

Switzerland in the EU Environment

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1. Introduction

Last weekend the Polish people gave the green light to Poland's membership of the European Union. This means that in May next year your country will be seeing the crowning of its political efforts of the last 10 years: its accession, alongside nine other states, to the European Union. I congratulate you and share your happiness. The integration within the EU of the countries of the former eastern bloc certainly represents a decisive milestone on the way to creating a peaceful, secure and prosperous Europe.

Of all the accession countries, Poland is Switzerland's most important economic partner. Trade between our two countries has doubled since 1995. Poland and Switzerland can also look back on more than ten years of continuing fruitful cooperation within the same constituency at the International Monetary Fund. Your EU membership and further integration will help to reinforce the economic ties between our two countries.

The Polish poet and Nobel prize-winner Czeslaw Milosz once said that Eastern Europe generally knew much more about the West than the West did about the East. I have no doubt that this is especially true in your case, as members of the Polish-Swiss Chamber of Industry and Commerce. Nonetheless, I hope to be able to give you some fresh insights into Switzerland's position in the European framework.

I shall first give you a brief overview of the present economic situation in Switzerland and then talk more specifically about our relationship with our neighbour countries. As you know, Switzerland is not a member of the European Union. But it is by no means an island or an isolated place in the Alps. Second, I should like to focus on Switzerland as a financial centre located in the heart of the continent and the challenges it currently faces. Finally, I shall outline the Swiss National Bank's monetary policy and what degree of freedom it has in a country fully surrounded by the euro zone. This question is particularly relevant, since progressive globalisation and Switzerland's close economic links with Europe regularly raise the question whether pursuing an autonomous monetary policy is still appropriate.

Let me begin with the current economic situation in Switzerland.

2. The economic situation in brief

In Switzerland, as elsewhere, the boom of the late nineties has been followed by a prolonged period of stagnation accompanied by rising unemployment. Not only was last year disappointing, but 2003 also began badly. Given the sluggish economic development,

especially in Europe, we have been forced to gradually downgrade our forecasts. On the exchange market, the strength of the Swiss franc has been an additional factor creating further difficulties for our export sector. Investment has declined sharply in an international comparison, suggesting that the excess capacities created in the late nineties were particularly pronounced. The bursting of the equity market bubble had a severe impact on the financial sector and business in the once flourishing investment banking and asset management sectors has slumped, resulting in the need for radical structural reforms and consolidation.

The Swiss National Bank has responded to the difficult economic situation with a rapid and massive easing of monetary policy. In the course of the last two years we have cut our reference interest rate – the three-month Libor – by 325 basis points to practically zero. With the marked slowdown in economic activity and the appreciation of the Swiss franc, inflationary pressures were also easing. Indeed, since spring 2001 our inflation forecast has indicated that the risk of inflation is very limited in the years to come, which has enabled us to bring about a significant reduction in short-term interest rates. Our expansive policy has aimed at supporting demand and limiting the upward pressure on the franc.

So far we see no sign of a concrete recovery. We expect GDP to stagnate in 2003. Growth should accelerate again at the end of this year following a strengthening of the world economy. Basically, our business cycle closely follows the economic development of our neighbours: Germany, France and Italy, which absorb the bulk of our foreign trade.

Let me now turn to Switzerland as partner of the EU.

3. Switzerland as a partner of the EU

Switzerland is deeply integrated in the European economy. Although it is not a member of the European Union, it has very close ties with it. The EU accounts for 60% of our exports and as much as 80 % of our imports. In 2001, one-third of the 30 billion Swiss francs that were transferred abroad in the form of Swiss direct investment went to the EU, while 80% of foreign direct investment in Switzerland came from the EU.

It is therefore not surprising that the Swiss business cycle is highly correlated with the activity in the EU, and that the exchange rate between the Swiss franc and the euro is of crucial importance to us.

