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Should Switzerland Adopt the Euro?

During periods of turmoil in the eurozone, such as those we are currently witnessing, foreign and domestic investors seek safety in the Swiss franc. As a result, the Swiss franc strengthens significantly. This has both positive and negative effects. On the positive side, the purchasing power of Swiss residents increases. On the negative side, the strong currency creates problems for both exporting and import competing Swiss firms.

There exist different ways to deal with the safe haven issue. Among those that have been tried are the adoption of an exchange rate floor and the adoption of negative interest rates on deposits with the central bank. These measures do not seem to have stemmed the appreciation of the Swiss franc.

As a result, more radical propositions have been put forward, such as having Switzerland give up the Swiss franc and adopt the euro. Switzerland would not be the first country to give up its currency. Other countries have done so before. Their respective contexts, though, may have been quite different, so the Swiss case must be studied within the setting of the country's own particular circumstances.

The safe haven problem and its consequences for the Swiss economy are questions of national interest. Swiss Finance Institute's (SFI) ultimate objective is to contribute to the welfare of Swiss society. We thus asked a number of prominent SFI and non-SFI specialists for their views on the desirability of giving up the Swiss franc as a specific way of coping with the safe haven issue. I would like to thank them for taking the time to respond to our questions. It should be stressed that our inquiry concerned solely the adoption of the euro (or another currency such as the US dollar) as the national currency, not joining the European Union, which is a separate and–as we all know–politically highly controversial issue.

The study is based on individual interviews with the experts and summarizes their answers. It is likely that not every reader will share these opinions. Too many divergent interests are at stake. Still, I hope this article helps readers form their own opinions. I am particularly grateful to Harris Dellas from the Economics Department at the University of Bern for supervising the survey's contents. Stefan Aebischer and Oliver Dichter (University of Bern) did most of the work. Without them, this survey would not have been possible. They interviewed the following experts in alphabetical order: Philippe Bacchetta (University of Lausanne and SFI), Ernst Baltensperger (University of Bern), Giovanni Barone-Adesi (Università della Svizzera Italiana and SFI), Aymo Brunetti (University of Bern), Harris Dellas (University of Bern), Harald Hau (University of Geneva and SFI), Jean-Charles Rochet (University of Zurich and SFI), and Jan-Egbert Sturm (KOF, Swiss Federal Institute of Technology–Zurich). I am grateful to Urs Wälchli from the Rochester-Bern Executive Programs for critical comments.

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Disclaimer
The findings and conclusions presented in this study do not necessarily represent the views of Swiss Finance Institute or the Institute's staff.

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17.09.2015 – Geneva
The new Swiss Financial Market Infrastructure Act: What does it mean for me?
Dr. iur Martin Liebi, Geneva.

24.09.2015 – Zurich
Risk and Uncertainty in Asset Management
Elizabeth Corley (Allianz Global Investors), Zurich.

For more information on upcoming events: www.SFI.ch/Events

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Quadratic Variance Swap Models, E. Gourier, **D. Filipovic**, and **L. Mancini**, *Journal of Financial Economics.*

Asset Allocation and Monetary Policy: Evidence from the Eurozone, **H. Hau** and S. Lai, *Journal of Financial Economics.*

Should Switzerland Adopt the Euro?

Executive Summary

The consensus opinion of our experts can be summarized as follows.

The Swiss franc is a safe haven currency. In normal times, this benefits Switzerland because it brings about an exceptionally low cost of capital, which fosters corporate investment and economic growth. However, in times of turmoil, as we are currently witnessing in the eurozone, this safe haven status induces a steep appreciation in the value of the Swiss franc abroad, which is detrimental to the Swiss economy. The classical monetary policy instruments of the Swiss National Bank (SNB) are not sufficient to resolve this problem. The reintroduction of a regime of (quasi-) fixed exchange rates would invite even worse speculative attacks than in the past. This would unavoidably threaten price stability. Adoption of the euro would solve the safe haven problem. Yet it would come at significant economic cost. Not only would Switzerland lose the advantages of low real interest rates; it would also be tied to a monetary policy that may lack a fully credible commitment to price stability. The costs of euro adoption would likely outweigh the benefits. No monetary policy can shield Switzerland completely from the current turmoil in the eurozone. In one way or another, the current crisis will be costly to the Swiss economy.

