

Fritz Zurbrügg: Comments on financial market developments

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, 18 June 2015.

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Accompanying charts can be found on the Swiss National Bank's [website](#).

I will begin with a review of the situation on the financial markets. I will then talk about the implementation of negative interest and its impact on the Swiss money and capital markets.

Situation on financial markets

Since the beginning of the year, monetary policy has continued to be an important pacesetter on the financial markets. This applies first and foremost to Switzerland, where events, especially on the foreign exchange and interest rate markets, were shaped by the discontinuation of the minimum exchange rate and the lowering of the negative interest rate on 15 January. The Swiss stock market experienced a price correction, but losses were rapidly recouped. At present, the SMI is at roughly the same level as the start of the year. Thus Swiss shares benefited from a generally favourable mood among investors. Since the beginning of 2015, all the major share indices have recorded gains – albeit to varying degrees.

On international bond markets, exceptional price movements have been recorded over the past few months, as shown in chart 1. Until mid-April, the government bonds of a number of countries with high credit ratings traded at historically low, or even – in some cases – negative yields. With both this development and the introduction of negative interest, yields on Confederation bonds declined over the entire spectrum of maturities. However, since mid-April, the government bond markets have suffered substantial losses, with yields on ten-year German government bonds, for instance, rising within a very short period from about 0.1% to, most recently, 0.8%. In Switzerland the increase in interest rates was significantly smaller. Yields on ten-year bonds are currently around 0.1%, compared with –0.2% in mid-April.

Since the beginning of the year, numerous central banks have adopted more expansionary monetary policy stances. They include, in particular, the European Central Bank, which in January announced an asset purchase programme in excess of market expectations as regards both the amount and duration. In the US, by contrast, monetary policy continues to point in the opposite direction. Thus, most market participants expect that the US Federal Reserve will initiate a reversal in interest rates before the end of the year. For over a year, this monetary policy divergence has been a major factor behind the depreciation of the euro against the US dollar. As chart 2 shows, since mid-2014, the European currency has declined some 18% in value and has also weakened on a trade-weighted basis, by around 9%. The trade-weighted US dollar, by contrast, has gained approximately 15% in this period.

Another important issue on financial markets has been the increased uncertainty due to the unresolved debt problem in Greece. Despite the fact that risk attitudes, as such, are positive, demand for safe investments and thus for the Swiss franc has remained particularly strong. Consequently, recent movements in the Swiss franc have been influenced not only by the divergence between the dollar and euro regions, but also by persistent safe haven flows.

The discontinuation of the minimum exchange rate led to a very substantial but short-lived appreciation in the Swiss franc. The extent of this appreciation is shown in chart 3. The extreme movements in the exchange rate were accompanied by a sharp increase in volatility on the Swiss franc foreign exchange market. Since then, Swiss franc volatility has declined, although it remains high in a long-term comparison with the period prior to the financial crisis.

At the same time, bid-ask spreads, i.e. differences between the best purchasing and selling offers, widened substantially following the end of the minimum exchange rate. These, too, have declined in the past few months, although the bid-ask spreads remain relatively large. In trade-weighted terms, the Swiss franc is no longer at the extreme levels that prevailed immediately after the discontinuation of the minimum exchange rate. However, it is still some 12% above the level at the beginning of the year. Thus, the Swiss franc is still substantially overvalued.

Implementation and impact of negative interest

Exactly six months ago, on 18 December 2014, the Swiss National Bank (SNB) decided to impose negative interest on sight deposit account balances at the SNB for the first time, setting the rate at -0.25% . When it discontinued the minimum exchange rate, it lowered the rate once again by 0.5 percentage points, to -0.75% . By imposing negative interest on sight deposits, the SNB intends to move the three-month Libor into negative territory and significantly reduce interest rates in the money and capital markets. The lower interest rate makes it much less attractive to hold Swiss francs compared to other currencies. This should lead to a weakening in the Swiss franc over time.

