Jean-Pierre Roth: Switzerland - an island in Euroland?

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the Bank of Greece, Athens, 21 May 2004.

* * *

It is a great pleasure for me to talk to you today about Swiss monetary policy. Athens is the place to go to this summer. For sure, it will soon become, once again, a symbol of sport and peace, competition and fairness.

Switzerland too will follow the Games with passion. But for many Swiss, your country is not just associated with sport, it is part of our culture and part of our history. In fact, Greece and Switzerland have enjoyed continuing cultural and economic ties over the centuries. Your great statesman, Ioannis Capodistrias, had retired to Geneva when he was elected Head of State of the newly created Greek Republic in 1827, and he was named honorary citizen of Lausanne and of Geneva. His friendship with the banker Eynar contributed also to the foundation of the National Bank of Greece. Later, the relationship between Greece and Switzerland strengthened further when both countries became members of the Latin Monetary Union. The Union, which led to the setting of a fixed exchange rate between Greece, Switzerland, Belgium, France, and Italy, was the first attempt in continental Europe to create an extended area where gold and silver coins could circulate freely.

While Greece, with its strategic position between Asia and Central Europe, has long been exposed to commerce, Switzerland, a country without natural resources, has in some sense been forced to embrace trade in order to survive. Switzerland has now become a global player. Today, the “cliche” of Switzerland as an isolated country with its citizens “entrenched in the Alps, living happily and looking after their cows” totally belies the facts.

We tend to easily forget that exports of goods and services account for more than 40 percent of our gross domestic product and that the European market absorbs about two thirds of our exports. The presence of Swiss firms in European countries is also very pronounced, with more jobs created abroad than at home in recent years. In 2002, Swiss direct investments in Europe represented around 7 billion euros, i.e. 13.5 percent of total investments in Switzerland, and Swiss firms employed close to one million people in Europe, equivalent to about one quarter of Swiss employment. Around 9’000 of those employees are living in Greece.

My purpose here is not to brag about the Swiss economy, but to emphasize the fact that Switzerland is very open to international trade, investment, and migration, and that our economy is very integrated in the global economy and intimately linked to the euro zone.

Swiss monetary policy

With those facts in mind, you might wonder whether Switzerland, a highly integrated country surrounded by trading partners sharing the euro, can still follow an autonomous monetary policy. What are the consequences of the introduction of the euro on the Swiss franc and on the effectiveness of Swiss monetary policy? And what are the effects of this new international monetary order on countries outside the dollar-euro block more generally?

I will try to provide some insights on these questions today. First, I will present the change in monetary framework due to the introduction of the euro. Then I will enumerate the main fears that we originally had regarding the effects of that transformation, and our experience with the new environment over the past 5 years. Finally, I will share some lessons on the influence of the introduction of the euro for the international monetary system and for the autonomy of Swiss monetary policy.

1. A new international framework

January 1, 1999, constituted a true revolution for Europe. Many observers argue that the introduction of the euro represents the major postwar stage in European integration. They are right. The Maastricht Treaty, by removing national currencies and defining budgetary rules, lead to an important transfer of power from national capitals to European institutions. The French franc, the Italian lira, and the German mark were all symbols of national identity. The euro is now playing an integrating role in people's minds. In this regard too, the new currency brings a revolutionary dimension. Is it not the case that national currencies were almost always and everywhere brought about by fundamental political changes? Let us not forget that the Greek Drachma was launched after Capodistria's assassination and Greece's switch to a monarchy, the French franc was the "franc Germinal", the Italian lira was created with the Italian unification, and the Reichsmark appeared in 1873 at the foundation of the German empire. These are very strong symbols indeed.

For Switzerland too, the introduction of the euro was a kind of revolution. For the first time in our history, our country was completely surrounded by a single currency area. In terms of population, Switzerland, with its 7 million inhabitants, could be compared to Missouri in the middle of the United States. Just try to imagine Missouri with its own currency! Although perhaps my good friends and central bank colleagues from the Federal Reserve Bank of St. Louis would not mind all that much! Until 1999, we had been living amidst very diverse European currencies. In fact, our country had always lamented about this situation. Indeed, given our large export sector, we could only dream of a stable monetary environment without exchange rate fluctuations, which interfere with economic decisions and price comparisons. Among our earlier efforts, I should mention here, not only our participation with Greece in the Latin Monetary Union, but also steps towards close cooperation between Switzerland and the European Monetary System in the mid-1970s, steps which remained, however, without concrete results.

