Thomas Jordan: Switzerland at the heart of Europe – between independence and interdependence

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Université libre de Bruxelles, Brussels, 17 January 2015.

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Ladies and Gentlemen,

I am very honoured to be with you today in Brussels, and I would like to thank the Swiss Mission to the European Union and the Institute of European Studies at the Université libre de Bruxelles for their kind invitation.

When I arrived at Brussels airport, I couldn't help noticing the range of delicious chocolate on offer. It seems to be as abundant as in Switzerland.

So I can see immediately that Switzerland and Belgium have important things in common. This certainly makes me feel very comfortable here. Although I am unlikely to end up emulating Jean Neuhaus. As some of you may know, Belgium's most famous chocolatier was actually a native of Switzerland. He came to Belgium in 1857, and decided to stay and set up shop in Brussels. As for me, I plan to return to Switzerland.

1. Introduction

Belgium and Switzerland have a lot of other things in common besides chocolate: Both are small, very open economies, which have successfully embarked on the road to globalisation. Both are home to world-class corporations, as well as very innovative small and medium-sized enterprises.

But there are also some crucial differences. Unlike Belgium, Switzerland is not part of European monetary union – nor indeed of the European Union (figure 1). Switzerland has chosen to preserve its political autonomy and conduct an independent monetary policy. As a result, its economy has at times been subject to major exchange rate shocks. Furthermore, since it is not part of a large internal market, Switzerland is particularly dependent on open international markets.

The purpose of my remarks this evening is to show how Switzerland perceives its position on the international economic scene, between the two poles of attraction mentioned in the title of my speech: independence and interdependence. I will, in particular, elaborate on features which, in my view, have been key in allowing the Swiss economy to strengthen its resilience to external shocks and to fully benefit from globalisation. Switzerland is known as a country with one of the highest living standards in the world. Yet this privileged condition should not be taken for granted. Quite the opposite: Achieving and maintaining economic and social progress is an ongoing challenge.

The years since the beginning of the global financial and economic crisis have been particularly testing. The events of the last few weeks are a striking example of this. As you certainly know, the Swiss franc has again appreciated rapidly and massively. I will take this event as the starting point for my presentation.

2. Monetary policy and the Swiss franc

Switzerland conducts an independent monetary policy and has historically had a strong and important currency that plays a much bigger role in the international financial system than the size of the economy would imply. The attractiveness of our currency as a safe haven reflects the stability of the country and is, as such, an asset for our economy. However, since the start of the crisis back in summer 2007, this factor has also repeatedly been a source of pressure.

The Swiss franc started appreciating in August 2007 (figure 2), with the onset of the US subprime crisis. The huge uncertainty generated by the collapse of Lehman Brothers one year later and the Great Recession which ensued put the Swiss franc under further upward pressure. The situation worsened in 2010 and 2011. The European sovereign debt crisis and the fears of a break-up of the monetary union sent jitters through financial markets. In addition, market participants were worried that the US Congress would not reach an agreement to avoid hitting the debt ceiling. To complicate matters still further, the global economic outlook turned noticeably gloomier. As a result, enormous safe-haven flows poured into the Swiss franc. From August 2007 until August 2011, the Swiss currency appreciated by about 40% in real effective terms. Yields on Swiss Confederation short-term debt turned negative and have remained negative ever since.

Confronted with such dramatic developments, the Swiss National Bank (SNB) introduced a minimum exchange rate of CHF 1.20 per euro on 6 September 2011. Against the backdrop of a rapidly deteriorating global economic outlook and policy rates that were already at the zero lower bound, this measure helped to avoid an extreme tightening of monetary policy conditions. By setting a cap on exchange rate appreciation, the SNB provided some relief to businesses and bought them time to adopt measures that would reduce costs and improve productivity. Nonetheless, the Swiss franc remained highly valued.

