

## Philipp Hildebrand: SNB overview of financial market activity

Introductory remarks by Mr Philipp Hildebrand, Member of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Berne, 16 June 2005.

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### 1. Developments in the financial markets

Financial market activity has been dominated in recent months by three key developments. Firstly, the US dollar started to strengthen. Secondly, long-term capital market yields declined further despite their already low levels. Thirdly, changes in credit risk premiums in the different debtor categories have been more mixed than in the preceding months.

Despite the persistently high current account deficit in the US, the dollar has appreciated since the beginning of the year by roughly 12% against both the euro and the Swiss franc, and by approximately 7% against the yen. The dollar benefited in particular from the willingness of foreign investors to back US financial investments. In 2004, net purchases of US securities were dominated by the strong demand from certain Asian central banks. While such purchases have remained significant so far this year, private investors outside the US, too, have bought more US securities. This surge in demand is due in part to the fact that the markets continue to rate the growth prospects in the US better than those in Europe and Japan. The growing yield spread in favour of dollar investments as well as political uncertainty regarding the future development of the European Union have also contributed to the relative attractiveness of the greenback.

At present, there are few indications of any unusually pronounced imbalances between the real exchange rates of the currencies of the large economic blocs. Looking at their development, it becomes apparent that they are all close to their long-term averages (cf. Graph 1). This suggests that the US current account deficit is not primarily a product of exchange rate distortions. It is mainly due to a comparatively high growth momentum and a low savings rate in the US.

Yields in the capital markets continued to fall. While this decline was weakest in the US, yields in continental Europe hit historical lows. In Switzerland, for instance, the yields on ten-year Swiss Confederation bonds reached an all-time low of less than 2%.

The extraordinarily low capital market yields reflect the market's low inflation expectations. During recent months, certain concerns about economic growth have triggered a further decline in yields. Both strong demand for long-term debt securities in industrialised countries (driven by demographic factors) and high savings rates in the emerging markets – particularly in China – have probably also contributed to the generally low level of interest rates.

While 2004 was characterised by a steady and uniform decline in credit risk premiums in the different debtor categories, the past six months saw a less even trend in the credit risk premiums of individual bonds. In the corporate bonds area, the market's attention focused on the two major US automakers. Their downgrading to junk bond status sent a small shockwave through the relevant market segments; other segments have so far remained largely unaffected, however. The credit risk premiums of other corporate debtors rose only slightly and have remained at a historically low level (cf. Graph 2). Meanwhile, those of emerging markets have developed in line with the economic fundamentals of their respective countries.

### 2. Investment policy

A large proportion of the SNB's assets comprise currency reserves. An internationally accepted means of payment in crisis situations, they serve as a safety net for the Swiss economy and the Swiss franc. In order to fulfil this function, these reserves need to be invested in foreign currencies – primarily in the reserve currencies such as the dollar and euro – and in gold. The Bank's leeway for investment was extended considerably with the entry into force of the new National Bank Act in May 2004. This has allowed the SNB to invest part of its currency reserves in foreign equities and corporate bonds. In mid-February 2005, the SNB – having already invested in corporate bonds since June 2004 – turned its attention to the expansion of its equity portfolios. At present, a little over CHF 3 billion are invested in internationally diversified equity portfolios. As the equities are index-managed by external asset

managers, the SNB takes no active decisions regarding the weighting of individual sectors or securities.

In principle, the National Bank does not invest in Swiss equities and corporate bonds, thus avoiding, from the outset, any potential conflicts of interest which could jeopardise the SNB's independence. As a shareholder in Swiss companies, the Bank would risk being confronted with structural issues. It could also lead to a conflict between its monetary policy and investment policy goals if an interest rate hike by the SNB were to erode the domestic companies' profits. Furthermore, such a move could have an adverse effect on prices should the SNB have to liquidate securities of Swiss businesses at short notice. And finally, it is conceivable that the National Bank could gain access to privileged financial market information through its activity in the area of system stability. This would make investing in the Swiss financial sector even more problematic.

