# Philipp M Hildebrand: Monetary policy challenges – Swiss exports in a globalised world

Speech by Mr Philipp M Hildebrand, Chairman of the Governing Board of the Swiss National Bank, at the Swiss Mission to the European Union, Brussels, 23 November 2010.

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*I would like to thank Caroline Schmidt and Rita Kobel Rohr for their valuable support in drafting this speech.*

## 1. Introduction

I am pleased and honored to speak to you today at the Swiss Mission to the EU. Thank you for the invitation and the warm welcome.

In the past few decades, globalisation has had a deep impact on the world economy. Whether the world has indeed become "flat", as Tom Friedman put it, remains to be seen. Certainly, the notion of a "global village", in which all aspects of life are ever more interconnected, is an apt description of our world today.

One of the areas most affected by globalisation is the world economy, which has become highly integrated. This is due not only to technological innovation, but also to the fact that countries have deliberately opened up their economies; a phenomenon witnessed around the globe in recent decades. The results – greater trade and financial flows – have brought many countries enormous prosperity. This applies to the EU and it certainly applies to Switzerland with its small home market.

However, the most recent financial and economic crisis has clearly demonstrated that the growing integration of the world economy also entails a number of risks. The international integration of finance and production flows made it possible for the sub-prime crisis in the US real estate market to spread so quickly to so many countries. The global extent of the crisis called for rapid and coordinated intervention. And that is exactly what happened – governments and central banks around the world joined together and took decisive action. The extent of this cooperation was unprecedented in both scale and scope. It prevented a worst-case outcome. Nonetheless, the world economy experienced the most severe financial and economic crisis since the 1930s.

What was impressive about the crisis was the speed and force with which it spread not only through financial markets, but also impacted world trade. In just three quarters, world trade contracted by 15%. This was by far the most significant decline since World War Two.[1] The slump was particularly pronounced in the goods trade.[2]

As a small open economy, Switzerland could not escape this historical collapse in world trade. Exports and, in particular, goods exports were hit hard. However, compared with other industrialised countries – especially Germany – the decline was less pronounced. What's

[1] Cf. WTO (2010): *World trade 2009, prospects for 2010*.

[2] Cf. Richard Baldwin (2010): *The great trade collapse: What caused it and what does it mean?* Baldwin attributes the severe and synchronous slump in goods exports to two main factors: first, the uncertainty that was triggered simultaneously around the world by the collapse of Lehman Brothers; second, the strong internationalisation of the value chain. The former led to a concurrent drop in demand, particularly for consumer durables, while the latter resulted in the goods trade volume reacting disproportionately to changes in production. This is because a product can cross national borders several times during the manufacturing process. Demand for services remained relatively robust, however, with the exception of financial services. Cf. also Ingo Borchert and Aaditya Mattoo (2010): *Services trade – the collapse that wasn't*.

more, the recovery observed since mid-last year has been comparatively brisk. As a result, by mid-2010, Swiss goods exports had recouped almost two-thirds of the losses suffered.

The Swiss National Bank's decisive action undoubtedly contributed to the fact that the Swiss economy as a whole emerged from the crisis relatively unscathed. The SNB didn't hesitate to lower interest rates decisively and – like other central banks – to employ unconventional monetary policy measures when required by the legal mandate, once the room for manoeuvre using the traditional interest rate instrument had been exhausted. In particular, we created additional liquidity through the purchase of foreign currency. In doing so, we resisted extreme exchange rate developments that could have initiated a deflationary dynamic and would have had devastating consequences for the Swiss economy.

As the economic recovery took hold, the deflationary risks diminished, notwithstanding the appreciation of the Swiss franc. Over the past few years, my Governing Board colleagues and I have repeatedly emphasised that the SNB does not pursue an exchange rate target, but consistently bases its monetary policy on its legal mandate. This mandate stipulates that the Swiss National Bank is required to ensure price stability, while taking due account of economic developments.

The dreaded scenario of a deflationary dynamic could thus be avoided so far. Nonetheless, the appreciation of the Swiss franc that ensued obviously impaired the price competitiveness of Swiss exporters. However, the exchange rate is only one factor to affect exports. This raises the question as to which other factors were potentially beneficial for the development of Swiss goods exports in the most recent crisis.[3] To answer this question, I would now like to take a closer look at the structure and developments of Swiss goods exports in the last 20 years. I will concentrate on three factors in particular, namely the geographical, the sectoral and the qualitative dimensions of the Swiss export industry.

