Jean-Pierre Danthine: Swiss monetary policy and Target2-Securities

Introductory remarks by Mr Jean-Pierre Danthine, Member of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 16 December 2010.

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My remarks today will focus on three topics. I will start by looking at the situation on the international financial markets. I will then speak about the SNB's own financial market activities in connection with the two core tasks of monetary policy implementation and foreign exchange reserves management. Finally, I would like to briefly discuss the planned pan-European securities settlement system, Target2-Securities.

International financial markets

The situation on the international financial markets reflects the gradual global economic recovery. At the same time, these markets continue to be affected by the fallout from the financial crisis and by doubts as to whether the current global economic recovery will be robust enough to reduce the existing financial imbalances.

On the stock markets, volatility has trended downwards over the past half-year, but has remained high. Shares and corporate bonds have benefited from investors' growing risk appetite, the ongoing expansionary monetary conditions and good corporate results. On the bond markets, by contrast, uncertainty has, if anything, grown. With the global economic recovery, yields on long-term government bonds have picked up from their low levels. In Europe risk premia for heavily indebted sovereigns have risen markedly. The imbalance in many government budgets has taken problematic proportions. Wide-ranging cuts have been announced in the affected countries, and international rescue packages have been put together, first for Greece and latterly also for Ireland, in order to prevent the situation from escalating. The markets will, however, be monitoring the effectiveness of the announced cuts and support measures very closely. The problem of sovereign indebtedness in Europe remains a source of considerable uncertainty.

A high level of uncertainty also remains on the foreign exchange markets. The continuing high volatility is coupled with strongly divergent exchange rate developments. Over the last few years, a number of currencies have appreciated substantially against the two major world currencies: the euro and the US dollar (cf. chart 1). These currency shifts do not just negatively affect the export capability of the countries whose currencies have appreciated; they also have a heavy impact in monetary terms. This is because, in order to keep appreciation in check, some countries have intervened in the foreign exchange markets, with some others even resorting to restrictions on the movement of capital flows. The result has been a global rise in foreign exchange reserves. Indeed, they have almost doubled in the past four years (cf. chart 2). The high level of foreign exchange reserves ultimately reflects substantial global economic imbalances.

As we know, the Swiss franc also appreciated substantially in the wake of the financial crisis. Looking at how the Swiss franc's real and trade-weighted external value has changed over the long term (cf. chart 3), we can see that, historically, periods of Swiss franc strength have alternated with periods of weakness. The fact that the current Swiss franc strength is proving particularly burdensome for the Swiss economy is due partly to the rapidity of the appreciation, but also to the uncertain economic climate.

Diversification of foreign exchange reserves

As you will be aware, our foreign exchange interventions since March 2009 have resulted in the SNB's foreign exchange reserves expanding to over CHF 200 billion. As we were primarily buying euros, euro holdings accounted for 70% of foreign exchange reserves at one point. In the meantime, we have reduced the euro's share in the foreign exchange reserves substantially, to 55%. Moreover, we have diversified foreign currency risk further by investing for the first time in Australian and Singapore dollars, as well as Swedish kronor and Danish kroner. Together, these currencies make up 3% of the foreign exchange reserves. The majority of non-euro holdings continues to be in US dollars (25%), Japanese yen (10%), Canadian dollars and pounds sterling. Finally, we have increased the proportion of the foreign exchange reserves that is made up of equities, from 4% back to 10%. This comprehensive repositioning was carried out gradually, and the market had no problem in absorbing it. We were thus able to considerably reduce the risk concentrations in the foreign exchange holdings. An examination of further diversification measures forms part of our annual investment strategy formulation process.

Normalisation of the Swiss franc money market

The effect of the monetary policy crisis measures introduced in recent years was also felt in the area of monetary policy implementation. By buying foreign currency against Swiss francs, we created a structural liquidity surplus on the Swiss franc market. We have since largely reabsorbed this excess liquidity via a set of instruments that are already well established. Liquidity is absorbed, on the one hand, through weekly issuance of the SNB's own money market bills (SNB Bills) with terms of 4, 12, 24 or 48 weeks, and on the other through daily one-week repo transactions (cf. chart 4). We are currently using both instruments to absorb around CHF 140 billion of liquidity, of which some CHF 110 billion is accounted for by SNB Bills. This brings banks' sight deposits, which ultimately determine the level of interest rates on the money market, to around CHF 20 billion. Compared to the period prior to the financial crisis, this level of liquidity is still high. However, our experience with liquidity-absorbing operations shows us that we can reabsorb the excess liquidity at any time. This allows us to manage the three-month Libor.