The influence of equity portfolios and corporate bonds on the National Bank's risk profile is only moderate. The overall risk attached to assets – as measured by value-at-risk – has not changed greatly since the introduction of these investment options. Gold and exchange rates are still the biggest factors contributing to overall risk. Equities account for less than 5% of the total risk, while corporate bonds contribute only a negligible proportion. The current investment structure and the performance of the SNB's assets are published online on a quarterly basis in an updated appendix to the Investment Policy Guidelines of the Swiss National Bank.

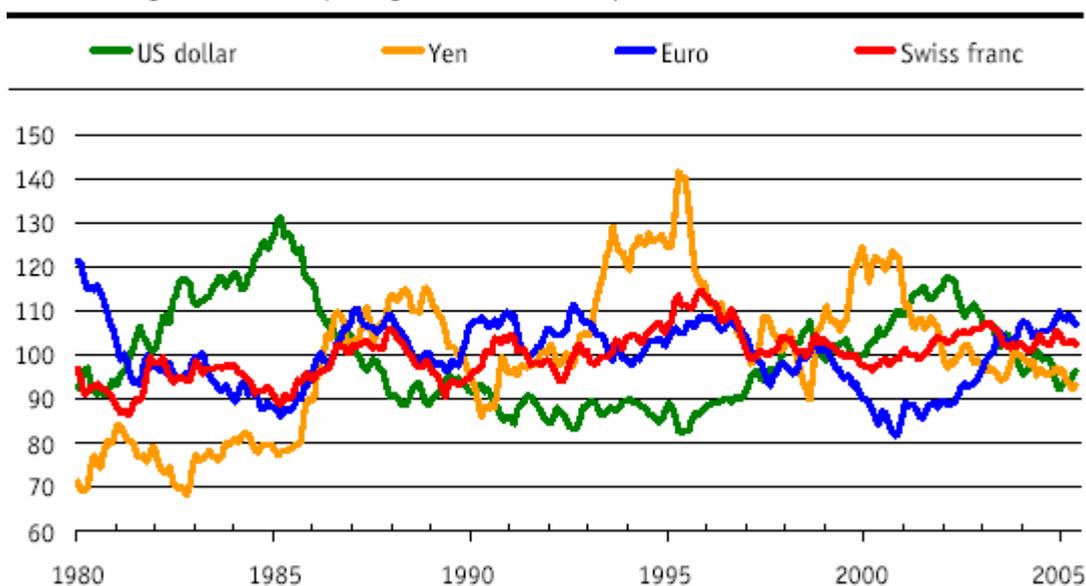
### **3. Risk measurement and management**

The return on the SNB's assets – particularly on currency reserves – fluctuates dramatically from year to year. The absolute loss can be considerable. While it is true that earnings fluctuations have been reduced by the scaling-back of dollar and gold holdings in recent years along with the improved diversification of currencies and investment categories, it is not possible to continue reducing risks *ad infinitum*. Hence, hedging the currency reserves' dollar and gold risks to a high degree, for instance, is impracticable, as these reserves would then no longer serve their intended purpose. Professional risk measurement and management is thus crucial for the SNB.

The risks attached to the National Bank's assets are primarily assessed using the value-at-risk (VaR) method. This widely used risk indicator quantifies the level of loss that will most probably not be exceeded within a specific period of time. The SNB calculates the VaR based on a 95% probability and a time horizon of one year. Value-at-risk analyses are undertaken both for individual portfolios and the total assets. The current VaR for the total assets of approximately CHF 100 billion amounts to roughly CHF 4.5 billion.

A value-at-risk analysis gives no indication of how much could potentially be lost beyond the specified level of 95%. Furthermore, it is based on current risk and correlation structures that are not necessarily an accurate reflection of future risks. This is particularly the case at the moment – at a time when market volatility is low by historical standards. The SNB therefore backs up the VaR calculations with stress and scenario analyses. These simulate extreme market fluctuations and examine the impact of such fluctuations on the assets. Scenarios that have an especially severe impact on the SNB's assets include a fall in the gold price and a depreciation of the dollar and euro. Such scenarios show that serious losses could potentially be sustained. The volatility of the SNB's earnings therefore remains high despite the new investment universe. Experience has shown, however, that major losses tend to even themselves out in the medium term, i.e. over a period of three to five years.

Graph 1  
Real exchange rate indices (average 1980-2005 = 100)



Graph 2:  
Corporate bonds - credit spreads in the US (Merrill Lynch Investment Grade Indices)

