Mr Roth remarks on the euro and Swiss franc: two sister currencies?

Speech by Mr Jean-Pierre Roth, Vice-Chairman of the Governing Board of the Swiss National Bank, at the Swiss Business Association Annual General Meeting, Singapore, 24 February 2000.

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For more than a year now, the euro has been a reality. It has crowned a decade long process of monetary integration in Europe. The introduction of a common currency in eleven closely related, but independent countries is an unique experiment. It is still too early to assess all the far-reaching implications of this monetary revolution. Therefore, the thoughts and remarks I am going to express today can only be intermediate and provisional.

1. Consequences of the euro for the Swiss economy

Switzerland is not part of the Monetary Union. It is nonetheless deeply integrated in its European environment through its geographic situation and its strong historical, cultural and economic links with Europe. Over 50% of our exports go to countries of the euro-zone, while 70% of our imports come from there. But, besides that, Switzerland has strong traditional links overseas, too. The US, Canada and Japan account for 10% of our imports and 15% of our exports while emerging markets represent 4% and 10% respectively. Although concentrated on Europe, our foreign trade is geographically more diversified worldwide than that of other small open European economies such as Austria, the Netherlands or Belgium.

For the first time in its history, Switzerland is surrounded by countries all sharing the same currency. Even without being a member of the Union, it is affected by this new monetary situation. De facto, our trade with Europe is already taking place in one currency only - the euro - because the parities of the former national currencies have been definitively locked. That means that our foreign trade is less diversified by currencies than earlier and that fluctuations of the SF/euro exchange rate have an even stronger impact on the Swiss economy than the former SF/DM or SF/FF exchange rates. At the same time, a common monetary policy for Europe is likely to lead - over time - to a stronger synchronization of business activity in the EMU member states. This, in turn, means that the impact of the European business cycle on the Swiss economy will become more even and thus also stronger. More than ever, Switzerland’s economic destiny will be linked to that of Europe.

Today, Switzerland benefits already from the technical simplification induced by the substitution of ten different currencies by a single one. Monetary unification brings advantages to internationally oriented firms as it simplifies their foreign currency management and their accounting procedures. From the year 2002 onward, when the euro will exist in the form of cash, the single currency will make things even easier for a broad public, not only for the Europeans, but also for every Swiss travelling through the euro-zone. At that time, the euro will probably also be easily accepted for payments in Swiss border regions and tourist areas.

As final advantage, the single currency greatly enhances market transparency and stimulates competition. On the one hand, Swiss importers can now directly compare euro denominated offers from different countries. On the other hand, exporters can less easily differentiate prices according to the market destination of their products. In the long run, transparency will promote efficiency for EU-members and non-members. The almost daily news about mergers and acquisitions in Europe is an expression of the ongoing fight for a favorable position on the unified European market.

2. Extraordinary stability of the Swiss franc/euro exchange rate in the past ...

After these remarks on the general consequences of the euro for Switzerland, let us now turn to the more specific, but nonetheless central, question of the exchange rate between the Swiss franc and the euro. As already mentioned, the exchange rate between the Swiss franc and the euro is of crucial importance to the Swiss economy. So far, the relation between the two currencies has been remarkably stable. Since the introduction of the single currency, the Swiss franc/euro exchange rate has fluctuated in an extremely narrow band of only 2%. Thus, exchange rate volatility has until now been even lower than the 8% volatility observable between the Swiss franc and the Deutsche mark during the three years preceding the monetary unification.

The extreme stability in the exchange rate has surprised many observers, including the Swiss National Bank itself. It has led to the notion of “sister currencies”, the euro being the big sister and the Swiss franc following her everywhere like a shadow. But is the Swiss franc really the euro’s little sister? Let me discuss this question in detail.