A common misrepresentation should be corrected here, that of Switzerland somehow benefiting from external monetary disorders. The notion that the welfare of a country boils down to the short-run profits of a few foreign exchange dealers is narrow minded. The reality offers a completely different picture. Switzerland has always suffered from external monetary turbulences and always wished for a stable monetary order. For example, the various crises of the European Monetary System in the 1990s, with a dramatic drop of the Italian lira, have led to the complete removal of the traditional textile industry from our economic geography. Such structural adjustment could arguably have occurred anyway, but the decisive factor at the time was of monetary origin.

The purpose of the creation of the common currency was not only to concentrate the monetary power in the hands of the European Central Bank, but also to promote the conditions for transparency and competitiveness that would in turn foster trade, investment and growth in the internal European market. Price comparisons are indeed easier today, andtrade and liquidity management are much simplified, although it is still too early to numerically assess the impact of these effects on growth.

Simplifying trade and investments in the European market not only benefits members of the European monetary zone, but it also helps anyone interested in being active in the European market. Switzerland, with its high degree of integration in the euro zone, reaps large benefits from this stable situation. Thus, it is clear that on those aspects, the introduction of the euro was very good news for the Swiss economy.

2. Potential drawbacks of the new framework on a small open economy

But would the introduction of the euro be only good news for the Swiss economy?

A revolution is always associated with risks and uncertainties, thus it should not surprise you that we were concerned about potential negative developments.

In the mid-1990s, as the European monetary construction was under way, we tried to imagine the potential negative effects of the euro introduction on the Swiss economy. Our goal was to be prepared to face difficult situations. This is what central bankers are paid for, after all. We had identified three main challenges:

(a) First, the major risk was that the introduction of a European currency would destabilize the Swiss franc. In the past, the Swiss franc, along with the German mark, played the role of a safe haven currency whenever monetary crises occurred. With the disappearance of the German currency, the Swiss franc would find itself first in line of fire in case of a dollar crisis, for example, or even worse, in case of doubts about the stability of the European currency.

(b) Second, we risked seeing the euro being increasingly used as a means of payment in Switzerland. As the common currency was about to become the main unit of account for our exports, we feared that domestic firms might adopt the euro as well, so as tominimize exchange rate risks. Some were even imagining wages being paid in euros. If use of the franc were to be crowded out by the euro, the Swiss National Bank would have had little leverage left to influence monetary conditions in our own country. It would become a paper tiger!

(c) Third, even short of a “euroization” of the Swiss economy, we feared the loss of our monetary autonomy. Given the importance of the common currency for the Swiss economy, what else could the Swiss National Bank do other than follow the European Central Bank’s monetary policy and de facto integrate the franc into the euro zone? A gradually shrinking interest-rate differential between euro and Swiss franc investments as well as a loss in monetary autonomy would have resulted.

How does our recent experience relate to these concerns?

3. Our experience as an independent monetary entity

(a) The euro/Swiss franc relationship

Our fears of a euro destabilizing the Swiss franc did not materialize. Relative to the euro, and since its introduction, the franc has been fluctuating in a relatively narrow band of plus or minus 5 percent, about four times less than against the dollar during the same period. The Swiss franc appears now to be less affected by exchange rate shocks and more shielded from speculative movements. In the past, the Swiss franc was overreacting to the dollar’s fluctuations, so that the pain of an appreciation of our currency relative to the greenback was exacerbated by a simultaneous appreciation of the Swiss franc relative to the German mark. This double whammy effect, attributed to the narrowness of the Swiss franc market, was highly penalizing for our export sector.

