Niklaus Blattner: Review of the Swiss economy

Introductory remarks by Prof Dr Niklaus Blattner, Member of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 13 December 2002.

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In conducting monetary policy, the Swiss National Bank (SNB) must be able to rely on a healthy banking system. We can consider only efficient and solvent banks as counterparties. Monetary policy can only be implemented effectively in a system made up of such banks. Furthermore, only efficient and solvent banks (including the non-bank Postfinance and the infrastructures for the settlement of payments and securities) can maintain efficient and secure payment transactions.

The current bill for a comprehensive revision of the National Bank Law took this realisation into account. Overseeing the payment and securities settlement system is only one of the central bank functions spelled out in the Law. What is new, in particular, is the explicit requirement that the National Bank shall contribute to the stability of the financial system. By taking organisational measures, we already created better preconditions for fulfilling the expanded mandate in 2001. The Law and the organisation are moving in the direction taken by other central banks worldwide ever since they have increasingly identified the stability of the financial system as a necessary precondition for pursuing an effective monetary policy.

In accordance with the revised Law, our close cooperation with the Swiss Federal Banking Commission (SFBC) will be further expanded. The responsibilities will remain clearly delineated, however. The SFBC is mainly responsible for the supervision of banks and institutions, while the National Bank is entrusted with overseeing payment and securities settlement systems and promoting the stability of the financial system.

Our activity in this area focuses on analysing the structures, the behaviour and the results in the Swiss banking system. Up until now, the National Bank was known primarily for its banking statistics. Furthermore, it frequently conducted and published banking surveys. We are now increasingly turning our attention to the analysis of topical issues, including a periodic analysis of the situation in the financial system. In so doing, we concentrate on those aspects which are relevant for assessing system stability. For this reason, banks are the main focus. Developments in the insurance world jeopardise system stability only indirectly at the most, e.g. in the case of a financial conglomerate.

The situation in the Swiss banking sector

The Swiss banking sector found itself in a hostile environment in the past few months. There was a slowdown in economic development. Hope for a prompt recovery was dampened. The number of corporate bankruptcies increased substantially compared with the previous year. Uncertainty surrounding company profits hit the stock markets with full force. As elsewhere, Swiss stock prices dropped significantly amid high volatility. While the Swiss market as a whole (SPI) lost 22% from the beginning of the year, the SPI banking index weakened by 30% and the share index of insurance companies plummeted by as much as 47% (as of 9 December 2002).

What are the repercussions that banks are exposed to? The weak economy results in a deterioration in the quality of loan portfolios, and the collapse of stock prices has an adverse effect on profits. Banks not only suffer losses on their own securities portfolios. The stock market slump also has an impact on earnings from commissions and services. Lucrative services in investment banking, such as those in connection with IPOs or mergers, are less and less in demand, and the reluctance on the part of many investors – with the resultant lower turnover – cuts into the income from commission business. In the wake of falling stock prices, profits in asset management are declining as well. This is because a part of the fees and commissions levied on the assets under management is value- or performance-based.

This year, the big banks recorded profit setbacks in most areas compared with year-earlier quarters, in some cases even considerable losses. This was especially due to the poorer results from trading for own account and to a decrease in investment banking business (new issues, mergers and acquisitions). Particularly insurance business accounted for these losses. In traditional banking business, notably in retail banking, the big banks recorded satisfactory results, however. The BIS equity ratios disclosed by the big banks clearly exceed the required minimum.

Banks which concentrate on asset management are struggling especially with the repercussions of the poorer performance on the capital markets and costs, which have risen sharply just in the last few years.

For banks primarily active in interest-earning business, economic development plays a pivotal role. As already mentioned, due to the slowdown in economic activity, a deterioration in loan quality and the resultant need for higher provisions is something this business segment must reckon with.

Of some 250 banks which published their half-yearly results, two-thirds saw their profits decline vis-à-vis the first six months of the previous year. Thirteen banks even posted a loss; the remaining banks, however, recorded a rise in profits. The aggregate profit was down by 21% compared with the year-earlier period.

Despite the regrettable case of Banque Cantonale Vaudoise, the overall situation is favourable as far as equity ratios are concerned: all banks continue to meet the capital adequacy requirements. The average capital ratios of all banks (excluding the big banks, September) exceeded the regulatory minimum by 79%. 98% of banks reported at least a 20% capital surplus.

