

# **Will the Euro Make the Swiss Franc Obsolete?**

Ulrich Kohli

Chief Economist

Swiss National Bank

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I am deeply honored to have been invited to address such a distinguished audience, and it is with great pleasure that I will share with you some thoughts about the euro and what it might mean for Switzerland.

Will the euro make the Swiss franc obsolete? I originally thought of a different title for my talk: «Heidi in Euroland», but then I thought that perhaps this would sound somewhat frivolous coming from a central banker. There is no question, though, that the Swiss monetary environment has changed drastically with the introduction of the euro, and that most Swiss residents will feel the change. The Swiss monetary zone, which includes Liechtenstein, is totally surrounded by the euro-zone. It is often described as an island amidst the euro-ocean. In fact, Switzerland might well qualify for the Guinness Book of Records as the only land-locked island in the world!

## **1. Birth of the euro**

After a long pregnancy, the euro has finally seen the light of day. In truth, the euro is already a toddler. It was born over three years ago, on January 1, 1999. It has been widely used as a means of payment and a store of value ever since, and we have long learnt how to live with it. What happened just over two months ago, on January 1, 2002, however, was the most spectacular phase of the entire operation, the introduction of the physical euro: euro coins and euro notes. To the public at large, the euro has finally become a reality. People throughout Europe can now see it, they can touch it, they can own it, and they can spend it.

The creation of a monetary union between a dozen independent nations was a bold and unprecedented move. Twelve countries willingly giving up monetary sovereignty is an achievement of historical proportions. It was all the more daring as it precedes political unity and fiscal integration.

## **2. Monetary union: pros and cons**

Monetary integration brings many benefits to its members. Transaction costs are sharply reduced. Exchange-rate volatility and uncertainty vanish within the union. Price comparisons are facilitated and transparency more generally is enhanced. Trade and capital flows between the participating states are invigorated, and this in turn should fuel economic growth. Monetary integration under the Maastricht Treaty also promises price stability to those countries that, in the past, had seemed incapable of achieving it on their

own. Furthermore, the common currency is becoming a powerful political and social force stimulating further integration.

Naturally, monetary integration has its costs too. The most important one is the loss of monetary sovereignty. That is, member countries are no longer able to pursue a monetary policy of their own. There is now just one monetary policy for the entire euro-zone. If you turn it upside down, you will see the stamp «made in Frankfurt». And, in smaller print, «one size fits all». This could lead to severe problems in case of asymmetrical shocks; that is, if one country, or one group of countries, is affected by specific external events. Given the large diversity of the European economy that ranges from Portugal and Greece to Germany and Finland, asymmetries cannot be ruled out. The situation could even become trickier with enlargement and the arrival of new members. Under monetary union, adjustments that would otherwise occur through changes in the exchange rate and domestic interest-rate conditions must imperatively take place through changes in prices and wages, and through adjustments in quantities, all of which can be very painful.

True, the situation is somewhat similar in the United States. There is only one monetary policy for all 50 states. It is made in Washington. Given the diversity of the land, it is obviously challenging to come up with the right policy for the entire country. West Virginia might be in a recession, whereas Arizona is booming. California might be particularly affected by a downturn in the high tech industry, while Michigan is more dependent on the good fortune of the car industry. One important difference compared to Europe, however, is that the adjustment here is facilitated by the more flexible goods and labor markets. Labor mobility in the United States has traditionally been high and it is made easier by cultural similarities, and the fact that most people in this country speak more or less the same language. Moreover, fiscal integration means that public transfers can take place between regions and that powerful automatic stabilizers are at work.

Monetary integration has been costly in terms of resources as well. It has necessitated numerous high-level government meetings, working groups, conferences and seminars, not to forget the fancy and expensive dinners, banquets, and parties. For the private sector too, preparing for the changeover has been an expensive proposition and it proved to be a distraction. Businesses had to adapt their accounting practices, update their computer hardware and software, and transform or replace numerous machines, from cash registers and coke machines to public phones and ATMs, from ticket dispensers and toll machines to gas pumps and taximeters. The cost to the European economy has been in the tens of billions of euros.

But these preparations are now behind us. The phase-in of the new currency over the past two months has worked remarkably well, with hardly a glitch. It was an extremely well prepared operation, and our European neighbors ought to be congratulated on this achievement.

### **3. Monetary union: a Swiss perspective**

There is no question that Switzerland, too, will greatly benefit from European monetary integration. It will make life much easier for all the Swiss who travel and do business in Europe. In the past, every Swiss returning from a journey abroad came back with a pocketful of small change from the countries he or she visited. Marks, shillings, guilders, liras, pesetas, escudos, or drachmas, all of which had to be carefully saved for the next trip, in the knowledge that they would often have lost much of their value in the meantime. Now all that is needed for a trip through much of Europe is a fistful of euros. This is a great convenience, and we will save a lot in foreign exchange fees, transaction costs, and other worries. Business, too, will find it easier to deal in merely three or four currencies, rather than fifteen. Prices will become more transparent for everyone, and this should foster competition in Switzerland as well.

