following the social-market economy model. The current meltdown of the euro has exposed the real cost of those governmental models. Furthermore, the regulatory environment in Switzerland provides good controls over the financial sector, without the huge burden placed on American public companies by the Securities and Exchange Commission.

In the midst of global crises, Switzerland provides a secure location with the best quality of life offered anywhere in the world. Zurich and Geneva are always in the top lists of best cities in the world. If you can live anywhere in the world, where would you live? Switzerland is the most frequent answer.

However, nothing stays the same. Switzerland, Zurich and Geneva cannot rest on their success over the years. Taxation and regulation are constantly changing with the intent to lure tax-motivated institutions and individuals away from Switzerland. To give a local example to the Zurich area, it is like the competition between the Gold Coast and Schindellegi or Pfäffikon in the Canton of Schwyz. If one looks at the empty apartments on the Gold Coast and the top-class condominiums in rapidly growing Schindellegi, one can see a local example of the effect tax laws and regulations can have on a global base. The lump-sum taxation for foreigners was eliminated in the Canton of Zurich and certain taxpayers quickly found an alternative across the lake. With global capital flow, it just takes a mouse click and the money is transferred somewhere else.

Remaining calm and neutral as a competitive advantage

In the next few years, governments around the world will pass new legislation and create new regulations that will greatly affect the financial-services industry and global investors. If Switzerland can remain relatively calm and neutral in its own legislation, it will mean a continued position at the center of global capital flow. If it does not, it stands to lose a major competitive advantage in the regulated world and, like the Gold Coast of Zurich, wonder where everyone went. Just ask New York City. *fmshepperd@ shepperdinvestors.com*