Mr. Meyer considers the approach of the Euro Address given by the Chairman of the Governing Board of the Swiss National Bank, Dr. Hans Meyer, to the Swiss-American Chamber of Commerce in Zurich on 4/11/97.

European Monetary Union (EMU) is set to change the monetary landscape not only in the participating countries, but also in Europe and worldwide. By the sheer size of the European Union (EU), the new single currency -- Euro -- will become the second most important currency in the world, surpassed only by the US dollar. Dealing with the likely consequences of the introduction of the Euro is therefore a must for both policymakers and business leaders.

Creating a single currency and thus a single monetary policy in the member states of the EU is by no means an easy task. Its complexity, its need for technical expertise, and its tight time schedule all make the creation of the EMU one of the most daring and most far-reaching monetary experiments in history. The national currencies of a number of countries will cease to exist. In addition to losing their currencies, these countries will also lose their prerogative to conduct an autonomous monetary policy. A new institution -- the European Central Bank (ECB) -- will henceforth determine the course of monetary policy in the participating countries. These countries will be able to influence the ECB's monetary policy only to the extent that they will all be represented in the decision-making body of the new central bank.

As history tells us, a national currency and an individual monetary policy are both important symbols of an independent, sovereign country. EMU is breaking with this tradition. The reasons for so doing are numerous: First, a single currency is a desirable addition to the European single market. Cross-border transactions will no longer be impeded by the need to exchange one currency for another or by uncertainties about the future development of exchange rates. Second, the current influence on monetary policy in the EU is unevenly shared among the member states. Germany stands at the center of the European Monetary System and is thus able to significantly influence the course of monetary policy in the EU. EMU will decrease Germany's influence and will increase the influence of other countries, notably France. Third -- as is hoped and expected by officials in the EU -- the advent of the Euro will strengthen Europe's role in the international monetary arena. It will thus put the continent on a more level playing field with the United States. And fourth, achieving monetary integration is viewed as an important step towards achieving ever closer cooperation in Europe.

Given the various reasons for replacing national currencies by a single European currency, it comes as no surprise that EMU is burdened with high expectations. A failure to achieve it according to the time-table laid down in the Maastricht Treaty is often viewed as a serious threat to further integration in Europe. Now, EMU is certainly an important project. Its importance, however, should not be overstated. Otherwise, rational decision-making is made difficult. It is therefore important to de-emotionalize the discussion and to take decisions based on facts, economic and political common sense rather than on wishful thinking and unrealistic expectations.

The introduction of the Euro presents Europe with both opportunities and risks. Let me first dwell on the opportunities. A successful monetary union will contribute to sustainable economic growth in Europe. It will complement the most important part of the EU, which is the single market. The free movement of capital, labor, goods and services will be made easier when only one currency exists. The allocation of resources will reflect expectations about the profitability of investments and will not be distorted by unexpected exchange rate movements. Comparing prices of the same goods in different countries will become much easier as they will all be expressed in the same currency. Competition will thus be enhanced.

Monetary union will also most likely contribute to lower interest rates in at least those participating countries which now have interest rates above the average. This should further enhance growth prospects.

All of these advantages depend of course on the belief that monetary union will be a success. The likelihood of this happening is relatively high. The new ECB will have as its primary statutory goal price stability. In the performance of its task, it will enjoy a high degree of political independence. Both factors are viewed today as important elements in the quest for stable prices which are a prerequisite for sound economic development. Stable prices can only be achieved when those responsible for monetary policy are in a position to take decisions based on a longer-term view. Short-term activism, caused by an attempt to finetune the economy, invariably results in higher inflation, higher interest rates and a loss of credibility. Giving the central bank a clear goal and protecting it from outside interference is thus a basic ingredient of a successful monetary policy. Viewed from that angle, the ECB is in a comfortable position.

However, a good legal framework is not sufficient for ensuring a successful monetary union. The ECB must also be in a position to conduct a coherent monetary policy for all participating countries. There will no longer be a German monetary policy and there will no longer be a French monetary policy: There will only be a European monetary policy. It will thus no longer be possible to conduct a monetary policy that is in tune solely with the economic situation in a specific country. For a European monetary policy to be successful, the economic situation in the member states of EMU must therefore be comparable. To put it another way: the economic situation in the participating countries should converge before EMU starts.

The EU tries to achieve convergence by making membership of the EMU subject to a country’s ability to satisfy so-called convergence criteria. Inflation and interest rates should be low and in line with those in the other participating countries. The exchange rate should be stable. Last, but certainly not least, the budget deficit should be under control and the level of official debt sustainable. Over the last five to ten years, most member states of the EU have come a long way towards fulfilling these criteria. Inflation rates are at or close to historical lows in various countries. The same is true for interest rates, where differentials have diminished considerably. Much less successful was the quest for fiscal stability. Budget deficits in most countries are still too high and debt levels have often, instead of falling, risen over the last years.

Without any doubt, the pursuit of the convergence criteria with a view to joining the EMU has been instrumental in improving economic policies in various member states of the EU. Who, for instance, would have thought ten years ago that Italy would today post an inflation rate lower than the one in Germany? Yet, despite the progress achieved over the last decade, two problems remain: First, convergence in important areas is still far from being satisfactory. Second, the convergence criteria require the aspiring members of the EMU to achieve certain goals by spring 1998. But what about their future policies?

