News Conference

Zurich, 13 December 2002

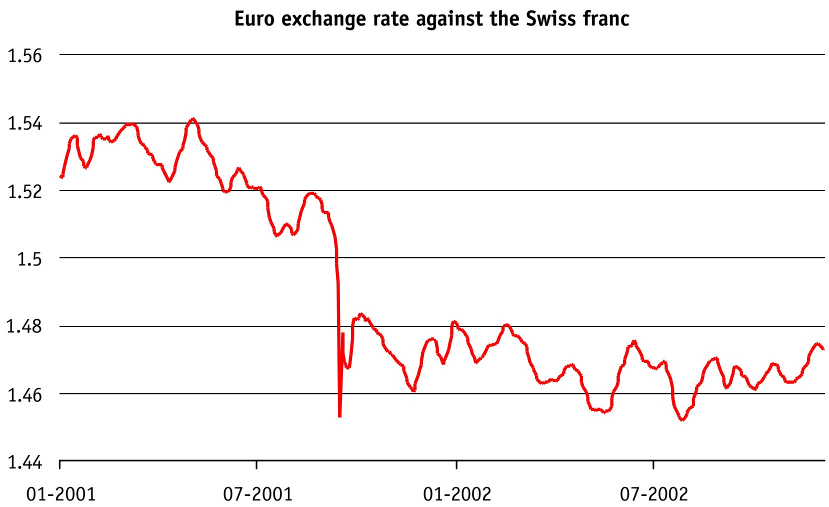
Introductory remarks by Bruno Gehrig

The past year was an eventful one for the international financial markets. The global deterioration in economic prospects and eroded investor confidence deepened the stock market slump as from the middle of the year. Parallel to this development, the interest rate level continued to fall. The central banks contributed to the interest rate reduction. However, with risk premiums increasing at the same time, financing conditions failed to improve for many companies but actually often deteriorated.

Foreign exchange

Following the steep slide of the US dollar, exchange rates stabilised again from mid-year onward once it had become clear that the growth slump was affecting all major economic regions equally.

The Swiss franc fluctuated within a relatively narrow margin to the euro this year. The geopolitical uncertainty premium applied to the Swiss franc after the shock of 11 September 2001 is still being paid (see graph).

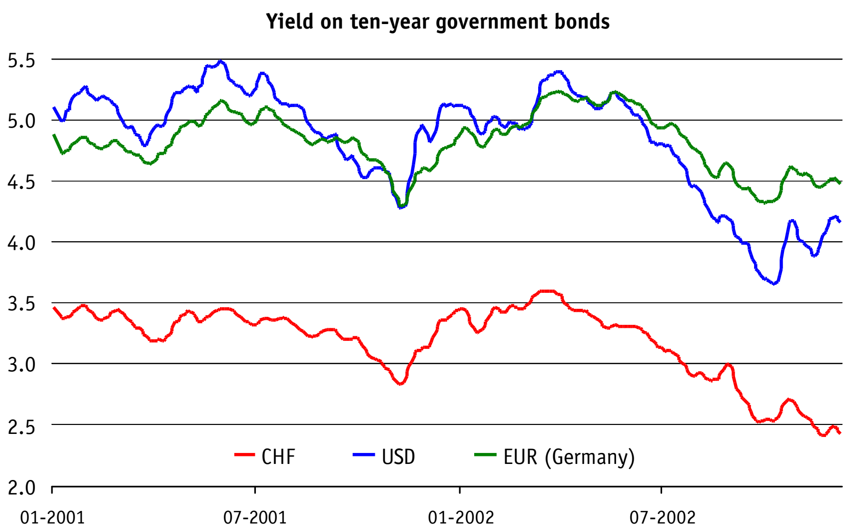


In the current year, we again recorded phases of heightened upward pressure on the Swiss currency. We tried to counteract the negative consequences of the strong Swiss franc and the risk of further upward movements by lowering the interest rate several times. Since the beginning of September 2001, the key interest rate differential between the euro and the Swiss franc has widened from one to two percentage points. The yield on long-term bonds in Swiss francs is also around two percentage points below that on corresponding euro paper. This has lowered the attractiveness of the Swiss franc somewhat compared with the euro.

The stabilisation of the euro/Swiss franc relationship – albeit at a relatively high rate for the Swiss franc – is a positive development. Experience has shown that the exchange rate development has a significant influence on business activity in Switzerland. We are still determined to counteract any additional upward trend of the Swiss franc that might jeopardise the economic recovery.