If one examines the reasons for the extraordinary stability in the exchange rate, one quickly finds that convergence in fundamentals has played a central role. Both Europe and Switzerland have suffered from slow growth in the 1990s and from deflation fears in the aftermath of the international financial crisis of 1998. Rising unemployment and weak economic activity led the ECB and the SNB to adopt an expansive monetary stance and to cut interest rates. Broad similitude in business cycle and monetary stance has created conditions leading to an almost fixed exchange rate between the euro and the Swiss franc. At the same time, converging fundamentals explain why both currencies have been equally weak against the US dollar: the American business cycle is well in advance of the European and Swiss business cycles, requiring a different policy response from the Fed.

While fundamentals play a key role in explaining long run exchange rate developments, political factors can also be of some importance in the short run. By political factors I mean, for example, elections, government crises, political conflicts or new legislation, but also the relation between the government and the central bank, and the credibility of both. In 1999, these widely defined political factors may have played some role for the relation between the euro and the US dollar. The conflict between the former German finance minister Lafontaine and the European Central Bank, the European undecidedness in the face of the Kosovo conflict, and the plans for a harmonization of taxes on interest payments, for example, may have contributed to the weakness of the euro against the dollar. In addition, the not always clear communication strategy of the European Central Bank concerning its views on the exchange rate of the euro may also have created some uncertainty.

However, it is puzzling to see that the relation between the Swiss franc and the euro has not been disturbed by these factors. It may be that the markets perceived Switzerland as so strongly integrated in Europe that they almost forgot that the Swiss franc is an independent currency. Or, they believed that the Swiss National Bank, as declared in the early and uncertain days of the introduction of the euro, would not tolerate a sharp appreciation of the Swiss franc. Expectations of a SNB reaction certainly played a role.

In my view, a further factor may explain the greater stability of the Swiss franc vis-à-vis the European currencies. One cannot exclude that the emergence of a large market for the euro has had a structural impact on the demand for Swiss francs. Today, the currency diversification of international portfolios occurs between blocks (dollars, euros, yen and Sterling). Given its size and its traditional low volatility vis-à-vis the DM, the market for Swiss franc denominated assets does not offer an attractive way to counterbalance the risks born by large holdings of key currencies. Our currency is thus less demanded as reserve currency and less involved in speculative capital movements. This is basically good news for the Swiss economy.

3. ... and what about the future?

What conclusions can be drawn from the past? Will the Swiss franc remain stable vis-à-vis the euro, or will we see a more independent development of our currency? Again, the answer to this question will depend crucially on economic fundamentals in Switzerland and in the euro-zone. In both areas, the economy is now recovering from the recession, following a steady upward path. The expected growth rates for this year amount to 2.2% for Switzerland and 2.9% for the euro-zone. The central question for the exchange market is to what extent the economic upturn could endanger price stability, and what kind of central bank's reaction can be expected.

3.1 Uncertainty about lasting convergence in European and Swiss fundamentals

While Europe is now growing faster, it still suffers from an unemployment rate of roughly 10%. At first sight, one might think that this big labor reservoir would allow the economy to grow without tensions on the labor market and without large wage adjustments. Inflation would remain subdued, and there would be no need for an all too restrictive monetary policy. This, however, is only the "first sight" scenario. European unemployment is largely structural, meaning that although there is a demand for labor on the part of the firms, this demand is not necessarily matched by the supply on the labor market. Under these circumstances, the labor market could constitute a bottleneck for growth and lead to inflationary pressure. To prevent inflation from rising, the European Central Bank would have to further increase interest rates. Clearly, structural adjustments are of the essence in Europe. In the absence of flexibility, the unemployment rate cannot be lowered significantly and doubts exist about the actual room of maneuver of the monetary authorities.

Expected growth for Switzerland, on the other hand, looks quite moderate by international standards. Thus, one might think that there is little danger of inflation and that the Swiss National Bank should further support the seemingly fragile economic upturn. A look at the labor market, however, shows another picture. Unemployment has fallen steadily since the summer of 1997 to a low rate of 2.3% only. Its recent increase to 2.6% is due to seasonal factors. Moreover, there are already clear signs of a shortage on the labor market. Stronger growth could thus fuel the well-known wage-price spiral. Under these circumstances, a further tightening of monetary policy is a realistic hypothesis.

