Philipp M Hildebrand: Inside Europe, outside EMU - lessons and outlook

Speech by Dr Philipp M Hildebrand, Member of the Governing Board of the Swiss National Bank, at the British Swiss Chamber of Commerce, Geneva, 23 April 2004.

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My long-standing personal attachments to the United Kingdom make it a special privilege to be here this morning to speak about Europe and its significance to our two countries. Geneva is one of Europe's truly international cities and provides a fitting platform for a discussion on some of the salient characteristics about the relations of the United Kingdom and Switzerland toward Europe.

The United Kingdom and Switzerland are both undeniably European nations. Nonetheless, they both firmly remain outside of the European Monetary Union (EMU). Institutionally, the links of the two countries with Europe differ, of course. The United Kingdom is in EU Europe while Switzerland is only in Europe, despite the fact that until the EU welcomes ten new Member States next week, we Swiss can be forgiven to think of ourselves as representing the "heart" of Europe. Culturally, our two countries are rooted in different European traditions: Anglo-Saxon on the one hand and Continental European on the other hand, notwithstanding the fact the historical roots of the Saxons are, of course, on the continent.

During the remainder of my time with you today, I will sketch more fully a number of salient common features and differences between the United Kingdom and Switzerland. Based on these commonalities and differences, I will then draw some tentative economic, financial and political conclusions about the respective experiences and relations of our two countries with Europe and more specifically with EMU.

UK and Switzerland: Common features and differences:

It seems to me that even a perfunctory comparison of our two countries' relations to Europe and EMU needs to touch upon law, politics and recent economic history.

Law and politics

There is a fundamental judicial divide between the common law tradition of Anglo-Saxon countries and the civil law tradition of Continental Europe. Over the centuries, this divide has undoubtedly spread into culture and minds. The custom and case-based common law was institutionalized in 1154 by Henry II through elevating local custom to a unified system of law "common" to the country. It may be unwritten, as it was at the outset, or captured in statutes and codes. This judicial history is reflected by the absence of a written constitution in the United Kingdom. Civil law in Continental Europe, on the other hand, has its roots in the Corpus Juris Civilis of Emperor Justinian. It constitutes broad legal principles and doctrinal writings and is explicitly written law. This explicit and written tradition is reflected in the "acquis communautaire" of the European Union with nearly 100'000 pages and some 20'000 laws, decisions and regulations. In light of our two countries' legal roots, the legal consequences of relations with the European Union are undoubtedly of greater concern to the people of the United Kingdom than to Continental Switzerland.

More importantly, in my view, the political systems of the U.K. and Switzerland differ in fundamental ways. The United Kingdom is one of the oldest representative parliamentary democracies. Its electoral system tends to yield clear-cut political majorities. The ruling party - Tory or Labour - is elected for typically four years and can manage the country quite independently as it is assured quasi-autonomy to alter existing legislative acts or enact new ones. Switzerland has an equally proud democratic tradition. It is, however, deeply rooted in direct participation by the sovereign. A vote by the people is possible on nearly everything. Indeed, it is often compulsory. The Swiss parliament is elected every four years. Due to the proportional voting system, no political party can expect to achieve an absolute majority. Thus, the parliament elects the government as a collegiate body which traditionally encompasses all four main political parties. Consequently, legislative decisions tend to be deeply rooted in compromise, not least to overcome the potential referendum hurdle.

The mechanics of a particular political system affects the ability of legislative bodies to pass politically contentious reforms to a country's underlying economic structure. In parliamentary systems with a clear majority the speed of structural adjustment - once initiated - tends to be higher. On the other hand, policies are possibly more short-term oriented and large policy errors more likely. Investors may therefore demand a higher risk premium. In direct democracies, the speed of reform is typically slower. Grid-locks are possible through referenda and therefore more common. On the other hand, political stability in direct democracies tends to be higher and economic policies typically have a more long-term orientation. As policy changes take more time to be introduced, the risk of large policy errors tends to be smaller. Over the long-term, investors appear to be willing to pay a premium for higher stability.

