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EUROPE'S FISCAL CHALLENGES

Philipp M. Hildebrand*
Chairman of the Governing Board
Swiss National Bank

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I want to thank the Swiss American Chamber of Commerce for the kind invitation. It is a privilege to speak to you this evening at your Annual General Meeting.

The last time I was with you – it is now nearly two years ago –, I paid homage to Albert Gallatin, the legendary Swiss-American Secretary of the Treasury of the United States at the beginning of the 19th century. On that occasion, I chose to honour Gallatin because I felt he incorporates fundamental values long shared by Swiss and Americans alike. As it turns out, recent developments in Europe and elsewhere demonstrate compellingly that one of the important lessons of Gallatin's outstanding career remains particularly relevant today. He teaches us that public debt reduction requires unwavering political commitment to fiscal discipline.

In my remarks this evening, I will attempt to put the fiscal challenges Europe is currently facing in a broader context. The handling of these challenges by Europe's governments and its citizens will have implications for Switzerland, but also for the United States and ultimately for the world.

In an attempt to understand what is currently happening in Europe, we have to go back to the 1950's. European integration as we know it began 60 years ago, and until recently, it has been a success. The signing of the treaty establishing the European Coal and Steel Community on 18 April 1951 was the first genuine step towards economic and political integration. The six signatories – Germany, France, Italy, the Netherlands, Belgium and Luxembourg –, agreed to run their coal and steel industries under a common management. The overriding goal was to secure a lasting peace on the European continent. The introduction of the Euro in 1999 was just one further – albeit major – step in this long-standing integration process. Throughout these decades, the world benefited from economic prosperity and peace on the European continent; a continent, that had previously been torn apart by two world wars within the span of forty years.

From a Swiss perspective, regardless of one's political or ideological leanings, there can be no doubt that the Swiss economy situated at the very heart of Europe but remaining outside the European Union (EU) has benefited from the continued process of European integration. There are a host of examples to illustrate this.

The bilateral agreements Switzerland concluded with the EU in 1999 and 2004 would have been very difficult to reach with 27 individual nations. Among other things, this has led to greater immigration from the EU. Despite initial fears here in Switzerland, open and integrated labor markets between the EU and Switzerland have clearly given the Swiss economy a welcome boost in recent years.

Indeed, private Swiss firms and even semi-public sectors like health care have reaped substantial benefits by drawing on the supply of large numbers of highly skilled immigrants from the EU member states and in particular from Germany. Moreover, this has not come at the expense of Swiss workers. Recent research actually suggests that the immigration from the EU during the last couple of years has narrowed the wage differential.[1]

Immigrants have also been an important source of demand during the financial crisis. They are clearly one of the reasons why Switzerland's economy has weathered the financial crisis relatively well. Indeed, Switzerland is one of the very few developed countries where private consumption remained a steady source of growth virtually throughout the entire financial crisis.[2]

A particularly relevant benefit directly linked to the introduction of the Euro pertains to exchange rate volatility. After the introduction of the Euro and before the peak of the financial crisis in 2008, the average Euro – Swiss franc volatility was roughly 30% lower than the prevailing Deutsche Mark – Swiss franc volatility in the 1990. The compression

[1] See Gerfin, Michael and Boris Kaiser (2010), „Auswirkungen der Immigration der Jahre 2002 bis 2008 auf die Löhne in der Schweiz", in: Die Volkswirtschaft, No. 6.
[2] In 2009, annual growth of private consumption amounted to 1.2% in Switzerland, while in the euro area, it contracted by 1.2%.

in exchange rate volatility is significantly larger if one takes the Lira or the Peseta or any of the other peripheral European currencies as a reference point.

With the mounting concerns in financial markets over the ability of several, mainly peripheral European countries to handle their public debt level, the situation has evolved significantly. Exchange rate developments became a challenge for the Swiss National Bank (SNB). With interest rates at zero and limited means to further expand monetary policy through other quantitative easing channels, exchange rate interventions were a necessary unconventional monetary policy tool. The SNB made it clear that it would fight off “safe haven” flows out of the Euro in accordance with its objective to prevent deflationary risks from materializing by way of an excessive appreciation of the Swiss franc.

