Can Switzerland Meet Its Latest Challenges?

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LOOKING AT THE MORE RECENT developments of the Swiss economy, the view is sobering. Between 1990 and 1996, real GDP stagnated, earning Switzerland the dubious position as the slowest-growing OECD country. Though the Swiss economy had grown at below-average rates during the 1970s and 1980s, it at least succeeded in maintaining its cherished full-employment situation. But since 1990, even this halo has darkened. At 5.7%, the unemployment rate reached a post-war record in the winter of 1997. The jobless numbers, while still modest by international comparison, have intensified Swiss insecurity regarding the future of what had been an exceptionally successful economic model. A few years ago, Paul Krugman's study had him proclaim the "age of diminished expectations" for the United States; at the moment, Switzerland seems to have found itself in the "age of very diminished expectations".

It is true that 1990 displayed all the signs of an economic boom—full employment and inflationary pressures. But that situation, characterised by a general overutilisation of productive factors, has now swung to the other extreme, mainly due to the very tight monetary conditions proscribed by the Swiss National Bank. On the face of it, this seems to indicate that the statistically measured stagnation, to a large extent, reflects the cyclical slowdown in GDP growth rates relative to its long-term trend. Only after the forces of recovery have started to push through will it be possible to more accurately assess the actual effects on Switzerland's long-term growth.

Changes in the Economic Environment

Switzerland is an archetype of a small, open economy. It has earned its prosperity with top-class performances from its corporations on the world market. The main factor in its success was the high degree of flexibility that Swiss firms demonstrated in the face of changing demand conditions and competitive market forces. Over the last decade, the international environment facing the Swiss economy has changed drastically in several ways:

• With the completion of the common market and the planned monetary union, European integration has progressed quickly. The collapse of the Soviet empire has fundamentally changed the political and economic world map. An eastward expansion of the European Union is already emerging on the horizon.

• In a parallel development, the policy of rapprochement with the European Union has suffered a set-back with the Swiss electorate's rejection of membership to the European Economic Area (EEA) in the referendum of December 1992. Consequently, the Swiss government's previous petition for EU-membership had to be put off as well. Swiss trade politicians are still busy trying to come to terms with the aftermath of the

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damaged integration process. At the moment, they are embroiled in tricky bilateral negotiations with the EU over narrow sub-topics, of which the mutual freedom of persons to move and reside and the regulations of the European transit traffic through the Swiss Alps are the most problematic ones.

• Economic globalisation has allowed capital, knowledge and entrepreneurial activities to dismiss and overcome national borders with increasing ease. The conclusion of the GATT's Uruguay Round and the creation of the WTO have improved the foundations for free multilateral trade relations. With Switzerland being the home base to several multinational corporations, the effects of globalisation are naturally of direct concern. With its large current-account surplus, Switzerland has exported more capital than any other industrialised country. The capital streams find their reflection also in the balance of direct investments. While employment has been decreasing in Switzerland, the number of workers employed by Swiss corporations abroad has continuously risen. Swiss industry has, for some time, been employing more people abroad than at home.

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In 1987, prior to the stagnation and before the aforementioned politico-economic developments were foreseeable, the Swiss government commissioned a National Research Programme (NRP) that, under the auspices of the Swiss National Science Foundation, was designed to analyse trade and development challenges through 26 different studies. The final report on this programme, commonly referred to simply as NRP 28, has recently been published. Much of the discussion in this article is based on NRP 28.

The Loss of International Competitiveness?

In the light of the difficult economic situation, the public frequently views Switzerland's competitiveness as being shattered and globalisation as a threat rather than an opportunity. Much of the discussion of international competitiveness, however, suffers from conceptual difficulties—difficulties severe enough to lead Paul Krugman, in a 1994 *Foreign Affairs* article, to dismiss the entire concept as a "dangerous obsession". One interpretation of international competitiveness that is reasonably straightforward—but, strangely enough, did not play any role in the debate between Krugman and his critics—is the one of a country's ability to attract mobile productive factors. In the words of Ronald Jones, a country's competitveness can be thought of as its "relative attractiveness".