Since the introduction of the euro however, this pattern is no longer observed. Thus, the evolution of the Swiss franc sticks closer to our economic fundamentals. I will address this issue more extensively later on and argue that this trend can be generalized to apply to other currencies as well.

(b) The euro as a means of payment

Those who thought that the euro would make the Swiss franc obsolete as a means of payment were also mistaken. True, our ATM machines have been adapted to provide euro banknotes, so that it is now possible to pay in euro almost everywhere in Switzerland. Yet, despite these efforts, the demand for euro notes is still weak and those notes do not circulate any more extensively than French francs, Italian lira and German marks used to. In truth, it may well be that the expenses incurred to transform all those ATM machines ended up being a misallocation of resources. In stores and restaurants, prices denominated in euros are usually not very attractive. Obviously, small shop and cafe owners are not thrilled by the idea of accepting cash payments in euros. Anyway, they cannot offer as good financial services as commercial banks or credit card companies!

(c) Monetary autonomy

The last fear we had was related to the potential loss of monetary autonomy. Could Switzerland, a country completely surrounded by the euro zone, possibly hope to implement an interest rate policy different from the one of the European Central Bank? With the loss of its monetary identity, Switzerland would have seen its interest rates, traditionally below German rates, converge to higher European interest rates causing severe pains to the Swiss economy.

Fortunately, we did not experience this outcome. First, in the months following the introduction of the euro, it became apparent that markets were not anticipating a pegging of the franc to the euro. An expected peg would have generated a convergence in interest rates, which simply did not happen.

Second, and as could have been expected, the monetary needs of the Swiss economy differed from those of the euro zone:

- As an open economy strongly oriented towards global markets, the Swiss economy felt more deeply the slowdown in global trade than the euro zone.
- Furthermore, the Swiss franc kept playing its role - although to a smaller extent - of safe haven in tense international situations.
- Finally, Swiss inflation was considerably lower than inflation in the euro zone, where adjustments and catch-up phenomena occurred.

Facing this reality, we decided to act independently and lowered interest rates initially in March 2001, a few months before the European Central Bank. Then, facing a clear economic slowdown and a strengthening of the Swiss franc, we lowered interest rates repeatedly and aggressively. So far, the magnitude of our policy loosening has exceeded that of the European Central Bank. We thus kept our monetary autonomy intact, and the interest rate differential between the euro and the Swiss franc has even slightly increased.

4. Swiss monetary policy in the new monetary order

What have we learned about the effects of the new monetary order on the international monetary system and on the effectiveness of monetary policy?

(a) The stabilizing role of the euro

Developments in currency markets over the past 5 years have taught us that the introduction of the euro has fundamentally modified and stabilized the international monetary system. In the past, this system was dominated by the dollar. Dollar crises were violently affecting economies dependent on international trade and capital mobility. The Swiss franc was particularly vulnerable as Switzerland is a small open economy with a currency playing the role of safe haven.

Today, the euro has become the counter-weight of the American currency. When the dollar tumbles, the euro absorbs funds in quest for stability. Third party currencies are thus better shielded from speculative flows.

Indeed, the Swiss franc is not the only currency to benefit from this new monetary order. In fact, the stabilizing role of the euro is a general phenomenon, allowing third currency exchange rates to stay closer to their fundamentals, as dollar fluctuations often incorporate strong and persistent unexplainable components.

After the introduction of the euro in January 1999, the dollar first appreciated and later fell against most currencies. As the euro was the major counter-weight to those fluctuations, most countries experienced offsetting movements of their currencies with respect to dollar and the euro. First, while third currencies depreciated against the dollar, they appreciated against the euro. And later, when they started to appreciate against the dollar, they fell against the euro. These offsetting movements have been observed, among other currencies, for the Swiss franc, the British pound, the Japanese yen, the Canadian dollar, and the Norwegian krona.

By absorbing exchange rates shocks, the euro thus contributes to stabilizing external payments of countries trading with both the EU and the US.

(b) The autonomy of Swiss monetary policy

Financial market developments over the past 5 years have also demonstrated that the monetary autonomy of the Swiss National Bank has not disappeared.

