The Euro and Swiss Monetary Policy

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Presented at the Norwegian-Swiss Euro Seminar, organized by the Royal Norwegian Embassy and Credit Swiss Group, Lugano, 18 September, 1998.

The Swiss public is deeply divided about the question of joining the European Union. Although the Swiss government applied for membership in the spring of 1992, Switzerland will unlikely enter the European Union in the near future. The ambivalent attitude of the Swiss public also comes to the fore in the internal discussions on European monetary unification and the euro. Many Swiss are concerned that the transition to the euro will create various problems for the Swiss economy. A frequently voiced fear is that after the adoption of the common currency, the exchange rate of the Swiss franc vis-à-vis the euro might fluctuate too much. Are these concerns justified? In my contribution to this conference, I will first look at the likely developments in the European Monetary Union after the introduction of the euro at the beginning of 1999. I will then examine the possible effects of the euro on the Swiss economy and conclude with a discussion of how the Swiss National Bank (SNB), if necessary, might respond to excessive turbulences in the exchange rate.

1. European Monetary Union: What is Likely to Happen?

The introduction of the euro will entail both economic benefits and costs. The benefits arise from the elimination of transactions costs and exchange rate uncertainty once the need to exchange national currencies within the euro area disappears. Moreover, the introduction of a common currency will promote competition by improving the transparency of prices charged by firms within the euro area. Another benefit is the clear mandate conferred upon the European Central Bank (ECB), which will issue the common currency and conduct monetary policy in the euro area. According to the Maastricht Treaty, the ECB's main task is to achieve and maintain price stability. In view of the ECB's mandate, there is a good chance that the euro will be a stable currency and will thus contribute to fostering economic growth in the European Union. Moreover, the introduction of the common currency implies that unified money and capital markets will emerge within the euro area. On 1 January, 1999, short-term money market rates will become identical throughout that area. In the capital market, interest rate differentials between the various countries will also largely disappear. As a matter of fact, they have already narrowed substantially within the euro area. Thus, the fragmented national capital markets will be replaced by a large and liquid market for fixed-income securities and equity. As a result, the cost to European enterprises of financing their business activities is likely to fall.

In the public debate about European monetary integration, it is frequently forgotten that the introduction of the euro will not only convey economic benefits. There are also economic costs. The main cost of introducing a common currency lies in the loss of national monetary autonomy incurred by the countries in the euro area. After the transition to the common currency, it will no longer be possible to tailor monetary policy to the needs of individual countries or regions of the euro area. As indicated above, uniform short-term interest rates will rule throughout the euro area. Therefore, the ECB cannot take into account the needs of individual countries or regions in setting interest rates.

The loss of national monetary autonomy would not matter much if economic developments of individual countries within the euro area were highly synchronized. The ECB's uniform monetary policy would then be suitable for all the countries of the euro area. While the economies of Germany, France and their smaller neighbors tend to move together, economic developments in the southern part of the euro area have often been out of step with those further north. Thus, the uniform monetary policy — even if appropriate for the euro area as a whole — may create problems in individual countries or regions in the form of high unemployment or inflationary overheating of the economy. Needless to say, exchange rate adjustments within the euro area will be ruled out as a means for relieving regional imbalances. In the event of serious imbalances, the question arises whether other methods of adjustment are available. Two possibilities come to mind.

First, the authorities at the European and national levels could attempt to deal with local problems by making more vigorous use of fiscal policy in lieu of adjustments in the exchange rate. However, greater reliance on fiscal policy may run up against a major obstacle. The member countries of the European Union have concluded a Stability and Growth Pact, designed to ensure that national authorities will continue to pursue sound fiscal policies after the introduction of the euro. While that pact does not preclude use of fiscal policy to stimulate local economic activity, it clearly limits the national governments' room for maneuver in the budgetary area. Moreover, the European Union does not intend to expand its modest existent programs for financial support of its low-income regions. Therefore, it is likely that regional imbalances will have to be corrected in another way.

In the United States, flexible labor markets play an important role in leveling regional disparities. In regions with high unemployment, wages tend to rise less than elsewhere, inducing new firms to enter and to create jobs. Furthermore, people are prepared to move to regions with better job prospects. In many member countries of the European Union, by contrast, labor markets are inflexible. Wage structures are too egalitarian and do not take sufficient account of labor supply and demand conditions in individual occupations, industries and regions. In addition, people are reluctant to move, not only across national borders, but also within their own countries. European Union officials recognize that greater flexibility of labor markets is required if the euro is to enhance economic welfare. However, while some modest reforms of labor markets have been implemented, efforts to tackle the rigidities head on tend to run up against fierce political resistance in most countries of the European Union.