For Switzerland, the international competition of different production sites has become more important recently, mainly due to the innovations in transportation, information technologies and the liberalisation of markets. Still, measuring a country's "relative attractiveness" is fraught with a multitude of conceptual problems. Particularly when interpreting the statistics of direct investments, caution is advised. The fact that a capital-rich country like Switzerland exports capital is congruent with basic economic logic and cannot necessarily be seen as an indication of a country's production-site disadvantage. Quite the opposite, empirical studies have shown that most direct investments are made to develop new foreign markets and, therefore, are complementary to, rather than a substitute for, the parent company's domestic production and export activities.

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The creation and protection of a country's relative attractiveness is fundamentally a challenge of industrial policy *(Ordnungspolitik)*. Its requisites are still dependent on those that Adam Smith mentioned as preconditions for prosperity about 200 years ago: "peace, easy taxes and a tolerable administration of justice." The demands made on economic policy for strengthening a country's international position as a production site are the same as those made to overcome domestic deficiencies in industrial policies causing losses in efficiency and productivity. Insofar as an unattractive economic environment induces mobile productive factors to move elsewhere, these deficiencies will be accentuated. What ultimately matters is neither "international competitiveness" nor "relative attractiveness"—what matters is a level of production and prosperity that is potentially possible for the citizens of a country.

A prerequisite for the realisation of an economy's productive potential is a private sector that is both innovative and technologically up-to-date. A comprehensive innovation survey, compiled within the context of the NRP 28, was unable to detect any indications of dwindling technological competitiveness. By international comparison, the willingness and ability of Swiss corporations to innovate is actually rather high. Even though Switzerland's costly programme of basic research results in leading-edge products (for example in the pharmaceutical industry), the NRP 28 study demonstrates clearly that, from a macroeconomic perspective, the strength lies in the development of application technologies. This points not only toward a technological policy that attempts to steer the innovative process in a technical and contextual manner, but also toward a diffusion-oriented one. This result is supported by a recent OECD study that stresses the relevance of an efficient diffusion of technology, as contrasted with actual R&D efforts. The most important pillar of a diffusion-oriented technological policy is the strengthening of the base of human capital, the improvement of the exchange of knowledge between universities and private research institutions, and an increased degree of competition in Switzerland's domestic market. In all of these areas, the NRP 28 has detected scope for reform.

Integration Deficiencies from a Protected Domestic Market

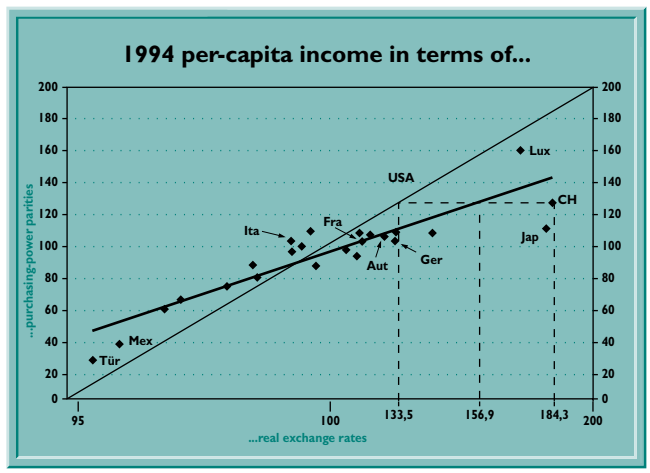
Despite its openness and trade dependency, the Swiss economy shows significant deficiencies with regard to its

international integration—regardless of the fact that the export sector has proven highly adaptable even under unfavourable conditions. By contrast, large parts of the domestic market are protected from the fresh wind of international competition, suggesting significant scope for efficiency gains.

This dichotomy cannot be reduced to the traditional distinction between industry and services. Rather, it cuts across all categories. In some cases, it can even be seen within one sector, as demonstrated in the NRP 28 study on Switzerland as a financial centre. A detailed analysis had already unveiled the need for reform in the areas of performance and cost efficiency of Swiss banks during the "golden 1980s". Given today's difficult economic environment, the need for such reform has become even more evident. Competitive forces led to a high degree of efficiency and productivity in international transactions. In the protected domestic market, however, overcapacities have been created, largely as a result of the widespread orientation toward market share and an overly extensive branch network. Not without reason is Switzerland considered "one of the world's most overbanked countries", as the *Financial Times* once put it. The restructuring efforts in this sector have led to a reduction of domestic employment in this formerly expanding industry. The frequently evoked conflict between Switzerland's successful financial centre and its ailing industrial base has thus lost much of its urgency. With increasing domestic competition, it was impossible to preserve the overcapacities from the increased rivalry in the marketplace. Similarly, no artificial hurdles should be put in the way of further development of the obvious strengths in this sector (for example, in the form of transaction taxes). The political sector has to learn to adjust the structure of public financing to the restrictions imposed by fierce international competition over location.

