Philipp Hildebrand: The Swiss National Bank's view of international financial markets against the background of trends in the United States

Introductory remarks by Philipp Hildebrand, Member of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 12 December 2003.

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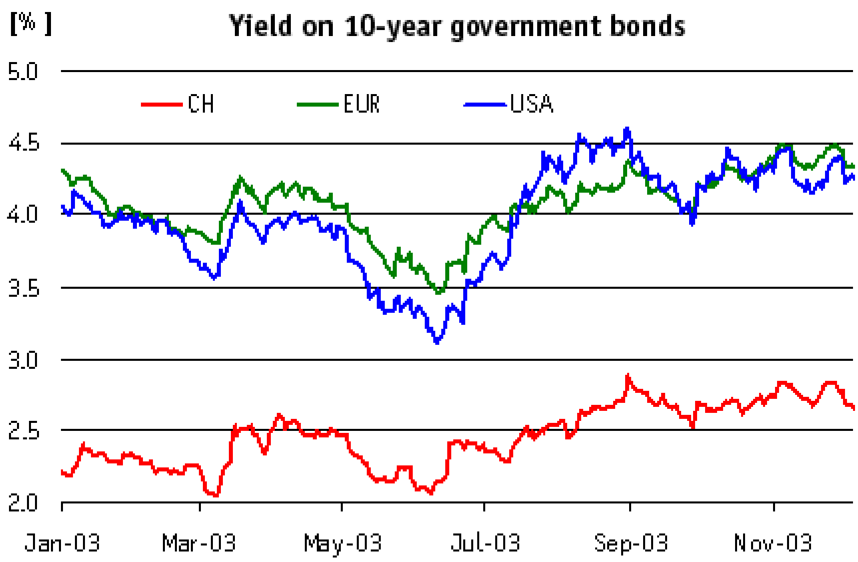
The past year was a turbulent one for the international financial markets, which were essentially influenced by trends in the US. During the first half of 2003, market developments were shaped by economic and deflation fears as well as by the war in Iraq. In this environment, equity markets reached an annual low in March. In June, bond market yields fell to their lowest level. The second half of the year saw an economic recovery in the US, which is now spreading to other economic regions as well.

Capital markets

Long-term yields on Swiss paper rose by approximately 60 basis points from their low in June to roughly 2.7%, approximately tracking yields in the euro area. In both cases, yields followed the US market very closely, albeit with modest fluctuations (see graph 1). Under the present economic conditions, the interest rate environment in Switzerland is still viewed as attractive by consumers. The high level of new fixed-rate mortgages is an indication of this sentiment. The higher Swiss yields reflect the improved economic outlook and not inflation expectations, which are modest given that there is still pronounced underutilisation of capacities. In contrast to capital market yields, money market yields were decidedly stable. The three-month Libor remained almost constant at 0.25%.

Graph 1



The global trend in capital market yields was chiefly determined by long-term yields in the US, which themselves were shaped by the recovery of the US economy. In the early summer, deflation fears had dragged the yield on ten-year US government bonds down to 3.1% - a level last reached at the end of the 1950s. In July and August, however, positive economic data pushed the yield right up to 4.6%. Convexity hedging was one of the factors contributing to the unusual scale of the turnaround. As interest rates fell in the early summer, the refinancing of existing mortgages - which is possible in the US at any time - had triggered extensive buying of government bonds. US investors holding substantial mortgage portfolios had to make these purchases in order to keep the residual maturities of their portfolios constant. When interest rates rose, therefore, the correction was similarly swift. In September, increasing doubts were voiced as to the sustainability of the economic upswing in the US:

compared with earlier cycles, the essential element of an improving labour market was missing. This led to a consolidation on the capital markets even though the economic indicators remained largely positive. With the first signs of the US labour market recovering at the end of September, coupled with rapid growth in gross domestic product in the third quarter (8.2%), the strength of the economic revival in the US economy was confirmed. Just how sustained this pick-up proves to be will become evident in the coming months when the extraordinary fiscal and monetary stimuli weaken.