This strategy of fighting off deflation risks has yielded the intended results. The deflationary risk in Switzerland has largely disappeared and the Swiss economy has been able to benefit from the ongoing recovery of the global economy. While the weakening of the Euro with respect to the Swiss franc is dampening export activity, exports are being supported by growth in foreign demand. Overall, today the outlook for the Swiss economy remains a favourable one. Admittedly, the adopted strategy is not without risk which comes primarily in the form of increased currency and concentration risk in the SNB’s balance sheet. This risk reflects the burden the SNB has assumed in order to protect the Swiss economy from the threat of deflation. The SNB has sufficient equity capital to withstand even large losses.

When considering the favourable economic outlook for Switzerland, we must not lose sight of the fact that the latest tensions on the financial markets have increased the downside risks. Should these downside risks materialise and, via an appreciation of the Swiss franc, lead to a renewed threat of deflation, the SNB would take all the measures necessary to ensure price stability. In other words, the SNB would do whatever it takes to fight deflation and safeguard price stability in the medium- and longer-term.

Switzerland has an obvious and enormous interest in Europe's ability to manage through this public debt crisis decisively and ultimately successfully. Europe's ability to navigate out of the current crisis is also very much in the interest of the United States and indeed the world. When I say this, I don't mean to refer solely to the potential economic strains as a result of Europe's public debt concerns.

What is ultimately at stake is the vision of the founding fathers of the EU; the vision of a continent living in peace and prosperity and thereby contributing to a stable world order.

Merely upholding this vision will not, however, resolve the debt situation. But it explains the bold and decisive steps taken by European governments, together with the International Monetary Fund (IMF), to begin to address market concerns. It also explains why after a rapid deterioration of public finances in Europe, collective monitoring of fiscal discipline and peer pressure experience a revival. Arguably, more importantly, several countries have embarked on a path that entails much needed structural reforms.

This public debt crisis is multi-layered. It is clearly a crisis of market confidence and as such a liquidity crisis. The trigger was a classic fiscal crisis combined with severe competitiveness problems in the periphery of the EU. However, it is also an institutional crisis. The institutional mechanism to ensure fiscal discipline inside the Eurosystem was clearly insufficient.

Obviously, part of the fiscal imbalances and the resulting build-up in public debt were directly related to the financial crisis and its aftermath. One part of the fiscal expansion can be explained by the direct fiscal effects of the measures taken to stabilize the financial system. Another part is explained by the drop in revenues and increases in social benefit payments in response to the post-crisis recession. According to recent IMF calculations, this accounts for about fifty percent of the increase in debt levels globally since the outbreak of the crisis. The other roughly fifty percent are unrelated to the

financial crisis and its effects on the broader economy.[3] To put it differently, some countries had simply lived beyond their means well before the financial crisis erupted in 2007.

The reaction of financial markets is a wakeup call to all countries that sooner or later government finances must be put on a sustainable path.

The main measures implemented so far at the EU level are mainly short-term oriented to fight of the liquidity crisis and associated contagion risks. A large assistance package has been established jointly by the EU and the IMF for Greece. To ward off the risk of contagion, the EU has put in place the European Financial Stabilization Facility (EFSF) while the IMF has committed to provide significant bilateral funding. Overall, the funding secured amounts to 750 bn Euros. This significant amount is justified by the high risk of international spillover effects. Additional support to ward off this contagion risk was given by the European Central Bank which decided to intervene in the euro area public and private debt market in order to restore an appropriate monetary policy transmission mechanism.[4]

These measures provide essential backstops. By adopting them, the governments of the EU member states and the European authorities have unequivocally stated their intention to safeguard the Euro. While this was a crucial first step, initial market reactions suggested persistent scepticism. The uncertainty regarding the health of the balance sheet of European banks is high and is keeping tensions on financial markets elevated. It is not only the exposure of European banks towards mainly peripheral EU countries that is a concern to market participants. Markets are also questioning the overall solidity of bank balance sheets in the aftermath of the financial crisis.