At the same time, the costs for Switzerland have been relatively small. True, many businesses had to make some adjustments. In the border areas, some ATMs had to be reprogrammed to spit out euros instead of liras, shillings or marks. Some cash registers have been modified to show both Swiss franc and euro prices, and some menus and wine lists had to be reprinted to show the prices in both currencies.

### **4. Will the euro displace the Swiss franc?**

Many observers have expressed the view – the hope or the fear, as the case may be – that the euro will become a parallel currency in Switzerland. Will the euro circulate in Switzerland? The answer is, undoubtedly, yes. Will it threaten to displace the Swiss franc, thus leading to the de facto integration of Switzerland into the euro-zone? Hardly. The euro will circulate – in fact it already does – in Switzerland, particularly in the border areas and in the tourist regions. This is nothing new. French francs and German marks have long been accepted in shops in Geneva or in Basle. So are U.S. dollars on the Bahnhofstrasse in Zurich, for that matter. But the reverse is also true, your Swiss francs will gladly be accepted on the other side of the border, in Como or in Megève. This is no joke, the Swiss

franc circulates in the euro-zone, but rest assured, we do not believe that it will displace the euro!

In many shops, restaurants and hotels euros will, and already are, accepted as a form of payment. But let us not kid ourselves. This practice will remain very limited. First of all, in nearly all cases the change is given back in Swiss francs. Second, the exchange rate is generally unattractive. These businesses provide a foreign-exchange service to their customers as a convenience, but this is obviously not where their comparative advantage lies, and the visitors will therefore almost always be better off converting their money at a bank or using their credit cards. It may well be that the use of euros in Switzerland will somewhat exceed the sum of the French francs, Italian liras, German marks and Austrian shillings used within our borders in the past, but we expect the total figure to remain fairly trivial.

Indeed, the overwhelming majority of internal payments will continue to be denominated in Swiss francs. Wages, rents, insurance premia, and taxes will go on being paid in francs. Payments in euros at the bank or the post office will still be more cumbersome and more expensive than payments in the local currency. Whereas it is perfectly possible in Switzerland to have a bank account denominated in foreign currencies, I know of no bank that offers the possibility to make foreign cash withdrawals at no extra cost.

While the option of using a foreign currency when one is short of local money is convenient, there is generally no need for a country to have more than one currency as a means of payment. As long as the existing currency is widely accepted, as long as the public trusts it, and as long as it is expected to keep its value, there is no need to replace it. Parallel currencies would only make life more complicated for the ordinary citizen. Historically, spontaneous dollarization has only taken place in those countries that no longer had a sound currency of their own. Euro-ization, if I may call it this, will not take place in Switzerland in the foreseeable future.

Admittedly, the Swiss franc has lost some of its importance on international capital markets in recent years. The use of our currency in international debt issues has steadily declined over the past two decades. This trend, which clearly predates the creation of the euro, is probably indicative of a return to a more normal situation, in check with Switzerland's economic size, after a long period during which the Swiss franc was one of the world's few fully convertible currencies. At the same time, the Swiss franc also seems to lose some of its safe-haven attractiveness, which is not something that we at the SNB

will complain about, since this characteristic of our currency has always made our life a little bit more difficult.

Although the Swiss franc weighs much less compared with its young sibling than it did compared with either the German mark or the French franc, it has gained in stature simply because it is a member of the dwindling family of international currencies. For this reason, we would expect it to remain attractive as an instrument of portfolio diversification, for lenders as well as for borrowers.

## **5. Exchange-rate policy**

But short of encouraging the domestic use of the euro, shouldn't the Swiss National Bank at least aim at fixing the exchange rate between the franc and the euro? Many calls, coming from industry and the unions, demand no less than that. Our critics argue that the appreciation of the franc against the euro is undermining the Swiss export industry and, if left unchecked, it will generate mass unemployment. By targeting the exchange rate, they say, the SNB could eliminate an important source of uncertainty and safeguard the international competitiveness of our export industry. One must remember that about two-thirds of Switzerland's foreign trade is with countries from the euro-zone.

One should put things in perspective, though. Over the past three years, the Swiss franc has appreciated by about 8% against the euro. In real terms, the appreciation is only about half as large. A 4% or 5% real appreciation over a three-year period is not extraordinary by historical standards. Furthermore, it must be said that over the same period the Swiss franc has depreciated against the dollar and against the yen. It is therefore far from obvious that the Swiss franc is overvalued. It is rather the euro that is undervalued.