Beyond differing parliamentary systems, our two countries' political structures are organized along different principles. Whereas the political process in the United Kingdom can be broadly characterized as top down, Switzerland's federalist structure implies a bottom-up political process with a great deal of political autonomy for our nearly 3000 communes and 26 cantons. It is interesting to note that there are at least some tentative signs of converging trends: In the United Kingdom, Tony Blair's government has initiated constitutional reforms by establishing the Scottish Parliament and the Welsh Assembly in 1998 and by advancing the Regional Assemblies in England. In Switzerland, a number of centralization proposals are debated such as directly enhancing the power of the federal government or alternatively, merging a number of cantons with the aim of ending up with larger and fewer regional authorities. These trends illustrate that Switzerland and the U.K. both face a trade-off between increasing economic efficiency on the one hand and retaining long-standing political and historical traditions on the other hand. Under pressure from rapidly evolving global economic forces and the need to adjust to them, both countries will need to continue to identify respective strategies to maximize economic welfare and optimize political structures.

Recent economic history

Let me now turn to some recent economic history. History shapes memory and experience. The work of Nobel Laureate Daniel Kahnemann demonstrates that experience constitutes a reference point for human beings by which current and expected welfare are evaluated against.[1]

The United Kingdom has experienced profound economic crisis relatively recently. In 1976, the pound sterling collapsed. The Labour government under Prime Minister Callaghan faced a near bail-out by the International Monetary Fund.[2] The crisis left deep scars in the real economy. As some of you will remember, power failures were a common phenomenon in those days in London. The experience of a severe economic crisis commonly shared by the British people undoubtedly played a role in paving the ground for the ultimate acceptance of the far-reaching and rapid economic reform agenda under the leadership of Margaret Thatcher which boosted economic growth in the United Kingdom.

In contrast, Switzerland has no recent memory of a comparable economic crisis. On the whole, economic reforms progress only gradually and fail to cover the economy as a whole. Fortunately, in some areas, liberalization has advanced rapidly. A positive example is the Swiss labor market. Unencumbered by a history of pervasive unionization, Swiss labor market flexibility has continuously been strengthened. Today, it is comparable to Anglo-Saxon standards.

Against the backdrop of our two countries' differing legal, political and economic traditions, let me now turn to what strike me as significant lessons with regard to our respective relations with Europe and, more specifically, with EMU.

Structural reform and EMU

The United Kingdom is currently harvesting the fruits of its growth-boosting liberalization policies implemented during the past 20 years. A dynamic market economy yields strong and stable output

[1] See e.g. *Judgment Under Uncertainty: Heuristics and Biases*, D. Kahneman (editor), Cambridge University Press, 1982.

[2] Rising current account deficits, increasing unemployment and inflation led to the collapse of the Sterling. The UK requested for IMF assistance and the BoE secured a stand-by credit from other central banks, among them the SNB. Negotiations with the IMF were protracted. Fund officials were determined to ensure that UK officials had in place a set of policies that promised a drastic decrease in public sector borrowing in order to achieve a deceleration of inflation and an improvement of the balance of payments. An agreement was reached in December 1976. Immediately afterwards, confidence in the pound was restored. See e.g. *The International Monetary Fund, 1972-1978: Cooperation on Trial*, Margaret Garritsen De Vries, IMF, 1985.

with low unemployment and monetary stability. This stands in contrast to the current situation in the European Monetary Union. Its large member states in particular suffer from endemic growth problems, structural weaknesses and high unemployment. In light of this comparison, it is not surprising that any proposal for the UK to join EMU at this stage is widely regarded as economically disadvantageous, quite apart from deeper cultural-historical misgivings in the UK about further European integration. Moreover, correlations suggest that the US business cycle is no less important for the British economy than the degree of activity in the EU (Chart 1).

In many ways, the lessons for Switzerland are more complicated. Unlike the UK, Switzerland has had to endure a protracted period of very low economic growth. Indeed since 1980 and on an accumulated basis, Switzerland has had the poorest growth performance amongst the advanced economies (Chart 3).[3] As a result, a widespread and welcome political and media debate about how to boost our country's growth performance has emerged. At the same time, the absence of a deep economic crisis experience, the mix of proportional representation, direct democracy, strong federalism and the resulting consensus-oriented political process has so far prevented the implementation of a genuine wide-ranging liberalization program.