1. Introduction

On January 15, 2015, when the Swiss National Bank (SNB) announced it would remove the exchange rate floor of 1.2 Swiss francs to the euro, the Swiss franc quickly soared to close to parity with the European currency. The SNB's decision has attracted sharp criticism from different economic and political quarters. The argument is that the strong Swiss franc is causing serious damage to the Swiss economy. There are consequently demands for renewed intervention by the SNB. There are also a few critical voices that suggest simply giving up the Swiss franc in favor of the euro. No Swiss franc–no safe haven–no economic problems. Or so it would seem. We therefore asked a group of academic experts to examine the merits of that solution: abandon the Swiss franc and adopt the euro.

This paper summarizes the answers to a range of questions we put to these experts. If there was no unanimity, we point that out. We have organized these answers according to three main topics. First, we ask whether there is any evidence of the Swiss franc having safe haven status, and how serious the threat of such a status is to the Swiss economy. Next, we discuss the advantages and disadvantages of adopting the euro. Finally, we briefly describe and compare the two possible ways in which Switzerland could adopt the euro–namely, via membership of the eurozone or via unilateral adoption. Unless explicitly stated, all views expressed in the paper are those of our experts.

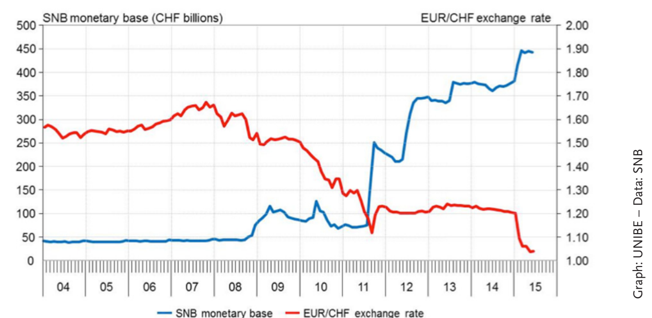
2. Switzerland and the Safe Haven

2.1. Is the Swiss Franc a Safe Haven?

An investment is considered to be a safe haven if it limits the exposure of investors to losses in times of market turbulence. Our interview partners unanimously agree that the current strength of the Swiss franc cannot be explained in any other way than by its safe haven status. The current exchange rate of around 1.05 Swiss francs to the euro, they argue, is far less than what economic fundamentals would warrant. The evidence documenting the flight of investors into the Swiss franc is that, without substantial SNB intervention, the Swiss franc appreciated significantly; and that with intervention it was the Swiss monetary base that ballooned. This can be seen in the following graph (*Figure 1*).

From September 2008 and the collapse of Lehman Brothers, to August 2011–and after January 2015–the SNB's interventions were comparatively moderate and the Swiss franc appreciated fairly significantly. In August 2011, the SNB started to intervene to stop the appreciation of the national currency. On September 6 of that year, the SNB announced that it would not tolerate an exchange rate below 1.20 Swiss francs to the euro. As a consequence, it had to buy substantial amounts of euros, which caused the monetary base to rise from 77 billion (end of July 2011) to 420 billion Swiss francs (January 2015), when the SNB removed the floor.