Close economic ties also mean close institutional co-operation. An initial step in this direction was taken with the 1972 Free Trade Agreement concluded with the European Economic Community (EEC). Full membership was never a serious option. In 1992, the Swiss people even rejected the option of becoming a member of the European Economic Area. Further progress was made with the implementation, one year ago, of bilateral agreements between Switzerland and the EU. The purpose of this set of agreements is to secure for Switzerland sectoral access to the European single market. They cover seven issues, among them an agreement on labour mobility and an agreement on transportation.

Since the middle of last year new negotiations have been under way between Switzerland and the EU on a further ten issues. Some of these are "left-overs" from the first bilateral agreements, some are new issues which have been raised by either the EU or Switzerland. The EU wanted the adoption of anti-fraud measures and the creation of a tax system in Switzerland which would allow the EU to adopt a regime of exchange of information between tax authorities. On their side, the Swiss sought an improved cooperation in the areas of internal security and asylum policy. The negotiations on seven out of the ten issues have now been substantially completed. We hope that this second round of negotiations will be concluded this year, provided that the right balance can be struck in the overall package.

You may well be asking yourselves: why doesn't Switzerland simply join the EU instead of following the bumpy path of bilateral agreements ? The reason is that there is still no consensus in Switzerland on the question of EU membership. Winston Churchill used to say to his chauffeur: "Drive slowly. We are in a hurry". These words could apply to Switzerland's policy on Europe. Eleven years ago the Swiss people voted "no" to entry into the European Economic Area, because many saw this as a first step towards EU membership. Two years ago a referendum aimed at speeding up the process towards EU membership was likewise roundly rejected. Since any further moves would clearly lack political support within the country, EU membership is not on the Swiss agenda at the present time.

There are many reasons for Switzerland's scepticism. Many people see EU membership as posing a threat to Swiss federalism and direct democracy. A full membership would also have a major impact on our monetary and exchange rate policy.

Indeed, if Switzerland joined the EU, it would have to abandon its independent monetary policy and its own currency. This would deprive us of an essential component of our flexibility in setting economic policy. We could no longer pursue an interest rate policy

geared to the needs of the Swiss economy. Membership would also spell the end of the interest rate advantage with respect to the euro area, which still stands at one and a half to two percentage points. This would entail the loss for the Swiss economy of an important competitive advantage.

If there are grounds for hoping that an enlarged EU will lead to greater stability and prosperity on the European continent, it is also conceivable that a larger market will open new opportunities for Switzerland. Once the bilateral agreements have been extended to cover the new member countries, our economic relations with the enlarged EU will be regulated by the same network of bilateral treaties, as is the case with the current EU. The Swiss economy will thus enjoy easier access to a greatly expanded market totalling 450 million people.

However, EU enlargement also represents a challenge for Switzerland. A larger Union needs to work out its joint position in lengthy internal consultation and decision-making procedures. It could thus become increasingly difficult for us to defend our own interests. Enlargement is therefore very likely to influence our relationship with the EU.

Let me now move to one of the key features of our economy: our financial sector, which currently also faces some major challenges.

4. Switzerland as a European financial centre

Since the beginning of the last century the Swiss financial sector has been a mainstay of our economy. It accounts for just under 6% of total employment, but currently generates over 10% of the country's GDP. Relatively speaking, therefore, it is more than twice as big as the German or French financial sectors, for example. Switzerland's globally active big banks and insurance groups are also major international competitors in most market segments. The two big banks are among the world's ten largest banks. In terms of value added by the financial sector, Switzerland occupies fourth place behind New York, London and Paris, but is ahead of Frankfurt.

Switzerland plays a leading role in banking, above all, in asset management. Almost four trillion francs worth of assets are managed in Switzerland. This accounts for around one-third of the world's portfolios of cross-border investments.

Over the last 10 years, our financial institutions have also greatly expanded their activities abroad on a global basis. In 2000 the value of their foreign investments amounted to some

54 billion Swiss francs, which is equivalent to around 14% of total Swiss investments abroad.

Switzerland is also a magnet for foreign banks. Nearly one in every two banks in Switzerland is foreign-owned. Foreign banks contribute around 2% to Switzerland's gross domestic product, which makes them as important as the Swiss insurance industry and even more important than, for example, the watchmaking or the food industries.