As a result, there is a latent belief embedded in many economic debates in Switzerland that the only way successfully to complete the necessary structural reform program is to join the European Union. Given that an opt-out clause for Switzerland would be unlikely**,** joining the European Union would in fact be tantamount to joining EMU. In other words, many of those who propose EMU membership accept the need aggressively to push on with economic reforms but reject the notion that it can be done independently. The responsibility for introducing reforms is in effect delegated to the European Union.

This line of reasoning is flawed and must be dismissed. It is true that the obvious appeal of such a strategy is the ability to blame the European Union for having to introduce unpopular reforms and ultimately transfer the political costs of reforms to Brussels. Nonetheless, as the examples of several member states demonstrate, EMU membership does not guarantee successful reforms. First of all, the European Union, let alone the European Monetary Union were not primarily designed to be vessels to accommodate liberalization efforts. Moreover, in the cases where membership does require legislative adjustments which amount to economic reform steps, EU law only prescribes the formal legislative change. Implementation responsibility typically remains with local authorities on the basis of the subsidiarity principle.

This point is reinforced when considered from a macro-economic perspective. Far-reaching domestic reforms often constitute painful macro-economic adjustment processes. With EMU membership, a country loses its monetary policy and at least to some extent its fiscal policy lever. With these important macroeconomic compensating mechanisms no longer available, the cost of domestic economic reform is in fact likely to rise. Necessary real exchange rate adjustments will have to occur via wage and price changes while the ability for fiscal policy to reduce the cost of higher unemployment is curtailed. At the same time, labor mobility that could absorb some of the costs remains limited in Europe. Arguably, therefore, far-reaching economic reforms become in fact more difficult to implement once a country loses its independent monetary and fiscal policy inside EMU. This is particularly true for countries with rigid labor markets. The recent electoral results in Germany and France illustrate this dilemma.

It is of utmost importance for the Swiss political authorities not to fall into the trap of the kind of 'help us from ourselves' line of reasoning that I tried to outline. There may well be political reasons to have a long-term EMU accession strategy in place. But it is a mistake to link the question of domestic economic reform to EMU accession. As I pointed out earlier, in light of Switzerland's legal, political and historical context, far-reaching reforms will be a formidable challenge, despite the extraordinary asset of a highly flexible labor market. Nonetheless, there is no alternative to tackling independently and directly the domestic economic restructuring process and its consequences if Switzerland is serious to boost its growth potential and thereby safeguard its tradition of broad social and welfare programs.

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[3] Because Swiss GDP statistics do not fully take into account the improvement of the terms of trade regularly realized by the tradable sector, the growth differential between Switzerland and other advanced economies is overstated but remains significant nevertheless. See e.g., Term-of-Trade Changes and Real GDP: Evidence from Switzerland, Ulrich Kohli, SNB Quarterly Bulletin, June 2002.

Monetary policy and EMU

Accession to a monetary union transfers the power over monetary policy from the national to the union level. There are costs and benefits to such an abdication of monetary sovereignty. Nominal interest rates are equalized throughout a monetary union and the nominal exchange rate is no longer available as a tool for alleviating the impact of asymmetric shocks. Necessary economic adjustments between different countries of a monetary union must therefore occur through various price and factor movements. As I have already suggested, imposing real wage adjustments in particular can be politically costly. In the case of both the UK and Switzerland, these potential costs of EMU membership are mitigated by virtue of flexible labor markets in both countries.

In the case of Switzerland, EMU accession would also lead to the loss of an interest rate bonus our country has traditionally enjoyed. At least partly, this bonus is rooted in the credibility of the Swiss National Bank, acquired over a long period of independent and successful monetary policy (Chart 2). One benefit of EMU membership for Switzerland as a trading nation would be lower transaction costs derived from the use of a single currency and the disappearance of a considerable part of exchange rate risk for our exporters. Interestingly, with the Swiss Franc's recent stability vis-à-vis the Euro, Swiss Euro oriented exporters have of late enjoyed both the interest rate bonus and considerable currency stability. This, of course, does not apply to our dollar-oriented exporters who have to manage a substantially higher exchange rate risk. When we observe Switzerland's business cycle and its degree of relative synchronization with that of the Euro-zone, there is little evidence that the two business cycles would be fundamentally incompatible in the context of a monetary union. Not surprisingly in light of our trade links, our business cycle is relatively closely correlated with that of Germany. Nonetheless, it is worth pointing out that in terms of annual real GDP, Switzerland has outperformed Germany in ten out of the last 24 years (Chart 4). There seems to be an increasing synchronization of national business cycles inside the Euro-zone, though this pattern can also be observed for economies that were outside EMU such as the UK, Switzerland and Sweden (Chart 5). Higher business cycle synchronization may simply reflect the fact that with growing globalization, the overwhelming economic trends are global rather than intra-regional. In the context of benefits for Switzerland, I have already discussed why the argument that EMU membership would induce the Swiss political authorities to embark upon a necessary and otherwise impossible economic reform program should be dismissed.

