Jean-Pierre Roth: Life in a two-headed monetary system - the Swiss experience

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the 50th Anniversary of the Bank of Israel, Jerusalem, 29 November 2004.

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1. Introduction

It is almost a common-place to state that the birth of the euro on January 1, 1999 was a milestone in the process of European integration. Giving up national sovereignty in monetary matters was without doubt a very bold move of historical proportions. It will have long lasting economic and political consequences. It is meant to promote efficiency, transparency, and growth. The creation of a single currency should also act as catalyst towards further European integration. Moreover, and this is really what I would like to focus on today, the creation of the euro has changed the world's monetary landscape. I believe that one can say without fear of exaggeration that it has led to a new international monetary order. Countries such as Israel and Switzerland, situated on the periphery of the euro area, are affected as well. I would like to share with you some of our experiences in this regard, and I would be very interested to know to what extent these findings apply to your country too.

2. Our *pre*-euro worries

Quite frankly, my colleagues and I at the Swiss National Bank were somewhat worried before the introduction of the euro. Although we fully appreciated the benefits that Switzerland would draw from the creation of the euro in terms of increased transparency and lower transaction costs, we were also quite concerned about the possible risks. Three of these came to mind.

First, we feared that the Swiss franc might be in for a bumpy ride. In the past, whenever the dollar was under attack, international investors turned their attention to the German mark and the Swiss franc. Their status as safe-haven currencies meant that at times of turbulences on foreign exchange markets they would move well beyond what economic fundamentals could justify. In fact, the Swiss franc often revealed a tendency to appreciate even more than the German mark, a phenomenon that was generally attributed to the relative narrowness of the Swiss financial markets. Now with the German mark gone, wouldn't all attention focus almost exclusively on our currency? Would it not mean that in a dollar crisis the franc would have to bear even more of the adjustment than in the past? Even more frightful, what would happen if the euro itself were under attack? The last thing we needed was for the franc to become the first currency in the line of fire, or something like the lightening rod of the international monetary system.

A second apprehension that we had was that it might become very difficult in the future to conduct an autonomous monetary policy. Switzerland, together with Liechtenstein, would now be totally surrounded by a single monetary zone. As you know, Switzerland, like Israel, is a small open economy, and I emphasize both the words *small* and *open*. Indeed, we are widely open. Nearly half of our national income is generated abroad, and the European Union is by far our largest foreign partner. About two thirds of our exports head in that direction, and we are one of the best customers of the EU. We are also very small, meaning that although we have no significant impact on the rest of Europe, we are very exposed to foreign shocks, whether they are real or monetary in nature. Our activity is highly correlated with that of the eurozone. Under these conditions, would the SNB still be in a position to conduct an independent monetary policy? Would it be realistic to expect the SNB to follow a course that deviated from the one set by the European Central Bank, or would the SNB be forced to shadow the actions of the ECB?

The question of an independent monetary policy is not just a matter of safeguarding the appeal and the prestige of our jobs as Swiss central bankers. The stakes are much higher. For one thing, even if Swiss activity and economic conditions more generally are highly correlated with events in Europe, the correlation is less than perfect. Our economy, although offering many similarities with those of Germany, France, and Italy, also has its specific features. Thus, Switzerland is very well endowed with physical and human capital. As a consequence, the return on capital is relatively low and wages are comparatively high, particularly so for unskilled labour. We thus tend to specialize in capital intensive and high-value added activities. External shocks tend to impact on us in a way that is not quite the same as on the rest of Europe. Moreover, we also have to cope with home-brewed shocks. It is for these reasons that we are eager to keep an autonomous monetary policy.

Furthermore, if markets became convinced that in the future the SNB's actions would simply mimic those of the ECB, they would rapidly force a convergence between Swiss nominal interest rates and those of the eurozone. Our real interest rates might remain lower for a while, given our relatively large supply of physical capital, but a tendency towards equalization would nonetheless set in. What this might mean for us is a higher rate of inflation for some time, together with a collapse in asset prices and in domestic gross capital formation. A mixture of higher interest rates and high, sticky wages would be very harmful to our economy.

The third fear that was sometimes expressed, although here I must say I was rather sceptical myself, was that the euro would gradually render the Swiss franc obsolete. With many of our trading firms billing and paying their suppliers in euros, there might be a tendency for them to adopt the euro more generally for their accounting as well as for their domestic transactions. Some people even went as far as predicting that before long wages would be paid in euros. Shops, hotels and restaurants would rapidly be forced to accept euros, so that visitors from abroad would no longer see the need to convert their euros into francs. Eventually Swiss consumers themselves would follow suit, so that Switzerland would be *de facto* integrated into the eurozone.

More than national pride would be hurt by such an "euroization" of the Swiss economy. For one thing, such a development would entail the loss of seigniorage income. With a monetary base of about 40 billion francs (26 billion euros), that is about 5'700 francs (3'700 euros) per person, seigniorage in our case is far from trivial. But even more seriously, the loss of monetary autonomy caused by a displacement of the Swiss franc by the euro would prevent the SNB from creating liquidity in case of need.

