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The fruits of Swexit

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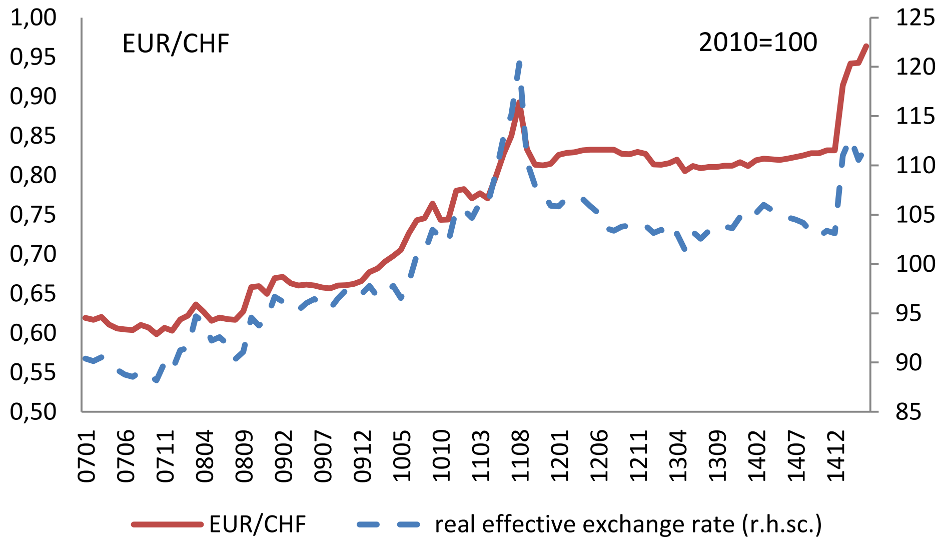
- When the Swiss National Bank scrapped the upper bound for the exchange rate of the Swiss Franc against the euro, the franc immediately surged towards parity against the single European currency and many economists predicted that the Swiss economy would disappear in a black hole.
- Four months after the event, there is not much evidence that the earlier dire predictions for the Swiss economy are materializing.
- The exchange rate appreciation undoubtedly exerts downward pressure on the export industry and makes life difficult for the producers of domestic goods competing with imports. At the same time, however, it generates welfare gains for the population at large.
- As has often happened in the past, the gains from currency appreciation will turn out to be permanent while the losses will be temporary. In Germany, where the trade-weighted real exchange rate recently fell, the opposite is likely to happen: the gains from depreciation will be temporary, the losses permanent.

The shock was great. When the Swiss National Bank scrapped the upper bound for the exchange rate of the Swiss Franc against the euro, the franc immediately surged towards parity against the euro. With this step, observers noted, Switzerland had ended its shadow membership in the European Monetary Union, which it had unilaterally initiated in 2011 by fixing an upper bound for the franc-euro exchange rate. Some economists predicted that the economy would disappear in a black hole. In Germany, commentators pointed out that the example of Switzerland would reveal the benefits of EMU membership. The German economy was protected against a blow of the sort that would now knock the Swiss economy off its feet.

No black hole

Four months after the event, there is not much evidence that the earlier dire predictions for the Swiss economy are materializing. In April, the trade-weighted real exchange rate of the Swiss franc was 7.3% above its average level of 2014 (Figure 1). This represents a substantial appreciation, but is much less than the nominal rise against the euro by 17.0%. To some degree, the franc's rise against the euro was offset by the decline of the euro against the currencies of other trading partners of Switzerland.

Figure 1. Exchange rate of the Swiss france against the euro and in real effective terms



Source: Haver

Following the surge of the exchange rate in January, the KOF business climate index and the Markit purchasing managers' index (PMI) for the manufacturing sector dropped (Figure 2). However, the PMI stabilized again in March and April and the KOF index rebounded in April. In the first quarter of this year, the level of the PMI was consistent with real GDP growth of about 0.6% (Figure 3). Consumer confidence remained broadly stable in the first quarter as improvements in the assessment of consumers' personal financial situation and their inclination to make major purchases were partly offset by a moderate deterioration of their feeling of job security (Figure 4).