Consequently, it is an open question whether the shift to the euro will help the European Union to promote its economic welfare. The uncertainties surrounding the economic effects of the euro must be kept in mind if we try to assess the consequences of the common currency for the Swiss economy.

2. Consequences for the Swiss Economy

European monetary integration may affect the Swiss economy in various ways. During the planning phase of the euro project, monetary integration already began to cast shadows on our economy. In 1994 and 1995, the Swiss franc appreciated strongly in nominal and real terms against most currencies, including those of our key European trading partners. The upsurge of the Swiss franc was attributable in large measure to the uncertainties arising from European monetary integration. Many investors — both inside and outside the European Union — appeared to place little confidence in the stability of the future euro. They viewed the Swiss franc as a safe currency providing a hedge against the vagaries of the euro project. The rise of the Swiss franc magnified the pain felt by the domestic economy, which was just about to recover from a severe recession. A shift in Swiss monetary policy in the spring of 1995 — to be discussed later — and a significant strengthening of the US dollar in 1996 served to rectify the exchange rate misalignment. More recently, our currency has again tended to strengthen to some extent. However, that modest rise in the real exchange rate of the Swiss franc does not reflect concerns about the stability of the euro. It is due rather to save-haven effects emanating from the crises in East Asia and Russia.

As a matter of fact, investor sentiment turned strongly in favor of the euro after the decision to introduce the common currency. Before that decision was taken, many Swiss had been concerned that the shift to the euro might trigger an excessive appreciation of the Swiss franc. These anxieties proved to be unfounded. On the contrary, markets became convinced that the euro would be a stable currency. They recognized the efforts made by the member countries of the European Union to meet the Maastricht convergence criteria. They were also impressed by the highly competent professionals appointed to manage the ECB.

The euro certainly stands a good chance of becoming a stable currency, as currently anticipated by market participants. I am convinced that the management of the ECB will make every effort to fulfill the mandate of the Maastricht Treaty and to conduct monetary policies aimed at price stability. A stable euro would also be in the interest of our economy as it would contribute to restrain exchange rate movements of the Swiss franc vis-à-vis our neighbor countries. Nevertheless, I believe that markets right now are too optimistic about the prospects of the euro. They are underestimating the technical difficulties faced by the ECB in setting monetary policy. The ECB will operate in a radically different policy environment, characterized by unified financial markets within the euro area. This is likely to distort the indicators central banks require to spot impending threats to price stability. Central banks cannot wait until an inflation or deflation problem actually occurs because monetary policy tends to affect the price level with a long lag. Therefore, central banks, if at all possible, must detect such problems well in advance if they are to maintain price stability. Without reliable indicators of future inflation or deflation, the conduct of monetary policy is akin to steering a ship in uncharted waters. Furthermore, markets, in my opinion, take an overly benign view of the economic costs that are likely to arise after the transition to the euro. Since these costs — as indicated earlier — may be significant, I would not be surprised to see the current wave of optimism give way again to a more sober assessment of the euro once it dawns on market participants that the common currency is unlikely to lead to economic paradise.

For these reasons, one cannot rule out the possibility that shifts in market expectations about the stability of the euro will elicit renewed exchange rate turbulences even if the ECB strives to stick to the mandate of the Maastricht Treaty. Some analysts fear that the fluctuations of our currency vis-à-vis the euro will far exceed those observed in the past for the Swiss franc/Deutsche mark exchange rate. In their view, the highly unequal size of the euro and Swiss franc areas will exacerbate exchange rate volatility. Should the euro giant sneeze, the Swiss franc dwarf will likely be tossed about in the air. However, I am not aware of any research pointing to a relationship between exchange rate volatility and the relative size of currency areas. Moreover, I can also think of forces that will help to curtail exchange rate volatility after the introduction of the euro. In 1994 and 1995, the Swiss economy was hurt, above all, by a sharp appreciation of the Swiss franc in relation to the Italian lira. Since the Italian currency will soon be replaced by the euro, an important source of exchange rate instability will disappear. Thus, I am unable to predict whether, on balance, the introduction of the euro will increase or decrease the volatility of the Swiss franc exchange rate vis-à-vis our neighbor countries.

