Thomas Jordan: Swiss National Bank monetary policy in light of financial market disruptions

Introductory remarks by Mr Thomas Jordan, Member of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 11 December 2008.

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Situation in the financial markets

Looking at the financial markets, we currently find ourselves in a historically unprecedented situation. The financial crisis has escalated dramatically since September. In the course of the past three months, it has taken hold in almost every market segment around the globe. At the time of the last news conference in June, we had already experienced three waves of money market turbulence; now, a fourth wave has eclipsed all others (cf. chart 1).[1]

The situation in the money markets has calmed somewhat since November. This is due in part to the measures taken by central banks and governments, in particular the generous amounts of liquidity injected into the system, the recapitalisation of banks, the provision of state guarantees for bank liabilities and the transfer of risk positions. After unsecured money markets had all but frozen in the autumn, central banks increasingly found themselves acting as lender of first resort, in other words, they were becoming the primary supplier of liquidity to the financial system. To this end, new monetary policy instruments and facilities were introduced, and the liquidity supply was expanded significantly. Despite the calming in the money markets, the situation in the stock and credit markets continued to worsen as a result of the rapid deterioration in economic conditions.

I would like to illustrate the unique nature of the current situation with a comparison of the Dow Jones Industrial Average from five stock market crises (cf. chart 2).[2] Price declines this time round are significantly steeper than those in 2000 and 1973 and not at all comparable with 1987, when the stock markets recovered very quickly. Measured by the extent of the Dow Jones losses, the current crisis can only be compared to that of 1929. Although the financial losses suffered this time have probably already far exceeded those of 1929. The reason for this is the considerably higher market capitalisation of the stock markets, as measured by gross domestic product (GDP). What is more, the losses suffered today are not merely limited to the stock markets, they also affect practically every other type of asset, of which there are significantly more nowadays than back then. Prices have plummeted across the board, from corporate bonds to structured products, from raw materials and emerging market currencies to real estate investments. While US property prices dropped by 2% in 1929 and 4% in 1930, they are currently falling at a rate of 17%.[3] Never before have so many assets been wiped out worldwide in the space of a few months as they were this year.

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[1] Chart 1 shows the “fever curve” of the money market, i.e. the difference between the three-month Libor and the three-month (T)OIS rate (tom-next/overnight indexed swap). This difference reflects the credit and liquidity risk premium on unsecured money market trades. It is a barometer of the health of the money market and, in the broader sense, also for that of the financial markets in general.

[2] The five crises in the comparison are the stock market crash of 1929, the oil crisis of 1973, Black Monday in 1987, the bursting of the IT bubble in 2000, and the current crisis. In each case, we look at price performance in and around the index’s highest recorded level prior to the crisis, which does not necessarily coincide with the onset of the turmoil. The highest levels were reached on 3 September 1929 (Black Tuesday was on 29 October 1929), on 11 January 1973 (oil crisis), on 25 August 1987 (Black Monday was on 19 October 1987), on 14 January 2000 (IT bubble), and on 9 October 2007.

[3] For annual data and the Case-Shiller Composite 20 Index, cf. Robert J. Shiller, Irrational Exuberance (2006, 2nd edition).

These financial losses alone will continue to have a major impact on the real economy for some time to come, owing to the fact that their full effect is not generally felt immediately.

Despite the historic disruptions in the financial markets, this is not the 1930s. The main differences to back then being the decisive way in which monetary and fiscal policy reacted and the far-reaching government intervention aimed at bolstering the financial system. As a result, the financial markets have been able to continue functioning, albeit to a much lesser extent. Yet the extraordinary circumstances pose a huge challenge to all market participants, not least to central banks. Both the Swiss National Bank's (SNB) monetary policy strategy and its instruments have been thoroughly put to the test. Over the past few months, several observers have remarked that the SNB's monetary policy had occasionally slipped from its control. We do not share this view. While it cannot be ruled out that we will be faced with new challenges, our strategy and instruments have so far proved very flexible and well suited in this crisis.

Implementation of monetary policy

The SNB implements its monetary policy by defining a target range for the three-month Libor; an interest rate for an unsecured transaction. We cannot influence the three-month Libor directly, but rather indirectly through secured money market trades, such as repo transactions and swaps. Before the onset of the crisis, there was very little difference between the interest rates for secured and unsecured transactions. Rising risk premia have since widened the gap between the two rates, however. The high and volatile risk premia have made steering the three-month Libor increasingly challenging.