Figure 2. Swiss KOF business climate and Markit purchasing managers' indices

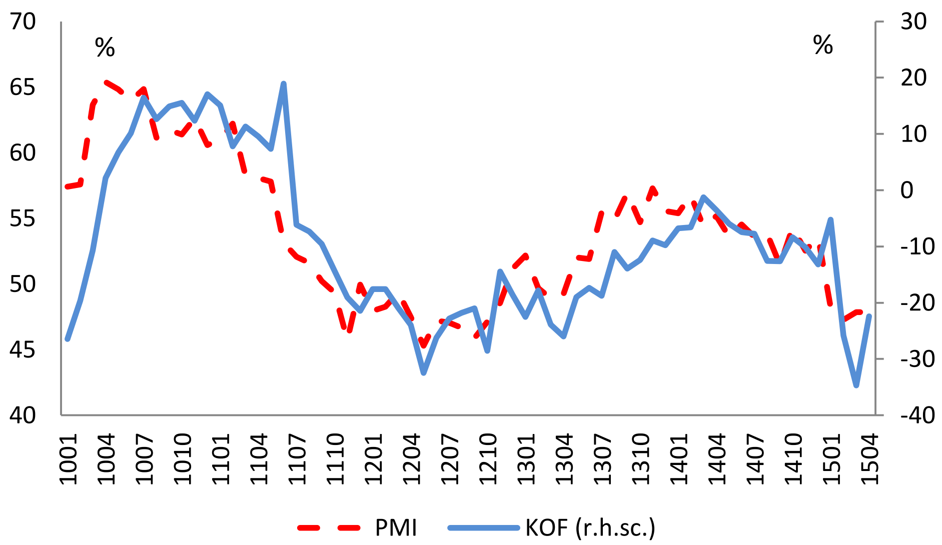


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Figure 3. Swiss purchasing managers' index and real GDP growth

