Fritz Zurbrügg: Current developments in the financial markets

Introductory remarks by Mr Fritz Zurbrügg, Member of the Governing Board of the Swiss National Bank, at the media news conference of the Swiss National Bank, Berne, 19 June 2014.

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I will begin today by looking at the situation on the financial markets. Then I will discuss structural changes on the foreign exchange and money markets which are of importance for the SNB. I will close with a few comments on the progress that has been made in reforming benchmark interest rates.

Situation on financial markets

The positive sentiment on financial markets overall has continued since the beginning of the year. On the one hand, investors have been encouraged by the fact that economic recovery has continued on both sides of the Atlantic, even if it has been hesitant, as well as by mainly positive business results. On the other, the general low-interest-rate environment, with the accompanying search for yield by investors, is likely to have been a major factor. Nevertheless, this positive sentiment was put to the test on a number of occasions – for instance, in January, when signs of economic weakening and political risk in a number of emerging economies gave rise to considerable uncertainty, and again in March, when the political conflict in Ukraine intensified. The gradual tapering of the US Federal Reserve bond purchase programme, however, was taken quite calmly by market participants.

In this situation, most stock market indices have registered gains since the beginning of the year. Indeed, a number of indices, such as Switzerland's SPI, the US S&P 500 and Germany's DAX, have attained record levels in recent weeks. Meanwhile, demand for sovereign bonds issued by euro area peripheral countries was high. This was attributable, first to a gradual improvement in fundamental data, but also to the fact that investors were anticipating the monetary policy easing measures introduced by the European Central Bank at the beginning of June. Consequently, risk premia against German sovereign bonds declined again significantly. They are currently at levels last seen in 2010, before the onset of the sovereign debt crisis. Sovereign bonds issued by emerging economies also benefited from investors' increasing risk appetite. Despite the uncertainty at the beginning of the year which I mentioned before, their risk premia are now lower than at the end of 2013, apart from a very few exceptions.

Alongside sinking risk premia, volatility on financial markets has also decreased since the beginning of the year. Chart 1 shows the standard volatility measures for US equities (VIX), US government bonds (MOVE) and foreign exchange markets (Global FX), all of which are derived from option prices. To ensure comparability, the individual data series have been normalised. They show how many standard deviations above or below their long-term average the figures are situated. In addition, the troughs since 2000 have been indicated at the right-hand edge of the chart. In January, volatility measures rose temporarily; since then, however, they have returned to a declining path. At present, they are at least one standard deviation below average in all markets – and only marginally above the lowest level. Apparently, expectations that the major central banks will continue their exceptionally accommodating monetary policy in the foreseeable future have firmed. The danger here is that risks will no longer be correctly priced, thereby making financial markets vulnerable to sudden mood swings on the part of investors.

Despite the fundamentally positive investor sentiment, demand for secure investments remains high. Yields on sovereign bonds with high credit ratings have therefore declined significantly since the beginning of the year, particularly in the US, Germany and Switzerland, where ten-year yields are currently around 50 basis points lower than at the end of 2013. The decline in yields was especially marked in January, when uncertainty in a number of emerging economies and surprisingly weak economic data from the US spurred demand. In April and May, yields decreased further. This time, demand was attributable less to the publication of economic data and more to investors who, having speculated on rising yields, had covered their short positions when yields declined. The cautious attitude of many investors was also reflected in the continued high value of the Swiss franc. Chart 2 shows how the Swiss franc has moved sideways against both the euro and the US dollar since the beginning of the year. In trade-weighted terms, the Swiss franc is currently almost unchanged from January.

Structural changes in the foreign exchange and money markets

As you will know, the Swiss National Bank (SNB) implements its monetary policy via the money and foreign exchange markets. Consequently, structural changes in these markets are particularly important to us. I would now like to talk briefly about the major changes and their significance for our work.

On the foreign exchange market, we are seeing a substantial decline in turnover in the primary interbank market. Meanwhile, the size of the market as a whole has decreased only slightly. This means that the interbank market has lost market share. The primary interbank market covers trading via the electronic communication networks. Between 2010 and 2013, turnover through these networks fell by almost 40% overall. In chart 3 you can see an example of this decline in turnover for the EURCHF and USDCHF currency pairs. In 2013, this was already below the previous levels, and a further decline in turnover is becoming evident for the current year. This development is attributable, in essence, to three factors. First, there is an increasing tendency for large merchant banks to use internal clearing for customer transactions. This means that the need for hedging transactions on the interbank market has declined. Second, to an increasing extent, merchant banks are offering liquidity via other electronic distribution channels such as their own trading platforms or multibank platforms. This enables them to attract more business and to benefit from the additional internalisation. Third, smaller banks are increasingly becoming direct customers of larger banks, which means that less trading is taking place on the interbank market.