## 2. Swiss exports: developments and an international comparison

### *2.1 The geographical dimension*

Geographically speaking, Switzerland's export structure has become increasingly diversified over the last two decades. Even though the EU – with an export share of over 60% – remains its most important trading partner by far,[4] there are other more dynamic regions that – measured by their contributions to export growth – are becoming increasingly important for Swiss foreign trade.

This is particularly true for China. Since 2001 alone, when it joined the World Trade Organization, the value of Swiss exports to China has increased more than threefold. But also exports to Brazil, Russia and India have grown at an above-average rate.[5] Countries of the Middle East, whose earnings have soared in recent years as a result of high oil prices, are also becoming increasingly important markets for Switzerland. And finally, the share of exports to Central and Eastern Europe has also increased, though only slightly. Overall, the share of Swiss goods exports to developing and emerging economies has risen from around

[3] The other fundamental determinant of exports besides the real exchange rate is foreign demand. Yet, how changes in foreign demand and the exchange rate ultimately translate into changes in demand for Swiss products also depends on other, more structural factors. These will be discussed in the remainder of this speech.

[4] In terms of imports, the EU is even more important for Switzerland, with a share of almost 80%. Consequently, Switzerland runs a trade deficit with the EU.

[5] Last year around 7% of Swiss goods exports went to the BRIC countries.

14% to over 21% in the last 20 years.[6] This shows just how well Swiss companies – including small and medium-sized enterprises – have diversified their markets in the past few years.

But the pie is only so big and the total is always 100%. This means that the share of exports to industrialised countries has inevitably decreased. In particular, Switzerland's dependence on the European market has declined. Especially countries such as Germany, France and the United Kingdom have lost some of their relevance as export destinations.

Switzerland is not alone in experiencing a shift in its market share in favour of emerging economies. This is merely a reflection of the growing significance of these countries for the global economy.[7] Accordingly, many EU countries have witnessed similar developments.

There are, however, two very divergent developments responsible for this aggregate trend; both of which proved highly beneficial for Switzerland in dealing with the latest crisis.

While many European countries intensified their trade relations with the emerging economies of Eastern Europe as part of the EU's expansion eastwards (cf. chart 1a), Swiss exporters focused more on the Asian market (cf. chart 1b). As a result, Switzerland's share of exports to emerging Asia – not including the four tiger economies – practically doubled in the last 20 years, and recently amounted to around 6%, compared to around 4.5% for the EU.[8]

Chart 1a

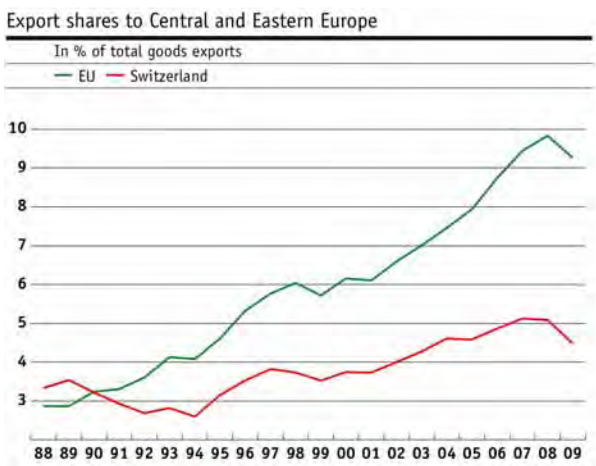
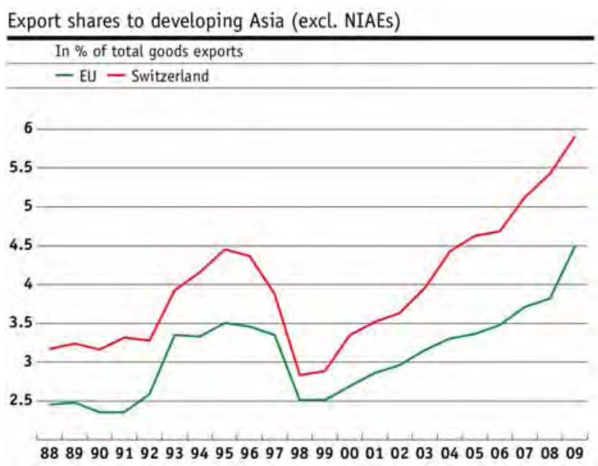



Chart 1b




Sources: IMF Direction of Trade Statistics (DOTS)[9], Federal Customs Administration (FCA).