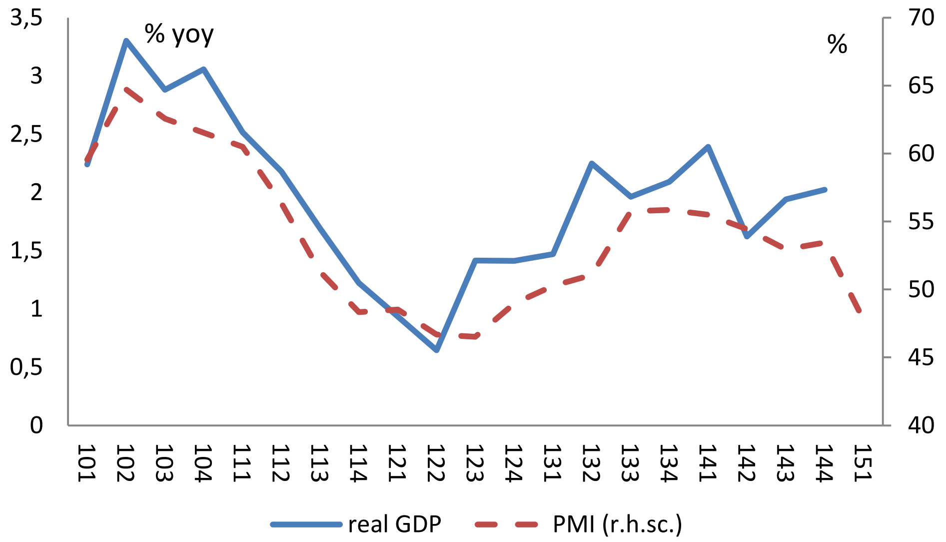

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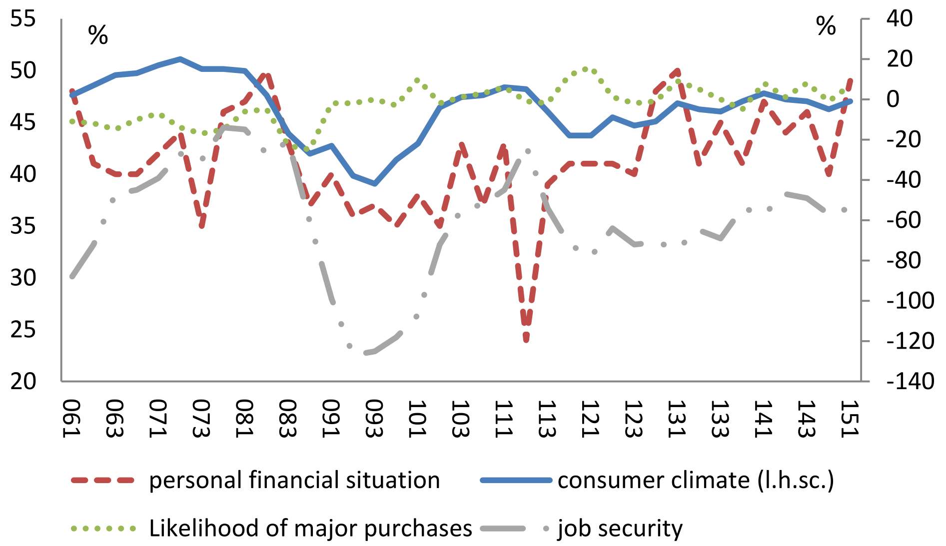
Figure 4. Swiss consumer confidence



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Against the background of the currency appreciation, the Swiss Economic Research Institute KOF in March cut its forecast for real GDP growth in 2015 to 0.2% from 1.9% expected in the autumn of last year. A month later, the International Monetary Fund saw things already somewhat less dramatic and reduced its 2015 growth forecast to 0.8% from 1.6% in its World Economic Outlook of autumn 2014. For the unemployment rate, the IMF expected a moderate increase to 3.4% in 2015 from 3.2% in 2014. Since then, other forecasts have clustered around the IMF rate.

On balance, business cycle indicators and economic forecasts point to a loss of growth in the first quarter and for 2015 as a whole. The loss in the first quarter may have been caused in part by the currency appreciation, but could also have reflected slower growth of the global economy in this period. In any case, earlier worries that the economy would disappear in a black hole seem grossly exaggerated.

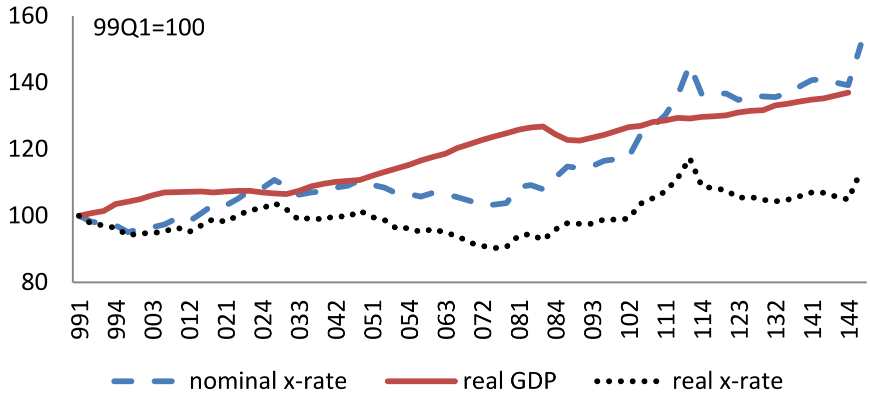
A gain in the terms-of-trade

The exchange rate appreciation undoubtedly exerts downward pressure on the export industry and makes life difficult for the producers of domestic goods competing with imports. At the same time, however, it generates welfare gains for the population at large. These gains arise from the improvement of the rate of exchange between goods produced for export and imported goods, the terms-of-trade. Thanks to the currency appreciation, a given amount of domestically produced goods for export can be exchanged against a larger quantity of imported goods. The welfare gain can be roughly estimated as savings on the bill for imports. Assuming that the real effective appreciation of 7.3% by April reflects the appreciation of the year as a whole, the savings amount to about CHF30 billion (or 4.7% of GDP), based on total imports of 2014.