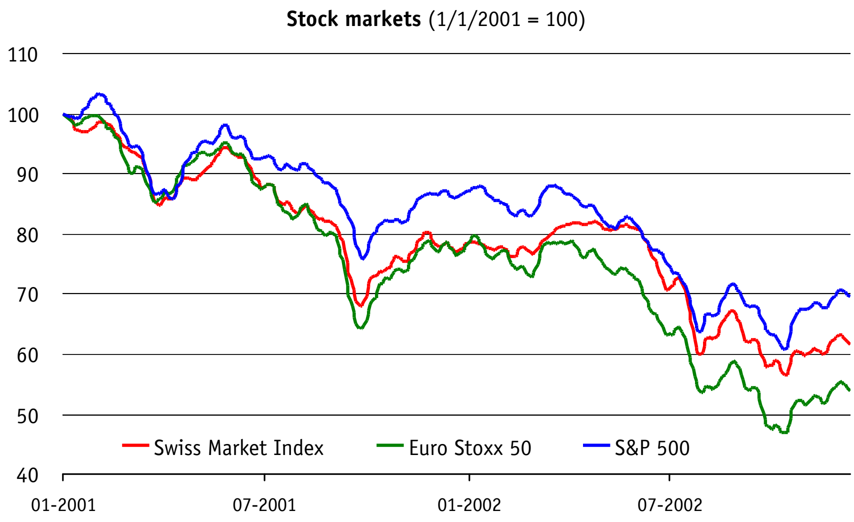
Bonds

In the capital markets around the world, nominal yields dropped considerably (see graph). However, borrowers with medium and low credit ratings did not benefit much from this development as credit risk premiums rose during the year. This also limits the macroeconomic stimulus effect of the yield decline. In addition, real interest rates did not decrease to the same extent because simultaneously inflation expectations again subsided markedly. Particularly in the euro's core countries – first and foremost in Germany – real interest rates are high. They depress the economic outlook and increase the growth differences between the member countries.



Shares

Stock markets were characterised by extraordinarily sharp fluctuations and hefty price losses. This was due to risk aversion increasing in the course of the year and the effectively higher risk level, which both depressed share prices. The sharp price swings mirror the difficulty of assessing the risks and opportunities in this environment. The stock market slump has persisted for almost three years now. In the past few weeks, though, all major stock markets have at least witnessed some upward corrections.



The long-term expectation that higher yields can be achieved only by taking higher risks has not proven true over a relatively long period of time. Unlike shares, low-risk bonds have generated attractive yields during this phase. This experience together with the fact that numerous, notably institutional investors have lost part of their risk capability might, in many instances, result in equity weightings remaining low in the foreseeable future. This change of behaviour will limit the stock markets' growth potential for the time being.

At present, the price/earnings ratios of the major stock markets are close to the average of the past 15 years. This indicator suggests that, despite the price losses suffered, shares are not yet particularly low-priced. However, compared with the very low yield level of bonds, which are the most important investment alternative, shares do seem quite inexpensive.

Does the stock market slump have any adverse effects on economic development? This seems certain for several reasons. For the corporate sector, it has become more expensive to raise capital, which undermines investment activity. Although direct shareholding is less common in Switzerland than, for example, in the United States, the asset losses incurred discourage private consumption. In many cases, the deteriorated financial position of pension funds necessitates an increase in contributions and/or a decrease in existing premium reductions. Such perspectives and occasionally voiced doubts about the reliability of pension promises adversely affect consumption and investors' willingness to take risks. Last but not least, the bearish stock markets directly affect the value added by our financial sector, which contributes over 10 percent to GDP.

Risk management

In Switzerland and abroad, banks have adopted a more cautious attitude. International institutions, in particular, manage their credit risks much more actively than they used to. They sell some of these risks to other financial intermediaries, including insurance companies and institutional asset managers. The available data do not allow any reliable conclusions to be drawn as to the risk distribution after the credit risk transfers. It can be concluded, though, that credit risks are borne by a larger number of market players than previously and that diversification possibilities are probably better utilised nowadays.

In interbank business, too, more attention is being paid worldwide to default risks. A growing share of interbank business is hedged; this is also the case in Switzerland, where repo business has developed steadily. Unhedged transactions still clearly account for the bulk of interbank business, but with an average volume of approximately Sfr 20 billion, interbank repos, which were neglected for a long time, have grown to a respectable size. With respect to system stability, this development is favourable and should be further promoted.

Continuous Linked Settlement (CLS)

As regards credit risks in foreign exchange business, the launch of the CLS system this autumn is a milestone achievement. CLS Bank, which has its headquarters in New York, serves as a platform to eliminate the so-called Herstatt risk, i.e. the settlement risk inherent in foreign exchange deals. Previously, the two legs of a foreign exchange transaction were settled at different times. If US dollars were bought against Swiss francs, the franc amount was to be paid during European trading time. The corresponding amount in US dollars, however, was credited only a few hours later – during US trading time. In the few intervening hours, a credit risk existed. If a bank had been closed down during this time period, its counterparties might possibly have lost huge amounts of US dollar receivables. CLS Bank now makes it possible to settle foreign exchange transactions in the major currencies based on the "payment versus payment" principle, thereby eliminating the settlement risk for these transactions.

Currently, 42 financial institutions are directly linked to the system (Settlement Members) and settle their foreign exchange payments via CLS in seven different currencies. One of these settlement currencies is the Swiss franc. Three Swiss banks – UBS, CS and Zürcher Kantonalbank – participate in CLS. Apart from these three Swiss banks, two other financial institutions – HSBC and Bank of America – effect foreign exchange transactions in Swiss francs via CLS. Every day, these five institutions together enter around 1,400 payments in the amount of almost Sfr 20 billion into CLS. Settlement takes place via a direct link between the Swiss Interbank Clearing System (SIC) and CLS Bank. To meet their delivery obligations in Swiss francs, the five banks draw on intraday liquidity, which the SNB offers through interest-free repo transactions. Since November, direct system participants have been able not only to use CLS services for their own purposes but also to offer these services to other banks. With this so-called third party business expanding and further direct participants and currencies joining the system next year, more and more payments will be settled through CLS.

Currently, about 35,000 transactions in the amount of approximately USD 400 billion are settled in CLS every day. All parties involved are very satisfied with the system's mode of operation. By eliminating the settlement risk, CLS has made a significant contribution to the stability of the international financial infrastructure.