Niklaus Blattner: The euro - implications for Switzerland and for the monetary policy of the Swiss National Bank

Speech by Professor Niklaus Blattner, Member of the Governing Board of the Swiss National Bank, at the Banking Studies Center Colloquium, Lugano, 22 October 2002.

*   *   *

1. Introduction

Where do we stand more than three and a half years after the launch of the European Economic and Monetary Union (EMU) and almost ten months after the introduction of euro notes and coins? On the whole, from the perspective of the Swiss National Bank (SNB), the experience with the euro has been primarily positive so far, even though the Swiss franc has somewhat appreciated against the euro since 1999.

First of all, Switzerland is now surrounded by a large currency area that pursues similar goals in terms of monetary policy, and, in particular, with respect to price stability. Competitive currency devaluations are no longer an option for members of the euro area, and the exchange rate volatility of the Swiss franc vis-à-vis the currencies of the European trading partners has declined considerably.

For Swiss enterprises, foreign currency management has become easier. Apart from decreasing transaction costs, Swiss firms also benefit from enhanced price transparency and competition in Euroland. At the same time and despite some initial fears to the contrary, Switzerland has been able to retain its advantage of lower interest rate levels. There has also been some concern that the euro would make the Swiss franc obsolete as a means of payment, but this is very unlikely.

These are, in a nutshell, some of the main conclusions from a Swiss perspective, on which my remarks today will focus. Moreover, I will address the consequences for the SNB’s monetary policy. In the light of current experience, the SNB will undoubtedly continue to conduct an independent monetary policy. But before turning to the implications for Switzerland in more detail, let me briefly recall the principal pros and cons of creating a monetary union.

2. Benefits and costs of a monetary union

The launch of a common currency promises benefits and causes costs. Since the benefits are mainly the result of structural improvements and the costs are due largely to the greater difficulty in steering inflation and economic activity, it is difficult to offset the advantages of a monetary union against its disadvantages. Whether a monetary union on balance creates benefits or causes costs depends on a whole range of factors, not least among them the characteristic features of the common currency area. What is theoretically uncontested is the following: in order to form a so-called optimal currency area, the member countries must be structured along similar lines or exhibit a high degree of flexibility.

The benefits of a monetary union consist in a reduction of transaction costs for changing money, the elimination of internal exchange rate uncertainty, tighter competition thanks to easier price comparisons, the expansion of trade within a region, the prevention of competitive depreciation and speculative attacks on a currency, and growth in the liquidity of the financial markets. Those advantages, in particular, that are associated with an increase in competition and an expansion in the trade of goods and services need time to develop.

The costs of adopting a common currency include, first, one-off expenditure in connection with the introduction of notes and coins. In the European Monetary Union, these were estimated to be around 0.5% of gross domestic product. Naturally, these costs are evident from the start and of a merely temporary nature. Potentially the most significant costs of a currency union, however, arise from the loss of the individual countries' independent monetary policies. Particularly at the early stage, these costs are a considerable factor. Depending on the further economic development of the Monetary Union, they might eventually decline over the years.

So where is the problem? The loss of autonomy in monetary policy is felt all the more with the growing number of asymmetric shocks. Such shocks are disruptions that affect the economic structure, business activity and inflation of member countries in different ways. Thus, they cannot be combated with a uniform economic policy. The recession of 1990-92 vividly illustrates the potential consequences of a single currency in regionally diverging economic situations. At that time, Britain and Italy withdrew from the European exchange rate mechanism and devalued their currencies. This measure permitted them to recover relatively quickly from the recession but they had to put up with higher inflation instead. Conversely, and at the same time, Germany had to contend with the inflationary effects of reunification. Therefore, the German Bundesbank had to raise interest rates to support price stability.

What would have happened if the Monetary Union had already existed at the time and if Italy, Britain and Germany had been members of the Monetary Union? Italy and Britain would not have been able to devalue their currencies. The sole instrument would have been monetary policy. The European Central Bank (ECB), had it already existed then, might possibly not have increased interest rates out of consideration for Britain and Italy, or at least might not have permitted rates to rise to the extent that the Bundesbank considered necessary. This would not have served either Germany or Italy and Britain well. In the case of asymmetric shocks a uniform monetary policy is second best.

