Fritz Zurbrügg: The Swiss National Bank's investment policy – some topical issues

Speech by Mr Fritz Zurbrügg, Member of the Governing Board of the Swiss National Bank, at the Money Market Event, Geneva, 20 November 2014.

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Accompanying slides can be found at the end of the speech.

Ladies and gentlemen

Welcome to the Money Market Event of the Swiss National Bank (SNB) in Geneva. I am delighted to be able to speak to you today about some of the topical issues facing the SNB's financial markets department. As usual, I shall share the floor with the head of the Money Market unit, Sébastien Kraenzlin. I shall focus my remarks on some of the investment policy challenges currently confronting the SNB. Related issues – specifically the steep rise in our currency reserves following our decision to purchase foreign exchange to enforce the minimum exchange rate of CHF 1.20 against the euro – were the focus of attention some two years ago at this same event. Since then, our currency reserves, which are primarily made up of foreign exchange reserves and gold, have stabilised (slide 1). However, the question of how to manage these investments as advantageously as possible is still a major concern for us. In this context, I shall speak about two issues this evening: first, the importance of the Asia-Pacific markets for the SNB; and second, the role of gold in our currency reserves. In doing so, I shall reference the popular initiative "Save our Swiss gold" (also known as the "gold initiative"), on which the Swiss electorate will be voting on 30 November. After I have spoken to you, Sébastien Kraenzlin will outline some of the latest money market developments.

The SNB's currency reserves – an overview

The SNB's currency reserves currently stand at more than CHF 500 billion – 80% of gross domestic product (Switzerland's annual economic output). With a share of some CHF 460 billion, foreign exchange makes up around 90% of our currency reserves. Since autumn 2012, the size of the SNB's currency reserves has principally been determined by financial market valuations and by interest and dividend income. Given how large our portfolio of currency reserves is, fluctuations in value have a much greater impact today than they did in the past, as has once again become clear this year. The SNB reported a profit of CHF 28.5 billion for the first three quarters of this year.

I should emphasise at this stage that our investment policy is always subordinated to monetary policy; it can only be understood in this context. Since September 2011, our monetary policy has been dominated by the minimum exchange rate of CHF 1.20 against the euro. With interest rates close to zero, the minimum exchange rate is the key instrument we are deploying to avoid an undesirable tightening of monetary conditions. The SNB will continue to enforce the minimum exchange rate with the utmost determination. To this end, it is prepared to purchase foreign exchange in unlimited quantities and to take further measures immediately if required.

Once monetary policy requirements have been met, our foreign exchange investments are guided by three criteria: security, liquidity and return. In order to ensure that we meet the first two criteria – security and liquidity – we hold a substantial portion of our foreign exchange reserves in liquid government bonds, in the most important global currencies; almost three-quarters of our foreign exchange reserves are currently invested in such instruments. When it comes to our third criterion – return – equities play an important role as they generally have a higher return potential than the government bonds of the major advanced economies. Currently, 16% of our foreign exchange reserves are invested in equities.

Given how substantial our foreign exchange reserves are, doing justice to all three of these criteria simultaneously is no simple matter. On the one hand, the considerable growth of our foreign exchange reserves has increased the concentration risk associated with conventional government bonds; on the other hand, there is the risk that we may overuse certain markets, thereby potentially triggering undesired price fluctuations. We therefore evaluate investment possibilities on a continual basis. As part of our search for diversification, Asia-Pacific markets in particular have become increasingly important for the SNB's investment policy in recent years.

Growing importance of Asia for the SNB's investment policy

In recent decades, the focus of global economic activity has increasingly been shifting towards Asia. The region now accounts for more than a third of global economic output. Asia has contributed more than 50% to global growth over the last decade, with China and India together generating over 40% (left-hand side of slide 2). For Switzerland – a country that is highly export-oriented – Asia has become increasingly significant, too. Swiss companies exported almost CHF 30 billion of goods to the region last year, almost three times more than in 2000, bringing its share to 14% of the country's total exports (right-hand side of slide 2).