The amplitude with which the SNB has reacted to changes in the economic environment since the end of 2000 lies in between the reactions of the Federal Reserve and the European Central Bank, with more aggressive interest rate cuts by the Federal Reserve and a relatively modest reaction by the European Central Bank.

The different responses of those central banks reflect their institutional framework as well as the economic circumstances of the respective countries. On one hand, the SNB has been more flexible than the ECB. The ECB is a new institution without historical record. Moreover, the ECB has a strict mandate of maintaining low inflation, and there have been upward inflationary pressures in certain European countries due to the convergence process. Those factors induced a less aggressive easing of monetary policy in an uncertain environment. In contrast, with traditionally low inflation, the credibility of the SNB is strong, which allows it to react quickly to economic shocks without creating turmoil in financial markets. In the past few years we have thus been able to act in a flexible way, with our own timing, in order to respond to the global economic slowdown and pressures on the Swiss franc.

On the other hand, the SNB reacted less strongly than the Federal Reserve to the deterioration of the international economic environment. The United States is a relatively closed economy where the Federal Reserve mandate is broader than price stability. In contrast, our freedom to maneuver is limited by the openness of our economy. In a small and open economy, monetary activism cannot fine-tune economic activity. Institutional and economic characteristics of the different countries and central banks have thus implied differentiated monetary policy profiles.

5. Conclusion

Let me conclude by first emphasizing the positive global influence that the euro has had since its introduction in 1999. Not only does the common currency contribute to the integration of the European market, but the appearance of a counter-weight to the US dollar has helped stabilize the international monetary order. Exchange rates around the world can thus evolve closer to their economic fundamentals, and the impact of exchange rate fluctuations on capital flows and foreign trade are dampened.

Developments in the financial markets over the past 5 years have shown us that although highly integrated in international markets and despite the emergence of a bipolar currency environment, the SNB can keep its monetary autonomy and follow an independent monetary policy that is adapted to the needs of the Swiss economy. As a result of our independent and successful monetary policy, together with the global character of the Swiss economy, the Swiss franc has retained its own profile. However, as we have experienced, this particular profile is not without risks. Extreme volatility of exchange rates cannot be excluded, but our experience with the euro/Swiss franc exchange rate has shown that currency markets are not as irrational as some people believe. With a relatively stable exchange market, low inflation and lower interest rates than the rest of Europe, the monetary situation of Switzerland is relatively comfortable.

Things would evolve in a completely different way if Switzerland were to set its mind on joining the European Union and entering the euro zone. If markets were anticipating such an evolution, spreads between the Swiss franc and euro deposits would progressively shrink, in the same way spreads between German marks and French francs deposits fell in the 1990s during the build-up of the monetary union. Market pressures could then force the SNB to shadow the monetary policy of the European Central Bank. Many observers overlook the fact that, contrary to other countries which have gained an interest rate bonus by joining the European monetary union, as they previously had higher interest rates than Germany, Switzerland would loose its interest rate advantage in joining the monetary union.

No tendency of a convergence in interest rates has been observed over the past few years. On the contrary, the interest differential has broadened slightly. For the time being, markets are not expecting any move from Switzerland towards monetary union, and rightly so, I might add. This does not mean that my country will never join the EU.

As you probably know, important decisions shaping the relations between the EU and Switzerland have been taken in recent years. A first set of bilateral agreements has already come into effect. It gives us access to the single market and ensures labor mobility. New agreements have now been negotiated with the aim of harmonizing taxation on savings and integrating Switzerland in the Schengen and Dublin frameworks, a further step toward closer cooperation.

As you see, without being formally an EU member, Switzerland is increasingly part of the European reality. As a matter of fact, we become more and more European and the EU looks more and more Helvetic! Indeed, the EU has almost caught up with Switzerland in many respects. We have 26 Cantons and you have now 25 Member States!

But in all seriousness, while the European integration of Switzerland proceeds, I see no reason, now, for artificially speeding up monetary adjustments by linking the franc to the euro. We would give up our low interest rates without gaining more stability: an unattractive deal in the present circumstances. In monetary affairs we remain indeed an island in Euroland!