However, the minimum exchange rate of CHF 1.20 per euro was only ever meant to be an exceptional and temporary measure. A few weeks ago, on 15 January, the SNB announced its discontinuation. Publishing such a decision as a surprise announcement for the markets and the public was unavoidable. No pre-emptive guidance is possible for this kind of decision. Any guidance would have invited speculative attacks. Markets reacted accordingly, and the Swiss franc appreciated massively within minutes after the announcement. Although some of the overshooting has since been corrected, our currency is still trading at a significantly overvalued level as we speak.

Once again, the reasons for the SNB decision are to be found in international developments. In particular, over the course of 2014 it became increasingly evident that the European Central Bank (ECB) and Fed policies would diverge. In the US, the ongoing recovery rendered the prospect of an exit from the unconventional policies more likely. In the euro area, meanwhile, the ECB made it clear that additional monetary stimulus would be required. A tangible sign of these diverging patterns was the substantial weakening of the euro against the dollar. With the clear prospect of a significant QE programme in the euro area, the pressure on the minimum exchange rate intensified hugely at the beginning of 2015 – especially in the last few days leading up to the SNB's decision on 15 January.

Against that backdrop, the minimum exchange rate became unsustainable and the SNB had no choice but to discontinue its policy. By maintaining the minimum exchange rate for longer, the SNB would have run the risk of losing control over its balance sheet. This, in turn, would have hampered its stability-oriented policy in the future. Once you have arrived at such a conclusion, you have to act swiftly. Speculative position-taking against the minimum exchange rate could easily have caused the SNB's balance sheet to double within a few months. We would subsequently have been compelled to discontinue the exchange rate floor under even greater pressure, with all the consequences for our balance sheet and the Swiss economy that this would have implied. The costs of maintaining the floor would have been out of all proportion to the benefits.

As a consequence, the Swiss economy is now dealing with very difficult exchange rate conditions. In an interdependent world with highly integrated and liberalised capital markets, the strengths of an economy like Switzerland can, paradoxically, turn into a major challenge.

How should Switzerland deal with these extreme conditions, overcome the difficulties and maintain its current high living standard? To answer this question, I will now step back for a moment from current events, and highlight some of the factors that, historically, have been instrumental in allowing Swiss businesses to seize opportunities abroad and cope with an ever-changing environment.

3. A tradition of political independence

However, let me first briefly turn to our tradition of independence. Although mostly favouring a free-trade approach in its economic relationships with the outside world, Switzerland has traditionally been very reluctant to relinquish political sovereignty.

In particular, federalism, direct democracy and citizen involvement are seen by the Swiss population as crucial elements of their identity. They are considered key factors to ensure the cohesion of a country made up of different linguistic and cultural groups.

External neutrality helped Switzerland to escape the tragedies which devastated the European continent during the last century, while maintaining internal cohesion. Hence, the two world wars fostered Switzerland's attachment to its political autonomy.

But autonomy does not mean isolation, or neglect of what happens abroad. Switzerland's political neutrality has often put it in a good position to mediate during conflicts and provide active solidarity. Our country has made very active use of this comparative advantage. The most well-known example is the Swiss engagement in the International Committee of the Red Cross (ICRC). It has also a long and well-established tradition of offering its good offices for diplomatic negotiations.

From an economic point of view as well, political autonomy should not and does not mean economic isolation. Today, Switzerland's economy is amongst the most internationally integrated in the world. As a small country lacking in natural resources, Switzerland started very early on to cultivate cross-border economic relations. Since then, economic integration has contributed greatly to Switzerland's prosperity. The flipside of the coin, however, is the country's broad exposure to economic and financial developments abroad, as demonstrated by the global financial crisis and its aftermath.

