Neutral Zone meets Euro Zone: A Financial Policy Analysis of the Accession Question

Switzerland

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Should Switzerland join the Euro Zone?

Background

Switzerland is a prosperous and stable modern market economy with low unemployment, a highly skilled labor force, and a per capita GDP larger than that of the big Western European economies.[1] Additionally, Switzerland's economy has long been admired for its veracity and ability to withstand crises of neighboring countries. Geographic advantage plus strict regulation of economic policy has made Switzerland Europe's 8th largest economy[2]. Switzerland's largest exported goods include chemicals, watches, textiles, and precision instruments while their greatest imported goods include machinery, chemicals, vehicles, and metals.[3] With an economy closely tied to countries in the euro, Switzerland's economy closely follows the policies of the Euro Zone. Thus, the member countries are Switzerland's most important political and economic partners.

Prior to the formation of the EMU, Switzerland enjoyed a robust economy with a strengthening exchange rate and dramatic growth levels. Due to bank secrecy, investors saw Switzerland as a stable market to keep their investments in and this led to high foreign reserves. The reserves later helped Switzerland recover from a current account deficit and allowed their vigorous growth until January 1, 2002 when the Euro was introduced.

During the 1990s when discussion of forming a united Europe reached its peak, Switzerland citizens remained distanced from negotiations and opted to continue with their own constitution, emphasizing their historical trend of neutrality.[4] Since the complete introduction of the Euro in 2002, Switzerland has experienced mixed ramifications for not joining the European Union. A prominent example includes a decline in the exchange rate leading to an appreciated Swiss Franc, high price levels, and inflation.

Macroeconomic Summary and Problems

It is important to consider that Switzerland tends to outperform the Euro Zone's economy on various indicators but this does not mean Switzerland's economy is problem free. Currently, Switzerland is dealing with several macroeconomic dilemmas.

Switzerland has experienced a steady increase in its unemployment rate over the past five years. The steepest increase occurred between 2002-2003, with a reported 2.6% in 2002 and climbing up to 4.1% by the end of 2003. As of January 2005, the unemployment rate was 4.1%[5]. Despite increasing unemployment, this rate is relatively low when compared to the Euro Zone. However, this rise in unemployment jeopardizes Switzerland's internal balance. The Swiss Franc, Switzerland's official currency, is depreciated against the Euro.

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[1] http://www.cia.gov/cia/publications/factbook/geos/sz.html

[2] Introductory remarks by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Geneva, 17 June 2004.

[3] http://www.cia.gov/cia/publications/factbook/geos/sz.html

[4] Neiderkofler, Barbara *The Swiss Question.* The Yale International Forum. Spring 1997.

[5] http://www.dailyfx.com/index.php?option=com_events&task=view_detail&agid=264&year=2005&month=03&day=07&Itemid=41

The current floating exchange rate is approximately .64 and has consistently hovered around this figure for 2 years. Prior to the introduction of the EU, the exchange rate went as high as .69. Relative to other currencies, this was a dramatic decrease.

Most recently, the Swiss Central Bank has tightened monetary policy as evidenced in the slowly rising interest rate. The country is very concerned about curbing any inflationary tendency and maintaining a stable price level. Price levels are of particular interest to Switzerland since this determines its ability to trade with countries in the Euro Zone. Most recently, their high price levels have led to a decrease in exports to Germany, on of their largest trading partner. Still, Switzerland remains a leading trade partner of several Euro Zone member countries.

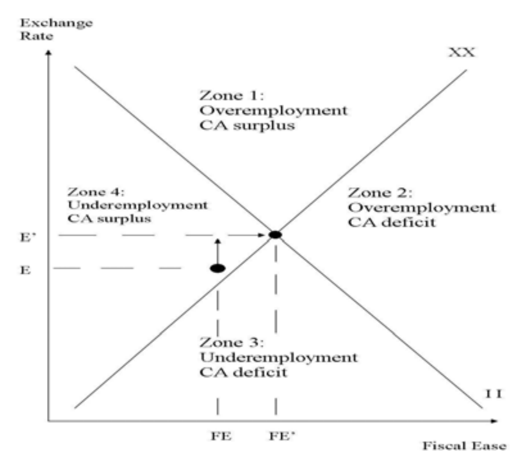
It appears Switzerland has not suffered tremendous economic loss from Euro Zone exemption. Yet, a better assessment of the sacrificed benefits is needed.

<u>Our Recommendation</u>

We recommend that Switzerland join the Euro Zone and reap the numerous benefits. Specifically, in exploring the 4 zones of economic discomfort, we will emphasize external and internal imbalance, expansionary fiscal policy and changes to the exchange rate. Additionally, the GG/LL schedule will examine the potential for decreasing the price level and improving exports.

Balancing the rising unemployment rates and current account surplus:

The 4 zones of economic discomfort place Switzerland in Zone 4 due to their current account surplus and underemployment. In order to attain both internal and external balance Switzerland will need to enact a combined policy of raising their exchange rate and endorse a policy of fiscal expansion, through increasing the money supply, for example.



Internal Balance:

Switzerland's internal balance, or employment level, is largely determined by the aggregate demand defined as:

$$Y=C(Y-T) + I + G + CA (EP^*/P, Y-T)$$

By depreciating its currency, Switzerland will be raising the exchange rate which will cause the Swiss Franc to devalue against the euro, making domestic goods cheaper, and increasing output. In order for Switzerland to hold output steady at its full employment level "Y" there will need to be a combination of fiscal policy and exchange rate changes. For example, if Switzerland joined the EU they would need to depreciate the Swiss Franc relative to the Euro and expand money supply in order to integrate, thereby lowering their price levels. Since Switzerland needs to do this to maintain internal balance anyway, joining the EU would help expedite the process and provide Switzerland with already stable countries to depend on.

