Switzerland: Will a Stronger Currency mean a Weaker Economy?

Edith Rigler, article for *gtnews*, 19 January 2015

Switzerland is suddenly finding itself on a tough road. Last week (on 15th January, 2015) the Swiss National Bank (SNB) abandoned the link to the euro and let the Swiss franc float freely. On foreign exchange markets, the Swiss franc promptly rocketed upwards. Whether the SNB´s decision was the right measure or not is being debated widely in the markets and will certainly be on the agenda of the World Economic Forum in Davos which starts in a few days. The SNB currency intervention has stunned market participants and led to significant losses not only in the Swiss stock market, but in banks and brokers.

What happened? In 2011 the SNB had introduced a cap on the exchange rate of the Swiss franc (CHF) to the euro, so that one euro would cost at least CHF 1.20. In effect, the SNB had pegged the Swiss franc to the euro. However, last week, the SNB removed the peg giving only a limited explanation for its decision.

One euro now costs CHF 0.99. From the Swiss perspective, a franc now buys 20 percent more than it did a week ago. Conversely, from a euro (or US dollar) perspective, that Swiss holiday or Swiss watch now costs 20 percent more. Suddenly, everything in a very expensive country has become even more expensive.

The immediate impact of a drastic measure

The stronger franc is already hurting tourism: while the last few years have already seen a drop in tourists, Switzerland has now become unaffordable for many. Although the Swiss Alps are spectacular, so are the scenery and the skiing in Austria, Italy, France and Germany. Over the last few days, tourists have already cancelled planned trips to Switzerland and chosen other ski resorts outside Switzerland. And, the Swiss themselves are likely to book their winter holidays abroad.

Retail sales will certainly feel the pinch. A significant share of the Swiss population lives close to the borders with neighbouring countries. Not surprisingly, many Swiss are taking short trips into the euro zone to shop: parking lots at German, French, Italian or Austrian border towns are full with Swiss cars and the Swiss railways had to add extra trains to cater to the increased "border tourism". And Swiss banks report that their cash machines ran out of euros the day after the SNB´s announcement.

The industrial sector is starting to feel the impact: although Swiss pharmaceuticals, speciality chemicals, machinery, chocolates and luxury goods like watches are all top of the line, it is clear to customers that these goods have not suddenly become 20 percent better. Share prices in Swiss companies have fallen sharply, particularly for those firms whose production costs are in Swiss francs, but whose revenues are in euros or dollars.

Banks have also seen their share prices drop. Some have already incurred sizable losses on their FX positions. All will potentially suffer higher credit losses, if the appreciation of the franc undercuts the ability of borrowers to meet their loan payments. Even private banks may suffer: will customers readily accept a price increase of 20 percent to continue to have their assets managed from Switzerland, if a comparable service is available in another financial centre such as Singapore or Hong Kong? Some banks fear that their wealthiest clients will be attracted to US dollars.

So in the short run, thanks to the stronger franc, fewer tourists will come to Switzerland, fewer exports will go out of Switzerland and fewer assets will be managed from Switzerland. All this will adversely affect growth in 2015 and 2016. Early estimates are that economic growth in 2015 will now come in at 0.5 percent - previously, economists had expected growth to be as high as 2 percent. For 2016, predictions are now at 1.1 percent, down from 1.7 percent.

The longer term outlook

However, the stronger franc need not lead to long-term stagnation. In fact, the Swiss have been coping with an appreciating currency for decades. To do so, Switzerland has been able to rely on multiple positive factors: a stable political environment, low inflation, low interest rates, low budget deficits, low government debt, low tax rates, a highly trained labour force, excellent transport and communications infrastructure and an open attitude toward new ideas and new people. All these factors have contributed to a steady growth in productivity as well as to a growth in employment. That in turn has made Switzerland an attractive location for many international firms in industry and finance - many large multinationals have moved their global or European headquarters to Switzerland. When countries are compared for competitiveness, Switzerland consistently ranks at or very near the top of the list. Indeed, Switzerland ranked first in the *World Economic Forum´s* Global Competitiveness Survey for 2014-2015.

The stronger franc is unlikely to eliminate these success factors. However, whether these factors will be strong enough to outweigh the adverse effects of the stronger franc remains to be seen.