The Creation of the Euro and the New International Monetary Order: A View from Switzerland

Speech by

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1. Introduction

It is widely acknowledged that the birth of the euro on January 1, 1999 was a milestone in the process of European integration. Giving up national sovereignty in monetary matters was a very bold move of truly historical proportions. It will have long-lasting economic and political consequences. It should promote efficiency, transparency, and growth. The creation of a single currency should also act as catalyst towards further European integration. Moreover, and this is really what I would like to focus on today, the creation of the euro has changed the world's monetary landscape. I believe that one can say without fear of exaggeration that it has led to a new international monetary order. And for most of it, this is very good news indeed.

2. Our *pre*-euro fears

To be honest, I must admit that prior to the introduction of the euro we were somewhat worried at the Swiss National Bank. Although we fully appreciated the benefits that Switzerland would draw from the creation of the euro in terms of increased transparency and lower transaction costs, we were also quite concerned about possible risks. We had three main fears.

First, we were concerned that the Swiss franc might be in for a roller-coaster ride. In the past, whenever the dollar was under attack, international investors turned their attention to the German mark and the Swiss franc. Their status as safe-haven currencies meant that at times of turbulences on foreign exchange markets they would move well beyond what economic fundamentals could justify. In fact, the Swiss franc often exhibited a tendency to appreciate even more than the German mark, a phenomenon that was often attributed to the relative narrowness of the Swiss financial markets. Now with the German mark gone, wouldn't all attention focus on the Swiss franc? Would it not mean that in any dollar crisis the franc would have to bear even more of the adjustment than in the past? Even worse, what would happen if the euro itself were under attack? The last thing we needed was for the franc to become the first currency in the line of fire, or something like the lightening rod of the international monetary system.

A second fear that we had was that it would become very difficult in the future to conduct an independent monetary policy. Switzerland, together with Liechtenstein, would now be totally surrounded by a single monetary zone. As you know, Switzerland is a small open economy, and I emphasize both the words small and open. Indeed, we are widely open.

Nearly half of our national income is generated abroad, and the European Union is by far our largest foreign partner. About two thirds of our exports head in that direction, and we are one of the best customers of the EU. We are also very small, meaning that although we have no significant impact on the rest of Europe, we are very exposed to foreign shocks, whether they are real or monetary in nature. Our activity is highly correlated with that of the eurozone. Under these conditions, would the SNB still be in a position to conduct an independent monetary policy? Would it be realistic to expect the SNB to follow a course that deviated from the one set by the European Central Bank, or would the SNB be obliged to shadow the actions of the ECB?

The question of an independent monetary policy is not just a matter of safeguarding the interest and the prestige of our job as Swiss central bankers. The stakes are much higher. For one thing, even if Swiss activity and economic conditions more generally are highly correlated with Europe, the correlation is not perfect. Our economy, although offering many similarities to the German and French economies, also has its specificities. Thus, Switzerland is very well supplied with physical and human capital. As a consequence, the return on capital is relatively low and wages are relatively high, particularly so for unskilled workers. We thus tend to specialize in capital-intensive and high-value-added activities. External shocks tend to impact on us in a way that is not exactly the same as for the rest of Europe. Moreover, we have to cope with home-brewed shocks as well. It is for these reasons that we are eager to keep an independent monetary policy.

Furthermore, if markets became convinced that in the future the SNB's actions would merely be a Xerox copy of the ECB's monetary policy, they would rapidly force a convergence of our nominal interest rates with those of the eurozone. Our real interest rates might remain lower for a while, given our relatively large endowment of physical capital, but a tendency towards equalization would nonetheless set in. What this might mean for us is a higher inflation rate for some time, together with a collapse in asset prices and in domestic gross capital formation. A cocktail of higher interest rates and our high wage structure would be highly detrimental to our competitiveness in export markets.

The third fear that was sometimes expressed, although here I must say I was rather sceptical myself, was that the euro could eventually make the Swiss franc obsolete. With many of our trading firms billing and paying their suppliers in euros, there might be a tendency for them to adopt the euro more generally for their accounting as well as for their domestic transactions. Some people even went as far as predicting that before long wages would be paid in euros. Shops, hotels and restaurants would rapidly be forced to accept euros, so that visitors from abroad would no longer see the need to convert their euros into francs. Eventually Swiss consumers themselves would follow suit, so that Switzerland would be de facto integrated into the eurozone.