To a large extent, the fears that we had reflect the more fundamental debate about fixed versus flexible exchange rates. Which foreign exchange regime is appropriate for a given country at a particular time? Although this view is not universally shared, many economists argue in favour of a corner solution: either purely flexible exchange rates, or rigidly fixed ones. Intellectually, I tend to share this view, except that I would like to take it one step further: either purely flexible exchange rates, or monetary union. Rigidly fixed exchange rates do not constitute a polar case. In fact, they accumulate many drawbacks. Thus, fixed exchange rates have never been known to be fixed for very long. Fixed exchange rates are fixed until the day they change, and when they do change, they tend to do so brutally in an atmosphere of crisis, of pain, and of tears. No, I believe that if one really aims at exchange rates that are irrevocably fixed, then one should go all the way, that is, one should opt for monetary union. As long as two currencies are distinct, their relative price might change. So the options boil down to a choice between purely flexible exchange rates and monetary union. Needless to say, since Switzerland is not a member of the European Union, joining the eurozone is not an option worth discussing at this stage. Far from being a second best solution, fixing the franc against the euro would rather cumulate all the negatives, by suppressing our monetary independence, and, at the same time, exposing us to all the dangers of speculative attacks by setting us up, the back against the wall, alone against the market.

3. Our *post*-euro experience

What has happened since January 1999 has proven very reassuring. Our worst fears did not materialize, and indeed, in some ways, the outcome was even much more positive than we could have hoped for.

First, let me briefly sum up our experience with regard to the fears of "euroization" and of the loss of our monetary degree of freedom. As expected, the Swiss franc was not crowded out by the euro. Sure, the euro circulates in Switzerland, just like the Swiss franc is being used in neighbouring France, Germany, and Italy, but the phenomenon remains marginal, and it does not exceed the use the French francs, German marks, and Italian liras in the *pre*-euro world. This is not surprising for, even though the euros (and dollars for that matter) are happily accepted in Swiss shops, cafés, and hotels, the exchange rate is usually unattractive and the change is given in Swiss francs. Shopkeepers and restaurant owners are not in the business of providing financial services, and foreign tourists are still better off changing their euros at banks or using their credit cards. True, Swiss firms use the euro extensively, some do much of their billing in the European currency, and a few of them have even switched their accounting to euros. Some natural hedging takes place as well, although it is not clear how efficient this is. It is worth pointing out, however, that some of our largest firms do much of their billing and their accounting in dollars, while others continue quite happily to use the Swiss franc. The fact that "euroization" has not taken place should not really surprise us. There have been other examples of small independent currencies surviving in the neighbourhood of much larger monetary zones. The example of the Canadian dollar comes to mind. The Loonie has been floating for the past several decades, and it has served Canada rather well. More generally, there is nothing to be gained in having more than one currency for transaction purposes. Much of the benefit that allows one to get around the double coincidence of wants gets lost if several currencies circulate simultaneously. "Dollarization" only occurs in those countries where hyperinflation threatens. This is not about to happen in Switzerland which has a long established record of price stability.

The fear of losing our monetary independence was clearly misplaced as well. Over the past six years the SNB has repeatedly demonstrated that it can act decisively and independently, often well before the ECB. Given its openness, Switzerland was badly affected by the world slowdown a couple of years ago. The situation was made worse by the fact that our main trading partner, Germany, was itself severely hit, and to compound our difficulties, the worldwide capital overhang had a very adverse effect on our exporters, many of whom specialize in the production of capital goods. Exceptional circumstances require extraordinary measures. From March 2001 to April 2003, the SNB cut interest rates aggressively, lowering the target range for our reference rate, the three-month Libor, by 325 basis points, from 3.5% to just 0.25%. And earlier this year, the improved performance of our economy has allowed us to take some of our interest-rate easing back, even though the ECB did not budge.

What about the stability of the external value of the Swiss franc? Here, I must say, our fears proved not just to be unfounded, but the reality turned out to be much more favourable than we could have hoped for. The exchange rate between the Swiss franc and the euro ended up being much steadier than expected, in fact even steadier than it used to be against the German mark, not to mention the French franc and the Italian lira. Over the past six years, the real exchange rate has moved within a relatively narrow band little more than five percentage points wide. Except for the immediate after-September-11 period, when the Swiss franc appreciated significantly, the external value of the franc has largely reflected economic fundamentals. In fact, even the post 9/11 safe-haven effect was relatively mild compared to what we experienced in the past, during the seventies and the eighties, for instance.

But vigilance is of the essence. Recent foreign exchange market developments show that in highly turbulent times the Swiss franc can come under upward speculative pressure. This may interfere with our domestic monetary strategy and can eventually trigger corrective policy actions.

4. A new international monetary order

I truly believe that one can make the case that the introduction of the euro has brought about a new international monetary order, that it has produced an element of stability that benefits many countries, not just Europe's immediate neighbours, but nations around the globe. As we have seen, movements in the dollar/mark exchange rate were magnified as far as the Swiss franc is concerned in the past, but are much dampened since the birth of the euro. When the euro depreciated against the dollar at first, the Swiss franc did so too, but to a much lesser degree. And later, when the euro recovered against the dollar, the franc appreciated as well, but again to a lesser extent. In order words, our effective exchange rate has been less affected, the movement of the dollar being offset, at least to some extent, by a movement of the euro in the opposite direction. It seems to me that this phenomenon has benefited not just Switzerland, but also many other countries with their own independent currencies, such as the United Kingdom, Canada, Australia, New Zealand, Singapore, and Norway. I would be very curious to know what your experience has been in this respect.