Apart from this historical case in point, the general rule is that the costs of the loss of monetary independence will be progressively lower as the pace of economic adjustments increases. In particular, the speed with which the economy recovers depends largely on the flexibility of the labour market and on job mobility. When salaries develop in line with the regional economy and a potential for direct investment exists, regionally diverse shocks may be more easily absorbed despite a uniform monetary policy. The mobility of the workforce is also a helpful factor. If a workforce is mobile, there will be some who will leave a country suffering from a crisis and settle where job prospects are better.

An illustration of how useful such flexibility can be was provided by the 1990-91 recession in the United States. Following substantial cuts in military expenditure, the economic downturn in particular affected regions with a high proportion of military bases and arms manufacturers. Notably in California, the unemployment rate rose much more markedly than in the rest of the country. Thereupon, between 1993 and 1994 more than 250,000 employees (in net terms) emigrated from California, while in the previous boom year 200,000 persons had been attracted to this region. Even if the adjustment process was painful for many people, the flexibility of the US labour market dampened the costs of this asymmetric shock.

Coming back to the European currency union, it might be objected that monetary policy is not the sole economic policy instrument. Fiscal policy measures such as a tax reduction or an increase in public expenditure are also a means of boosting overall demand. Yet the stability and growth pact, which helps to ensure budget discipline in Euroland, imposes restrictions on the fiscal policy of the individual members. By contrast, interventions in the field of fiscal policy on a European level would hardly be in contradiction to the stability and growth pact. For a long time to come, however, the Union's budget is still likely to be too modest to bring about the desired effects within the Union by means of a stabbility-oriented fiscal policy. For the time being, fiscal policy is therefore not a realistic option.

Finally, one should take into account that by its very nature a monetary union promotes the division of labour between the participating countries. Instead of being evened out, differences between countries may thus become more acute. In fact, regional specialisation in the United States is more pronounced than it currently is in Europe. Major industries have joined together in national clusters - car manufacturers in Detroit, software producers in Silicon Valley, the film industry in Hollywood. One might argue, in this context, that the Fed in Washington faces the same problems as the ECB in conducting a common monetary policy that fits economically diverging regions. However, there are two remarkable differences between the United States and Euroland. First, the US labour market exhibits a higher degree of flexibility, and second, the United States are a federal state with a large budget and fiscal policy power of its own.

The European Union (EU) is still far removed from all this. Nevertheless, despite all the reservations, it should not be overlooked that a monetary union creates facts. The elimination of transaction costs and of exchange rate volatility helps to lower interest rates, stimulates trade and facilitates direct investment within the Monetary Union. The project of the European single market, which, among other things, also serves to encourage mobility among the workforce, is thus provided with further valuable stimuli. Moreover, the stability and growth pact contributes to the harmonisation of economic policy. Asymmetric shocks may thus become less important in the course of time. It is precisely this type of shock that has the most adverse effect on the functioning of a monetary union.

3. Implications of the euro's launch for Switzerland

3.1. Implications for the Swiss economy and the Swiss franc as a means of payment

Like many enterprises in the euro area, Swiss companies benefit from the greater price transparency created by the euro for goods purchased from Euroland. Besides, this leads to enhanced domestic competitiveness with beneficial effects on national prosperity.

A further positive effect for Switzerland results from the reduction in the number of European currencies. Hence, foreign currency management becomes easier. The danger of extreme exchange rate fluctuations such as the 70% real depreciation of the Italian lira between 1992 and 1995 has diminished drastically with the disappearance of the most volatile European currencies. Nevertheless, in a system of flexible exchange rates fluctuations can never be ruled out entirely.

A hedging strategy for Swiss entrepreneurs would consist in using the euros that they earn for settling suppliers' bills or, in theory, even for paying wages and salaries in Switzerland. In reality wage earners are likely to offer resistance to being made to bear the exchange rate risk. So-called natural hedging is a more obvious option. In this case, Swiss exporters use the euro amounts for paying for intermediate services, i.e. their suppliers from Euroland.

Naturally, the Swiss financial centre, too, will not remain immune to the euro. The integration of the European financial markets propelled by the single currency will trigger waves of innovation and, in particular, of consolidation. As virt-x in London shows, financial markets are not tied to a specific location. A strengthening of locational competition on a global level represents a considerable but desirable challenge for the Swiss financial centre.