Nevertheless, because the interbank market allows for price determination and therefore provides reference prices, it performs a key function for the foreign exchange market. Consequently, a well-functioning interbank market is also very important for the SNB. Our analyses show that the decline in turnover has not yet resulted in a deterioration in market quality. Despite the fall in turnover, transaction costs are low and the interbank market is still working properly. However, we are keeping a close eye on developments in the structure and quality of the market.

The focus of monetary policy implementation is currently the foreign exchange market. However, a well-functioning money market is no less important to us. Structural changes have also taken place in this market. On 2 May 2014, SIX Group Ltd commenced operations with a new trading platform for the Swiss money market. Since then, the SNB has conducted all open market operations, all transactions for its standing facilities as well as the auctions for the Swiss Confederation through this platform. This also means that banks can only obtain funds under the liquidity-shortage financing facility through this platform. The successful launch of the new platform can be measured by the fact that 140 foreign and domestic participants already have access, and additional participants have applied to join.

With the introduction of the new platform, collateral eligible for SNB repos has been combined in new baskets. For the first time, the SNB has classified these securities according to the new Basel III liquidity coverage ratio requirements, which require credit institutions to hold a minimum level of high-quality liquid assets so that they can cover an exceptional short-term liquidity requirement themselves. These new baskets therefore meet a significant market need. In this way, the SNB is helping to ensure that the repo market remains liquid, also under the new liquidity requirements.

Reform efforts in the area of benchmark interest rates

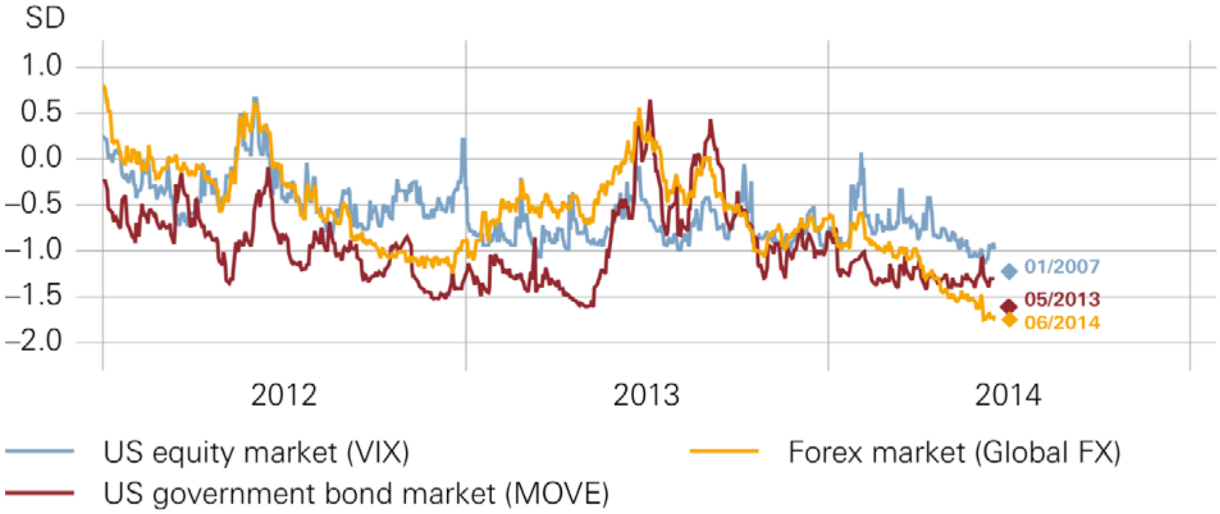
I would like to close by talking about progress that has been made in reforming benchmark interest rates. The international efforts to improve the credibility and acceptance of benchmark interest rates are being coordinated by the Financial Stability Board, whose final report on this matter will be published this summer. As part of this work, a group of private sector financial market participants has drawn up alternatives to the Libor. Data are currently being collected so that the proposals can be evaluated. Surveys are being carried out in all currency areas affected, including the Swiss franc area, and the first results will also be available this summer. Both the final report and the survey results are important steps towards reforming benchmark interest rates.

However, the organisation that will administer the Libor interest rates has already been established. It is ICE Benchmark Administration Limited (IBA), a London-based subsidiary of the US exchange operator, Intercontinental Exchange (ICE). Along with the Bank of England and the Federal Reserve, the SNB is represented as an observer in the IBA oversight committee. Matters discussed by the oversight committee include methodology, definition and data basis for the Libor rates; as such it plays an important role in supporting and evaluating the reforms that have been adopted.

