Foreign currency-related risk-taking by financial institutions, firms and households

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1. Welcome

Ladies and gentlemen, it is a great pleasure for the Swiss National Bank to welcome you to this wonderful conference venue in Zurich. We are delighted to bring together leading academics, policymakers and private sector representatives to discuss the microeconomic drivers and macroeconomic implications of *foreign currency-related risk-taking by financial institutions, firms and households*. Over the next two days, you will debate recent research on why economic agents choose one currency over another in their economic transactions, and how this impacts on macroeconomic and financial stability. Before you do so, however, I would like to explain briefly why the Swiss National Bank is so interested in these issues.

2. Motivation for the conference

The topic of this conference is relevant for the two main tasks of the Swiss National Bank: maintaining price stability and contributing to financial stability.

The primary task of the SNB is to ensure **price stability**. With Switzerland being a small open economy, the exchange rate plays quite an important role in the determination of prices. A depreciation, for instance, tends to increase the price of tradable goods. Moreover, it stimulates activity and can thus add to price pressures. Understanding how foreign currency risk-taking affects our exchange rate is therefore important to us. As an example, let me mention the widely reported phenomenon of carry trades. The Swiss franc is often cited as a major funding currency, with estimates of Swiss franc carry trades reaching more than CHF 800 billion in 2007.[1] This exceeds both the volume of domestic lending in Switzerland and Swiss annual GDP. As a consequence, carry trades have been argued to be a major force behind the weakening of the Swiss franc in recent years.[2] Understanding what drives these carry trades, how they have impacted the exchange rate in the past, and how a reversal of these positions may affect exchange rates in the future is of key significance for Swiss monetary policy.

An increasingly more important task of the Swiss National Bank is to contribute to the **stability of the financial system**, which is not only crucial for maintaining real economic activity, but also for the implementation of our monetary policy. While the SNB is not

[1] "Yen and Swiss franc used for speculative bets", *Financial Times*, 3 September 2007.
[2] "The Domino Effect", *Economist*, 3 July 2008.

legally responsible for the oversight of individual financial intermediaries, we are strongly involved in overseeing developments in the banking sector which could be of systemic relevance. As you are certainly aware, the exposure of Swiss banks to the real estate market in the US is one such incident. And we are naturally keeping a very close eye on the development of that crisis. What you may be less aware of, however, is that recent developments in real estate markets in Europe have also become of interest to the SNB. In several European countries, the Swiss franc is increasingly being used by households as the currency for their mortgages. In Austria, for example, 30% of total mortgage lending is in Swiss francs, rather than in euros. In Poland and Hungary, more than half of all household borrowing is in Swiss francs, rather than in zlotys or forints. Indeed, recent research by SNB economists suggests that, at the end of 2007, more than CHF 350 billion in Swiss franc loans were outstanding in other European countries.[3] For the SNB, this phenomenon raises the immediate policy question of the degree to which our banks are exposed in refinancing these loans, and what this could mean for financial stability in Switzerland. Fortunately, our research suggests that, in Austria, where Swiss banks are involved in refinancing Swiss franc loans, the underlying risk is low, as households taking Swiss franc mortgages seem to be the most creditworthy ones.[4] As for Poland and Hungary, where the underlying credit risk of Swiss franc mortgages may be higher, Swiss banks are hardly involved in refinancing these loans at all.

The phenomenon of Swiss franc lending in Europe and the more general phenomenon of financial "dollarisation" – or perhaps I should call it "francisation" – is, however, of interest to the SNB beyond their immediate implications for Swiss banks. A further key activity of the SNB's is to contribute to the **stability of the global financial and monetary system**. The SNB is an active member in the international financial system, with a representation at the International Monetary Fund, the Group of Ten (G10), the Bank for International Settlements and the Financial Stability Forum. In these forums, we have been regularly involved in discussions on currency and monetary matters, and their financial and macroeconomic implications. In hindsight, we now know that the macroeconomic policy and financial regulation of several Asian countries prior to the Asian crisis in the 1990s as

[3] M. Brown, M. Peter and S. Wehrmüller: "Swiss franc lending in Europe", mimeo, August 2008.
[4] C. Beer, S. Ongena and M. Peter: "Borrowing in Foreign Currency – Austrian Households as Carry Traders", mimeo, September 2008.

well as the international policy response to that crisis were less than optimal. But in view of the increasing "dollarisation" of Eastern Europe, do we really know how to prevent such crises in the future or how to tackle them if they arise? The SNB is convinced that we can contribute to reducing the occurrence and impact of future currency crises by improving our understanding of previous crises and the microeconomic behaviour underlying them. This is why we are strongly interested in the research that will be presented here on these topics.

3. Concluding remarks

Ladies and gentlemen, given the openness of our economy, the international use of our currency and our strong role in the international financial system, the SNB has a vested interest in encouraging research on foreign currency-related risk-taking by financial institutions, firms and households. We are therefore very pleased that such a broad array of related research will be presented at this conference.

This morning, the **first session** of the conference will examine the drivers of foreign currency choice by borrowers, at the household, firm and national level. The **second session,** this afternoon, will examine patterns of foreign exchange markets and the impact of dollarisation on monetary policy. The **third session**, tomorrow morning, will go beyond borrowing behaviour to examine more generally foreign currency hedging by firms. The **final session**, tomorrow afternoon, will examine the impact of currency mismatches on financial stability and growth and how this may be mitigated by regulation.

I am confident that the participation of researchers and practitioners with backgrounds in banking, finance and macroeconomics will contribute to a broader understanding of the determinants and impact of foreign currency use. I hope that the interaction between economists from these different fields will also help us to identify areas where further research is required. I wish you an interesting and rewarding stay in Zurich.