

Jean-Pierre Danthine: Signals from the financial markets and developments in the implementation of Swiss monetary policy

Introductory remarks by Mr Jean-Pierre Danthine, Member of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Geneva, 17 June 2010.

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As has been pointed out in the speeches of my two colleagues, reports on the economy are quite positive and indicate a faster economic recovery than anticipated. The signals from the financial markets, however, are less favourable and I will be talking about them in the first part of my remarks. I will devote the second part of my comments today to developments in the implementation of monetary policy over the last few months. These developments result from the unconventional monetary policy measures adopted by the Swiss National Bank (SNB) to combat the financial crisis and to ensure price stability in line with its mandate.

International financial markets experience an uncertain period

The period of calm which prevailed on international markets from spring 2009 onwards gave way to a new phase of uncertainty in the second quarter of 2010. Since April 2010, the climate on financial markets has deteriorated again. Share prices have fallen, credit risk has risen and instability has increased on the major foreign exchange markets. As Philipp Hildebrand has already stated, the return of uncertainty chiefly reflects investors' doubts about the capacity of certain countries to service their debt. These doubts are reflected in a significant increase in risk premia for sovereign debt in these countries, which has prompted them to establish major cost-cutting programmes. This situation is weighing on financial markets, despite the relatively favourable reports of economic recovery at the global level. Indeed, current market uncertainty has reached a high level, although it remains lower than that observed during the recent crisis. To give an example, the VIX index (which measures uncertainty on the equity market) and the CDX index (which measures credit risk) are both rising again. However, they are still significantly lower than at the end of 2008, i.e. at the peak of the subprime crisis (cf. chart 1).

The uncertainty associated with the fiscal situation of certain European countries has also triggered another rise in tension on the interbank market for US dollars. To counter this, several central banks, including the SNB, have reactivated swap facilities in cooperation with the Federal Reserve in order to provide dollar liquidity that may be required for the smooth functioning of the markets. In Switzerland, the interbank market has remained calm. Indeed, the ample supply of liquidity has reduced Swiss franc interbank rates. As can be seen in chart 2, risk premia on the Swiss franc interbank market have also declined. They fell by more than a half in May while, during the same period, US dollar risk premia on the interbank market in the US rose again.

Alongside the uncertainty, investor risk aversion has grown over the last few months. As a result, there has been a movement of capital in the direction of investments that are considered to be more secure (flight to quality). This is reflected, for example, in a rise in the gold price since February 2010. In May 2010, the gold price in Swiss francs reached new heights.

The flight to quality has also had consequences for Switzerland, since our country has traditionally been regarded as a safe haven for investors. This situation has been reinforced by the fact that, until now, the Swiss economy has withstood the crisis better than most developed countries. This has resulted in upward pressure on the Swiss franc, which has led to repeated interventions on the foreign exchange market. The liquidity injected into the market in the course of these interventions has reduced Swiss franc interest rates, in

particular for short term maturities. In addition, the yield on 10-year Swiss Confederation bonds fell to below 1.50% in May 2010. For the sake of completeness, it should be pointed out that the Swiss franc has not been the only currency to appreciate. The yen, the US dollar and the currencies of the Nordic countries have also strengthened against the euro.

Investing foreign exchange reserves

As already mentioned by Philipp Hildebrand, the SNB had to implement unconventional monetary policies in order to combat the financial crisis and avert deflation risks. This resulted in an expansion in the SNB balance sheet, which took place in two stages. In the first stage, during the crisis, the SNB made use of EUR/CHF swaps, while in the second stage, when it was confronted with the appreciation of the Swiss franc, it intervened on the foreign exchange market. As part of these unconventional measures, the SNB purchased Swiss franc bonds issued by private sector Swiss borrowers and temporarily extended the terms of its repo operations.

Today I am going to focus on the impact that the SNB's interventions have on its balance sheet. In these interventions, the SNB purchased euros as well as, to a lesser extent, US dollars. These acquisitions led to a significant increase in currency reserves, which rose from CHF 95 billion in December 2009 to over CHF 230 billion at the end of May 2010.

The foreign exchange acquired through SNB interventions has been placed in securities. The SNB's investment policy is founded on the criteria of security and liquidity, but also return. In order to satisfy the requirements of security and liquidity, the SNB has focused on the purchase of liquid instruments of first-class quality. All investment activity is carried out according to a strategy based upon diversification, while also taking into account potentially major but low-probability events. A further aim of this strategy is to ensure maximum resilience of the SNB balance sheet. For the sake of completeness, let me add that, given the accumulation of additional dollar reserves, the issuance of SNB Bills initiated in February 2009 to finance the SNB stabilisation fund is no longer necessary. Consequently, the SNB will suspend its issuance of SNB USD Bills. The last auction will be held on 21 June 2010.