How the negative interest rate is applied

I would like to take a moment to remind you how our negative interest rate is applied. It is imposed on all sight deposit account balances of banks and other financial market participants held at the SNB exceeding a given exemption threshold. For domestic banks, the exemption threshold is 20 times the statutory minimum reserve requirement. For non-banks and foreign-domiciled banks (which are not subject to the minimum reserve requirement), a fixed exemption threshold of at least CHF 10 million has been set. The cumulative exemption thresholds come to about CHF 300 billion. This means that, with current sight deposits amounting to some CHF 455 billion, approximately CHF 155 billion are subject to negative interest. To date, the interest due on this amount has totalled around CHF 100 million per month.

The exemption thresholds take account of the very high level of liquidity in the banking system, which is due to the SNB's past interventions on the foreign exchange market. The exemptions are calculated to ensure that they remain virtually unchanged over time. This means that the interest burden increases as soon as the SNB feeds more liquidity into the system – in particular in the event of further foreign exchange interventions. Consequently, the SNB's readiness to remain active in the foreign exchange market and the negative interest rate are two mutually reinforcing measures.

By imposing negative interest on sight deposits that exceed a given exemption threshold, we set incentives for the entire financial system to give preference to investments in foreign currencies over those in Swiss francs, thereby limiting new inflows into the Swiss currency. Since the exceptional demand for Swiss francs is not only foreign but also domestic, there is no economic argument for differentiating by origin of investor. What is more, we have reduced to a minimum the number of exceptions from the obligation to pay negative interest.

Impact of negative interest

Six months after the announcement of negative interest, we can see that the measure is having the desired effect on the money and capital markets. The money market is working well, even with negative interest. Money market interest rates have reacted rapidly, and the three-month Libor has settled in the middle of the range we targeted. This shows that marginal costs – the costs of an additional unit of Swiss franc liquidity – are relevant for transmission on the interbank market. Although trading activity on the money market remains lower than before the financial crisis, it has revived somewhat. For instance, turnover on the

secured money market, in particular on the Swiss franc repo market, has risen since the introduction of negative interest.

As intended, negative interest has been transmitted from the money market to the capital market. The lower interest rates for all maturities have widened the traditional interest rate differential against other countries again somewhat. Previously, they had narrowed substantially. On the money and capital markets, the interest rate differential is now greater than it was without negative interest, in particular for short-term interest rates. Chart 4 shows the path of interest rates for three-month loans on the Swiss franc and euro money markets, together with the differential. The greater interest rate differential helps to ensure that Swiss franc investments are less attractive than investments in euros and other currencies. Moreover, the rise in the interest rate differential has increased the cost of hedging foreign currency positions on the forward exchange market, which is an additional factor dampening Swiss franc demand. Although the interest rate differential has risen, it is still considerably below the long-term average, particularly since interest rates abroad decreased more substantially during the financial crisis than those in Switzerland. This can be seen in chart 5, which shows the example of interest rate differentials between Germany and Switzerland for three-month, two-year, five-year and ten-year maturities.

While interest rates on the money and capital markets declined as a result of negative interest, mortgage rates did not decrease to the same extent. Indeed, for mortgages with longer terms, rates are slightly higher than they were at the beginning of the year. The main reason for this divergence is that a major part of bank refinancing costs consists of interest paid on savings deposits, which has not fallen below zero as did interest rates on the money market. Because interest on savings deposits is significantly higher than the money market interest rate, bank interest margins came under pressure after they had hedged the interest rate risk associated with their mortgage business, and some mortgage rates were increased. Fears that negative interest might contribute to a significant decline in mortgage rates and, in turn, to stronger growth in mortgage lending have so far proved unfounded.

For investors, by contrast, the current low interest rate environment means that the challenges have increased. It is even more difficult for them to find yield-bearing investments. I should emphasise, however, that this investment predicament is an international phenomenon and not limited to the Swiss franc alone.

Conclusion

I will now come to my concluding remarks. Initial experience has shown that the interest rate instrument is also effective in negative territory. As intended, negative interest on sight deposits at the SNB was rapidly transmitted to all segments of the money and capital markets. In the current situation, negative interest fulfils a very important monetary policy purpose: to help correct the overvaluation of the Swiss franc over time.