Currently, Switzerland's unemployment rate is 4.1% and is slowly rising.[6] Although this is low relative to the Euro Zone's unemployment rate, it has been a cause for concern because there is still internal imbalance. A remedy can be to increase government expenditures ("G") or lower taxes ("T"), which will stimulate the aggregate demand and cause output to rise.

External Balance:

Switzerland's external balance is largely determined by its current account status defined as:

$$CA\ (EP^*/P,\ Y\text{-}T) = X$$

There is a current account surplus of 36 million with exports (110 billion) larger than imports (102.2 billion).[7] Switzerland will need to lower taxes, which will raise output and result in an increase in disposable income. By joining the euro, taxes would automatically be decreased and Switzerland would move closer to equilibrium. This will increase spending on foreign goods and make the current account fall closer to zero. Switzerland can also raise government expenditures which will cause the current account to fall. The current account is slowly rising and threatens to be speculated as a country ready for revaluation. If this occurs, Switzerland will need to sell Swiss Francs on the exchange market to keep it from appreciating which could push up the price level even more. This could lead to a balance of payment crisis. Therefore, maintaining Switzerland's growing current account surplus is necessary.

***Stabilizing exports, lowering price levels and decreasing shocks to the economy*:**

According to a GG-LL schedule analysis, Euro Zone membership would stabilize and increase Switzerland's volume of exports. Together, France and Germany are Switzerland's largest trading partners, comprising 60% of its exports. By adopting the currency of its largest trading partners the country would shield itself from the Euro Zones exchange rate disturbances that it currently is vulnerable to. For example, with the current independence, when the euro depreciates against the Swiss franc, Switzerland endures a decrease in its exports as these become more expensive for the Euro Zone members to purchase. Other gains include an increase in exports to Euro Zone member countries that did not previously trade because of exchange rate transaction costs.

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[6] http://www.dailyfx.com/index.php?option=com_events&task=view_detail&agid=264&year=2005&month=03&day=07&Itemid=41

[7] International Monetary Fund: International Financial Statistics. March, 2005

The challenge of lowering the high price level of Swiss goods and services would be resolved by joining the Euro Zone. By adopting a price level that is identical to that of its main trading partners, Switzerland will no longer be susceptible to sharp changes in its volume of exports to Euro Zone members that normally respond negatively to the high price level. A lower price level would also increase exports to countries outside the Euro Zone that never before purchased Swiss goods because they were too expensive.

Even though Switzerland would have to surrender its ability to use monetary policy for the management and control of domestic output and employment, the country stands to gain from a reduction in shocks to its economy caused by a decrease in world demand for Swiss goods. For instance, if a large reduction in demand for Swiss watches-one of the country's largest industries- occurred worldwide, the negative impact to Switzerland would be lessened as the Euro Zone would absorb the shock. The lower prices of watches that would follow would incite the established trading partners in the Euro Zone to increase their demand for watches. Meanwhile, the risk of large unemployment in this sector would be cushioned by the ability of Swiss citizens to move freely into other Euro Zone member countries and find work.

Weaknesses and Limitations

Despite the gains from macroeconomic coordination with the Euro Zone, Switzerland faces numerous trade-offs. Depending on the country's macroeconomic priorities and unique industry characteristics, the perceived benefits can be reduced.

Since joining the Euro Zone would be akin to pegging the Swiss Franc to the Euro, Switzerland would lose its ability to use monetary policy to control domestic output and employment. If aggregate demand for the entire Euro Zone falls then the Euro currency will depreciate and correct for this but a large problem emerges if aggregate demand for Switzerland's goods falls on its own. In such a case, the stabilization through currency depreciation will not be an option since the entire Euro Zone is not experiencing that same fall. Under such circumstances, the price of Swiss goods and the wages of Swiss workers would decrease by a much larger percent than if the country were not a member of the Euro zone and could correct this through a depreciation of the Swiss Franc.

By joining the European Union, they would inherit a larger negative current account, which could be just as detrimental as an excessive current account surplus. This could potentially push Switzerland into Zone 3 where unemployment and a current account surplus would exist, however, investors would more likely not react if Switzerland were apart of the EU rather than if they were on their own.

Switzerland would acquire a higher unemployment rate which could push the country further into internal imbalance. The problem is intensified because immigration is a very contentious issue in Switzerland, both internationally and domestically. Citizenship status is a highly protected category, even within the various cantons inside the country and it is likely that unemployed workers in the Euro Zone would not flow as easily in and out. This would have negative implications for correcting any change in employment availability that is fueled by a change in aggregate demand for both Swiss and other euro member goods. Additionally, with strict citizenship, it would be difficult for Swiss citizens to leave the country and seek employment in other euro member countries.

Finally, although Switzerland will certainly lower its price level, it's important to consider that the Euro Zone's price level tends to fluctuate much more. This leads us to the risk of inflation and potential for some loss of economic stability.

Conclusion

Switzerland faces several gains but with considerable limitations. While joining the Euro Zone allows the country to protect itself against strong shocks to its economy, it also requires that the country be open to greater vulnerability by enduring the problems of other euro members. These trade-offs can obscure the overall benefits of joining the Euro Zone. Clearly, the question of joining the Euro Zone is a very difficult case because Switzerland has a history of outperforming the Euro Zone on most macroeconomic indicators. Nevertheless, relative to most counties, the Euro Zone member countries are considered to have stable and growing economies with extensive trade relations.