News Conference

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Introductory remarks by Bruno Gehrig

Interest rate and monetary situation

Interest rate changes during the past half-year mirror the changes in the economic outlook. These movements, however, showed an uneven development. Owing to the Fed's five interest rate adjustments, short-term rates declined significantly, especially in the case of the US dollar. Long-term rates, however, rose in most major currencies and are higher today than at the beginning of the year. As a result of this development, yield curves are now back in a "normal", ascending shape, which is typical for growing economies. Inflationary risks might also be contributing to the rise in long-term yields. The Swiss franc interest rates followed the international interest rate trend only to a limited extent. Yields on long-term Confederation bonds are more or less as high as at the beginning of the year. The yield differential between Swiss franc and euro-denominated investments - which has widened somewhat - reflects the difference in inflation rates between the two currency areas. The yield gap between long-term investments in euros and US dollars also roughly corresponds to the difference in inflation rates. Real interest rates, therefore, have undergone an alignment internationally.

After declining sharply at the end of the past year, the US dollar has regained strength since the beginning of 2001. Its recovery has been underpinned both by the expectation that the economic slowdown in the US would only be short-lived and by a dimmer economic outlook in some European countries. Once again, fundamentals (interest rate and growth differentials, current account balances) fail to account satisfactorily for the changes in the euro-dollar exchange rate. The performance of the Swiss franc was shaped mainly by these transatlantic exchange rate variations. At the end of May, the franc was quoted approximately 6% below its average value for the year 2000 against the dollar, whereas it fluctuated within a narrow range vis-à-vis the euro. The volatility of this currency pair is currently lower than at any time since the spring of 2000. It would be risky, however, to simply extrapolate the current exchange rate stability into the future. Experience has taught us that exchange rates can change quickly and unpredictably.

International equity markets have stabilised and recovered somewhat. Taking a long-term view, it is apparent that different equity markets seem to influence each other to a greater degree than was the case previously and that their performance is often in step. Switzerland is a special case, as its market movements - due to a different sector composition of the index - correlate less strongly with developments at other international exchanges. Consequently, international diversification is extremely important for Swiss investors. For the same reason, Swiss equities are also attractive in

international portfolios. At the global level, there are obvious parallels in market trends in the individual sectors. As a result of globalisation, many companies have similar production structures and are active in the same international markets. Changes in technological potential and market perspectives thus have comparable repercussions on the profitability of all enterprises in a sector.

Monetary policy relevance of equity trends

With the downslide in equity prices on international stock markets - precipitous in part and hitting the technology sector hardest - the question as to the monetary policy relevance of equity market trends was increasingly brought to the forefront. First of all, let me state that it is the core task of stock exchanges to rate companies and hence also adjust their valuation. In this sense, there is no such thing as a "correct" valuation, but only varying assessments of future prospects. Naturally, the SNB's stability mandate does not take equity prices into account. The question as to whether stocks are over-priced or under-priced does not enter into monetary policy considerations as such. But equity prices can nevertheless indirectly influence monetary policy in certain situations:

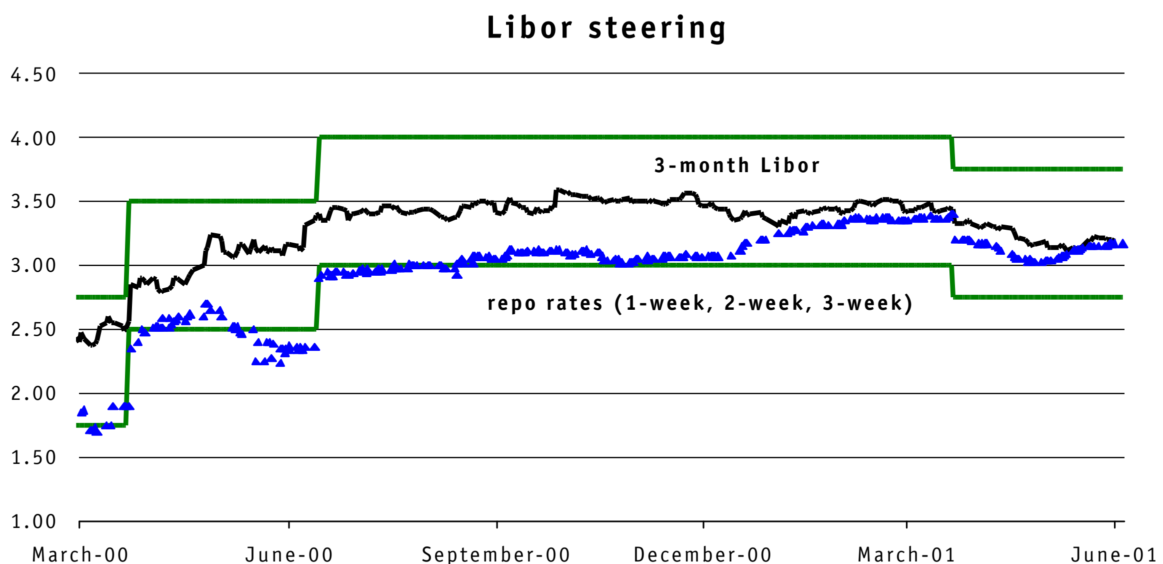
As with other assets, prices of equities affect monetary policy to the extent that they influence economic activity. Firstly, stock market slumps can disrupt the financial system, which in turn can interfere with the granting of credit. In such situations, monetary policy can only have a short-term tempering effect. Secondly, a change in the price of assets can have a direct impact on overall demand. Individuals who feel wealthier consume more, and companies that can easily gain access to cheap capital as a result of a high valuation invest more. This wealth effect can alter the transmission of policies. How relevant is the wealth effect? In the United States, where the savings rate is now very low and stock ownership commonplace among consumers, there are fears that a negative wealth effect might accelerate the economic downturn. So far, such fears have not yet materialised, however. In Switzerland, the situation is a little different: the savings rate has traditionally been high and stable in our country. In addition, equity ownership is more heavily concentrated among institutional investors and wealthy individuals than in the United States. No exact data is available on the distribution of private stock ownership in relation to the various other types of assets. In the past, however, numerous pension funds have been able to pass on considerable portfolio returns to their members in the form of premium rebates. This has led to an increase in disposable income and has perhaps fuelled consumer spending. Even so, the wealth effect triggered by equity price fluctuations is not likely to have had a significant impact given the conditions in Switzerland. The situation on the labour market is of considerably greater importance in terms of consumer spending and the overall business activity.

Every so often, we have heard calls for central banks to take preventive measures whenever "exaggerated" equity price movements are on the horizon, thereby evening out index fluctuations. This is unrealistic or even counterproductive. Unrealistic, because it assumes that the central bank has a deeper insight into stock valuations than is actually the case. Counterproductive, because such a promise would increase investors' readiness to take risks, thus triggering a dangerous distortion. Furthermore, the high volatility of

the stock index would carry over to monetary policy - a development which would be diametrically opposed to the bank's stability mandate.

Monetary policy steering

During the past five months, we have seen that even with the market keenly expecting an interest rate cut - emanating from the international environment - Libor steering can still be handled satisfactorily. In the second half of 2000, the market was still expecting relatively stable money market rates. The spread between our repo rates and the Libor, therefore, remained fairly constant as well. When short-term interest rates began to plummet in the US, money market rates came under pressure in Switzerland too. Against this backdrop, Libor steering became a little more difficult. In order to keep the Libor in the middle of our target range, we raised the repo rates, thus simultaneously tightening liquidity. This resulted in a narrowing of the spread between the repo rates and the three-month Libor. From a purely technical point of view, we would have the means to keep the Libor in the middle of the target range at all times. However, this is not our intention in every case. The Libor target has been consciously defined as a band, which allows for certain fluctuations. We have repeatedly signalled to the markets that repo rates should not be seen as a monetary policy indicator. Our monetary policy intentions - aside from our public comments - are communicated by the positioning of the target range.



Development of monetary policy instruments

Since the beginning of last year, we have been conducting monetary policy exclusively by means of repo transactions. Foreign exchange swaps, which used to be our most important instrument, are now only used in exceptional circumstances. This was not necessary in the last year and a half. Repo transactions are an extremely flexible instrument, allowing us to meet different needs with one and the same tool. Interest-free intraday liquidity is also offered by way of this instrument. Efficient processing, based on the delivery-versus-payment principle, can largely exclude the settlement risks inherent in foreign exchange swaps. It is important to us that repo auctions - unlike foreign exchange swaps - are

taken advantage of by large number of banks. Within the statutory limits, we can adapt the collateral we accept in line with changing needs: as of this spring, for example, we have been accepting a third bond basket consisting of euro-denominated mortgage bonds. This has made it easier for foreign institutions to participate in our repo auctions. Their interest in these auctions is likely to increase once the newly-created CLS Bank starts business in October. This bank offers a multi-currency processing system for foreign exchange transactions. International banks need liquidity in different currencies, Swiss francs among others, in order to carry out their transactions. Consequently, it might be an interesting option for some foreign banks to obtain their franc liquidity directly from the SNB.