Euro cash is also a welcome innovation that makes things easier. The introduction of the euro in its physical form has primarily affected the hotel and catering industry, retail trade and banks. In this connection, some observers have raised concerns that the euro might displace the Swiss franc as a means of payment. Obviously, the euro is now circulating in Switzerland. This will not lead to a new world, however. Numerous businesses and hotels, notably in border areas and in holiday resorts, have long-standing practical experience in accepting foreign currencies. But even though they provide a foreign-exchange service to their customers, this is definitely not where their comparative advantage lies. Hence, the offered exchange rate is generally unattractive, and visitors will almost always be better off converting their money at a bank or using their credit cards.

Historically, parallel currencies have only prevailed in those countries that no longer had a sound currency of their own. As long as the SNB continues to pursue a policy that aims at maintaining price stability, the Swiss franc will remain a widely accepted and trustworthy currency. There is no reason to expect it to disappear.

By contrast, the declining significance of the Swiss franc as a denomination of foreign bonds in recent years is not primarily due to the creation of the single currency. This trend had already been observable long before 1999. It can be seen as a return to a situation in which the importance of the Swiss franc is more in check with Switzerland's economic size, as compared with its former extremely over-proportional weighting as an investment currency.

Certainly, the launch of the euro has not enhanced the attractiveness of Swiss franc bonds, mainly because the market liquidity of euro bonds has grown significantly since 1999. On the other hand, the Swiss franc has gained in stature simply because it is a member of the dwindling family of international currencies. For this reason, we expect it to maintain a role as an instrument of portfolio diversification.

3.2. Implications for the exchange rate

In principle, the following applies: the more the single currency proves to be a stable and strong currency, the greater will be its advantages for Switzerland, too. With the launch of the euro, the standard deviation of the trade-weighted exchange rate of the Swiss franc vis-à-vis the currencies of the European trading partners has narrowed considerably. The decrease in exchange rate volatility is due to the fact that the euro - as already mentioned - has to some extent replaced weak and extremely volatile currencies. This is a welcome advantage for the Swiss economy, which is closely interconnected with the EU.

The volatility of the exchange rate is one thing; the *level* of the exchange rate is another. Since the beginning of 1999, the Swiss franc has appreciated by more than 9% against the euro. In the beginning, the development of the Swiss franc exchange rate against the euro was relatively stable. However, in the aftermath of 11 September, investors became increasingly risk-averse. This led to a further strengthening of the Swiss franc, which had already appreciated during the year 2000.

The strength of the Swiss currency is a considerable challenge for our export-oriented economy. One has to put things in perspective, though. First, rather than on the *nominal* exchange rate, the competitiveness of the Swiss economy depends on the *real* exchange rate, which is corrected for inflation. If, for example, the Swiss franc appreciates by 2% and domestic inflation is 1%, prices of Swiss products are raised by 3% abroad. Yet as soon as foreign inflation exceeds the level of 3%, the competitive disadvantage for the Swiss export sector resulting from the nominal appreciation is more than compensated for. In fact, inflation has been slightly higher in Euroland. In real terms, the appreciation of the Swiss franc against the euro is therefore about 5%. It should be noted that a real appreciation of 5% over a period of more than three years is not extraordinary by historical standards.

To be sure, the euro has also lost some ground against the US dollar and the yen. There are, however, some factors that point to a future rise in international demand for euros. These include the growth of the euro financial market and of its liquidity, the growing significance of the euro as a benchmark currency, and the euro area's largest trading share worldwide. Moreover, the gap between the US growth rate and that of Euroland has narrowed recently, albeit ultimately for cyclical rather than for structural reasons.

The most decisive positive factors for the future exchange rate development of the single currency are, for one thing, the convincing removal of the structural and institutional weaknesses in numerous member countries and EU institutions. The willingness to continue and implement reforms will in large measure influence the growth path of Europe. For another thing, the euro rate is determined by confidence in the ECB's monetary policy. The institution's determination to achieve price stability may not be seriously doubted despite some minor initial inconsistencies in communication.

Finally, a danger potential for Switzerland derives from the traditional notion that the Swiss franc is a safe haven currency. The events after 11 September have shown that this notion still plays a certain role. Nonetheless, a mere glance at the map of Europe, on the one hand, and at the integration of the Swiss economy in the euro area, on the other hand, should convince any investor that the Swiss franc could hardly remain immune to a major crisis in the euro zone.