Figure 1: SNB monetary base and EUR/CHF exchange rate

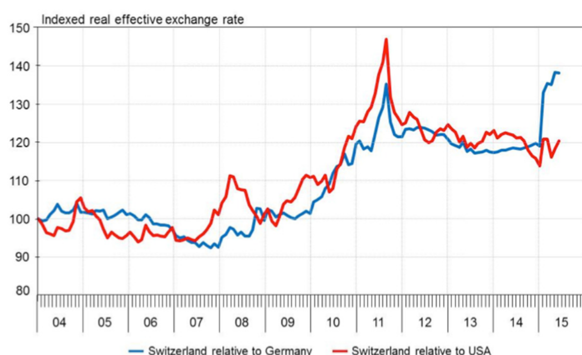


Interestingly, all currencies have fallen in nominal terms compared to the Swiss franc in recent years. Between September 2008 and May 2015, the US dollar fell by 14 percent, the euro by 36 percent, the Japanese yen by 24 percent, and the British pound by 29 percent. This suggests that the Swiss franc is a safe haven also to investors outside the eurozone.

2.2. Economic Impact of the Safe Haven Status of the Swiss Franc

The experts believe that the current strength of the Swiss franc erodes the competitiveness of the Swiss economy. This is particularly true with respect to the eurozone, which receives almost 40 percent of Swiss exports. The following graph (*Figure 2*) supports this expert view. It shows the behavior of the Swiss franc when taking into consideration the inflation differential between Germany and Switzerland. Accordingly, the euro value of the Swiss franc in inflation-adjusted terms has appreciated substantially since Lehman Brothers' collapse. It spiked in 2011, decreased rapidly after the SNB introduced the minimum exchange rate, and jumped to an all-time high after the SNB abandoned the exchange rate floor. From the end of 2007 to date, the real exchange rate of Switzerland relative to Germany increased by almost 50 percent. In other words, Swiss goods have become almost 50 percent more expensive for German consumers in just about eight years. The graph shows that something, in principle similar, also applies relative to the US dollar. During the same period, Swiss goods and services have become 20 percent more expensive for US consumers.

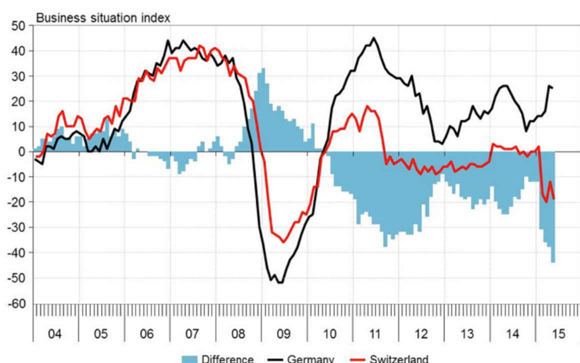
Figure 2: Real effective exchange rate of Switzerland relative to Germany and to the USA



Graph: KOF – Data: BIS

Even though the strong Swiss franc has not yet caused a measurably dramatic deterioration of Swiss exports, business leaders are very concerned. The following graph (*Figure 3*) vividly illustrates these worries with a comparison of Swiss and German business situation indices for the manufacturing sector. Whereas the two were highly correlated in the past, they moved in opposite directions after the SNB scrapped the currency floor in January 2015: the business situation improved in Germany but deteriorated in Switzerland.

Figure 3: Business situation in the manufacturing sectors of Switzerland and Germany



Graph: KOF – Data: ifo, KOF

The experts concur that the overvalued Swiss franc weakens various sectors of the Swiss economy. Exports, in particular, are expected to decline because Swiss products and services have become more expensive for foreign consumers. However, the non-exporting sectors of the economy are also affected. Part of the reason for this, the experts contend, is that foreign competitors can sell at lower prices in Switzerland. To check this assertion, we computed the two-day stock market reaction to the repeal of the exchange rate floor of January 15, 2015. We found that firms with the largest fractions of foreign sales suffered the largest stock price declines: a huge 14 percent. But firms that sell mostly in the domestic market still experienced a loss of 9 percent. Even if this computation is only indicative, it does support the experts' claim that the losses incurred by domestically-oriented firms were considerable too.

