The Swiss Franc within an Euro Environment

Address given by

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It is a great pleasure for me to be here, in this beautiful city of Vienna, the present capital of the European Union. The venue of this conference could not have been better chosen. In just a few weeks, Europe will take the historic step of monetary integration. On this particular occasion, I am especially honoured to address such a gathering of central bank officials, representatives of finance ministries and commercial bankers, and to offer you the views of the Swiss National Bank (SNB) on the monetary challenges ahead.

As you are well aware, Switzerland, like a few other European countries, will not be integrated in the future Monetary Union. Its position outside « Euroland » is the logical consequence of its political decision not to adhere to the European Union for the time being.

For all Europeans, the most visible short-term consequence of the Monetary Union will be the new central bank architecture and the creation of the euro. On January 1st, the national central banks will merge in the System of European Central Banks where monetary sovereignty is to be exercised, and banks will be allowed to denominate deposits in euros. In future, the ECB will be in charge of the monetary management of Euroland, a zone as large as the United States. Euroland will be a vast market without exchange rate risks in domestic transactions.

Although Switzerland will remain outside the euro area, it will also be affected by the revolution produced by the single currency. I use the word « revolution » here to stress how deep and far-reaching the final impact of the euro will be, and also to show up the uncertain implications of the introduction of the common currency.

The Monetary Union is a big step forward, but it is a big step in the dark ! We all expect that the single currency will enhance transparency on the EU market for goods and services, and we believe that it will be a tremendous integration factor on the European capital market. No doubt, the euro will stimulate competition among producers and create a new framework for the banking and financial industry. But, like in any revolutionary situation, there will be considerable uncertainties following the introduction of the euro, especially uncertainties surrounding the structural impact of the common currency in the long run.

All Europeans have to live with these uncertainties, whether they have decided or not to join the union. In our case we know that the Swiss franc will remain an independent currency. We also realise that our country will be totally surrounded by the euro zone.

What kind of impact can we expect for our economy, what challenges will it represent for monetary policy ?

1. The impact on the Swiss economy

For Switzerland, the unification of the European monetary landscape is basically excellent news. For the first time in our history we will be located in the middle of a large monetary zone where price stability will be the objective of monetary policy.

Why is it good news ? Because Switzerland always had to go through painful adjustments whenever any of its trading partners were afflicted by monetary disorders. It is not necessary to go back as far as the 19th century or even the 1930s to be convinced of the perverse impact of large currency fluctuations or competitive devaluations. Even during the 1990s, the marked weakening of the Italian lira created a major problem for us, especially for our textile industry and for the south of Switzerland, where relations with Italy are traditionally very close. If, tomorrow, the euro provides Europe with a stable currency, this will not only be profitable for the participating countries, but it will also be in the interests of small countries such as Switzerland. 70% of our imports come from Euroland, which, in turn, absorbs more than half of our exports.

The main issue facing non-participating countries is the issue of the stability of the euro.

Here again, we have little to go by because the value of the euro will depend on the future policy adopted by the ECB.

We have good reason to believe that the relationship between the euro and the Swiss franc will be stable.

- First, the objective of monetary policy of the ECB coincides perfectly with our own policy orientation towards price stability. The fact that the ECB will be an independent central bank is a further factor in favour of a stable policy.

- Secondly, our experience of more than 25 years of currency floating shows that with converging fundamentals and similar policy objectives, there is a good chance that the exchange rate relations between Euroland and Switzerland will remain within an acceptable fluctuation band.

It is striking to see how relatively stable a flexible Swiss franc (measured in real terms) has been vis-à-vis the German mark. From 1983 to 1998, our currency has strengthened yearly at the low rate of 0.5% vis-à-vis the mark and fluctuated within a band of +/- 5%. These results, which have been achieved by market forces alone since the SNB did not intervene in the foreign exchange market, produced a situation of a quasi-fixed exchange rate. At least, they do not give the impression that the foreign exchange market has been behaving irrationally in contradiction to the fundamentals of the respective countries. This stability demonstrates that two countries having the same policy objectives, similar inflation rates and strongly correlated business cycles can enjoy a relatively stable bilateral exchange rate.

The bottom line of this is clear : the more Switzerland behaves like a European country, the greater the chance of currency stability between the Swiss franc and the euro. We are thus confident that the absence of major tensions observable over the last two years will be an enduring phenomenon and that the market will gradually come to recognise that the Swiss franc and the euro are two currencies belonging to the same European family.

The exchange rate is not the only channel through which the single currency will have an impact on our economy. With more homogeneity in the monetary landscape, the position of the Swiss franc as a transaction currency could weaken. All the ingredients are there for Euroland to become progressively a large domestic market where transactions in foreign currencies could represent only a small portion of the exchanges on the market. As we know that small economies trading with large markets have to adjust to the conditions imposed by their larger partners, Switzerland can be expected to make less use of the Swiss franc as a means of payment in its foreign trade than in the past.

