The Swiss Franc or the Euro? That is the question.

Stability is expected. But if it comes to a choice,
There is a slight preference for the franc.

Driving through Switzerland

After a brief stop in Lucerne, where a walk around the Old Town always has its charm, we drive north toward the German border. We are intrigued by several broker reports suggesting that the purchasing power parity of the Swiss currency makes the franc more attractive than ever. For what it is worth, anecdotal evidence suggests that the price level in Switzerland has come down somewhat relative to the euro-zone, although it remains in absolute terms expensive.

People living in the Confederation tend to confirm this picture.

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When the Swiss franc was pushing against the upper limit of its trading range a couple of weeks ago, **Jean-Pierre Roth**, President of the Swiss National Bank, expressed dissatisfaction with the weakness of his currency. He said, “over the past few months, the Swiss franc has even trended downward. If this trend were to accelerate and give rise to an excessive relaxation in monetary conditions with respect to economic developments, a normalization of interest rates would become even more essential.” Traders may have interpreted these words as a good reason to sell the euro against the franc, and the exchange rate moved back toward 1.54, after earlier reaching 1.58. Some currency operators interviewed off the record by this magazine were disposed to believe that the recent peak of roughly 1.58 should represent a short-term ceiling because beyond that level the Swiss National Bank is expected to increase interest rates in larger steps in response to a weakening currency.

The analysts say that the single most important variable driving the exchange rate is the interest rate differential between the two economic areas. “The Swiss franc,” explains **Carsten Fritsch** of Commerzbank, “may lower a little bit to retest the 1.58 resistance in the expectation that the European Central Bank (ECB)

Euros or francs? Your reporter is puzzled. We are at the border between Switzerland and Germany. Swiss consumers are attracted to Germany because prices are still cheaper. A customs agent suggested that after the introduction of the euro, prices rose a little bit in Germany.

A supermarket in Chiasso, Switzerland, 5 minutes from Italy. Many cars in the parking area are from Italy. Several items Italians find more convenient to buy in Switzerland than at home.

Families arrive from Italy for their shopping in Switzerland, but the activity is not frenetic, considering it was on Saturday.

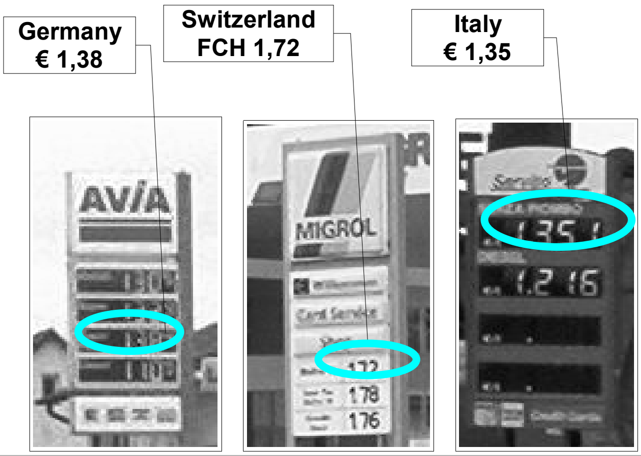
would normalize the cost of money faster than its Swiss counterpart over the short run. After that, the circle should be moving into reverse gear when the yield spread is supposed to decline later this year." **Roberto Mialich** of Unicredit adds, "if both the euro and the franc appreciate against the dollar, then the euro is likely to lag behind the franc." He says, "at some point, for instance, 1,30, the ECB may start to release statements in order to slow down the euro, while the Swiss National Bank ought to show greater tolerance. In turn, this will provide support to the franc vis-à-vis the common currency."

Analysts cite other positive Swiss developments as well. Switzerland has a very substantial current account surplus compared with Euroland, running at times as high as 15% of gross domestic product. The export sector is in great shape, as demonstrated by an 8.6% advance in April. There is also little doubt that the external performance of the country is poised to benefit from the pick-up in economic activity beyond its boundaries. That is another reason given by the experts as to why the central bank must normalize monetary policy to avoid problems in the future. Finally, the Swiss National Bank has let some comments drop on rising employment and the good health of the economy, presaging some rate hikes.

In general, professional economists would be surprised if wild swings in the exchange rate occurred. In the words of **Niels Christensen** of Société Générale, "the franc is very stable against the common currency and the mirror image of this reality is the low volatility observed in the option market." But if it comes to a choice, there is a slight preference for the franc.

Staff

Switzerland continues to appeal foreign motorists. At 1.72 francs per litre (1.10 €), gasoline is 20% less expensive than in contiguous countries.



Swiss franc/euro

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*"When the euro was introduced," recalls **Hanspeter Ehrsam**, an analyst living in Bedano, Switzerland, "I thought my country would endure some kind of deflation because the price level was significantly higher than in the rest of Europe, but as it happened, it was the rest of Europe that lifted its price level, and now the difference has tapered off." But whether the trend will continue or reverse its direction is still unclear.*

***Marc Faber**, the famous Hong Kong guru, who was born in Zurich, thinks, "the trend will go on because prices are still noticeably higher in Switzerland than in Germany." His thesis can be witnessed in practice as one crosses the border between the two countries: the Swiss are definitely going to Germany for their shopping. A customs agent corroborated this impression, agreeing that some slowing in traffic toward Germany has followed the introduction of the euro.*

The shift has been still more dramatic on the border between Switzerland and Italy. Now many items are more expensive in Italy than in Switzerland, and over the weekend one sees Italians shopping in supermarkets just across the border. As for money moving from Italy to Switzerland in reaction to the new left-oriented government in Rome, our conversations with money managers say that no such thing has happened. It was a tide some had feared.