Asian countries have made substantial progress in developing their financial markets since the Asian crisis at the end of the 1990s. Most financial markets in the region have become significantly more liquid and diversified than they were 15 years ago thanks to gradual liberalisation of capital flows, better financial market infrastructure and an expanding domestic investor base. Hong Kong and Singapore now rank among the world's most important financial centres. Between 2003 and 2013, Asian stock markets' contribution to global market capitalisation increased from approximately 20% to over 30%.[1] Bond issues denominated in local currencies have also gained steadily in importance. This market quadrupled in size between 2005 and 2014 and now totals some USD 8,000 billion.[2] Equally, Asian financial centres have made substantial inroads into global foreign exchange markets in recent years (left-hand side of slide 3). In 2013, almost one-fifth of global foreign exchange transactions took place in Singapore, Japan, Hong Kong and Australia. While these centres have not yet reached the UK level, they are now almost on a par with the US. Singapore last year supplanted Japan as the world's third-largest foreign exchange trading centre (right-hand side of slide 3).[3]

Against this backdrop, these markets have understandably gained in significance for the SNB, too, which explains why we decided to open a branch office with eight staff in Singapore in mid-2013. This office is primarily significant from the point of view of investment policy, and to date our expectations on this score have been met in full. Our presence on the ground in Singapore enables us to manage our Asia-Pacific portfolio much more effectively. The importance of being able to operate on the Asian bond and stock markets during local trading hours, for instance, has been confirmed. Our office there also allows us to manage a host of on-site relationships, which deepens our understanding of Asian financial markets – and economies in general. Moreover, having a local presence makes it easier for us to monitor and enforce the minimum exchange rate round the clock, thereby contributing to the implementation of monetary policy.

The growing importance of Asia is also reflected in our foreign exchange reserves. As I mentioned earlier, given the enormous increase in our foreign exchange reserves, the

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1 World Federation of Exchanges. www.world-exchanges.org, Statistics/Annual Query Tool.

2 Asian Development Bank. 2006 and 2014. *Asia Bond Monitor*. Includes bonds issued by governments, regional authorities, supranational organisations and corporations.

3 BIS. 2013. *Triennial Central Bank Survey, Foreign Exchange Turnover in April 2013: Preliminary global results*.

broadest possible diversification of our investments is extremely important. Consequently, we have increased our exposure in this region over the last few years, in particular to Japan, Australia, Singapore and Korea. Since 2010, the share of Asian currencies in our foreign exchange reserves has almost doubled, from just under 6% to almost 12%. Prior to the financial crisis, the SNB had less than CHF 5 billion invested in Asian assets – and these investments were denominated exclusively in yen. Since 2010, we have been investing in the Australian and Singapore dollars, and since 2012, in the Korean won as well. At the end of 2013, we had over CHF 50 billion invested in Asia, and of this, CHF 15 billion was invested in these three new currencies (left-hand side of slide 4).[4] Today, 3.5% of the SNB's total foreign exchange reserves are allocated to these currencies (right-hand side of slide 4). We see further potential in Asia as we move forward and it will not surprise you to hear that we see China playing an increasingly important role here.

Investment quota for Chinese government bonds

Why does China interest us? The size of the Chinese market is undoubtedly a key factor: central government has outstanding bonds worth approximately USD 1,000 billion.[5] This makes the onshore Chinese government bond market the fifth-largest in the world after the US, the euro area, Japan and the UK (left-hand side of slide 5). Over and above the consideration of market size, investments in China are also attractive from the point of view of our security criterion, as they offer additional diversification of market, credit and concentration risks.

As regards the diversification of foreign exchange risks, however, China offers only very limited potential for us, as the renminbi is pegged to the US dollar. Nonetheless, the renminbi has been allowed to appreciate relatively constantly against the US dollar since 2005 and this incremental appreciation has had a positive effect on onshore Chinese bond yields in francs. In Swiss franc terms, investments in three to five-year Chinese government bonds have, on average, yielded more than 5% per year since 2005; this is substantially higher than the yield available on other major government bond markets (right-hand side of slide 5).

In addition to these financial market advantages, China has strong economic fundamentals. At 40%, China's government debt ratio is much lower than that of many advanced economies.[6] Furthermore, the credit quality of Chinese central government bonds is high compared to that of other emerging economies, as is reflected in the ratings.

Foreign investors still enjoy only very limited access to the onshore Chinese bond market, however, as the renminbi is not freely convertible and capital flows are still subject to controls. Notwithstanding this, the Chinese government has been working towards a gradual opening-up of its domestic capital market for several years now. As part of this, China's central bank, the People's Bank of China (PBC), launched a so-called Interbank Market Programme in 2010, enabling central banks, sovereign wealth funds and insurance companies to request an investment quota for the onshore Chinese interbank bond market from the PBC. Provided they do not exceed this quota, these entities may invest freely in the (onshore) Chinese government bond market.