4. Factors supporting Swiss economic performance

In the wake of the global shock triggered by the Lehman Brothers collapse in September 2008, activity in Switzerland declined very significantly (figure 3). However, the recession was softer and the ensuing recovery stronger than in the euro area. There are various reasons for the relatively solid performance of the Swiss economy. First, the purely domestic banking sector was in good shape and the economy was never faced with a credit crunch. Second, domestic demand has stayed robust, amid favourable housing market developments. Third, exports were relatively resilient to international headwinds. Fourth, as we have already seen, monetary policy acted to limit the negative impact of the Swiss franc's massive appreciation.

Let me now elaborate on the structural factors that have played an important role in strengthening the resilience of the Swiss economy to shocks. I will start by focusing on some interesting shifts that have taken place in the structure of Swiss international trade.

4.1 Innovative and diversified Swiss international trade

Looking at the structure of Switzerland's international trade will allow me to dispel some well-established preconceptions about the Swiss economy. If I asked you to list some core Swiss economic sectors, you would probably mention banks, watches and chocolate. But Switzerland is much more than that. The Swiss economy is in fact highly diversified. For example, the share in total value added of the sector comprising financial, insurance and business services is smaller than the EU average (20.3% vs 26.2% in 2012, according to OECD figures). By contrast, the share of the manufacturing sector is significantly larger.

Overall, the amount of goods and services that Switzerland sells abroad is equivalent to half of its Gross Domestic Product (GDP). Goods dominate export activity but, with a share of one-third, the contribution of services is by no means negligible. The export intensity is significantly above the OECD average. Switzerland is surpassed by the Benelux countries, however. Part of the gap with the Benelux reflects the extensive re-exports of imported goods generated by the activity of the world-class ports in Belgium and the Netherlands. Admittedly, access to the sea is not a key comparative advantage of Switzerland…

In order to maintain competitiveness, the Swiss export sector has gone through profound structural changes during the last decades.

First, there has been a shift in the composition of the export sector (figure 4). The pharmaceutical industry has gained in importance, whereas the share of exports of machinery has declined. In passing, let me just mention that the popular cliché which associates Switzerland with watches is actually true. Their share in total goods exports is sizeable (11%). Note, however, that this has nothing to do with cuckoo clocks, which were invented and are produced in Germany.

A closer look at the development across industries reveals that this compositional shift is important in understanding Swiss performance during the crisis. In fact, individual export categories were affected very differently by the great international trade collapse in 2009. While shipments of machinery and metals suffered severely, dropping by roughly 30%, exports of chemicals and pharmaceuticals barely declined at all. As this sector accounted for more than one-third of total exports in 2008, it strongly dampened the negative impact of other sectors. Exports of watches also provided important support.

The second structural change has occurred within industries. For instance, the machine industry today is not the machine industry of the 1990s. There has been a constant effort to innovate both products and production processes. Swiss businesses have specialised in high-value-added products. Switzerland has among the highest densities of high-tech industry in the world. The volume of research and development spending is driven by large multinational firms in globally integrated economic sectors, such as pharmaceuticals and chemicals. But small and medium-sized manufacturing firms in a broad range of market segments also play a key role in Swiss exports, and are typically also strong innovators. More than 40% of them undertake in-house research and development, a world record. Overall, thanks to this innovation strategy, the contribution of the manufacturing sector to Swiss GDP has been remarkably stable since the beginning of this century, breaking the previous downward trend.

The third structural change concerns the regional composition of Swiss exports (figure 5). Swiss exporters have increased their focus on the US, China and other emerging economies, while relying less on traditional markets such as Germany, France and Italy. This stronger diversification turned out to be very helpful during the global financial crisis. Indeed, exports across regions evolved differently. Shipments to Germany, France and Italy declined much more at first and then picked up much less substantially than those to the US and China.

Despite this increasing regional diversification, Swiss exporters remain strongly dependent on the European market. Today, the EU market still absorbs more than half of Swiss goods exports. The European sovereign debt crisis, amid the sharp weakening of domestic demand in the euro area and the dramatic appreciation of the Swiss franc against the euro, has thus heavily weighed on Swiss exports. While the demand effect dominates, the negative impact of the exchange rate is very significant.