The overall picture can be characterised as follows: the Swiss banking sector suffers from uncertain economic prospects and the tense situation on the financial markets. Many financial institutions are forced to take corrective action. Measures taken range from cost cuts, streamlining the product line, decreasing risk exposure, continued tightening of risk and liquidity management to capital increases and mergers. For the most part, these measures are implemented without delay. Plans for cooperation on a logistical level and in connection with raising capital have become more attractive as well. It is to be hoped, however, that the reluctance to give up an often only presumed autonomy will be overcome sooner rather than later. The idea that a bank is only a «real bank» if it is itself involved in the entire value chain as much as possible is a thing of the past.

Moreover, further development will depend heavily on the economic trend and the stabilisation on the financial markets.

Two things merit particular mention: firstly, the capital ratio of Swiss banks is on a comfortable level overall, allowing them to act from a position of strength. Secondly, banks in Switzerland have mostly used the prosperous years since the end of the nineties to bring their lending business in line with the risks and to reform their liquidity and risk management. Under the current difficult circumstances, these efforts are now paying off.

In other words, the problems facing the Swiss banking system will be solved. The banks in Switzerland have the necessary strength. Structural changes are taking place at a fast pace and are likely to progress even more quickly. The banking system may be undergoing radical changes, but is nevertheless stable.

The role of the euro in payment transactions

A little less than a year ago, the euro was introduced in the European Monetary Union in its physical form. In the summer of 2001, in the run-up to the launch of euro cash, the National Bank held talks with over 100 Swiss companies and associations querying them on their expectations in connection with euro coins and banknotes as well as their experiences so far with the euro as deposit money. Last summer, i.e. well over half a year after the introduction of euro cash, the National Bank conducted another similar survey. The purpose of this second survey was to gather information on the first experiences made with the new euro cash in Switzerland. The questions focused on the euro as a means of payment in tourism and in retail trade. In addition, export companies were again questioned as to their handling of the euro as deposit money. In this connection, the National Bank was particularly interested in the prevalence of the euro as a billing currency as well as the treatment of the foreign exchange risk.

As had been expected, the introduction of euro cash did not lead to a sharp increase in payments made in foreign currencies. In the majority of the businesses we visited in the tourism sector and in retail trade, payments currently made in euros are approximately on a par with the ones formerly made in the original European currencies. Guests who stay for a very short period (overnight) pay in euros most frequently. The same applies to some tourists from the United States and Asia who make only a short visit to Switzerland during a tour of Europe. The traditional European holidaymakers, however, continue to change their money into Swiss francs.

In practice, most businesses apply the current rate plus a margin of 2%-3% when payment is made in euros. The majority of businesses only accept euro banknotes and return change in Swiss francs; a minority also accept euro coins, giving the change in euros. The management of coins is made more difficult because most banks do not buy or sell coins. All businesses queried feel that the simplification brought about by the replacement of the former European currencies with the single currency is positive.

With regard to the euro as deposit money, many export companies switched to billing in euros relatively soon after the introduction of the single currency. Consequently, this practice has not become significantly more prevalent in the most recent past. Invoicing in euros of exports destined for the euro zone is widespread. Producers of some niche and luxury products are an exception. They continue to bill in Swiss francs. Euro-denominated receipts are hedged in exceptional cases only; companies still consider hedging on the financial markets to be too expensive. What is widely practised, however, is so-called “natural hedging”, which means that receipts in euros are used to settle suppliers' invoices: primary products and raw materials from the euro zone are paid for in euros.

Swiss suppliers have increasingly been requested to provide euro-denominated invoicing. It is unclear to what extent inter-company payments in Switzerland are effected in euros. There is agreement, however, that these payments have increased compared with last year's survey and that this trend is likely to continue in future. Wage and salary payments in euros are still not an issue. Employees would not accept wage and salary payments in euros. Furthermore, such a practice would result in substantial administrative complications (social security deductions and taxes in Swiss francs).

The selective use of euros in place of the Swiss franc does not create any difficulty with regard to monetary policy. On the one hand, the bulk of payments in Switzerland will probably continue to be effected in Swiss francs also in future. On the other hand, under the current monetary policy strategy, a possible euro-induced decline in the demand for money will not lead to any problems either. Contrary to the previous policy of targeting the money supply, the steering of the interest rate the National Bank pursues today is not dependent on a stable demand for money.

The National Bank realises, however, that, as invoicing in euros becomes more widespread, our export industry must bear higher exchange rate risks.