More than national pride would be hurt by such an "euroization" of the Swiss economy. For one thing, such a development would entail the loss of seigniorage income. With a monetary base of about 40 billion francs (25 billion euros), that is about 5,700 francs (3,500 euros) per person, seigniorage in our case is far from trivial. But much more seriously, the loss of monetary autonomy caused by a displacement of the Swiss franc by the euro would prevent the central bank from creating liquidity in case of need.

To a large extent, the fears that we had reflect the more fundamental debate about fixed versus flexible exchange rates. Which foreign exchange regime is appropriate for a given country at a particular time? Although this view is not universally shared, many economists argue for a polar solution: either purely flexible exchange rates, or rigidly fixed ones. Intellectually, I tend to share this view, except that I would like to take it one step further: either purely flexible exchange rates, or monetary union. Rigidly fixed exchange rates do not constitute a polar case. In fact, they accumulate many shortcomings. Thus, fixed exchange rates have never been known to be fixed for very long. Fixed exchange rates are fixed until the day they change, and when they do change, they often do so brutally in an atmosphere of crisis, of pain, and of tears. No, I believe that if one really aims at exchange rates that are irrevocably fixed, then one should move all the way, that is go for monetary union. As long as two currencies are distinguishable, their relative price might change. So the choice is between flexible exchange rates and monetary union. Needless to say, since Switzerland is not a member of the European Union, joining the eurozone is not an option worth discussing at this stage. Fixing the franc against the euro would not even be a second best. It would rather be the worst of all worlds by suppressing our monetary independence, and, at the same time, exposing us to all the dangers of speculative attacks by setting us up, the back against the wall, alone against the market.

3. Our *post*-euro experience

What has happened since January 1, 1999, all in all, has proven very reassuring. Our worst fears have not materialized, and indeed, in some ways, the outcome has been even much more favourable than we could have hoped for.

First, let me briefly sum up our experience with regard to the fears of "euroization" and of the loss of our monetary degree of freedom. As expected, the Swiss franc was not crowded out by the euro. Sure, the euro circulates in Switzerland, just like the Swiss franc circulates in neighbouring France and Germany, but the phenomenon remains marginal, and it does not exceed the use of the French francs, German marks and Italian liras in the pre-euro world. This is not surprising, for even though the euros (and dollars for that matter) are happily accepted in Swiss shops, cafés, and hotels, the exchange rate is usually unattractive and the change is given in Swiss francs. Shopkeepers and restaurant owners are not in the business of providing financial services, and foreign tourists are still better off changing their euros at banks or using their credit cards. True, Swiss firms use the euro extensively, some do much of their billing in the European currency, and some have even switched their accounting to euros. Some natural hedging takes place as well, although it is not clear how efficient this is. It is noteworthy, however, that some of the largest firms do much of their billing and their accounting in dollars, while others quite happily continue to use the Swiss franc. The fact that "euroization" has not taken place should not really surprise us. There have been other examples of small independent currencies surviving in the neighbourhood of much larger monetary zones. The example of the Canadian dollar comes to mind. The loonie has been floating for the past several decades, and it has served Canada rather well. More generally, there is nothing to be gained in having more than one currency for transaction purposes. Much of the double coincidence of wants gets lost if several currencies circulate simultaneously. "Dollarization" only occurs in those countries where hyperinflation threatens. This is not about to happen in Switzerland, which has the best record of price stability in Europe!

The fear of losing our monetary independence was misplaced as well. Over the past five years the SNB has demonstrated that it can act decisively and independently, often well before the ECB. Given its openness, Switzerland was badly affected by the world slowdown. The situation was made worse by the fact that our main trading partner, Germany, was itself severely hit, and to compound our difficulties, the worldwide capital overhang had a very adverse effect on our exporters, many of whom are specialized in the production of capital goods. Special circumstances require special action. From March 2001 to April 2003, the SNB cut interest rates aggressively, lowering the target range for our reference rate, the three-month Libor, by 325 basis points, from 3.5% to just 0.25%. If anything, the differential between Swiss and euro interest rates has slightly widened, putting all fears of a rapid loss of our interest rate advantage to a rest.

What about the stability of the external value of the Swiss franc? Here, I must say, our fears proved not just to be unfounded, but the reality turned out to be even more favourable than we could have hoped for. The exchange rate of the Swiss franc against the euro ended up being much steadier than expected, in fact even steadier than it used to be against the German mark, not to mention the French franc and the Italian lira. Over the past five years, the real exchange rate has moved within a relatively narrow band little more than five percentage points wide. Except for the post-September 11 period, when the Swiss franc appreciated markedly, the external value of the franc has largely reflected economic fundamentals. In fact, even the post-9/11 safe-haven effect was relatively mild compared to what we experienced in the past, during the seventies and the eighties, for instance.