There is a liquidity overhang in the banking system as a result of the interventions. This does not pose a problem for monetary policy, as we reduce the monetary base directly through the liquidity-absorbing operations. Since the absorbed liquidity is tied up in the form of securities, the banks cannot use it either as a means of payment (like cash or sight deposits) or to satisfy their minimum reserve requirements. To the extent that SNB Bills are purchased by non-banks, customer deposits in the banking system decrease, thereby directly reducing the broader monetary aggregates. The decisive factor in determining the degree of monetary policy restrictiveness remains the level of interest rates on the money market. And we are able to control this level by tailoring the scope and conditions of our liquidity-absorbing operations accordingly.

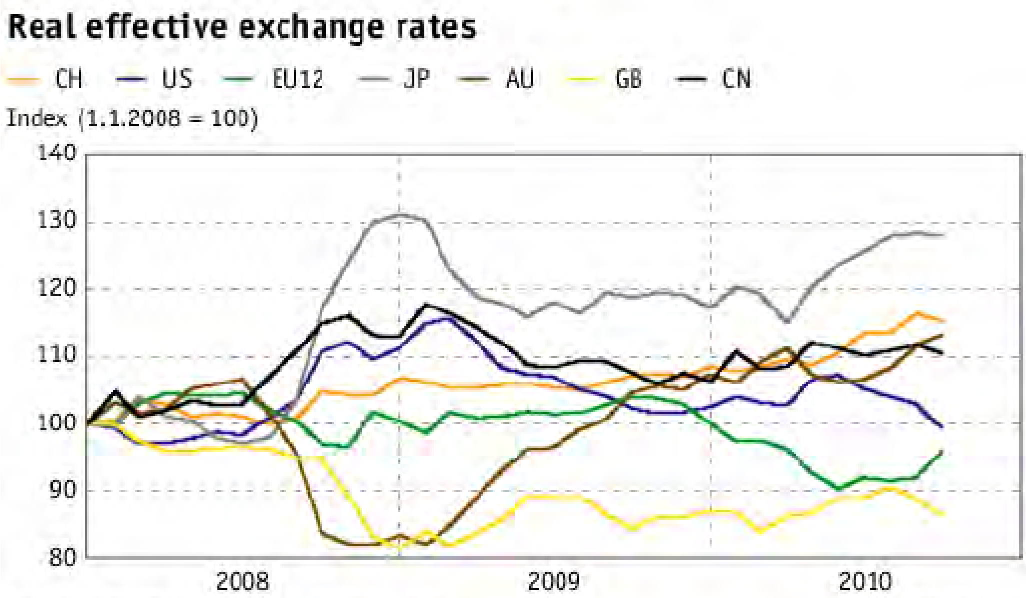
The shift in the liquidity regime has brought about a certain number of changes in SNB central bank operations with banks. For instance, we now normally only conduct operations with banks that need to place excess liquidity. The group of these banks is fairly large, consisting of 80 mainly domestic banks. Something that we no longer offer, by contrast, is regular refinancing. Banks now have to cover their refinancing needs via the money market. Refinancing through the SNB is available only in exceptional circumstances via the liquidity-shortage financing facility, at a higher rate of interest. Access to this facility should thus be part of domestic banks' own liquidity arrangements. A further effect of the regime shift on the money market is that the SNB pays the banks interest for liquidity-absorbing operations, whereas previously it received interest payments for providing liquidity. The SNB's additional interest costs – which amount to some CHF 100 million for the current year – are offset by the additional income from the correspondingly higher foreign exchange reserves.

Experience shows that, in the longer term, the income on diversified foreign exchange holdings will exceed the interest costs on the Swiss franc money market, even after any exchange rate losses are taken into account. However, as we can clearly see from this year's income statement, the fluctuations in income can be very large.