For the United Kingdom, the economic cost-benefit assessment of EMU membership is a different one. Analogous to the Swiss case, the UK would lose monetary policy as a flexible instrument to respond to asymmetric domestic shocks such as the current steep rise in domestic house prices (Chart 6). However, unlike Switzerland, the UK would gain from lower interest rates. In this context, it must be remembered that the Bank of England's post-monetary independence highly successful monetary policy under an inflation targeting regime follows a long period of stop-and-go monetary policy and relatively high inflation (Chart 7). The argument that EMU would somehow induce further structural reforms is equally irrelevant for the UK as it is for Switzerland though partly for different reasons. As I outlined earlier, initiated by the economic shock experience of the late 1970s, the United Kingdom has independently and autonomously embarked upon a long-standing and far-reaching economic liberalization course. The current nature of the relative business cycles between the UK and the Euro-zone points to higher economic costs of UK membership in EMU than for continental European countries. This is illustrated by the different interest rates settings of the ECB and the Bank of England in recent times.

To join or not to join

To join or not to join EMU is a complex and multi-faceted decision for any sovereign nation. By definition, it amounts to a long-term commitment to an uncertain process subject to unpredictable influences. The long-term costs and benefits of such a decision are therefore not easily evaluated. In addition, the cost-benefit analysis must take place at many different levels. Economics constitutes only one layer of analysis and by no means the only relevant one. Switzerland and the United Kingdom are both nations with long-standing traditions of global integration and free trade. Both nations rely fundamentally on multilateral contractual frameworks such as the one offered by the World Trade Organization (WTO). Our nations and our peoples live in and benefit from a global and open world. Europe is and must remain part of that world. Surely an open multilateral global economy must be our primary long-term commitment. The decision to join a regional agreement such as the European Monetary Union must be evaluated against this global backdrop. I have tried to provide you with a brief sketch of some of the salient macro-economic issues related to such an evaluation. Beyond economics, both of our nations have a proud political history. Ultimately, the decision to surrender national sovereignty - be it monetary or otherwise - will always be a political one. Central bankers may have views as private citizens which they would presumably express at the ballot box. In the public domain, however, their responsibility should be to illustrate potential economic consequences of the ultimately political decision to join or not to join the European Monetary Union.

Conclusion

Ladies and Gentlemen, the decision formally to join EMU does not appear to be a policy issue of imminent concern in either of our two countries. In the United Kingdom, the issue was indefinitely pushed back in time in June of last year. Here in Switzerland, it is the ratification of the second package of bilateral treaties with the European Union that dominates our current external political agenda. Since this contractual arrangement with our European partners was designed from the outset as a multi-issue legal document with costs and benefits spread over multiple issues, the Swiss government is to be commended for insisting on negotiating the agreement as a comprehensive package and not break it down into multiple single issues.

Meanwhile, globalization is set to proceed. With the rapid integration of China and India into the global economy and the subsequent reorganization of production processes, global competition is rapidly increasing with changes in relative prices that become increasingly a function of global demand and supply. Needless to say, the globalization path will neither be linear nor smooth. There are risks, perhaps none less so than the temptation of governments to resort to protectionism in a misguided effort to respond to the costs associated with global economic integration.

In Europe, integration is also proceeding. In less than a week, ten countries will join the European Union. They will add twenty-five percent to Europe's population, twenty-three percent to Europe's land mass and nine percent to European GDP on a purchasing power parity basis. Average GDP per capita in Europe will therefore decline by thirteen percent to a level slightly above sixty percent of that of the United States. Fifteen years after the fall of the Iron Curtain, the new member states are keen to compete on the internal market. The adjustment process will entail important challenges to both newcomers and old-timers. On balance, I remain confident that in the longer term, the growth contribution to the European Union will be a positive one.

