

Thomas Jordan: Switzerland – developments and challenges in 2012 from a monetary policy perspective

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Annual General Meeting of Shareholders of the Swiss National Bank, Berne, 26 April 2013.

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Mr President of the Bank Council

Dear Shareholders

Dear Guests

Once again, the European financial and debt crisis has dominated events of the past year. And, once again, the Swiss National Bank has been faced with considerable challenges in the conduct of its monetary policy. The crisis in Europe intensified in spring and summer and triggered strong upward pressure on the Swiss franc.

This was pressure we had to withstand. In an already fraught global economic environment, an appreciation of the Swiss franc would have caused an inappropriate tightening in monetary conditions for Switzerland. This in turn would have compromised price stability and had potentially serious consequences for the Swiss economy.

The SNB therefore enforced the minimum exchange rate of CHF 1.20 per euro with the utmost determination. This called, at times, for a high level of activity on the foreign exchange market on the part of the SNB. The extensive purchases of foreign currency were reflected on our balance sheet.

In my remarks today, I would like to start by addressing the key developments and challenges in 2012 from a monetary policy perspective and, at the same time, present you with our assessment of the current year. I would then like to turn my attention to the subject of gold as part of our currency reserves.

But first, let me begin with the key events in monetary policy.

Key events in monetary policy in 2012 and 2013

More than 20 months have passed since the SNB introduced the minimum exchange rate against the euro under exceptional circumstances. In summer 2011, the Swiss franc had appreciated to such an extent that we had to take action. It is the SNB's statutory mandate to ensure price stability, while taking economic developments into account. With money market interest rates already close to zero and conventional monetary policy options exhausted, we would have no longer been able to fulfil this mandate without the introduction of a minimum exchange rate. In taking this step, the SNB averted the threat of adverse developments to price stability and the Swiss economy. The minimum exchange rate provided the foreign exchange market with clear guidance and gave companies a sounder basis for their investment planning.

Notwithstanding the minimum exchange rate, conditions for the Swiss economy remained difficult in the past year. Global economic growth weakened, after having already lost momentum the previous year. This slowdown was mostly due to the deterioration in economic activity in emerging economies and to the recession in the euro area. Although the European financial and debt crisis is weighing particularly heavily on the euro area economy, it is also curbing growth in other regions.

The crisis intensified in spring and summer 2012 amid growing fears that one or more member states may leave the euro. Refinancing costs in the affected countries climbed and

uncertainty among economic agents rose considerably. Owing to the fact that the Swiss franc was highly sought-after in its role as a safe haven currency, the deepening of the crisis triggered strong upward pressure on the franc. Particularly in the critical months of May to August, the only means of enforcing the minimum exchange rate was through extensive foreign currency purchases. Overall, the SNB purchased foreign currency last year to the value of CHF 188 billion.

The SNB was well-prepared from the outset for the enforcement of the minimum exchange rate. Since its introduction, we have been monitoring the foreign exchange markets round the clock, from when they open on Sunday evening in Sydney to when they close on Friday evening in New York. In order to achieve the required effect on the exchange rate, we conduct foreign exchange transactions with a wide range of domestic and foreign counterparties. With a network of well over 100 banks from around the world as counterparties, we cover the relevant interbank foreign exchange market.

The foreign currency purchases made in 2012 led to a significant rise in our foreign currency holdings. The increased volume also resulted in a considerably higher level of financial risks on our balance sheet. Yet these foreign currency purchases were necessary. An appreciation of the Swiss franc would have caused an inappropriate tightening in monetary conditions, which in turn would have compromised price stability and had serious consequences for the economy. We therefore firmly believe that, given the circumstances, there was no alternative to the minimum exchange rate.

Inflation remained in negative territory in 2012. From mid-year, however, the negative inflation rates trended closer to zero. Our most recent inflation forecast also shows that there is neither a threat of inflation nor a threat of deflation in the foreseeable future. In 2012, the Swiss economy did not escape entirely unscathed from the global slowdown in growth, and lost momentum. Nevertheless, Switzerland's GDP still grew on average by 1% for the year, as compared to 1.9% a year previously. The fact that price stability continued to be ensured in Switzerland and that our economy has held up relatively well in this difficult environment is, on the whole, largely attributable to the minimum exchange rate.