Aside from possible effects on exchange rate volatility, some analysts assert that the shift to the euro, sooner or later, will cause Swiss interest rates to rise to the levels prevailing in the euro area. Swiss interest rates, especially long-term rates, have traditionally been lower than anywhere else in Europe. In the 1950s and 1960s, the average yield on German government bonds, adjusted for exchange rate gains or losses, was typically more than 3 percentage points higher than the corresponding Swiss average. Over the years, this interest differential has tended to shrink, but it still amounts to close to two percentage points. In my view, it is unclear why the introduction of the euro should remove the „interest bonus" on Swiss-franc assets. Even after the shift to the euro, our currency will continue to be used by foreign investors as an attractive means of diversifying the asset composition of their portfolios. So long as the Swiss franc remains an stable investment instrument, the „interest bonus" will continue to stay with us. Thus, the chief threat to the Swiss economy arising from the shift to the euro lies in a possible increase in exchange rate volatility. In particular, a loss of confidence in the euro might trigger an excessive appreciation of the Swiss franc. What could the SNB do in the face of adverse exchange rate shocks?

3. How Could the Swiss National Bank React?

If confronted with an excessive appreciation of the Swiss franc, the SNB could react in two possible ways. First, it could continue to stick to its traditional policy approach of controlling money growth in an effort to achieve and maintain price stability. But it would relax its policy stance in response to the exchange rate shock. By shifting to a more expansionary course, the SNB would lower domestic interest rates and make Swiss franc assets less attractive to foreign investors. In this way, it could counter the appreciation of the Swiss franc. This is exactly the approach the SNB adopted three and a half years ago, when it relaxed substantially its monetary policy. At the beginning of 1995, the sharp appreciation of the Swiss franc, mentioned earlier, started to choke the modest cyclical recovery that had set in two years earlier. The SNB tried to perform a delicate balancing act in order to reconcile its desire to shield the domestic economy from the ill-effects of the strong Swiss franc with its obligation to preserve price stability in the longer run. Even though the SNB loosened considerably its monetary reins, it was unable to soothe entirely the pain inflicted by the strong Swiss franc because the exchange rate did not react instantaneously to its policy shift. Nevertheless, SNB was reluctant to adopt an even more expansionary stance. It was concerned that an overly expansionary policy might fuel inflation at a future point in time. However, in 1996 it became clear that the shift to an expansionary stance had been fully justified as the main problem at that time was a threat of deflation, rather than inflation

By relaxing its policy course, the SNB set the monetary pre-conditions for a sustained recovery of the Swiss economy. Thanks to the lower real exchange rate of the Swiss franc and a parallel recovery of Western European economies, Swiss real GDP has been growing again since the beginning of 1997. At present, the SNB is still pursuing its relaxed policy course. As the Swiss economy continues to expand, though, the SNB, at some future point in time, will have to tighten policy again in order to preserve price stability. However, considering the shadows cast by the East Asian and Russian crises on the cyclical recovery of the European economies, the SNB does not believe that the time has come for tightening its monetary reins. Thus, recent experience indicates that the SNB, through shifts in monetary policy, is able to offset to a large extent the ill-effects of adverse exchange rate shocks.

A second possibility would be to peg the exchange rate of the Swiss franc to the euro. The peg could either be temporary or Swiss authorities could decide to link the Swiss franc permanently to the euro through a fixed exchange rate. In the present environment, a permanent peg does not seem to be an attractive alternative to the SNB's traditional policy approach. With a permanent peg, the SNB would give up voluntarily its monetary autonomy. Thereafter, Swiss monetary conditions would be determined entirely by the ECB. Switzerland would forego the benefits of its past attempts to maintain price stability on the strength of its own efforts. In particular, we would have to accept a rise in domestic interest rates to euro-area levels since the Swiss franc, for all practical purposes, would become equivalent to the euro. It would clearly be odd to link the Swiss franc to an anchor currency whose stability record would still need to be established. Of course, the question of linking the Swiss franc permanently to the euro is closely related to the more general issue of how Switzerland will arrange itself with the European Union in the coming years. Should the Swiss decide to join the European Union, they will likely be drawn into the euro's orbit.

A temporary peg, by contrast, would not entail a loss of monetary autonomy. However, by placing a temporary ceiling on the Swiss franc exchange rate, the SNB would lose control over the money supply and, thus, run the risk of setting the stage for a subsequent rise in inflation. The SNB would regard a temporary peg only as a measure of last resort in the event of extreme exchange rate disturbances.

In conclusion, the SNB is certainly able to smooth excessive fluctuations in the exchange rate arising from portfolio shifts into Swiss francs, induced by doubts about the stability of the euro. But in the presence of extreme exchange rate shocks, the SNB would be caught in a dilemma: If it tried to shield the domestic economy entirely from these shocks, it would probably jeopardize price stability in the medium and long runs.