THE WALL STREET JOURNAL

Why Switzerland Is Leading the Haven Beauty Contest

By ALEN MATTICH July 29, 2011

Why, exactly, is Switzerland such a haven for investors?

It's a land-locked country with few natural resources besides water and scenery. And, as they say, you can't eat scenery.

More crucially, Switzerland is a small, open economy heavily dependent on its neighbors for trade and the resources it lacks at a time when one of the biggest of these, Italy, faces a looming crisis. Huge capital inflows and consequent currency appreciation have made the Swiss franc increasingly noncompetitive.

So why do investors keep flocking?

To be sure, Switzerland benefits from a reputation as the world's safe-deposit vault. Swiss banking secrecy may be less secure than it once was, but it still offers a haven for foreigners wishing to keep their money secure from their own governments. Swiss private banking has cachet.

And there are some good economic reasons, too. Switzerland consistently runs large current-account surpluses. This year's is expected to be above 13% of gross domestic product and the IMF forecasts that it will remain in double digits over the coming five years, the strength of the Swiss franc notwithstanding. Large surpluses help to immunize an economy from speculative attack because the country isn't dependent on foreign-capital inflows to finance itself.

Most appealing for investors is the Swiss National Bank's reputation as an inflation hawk in a world where central banks everywhere seem keen on pursuing easy monetary policies. Swiss inflation has tended to be 1% or less during the past two decades and is forecast to remain at or below that level over the coming years.

What better hedge, then, than gold and the Swiss franc against the fear that the likes of the Bank of England and the U.S. Federal Reserve will look to inflate their way out of their huge national-debt burdens?

So it's no coincidence that both gold and the Swiss franc have rocketed to highs. Since June 2007, the franc has appreciated by 38% on a trade-weighted basis, rising more than 16% in the past year alone. This has started to put a large squeeze on Swiss industry, which finds itself swimming against a currency that is between 40% and 50% overvalued. At the same time, Switzerland's export performance is likely to be dented by its dependence on increasingly fragile neighboring economies.

Around 60% of Swiss exports go to the European Union and nearly 80% of its imports come from there. As the sovereign-debt crisis takes a bigger bite out of demand from peripheral euro-zone economies and if, as some economists expect, growth in the common currency's locomotive, Germany, starts to slow in the coming year, Switzerland will feel the strain.

It's an irony that Switzerland's attractiveness to foreign investors has in no small part been down to the fact that it is seen as a proxy for a pre-euro Germany, at a time when Germany's membership of the common currency has given its economy a significant boost by keeping its exports competitive.

Capital Economics, a consultancy, figures Swiss exporters won't be able to continue bucking the strong currency. The result will be lower current-account surpluses than the IMF expects and a weaker economy. Ultimately, this will cause investors to rethink the franc's haven status.

And there is plenty of speculation the Swiss National Bank will again look to intervene in the market in an effort to put a lid on its rampaging currency.

So how can the Swiss authorities stifle capital inflows before they crush the economy? It's worth remembering that from 1972 to 1978, Switzerland imposed a surcharge on nonresidents' deposits in its banks that in effect created negative nominal interest rates. But given that real interest rates are negative across most of the developed world, would slightly negative nominal interest rates in a country with very little inflation really dissuade people looking for a safe place to park their money?

Perhaps a more significant vulnerability is Switzerland's continued dependence on the financial-services industry. In 2010, Swiss banking assets were equivalent to more than 700% of GDP. Only Ireland and Luxembourg exceeded this proportion. A systemic banking crisis caused by sovereign defaults in the euro zone would have a disproportionate effect on the Swiss economy. One strategist working for a Swiss bank drew wry comparisons between Switzerland and Iceland, whose economy was crushed by its own overly large banking sector.

But for all of Switzerland's potential flaws, in the zero-sum game that is the currency-market beauty contest it remains more attractive than the competition. Even rivals such as Norway, which has many of Switzerland's economic strengths without the additional weakness of dependence on finance, are hobbled by factors such as not having enough public-sector debt to give investors an easily tradable instrument.

For now, Switzerland remains one of the last refuges of the fearful.