We can also envisage Swiss exporters themselves being fascinated by the advantages of operating in euros. They will have an incentive to keep their books in euros and to balance their revenues in euros by covering expenses in euros in order to eliminate exchange risks as far as possible. It is not even excluded that domestic producers will be forced to offer euro conditions in order to remain competitive as intermediate suppliers. Labour costs will however remain an irreducible part of domestic production costs.

Equally, we can expect the euro to be widely used for payments in Switzerland. Europeans will see the euro as an excellent instrument of efficient cash management. Soon the euro could become the vehicle currency in Europe. Travellers will find it easier to pay in euros instead of using other currencies. As a first step, euro payments will take the form of transfers of electronic money, then payments will ensue in euro banknotes.

Switzerland is taking the necessary steps for dealing with payments in foreign currencies. All this requires a careful preparation of processing procedures and a close technical integration in the European payment system. Our banks have invested a great deal of time and money in preparing themselves to supply financial services in euros. Starting next year, they will clear their euro transactions through a special clearing institution established in Frankfurt and linked to the ECB. It will then be possible to carry out transactions in euros in Switzerland as efficiently as in the EU countries.

Given the very close relations between Switzerland and Euroland, the exchange rate sensitivity of the Swiss economy is expected to increase, which will require not only an efficient clearing system but also a tight management of exchange rate risks at all levels.

2. A challenge for monetary policy

I opened my speech by stressing the revolutionary aspect of the euro. The single currency will profoundly change the European monetary landscape and will affect not only the EU but also the countries remaining outside the Union. Switzerland, with its central position and its close economic and financial relations with its neighbours, will be particularly affected. This, of course, will create a new framework for monetary policy.

Switzerland traditionally implements an independent monetary policy. Since the breakdown of the Bretton Woods system in 1973, the Swiss franc has been floating, and the SNB's policy has aimed at price stability. From the outset, a considerable convergence of monetary policy objectives will exist between the SNB and the future European central bank.

This is of major importance. As I mentioned earlier on, experience shows that countries with similar policy objectives and converging fundamentals usually enjoy stable exchange rates. We can thus believe that, over time, the markets will realise that the Swiss franc and the euro are currencies with similar characteristics.

If that is so, why do we not change our monetary strategy, why do we not set a parity between the Swiss franc and the euro, following the policy pursued by Austria before the Schilling joined the European Monetary System ? There are voices in Switzerland asking for a return to an official fixed exchange rate regime or, at least, that the Swiss National Bank stabilises the external value of the Swiss franc in order to reduce uncertainty surrounding the value of the Swiss franc on the market, uncertainty which imposes hedging costs on our exporters.

Unfortunately, the implementation of a fixed exchange rate regime is not a feasible alternative for the time being. Why not ?

If we set a parity for the Swiss franc, this would be an autonomous decision which would not necessarily be taken as irrevocable by the markets. A fixed exchange rate strategy must be totally credible in order to play its stabilising role. If the market had any suspicion that the Swiss franc might be revalued in the future, the risk of speculative attacks against the declared parity would be considerable. As long as Switzerland is not a member of the European Union, it will be difficult to convince the market that any parity of the Swiss franc will never be adjusted. Any attempt to set a parity would thus stimulate speculation instead of calming it down. It is therefore in our interest to maintain a flexible relation between the Swiss franc and the euro.

But we also have to recognise that, with relatively low interest rates, Switzerland has no incentive, for the time being, to create a strong link between the Swiss franc and the euro. If the markets were to believe that the exchange rate risk between the euro and the Swiss franc is negligible, our interest rates would move rapidly towards the euro rates, and this would have a negative impact on aggregate demand in Switzerland, especially on investment and housing. Here again, flexibility of the exchange rate is of the essence.

Having said that, Ladies and Gentlemen, we do not exclude the possibility of intervening in the foreign exchange market or on the money market in order to fight against exchange rate developments which could be considered out of line with economic fundamentals. A relaxation of monetary policy in reaction to pressures on the Swiss franc is a clear option.

Flexibility in the conduct of monetary policy as an answer to market instability has been our strategy over the last two years. Without trying to stabilise the Swiss franc vis-à-vis the German mark, we have nevertheless been able to keep its fluctuations within acceptable margins. Our intention is to maintain such a flexible approach when the Monetary Union starts on 1.1.1999.

3. Conclusion

In a few weeks, the historic step of introducing the European Monetary Union will create a new environment for monetary policy in Europe. The participating countries will be affected, but also the countries remaining outside.

In Switzerland, we see the appearance of the euro as a unique chance for Europe to promote monetary stability. A more stable monetary regime will be beneficial to everybody and will promote transparency and efficiency. We expect the Swiss franc to play a less important role as a transaction currency and the euro to be accepted as a means of payment within our country.

Being a revolution, the introduction of the euro will be a source of uncertainty. But, as soon as the European Central Bank will be well established, we will have a good chance of seeing lower exchange rate volatility and lower interest rate differential between the franc and the euro. In the long run, given the strong correlation of economic fundamentals between Euroland and Switzerland, the foreign exchange market will consider the euro and the Swiss franc as two sister currencies.