This divergence in the regional focus becomes even more apparent when Asia is viewed as a whole. This is because Switzerland maintains far closer trade ties with Asia's industrialised countries than the EU does, particularly with the four Asian tiger economies of Hong Kong,

6 The USD value of goods exports to developing and emerging economies (excluding the tiger economies of Hong Kong, Singapore, South Korea and Taiwan) has grown by an average of 7.5% since 1990, i.e. it has quadrupled. Goods exports to industrialised counties increased by 4.7% annually during the same period, representing an increase by a factor of only 2.5.

7 From 1990 to 2008, the GDP of developing and emerging economies rose by an average of almost 8% (China alone grew by more than 10%). The GDP of the EU15, by contrast, rose by just 1.9% on average (US: 2.7%).

8 The USD value of Swiss goods exports to emerging Asia (excluding the tiger economies) has grown by an average of 9.1% since 1990 (since 2000: 18%). The corresponding growth rates for Germany amounted to 11.4% (since 2000: 17.8%), and for the EU, 9.6% (since 2000: 13.6%).

9 Including intra-EU trade.

Singapore, South Korea and Taiwan. Overall, Switzerland's share of exports to Asia, including Japan, came to 15% last year – more than twice the EU average.[10]

Furthermore, Switzerland is one of the few European countries – alongside Ireland, Sweden and Finland – to run a trade surplus with Asia.[11] This goes to show just how competitive Swiss industry really is in these markets.

This positive outcome is due in part to Switzerland's exceptional trade performance with China, with the result that Switzerland is one of the few industrialised countries that have not generated a deficit in its goods trade with China in recent years.[12] This confirms just how important the Asian market is as an export destination for the Swiss economy. And judging by Asia's strong growth prospects, it is likely that it will become even more important in the future.

The regional diversification of Swiss goods exports towards Asia turned out to be a considerable advantage in the recent crisis. Given that the global economic recovery first took hold in Asia – thanks in part to the many fiscal and monetary policy stimulus packages – Switzerland was able to reap the benefits of the fast-paced recovery. During the upturn, which began in mid-2009, more than one-third of the growth of Switzerland's goods exports was attributable to the increasing demand in Asia – even though, as mentioned above, exports to this region still account for only around 15% of the country's total goods exports.

### *2.2 The changing composition of goods exports*

It isn't just the regional focus of Swiss exports that has changed but also the product composition. This brings me to the second factor which promoted the development of Swiss goods exports in the recent crisis.

Although exports in most product categories over the last 20 years have increased in absolute terms; in relative terms, we have seen a clear shift from exports of production-related goods to exports of consumer goods. In the last two decades, the proportion of consumer goods has practically doubled and now amounts to more than 50% (cf. chart 2).[13] With this high share, Switzerland far outstrips other industrialised countries.

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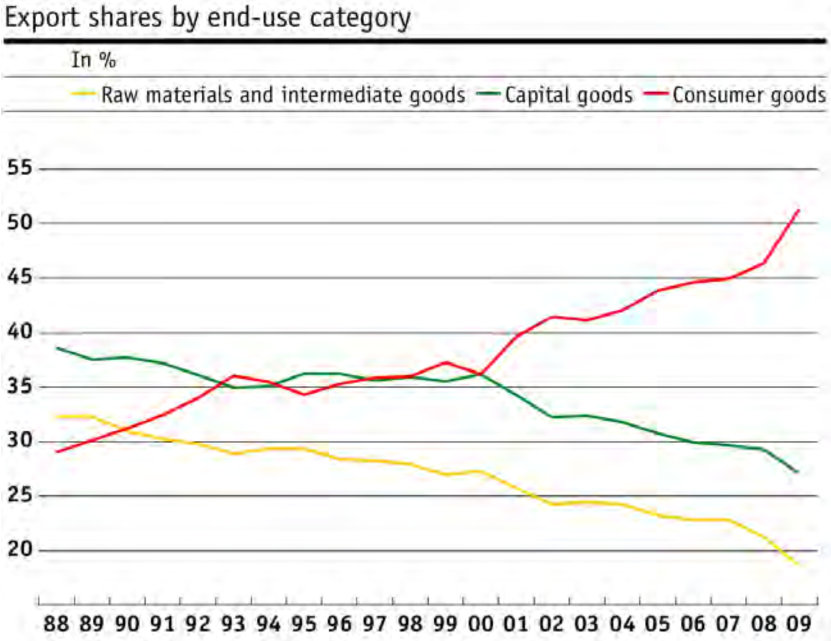
[10] When comparing the share of exports to Asian countries with the German economy – which also registered a significant rise – the equivalent figure for Switzerland is still roughly 50% higher.

