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Introductory remarks by Fritz Zurbrügg

In my remarks, I would like to examine three topics. First, I will expand on what, in our view, are the most important developments in the financial markets since the news conference in June. Afterwards I will address the management of our foreign currency investments. Finally, I will explore some of the issues surrounding the Libor rate, and the global discussion on reference interest rates in money markets generally.

Developments in the financial markets

As already mentioned by my colleagues, the situation on the international financial markets has eased somewhat since the last news conference. This stabilisation was mainly due to the announcement in late summer by various central banks of a further expansion of unconventional measures.

In Europe, the unequivocal declaration by the European Central Bank (ECB) to safeguard unity in the euro area had an especially calming effect on markets. Under its Outright Monetary Transactions (OMT) programme, the ECB announced that it would purchase, under certain conditions, unlimited quantities of government bonds with a maximum term of three years. The bonds of peripheral euro area sovereigns, in particular, benefited from OMT. Yield spreads over German government bonds have declined, although they remain at a high level. The euro recovered, on a trade-weighted basis, after having fallen to an eight-year low in July. It appreciated against the US dollar, the Japanese yen, the pound sterling and – to a lesser extent – the Swiss franc. In the US, the Federal Reserve embarked on a third round of asset purchases, intervening in the market to buy agency mortgage-backed securities.

Equity markets initially registered distinct gains. The S&P 500 stock market index, for example, climbed 10% between mid-June and mid-September. This was followed, however, by a consolidation phase from October onwards, which reflected the high levels of uncertainty persisting in the market environment. This uncertainty is largely connected to the emergency policy measures in Greece and Spain, the deterioration in the global economic outlook, and the looming 'fiscal cliff' in the US. Government bonds perceived as safe benefited from this, with yields persisting at extremely low levels.

Against this backdrop, it is notable that the volatility of risky investments has continued to decline. The VIX index, which measures implied volatility on the US stock market, and which is based on option prices, is virtually back down to the level last seen prior to the outbreak of the financial crisis in 2007. A very similar picture emerges from implied

volatilities on the foreign currency and bond markets. The low volatilities are due to comparatively low demand for options to hedge price movements. This suggests that market participants' misgivings about prevailing uncertainties have dissipated somewhat, which is likely not least of all a consequence of monetary policy measures by major central banks. In addition, some investors appear to expect that central banks will continue to pursue expansionary monetary policies for the foreseeable future, with low interest rates and an ample supply of liquidity.

In Switzerland, interest rates remain at a very low level. The yield on ten-year Swiss Confederation bonds declined to a new low at the beginning of December, at 0.39%. No other government has ever recorded nominal ten-year financing costs at such a low level. Money market rates also continue to be very low. Interest rates on the repo market are predominantly negative. At 1 basis point, the three-month Libor lies only just above zero. Based on Libor futures contracts, the interest rate expectations of market participants are that the low rate environment will continue for the foreseeable future.

Management of foreign currency investments

Our foreign currency purchases in early summer to enforce the minimum exchange rate have resulted in high inflows to the SNB's foreign currency holdings. These holdings have increased by CHF 167 billion since the beginning of the year to CHF 425 billion at the end of November. This is a direct consequence of our monetary policy. In the event that foreign currency purchases are necessary to implement the minimum exchange rate, our foreign currency reserves increase, and the balance sheet expands.

Monetary policy requirements also have highest priority when it comes to managing the foreign currency reserves. This is reflected, on the one hand, in the conditions on which we base our investment decisions, namely security, liquidity and performance. On the other hand, the primacy of monetary policy is also evident in the way we implement our investment policy. We proceed here with great caution to avoid causing distortions in the markets.

We take account of the security and liquidity requirements for foreign currency investments by ensuring that a substantial part of our portfolio comprises high-quality government bonds. At the end of September, 83% of foreign currency holdings were invested in foreign government bonds or held as sight deposits at other central banks and the Bank for International Settlements (BIS). A further 5% were held in other investments, mainly corporate bonds. Approximately 96% of our fixed-income securities are rated AAA or AA. Around 12% of the foreign currency investments are in – exclusively foreign – equities. The SNB thereby holds equities to a value of about CHF 50 billion. I would like to emphasise that all of our equity investments are managed passively. We first decide in which markets we want to invest, and then replicate appropriate share indices.

The primacy of monetary policy clearly differentiates the SNB from most other investors. In contrast to these, the exchange rate risk on our foreign currency investments cannot be hedged. This would directly conflict with our monetary policy, since any hedging would be equivalent to a purchase of Swiss francs against foreign currencies, which would intensify the upward pressure on the Swiss franc. Therefore the broadest possible

diversification of our foreign currency investments is our sole means of reducing exchange rate risk. At the end of September, 48% of foreign currency holdings were invested in euros, compared with 60% at mid-year, with 28% invested in US dollars, and 24% in other currencies. We are continuously evaluating new asset classes and currencies in both advanced and emerging economies; this year, the SNB began investing in the South Korean won. Our goal is to further diversify our foreign currency investments and thereby reduce risk concentration.

To avoid undesirable third-market effects, our entire investment activity is invariably undertaken with a high degree of prudence and caution in respect of potentially adverse effects on markets. This applies equally to inflows and reallocations of investments, as well as to the establishment of new positions. If, for example, we see ourselves confronted with very high foreign currency inflows, we might place these in sight deposit accounts at other central banks, before investing them in securities. The SNB has absolutely no interest in causing market distortions or influencing currency movements in other countries.

Issues surrounding the Libor and reference interest rates

I would like to conclude by exploring some of the issues in connection with the Libor rate, and the global discussion on reference interest rates in money markets generally. Incidents of the Libor being manipulated, whether already admitted or suspected, are problematic for the reputation of the banks involved, and for the financial sector as a whole. This discussion on the Libor is also significant for us, because we use the three-month Libor in the implementation of monetary policy. No Swiss franc Libor distortions relevant to monetary policy have thus far been ascertained. Furthermore, an SNB survey conducted among banks this year confirmed that the Libor remains an important variable for credit transactions, namely for mortgages. Of the banks surveyed, 80% indicated that they use the Libor as a benchmark for pricing loans. It also continues to play a key role in the pricing of financial products and derivatives. Neither the sharp decline in unsecured loans on the interbank market nor the incidents of manipulation have so far changed this.

In July 2012, the Financial Services Authority (FSA) in the UK was commissioned to undertake a review on reforming the Libor. At the end of September, the working group convened for this purpose presented its findings in the Wheatley Review, which included a series of proposed measures. These aim to prevent further attempts at manipulation, and to restore confidence in the Libor. The report recommends, inter alia, that rate-setting processes and their oversight be improved, and that certain maturities and currencies be withdrawn. Under the proposals, the three-month Swiss franc Libor will continue to be determined. Thus at present, there are no consequences for the implementation of our monetary policy.

Discussions are also currently underway at the international level on the meaning and structure of benchmark interest rates on money markets. The SNB, as member of a BIS working group, is also involved in these discussions. From the point of view of monetary policy and financial stability, the working group identifies core requirements for credible and robust reference rates. Central banks or banking oversight bodies could play a

supportive role in reform efforts, inasmuch as the extensive use of benchmark rates affects the general public. However, since reference interest rates are primarily there to cover the needs of the financial markets, market participants are themselves ultimately under obligation.