Tensions resulting from demand for the Swiss franc abroad have recently made steering the Libor even more difficult. In the past few years, a large number of Swiss franc loans have been granted in Europe that were refinanced through the Swiss banking system. Then, last October, many Swiss banks were suddenly no longer prepared to continue refinancing to the same extent, which put a considerable strain on the international Swiss franc money market.

To solve the problem, we decided to offer other central banks a foreign exchange swap facility. Since 20 October, the SNB has been providing the European Central Bank (ECB) with Swiss francs in exchange for euros through its swap facility. The ECB then allocates the Swiss francs to its counterparties in the euro area through swap transactions. A similar agreement has been in operation with the National Bank of Poland since 17 November.

In October, the turbulence in the money market caused the three-month Libor to overshoot the upper limit of the SNB's target range for a few days (cf. chart 3). We do not, however, consider this a strategy failure. The overshoot was preceded by an interest rate reduction that had come as a surprise to the markets. The three-month Libor cannot be expected to return immediately to the middle of the new target range. Even in periods of calm, the Libor does not react instantly to an SNB interest rate reduction and the associated lowering of the repo rates. Considering the historic dimensions of the money market crisis, the three-month Libor managed to return remarkably quickly to the target range – just one day after the two interest rate reductions of 6 and 20 November the Libor had already moved into the new range in both cases.

The turmoil in the money market prompted the SNB to conduct money market operations to an extent that had never before been witnessed. There were days when up to five auctions were held. The volume of the operations varied considerably. On record days, we carried out operations worth over CHF 100 billion. The reason for these sizeable operations can be found in our interest rate management – we first inject large amounts of liquidity into the market and later absorb it again. Until just a few weeks ago, the liquidity actually remaining in the system was not considerably higher than before the crisis. It was not until the SNB adopted a policy of very low money market rates that the sight deposit balances increased markedly. The low interest rate level means that the opportunity costs for banks to hold liquidity are lower, thus prompting them to hold more money in sight deposits. The extent of the money market operations also has a major impact on the size of the SNB's balance sheet. Before the crisis, approximately CHF 20 billion of the balance sheet went towards monetary policy; today, we are looking at around CHF 80 billion.

In recent weeks, the SNB has pursued a policy which has brought the repo rates close to zero. This does not mean, however, that our monetary policy will cease to transmit further expansionary impulses. In addition to the short-term repo rate, we use a whole range of other methods to pursue a more expansionary monetary policy. We can, for instance, extend the maturities of our money market transactions or intervene in markets other than the money market.

Updates to monetary policy instruments

The SNB's monetary policy instruments have fared quite well since the onset of the crisis. However, a review has highlighted two areas in need of adjustment. First, a liquidity-absorbing instrument was found to be necessary, and second, the conditions of the liquidity-shortage financing facility were no longer deemed appropriate. The liquidity-shortage financing facility serves to bridge unexpected, short-term liquidity bottlenecks. It can only be accessed if a bank has a corresponding limit and if that limit is fully covered by securities at all times.

Let's start with the liquidity-absorbing instrument: The crisis has made it clear that a central bank must be able to offer large quantities of liquidity at short notice and do so via a number of channels and with different maturities. Repo transactions and foreign exchange swaps meet these requirements very well. However, the SNB lacked a separate liquidity-absorbing instrument to handle large volumes. We therefore introduced our own debt certificates – SNB Bills – to our range of instruments in October. SNB Bills allow us to be more flexible in steering liquidity. Consequently, we are now in a position to offer more long-term transactions, which help calm the money markets and facilitate the steering of the three-month Libor.

The financial market crisis has also shown us that the liquidity-shortage financing facility can only contribute to calming the situation in the money markets if it is actually used when needed. However, even during the crisis, it was rarely called upon. The reason for this being that the direct costs of drawing on it were relatively high, as were the indirect costs ensuing from the stigma associated with using the facility.

The SNB has thus decided to lower the direct and indirect costs of using the facility. To start with, we will reduce the special-rate interest premium from 200 basis points to 50 basis points. This will become effective from 1 January 2009. The SNB will also make some changes to its reporting methods. In order to protect the borrower's reputation, claims from the liquidity-shortage financing facility will, in future, no longer be reported separately. These two measures should encourage banks to utilise the facility's limits more frequently and therefore increase their liquidity provisioning.