[11] In the case of Switzerland, the surplus is significant even in quantitative terms. Averaged over the last few years, the surplus in Switzerland's goods trade with Asia accounted for just over 2% of Swiss GDP, and this trend is on the increase.

[12] The picture is similar for Switzerland's trade with the BRIC countries. Switzerland's trade surplus with China is also a reflection of the comparatively small share of imports from China. Busch (2010) attributes this to the fact that, because of Switzerland's specialisation in pharmaceuticals and precision instruments, the Swiss industry can find only relatively few relevant intermediate products in China. Cf. Christian Busch (2010), *Die Struktur des Schweizer Aussenhandels mit China – eine vergleichende Analyse*.

[13] The shift from capital goods to consumer goods is a general trend in Switzerland's export activity across all trading partners.

Chart 2




Source: FCA.

Aside from Switzerland's classic exports – such as watches, cheese and chocolate – newcomers include Nespresso coffee capsules and Red Bull drinks. However, exports of pharmaceutical products make up the largest slice of the pie by far. In the last year, these accounted for roughly one-third of Switzerland's total goods exports, and this looks set to rise even further.

In an international comparison, Switzerland stands out it with its high proportion of pharmaceutical exports. And even though Germany is still the biggest exporter of pharmaceuticals in absolute terms, their share of Germany's total exports is considerably lower. This also applies to other important exporters of pharmaceuticals – such as Belgium, the US and the UK. Ireland is the only other country with a similarly large share of exports in pharmaceuticals.

Why is this significant? Over the course of a business cycle, demand for consumer goods – and particularly for non-durables like pharmaceuticals – fluctuates to a lesser degree than demand for capital goods. This is reflected in the trade volume for the relevant goods.

In the most recent crisis, not all types of goods were affected to the same extent by the slump in demand. In the wake of the collapse of Lehman Brothers, consumers and investors around the world postponed their plans to purchase major acquisitions, such as machinery or cars. This in turn led to a correspondingly sharp drop in demand for durable goods. This was also the case in Switzerland. Accordingly, trade in machinery, metals and textiles were particularly hard hit during the crisis.[14]

Meanwhile, demand for non-durable consumer goods – and this includes pharmaceutical products – remained relatively stable. As you can imagine, there were probably very few patients who restricted their medical treatment due to the recession. As a result,

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[14] However, it was precisely these industries which had, in the preceding years, already become considerably less significant for Switzerland's goods exports.

Switzerland's large share in exports of pharmaceuticals had a stabilising effect and helped avoid an even greater drop in Swiss goods exports.

Ladies and gentlemen, in addition to the diversification towards Asia, the longer term structural change in the composition of Swiss goods exports thus also proved beneficial during the crisis.

### *2.3 Quality matters*

The third aspect I wish to address today is the quality of Swiss goods exports. As a rule, the "Made in Switzerland" hallmark is used to denote excellence. But do Swiss exports actually deliver high quality?

Quality is not easily measured. Given the lack of alternatives, economists generally express the quality of goods in terms of "unit values". Literally speaking, this represents the average price per unit of weight, for instance per kilogram. I, too, will use this unit of measure. However, this unit makes more sense if groups of similar products are examined. In the aggregate figure for Swiss goods exports, the price per kilo of Rolex can be found alongside the price per kilo of Tamiflu or per kilo of a regional train. This makes an international comparison problematic. Thus, in addition to using unit values for aggregate exports, I will also include unit values for individual sectors.