Charts

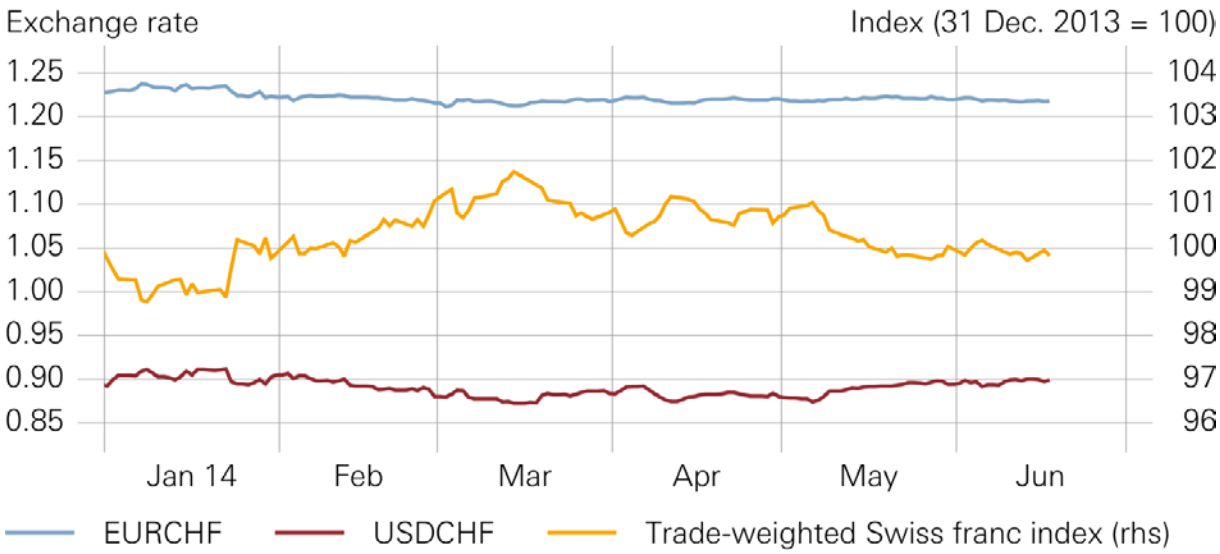
CHART 1: IMPLIED FINANCIAL MARKET VOLATILITY

Volatility indices on US equity, US government bond and forex markets; normalised



Sources: SNB, Bloomberg, CBOE, Merrill Lynch, JP Morgan

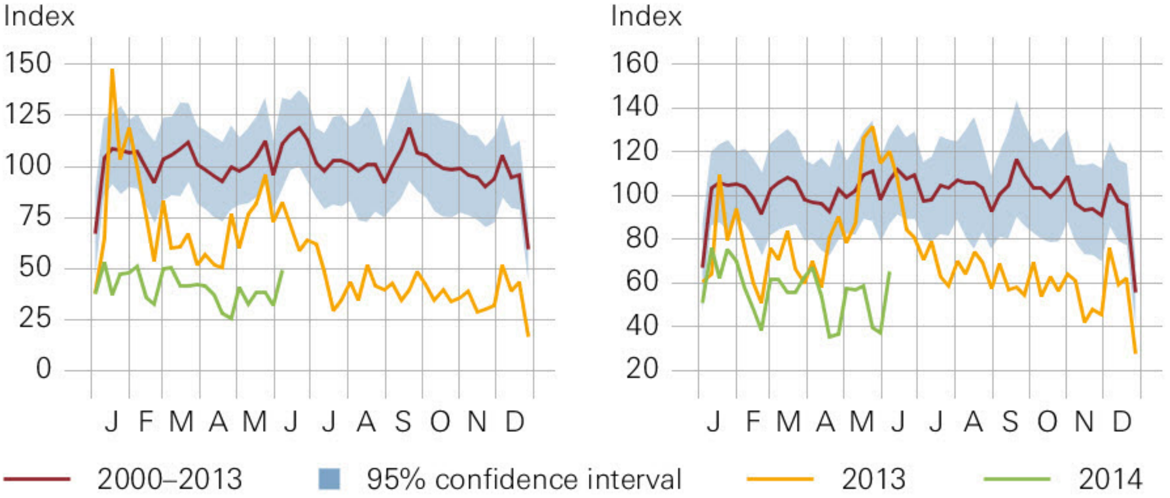
CHART 2: FOREIGN EXCHANGE MARKET



Sources: SNB, Bloomberg, JP Morgan

CHART 3: CHF TURNOVER ON THE PRIMARY INTERBANK MARKET

EURCHF (left) and USDCHF (right)



Source: SNB