What are the reasons for Switzerland's success as a financial centre?

For more than a century Switzerland has enjoyed peace. This has enabled it to develop conditions that are favourable to the economy as a whole, but especially to the financial sector. Among other benefits are political and economic stability, relatively moderate taxation, a reasonable regulatory environment, a very well-developed infrastructure and, not least, an independent monetary policy. The positive interaction of these various factors have in turn produced a strong currency, low inflation, a large current account surplus and, in international terms, a low interest rate level. These have been crucial factors in maintaining Switzerland's attractiveness as a market in which to invest.

In addition to the positive macroeconomic environment, efficiency and technical know-how are equally crucial for our success. This applies particularly to companies exposed to intense and global competition like the banking industry. Over many years the Swiss financial sector has been nurturing qualities such as efficiency, a diversified and globally oriented range of services and a highly educated workforce. Technological innovations in the area of electronic payments, the electronic stock market and automated settlement systems have given Swiss banks a further comparative advantage in terms of international competition. Close cross-border cooperation has been established with other European centres. Our stock exchange for blue-chips is located in London, our future exchange is associated with the German exchange.

While technical and professional know-how are important, integrity, reputation and trustworthiness are more and more of the essence.

Swiss banking secrecy has sometimes proved a source of misunderstanding and even tension in our relations with our partners. The objective of our bank secrecy is to protect the private sphere and to enhance the depositors' confidence in the banking system. It does not aim at encouraging tax evasion or protecting funds of dubious origin.

As I mentioned earlier on, an agreement on the taxation of savings has recently been negotiated with the EU. EU deposits with Swiss banks will be subject to a withholding tax whose proceeds will be transferred to the country of origin of the funds. Within this new tax regime no harmful tax competition between Switzerland and the EU will take place despite the presence of bank secrecy.

The importance we give to the integrity of our banking system can also be highlighted by our efforts made to combat money laundering and terrorist financing. Switzerland has done much in this area to protect its good name as a financial centre. Six years ago it placed its commitment to the fight against money laundering on a statutory footing. Our anti-money laundering laws serve today as reference for many countries.

Let me move on to the National Bank's monetary policy and the significance of the euro.

5. Switzerland as an independent monetary zone

As is the case in most countries today, the Swiss National Bank pursues a monetary policy that is independent of the political authorities. We regard this independence as a key prerequisite for a successful policy. Our main goal is to maintain price stability. Thereby we create the basis for rational investment and expenditure decisions, and we contribute to a balanced economic growth.

Price stability has been the traditional objective of our policy for decades, but our monetary strategy had to be adapted to changing circumstances.

Following the transition to floating exchange rates some 30 years ago, monetary policy was based on the control of the monetary aggregates. We had to fight against inflation by far exceeding today's levels.

Inflation could be sustainably reduced in the second half of the 1990s, although the monetary aggregates became increasingly unreliable as monetary indicators. Monetary policy needed to be re-designed. In 1999, we adopted a new strategy based on three elements:

- The first element is an explicit definition of price stability: price stability is achieved when inflation, as measured by the consumer price index, is less than 2%. We want to achieve this objective over the medium term since controlling inflation on a short-term basis would translate into high costs to the national economy. A monetary policy geared to medium-term price stability also helps to smooth out cyclical fluctuations. In a boom

phase such a policy will tend to have a restrictive effect and in a cyclical downturn it will tend to have an expansionary impact.

- The second element is an inflation forecast. We publish a quarterly forecast of medium-term inflation. Not only does our forecast provide extremely valuable information on the future effect of monetary policy; it also plays a key role in explaining the central bank action to the public.
- The third element is the publication of a target range for the three-month interest rate. The target range sets the parameters for day-to-day implementation of monetary policy.

Our experience with the new approach is positive. We have been able to enhance the transparency of monetary policy and to simplify lines of communication with the market.

How do we take account of the fact that Switzerland is now fully surrounded by the euro zone?