Unsurprisingly, there are major differences between the sectoral unit values for Switzerland. Last year, watch exports had the highest unit value, at around EUR 7,000 per kilo. This was followed – by quite a considerable margin – by pharmaceuticals, at roughly EUR 320 per kilo. Exports of precision instruments were also somewhat above-average, at around EUR 150 per kilo.[15]

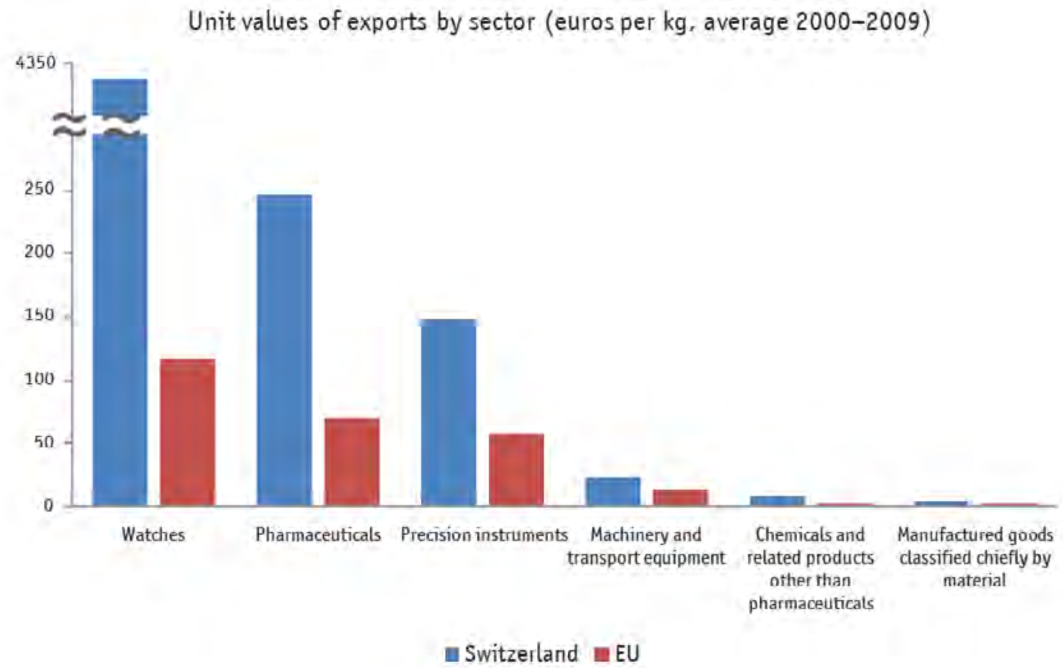
Where does Switzerland stand by international standards? Compared with many other European countries, the unit value of Swiss goods exports is very high. The only other country with a similarly high unit value for its exports is Ireland.[16]

When looking across sectors, it is evident that a considerable part of Switzerland's quality advantage can be attributed to watch exports. Averaged over the last ten years, their unit value was almost 40 times higher than in the EU (cf. chart 3). But there are also several other sectors where Switzerland has a higher unit value than the EU, for example precision instruments. This is a sector where Switzerland also has a comparative advantage; partly due to historical factors, but also to continuous innovation. But even for exports of processed metal goods and machinery does Switzerland have higher export unit values than, for instance, the EU.

[15] Looking at developments over the last 20 years, it is primarily the prices of watch exports that have risen considerably.

[16] Ireland also exports a lot of chemical and pharmaceutical products. Besides, the unit values of its exports of electronic products are also very high.

Chart 3




Source: Eurostat.

Overall, the results from a unit value analysis support the assessment that Switzerland is specialised in the production of high quality products. This is in line with previous studies. These show that Swiss export products largely compete on quality, rather than on price.[17] Given the level of know-how in Switzerland, this ought to be the case in the future as well, assuming that Swiss products can continue to fulfil the ever-growing demands on quality.

To what extent could this have had a positive influence on the way in which exports developed in the most recent crisis? For the short term, at least, it can be assumed that higher quality products are more difficult to substitute than relatively homogenous goods. This applies not only to pharmaceuticals, but also to highly specialised products such as precision instruments.