In a world of rapid change and integration, countries with a long history of open economies and societies are well positioned to reap economic and social benefits. Both of our countries doubtlessly fit into that category. Note that in a recent global survey, Switzerland was voted the third most open country in the world. The challenge will be to maintain our ability to adapt to changing external conditions. On the important issue of domestic structural reform, Switzerland would be misguided to consider EMU membership as a strategy for curing domestic problems. Instead, we have much to learn from our friends across the English Channel on how to reform a domestic economy on the basis of domestic needs.

Thank you.

Chart 1

Correlations of UK GDP Growth with US and EU

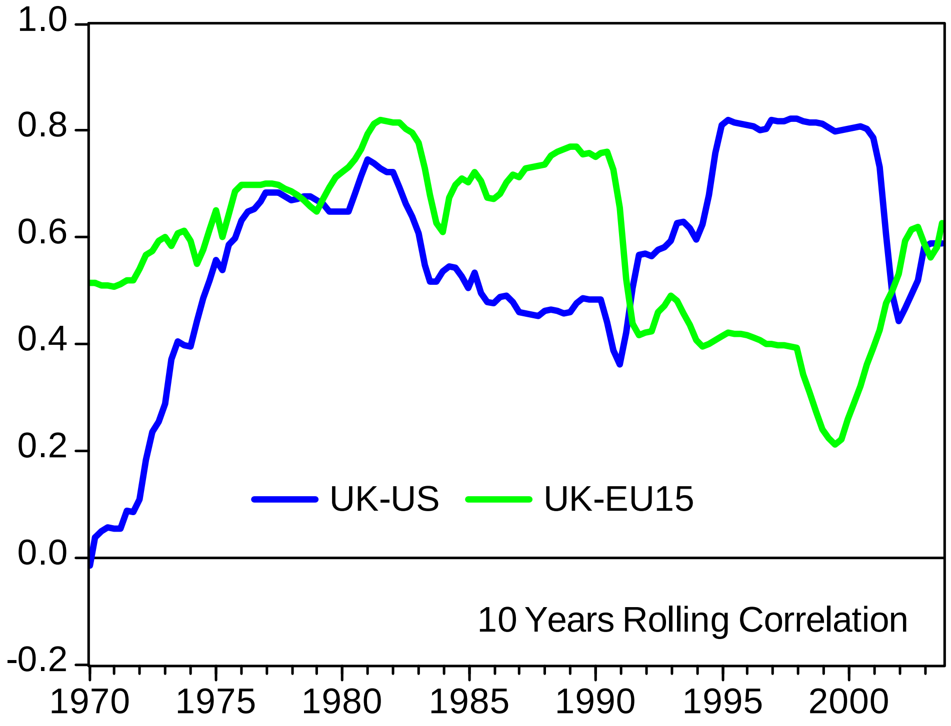

Chart 2

Long Term Interest Rates in the UK, Germany and Switzerland in percent

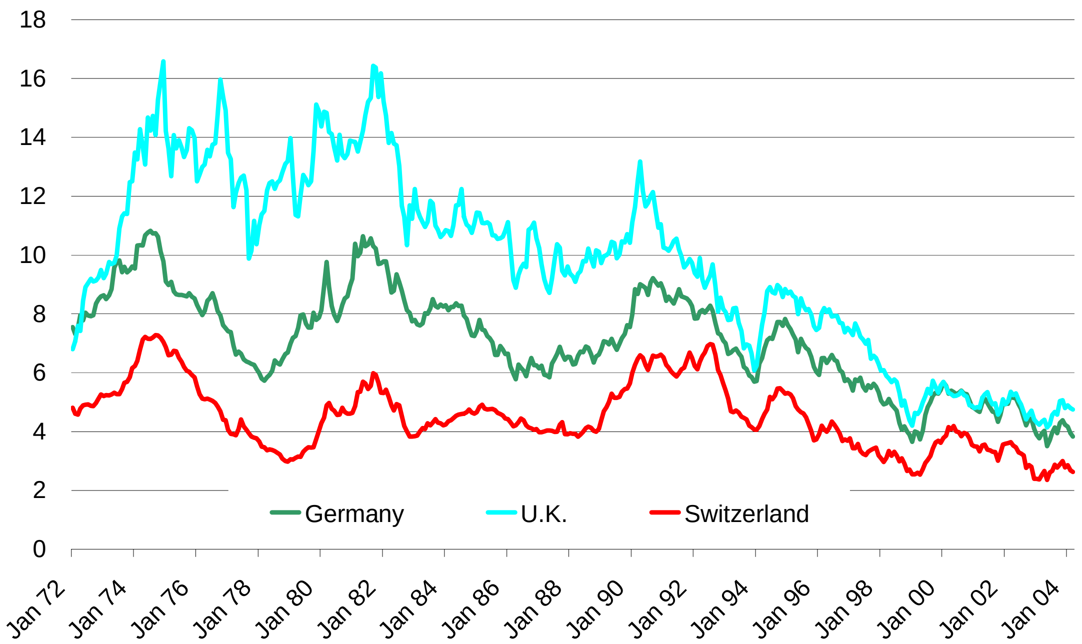

Chart 3
Real GDP Level in 2003 (1980=100)