3.3. Implications for the interest rate level in Switzerland

Both nominal interest rates and real interest rates, which are more important for growth, have been relatively low in Switzerland since the First World War. Averaged over the past twenty years, the interest rate spread on money market rates compared with Germany amounted to between 1 and 1.5 percentage points, while the differential between capital market rates came to approximately 2.5 percentage points. This interest differential represents an inestimable advantage for the Swiss economy.

The reasons for this so-called "interest rate island" are manifold. First, a lower real interest rate may simply be seen as a reflection of the Swiss franc which appreciates over time. If this were the only correct interpretation, more favourable interest rates would not represent a genuine advantage for the Swiss economy, because the real interest rate advantage would be fully offset by a corresponding real appreciation of the Swiss franc. This has not been the case during the past decades. On the contrary, the real interest rate lead in our country has on average exceeded the trend in real appreciation. Therefore, the upward trend of the Swiss franc is only one of the reasons for the "interest rate island". More convincing explanations include the high savings rate in Switzerland, political stability, the efficiency of the financial sector, and a by and large investor-friendly legal framework.

To the fore, however, are likely to be monetary arguments. In an international comparison, Switzerland has exhibited very low inflation rates and correspondingly low price fluctuations over a very long period of time. Beyond this, its higher-than-average gold and foreign exchange reserves create confidence. The relatively low Swiss franc interest rates may therefore be considered as a type of insurance premium paid by investors to hedge their portfolios against crisis situations.

The more than three years of relatively calm co-existence with the euro have not significantly diminished the interest differential in favour of the Swiss franc. Currently, the difference between German and Swiss long term rates on government bonds still amounts to more than 1.5 percentage points. As long as the SNB can conduct an autonomous monetary policy, the Swiss franc will remain a crisis-resistant investment currency, and the interest rate bonus will be maintained.

4. The euro's implications for the SNB's monetary policy

4.1. The monetary policy concept

With the euro now existing in its physical form, some cash transactions will tend to be effected in euros rather than in Swiss francs. This development will, in turn, have a negative impact on the demand for Swiss francs. But as I have set out before, there is no doubt that the large majority of domestic payments will continue to be transacted in Swiss francs. On the whole, the decline in seigniorage, i.e. the profit that central banks achieve with the circulation of money, is likely to be very limited. However, the main point I want to make here is that even if the creation of the European Monetary Union did have a significant impact on the demand for Swiss francs, this would not call the viability of the SNB's monetary policy concept into question.

A possible change in the demand for money hampers monetary policy decisions especially if a central bank pursues money supply targets. The steering of the money supply as a monetary policy concept has by now been abandoned by many countries. A prominent exception is the ECB, which uses a reference value for the growth of the money stock M3 as a second pillar besides a broad-based assessment of the inflation outlook to achieve its objective of price stability.

The SNB abandoned money supply targeting two years ago. Its new concept is based on an inflation forecast and an operational target range for the three-month Swiss franc Libor rate. The main goal has been, and will remain, price stability. Price stability is considered to have been achieved if inflation, measured by the national consumer price index, is below 2% in the medium term. In achieving this goal, the SNB always takes account of the economic development. This is also stipulated in the draft of the revised National Bank Law.

Due to the strategy change from money supply targeting to inflation forecast-oriented interest rate steering, shifts in the demand for money have become less problematic, as they are being offset automatically. But although the money supply no longer serves as an intermediate target, its development is an important element duly considered – along with other indicators – in producing the inflation forecast. The centuries-old observation that sustained changes in the price level are linked to changes in the supply of money remains valid.

4.2. The significance of the exchange rate

Another important variable in producing a medium-term inflation forecast is the exchange rate. The significance of the Swiss franc exchange rate against the major currencies is due to the Swiss economy being so small and open. The export share of the Swiss gross national product (GNP) amounts to approximately 42%, while the corresponding share is 29% in Germany and only 12% in the United States. Switzerland's major trading partners are the EU countries, which absorb 59% of Swiss exports. With regard to imports, the interdependence is even greater: 75% of Swiss imports come from the EU. Via foreign trade, the exchange rate exerts an influence on aggregate demand and, therefore, also on the price level in Switzerland. In addition, the exchange rate directly affects import prices.