Swiss market considers participation in Target2-Securities, the European securities settlement system

Finally, I would like to briefly discuss the planned pan-European securities settlement system. Target2-Securities (T2S) is designed to replace, either totally or partially, the existing domestic settlement systems of the national central securities depositories (CSDs), and to drastically reduce the cost of cross-border securities settlement in Europe. The European Central Bank (ECB) regards T2S as a contribution to the harmonisation and integration of the European market. T2S is scheduled to go into operation in 2014. The ECB's project will also have an impact on the Swiss financial centre. The question of how the Swiss financial market infrastructure will be connected is important for both the banks and the SNB. In 2009, with the agreement of the SNB, SIX SIS AG – the Swiss CSD and a subsidiary of SIX Group – signed a memorandum of intent to participate in T2S with euro-denominated securities. This would allow banks in Switzerland to settle securities transactions in euros more cheaply. T2S has a multicurrency dimension, and the ECB is very interested in integrating other currencies into the system. Consequently, the SNB, in agreement with SIX Group and the banks, is currently investigating the suitability of T2S for settling Swiss franc-denominated securities. For this to happen, the SNB would have to permit SNB accounts in Swiss francs to be maintained in T2S (similar to Swiss Interbank Clearing SIC), and allow the banks to hold part of their central bank deposits (sight deposits) on their Swiss franc accounts in T2S. The management of SNB accounts within a foreign system would be a significant change that needs to be investigated thoroughly. These investigations are currently underway, and a decision by the SNB on whether to settle Swiss franc transactions in T2S is expected by mid-May 2011.

Chart 1:



Sources: SNB Markets Analysis Platform, BIS 14.12.2010 08:17:05

Chart 2:

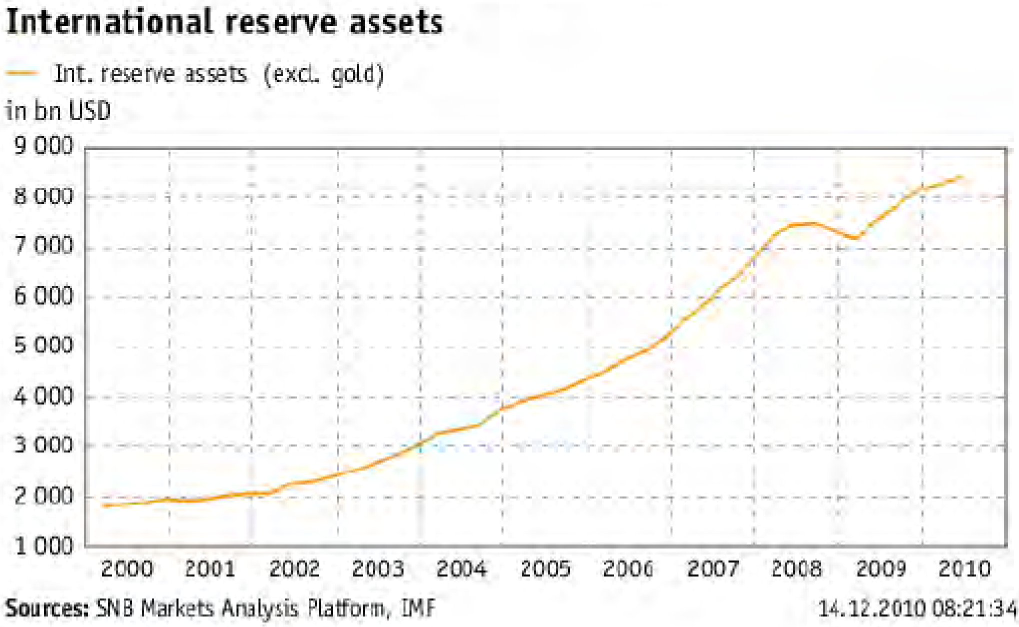


Chart 3:

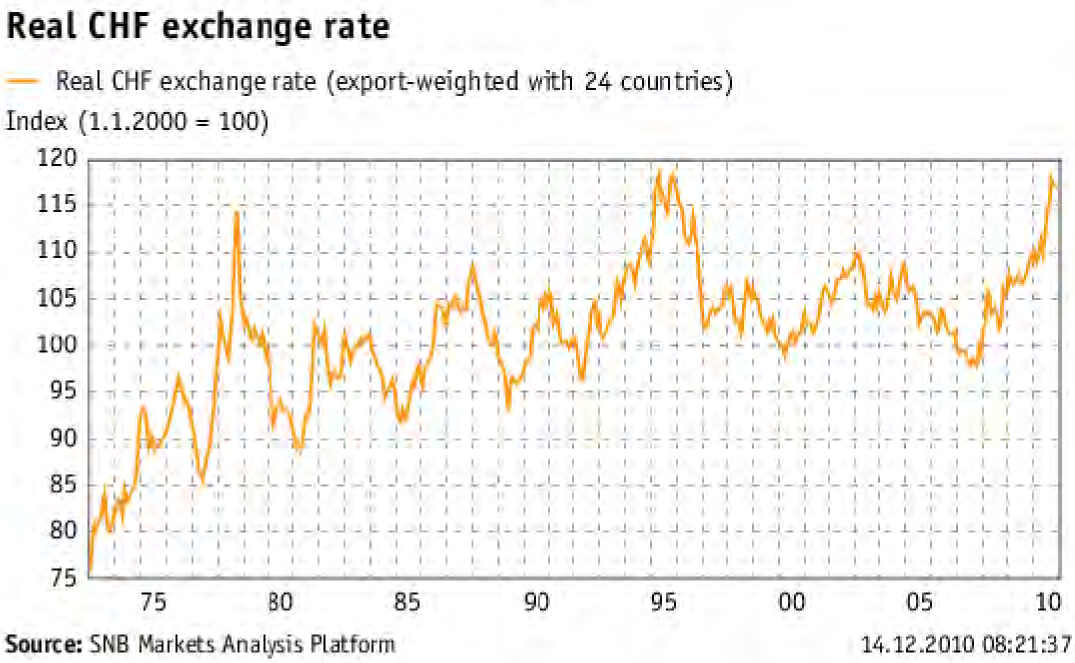
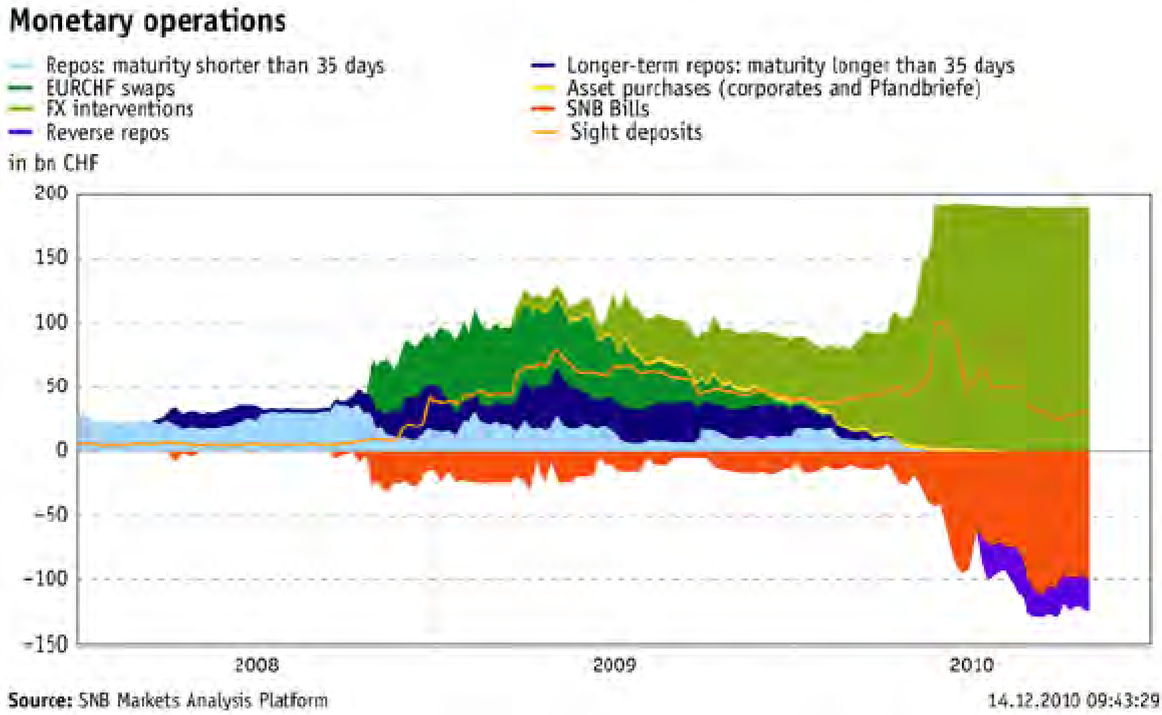


Chart 4 :


Monetary operations
Repos: maturity shorter than 35 days
EURCHF swaps
FX interventions
Reverse repos
Longer-term repos: maturity longer than 35 days
Asset purchases (corporates and Pfandbriefe)
SNB Bills
Sight deposits
in bn CHF
200
150
100
50
0
-50
-100
-150
2008
2009
2010
Source: SNB Markets Analysis Platform
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