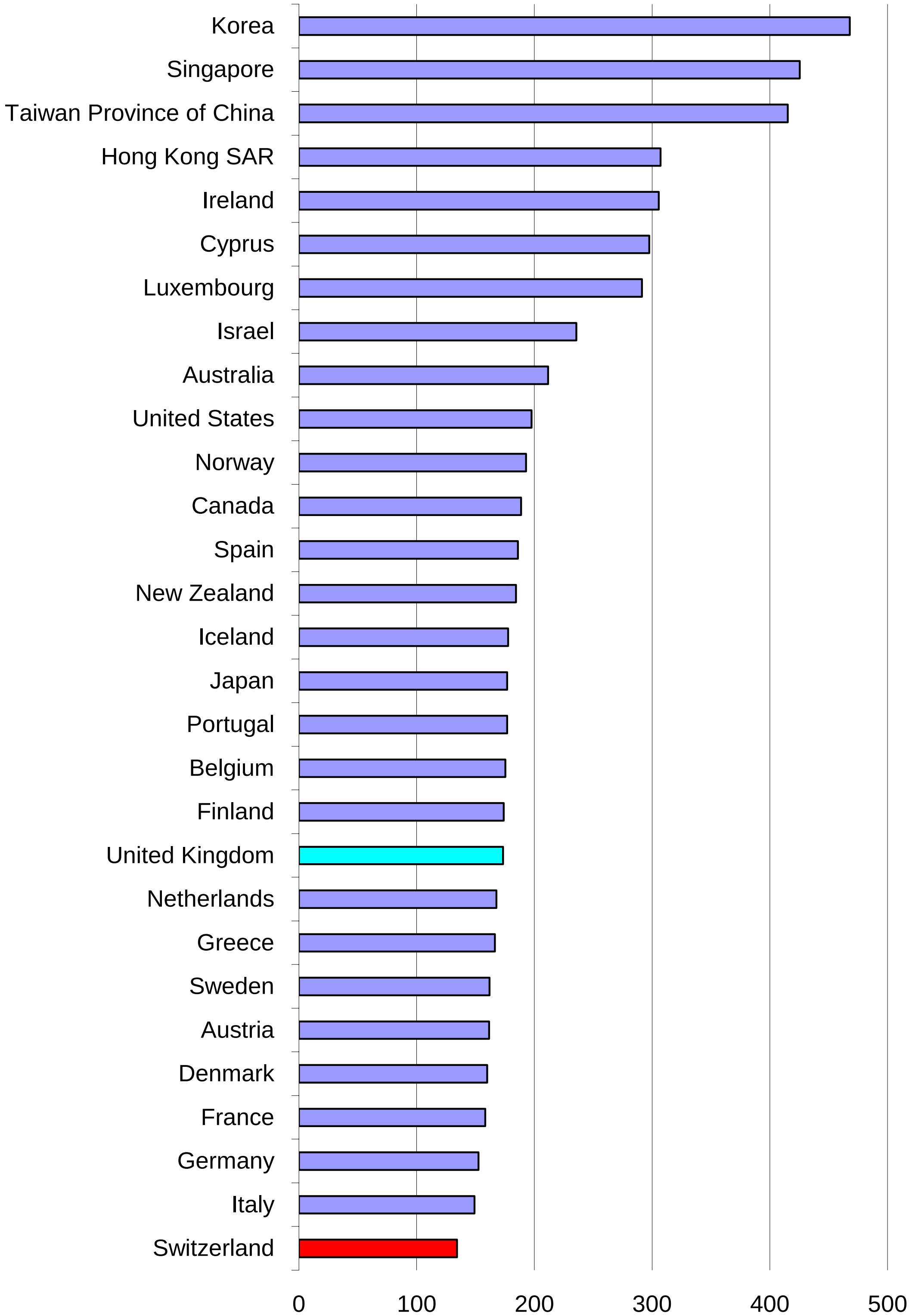

Chart 4
Annual GDP Growth in the UK, Germany and Switzerland in percent