Most of the experts interviewed fear that if the Swiss franc does not depreciate soon, the Swiss economy will likely experience further deindustrialization. This means that firms will increasingly move plants and headcount to foreign sites, source from abroad, and invest less domestically. And some firms will have to downsize or close. Most of the experts worry that this structural change might be irreversible. The remaining experts, however, argue that the safe haven problem will go away before deindustrialization becomes too serious. The reason being that if the economic situation in Switzerland does indeed worsen, the Swiss franc will lose much of its attractiveness.

2.3. Would Euro Adoption Solve the Safe Haven Problem?

There is agreement among the experts that the classical monetary policy instruments of the SNB have now reached their limits. For instance, the introduction of negative interest rates on Swiss deposits has not been able to discourage the upward pressure on the Swiss franc. This has prompted various outside observers to demand the reintroduction of a minimum exchange rate or the full pegging of the Swiss franc to the euro. Our experts do not support these calls. They doubt that the SNB can credibly reintroduce a regime of (quasi-) fixed exchange rates. Many of the experts argue that the recent discontinuation of the exchange rate floor revealed the impotence of the SNB to prevent the appreciation of the Swiss franc. They therefore believe that if the SNB tried to cap the runaway franc or to peg it to the euro, it would invite speculative attacks that would be even worse than in the past. This would result in another dramatic increase of the Swiss monetary base. According to some experts, the SNB's reserves could rapidly reach levels several times higher than Swiss annual GDP, which would unavoidably threaten price stability.

Since conventional monetary instruments have had a difficult time discouraging the upward pressure on the Swiss franc, and since re-pegging the Swiss franc is unlikely, euro adoption could solve the problem. If adoption could be implemented at a rate clearly above the current 1.05 Swiss francs to the euro, the experts unanimously agree that this would in fact resolve the safe haven issue. Moreover, it would automatically end any further appreciation of the Swiss currency vis-à-vis the euro. At the same time, however, they stress that this move would not come for free. Giving up the Swiss franc for the euro could have side effects, most of them negative.

3. Benefits and Costs of Euro Adoption

3.1. Benefits

The obvious benefit of adopting the euro is the resolution of the safe haven problem and the current related pressure on Switzerland's real economy. Our experts mention other possible benefits, although they question their importance in the case of Switzerland.

Reduction in conversion costs

By sharing a common currency with its main trade partners, Switzerland would benefit from the elimination of currency conversion costs in trade with these countries. However, the experts believe that this benefit would only be of a second order of magnitude since the Swiss franc is one of the world's most liquid currencies.

Stronger economic growth?

Euro adoption would eliminate the exchange rate risk vis-à-vis euro countries. We asked the experts whether this could boost Swiss economic growth by stimulating trade and investment activities with these countries. The majority of the experts would not expect a substantial increase in international trade to result from this effect. They argue that the economic integration of Switzerland into the eurozone is already high. An increase in trade with the zone would probably be easier to achieve via increased political integration

into the European Union (EU) than via euro adoption. However, the question of whether or not political integration into the EU is desirable is beyond the scope of this paper. Some experts also draw attention to the fact that Swiss trade has become relatively less euro-centered in the last decade, meaning that it is not the euro alone that matters. The exposure of Switzerland to the exchange rate fluctuations of other currencies has gained in importance as well. Given the turmoil in the euro area, that exposure might actually increase if Switzerland adopted the euro.

More credible monetary policy
Historically, a number of countries have chosen to abandon their national currency. The motivation for these decisions, according to the experts, was always an attempt to regain the benefits of a stable and credible monetary policy. Even though the SNB lost some credibility when it abandoned the Swiss franc floor, its commitment to price stability is undisputed. The experts do not believe that the European Central Bank (ECB) is a more credible monetary authority.

3.2. Costs of Euro Adoption

The experts concur that the adoption of the euro would be costly.