The fact that access to Switzerland's domestic market is still insufficient has also been stated in the latest WTO Trade Policy Review. The problem is not the existence of formal trade barriers, which with few exceptions (particularly in the agricultural sector) are quite low. The problems are regulations and restrictions that prevent international arbitrage in the markets for goods and services. This integrative deficiency is the main culprit behind the fact that Switzerland has become a high-price island. In comparison to the European Union alone, the average price differential approaches 50%. This represents a serious handicap for the internationally oriented sectors of the Swiss economy, whose costs are inflated by high domestic prices. One implication of high domestic prices is that, in international income comparisons, Switzerland fares less well after adjusting its income for the purchasing power parity (PPP) exchange rate rather than just using the current market exchange rate when converting the Swiss-franc values.

On the one hand, the high prices reduce Switzerland's prosperity. On the other hand, however, they are a direct consequence of Switzerland's prosperity. Experience has shown that rich countries are expensive ones. This is mainly because the international differences in productivity—which ultimately cause the income differentials—are larger in those sectors that produce tradable goods and services than in those producing non-tradable goods for the domestic market. The high-productivity industries push wage levels upward thereby causing higher costs (and thus prices) for the domestic low-productivity sectors. This is what leads to a generally higher price level.



The figure to the left demonstrates this effect for the 25 OECD countries. Per capita GDP, converted by market exhange rates and expressed in relation to the OECD average, is plotted on the horizontal axis. On the vertical axis, the conversion uses the PPP exchange rate. This means that the vertical axis is an index of the effective purchasing power that per capita GDP has in the domestic marketplace. The slope of the "line of best fit" in the figure suggests that for every percentage point that per capita GDP differs from the OECD average, only 0.6 percentage points is actually a difference in real purchasing power.

The line of best fit in the figure is, by and large, relatively close to the plotted points—meaning that differences in income among countries explain a large degree of the differences in national price levels. But there are outliers, and Switzerland is among them. Adjusted for differences in national price levels (vertical axis), per capita income in Switzerland is 33.5% higher than the OECD average. According to the line of best fit, the unadjusted per capita income figures (horizontal axis) should be 56.9% higher than the OECD average. Yet the actual unadjusted per capita income in Switzerland is 84.3% higher than the OECD average. Thus, Swiss prices are considerably higher than what can be explained only by Switzerland's real high income.

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To some economists, the finding that Switzerland is a high-price island suggests that the Swiss franc is overvalued relative to its long-run value. This view lies behind the foreign-exchange policy

pursued by the Swiss National Bank, which is frequently criticised for not taking into account the competitive position of the export industry. But critics often overestimate the influence that monetary policies have on real exchange rates. Their importance on the competitive position of export-oriented companies is mainly due to the fact that exchange-rate adjustments take place at a much faster speed than price-level adjustments in the domestic goods and labour markets. Therefore misalignments of exchange rates induced by monetary policy, even if they persist for a period as long as they did in the first half of the 1990s, are always temporary. Every attempt to alter international price and cost relations by means of exchange-rate policies will lead to a destabilisation of the domestic price level and will, therefore, ultimately fail. The only economic policy that will permanently improve the competitive position of the export industry is to break through the crusts of the domestic market.

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Distribution Conflicts Jeopardise Growth Potential

Empirical studies that attempt to estimate the real income effects of international integration regularly come up with rather small numbers. This is also likely to be true when quantifying the effects that the conclusion of the Uruguay Round had on Switzerland's economy. The dynamic consequences of capital accumulation and the encouragement of technological advancement should be more important, even though the exact transmission mechanism is not yet clear. An NRP 28 analysis had difficulty in detecting a significant correlation between foreign trade and the growth rate. No evidence was found to support the conventional wisdom that exports drive the Swiss economy. Surprisingly, the role that imports play appear to be more significant. This conclusion, however, is consistent with the hypothesis that access to the domestic market by foreign suppliers and the resulting increase in competition are important prerequisites for growth-supporting innovations.