More than 20 central banks – including those of France, Austria, Japan, Australia and Singapore – have now received a renminbi investment quota. In July this year, the SNB signed a renminbi investment quota agreement with the PBC. The SNB's investment quota amounts to CNY 15 billion (in excess of CHF 2 billion). While this quota represents a very

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4 Swiss National Bank. 2013. *106th Annual Report.*

5 Measured against a standard market index.

6 IMF. 2014. *Fiscal Monitor October 2014*. Includes central and local government debt as well as government-backed debt.

small proportion of our foreign exchange reserves, it allows the SNB to gather some experience of this market.

We intend to make use of this quota in the foreseeable future. According to the agreement, the SNB is authorised to exchange currency at the PBC for renminbi up to a maximum amount defined in the quota (slide 6). As in all global capital markets, bonds are traded over-the-counter (OTC), in other words they are traded off-market via local investment banks or the PCB's bureau in Shanghai. Approximately 90% of all bonds are traded on the interbank bond market, and the remaining 10% are traded on the exchange. The interbank market is regulated by the PBC. Bonds issued by the central government, local governments and quasi-government banks dominate the interbank market, while corporate bonds play a subordinate role. The SNB will only be investing in central government bonds – these make up around one-third of the interbank market – with maturities of up to 50 years.

The role of gold in our foreign exchange reserves

Let me now turn to an older – but no less topical – component of our currency reserves: gold. Since the foundation of the SNB over 100 years ago, gold has been an important part of our currency reserves, however its function has changed significantly over time. Until 1973, Switzerland was part of the Bretton Woods system of fixed exchange rates and the value of the Swiss franc was defined in grams of gold. Under this system, currency reserves – and thus also gold holdings – played an important role in monetary policy. The bulk of the SNB's gold reserves were formed at this time.

The move away from the system of fixed exchange rates enabled the SNB to structure its currency reserves more and more independently of monetary policy requirements. In the 1990s, the composition, management and optimal level of currency reserves were the subject of intense and protracted discussions among politicians and academics. The SNB was criticised for holding gold reserves that were in excess of what it needed for monetary policy and for the fact that they generated too little return. This debate finally resulted in a broad consensus, whereupon the SNB reduced its gold reserves and investment policy considerations became increasingly important in decisions relating to the remaining gold holdings.

This brings me back to the SNB's investment criteria mentioned at the outset: security, liquidity and return. Gold typically performs poorly when it comes to liquidity and return, and on the security front, gold should be viewed critically in the context of investment policy. Although a certain diversification effect can come into play between gold and equities, I am sure you are also aware that the gold price is even slightly more volatile than equity prices (slide 7). Just last year, this volatility made itself felt on our balance sheet. The collapse of the gold price in the spring of 2013 was responsible for a valuation loss of approximately CHF 15 billion.

The SNB has held 1,040 tonnes in gold reserves since 2008, putting Switzerland in seventh place internationally. At 125 grams per capita, Switzerland has the largest gold reserves per head of population of any country – triple those of Germany and quintuple those of the US (left-hand side of slide 8). The SNB's gold reserves have remained constant in recent years and it has no plans to sell its holdings. The value of our gold reserves has thus moved in line with the gold price in recent years (right-hand side of slide 8). However, given the substantial increase in the SNB's foreign exchange reserves since 2009, the share of gold as a percentage of total currency reserves has indeed changed, recently falling to just below 8%.

Now let us turn to the gold initiative, which goes to the vote in just a few days. The supporters of this initiative are demanding that the SNB hold at least 20% of its assets in gold and at the same time requiring a ban on ever selling gold again. Moreover, the initiative demands that the gold must be stored exclusively in Switzerland. In order to achieve the share of 20%, the SNB would have to almost triple its gold holdings within five years. In practice, given today's balance sheet total and gold price, the SNB would have to purchase around CHF 70 billion worth of gold – around two-thirds of the world's total annual gold production.

The SNB considers the initiative to be unnecessary and harmful. Its legal mandate is to ensure price stability. In a system of flexible exchange rates, gold is no longer required for it to perform this function and the gold initiative is therefore unnecessary. Price stability and the stability of the Swiss franc are not determined by the share of gold in the SNB's balance sheet, but by its monetary policy. It has achieved these goals more effectively than virtually any other central bank: average inflation has remained below 1% for the last 20 years, and never in the history of the SNB has there been such a sustained period of low and stable inflation.