Overall – and despite the strong appreciation of the Swiss franc – Switzerland's exports of goods declined somewhat less in the crisis than the exports of other European countries such as Germany or Belgium (figure 6).

4.2 Flexible labour markets

The structure of the labour market also plays an important role in strengthening resilience to shocks. It must provide the necessary flexibility for firms to adjust rapidly to changing conditions at home and abroad. A key characteristic of the Swiss labour market is the combination of little layoff protection with a fairly generous unemployment insurance system. If they have to, firms can reduce their workforce with relatively few administrative impediments. Conversely, when the economic situation improves, firms will readily hire new workers again. As a consequence, the outflow rate from unemployment is higher in Switzerland than in most European countries, with the exception of the Nordic countries (figure 7).

Another important institution is short-time working. It was used extensively by firms during the crisis. Short-time working enables firms to adjust their labour force to temporary shocks without destroying existing job matches. This is a crucial advantage, especially for businesses operating with a highly skilled workforce. It effectively cuts costs during the downturn while allowing businesses to quickly expand production once demand picks up again.

A further key feature of the Swiss labour market relates to the way employers and employees interact. Generally, labour-management relations are good and disruptive strikes are rare. In the context of wage setting, many employment contracts are regulated by collective labour agreements. However, in contrast to the situation in other countries, these agreements are typically the result of consensus-oriented negotiations, with very limited government intervention. In fact, the instrument of collective labour agreements is regulated by only three short paragraphs in Swiss law. The negotiation setup typically guarantees that firm and industry specifics are taken into account in the arrangements, so that competitiveness can be preserved.

The high employment rate among the domestic working-age population shows that the Swiss labour market is in good shape. Currently running at 80%, employment is almost 15 percentage points above the European average.

4.3 A sound fiscal policy

Another supporting factor for the Swiss economy is sound public finances, as reflected in relatively low fiscal deficits and public debt.

This fiscal discipline is related to the political institutions of direct democracy and federalism. Swiss voters tend to be pragmatic and have generally shown little inclination for large and 'creative' public projects. Furthermore, fiscal decentralisation is pervasive: the cantons, the main sub-national entities, are like sovereigns on a smaller scale, and have extensive taxation and spending powers. In Switzerland, regional autonomy enhances control of public spending and accountability. One element of the incentive scheme is the tax competition among cantons. The cantons are free to set their own tax rates or establish new taxes. As companies and individuals can vote with their feet, cantonal governments have an incentive to strike the best possible balance between the tax burden they impose and the public services they provide.

These traditional elements were complemented at federal level with a stringent debt brake mechanism in the early 2000s. The experience at federal level motivated various cantons to follow suit. This has proved to be a very effective fiscal policy reform. The debt brake is a rule that links expenditure to the amount of cyclically adjusted revenue. It aims at a balanced structural budget over the medium term. Fiscal policy maintains a countercyclical profile through the mechanism of automatic stabilisers. The strict implementation of this rule led to significant budget surpluses in the boom years preceding the global financial crisis. Importantly, the debt brake has made it possible to regain control over public spending, which had steadily increased during the 1990s.

Since the main focus of the debt brake rule is on long-term sustainability, the framework leaves little room for discretionary spending. The Federal Government can make an exception and allow additional emergency spending only in the event of a proven severe crisis.

During the recent crisis, the healthy state of Swiss public finances enabled the automatic stabilisers to play their role to the full extent, which contributed to supporting the economy, without threatening medium-term fiscal stability. In particular, public spending on the unemployed and short-term workers increased significantly, while income and profit tax revenues decreased. Contrary to what we have seen in other countries, no tax increases or austerity measures were needed to correct the public finance trajectory. This has had a positive impact on households' disposable income, and hence on both private consumption and business confidence.

Let me now wrap up my presentation and add a few words about our current monetary policy.