Therefore, last Thursday the heads of governments of the EU member states agreed that the results of stress tests on their respective banks will be published in the second half

[3] See IMF (2010): World Economic Outlook, April, chapter 1, p.9.
[4] ECB press release, 10 May 2010.

of July. This decision can play an important role in fostering market confidence. In the event that these stress tests reveal cases where additional capital is necessary, recapitalization efforts will have to be undertaken swiftly. Institutional investors appear to be underweight in their exposure to European banks. This should prove helpful in lending support to potential capital raising efforts following a credible and transparent stress test exercise. Indeed, one of the reasons investors currently appear to underweight European banking stocks may very well be related to the fact that there is insufficient transparency about bank balance sheet conditions in Europe. Credible stress tests can remedy this problem.

Contrary to what some commentators suggest, financial markets also look beyond the short-term. As a result, Europe's authorities had to recognize that decisive and comprehensive longer-term fiscal programs are needed to put the EU as a whole on a sound fiscal basis.

Equally, individual countries can't forever live beyond their means. Under pressure from the market, a number of countries have therefore initiated far reaching multi-year programs, which at least partly address structural problems.

Moreover, the way the EU as an institution deals with public finances will change. As many European officials have pointed out, in 2004, it was not Greece or Portugal but Germany – together with France – that undermined fiscal discipline by successfully averting sanctions foreseen under the Stability and Growth Pact. Now, the EU and in particular the big countries are openly advocating measures to amend and significantly strengthen the institutional mechanism in order to enforce fiscal discipline.[5]

In this context, the member states of the EU are faced with a fundamental issue. The public debt crisis has shown that interdependence between member states of a

[5] See also Lorenzo Bini Smaghi: "… it requires a strengthening of the institutional framework for budgetary surveillance", Speech at "Group of Thirty", 63rd Plenary Session, Session 1: The crisis of the Eurosystem, Rabat, and 28 May 2010.

monetary union is strong.[6] Going forward in reforming the institutional set up of the EU, the core question is to what degree EU member states are ready to further relinquish sovereignty. How centralised or federal should the EU be?

This discussion bears remarkable resemblance to the early years of the United States. At the time, an intense debate took place around the full assumption of the Revolutionary War debt of the states by the national government. The debate pitted the Treasury Secretary Alexander Hamilton against James Madison and Thomas Jefferson. While his opponents saw the assumption of the states' debt by the national government as a threat to the republican government, Hamilton saw it as a unique opportunity to pursue his agenda of creating a more powerful national government. He considered assumption as a way to assure the new country a solid credit standing at home and abroad. This would allow the United States to take full advantage of the emerging global commercial and financial opportunities. In the end, Hamilton prevailed thanks to a classic political compromise involving the future permanent site of the capital of the United States.[7]

With history in mind, let me end on an optimistic note:

As more details emerge about the EFSF and as the European authorities proceed with their stress tests, I am confident that market strains will begin to ease. While the EFSF provides a financial backstop, the importance of publishing credible bank stress test results cannot be overemphasized. I am convinced that meaningful transparency about the solidity of European banks and corresponding swift action to raise capital where necessary will bolster market confidence significantly.

In a longer term perspective, credible steps are now being examined and will be undertaken to enhance fiscal discipline in the EU. The EU authorities and governments

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[6] See also Tommaso Padoa-Schioppa: "...the sovereign debt crisis has finally alerted those who had not yet woken up to the fact, that interdependence has developed to such a degree that all of the Union's member states – the strong, and the weak, the virtuous and the sinners – have lost their full economic, and even political sovereignty.", in: The Debt Crisis in the Euro Area: Interest and Passions. Notre Europe Policy Brief No 16, May 2010.

[7] See Ron Chernov (2004): Alexander Hamilton, The Penguin Press, New York NY.

of the member states will have no choice but to take decisive steps to address the underlying institutional flaws that led to the current debt crisis in Europe.

This is decisively not the first time the European integration process arrives at a crossroad. Since it began in earnest sixty years ago, many severe challenges had to be overcome to bring Europe to where it is today. As Jean Monnet, the pre-eminent founding father of the EU wrote in his memoirs in 1976:

> "Europe will be forged in crises and it will be the sum of the solutions adopted for those crises."[8]

I have no doubt that Europe's authorities will once again rise to the occasion. They will ultimately adopt the necessary solutions to overcome the current public debt and confidence crisis. In doing so, they will safeguard the long-standing European integration process that has proven so valuable to Switzerland and to the rest of the world.

[8] See Monnet, Jean (1976): „Memoires".