Both the Swiss economy and the SNB are faced with challenges this year, too. There are some bright spots, however. According to economic indicators from the US and emerging economies, the recovery of the global economy has taken hold. With regard to the debt crisis, a number of measures taken at European level have helped ease the situation. In particular, the announcement by the European Central Bank that it would, under certain conditions, buy up unlimited quantities of sovereign bonds issued by indebted euro area countries contributed to easing tensions on the financial markets. The purchase programme alone cannot solve the crisis. However, it has significantly reduced tail risks, such as the exit of one or several countries from the monetary union, and it buys governments more time to implement fiscal consolidation and structural reforms. The affected countries have already made some concrete progress in this regard.

However, it is clearly too early to relax our guard. The global economic situation is still fragile and the way out of the crisis in Europe is long and arduous. In many countries – not just in Europe – there are still a number of unanswered questions with regard to the medium-term growth outlook and the sustainability of public finances. And while we expect the global economy to recover gradually this year and the Swiss economy to grow by 1–1.5%, considerable uncertainties remain. The Swiss franc is still high, even at today's level. In view of the fragile international environment, the downside risks for the Swiss economy remain substantial.

In particular, the threat that the franc could suddenly come under upward pressure again has not been averted. The minimum exchange rate is an important instrument in helping to prevent an undesirable tightening in monetary conditions. The SNB will therefore continue to enforce the minimum exchange rate with the utmost determination and, if required, is

prepared to buy foreign currency in unlimited quantities for this purpose. It stands ready to take further measures at any time.

Gold as part of the Swiss National Bank's currency reserves

In my following remarks, I would like to speak about the subject of gold as part of the SNB's currency reserves.

As reported in the media last week, the so-called gold initiative has formally qualified for a referendum vote to be held. This popular initiative demands that the SNB hold at least 20% of its assets in gold, that it be prohibited from selling its gold reserves and that all gold reserves be physically stored in Switzerland itself.

The SNB does not generally comment on any political initiatives. However, the gold initiative has a very direct impact on the SNB's capacity to act. This is why we are taking the opportunity today to present our viewpoint for the first time on the demands of the initiative.

The initiators see a high level of gold reserves as a guarantee for currency stability. They fear that the Swiss franc will decline in value and that price stability will be threatened if a large proportion of the balance sheet does not consist of gold holdings. They are also concerned that the SNB's gold reserves held abroad are not secure and will not be accessible in critical situations.

We share the objectives the initiators put forward, such as maintaining currency and price stability and ensuring both the SNB's capacity to act and its independence. However, the measures proposed to this effect are not suitable; in fact, they are even counterproductive. Instead, they are based on misunderstandings about the importance of gold in monetary policy and would compromise the SNB's capacity to act in pursuing its monetary policy, which would run counter to the objectives envisaged. In other words, these measures would, in certain situations, considerably hinder the SNB in fulfilling its monetary policy mandate and be detrimental to Switzerland. We therefore consider it our duty to point out the serious disadvantages of the initiative already at an early stage.

Having said that, however, the SNB is interested in a dialogue on any questions connected with the initiative. With this in mind, allow me to make a few remarks.

The SNB has the statutory mandate to ensure price stability, while taking due account of economic developments. The monetary policy operations that must be carried out in fulfilment of this mandate have a direct impact on the SNB's balance sheet. In order for the SNB to fulfil its mandate at all times, its capacity to act in monetary policy matters must not be compromised by rigid rules on the composition of its balance sheet, which would be the case with the required 20% minimum share of gold and the ban on the sale of gold.

It was precisely the latest crisis that demonstrated how important it is for the SNB to have the flexibility to expand its balance sheet, if needed. In future, the SNB will also need this flexibility to reduce the balance sheet again, if necessary. The demands of the initiative would considerably curtail this flexibility.

Were the initiative to be accepted, the SNB would – in the current environment – have to make large-scale gold purchases to meet the required 20% minimum share of gold. It would not be allowed to sell this gold at a later point, even if it had to reduce its balance sheet again in order to maintain price stability. In a worst-case scenario, the assets side of the SNB's balance sheet would, over time, be largely comprised of unsellable gold. Managing the interest rate level and the money supply would only be possible via the liabilities side of the balance sheet; in practice by issuing the SNB's own interest-bearing debt certificates (SNB Bills). This would have serious financial consequences: On the assets side, the SNB would neither have any interest income nor could it realise any profits on gold due to the ban on sales. On the liabilities side, it might have to pay high interest on debt certificates. The SNB

could therefore find itself in a situation in which it could only finance its current expenses by means of money creation.