5. Concluding remarks

Switzerland has a long history of political independence. At the same time the country has consistently pursued prosperity via strong integration in the world economy in general and the European economy in particular.

Through this active international integration into the global economy, the country has achieved and maintained a high level of affluence. However, the notion that Switzerland is a sheltered island in the midst of a stormy sea could not be further from the truth. For a small open economy like Switzerland, the international environment is source of both opportunities and large destabilising shocks.

The unavoidable discontinuation of the minimum exchange rate against the euro is a powerful example. It provoked a strong reaction on international financial markets and, as a result, the Swiss franc appreciated sharply. The significant overvaluation of our currency means that the Swiss economy, notably the sectors exposed to international competition, is currently facing strong headwinds and a number of challenges.

The SNB has lowered interest rates to unprecedented levels to cushion the effects of the currency appreciation. The lowering of interest rates means that holding Swiss francs is significantly more costly than holding foreign currency. The negative interest rate is set to have a corrective effect on the Swiss franc's valuation. Moreover, the SNB will continue to take the exchange rate situation into consideration when formulating its monetary policy. It will therefore remain active in the foreign exchange market, should this prove necessary in order to influence monetary conditions.

Nevertheless, the near future will see major challenges in Switzerland. Today more than ever, the Swiss economy has to focus on its structural strengths and flexibility, to ensure its international competitiveness and thus the country's prosperity in the future.

Thank you very much.

Figure 1. **Switzerland at the heart of Europe**

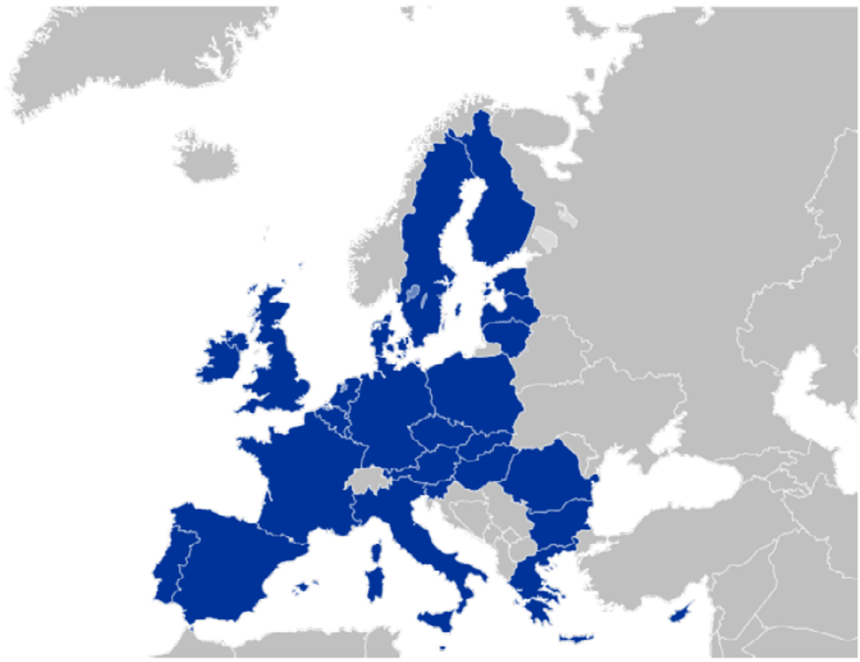

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Figure 2. **Flight into the Swiss franc**