Loss of an independent monetary policy
Abandoning the Swiss franc for the euro would mean sacrificing an instrument–namely, a domestic monetary policy–useful for mitigating the impact of real economic shocks. Instead of being able to have recourse to a tailored monetary policy when events call for such a move, the Swiss economy would have to embrace a policy that fits the eurozone. The current dispute within the eurozone over the appropriate monetary policy exemplifies this problem. Whereas Germany and other stability-oriented countries would prefer a more restrictive monetary policy, the weaker economies of southern Europe pressure the ECB to choose a more expansive policy.

As it turns out, the majority of our experts do not think that giving up an independent monetary policy would be an unbearable cost in the case of Switzerland. Unlike many current members of the euro area, Switzerland has a diversified and open economy with high labor mobility and flexible wages and prices. These characteristics make the Swiss economy better able to absorb real economic shocks. There is consequently less need for monetary interventions to dampen these shocks, even though they occasion significant adjustment costs for labor and capital.

Inflation and inflation uncertainty
Our interview partners think that the ECB has lost some credibility when it comes to price stability. In the aftermath of the European sovereign debt crisis, the bank has significantly increased the monetary base and continues to follow an extremely expansionary monetary policy. More importantly, most of the experts consulted doubt that the ECB would be able to change course and reduce the monetary base in a timely manner should inflation rates start increasing. Some of the experts predict inflation in the eurozone in the low two-digit range within the next few years. The issue with inflation is the difficulty in predicting its behavior correctly. The higher the actual level of inflation the larger its unexpected component, and unexpected inflation causes wealth redistribution from lenders to borrowers. The risk of this redistribution discourages lending and thus stifles investment. That is the danger of inflation. Moreover, historically, high inflation periods have triggered very restrictive monetary policies and thereby induced steep declines in GDP.

Loss of the benefits of a strong currency
A further aspect that is emphasized by our interview partners is that having a strong currency is not always bad. Throughout most of the 20th century, the high demand for the Swiss franc led to exceptionally low real interest rates, hence compensating higher prices for Swiss goods and services. Our experts estimate the real interest rate differential relative to other developed countries to be roughly 1 percent per annum, on average. Lower interest rates have encouraged corporate investment, increased labor productivity, and contributed to higher real wages. Adopting the euro would thus not only solve the safe haven problem but would also terminate access to cheap capital. Some of the experts also maintain that a slow and steady appreciation of the Swiss franc never was a problem for the Swiss economy. On the contrary, they argue, it provided incentives for Swiss firms to become more productive and innovative.

3.3. Euro Area Membership vs Unilateral Adoption of the Euro

There are two ways to adopt the Euro according to the experts consulted. One is by joining the eurozone, the monetary union that uses the euro as its common currency and sole legal tender. The majority of the experts believe, however, that this would require joining the EU as well. Alternatively, Switzerland could simply unilaterally declare the euro the relevant medium of exchange on its territory without becoming a formal member of the zone. If Switzerland chose this latter route, the SNB would have to use its currency reserves to buy the required euros. This would be feasible since the SNB has sufficient reserves. However, given the size of the Swiss economy and the magnitude of the Swiss financial market, the majority of our experts doubt that unilateral adoption could be carried out without a certain degree of collaboration with the ECB and the EU. Therefore, either way, adoption of the euro would involve political considerations that are difficult to assess. For simplicity, we ignore these issues and focus simply on a comparison of the economic costs of the two alternatives. In either case, one would have to convert all claims and debts at a specified exchange rate, and retire all banknotes and coins and replace them with euros. Given that the Swiss franc is currently overvalued, finding the appropriate exchange rate to do this would be a serious challenge according to our experts.

Costs of euro area membership
The current situation of Greece has shown that the Maastricht Treaty is unable to prevent weaker euro area member states from following fiscal policies that are detrimental to the other members of the community. Euro area governments and the ECB have had to install a bailout mechanism, and have effectively turned the eurozone into a large transfer union, where weaker and less competitive members are indirectly subsidized by more competitive countries like Germany. Since Switzerland is a wealthy and competitive country with a high propensity to save, our experts expect that the country would inevitably be drawn into this European transfer system.