One important problem is that the advantages of integration are not distributed equally—there are both winners and losers. Agriculture is a prime example of a sector that will suffer as integration proceeds. Almost no other country in the world provides the agricultural sector with a similar amount of support and protection, and in no other sector is the differential between the Swiss and the neighbouring countries' price levels as pronounced as in agriculture. In comparison to the EU alone, which itself fosters costly agricultural protectionism, the differential is almost 60%. For decades, economists have demanded a reform of the agricultural policies, but largely to no avail. Consumers react and, by now, spend more than SFr 1.5 billion in foreign countries close to the Swiss border. Politically, the long-term goals of EU-membership and the conclusion of the Uruguay Round have succeeded in increasing awareness for the need to reform Switzerland's agricultural policies.

An NRP 28 analysis demonstrated the distributional effects of integration with the EU. In the milk, meat, and bread sectors alone, consumers and taxpayers would save about SFr 4 to 5 billion by adjusting the agricultural market to EU norms. Reforms that, in the meantime, have been initiated provide for a compensation of the loss of subsidies with direct transfer payments that are not related to actual output. But with the defence of traditional distributional positions alone, it will be impossible to legitimise these transfers permanently. Politics has to clearly define its policy goals and its expectations with regard to farmers' behaviour. Included in these expectations must be environmental conditions with which farmers must comply—given Switzerland's status as having the most fertiliser-intensive agricultural sector in the world. The success and implementability of the reforms depend heavily on setting a framework on which Switzerland's very uncertain farmers can rely.

The successful model of the past—direct democracy and federalism domestically, neutrality and unilateral efforts externally—is not necessarily the best model for the future.

A second example of the sacrifice of economic efficiency due to distributional interests is the Swiss policy toward foreign workers, who account for about a quarter of the Swiss labour force. As the immigration regulations were misused to support the structurally weak and domestically oriented sectors of the economy and to pursue programmes of regional assistance, Switzerland's immigration policy has missed all its targets. It has become a brake for the growth sectors of the Swiss economy that, for years, suffered from a shortage of qualified foreign specialists. The NRP 28 study demonstrated that the shortage of qualified production and R&D personnel and the overly restricted allocation of foreign employees are the most important impediment to innovation. Today's high rates of unemployment can, to a large degree, be attributed to the misguided immigration policies. Unemployment affects low-skill workers more than others—and among the low-skilled workers, the ratio of foreign workers lies far above the average rate of non-Swiss workers in the general labour force.

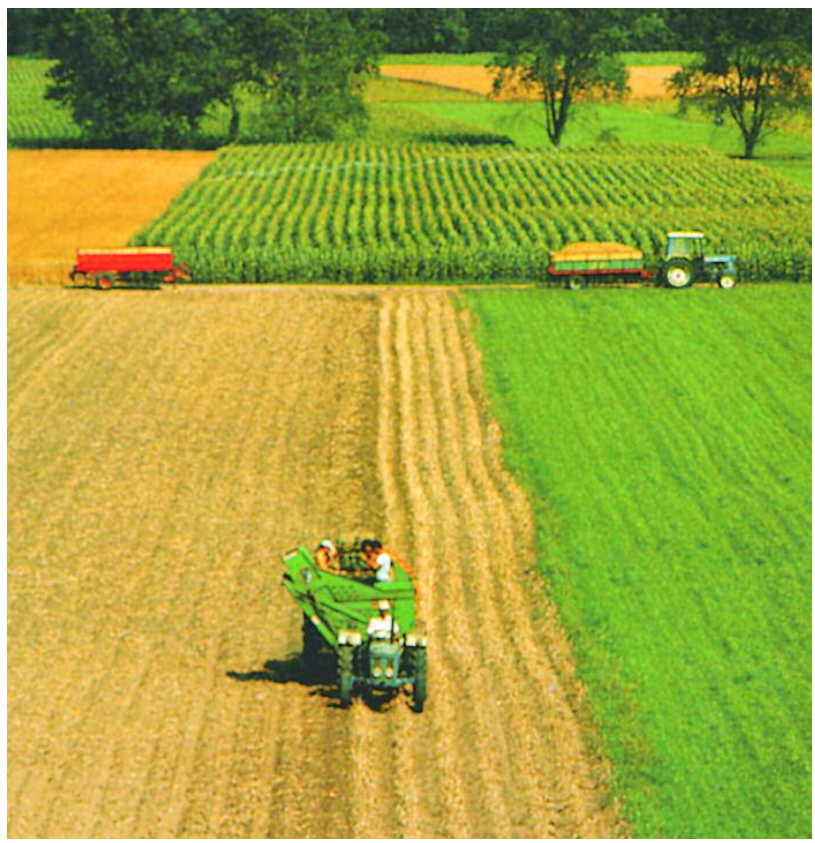
Switzerland's bilateral negotiations with the EU—even though they have not yet been concluded—should mark a new era of Swiss immigration policy. The EU has insisted on complete freedom of movement for people and managed to push these demands through with few concessions. Switzerland's flooding by a new wave of immigration need not be