Indeed, the introduction of the single European currency at the start of 1999 has profoundly changed the environment for our monetary policy. But the fears that were expressed when the euro was introduced four years ago failed to materialise.

In particular, the Swiss franc is no more volatile against the euro than it had previously been against the D-mark. Immediately following the introduction of the euro it remained remarkably stable for more than a year. This was due in part to the fact that the economies of Switzerland and the euro area were strongly converging and that both central banks were pursuing a similar monetary policy. The franc did not really begin to appreciate until after the events of 11 September. Within a very short space of time it had appreciated by 5% against the euro. Later on, the way the Swiss franc was moving caused us concern on numerous occasions. This led us to ease monetary policy further last year as well. It is only recently that the franc corrected itself against the euro. The stabilisation of the geopolitical situation is likely to have played a major role in this.

All in all, the Swiss franc has appreciated by 4% against the euro since its introduction – much less than had originally been feared. If one also takes into account the inflation differential between Switzerland and the euro area, the appreciation has been even more modest.

Our monetary policy concept enables us to take greater account of developments on the foreign exchange markets and to communicate our intentions openly. We do not, however, actually seek to manage the exchange rate. Only on rare exceptional occasions – such as

the extreme appreciation of the franc in the late 1970s – does an explicit exchange rate target make sense for Switzerland.

The frequently expressed concern that the introduction of the euro would mean the disappearance of the interest rate differential between Swiss franc and euro investments has also proved groundless. It was feared that, in order to keep the exchange rate stable, the National Bank would be forced to shadow the policy of the ECB, and, with a lower exchange rate risk, that the interest rate differential between Swiss franc and euro investments would gradually narrow. This has not occurred : both short-term and long-term interest rates in Switzerland are still around 2 and 1.5 percentage points respectively below those applying in the euro area. We can continue to pursue an independent monetary course.

6. Conclusion

Against the background of the persistent weakness of the international economy, Switzerland is stuck in a rut as well. In the past few months we have had to revise our forecasts downwards on a number of occasions, most recently in last week's quarterly monetary policy situation assessment. For this year as a whole we are forecasting that real GDP will stagnate. Even this modest projection presupposes that the economy will pick up in the second half-year. There are still considerable risks in this regard.

The exchange rate remains also a significant downside risk. Although the geopolitical situation has eased since the end of the war in Iraq, it cannot be ruled out that the franc will come under renewed upward pressure as a safe haven currency. In the present context of business stagnation, the recent correction in the exchange rate of the franc against the euro has brought our currency back to a more realistic level, which is good news for our export industry. The current weakness of the dollar, although it had been expected for some time, is a cause for concern for us especially as it comes at an unfavourable time. We watch therefore the exchange rate development very closely.

In the present economic situation it is not easy to identify positive factors. One of them is definitely the environment of price stability and strong competition which is keeping inflationary expectations at an historical low level. As a result, monetary policy can remain expansionary. This is clearly the case in Switzerland.

A second positive element are the structural adjustments. In Switzerland, the private sector has adjusted courageously to the new low-growth environment in which the

price/quality ratio becomes a key factor of success. I think that our economy is well positioned now to benefit fully from an upturn in international trade.

Last but not least - and here we join Poland - our main source of hope lies in Europe. Since Switzerland is heavily dependent on exports, sluggish economic performance in Europe, and especially in Germany, is a major cause for concern. But there are now signs of hope : the German government is considering a reform programme which should increase potential growth, and manufacturing orders are improving; in France GDP growth is positive; in the UK industrial production is accelerating again.

We can now expect a gradual improvement in the overall economic picture and a progressive strengthening of consumer and investor confidence. Only renewed confidence in the future can lead us out of this delicate phase of economic stagnation. In this respect, the decision taken by a country as important as Poland to join the EU in 2004 will be a triggering factor.

No doubt that joining the EU next year will give the Polish economy an additional boost. But your accession will also contribute to creating a more dynamic and competitive Europe. And this is our common interest.