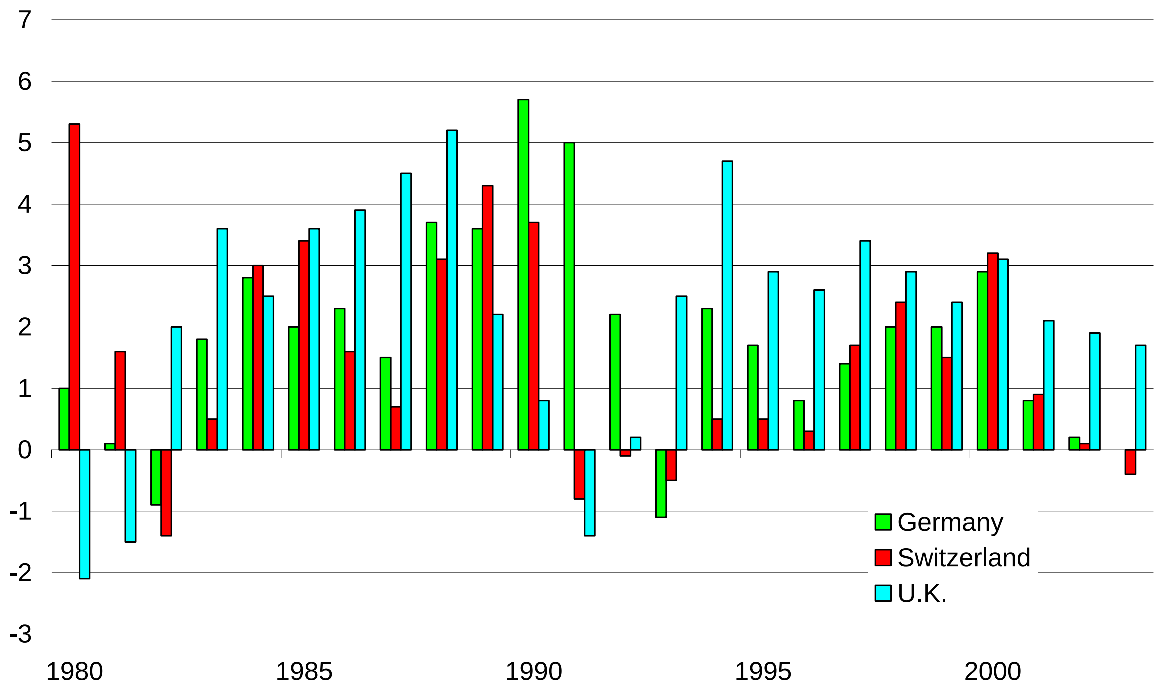

Chart 5
Correlations with Germany's GDP Growth

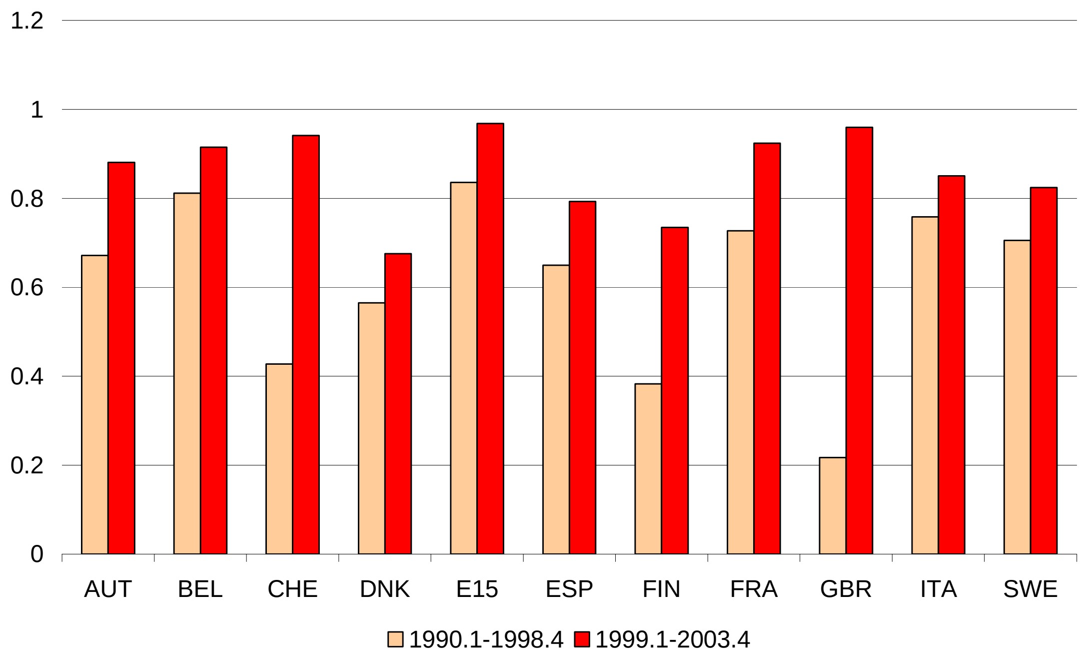

Chart 6
