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Is the Swiss Franc Overvalued ?

How much upward revaluation can an economy stand? This question has become a searching one for Switzerland in recent times, for the price of Swiss goods has gone up 40 per cent as compared with spring 1971 for the average customer in the principal areas with which the country trades. This percentage is admittedly based on the highly theoretical assumption that the price in Swiss francs would otherwise have remained unchanged. The price increase for sales to dollar countries has been nearly 70 per cent, and even more to those who pay in sterling or in Italian lire. No wonder watchmakers, hotelkeepers and other typical Swiss tradesmen begin to fear that the exchange rate of the franc will soon put an end to their business existence.

Remedies Sought In Vain

The volume of the country's exports began to decline last autumn, and this year the drop has continued at a disturbing rate, especially in some branches such as the watch industry, which has its main competitors in the dollar and yen areas. The call for a "realistic" exchange rate has become louder and more ominous — ominous in the ears of those who know that there is really no means of holding up exchange rate movements. Monetary authorities are of course able to take certain amounts of a given currency off the market and thus to "peg" or support its rate of exchange. They can also counteract the expansion of the inland circulation — resulting from the fact that the currency concerned is bought with the inland currency — by skimming off some of the liquidity of the commercial banks. But if this procedure became a habit, it would soon involve such losses for the banks that they would accept currencies only at an extra charge, which would in practice reinstate the tendency to upward revaluation.

In spite of this, interventions on the foreign exchange market are one of the few means of influencing rates of exchange which are both effective and in lieu with the market. The Swiss National Bank has also attempted to moderate the speculative element in the upward movement of the franc by drastically cutting back the volume of forward exchange operations. Forward exchange business may increase exchange rate fluctuations because it is not necessary for its exponents to possess the currency in question. If, for instance, the dollar rate is expected to sink, dollars can be sold for francs for future delivery only, it being assumed that they will be cheaper to obtain when due than they were at the time when the deal was closed. On the other hand, if large sums of dollars are offered for francs at a future date because the dollar rate is expected to drop, the premium that must be paid for forward francs as compared with the spot price will rise. And as this premium rises, such business becomes less attractive for a growing number of dollar sellers. If the permissible volume of forward purchases is severely reduced, even a fairly small dollar offer for this purpose will suffice to send the premium up to a prohibitive level. A further measure that can be taken on the foreign exchange market — though more with a view to preventing new "Herstatt risks" — is to make it inadmissible to keep large net assets or liabilities in foreign currencies overnight. The facilitation of capital export, which is today impeded by a number of restrictions, may also be a useful measure.

On the other hand, drastic interventions not in keeping with market functions, such as levying a negative interest of up to 40 per cent per annum on foreign bank balances, have had little effect. The loopholes in such deterrents can never be completely closed, quite apart from the fact that the rate of exchange of the Swiss franc is not "made" in Switzerland only, but in such international centres as London and Luxembourg, to which those desirous of investing in francs can always turn. For the same reason it would probably prove useless to prohibit the purchase of Swiss securities by foreigners.

The idea of protecting one section of foreign trade against revaluation by a controlled exchange market was also dropped fairly quickly. One reason for this was that it presupposed an almost complete supervision of foreign exchange, which was bound to break down, since a structurally active part of the balance of payments for the free market would have existed beside a passive part for the controlled market.

In the last definition, then, there is no measure which will stand up for any length of time to the pressures of the market. This situation is not likely to change if Switzerland joins the European currency "snake", especially as the EC seems determined not to let the snake be pulled upwards by the franc. Switzerland has given it some backing in this attitude by requiring that foreign currency payables should be settled daily not merely as a whole but for every individual currency. This prevents the holding of short dollar accounts against non-Swiss currencies. Switzerland's entry into the European currency union would certainly be a useful contribution to the reorganisation of the international monetary system, but it would hardly be more effective than any other measure in bringing about a lasting correction of the exchange rate as long as the market does not recognise the overvaluation of the franc.

What is the "Right" Rate of Exchange?

It is quite possible that the exchange rate of the Swiss franc will move back towards normal with the decline of the speculative excesses which have unquestionably influenced the turbulent developments of the last few months. But there is much to be said for the view that the "right" rate is not so very far away from the present rate. The Swiss balance of payments has remained positive since the beginning of the upward movement after the first temporary relinquishment of a fixed rate of exchange on May 5th, 1971. The legendary petro-dollar would not have been necessary for this development, for a structural deficit of the trade balance was made up by a surplus on the "invisibles", which has sufficed up to the present to equalise the account.

The oil crisis did not alter this situation. From the third quarter of 1973 till the end of February 1975 the prices of imports in Swiss francs rose on the average by more than 15 per cent in spite of revaluation, but exports went up by over 16 per cent. The recent drop in the export volume is probably only a result of the economic situation. In any case it is not accompanied by a growing trade balance deficit, as imports have shrunk even more.

What is the future likely to bring? If Swiss exports have so far not suffered unduly from the high price of the franc, this is partly due to the country's specialisation in products embodying a high degree of knowhow, for which it is very difficult to find cheaper substitutes at short notice. Over a long period, however, the picture may change. If manufacturing methods are finally modified to permit the use of less expensive non-Swiss machine tools, for instance, the Swiss share of the market will inevitably shrink in the long run. And markets once lost are, as experience shows, very difficult to recover. It is therefore quite understandable that the exporters who are most endangered are beginning to worry, the more so because short hours and unemployment are becoming commoner in Switzerland. Admittedly they have not yet grown into a large-scale phenomenon. If they should, the exchange rate of the franc would no doubt fall accordingly, provided that the situation is really due to overvaluation and not to the worldwide recession, or in other words if the Swiss balance of payments should move at the same time into the negative range.

At the moment, such possibilities are mere theory. And while it can be argued that substitutes for Swiss products are more likely to be found over long periods, the Swiss export industry can also switch, in the same interval, to the products that offer the best sales prospects.

Throughout the past-war period the terms of trade, which determine what amount of goods an economy must supply in return for its imports, have moved in Switzerland's favour, the chief reason for this being precisely the continuous adaptation of exports to the market. There is no reason to support that this situation is now suddenly undergoing a change, especially as at present particularly attractive markets are being opened up outside the main traditional sales areas. Moreover, Switzerland has always been one of the countries with the lowest rates of inflation — with a short interruption which was no doubt partly a result of her hanging on to an unduly low rate of exchange — and she is among them again today. The upward revaluation of the franc quite logically reflects this fact.

In Praise of Austerity

It is clear, then, that a strong currency, while no doubt unpleasant for those who have to sell their products at ever higher prices, may be a very good thing for the long-term health of the economy. It facilitates the control of inflation by exerting continuous pressure on import prices, and it leads to a continuous real increase in the economy's purchasing power, at least as long as the country is dynamic enough to ensure that its balance of payments does not drop into the negative range as a result of the constant challenge to its international competitive ability. And it does not seem very probable that this will happen to Switzerland in the near future.

Willy Linder.