Therefore, exchange rate movements have been, and will be, closely monitored by the SNB. The rapid succession of interest rate cuts by the National Bank since 11 September 2001 was also an expression of concern about an exchange rate-triggered threat to the economy. Since price stability was not jeopardised, it was possible to considerably relax monetary policy.

4.3. Steering the exchange rate?

Although the SNB takes account of the exchange rates when determining its monetary policy, it is sometimes called upon to do more than that. It is even requested to concentrate – at least temporarily – exclusively on the exchange rate. The underlying notion is that the National Bank could aim at a lower Swiss franc exchange rate and that exports would consequently pick up to the desired degree.

Theoretically, it is possible to weaken the franc in nominal terms by conducting a highly expansionary monetary policy. However, while the hope that a depreciation of the franc will boost export opportunities is understandable, it is deceptive all the same. On the one hand, the exchange rate is only one of the factors determining export success. Exports do not only depend on price elasticity, but also on their income elasticity, i.e. the cyclical development abroad. On the other hand, as I have pointed out before, it is the real rather than the nominal exchange rate that matters for production decisions and trade flows. It is well known that monetary policy cannot manipulate the real exchange rate for any length of time.

Expanding the domestic money supply until the Swiss franc was depreciated to the desired degree would inevitably lead to a massive rise in inflationary risks. As a consequence, the SNB would no longer be able to fulfil its mandate of ensuring price stability. In the long run, such a policy would result in the well-known costs of rising inflation without any compensating real benefits.

Moreover, if the SNB tied the Swiss franc to the euro, as some calls from the industry and the unions have demanded, a first consequence would be the erosion of the "interest rate island". One can only begin to imagine what this would mean for the Swiss financial centre, the building and construction industry, or Swiss asset prices. The sinking of the "interest rate island" would trigger substantial waves of redistribution from debtors to creditors, the financial system would come under pressure, and cyclical setbacks would be inevitable.

The view that a weaker franc might even compensate for structural shortcomings of the Swiss economy must also be rejected. Looking at the economy as a whole, we notice that the Swiss export sector in general is highly competitive. It is exactly the export-oriented companies that are the main driving force behind productivity gains in Switzerland. If, however, the domestic sector, which is less exposed to direct international competition, does not follow suit, growth prospects are limited. The continued improvement of economic policy conditions, in particular the strengthening of competition in the domestic industry, is the key to a sustained high level of prosperity in Switzerland. It is, therefore, justified in taking priority in terms of economic policy.

Without doubt, we are today confronted with an unstable economic situation worldwide. However, the economy cannot be improved by targeting a specific exchange rate. Given the limited prospects of success, the described inflationary risks and the risk of giving away the interest rate bonus, exchange rate targeting as a monetary policy strategy clearly must be rejected.

5. Conclusions

For more than three and a half years now, Europe - and in its midst Switzerland - have been living with the euro as deposit money. It has led to fixed exchange rates and a uniform interest rate level in the euro zone surrounding Switzerland. The conditions for an optimal currency area have probably not yet been met. But the currency union will develop further.

For large parts of the Swiss economy, the euro facilitates business. The Swiss export sector benefits from lower transaction costs. Currency devaluations, which were previously implemented by some European countries so as to improve their competitiveness, are now a thing of the past. In addition, Swiss monetary policy profits from the existence of a large economic bloc in Europe that pursues similar goals as Switzerland in terms of monetary policy. The exchange rate of the Swiss franc is likely to remain more stable against the euro than it used to be against the former currencies of the EMU members. However, exchange rate fluctuations must still be reckoned with, as the events after the terrorist attacks in the US demonstrated.

As a result of the introduction of euro notes and coins, the euro will be used increasingly as a means of payment in the tourism sector as well as in foreign trade. However, the euro will not become a parallel currency. In Switzerland, employment and loan contracts will continue to be concluded mainly in Swiss francs. The same applies to domestic payments.

The SNB's monetary policy concept will remain unchanged: in other words, the SNB will continue to conduct an independent monetary policy oriented to price stability and the needs of the Swiss economy. As a consequence, Switzerland is likely to retain its lower interest rate level. Exchange rate targets are incompatible with the SNB's mandate. Nevertheless, since the exchange rate can affect the health of the economy the SNB will also continue to take the exchange rate closely into account when determining its monetary policy.