The welfare gain accrues to all consumers, from the youngest to the oldest, according to their consumption patterns. Benefits also accrue to the producers of non-tradable goods for domestic consumption as their customers have more money to spend thanks to lower expenses for imports. Against this, producers for tradable goods lose out. Especially badly affected are those who sell goods primarily abroad or services to foreign visitors, but have to pay all production costs at home. The prime example for this type of producer is the tourism industry. However, the losers do not wait until they are crushed by foreign competition. They have already started to make great efforts to minimize their losses through a more efficient organization of production and increased flexibility of their employees. Consequently, the loss of output growth is contained.

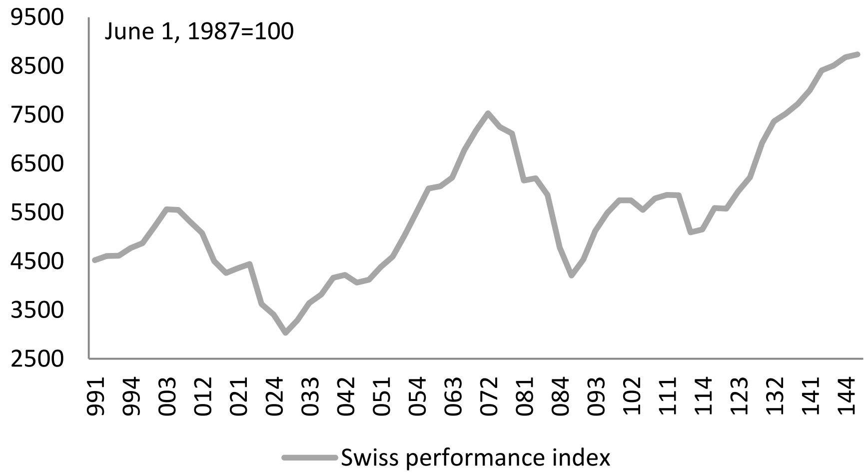
As has often happened in the past, the gains from currency appreciation will turn out to be permanent while the losses will be temporary. Between the first quarter of 1999, when European Monetary Union was launched, and the fourth quarter of 2014, real GDP rose by 37%, or 2.0% in the annual average (Figure 5). During the same period, the trade-weighted exchange rate appreciated by 39% in nominal and 5% in real (inflation adjusted) terms. Thus, 34 percentage points or 87% of the nominal appreciation reflected lower inflation in Switzerland than in its trading partner countries. Lower inflation was due in part to a less expansionary monetary policy, but probably more so to efficiency gains by producers that allowed them to keep prices down or lower them. Five percentage points or 13% reflected an improvement of the exchange ratio between Swiss exports and imported goods and services, the terms-of-trade, made possible by a greater value of these products to buyers at home and abroad. Not only consumers but also businesses benefited: Swiss equity prices and reinvested profits nearly doubled between the first quarters of 1999 and 2015 (Figure 6). The response to the latest round of appreciation will probably also be lower inflation and an upgrading of domestically produced products relative to those produced abroad.

Figure 5. Real GDP and trade weighted exchange rate in Switzerland



Source: Haver

Figure 6. Swiss equity market performance



Source: Haver

Swiss lessons for Germany

In January, quite a few German observers patted themselves on the back for not having to endure a Swiss-style exchange rate appreciation. They were wrong. They should have thought of the past German experience prior to EMU, when companies had to adapt to an appreciating D-Mark. As a result, they became more efficient and more competitive. Had the observers done a sober economic analysis they have would have seen their error.

According to OECD calculations, the real trade weighted exchange rate of Germany in March 2015 was 5.7% below its average level for 2014. If we assume this rate as the depreciation for the year as a whole, Germany's import bill this year would rise by EUR65bn or 2.2% of GDP. Against the loss of consumers due to their higher expenses for imports stands the gain of companies that export or compete with imports. This gain at first accrues to the owners. But labor unions will claw back a part of it through higher wages for their clientele.

As a consequence, the price level will rise above the immediate increase due to the depreciation when higher wage costs are passed on into prices. The latter will depress real incomes of other groups in society not benefiting from wage hikes for organized labor even more.

Depreciation takes pressure off industry for increasing efficiency, and the distribution struggle creates deadweight losses. In the end, the gains from depreciation will be short-lived while the losses will be permanent.

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