As has already been mentioned by Philipp Hildebrand, the extent of foreign exchange interventions are leading to a higher risk concentration for the SNB. However, monetary policy considerations remain paramount. Furthermore, we need to keep the overall picture in mind. Thus, since our portfolio is well diversified, no loss has been recorded overall since the beginning of the year. This is due, in particular, to investments in foreign currencies other than euro as well as our gold investments, which also constitute one of our main sources of risk. What is more, the important time period is the long term and over that horizon potential exchange rate losses should be offset (at least in part) by the return on foreign exchange investments. Finally, it must be borne in mind that the SNB has set aside substantial provisions to absorb any possible future losses.

Transition from a liquidity deficit to excess liquidity in the financial system

The unconventional measures taken by the SNB to combat the impact of the crisis and to avert deflation risks have led to an ample supply of liquidity to the financial system. Therefore, we have witnessed a gradual shift from a liquidity deficit to a situation characterised by excess liquidity. In fact, before the crisis, banks had to obtain liquidity from the SNB in order to satisfy their minimum reserve requirements. Today, they have sufficient liquidity to function without having to finance themselves via the SNB. This situation of excess liquidity is of a permanent nature.

The transition from a liquidity shortage to excess liquidity does not, however, change the SNB's monetary policy strategy, which is still aimed at stabilising the three-month Libor within the target range set by the SNB. The implementation of this strategy has nevertheless been

adjusted to reflect the new liquidity conditions. In times of a liquidity shortage, the SNB must supply the markets with liquidity to keep the Libor at the targeted level. If there is excess liquidity, it must drain liquidity from the market in order to keep the Libor at the same desired level (cf. chart 3). This situation can be compared with that of a driver going up a mountain pass. Driving up the hill, he pushes on the gas pedal in order to keep the vehicle driving at a certain speed. On the way down, however, he must step on the brake to continue to travel at the same pace.

Monetary policy with SNB Bills and reverse repos

The SNB is not the only central bank that finds itself in a situation of excess liquidity. The majority of central banks which have taken unconventional monetary policy measures are in the same position. Central banks have a range of measures at their disposal to reduce this excess liquidity. After analysing the different alternatives, the SNB decided to use a combination of SNB Bills and reverse repos. These instruments are perfectly in line with our monetary policy strategy. There is, however, still a range of alternative instruments available, should there be a need for them.

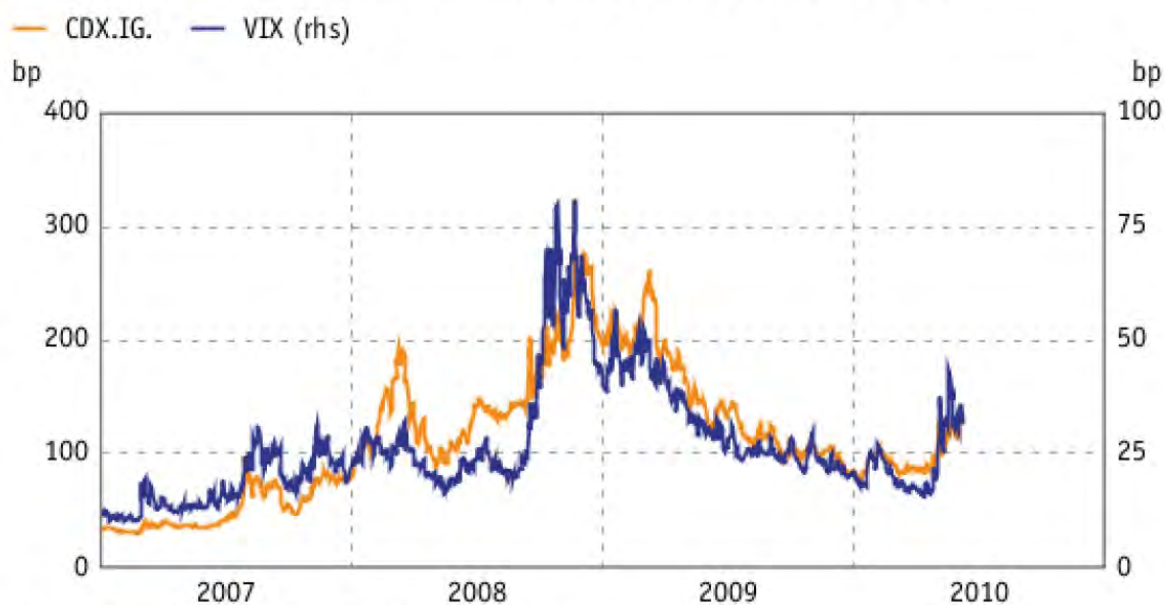
Let me explain briefly how the method chosen by the SNB works. As I have already mentioned, the SNB aims to keep the three-month Libor within a certain target range. This rate depends on the level of liquidity in the financial markets. If there is excess liquidity, the SNB must withdraw a certain amount to influence the level of the Libor. In so doing, it uses a two-pronged approach: on the one hand, it issues SNB Bills with different terms. Banks or investors who purchase these bills pay the SNB with liquid funds, which are thus drained from the financial system. On the other hand, the SNB also makes use of reverse repos in order to complete the withdrawal of liquidity achieved by the use of SNB Bills. In a reverse repo, the SNB delivers securities to a bank in exchange for liquid funds, thereby absorbing liquidity from the financial system. Reverse repos with a term of, in general, one week are used to manage short-term liquidity. SNB Bills, on the other hand, are used to manage liquidity in the longer term (one month or more). By combining these two instruments, the SNB is able to determine the volume of liquidity it wants to drain from the system, thereby influencing the three-month Libor. The SNB continues to use a three-month Libor target range as its reference band for monetary policy.