Prescriptions on the share of gold in the balance sheet, coupled with a sales ban, would make it considerably more difficult for the SNB to fulfil its mandate in future. For this reason, the gold initiative is harmful. In order to pursue a stability-oriented monetary policy, the SNB needs to be able to supply the Swiss economy with Swiss franc liquidity quickly in periods of crisis. The SNB's balance sheet expands when liquidity is increased. In the aftermath of a crisis, it is critical that this newly injected liquidity be reduced again, in order to prevent an undesirable rise in inflation. Scaling back liquidity, on the other hand, reduces the balance sheet total. Given that the initiative is calling for gold to make up at least 20% of the SNB's assets, a temporary liquidity increase would require gold holdings to be increased, too. In a post-crisis scenario, the excess gold would have to be retained on the balance sheet for ever due to the sales ban, and the SNB would have to sell some of its foreign exchange reserves in order to effect a liquidity reduction. Consequently, this prescription regarding the percentage of gold to be held, as well as the ban on sales, could ultimately lead to a situation in which the SNB's assets consist almost entirely of gold, but in which it is unable to perform balance sheet reductions required for monetary policy. In the long term, the passing of the gold initiative could therefore threaten price stability in Switzerland.

Even with regard to security, the demands made by the backers of the initiative are misguided. Insisting that the SNB hold a higher proportion of gold on its balance sheet even though this gold cannot be deployed in an emergency is counterintuitive. In such circumstances, the SNB's gold would lose its significance as a currency reserve; the notion that gold should be held even though it cannot be utilised quickly and freely runs counter to the very raison d'être of currency reserves. We may even go so far as to say that gold which cannot be sold in a crisis no longer meets the definition of a reserve and thus offers no security at all.

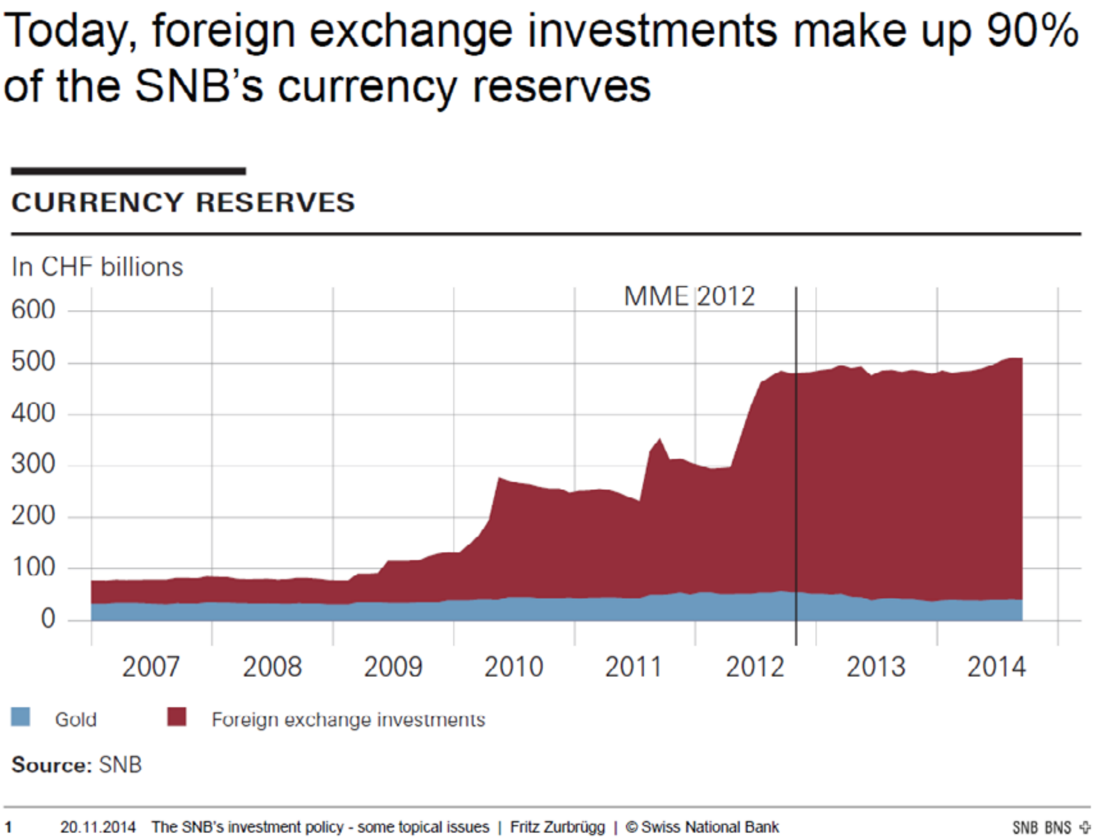
While the gold initiative's third demand – that all of the SNB's gold holdings should be stored in Switzerland – may be unproblematic in monetary policy terms, this too runs counter to the notion of security. Gold is stored in multiple locations for reasons of risk diversification, in other words to improve security. The lion's share of the SNB's gold reserves (approximately 70%) is already stored in Switzerland and an appropriate regional diversification serves to enhance the SNB's market access.

