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Interest rate and monetary situation

The year 2000 saw ambivalent interest rate and monetary developments. On the interest rate front, short-term rates rose while long-term rates remained stable or were on the decline. In view of robust and dynamic growth, the central banks, including the National Bank, had to raise their key rates markedly in the first half-year. This had the gratifying effect of very slightly dampening long-term interest rates, a development also supported by significant improvements in government budget prospects. Given the remarkable economic growth in Switzerland and in other countries, current interest rates are, by historical standards, at a conspicuously low level. The chances of a continued positive economic development accompanied by low inflation risks therefore seem to be good.

During the current year, the Swiss franc underwent a sometimes marked decline vis-à-vis the US dollar, while appreciating against the euro. In the wake of this contrary development, the export-weighted price index remained fairly stable. In other words, positive and negative exchange rate effects on the economy as a whole more or less balanced each other out. Such shifts in the exchange rate can, of course, have considerable implications for individual sectors and enterprises, depending on the currency distribution of income and expenditure. The high US dollar rate stimulates exports and makes imports more expensive, while the low euro exchange rate is a handicap for exports to the euro area and facilitates imports.

Given the exceedingly dynamic pace of economic activity and renewed full employment in our country, the disengagement of the Swiss franc from the weakening trend of the euro at the end of March was an altogether desirable development. This supported the National Bank's efforts to tighten monetary conditions somewhat by gradually raising interest rates. The financial markets interpreted this development as confirmation of the independent monetary policy course. The interest rate bonus, which has risen since then, goes hand in hand with the renewed significance of the Swiss franc as a diversification currency.

On the foreign exchange markets, however, the enduring weak trend of the euro was the central event of the year now drawing to a close. The growth differential between the United States and the countries of the European Monetary Union, which is narrowing in line with expectations, has succeeded in stabilising the euro in the past few weeks. To what extent interventions by the central banks have contributed to this is open to question. In principle, the chances of success of sterilised interventions, i.e. interventions with neutralised effects on liquidity, are limited. Experience with the euro has taught us that we have an imperfect understanding of the determinants of short- and medium-term exchange rate movements. In cross-border business, it is therefore of vital importance to assess exchange rate risks consistently and to steer them in such a way that even unexpected changes can still be coped with economically.

Steering of the interest rate - a first assessment

With the monetary policy concept presented a year ago - and which rests on three pillars: definition of price stability, inflation forecast and Libor target range - the National Bank has switched, on the operational level, to steering the interest rate after previously having primarily steered the money supply. What is our experience with this new policy? Let me first reiterate the principles of the steering method applied today: the target range for the three-month Libor rate reflects our monetary policy intentions. Within the target range, a band of one percentage point, we allow for a controlled fluctuation of the Libor rate. As a rule, we keep this interest rate around the middle of the target range. If this is necessary from a monetary policy point of view, we can let it rise or fall to the upper or the lower part of the band respectively. We steer the Libor rate indirectly by means of repo transactions with maturities of a few days or weeks, while the Libor rate applies to three-month investments. This distinguishes our steering method from the key interest rate regime of other central banks, which aim at a very short-term interest rate and transact business directly at this rate. We have opted for the three-month rate because, on the one hand, it is less susceptible to technical market disruptions and, on the other hand, it is more sensitive to economically relevant changes impacting on the Swiss franc money market from abroad or from the capital market.

In retrospect, the new steering regime has so far stood the test (cf. enclosed graph). The target range and the Libor rate as a reference rate are already firmly entrenched in the monetary policy discussion. As was to be expected, all parties concerned had to become accustomed in practice to the new steering concept. Thus numerous market participants at first concentrated on repo rates as the transmitters of signals, which led to increased movements of the Libor rate within the target range. In the meantime, the insight has gained ground that monetary policy signals emanate from shifts in the interest rate band - or possibly from the new positioning of the Libor rate within the target range.

Despite the misgivings expressed by a few persons in the early stage, there were never any serious doubts that the Libor could be steered. By and large, we were quite successful in steering it to the desired level, or to keep it there. This also applies to the first half-year, when we had to adjust the target range and the Libor position upward at relatively short intervals. Precisely in such phases, the Libor rate is a better transmitter of monetary policy signals than the repo rate. To some extent, the repo rate is subject to purely technically induced fluctuations whose stabilisation would be counterproductive from a monetary policy point of view. We also do not intend to adjust the width of the target range. It provides us with the necessary interest rate flexibility without undermining the significance of the target range as a signal for the market. A narrower target range would have obliged us to announce interest rate steps at intervals that would have diminished the credibility and transparency of the new concept.

Repo business made a major contribution to the positive results of interest rate steering. The fully automated repo trading and settlement platform gives us a maximum of operational flexibility. At the beginning of the year, we therefore switched to repos for steering the entire money market and are now holding the traditional instruments (foreign exchange swaps, placement of Confederation funds) in reserve for special cases only. We can transact and settle repo business on a continuous basis at variable conditions and in varying amounts with all counterparties linked to the system practically at any time during the day.

Thanks to the efficiency of the repo system, the circle of participants has widened to currently 90 banks, which conclude transactions among themselves or with the National Bank. Approximately 40 of these banks participate in our repo auctions including, in the meantime, renowned institutions from abroad. The direct link to the National Bank gives the participating banks advantages in liquidity management, but most of all it strengthens competition on the Swiss franc money market, thus enhancing the efficiency of price formation, which, in the final analysis, benefits all participants. With this opening, the influence of the big banks on conditions on the money market was reduced. Their share in total outstanding liquidity transactions has declined from more than 80% to now approximately 50%.

For just over a year now the SNB has, moreover, offered the banks interest-free intraday liquidity. Every day funds totalling approximately Sfr two billion are drawn. This transaction is intended to facilitate cashless payment transactions. Since the introduction of intraday credit, payment flows in SIC have become more regular in the course of the day. In particular, the accumulation of unsettled payment transactions in the runup to daily clearing settlement has declined markedly. This measure helps to ensure the safe functioning of our payment system.

Libor steering in the course of the year 2000