The use of SNB Bills and reverse repos

The SNB has been issuing SNB Bills since October 2008. At beginning of this month, a secondary market for buying and selling these short-term debt certificates was established. This secondary market improves market liquidity. SNB Bills have other advantages. First, their flexible terms can be adapted to the monetary policy objectives. Second, they permit greater flexibility and can be issued at high volumes.

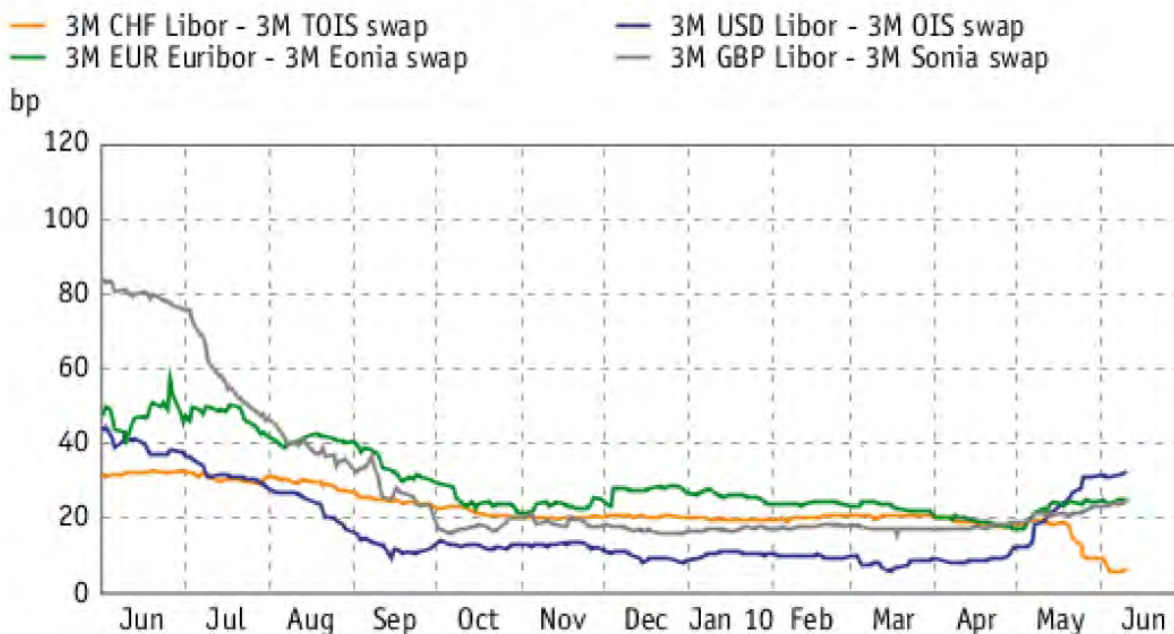
The SNB has been stepping up the issuance of SNB Bills since March 2010. It currently offers SNB bills with terms ranging from one week to three months. The total amount of SNB Bills outstanding last week amounted to about CHF 80 billion. This made it possible to reduce sight deposits to around CHF 70 billion. SNB Bills and reverse repos are characterised by their extraordinary flexibility, allowing for an efficient implementation of monetary strategy that is fully compatible with the monetary policy concept that has been proven and tested for several years now. In employing these instruments, the SNB continues to operate in an environment that is both familiar to and stable for its different partners. It is nevertheless ready to adjust its monetary policy instruments quickly, should this be required by developments in the financial markets.

Chart 1. Credit risk and uncertainty on stock market



Sources: Bloomberg, SNB Markets Analysis Platform

Chart 2. Money market risk premium



Sources: SNB Markets Analysis Platform, Bloomberg

Chart 3. Going from liquidity deficit to liquidity surplus