There is a widespread belief in the economics profession that nominal convergence -- as expressed by the convergence criteria -- is less important for a successful monetary union than real convergence. Real convergence encompasses factors such as labor mobility, price and wage flexibility, exposure towards external shocks, industrial structures, and so on. Judged by these factors, convergence among future members of the EMU still has a long way to go. This is important because to be successful a European monetary policy depends exactly on these factors. Without a high degree of real convergence, monetary policy is bound to have different effects in different parts of the monetary union. The very idea of a single European monetary policy would thus become unrealistic. The ECB would come under political pressure to accommodate mutually incompatible wishes from different parts of the monetary union. The result could only be a less than optimal monetary policy and rising inflation and interest rates. For EMU to be successful the member states of the EU should therefore make determined efforts to further real convergence.

The convergence criteria as laid down in the Maastricht Treaty require member states of the EU to achieve certain goals by spring 1998. Convergence, properly understood, can however never be something that can be pinpointed to a certain point in time, but must be an ongoing process. It does not make sense to require countries to get their fiscal situation under control by a certain date, just to let them go unpunished on a public spending spree shortly afterwards. Prudent fiscal policies should not only be a requirement for becoming, but also for remaining part of the EMU. What is necessary is not only a commitment to achieve fiscal stability at a certain point in time, but a commitment to conduct, from there on, a sustainable fiscal policy.

The member states of the EU answered this challenge by agreeing on the so-called Stability and Growth Pact. The main goal of this pact is to ensure that countries belonging to the EMU continue to follow prudent fiscal policies after the start of the single monetary policy. Countries that deviate from the target will -- in certain circumstances -- be subject to fines which depend on the degree and the duration of the violation of the target. These sanctions will certainly contribute to a more prudent fiscal policy in the participating countries. They will also help in signalling to the public and the markets the determination of the authorities to continue with fiscal consolidation.

However, it is not clear whether the Stability and Growth Pact will be enough to ensure fiscal stability. Stability is not something that can be achieved simply by institutionalized solutions. It can only be the result of the shared conviction of those that are involved in the decision-making process and the societies behind them. Only time will tell whether this shared conviction exists in the EU. Nonetheless, the Stability and Growth Pact is an important ingredient in the quest for a sustainable fiscal policy in the EU.

The EU is -- as I have tried to show -- well poised to seize the opportunities offered by EMU. There are, however, still various risks associated with the introduction of a single currency. Two I would like to mention: First, problems related to the decision on which countries are allowed to participate right from the start, and second, problems related to the transition period.

In an ideal world, the decision on which countries can participate in EMU would be based primarily on economic factors. Given the various expectations associated with the single currency, it is unavoidable that EMU is as much a political as it is an economic project. The decision on membership will thus be influenced by both political and economic factors. As the likelihood rises that some important countries will not be able to comply strictly with the convergence criteria, political factors will become more important. A loose interpretation of the convergence criteria for some countries would make it politically much more difficult to exclude other countries, which also miss some convergence criteria, from participating in the EMU. Depending on how well this selection process is handled, expectations about the future course of monetary policy by the ECB will be either positively or negatively affected. Should political factors unduly dominate economic factors, there is undoubtedly a potential for creating expectations about a less than optimal degree of political independence for the ECB. The ECB would therefore face an uphill battle at the start of EMU. It would have to convince the public and the markets even more than it would have to in more normal circumstances that it is determined and able to deliver price stability. This might involve a more restrictive monetary policy than otherwise required. Such an undesired development can only be avoided if the decision on the initial members of the EMU is based on sound economic foundations.

Once the decision on membership of the EMU has been taken, several months will pass before the ECB takes over the reins of monetary policy. This transition period will be critical in ensuring a good start for the single monetary policy. One of the most important elements will be the determination of those exchange rates that will be used for converting national currencies into Euro. What might sound trivial is in fact a very difficult problem. The EU intends to announce bilateral conversion rates at the same time it announces the participating member states. It is hoped that by so doing, market turbulence due to volatile expectations can be avoided. Making these exchange rates public will mean that monetary policies of the participating countries will have to be coordinated several month before EMU starts. This will require much closer cooperation among the central banks involved than exists today. All the competent bodies in the EU have to make sure this cooperation is put in place. Otherwise, market turbulence, exchange rate fluctuations and a heavy burden on the new ECB would result. Neither the EU, nor, as a matter of fact, Switzerland can be interested in such a development.

Like any other country in Europe, Switzerland has a vital interest in EMU becoming a success. Switzerland’s economy is closely linked to the economy of the EU. High growth in Europe is essential for a sound economic development in Switzerland, whereas a lackluster economic situation in the EU contributes to sluggish economic growth in our country. The success or failure of EMU will thus directly affect our economic well-being. In fact, not only our economic well-being, but also our ability to conduct a relatively autonomous monetary policy will be affected.