4. A new international monetary order

I believe that one could make the case that the introduction of the euro has brought about a new international monetary order, that it has produced an element of stability that benefits many countries, not just Europe's immediate neighbours, but nations around the globe. As we have seen, movements in the dollar/mark exchange rate were magnified as far as the Swiss franc is concerned in the past, but are much dampened today. When the euro depreciated against the dollar, the Swiss franc did so too, but by a much lesser degree. And later, when the euro appreciated against the dollar, the franc appreciated as well, but again to a lesser extent. In other words, our effective exchange rate has been less affected, the movement of the dollar being offset, at least to some extent, by a movement of the euro in the opposite direction. It seems to me that this phenomenon has benefited not just Switzerland, but also many other countries with their own independent currencies, such as the United Kingdom, Canada, Australia, New Zealand, Singapore, and Norway.

This evolution might not last. Perhaps it is the outcome of chance, but it has been persistent enough over the past few years to be noticeable. Maybe one day some smart graduate student will write a thesis on this topic, and confirm or falsify my hypothesis, but in the meantime let me outline why I believe that there are some good reasons for the assumption that the stability of the international monetary system has been enhanced by the creation of the euro.

I do not think that anybody would argue that the world as a whole makes up an optimal currency area. Our planet is not yet ready for a single currency. We are therefore bound to live in a world with n, n greater than one, currencies. For the second half of the 20th century, we lived with one dominating currency, the U.S. dollar, and many less important currencies, such as the British pound, the Japanese yen, the German mark, the Swiss franc, and so on. Moreover, the United States is a largely closed economy, so it could regard fluctuations in the external value of the dollar with benign neglect. Of course, most other countries, being rather small and quite open, were fully exposed to turbulences in foreign exchange markets, but there was not much they could do about it. There were several episodes when the internal stability of the dollar was threatened as well, with U.S. inflation rates in the double digits. The flight into more stable currencies put considerable pressure on these.

Today, the arrival of the euro has changed the landscape in some important respects. First, as the new kid on the block, the euro commands attention and respect. In economic size, the eurozone nearly rivals the United States. There is now an obvious alternative to the dollar as an instrument of portfolio diversification. If investors have doubts about the dollar, there is no longer any need to rush into the Swiss franc, the euro will do just fine.

Second, the eurozone, although not quite to the extent of the United States, is a largely closed economy. Movements in the euro are far less devastating than movements of similar magnitude in the Swiss franc or in the German mark. The euro is much more capable than any other currency to take on the role of shock absorber against the U.S. dollar. The eurozone, in some ways, is the large closed economy that the world needed as the counterweight to the U.S. economy. All small open economies, like Switzerland, should benefit from this new international monetary order.

There is a third reason why the arrival of the euro has changed the landscape and should fundamentally prove beneficial to the stability of the international monetary system, and that is competition. Even though the U.S. monetary authorities do not have a mandate that is as specifically directed at price stability as the ECB does, investors now have a choice and can vote with their feet. Thus the pressure is on the United States to deliver price stability as well. I find it very unlikely that we should again experience any time soon double digit inflation rates in the U.S., and this is very good news indeed for the good health of the international monetary system.

5. Conclusion

All in all, the introduction of the euro has been a very positive development for the international monetary system and for Switzerland as an economy strongly dependent on world trade.

We benefit from the greater transparency offered by the euro and the lower transaction costs made possible by its creation. Perhaps for the first time in history, we are surrounded by an area that shares the same monetary policy objectives as we do, namely that of price stability. This explains to a large extent why the Swiss franc/euro exchange rate has been relatively stable over the past five years. But the presence of a single European currency has per se also shielded third currencies – like the Swiss franc - from too much volatility in the case of dollar turbulences.

At the same time, we keep the trump card of an independent monetary policy that enables us to respond very rapidly to the specific needs of the Swiss economy. Since 2001, we have thus lowered interest rates more quickly and more decisively than the ECB. With inflation less than 1 percent, we enjoy price stability and our interest rates lie clearly below corresponding rates in the eurozone.

A more homogeneous monetary system in Europe and a more stable international monetary order will help Switzerland to fully benefit from the present recovery of the world economy.