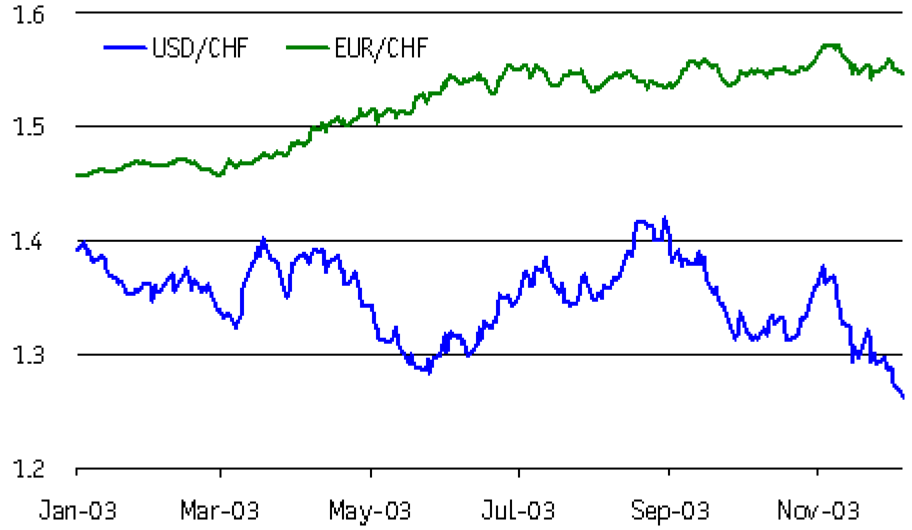
Foreign exchange markets

Fluctuations in the US dollar dominated the foreign exchange markets. After having lost considerable ground during the first half of the year, the greenback rebounded slightly by October amid growing signs of an acceleration of growth. Recently, the focus of market participants returned to the sustainability of the US recovery and the continued rise in America's current account deficit. As a result, the dollar weakened again (see graph 2).

Since the middle of the year, the Swiss franc has moved sideways against the euro. Heavier fluctuations were recorded vis-à-vis the dollar. With positive economic data emanating in the US from June onwards, the franc initially weakened before firming again as part of the general dollar consolidation witnessed since September. On the whole, the Swiss franc hardly registered any independent movements. It depreciated strongly during the first half of the year after our interest rate decision and has remained stable since the summer. In relation both to Switzerland's 24 major trading partners and to the euro zone, the real exchange rate index of the Swiss franc is now slightly below its level at the beginning of 1999, i.e. at the time of the euro launch.

Graph 2

CHF exchange rates



Gold market

Owing to the more favourable economic situation, raw material prices continued the rise which had started in 2001. At over 400 USD/ounce, the gold price was at a seven-year high at the beginning of December. Because of the weak dollar, the gold price increase in francs was more modest. However, its peak of approximately 17,000 CHF/kg was still the highest for several years. The main reason for this rise was persistently modest hedging activity by gold producers.