Market turbulence during the transition period, uncertainties about the future monetary policy of the ECB and unfulfilled expectations about the stability of the new currency and the degree of political independence of the ECB all have the potential to create an upward pressure on the Swiss franc. An appreciating currency would make it more difficult for our export-oriented companies to compete on the world market and would increase the competition faced domestically from abroad. Should the Swiss franc appreciate to an extent that economic activities in Switzerland were severely disrupted, we would have several courses of action open to us.

The Swiss National Bank (SNB) could relax monetary policy in an effort to counteract the effects of the strong Swiss franc on the domestic economy. Attractive as this response may be, its major drawback is that we would have to walk a tight rope. Relaxing monetary policy too little might not be enough to break the upward pressure on the franc; relaxing monetary policy too much might lead to inflationary tendencies later on.

The dilemma faced by the SNB would become even greater should the pressure on the Swiss franc to appreciate become more pronounced. In such a situation, we could react by pegging the exchange rate of the franc to the Euro. A peg could either be temporary or the Swiss authorities could decide to link the Swiss franc permanently to the new single currency through a fixed exchange rate.

A permanent peg could do away with the problem of an appreciating currency. It would, however, have major drawbacks: First, we would give up our relative autonomy in setting the course of monetary policy in Switzerland. Monetary conditions in our country would be determined entirely by the ECB. As a consequence, interest rates would rise close to the level prevailing in the EMU. Adapting to this new level of interest rates would pose major problems, especially for the real estate sector and for those sectors of the economy which rely on low interest rates to finance their capital-intensive production. Second, choosing the right parity in a system with fixed exchange rates is a very difficult task. A peg that would leave the Swiss franc overvalued would force the SNB to follow a monetary policy that is too restrictive. Conversely, a peg that would leave the franc undervalued would lead to a monetary policy that is too lax. Third, as a rapid appreciation of the Swiss franc would most likely be the result of problems in the EMU, it would be illogical to link our currency to an anchor currency whose stability is doubtful and questioned by the markets. We would give up our record of stability in favor of a yet unproven monetary policy.

A temporary peg would alleviate some of the problems associated with a permanent fixing of exchange rates. Monetary autonomy would be further restricted, but not completely lost. Interest rates would thus most probably not rise to the same level as in the case of a permanent peg. However, by placing a temporary ceiling on the exchange rate of the Swiss franc, the SNB would lose -- albeit temporarily -- control over the money supply. It would thus run the risk of triggering a subsequent rise in inflation. I would regard a temporary peg only as a measure of last resort in the event of extreme exchange rate disturbances.

It is sometimes argued that impediments to inflows of foreign capital might be helpful in fighting an appreciation of the Swiss franc. Historic evidence, however, lends little support to this view. In the second half of the 1970s, Switzerland was confronted with a strong appreciation of the Swiss franc. To curb this appreciation, our authorities, among other things, tightened existing and introduced additional controls on inflows of foreign capital. These measures proved to be nearly ineffective as they were easily circumvented. Today, in an environment of even more integrated markets, the result would be the same. Introducing such measures to combat an appreciation of the Swiss franc would thus be no solution.

Consequently, the SNB would certainly be able to smooth excessive fluctuations in the exchange rate should doubts about the stability of the Euro lead to portfolio shifts into the Swiss franc. However, in the face of extreme capital inflows, we would most likely not be able to entirely insulate the domestic economy from harmful disturbances unless we were willing to jeopardize price stability in the long run. Therefore, Switzerland, like any other country in Europe, has every interest in a successful transition towards EMU and a stability-oriented monetary policy by the new ECB.

Let me finish with some thoughts on the consequences of the introduction of the Euro on payments executed in Switzerland. Two cases have to be distinguished: payments related to domestic and payments related to cross-border transactions. As regards domestic transactions, there is no reason to expect that the Euro would to any considerable extent replace the Swiss franc as Switzerland’s main medium of exchange. The costs associated with using the Euro in domestic transactions will be and will remain higher than the ones associated with the Swiss franc. Historically, only in cases of extreme inflation have domestic currencies been replaced by foreign currencies as the main medium of exchange.

Things are different as far as payments related to cross-border transactions are concerned. In today’s situation, cross-border payments are executed through correspondent banks in each country. These payments are then processed through national payment systems. With the introduction of the Euro, this procedure will change for those countries that belong to the EMU. Correspondent banks will no longer be necessary for payments executed in Euros as the national payment systems will be directly linked through a system called TARGET.

This development will put Swiss financial institutions at a competitive disadvantage as they will still have to rely, for payments executed in Euros, on a less efficient system of correspondent banks. It would therefore be desirable to link the Swiss payment system with TARGET. To accomplish this, three conditions have to be fulfilled: The Swiss payment system must be compatible with TARGET, it must be able to execute payments denominated in Euros, and the European authorities must allow the Swiss system to be linked with TARGET.

The first condition is satisfied: The Swiss Interbank Clearing System (SIC) is fully compatible with TARGET. As regards the second condition, work is underway to create an Euro-SIC capable of executing payments in Euros. As regards the approval by the European authorities, a decision can only be taken once the ECB becomes operational. We would certainly welcome a positive answer.