Costs of unilateral adoption
In contrast, if Switzerland adopted the euro unilaterally, it would not have to directly subsidize weaker eurozone member states. Still, the experts believe that the country would end up contributing to the EU transfer system anyway, because it might have to accept a higher inflation rate should the ECB continue with an expansionary policy in its attempts to support weaker euro area states. Even so, unilateral adoption appears to present less of a redistribution problem than euro area membership.

Unilateral adoption, however, incurs additional costs compared to eurozone membership. First, Switzerland would have no say at all in the determination of the ECB's monetary policy. Second, it would have to withdraw all of its existing Swiss franc liabilities from circulation. To do this, it would have to use its assets (foreign currency reserves, gold, etc.). As the amount of franc liabilities exceeds euro reserves, the SNB and Switzerland would suffer a loss

equal to this difference. This loss is an indirect transfer to the ECB and constitutes a significant fraction of Swiss GDP. If Switzerland joined the eurozone, it would avoid this transfer to the ECB as it would obtain the necessary euros from the ECB free of charge. Third, Switzerland would lose its seigniorage profits–that is to say, the difference between the value of money issued and the cost of producing it. Though seigniorage is not a major source of income for the Swiss government, it amounts to approximately 1 percent of annual Swiss GDP. The last concern the experts have is that, without an independent currency, the SNB would be limited in its ability to play the role of lender of last resort if there was a liquidity crisis that involved a Swiss bank. According to some of the experts consulted, this would hurt mainly smaller institutions. Systemically important Swiss banks–that is, financial institutions whose failure might trigger a global financial crisis–would probably be supported by foreign central banks. Smaller Swiss banks might thus have an incentive to merge in order to become globally systemically relevant. Some of our experts also believe that the loss of a lender of last resort would expose the entire Swiss banking sector to unreasonably high risks. These experts therefore believe that unilateral adoption of the euro is not a feasible option for Switzerland.

4. Conclusion

Overall, our interview partners acknowledge that the current level of the Swiss franc is a serious challenge for Switzerland's economy. They also generally agree that reintroducing an exchange rate floor or a full peg of the Swiss franc to the euro is currently not feasible because doing so would not be sustainable and would result in a massive increase of the Swiss monetary base that would almost unavoidably threaten price stability. Adoption of the common European currency at a rate that lies above the current 1.05 Swiss francs to the euro would solve the safe haven problem and restore the competitiveness of the Swiss economy fairly quickly. However, it would be a costly decision.

Switzerland would lose its traditional low cost of capital, and would be tied to a currency with significant institutional flaws, a currency whose monetary authorities lack a fully credible commitment to price stability. Overall, the experts interviewed thus unanimously concur that adopting the euro is currently not a reasonable solution to the Swiss safe haven problem. There are too many costs associated with such a decision. However, certain of our experts would reconsider their position should the situation in the eurozone worsen and the Swiss franc appreciate further. Others argue that the turmoil in the eurozone could become so significant that, if anything, it would make more sense to adopt the US dollar. Yet another group believes that the SNB will still be able to credibly defend the current exchange rate of 1.05 Swiss francs to the euro, though this might come at the cost of future inflation.

There is full agreement, however, that no monetary policy can completely shield Switzerland from the current turmoil in the eurozone. In one way or another, the current crisis will be costly to the Swiss economy.

Definitions

Business situation index
Figure 3 is based on two business situation indices–the ifo Geschäftslageindex and the KOF Geschäftslageindikator for the manufacturing industry. Both indices are based on survey data of several thousand companies. The firms are asked to assess their current business situation according to the categories good, satisfactory, and poor.

Monetary base
The total amount of money created by a central bank. It is the sum of commercial banks' reserves in accounts with their central bank and currency circulating in the public.

Seigniorage
The annual net revenue that accrues to a government from being able to print money. It includes the value of the newly printed money (net of costs) and the return earned on the central bank's assets (monetary base).

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