We have also found that, in periods of turbulence, some of the data reported in our weekly publication *Important monetary policy data* are misinterpreted, which can have a destabilising effect. To remedy this, we have decided to discontinue the real-time announcement of individual transactions and facilities. The only data relevant for the assessment of the situation in the money market are those on sight deposits and interest rates. We will therefore continue to publish these on a weekly basis. From now on, data on individual balance sheet items and monetary policy operations will only be published in the SNB's *Monthly Statistical Bulletin*. Thus, the SNB essentially continues to report on its monetary policy operations in a transparent manner, the only difference being that certain data will be published less frequently. Our *Guidelines on monetary policy instruments* have been revised accordingly. These will enter into effect on 1 January 2009.

Transaction with UBS

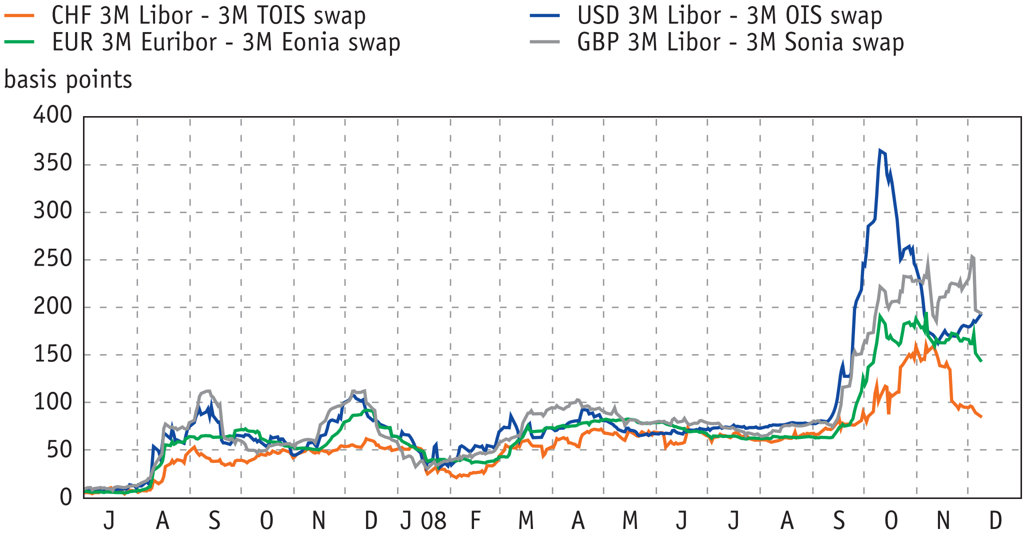
On 16 October, the SNB announced that it had concluded an agreement with UBS on the long-term financing and orderly liquidation of troubled assets in the amount of no more than USD 60 billion. To facilitate this transaction, a special purpose vehicle was set up at the end of November called *SNB StabFund Limited Partnership for Collective Investments*, which is domiciled in Berne. The company is structured as a two-party limited partnership. It comprises a general partner, which bears unlimited liability, and a limited partner, bearing limited liability. Both will be wholly owned by the SNB. The SNB and UBS formed a joint project management team, which is supported when necessary by external specialists.

In the meantime, the SNB chose Northern Trust to act as custodian of the securities. We also commissioned specialised agencies to carry out an independent valuation of the portfolio. An initial tranche of assets is due to be transferred to StabFund before the end of this year.

As regards the financing of StabFund, the SNB will contribute 90% of the funding in the form a loan; UBS, 10% in the form of equity capital. The SNB is currently securing the initial financing for the operation via its swap agreement with the Federal Reserve, but also on the foreign exchange market. It has also initiated steps to later be able to obtain funding on the market, independent of agreements with other central banks.