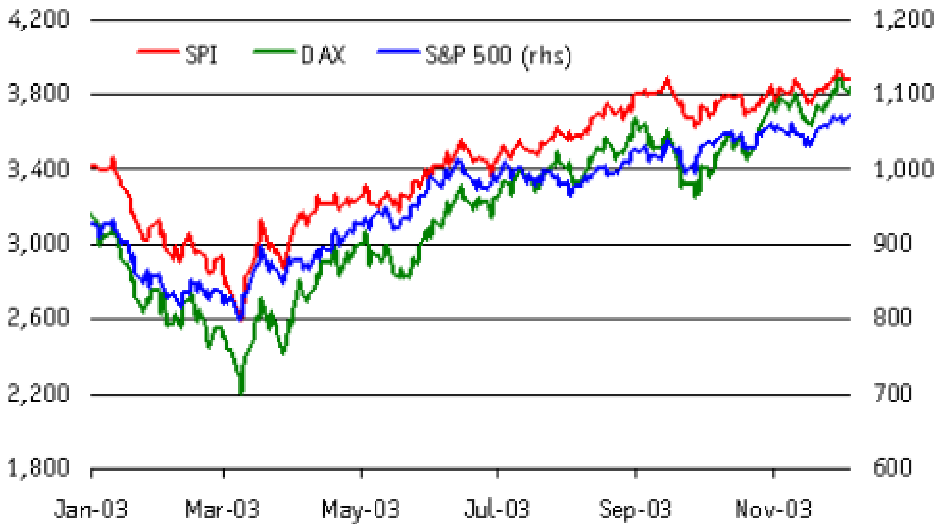
Equity markets

International equity markets exhibited a positive course overall, steadily making up lost ground after their mid-March low (see graph 3). As the equity environment began to present a perceptibly brighter picture, turnover also picked up. This, together with the more confident investor sentiment, reduced volatility. The ambitious profit expectations now reflected in share prices suggest that market players are optimistic about the economic situation and the corporate environment.

To sum up, the financial markets are currently influenced by a complex interplay of factors: a globally synchronised economic recovery is taking place against a backdrop of external imbalances. An autonomous economic recovery outside of the US - underpinned, not least of all, by supply-side reforms - would help substantially to redress these imbalances.

Graph 3

Share indices



Key features of the SNB's future investment and risk control process

The SNB's investment activity is subordinated to monetary policy and is determined by the criteria of liquidity, risk and returns. The new National Bank Law will extend the SNB's investment opportunities. The current National Bank Law (NBL) limits eligible investments to gold and fixed-interest securities, and eligible borrowers to states, international organisations and banks. Article 9 of the new NBL defines a wider scope of possible transactions. This allows the National Bank to further optimise the structure of its investments with a view to specific central bank needs. As part of this process, we are also evaluating the possibility of enlarging the investment universe. However, such an extension would raise a number of fundamental questions that will first need to be examined. Before the new law enters into force, we will establish and publish investment policy directives setting out how the Governing Board plans to make use of the extended investment policy scope.

While our assets have already been managed largely in conformity with the principles of modern asset management, improvements were nevertheless called for. It was essential to bring our internal investment and risk control processes into line with the new legal framework. The opportunities for diversification brought about by additional investment instruments would, in principle, reduce the market risk of the investments. At the same time, though, the SNB would incur new risks, e.g. additional credit risks. In addition, corporate governance is to be enhanced. The primary goal is to segregate powers as far as possible: firstly between monetary policy and investment policy operations, secondly between investment strategy and its implementation through asset management, and thirdly between risk taking and risk controlling. There are limits to the principle of segregation of powers insofar as the Governing Board is responsible both for monetary policy and investment policy.

Let me briefly outline our concept regarding the new investment process:

- The Bank Council approves the principles laid down for risk policy and the investment process.
- The Governing Board decides each year on the investment strategy based on the aforementioned criteria of liquidity, risk and returns.
- The organisational unit Asset Management, which is part of Department III, is responsible for the market-oriented implementation of this investment strategy. An investment committee chaired by the head of Asset Management makes the strategic investment decisions and sets the targets for each portfolio manager.
- A well-tested risk control process ensures that risk taking at the different levels is duly supervised.

Responsibilities and competencies are clearly assigned at all levels of the investment process. Performance at the different levels is assessed through the consistent use of benchmarks and the corresponding measurement techniques.

The process described above is applied to the management not only of the international reserves but also of the proceeds from the sale of gold no longer needed for monetary policy purposes. How the gold reserves deemed “free” at the time are finally used will be a political decision. Managing these assets is not part of the SNB’s statutory mandate. Thanks to the new NBL and the SNB’s internal know-how, however, the Bank is well qualified to perform this task.