Philipp Hildebrand: SNB's performance against the background of financial market developments

Introductory remarks by Dr Philipp Hildebrand, Member of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 15 December 2005.

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Developments in the financial markets

The international financial markets have been dominated in recent months by four key developments. Long-term capital market yields have improved; the equity markets have, on the whole, exhibited very positive developments; the US dollar has continued the uptrend which set in at the beginning of this year; and the gold price has climbed sharply.

The movements of the past few months in the international capital markets are largely attributable to economic developments and US monetary policy. Long-term dollar interest rates climbed significantly in the second half of the year thanks to the robust economic climate, the positive outlook in the US and the continued normalisation of monetary policy by the Federal Reserve. A rise in yields was also observed outside the US. The spread between US and European capital market rates, however, remained considerable. This is not least reflected in the differing business cycle phases of the US and European economies. Despite the improved economic outlook and higher oil prices, inflation expectations have, on the whole, remained moderate on both sides of the Atlantic.

The three major economic areas – US, Japan and Europe – exhibited divergent equity market developments. While the US equity market largely maintained its sideways trend, the European indices firmed substantially. Having recovered from its low in early 2003, Japan's equity market also made a marked recovery. The increase in optimism with regard to the economy and the highly favourable earnings situation of companies were major contributing factors to the rise in equity prices in Europe and Japan. The Swiss equity market – as measured by the SPI – is now trading once again at its peak level of September 2000. Looking at the developments since 1995, it becomes apparent that the Swiss equity market has strengthened far more significantly than equivalent foreign markets (cf. graph 1).

In the forex market, the dollar's recovery continued, with the greenback benefiting from the cyclical interest rate lead in the US, which has made dollar investments in all maturities rather more attractive. A number of market analysts believe that the Homeland Investment Act, which offers tax breaks to US corporations if they repatriate their foreign earnings held abroad before the end of this fiscal year, has boosted the dollar. Despite the fact that in the second half of the year the US current account deficit climbed higher still – to over 6% of GDP – and thus reaching an all-time high, the global imbalances did not appear to destabilise the greenback. On the whole, however, the real exchange rates are trending very close to their long-term averages (cf. graph 2).

Against the background of a robust global economy, commodity prices rose yet further, with oil and gold being in particularly strong demand. However, if energy resources and gold are excluded from the equation, raw material prices in dollar terms are at a similar level to the beginning of 2004. While the price of oil receded from its high-water mark in the wake of Hurricane Katrina to back within the region of USD 60 a barrel, the gold price is trading at a 24-year high of over USD 500 an ounce. A number of factors have contributed to this increase in price. The physical demand for gold has intensified significantly, rising by about 40% this year alone in India, which is the largest market. Increased demand at the central banks of emerging countries and in oil-producing countries is also being reported. Moreover, the currently low real interest rates push down the opportunity costs of interest-free investments, such as gold. Given, too, that the gold market is largely illiquid, even small shifts in demand can trigger serious price effects. In view of the fact that implicit inflation expectations are still firmly anchored – according to inflation-protected bonds and surveys – inflation fears can hardly be considered to be the main driver behind this gold price increase.

SNB's performance

Taking into consideration the development of the gold price, the SNB yielded an average annual return of just below 1% on its assets between 1980 and 2005 (end of September). While interestbearing assets posted a higher average yield during this period, the SNB had to settle for overall losses in gold. The annual yield – including the gold price movements – fluctuated very strongly between minus 25% and plus 20%.

For the assessment of future developments in earnings, these figures are only of limited significance, however. The level and spread of our earnings are determined by the balance sheet total, the structure of the assets and the achievable financial market yields. Since these measures change over time, it is rather difficult to estimate the long-term earnings potential of the SNB.

At the end of 2004, the National Bank's assets amounted to CHF 118 billion. After distribution of the proceeds from the gold sales in spring 2005, the invested funds contracted by CHF 21 billion. Furthermore, higher profit distributions to the Swiss Confederation and the cantons should deplete the existing distribution reserve by 2012, thus decreasing our assets by a further CHF 10 billion as compared with the end of 2004. From today's perspective, this leaves the SNB with assets in the region of CHF 85 billion.

At present, the National Bank's assets comprise 25% Swiss franc investments, 45% foreign exchange reserves and 30% gold. Foreign currency investments generate interest and dividend income. Given the globally low inflation rates, the nominal interest income is currently substantially lower than in the 1980s and 1990s. In addition, the valuation of bond and equity portfolios, foreign exchange positions and gold holdings at market prices result in valuation gains and losses. Meanwhile, the interest income on Swiss franc assets – primarily repos – is marginal. In 95% of cases, the massive fluctuations in our income can be attributed to the fluctuating values in gold and foreign exchange positions. Experience has shown that valuation gains and losses on financial investments tend to level out again in the long term.