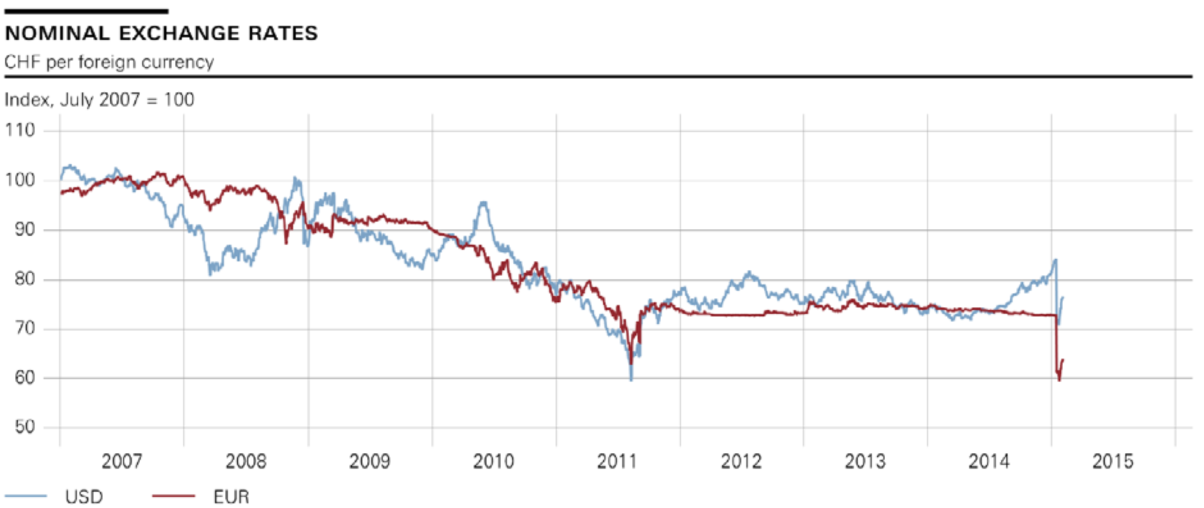

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Figure 3. **The Swiss economy in an interdependent world**