This evolution might not last. Perhaps it is the outcome of chance, but it has been sufficiently persistent over the past few years to be noticeable. Maybe one day some bright graduate student will write a thesis on this topic, and confirm or falsify my hypothesis, but in the meantime let me outline why I think that there are some good reasons to believe that the stability of the international monetary system has been enhanced by the creation of the euro.

I do not think that anybody would argue that the world as a whole today makes up an optimal currency area. Our planet is not yet ready for a single currency. We are therefore bound to live in a world with *n, n* greater than one, currencies. For the second half of the 20th century, we lived with one dominating currency, the U.S. dollar, and many, less important currencies, such as the British pound, the Japanese yen, the German mark, the Swiss franc, and so on. Moreover, the United States is a largely closed economy, so it could regard fluctuations in the external value of the dollar with benign neglect. Of course, most other countries, being rather small and quite open, were fully exposed to turbulences in foreign exchange markets, but there was not much they could do about it. There were several episodes when the internal stability of the dollar was threatened as well, with U.S. inflation rates in the double digits. The flight into more stable currencies put considerable pressure on these.

Today, the arrival of the euro has changed the landscape in some important ways. First, as the new kid on the block, the euro commands attention and respect. In economic size, the eurozone nearly rivals the United States. There is now an obvious alternative to the dollar as an instrument of portfolio diversification. If investors have doubts about the dollar, there is no need any longer to rush into the Swiss franc, the euro will do just fine.

Second, the eurozone, although not quite to the extent of the United States, is largely a closed economy. Movements in the euro are far less devastating than movements of similar magnitude in the Swiss franc or in the German mark. The euro is much more capable than any other currency to take on the role of shock absorber against the U.S. dollar. The eurozone, in some ways, is the *large closed* economy that the world needed as the counterweight to the U.S. economy. Be it by intent or by chance, the new, two-headed international monetary system, far from being a freak of nature, is a harmonious and balanced construct that should benefit all *small open* economies, not least Switzerland.

There is a third reason why the arrival of the euro has changed the landscape and should fundamentally prove beneficial to the stability of the international monetary system, and that is competition. Even though the U.S. monetary authorities do not have a mandate that is as specifically directed at price stability as the ECB does, investors now have a choice and can vote with their feet. Thus the pressure is on the United States to deliver price stability as well. I find it very unlikely that we should again experience any time soon double digit inflation rates in the United States, and this is very good news indeed for the continued health of the international monetary system.

The two-headedness of the new international monetary system confers special responsibility to the guardians of the dollar and the euro. Does this mean that their role and duties now extend beyond their respective monetary areas? Should the Fed and the ECB become the policemen of the international monetary system? I do not think so. Markets tend to police themselves. The greatest contribution that the United States and Europe can make to the good health of the global economy is to keep their house in order. Price stability and responsible fiscal and trade policies in both the European Union and the Unites States would go a long way in ensuring that the new international monetary order is a framework for world growth and prosperity.

5. Conclusion

Our experience convincingly demonstrates that a flexible exchange rate regime and an autonomous monetary policy are perfectly feasible in a world dominated by two currency blocs. The external value of the franc today is much more likely than in the past to reflect fundamentals. We are now free to pursue domestic policies destined to improve the working of our economy, without excessive concern about external implications. Ultimately, the markets' reaction will give us an objective assessment of our action.

All in all, the introduction of the euro has been a very positive development for the international monetary system in general, and for Switzerland in particular. We benefit from the greater transparency offered by the euro and the lower transaction costs made possible by its creation. Perhaps for the first time in history, we are surrounded by an area that shares the same monetary policy objectives as we do, namely price stability. This explains to a large extent why the Swiss franc/euro exchange rate has been relatively stable over the past five years. But the presence of a single European currency has *per se* also shielded third currencies - like the Swiss franc - from too much volatility in the case of dollar turbulence.

At the same time, we keep the trump card of an independent monetary policy that enables us to respond very rapidly to the specific needs of the Swiss economy. Between 2001 and 2003, we have thus lowered interest rates more quickly and more decisively than the ECB. Once economic activity showed signs of recovery, we were able to gradually shift to a less expansionary stance, again well before any similar move by the ECB. With inflation around the one percent mark, we enjoy price stability and our interest rates lie clearly below corresponding rates in the eurozone.

Thanks to enhanced stability in Europe with the introduction of the euro, a two headed international monetary system is good news for small countries. It provides them with a more stable environment than the former dollar-based regime. Today, the euro and the dollar act to some extent like mutual shock absorbers. As a result, small currencies are closer to their economic fundamentals than earlier, which gives third countries a real opportunity to implement independent monetary policies aiming at price stability.