12 Months Growth of the Halifax House Price Index

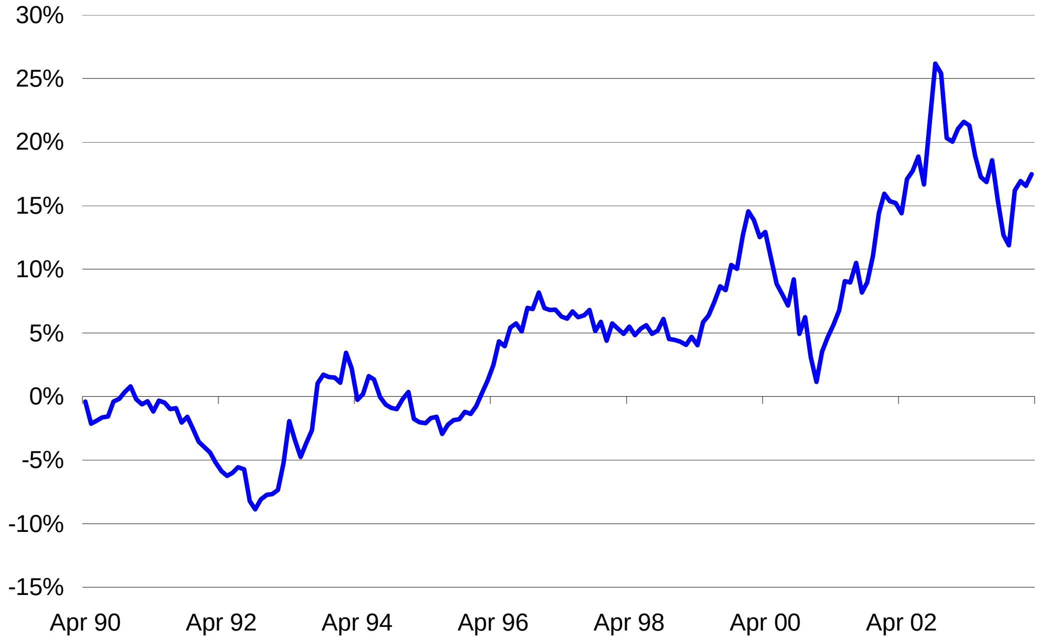

Chart 7
Annual CPI Inflation in the UK