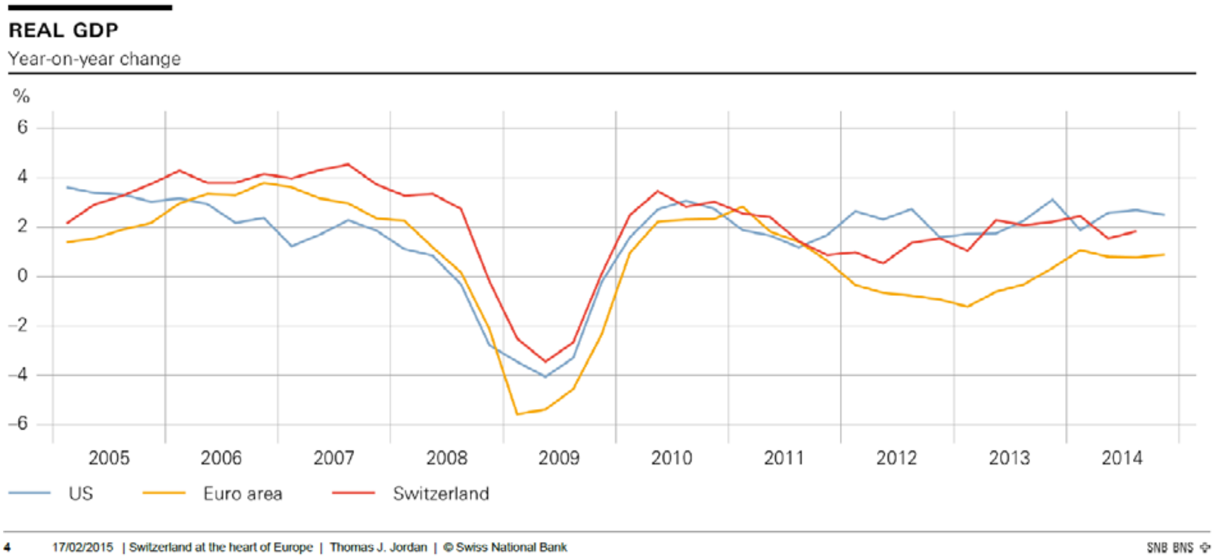

Figure 4. **Evolving Swiss international trade (I)**

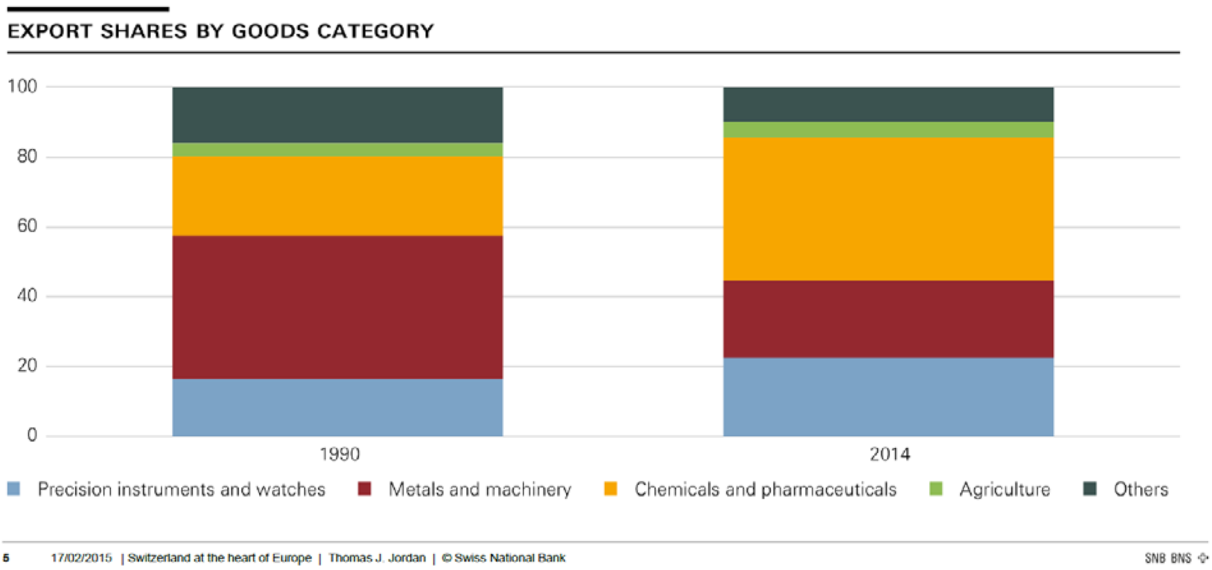

Figure 5. **Evolving Swiss international trade (II)**

EXPORT SHARES BY TRADING PARTNER

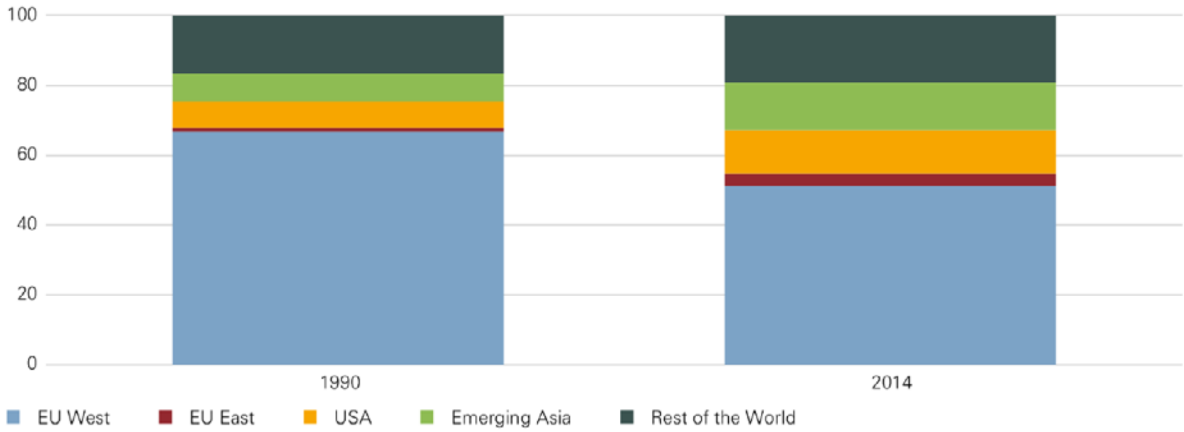

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Figure 6. **Structural shifts supported Swiss exports during the crisis**