expected, even though this is precisely the scenario that is frequently painted by Europe-sceptics. It is also untrue that the deepening of European integration in recent years has led to large movements from Europe's periphery into the industrial agglomerations. Moreover, the substantial increase in foreign nationals living in Switzerland over the last 15 years cannot be attributed to EU citizens. The NRP 28 analysis culminates in a demand to orient the immigration of non-EU citizens to the demands of the labour market.

Inadequacies of the Political System

The advantages that result from the elimination of remaining trade barriers, the intensifying of competition in the goods market and the unlimited access to productive factors are, from an economic perspective, evident. Therefore, the problems lie less in the determination of areas that are in need of reform than in the creation of the political ability to act. It is therefore no surprise that a discussion has begun in Switzerland as to whether the political structures are adequate to deal with today's economic challenges. The successful model of the past—direct democracy and federalism domestically, neutrality and unilateral efforts externally—is not necessarily the best model for the future. Critics especially complain about the fact that the current political institutions give too much weight to well-organised representatives of special interests who prevent reforms and slow down economic adjustment.

There are two ways to reduce the influence of structurally conservative elements. One is to transfer political jurisdiction to international organisations or supranational institutions. But as the EEA referendum has shown, Swiss people are not yet prepared to do so. The NRP 28 has analysed the reasons behind the EEA-rejection in a comprehensive survey. Even though pro-integration French-speaking citizens were outnumbered by the anti-integration German-speaking ones, the analysis shows clearly that the gap is not of a linguistic nature but is between the rural regions of the periphery and the rest of the country. Not only did the fear of centralised bureaucracy and environmentally harmful giantism tip the balance, but also the desire for the conservation of the economic culture of small enterprises, of which the people at the periphery are particularly fond. These are the structures that will be most endangered if Switzerland opens itself to the European internal market. Future integration policies must provide viable alternatives to the losers in the integration process.



A slow and bumpy ride toward the market-place.

A second way to reduce the influence of the structurally conservative element is to reform the institutional rules under which democratic decisions are made in Switzerland. The NRP 28 presents a two-tiered set of recommendations. The first tier includes a limit on the elements of direct democracy designed to prevent the misuse of the Swiss people's democratic right by well-organised special interests. The second tier modifies the economic article in the constitution, which defines the government's role in the economy by reducing the leeway for discretionary government intervention. This recommendation is based on the hypothesis that international competition between production sites is mainly competition between regulatory regimes and that Switzerland's worsening position over recent years must be improved.

How realistic is the implementation of these recommendations? The current discussion regarding the fundamental revision of Switzerland's constitution, currently work in progress, shows that even far more modest reforms—such as an increase in the number of signatures required for national referenda— are highly controversial. This does not mean that improvements in Switzerland's position as a production site have no chances at all. As part of the post-EEA rejection "revitalisation programme", it can be expected that specific improvements will be accomplished, as for instance the revision of the anti-trust legislation. The bilateral negotiations with the EU should be able to prevent the discrimination of Swiss suppliers and liberalise the movements of persons.

Apocalyptic scenarios are clearly misplaced. The generally expected improvement in the economic situation will result, once again, in positive growth rates. But they will, both by historical standards and international comparison, remain unimpressive. Chances are that, for Switzerland, the "age of diminished expectations" is there to stay. ◆