The far-reaching demands of the gold initiative would inevitably have repercussions for our monetary policy. In making its monetary policy decisions, the SNB would have to consider the long-term consequences the necessary gold purchases would have on its capacity to act and on the structure of its balance sheet. Furthermore, market participants would hardly regard monetary policy decisions as credible, should these decisions involve a substantial expansion of the balance sheet, which in turn would impair the effect of monetary policy. It is unlikely that decisions such as the introduction of the minimum exchange rate or the stabilisation of UBS would have been made in the same way given these circumstances. This constraint on the capacity to act would not be in Switzerland's interest.

Gold is nevertheless an important component of the SNB's assets. However, this is not because gold guarantees price stability. In today's monetary system, there is no direct connection between the proportion of gold on the SNB's balance sheet and price stability. This is also evidenced by the fact that the objective of price stability has been better achieved in recent years, even though the proportion of gold on our balance sheet was smaller, than at times when gold accounted for a much larger share. A high proportion of gold on the balance sheet is no guarantee for price stability.

There is another reason why gold is useful for the SNB and Switzerland. As part of a good diversification of currency reserves, a certain proportion of gold can help reduce the balance sheet risk. We have therefore never ruled out the possibility of future gold purchases. At the same time, however, gold is also one of the most volatile and thus riskiest investments. A high proportion of gold would increase the SNB's balance sheet risk. With the increasing share of gold on the balance sheet, a secondary effect would be that the profit distribution to the Confederation and the cantons would likely be lower. This is because, unlike foreign currency investments, gold does not generate income in the form of interest or dividends, and any valuation gains on gold could not be realised because of the ban on sales.

If, as the initiative demands, a ban on selling gold were to be enshrined in the constitution, the question would arise as to whether an immovable asset of this kind could even still fulfil the function of a currency reserve. Yet, the very purpose of currency reserves is that they are available quickly and without restriction when needed. This availability in a crisis situation is important, even if – as is currently the case – we are not intending to sell gold.

The availability of gold reserves also plays a role with regard to their storage. Let me therefore take a look at the third component of the initiative, i.e. the demand that all gold reserves be physically stored in Switzerland.

Decentralised storage in Switzerland and abroad is in line with the basic principles of due diligence in the conduct of business and business continuity management. It ensures that the SNB can in fact access its gold reserves, especially in an emergency. The same standards are applied to storing gold abroad as to storing gold in Switzerland. Our partner central banks keep clearly identifiable gold bar holdings for the SNB. Each bar stored abroad has a bar identification and remains the property of the SNB. The availability of our gold holdings is fully guaranteed at all times.

As with many other central banks, the SNB has never made the storage locations public. The SNB reviews the geographic allocation of its gold reserves periodically and adjusts it if necessary. In addition to security considerations, avoiding public discussions when gold is being relocated was one of the reasons why storage locations have so far been treated confidentially among central banks.

However, the SNB is aware that there has been a growing need for transparency in our population in the last few years. We have therefore decided to provide more detailed information in this matter. This is the only way for us to rectify the misinformation and misconceptions with regard to storage locations which have increasingly surfaced.

Of our 1,040 tonnes of gold, more than 70% – and thereby the overwhelming proportion – is stored in Switzerland. The remaining 30% is distributed between two countries. Roughly 20% of the gold reserves are kept at the central bank of the United Kingdom, and approximately 10% at the central bank of Canada. The SNB has been storing gold exclusively in these countries for over ten years. A number of clearly defined criteria are used when selecting countries for gold storage. First, adequate regional diversification and good market access for the storage of gold must be ensured. Second, the country in which the gold is stored must be politically and economically very stable and guarantee the immunity protection of central bank investments. Unlike the other two demands of the gold initiative, the manner of storing the gold reserves has no immediate implications for monetary policy. In our opinion, however, the principles of risk diversification and the requirements of due diligence in the conduct of business still speak for decentralised storage in Switzerland and abroad.

Concluding remarks

Ladies and gentlemen, in order for the SNB to continue fulfilling its statutory mandate, it is important that it can maintain its capacity to act in the conduct of monetary policy. Given the challenging environment in which we will also be operating this year, we once again need broad support. In this spirit, I would like to thank our shareholders for their loyalty and great interest in the activities of the SNB. On behalf of the Governing Board, my thanks also go to our staff for its tireless efforts for our institution. Thank you all for your attention.