

Jean-Pierre Roth: Swiss franc and euro - two sister currencies?

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the Swiss-Brazilian Chamber of Commerce, Sao Paulo, 19 November 2004.

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It is a great pleasure for me to talk to you today about the Swiss franc and the euro after six years of monetary integration in Europe.

Looking at the map, you might wonder whether Switzerland, a small spot in the middle of Euroland could still follow an autonomous monetary policy. What are the consequences of the introduction of the euro on the Swiss franc and on the effectiveness of Swiss monetary policy? And what are the effects of this new international monetary order on countries outside the dollar-euro block more generally?

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

1. A new international framework

January 1, 1999, constituted a true revolution for Europe. Many observers argue that the introduction of the euro represents the major postwar stage in European integration. They are right. The Maastricht Treaty, by removing national currencies and defining budgetary rules, leads to an important transfer of power from national capitals to European institutions. The French franc, the Italian lira, and the German mark were all symbols of national identity. The euro is now playing an integrating role in people's minds. In this regard too, the new currency brings a revolutionary dimension. Remember that national currencies were almost always and everywhere brought about by fundamental political changes: the French franc was the "franc Germinal", the Italian lira was created on the occasion of the Italian unification, and the Reichsmark appeared in 1873 at the foundation of the German empire. These are very strong political symbols indeed.

For Switzerland too, the introduction of the euro was a kind of revolution. For the first time in our history, our country was completely surrounded by a single currency area. In terms of population, Switzerland, with its 7 million inhabitants, could be compared to Missouri in the middle of the United States. Just try to imagine Missouri with its own currency! It would not be very realistic.

Until 1999, Switzerland had been living amidst very diverse European currencies. In fact, our country had always lamented about this situation. Indeed, given our large export sector, we could only dream of a stable monetary environment without exchange rate fluctuations, which always interfere with economic decisions and distort price comparisons.

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

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

Simplifying trade and investments benefits all members of the European monetary zone, and it also helps anyone interested in being active in the European market. Switzerland, with its high degree of

integration in the euro zone, reaps large benefits from this stable situation. Thus, it is clear that on those aspects, the introduction of the euro was very good news for the Swiss economy.

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

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

We know that a revolution is always associated with risks and uncertainties, thus it should not surprise you that we were very much concerned about possible negative developments.

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

- a) First, the major risk was that the new European currency would destabilize the Swiss franc. In the past, the Swiss franc, along with the German mark, played the role of a safe haven currency whenever monetary crises occurred. With the disappearance of the German currency, the Swiss franc would find itself first in line of fire in case of a dollar crisis, for example, or even worse, in case of doubts about the stability of the European currency.
- b) Second, we risked seeing the euro being increasingly used as a means of payment in Switzerland. As the common currency was about to become the main unit of account for our exports, we feared that domestic firms might adopt the euro as well, so as to minimize exchange rate risks. Some were even considering wages being paid in euro. If use of the franc were to be crowded out by the euro, the Swiss National Bank would have had little leverage left to influence monetary conditions in Switzerland. It would become a sort of paper tiger!
- c) Third, even short of a full "euro-ization" of the Swiss economy, we feared the loss of our monetary policy autonomy. Given the importance of the common currency for the Swiss economy, what else could the Swiss National Bank do other than follow the European Central Bank's policy and de facto integrate the franc into the euro zone? A gradually shrinking interest-rate differential between euro and Swiss franc investments as well as a loss in monetary autonomy would have resulted.

How does our recent experience relate to these concerns?

3. Our experience as an independent monetary entity

a) *The euro/swiss franc relationship*

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

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

b) *The euro as a means of payment*

Those who thought that the euro would make the Swiss franc obsolete as a means of payment were also mistaken. True, our ATM machines have been adapted to provide euro banknotes, so that it is now possible to pay in euro almost everywhere in Switzerland. Yet, despite these efforts, the demand for euro notes is still weak and those notes do not circulate any more extensively than French francs, Italian lira and German marks used to. In stores and restaurants, prices denominated in euros are usually not very attractive. Obviously, small shop and café owners are not thrilled by the idea of

accepting cash payments in euros. Anyway, they cannot offer as good financial services as commercial banks or credit card companies!

c) *Monetary autonomy*

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

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

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

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

Facing this reality, we decided to act independently and lowered interest rates initially in March 2001, a few months before the European Central Bank. Then, seeing a clear economic slowdown and a strengthening of the Swiss franc, we lowered interest rates repeatedly and aggressively. The magnitude of our policy loosening has exceeded that of the ECB. This year, with growth accelerating again an adjustment of monetary policy became necessary. We raised interest rates by 25 bp in June and September. We thus kept our monetary autonomy intact.

4. Conclusion

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

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

Ladies and Gentlemen,

The title of my speech was "Swiss franc and the euro: two sister currencies?" I can now answer the question.

Indeed, our recent experience has shown impressive convergence between Switzerland and the EU in monetary matters. The inflation differential has decreased and interest rates have moved closer. But we are still far from a monetary integration. On the contrary, the Swiss National Bank has been able to operate more freely since the introduction of the euro than before.

Thanks to a much more stable monetary landscape in Europe, the Swiss franc is today much less under speculative pressure than before. Our currency has still its international dimension, but it sticks closer to economic fundamentals, which is good news for our exporters. It also means that the exchange rate volatility between the franc and the euro is today less pronounced than the volatility we observed in the past between the franc and the German mark. Clearly the franc belongs to the family of the European currencies, reacting similarly vis-à-vis dollar fluctuations.

In that sense, for sure, the franc and the euro are sister currencies.