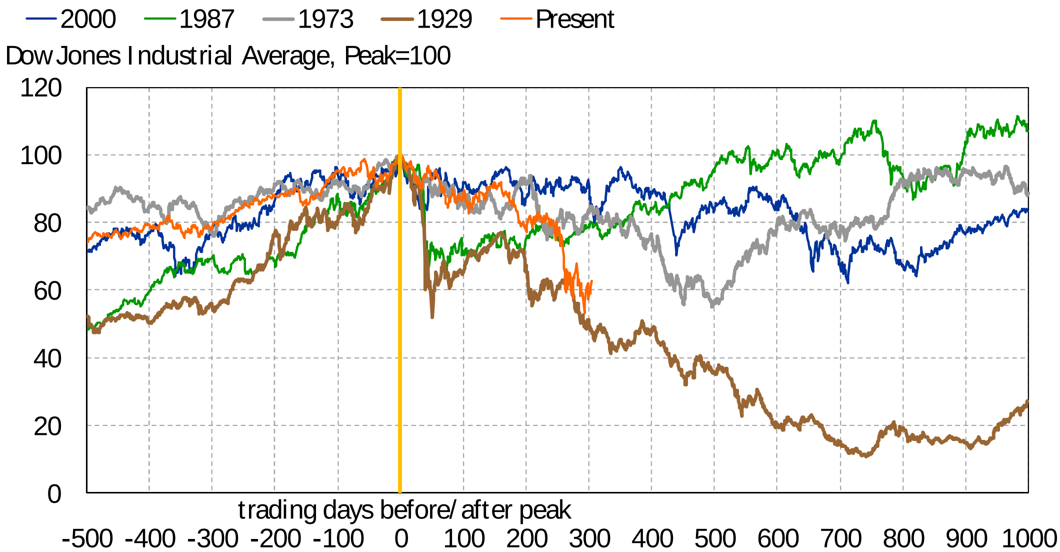
The transfer of assets to the StabFund will be based on prices as at 30 September 2008, with the UBS book value being compared to the value determined by SNB on the basis of the independent expert opinions. The lower value will apply. In October and November, following the intensification of the financial market crisis and the global economic downturn, the prices for these assets were pushed down further. The extent of any potential loss in this initial phase of StabFund's existence will only become apparent at the end of 2008 or at the end of March 2009, once the asset transfer has been completed and another comprehensive valuation has been carried out. It is important to note that StabFund is primarily pursuing a buy-and-hold-to-maturity strategy with the portfolio at present. Short-term price movements have no bearing on the strategy's success. A recovery of the affected markets in the long term is by far the more decisive factor here. Furthermore, the SNB has put in place two safety nets to cushion any losses on its loan to StabFund. First, with the 10% of equity capital from the UBS, and second, with a payment of up to 100 million UBS shares in the event that StabFund needs to be liquidated at a loss. The volatile price movements and severe illiquidity of the markets go to show just how important it was to have unburdened UBS of these risks when we did.

Chart 1: Risk premia in the money market



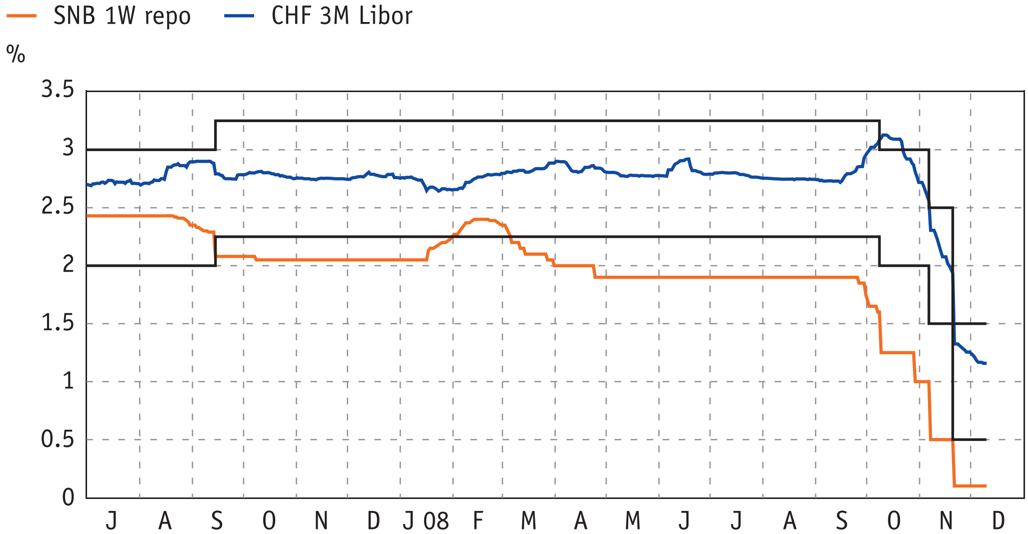
Source: SNB Markets Analysis Platform, Bloomberg

Chart 2: Comparison of share price performance



Source: SNB Markets Analysis Platform, Bloomberg

Chart 3: Target range, three-month Libor and repo rates



Source: SNB Markets Analysis Platform, Bloomberg