And this was indeed the case during the most recent crisis – Swiss exports of precision instruments receded only slightly, and have since risen to such an extent that they now already exceed their pre-crisis level. Even the watchmaking industry – which, as a producer of luxury goods, suffered a massive drop in demand during the crisis – has seen a strong recovery in the last year thanks to the global turnaround. Accordingly, exports of watches are now only slightly below their pre-crisis level.

## 3. Conclusion

In closing, let me recap. The geographical orientation, the focus on products less sensitive to the business cycle, and the specialisation in top quality goods are the three factors likely to have mitigated the negative impact of the most recent financial and economic crisis on Swiss exports.

On the whole, the Swiss export industry seems to be well positioned to compete successfully on a global level. Such a conclusion is reassuring, because major challenges still lie ahead.

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[17] For example, Credit Suisse (2006): *Quality – The Export Industry's Only Chance?*

For instance, Switzerland's increased focus on the Asian market also has its risks. A significant slowdown in Asia's economic recovery – particularly in China – would undoubtedly impair Swiss export prospects. Needless to say, however, a renewed downturn in Europe – still Switzerland's most important trading partner by far – would impact Swiss exports to a far greater extent.

Furthermore, current exchange rate developments pose a major challenge for Swiss exporters. Since the onset of the financial crisis, the Swiss franc has appreciated in real terms by around 15%.[18] This appreciation puts up the price of Swiss exports abroad or narrows the margins for Swiss exporters – or a combination of both. This will be reflected sooner or later in the export figures. Indeed, in recent months, the recovery of Swiss goods exports has slowed markedly; although this is also related to a slowdown in global economic momentum.

The financial crisis and financial market concerns regarding the public finances of a number of industrialised countries have increased demand for the Swiss franc as a safe haven currency. The stability of the euro area is therefore an important factor influencing the Swiss franc and the Swiss economy as a whole. EU citizens clearly have a vested interest in the stability of the euro. The same is very much true for the citizens of Switzerland. I am confident that the EU will ultimately succeed in once again deeply anchoring a culture of economic and financial stability. Earlier this year, European politicians and policymakers began to take decisive action to that end. As we all know, crucial challenges lie ahead. These call for determination, courage and perseverance – not only from policy makers, but also – and most importantly – from the citizens of the EU. I am confident that the EU and the euro area will overcome these challenges. In the past, Europe has always emerged stronger from periods of difficulty. Jean Monnet already recognised this in 1976, when he wrote in his memoirs:

> "Europe will be forged in crises and it will be the sum of the solutions adopted for those crises."[19]

As far as Switzerland is concerned, I am optimistic that it, too, will overcome the formidable challenges it faces. As with most countries, Switzerland benefited greatly from globalisation and from opening up its economy. Thanks to its flexibility and creativity, the Swiss economy is well placed to remain internationally competitive. But the Swiss people must recognise that the world does not stand still. In order to preserve and enhance our high standard of living, we must remain extremely flexible in every respect. This is where the real economy, in particular, faces a challenge: ongoing innovation and qualified human capital are of the utmost importance in a high-wage country such as Switzerland. Both of these factors will enable our companies to continue to bring successful new products onto the world market, many of which we aren't even able to imagine today.

Monetary policy can generate neither innovation nor growth. Nonetheless, the Swiss National Bank's conduct of monetary policy is relevant for Switzerland as a business location. After all, the innovative capabilities of a country also rely on a favourable and stable business environment. The SNB remains firmly focused on maintaining price stability; a task, which is consistent neither with deflation nor with inflation. As we have demonstrated, the Swiss National Bank is prepared, in a crisis situation, to take exceptionally far-reaching measures to fulfil its mandate. In doing so, the SNB is making its contribution to a favourable and stable business environment and, ultimately, to a continuously prosperous economy.

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[18] The extent of the real appreciation of the Swiss franc varies depending on the country sample, the deflator and the weighting method. In terms of the real exchange rate indices calculated by the SNB and the BIS using the CPI deflator, the Swiss franc has appreciated between 14% and 15% in real terms since the collapse of Lehman Brothers. The SNB's export-weighted exchange rate vis-à-vis 40 trading partners shows an appreciation of 14%.

[19] Cf. Jean Monnet (1976): *Memoires*.