In any case, fixing the nominal exchange rate against the euro, even if it were possible for a while, would not solve many problems, and it would create a number of new ones. For a start, only the exchange rate against euro-area countries would be fixed, but the policy would do nothing to stabilize the exchange rate against the U.S. dollar, the Japanese yen or the British pound. More importantly, it is well known that in the long run monetary policy has no hold on real variables. The real exchange rate, which is the only one that matters for production decisions and trade flows, cannot be manipulated by monetary policy for any length of time. A more expansionary monetary policy, aimed at depreciating the Swiss franc, would eventually lead to more inflation without any real benefits, quite the contrary. The long-run real appreciation of the Swiss franc against most other currencies would persist, but it would take the form of a rate of inflation that would be higher in Switzerland

than in the rest of Europe. This is to say that fixing the value of the Swiss franc against the euro is not compatible with the SNB's objective of price stability. Moreover, nominal interest rates would necessarily increase to the same level as in the rest of Europe, which would mean that Switzerland would lose its interest-rate advantage. One can only begin to imagine what this would do to the Swiss financial center, to the building industry, or to Swiss asset prices.

The very risk of higher inflation in Switzerland would stretch the credibility of a policy aimed at targeting the nominal exchange rate. Given the well-known Swiss preference for price stability, the determination of the SNB to maintain a fixed parity would rapidly be tested by the markets. Large speculative inflows betting that the monetary policy would have to change course would make the situation untenable. The problem with fixed exchange rates is that they only remain fixed until they change! Fixed exchange-rate regimes have a habit of collapsing at the worst possible time in an environment of crises and confusion. Economic theory and empirical evidence suggest that the only exchange-rate regimes that are plausible in the long run are the ones at the extreme ends of the spectrum, flexible exchange rates, or monetary union leading to a single currency.

Monetary union does not solve all the problems, though. The example of the Netherlands is a case in point. The Netherlands – perhaps the country within Europe that is the most similar to Switzerland – is a part of Euroland. It shares its currency – the euro – with France and Germany, among others. There cannot therefore be any nominal exchange-rate adjustments between these countries. Yet, over the course of last year, Dutch prices have increased by about 4.4%, whereas inflation was only 1.3% in France and 1.7% in Germany. This is to say that, over the past year, the Dutch currency has appreciated by about 3% in real terms relative to its two large euro-partners. Dutch exporters have suffered an even larger loss of competitiveness than Swiss firms, without even being able to enjoy the benefits of price stability and low interest rates.

To be sure, if Switzerland joins the European Union one day, it will almost certainly have to adopt the euro as part of the package. However, this will be a political decision, not an economic one. Until then, it is not in Switzerland's interest to tie the franc to the euro. I argued earlier on that the Swiss franc remains a significant vehicle for portfolio diversification, but this is only true if Switzerland conducts an independent monetary policy; that is, for as long as the franc is not perfectly correlated with the euro. The Swiss franc is an important asset for the Swiss financial center. It is a very successful product, and we have exclusive rights to it: so why throw it away?

While a strong currency is often viewed as a source of many problems, one should always keep in mind that fundamentally it is a very positive factor for the country as a whole. A strong currency is synonymous with high purchasing power. It is a source of economic welfare, and ultimately it is a mark of success. According to a recent study, Swiss wages are the second highest in Europe, after Denmark. True, this can be viewed as a burden for business. But of course, we should also look at the bright side. High wages mean a high standard of living, and they reflect the high productivity of Swiss workers. The overwhelming majority of firms are obviously able to pay such high wages, otherwise we would not record them. Naturally, there might be firms engaged in activities where Switzerland no longer has a comparative advantage, and these find it more and more difficult to survive given this high cost structure. This is an unavoidable part of the economic development process, however, and it would happen even in a closed economy. Marginal firms drop out and profitable ones prosper.

Having said this, I must add, though, that the Swiss National Bank is fully aware of the pain that sudden moves in the exchange rate can inflict. Exchange-rate movements are closely monitored, and they play an important indirect role in the formulation of our policy. Our action is aimed at price stability, which we define as a rate of inflation between zero and two percent. Our policy is based on an inflation projection over a three-year horizon. An appreciation of the Swiss franc will affect our inflation forecast through several channels, through its impact on import prices and through its influence on activity, in particular. A sudden appreciation of the Swiss franc is thus equivalent to a tightening in monetary conditions, which might need to be offset by a loosening of policy, that is, by a lowering of interest rates.

## **6. Concluding comments**

We love the euro in Switzerland. But we like the Swiss franc even better. In many ways, we got the best of both worlds. We enjoy most of the advantages of the euro, without the loss of an important degree of freedom. We benefit from the simplicity, the transparency and the more stable European monetary environment promised by the euro, but we keep the trump card of an independent monetary policy.

Will the euro make the Swiss franc obsolete? The only thing that seems to have become redundant in this affair is the word «Swiss». With the demise of the French franc and of the Belgian franc earlier this year, the Swissie is the only international currency left named a franc. It is therefore no longer necessary to refer to it as the Swiss franc. We do not call it



the European euro, after all. I rephrase the question. Will the euro make the franc obsolete? The short answer is «no»!

Thank you for your attention.