To make things even more difficult, there is a high degree of uncertainty concerning the development of labor productivity in both Europe and Switzerland. The rise in labor productivity is usually seen as the main factor behind the spectacular performance of the US economy, characterized by high growth and low inflation. Will productivity now also start rising in Switzerland and Europe? Where will it rise more? In Switzerland, where the labor market is more flexible and structural reforms are more advanced, or in Europe, where the large common market and the single currency are expected to break up old structures?

We have good reasons to believe that there is a potential for non-inflationary economic growth in Switzerland. Investment has been strong in 1998 and in the first part of 1999, deregulation and competition have made spectacular progress, large-scale adjustments have taken place in various economic sectors and more flexibility is now accepted in the labor market. Some adjustments in the interest rate have been made in order to restore a more neutral monetary stance. In one word, the degree of competitiveness of our economy is stronger today than it was 5 or 10 years ago, production capacities have not been fully exhausted and monetary conditions have been adjusted. Switzerland will thus benefit from the recovery in Europe without major risk of inflationary pressures.

Indeed, the assessment of the future stability in the exchange rate between the Swiss franc and the euro depends crucially on what will happen in Switzerland and in the surrounding countries. If the convergence in fundamentals goes on, the exchange rate should remain relatively stable; otherwise some adjustment will be needed. I am convinced, however, that the exchange market will not behave irrationally. Following the pattern of the DM/SF relationship of the past, it will not depart substantially from what fundamentals would suggest.

3.2 Political uncertainties

What about the political factors influencing the exchange rate? I would like to mention here two major themes that could possibly affect the relation between the Swiss franc and the euro.

The first factor is the uncertainty about Switzerland's future policy towards Europe. As you may know, the Swiss people rejected Switzerland's membership in the European Economic Area (EEA) in December 1992. This vote was regarded as an anti-EU signal by the government, which has since then shelved its plans for adhesion to the EU. As an alternative, Switzerland has negotiated Bilateral

Agreements with the EU in order to gain free access to the EU internal market for goods and services. The agreements need to pass a popular vote next May. The prospects for an adoption of the Agreements are good. Sooner or later, however, the question of Switzerland's accession to the EU will be considered again. Should the Swiss people still favor a Switzerland outside of the EU, then room for monetary independence will remain.

The second political factor is the uncertainty about the EU enlargement. There is a long list of Eastern European and Mediterranean countries pushing into the EU. Of course, EU enlargement will be a progressive step-by-step process. Nevertheless, it is uncertain today how an enlargement will change the EU's face in the future. How will these countries be integrated? How will the decision-making process inside the EU be affected? And finally, how will the EU enlargement be financed? All these open questions constitute a potential risk factor for the euro.

4. Conclusions

Looking back at the first 14 months of the euro from a Swiss perspective, the most striking observation is the extraordinary stability of the Swiss franc/euro exchange rate. A detailed analysis shows that this stability was due to a high degree of convergence in economic fundamentals and in the monetary reaction of the two central banks. Thus, solid economic reasons have been behind this stability and not some artificial strategy of currency pegging implemented in secret by the SNB. In the future, the exchange rate should evolve depending on the development of the fundamentals - in Switzerland and in the euro-zone - and on the answers to some important political questions. Exchange rate stability, on the scale that has been experienced so far, is not guaranteed to last forever. However, the risk of erratic movements seems limited because the presence of large currency blocks has lowered the attractiveness of the Swiss franc as reserve currency.

Nevertheless, I would hesitate today to qualify the euro and the Swiss franc as "sister currencies". If you have a sister, she remains your sister for life and not just in case of common interests. We should rather consider these two currencies as travel companions: they share the same objective - a sound macroeconomic development - and follow the same road towards price stability. It is up to their relative fitness to see whether they will continue hand in hand.