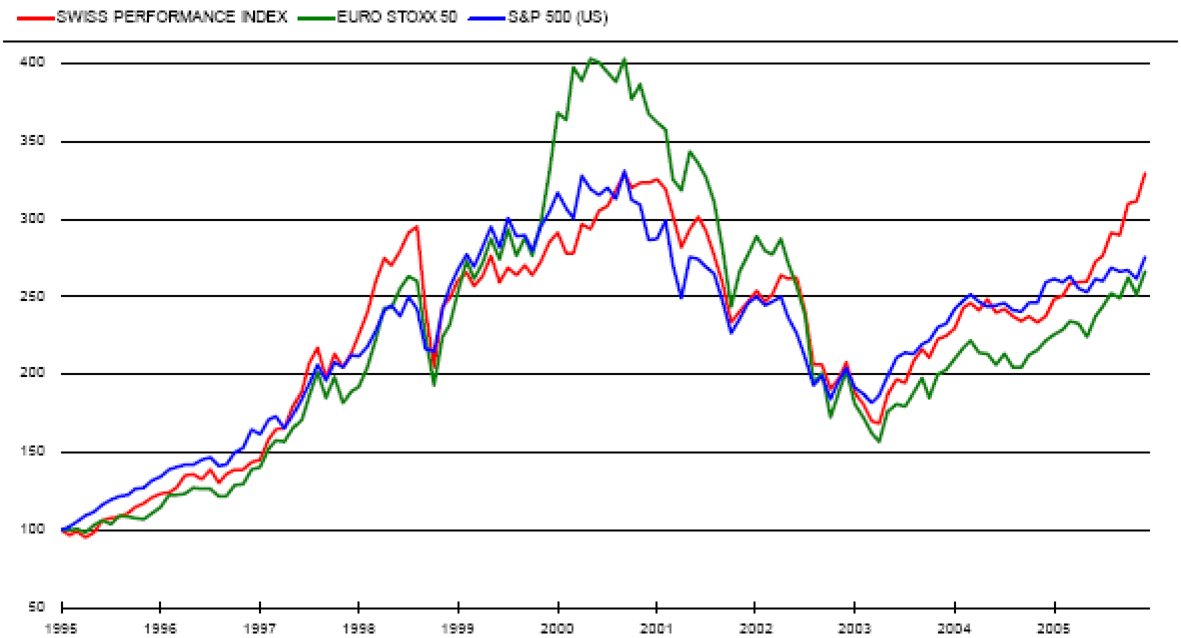
Based on these conditions, we thus estimate the earnings potential of our assets to be between 2% and 3%, which translates into an income of between CHF 1.7 and CHF 2.5 billion per annum on the total assets of CHF 85 billion. Given the fluctuations in the exchange rate and gold price, however, the earnings generated can deviate greatly from this amount. For instance, the marked increase in the gold price this year has resulted in valuation gains of roughly CHF 8 billion to date. Should the gold price drop back next year to its end-2003 level, however, this would lead to a valuation loss of over CHF 7 billion. Long-term income estimates should not be based on such unusual gains and losses.

Some of the income is allocated to provisions, thereby ensuring the growth of the currency reserves necessary for monetary policy. This allocation (currently approximately CHF 1 billion per annum) should be made in proportion to nominal GDP growth. After deduction of the SNB's operating expenses of currently CHF 250 million, roughly CHF 1 billion remains for distribution to the Confederation and cantons. Based on the assumptions regarding the earnings potential of our assets, we can expect a distributable annual profit to be somewhere in this region in the foreseeable future. Once the existing distribution reserve has been depleted, we will most likely have to reduce our profit distributions significantly.

Cosa initiative

The people's initiative "National Bank profits for the Old Age and Survivors' Insurance Fund (AHV/AVS)" – better known as the Cosa initiative – proposes allocating the SNB's profits which remain after deducting the CHF 1 billion for the cantons to the Old Age and Survivors' Insurance Fund (AHV/AVS). An obligation of this kind would impact on the National Bank's independence, putting it under political pressure to distribute higher profits, which in turn would only be possible were the SNB to expand the money supply, reduce the currency reserves or take greater risks. This would undermine the SNB's credibility and freedom of action as well as compromise the stability of the Swiss franc. The National Bank's most important task is to conduct monetary policy geared towards price stability. In order to do this, we have to be able to take monetary policy decisions – even in difficult situations – without political pressure or the obligation to generate a return.

Graph 1:
International equity markets (1.1.1995 = 100)



Graph 2:
Real exchange rate indices for various currencies (1980-2005 average = 100)