GOODS EXPORTS

Constant prices, 2005

Index Q1 2008 = 100

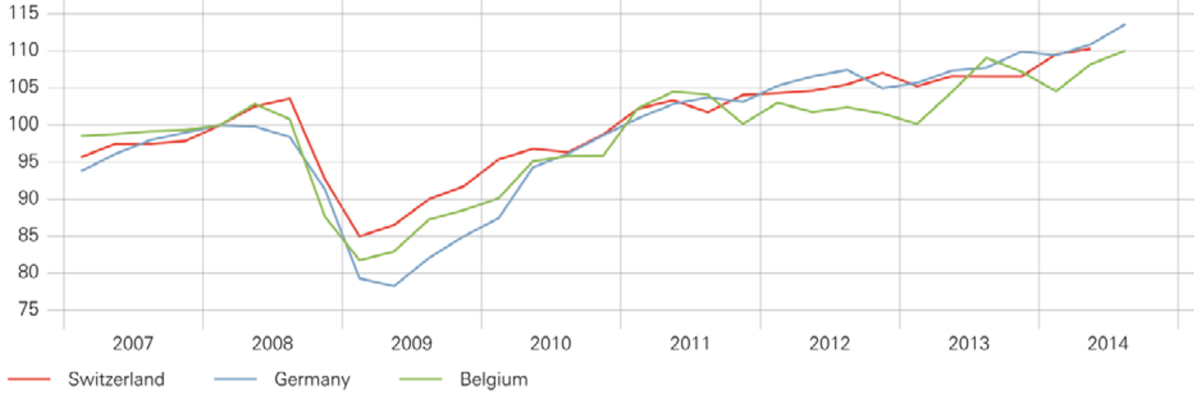

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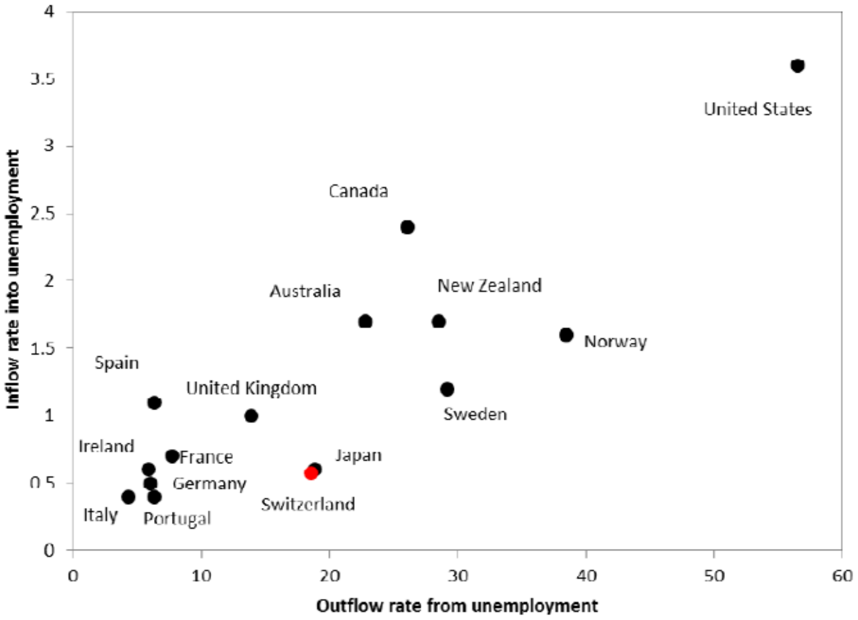
Figure 7. **Flexible labour market**



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