Concluding remarks

Please allow me to make a few closing remarks. Managing Switzerland's substantial foreign exchange reserves in the country's best interest remains our key investment policy challenge. New markets are playing an important role here. I have discussed the growing significance of Asia and explained the process by which we plan to be able to invest a small fraction of our foreign exchange reserves in China in the near future. Thanks to our branch office in Singapore, we are optimally positioned to monitor developments and manage our investments in the Asia-Pacific region efficiently.

Within the scope of its mandate, the SNB needs a certain amount of latitude in order to continue fulfilling its monetary and investment policy objectives, especially given that the Swiss monetary policy landscape is set to remain challenging in the foreseeable future. A "yes" vote for the gold initiative would severely restrict our scope for action. It would therefore make it considerably more difficult for the SNB to conduct successful monetary policy operations in future.

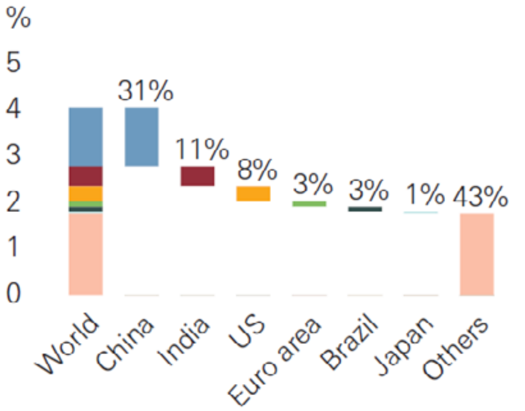
Ladies and gentlemen, thank you for the trust you have placed in the SNB in the past. We look forward to your continued support in the future.



Economic importance of Asia has increased; globally and for Switzerland as an export-oriented country

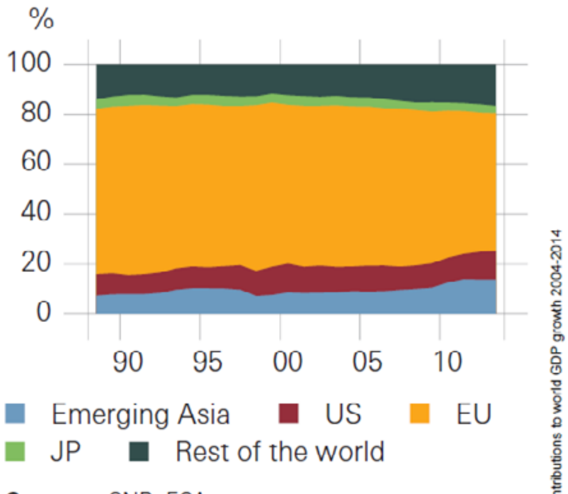
GDP GROWTH

Contributions to annualised global growth, 2004-2013



Sources: SNB, IMF

SWISS EXPORT SHARES, BY TRADING PARTNER

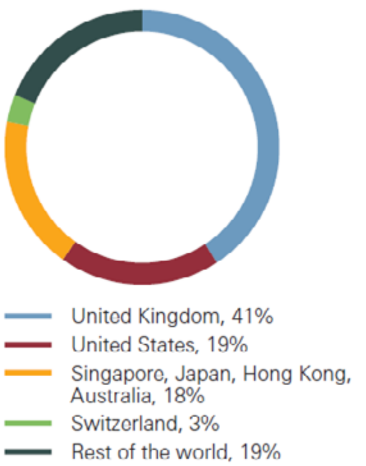


Sources: SNB, FCA

Almost 20% of global foreign exchange trading now takes place in Asia

FOREIGN EXCHANGE TURNOVER BY COUNTRY

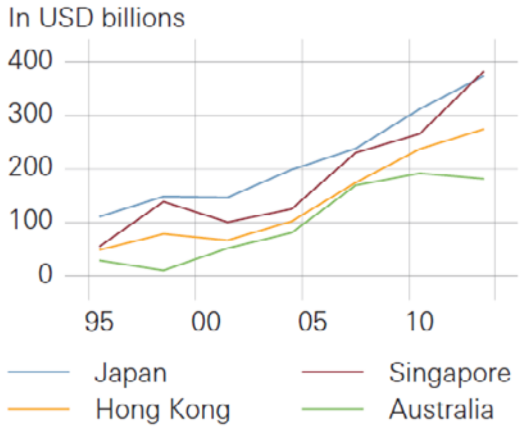
Over the counter trades, April 2013



Sources: SNB, BIS

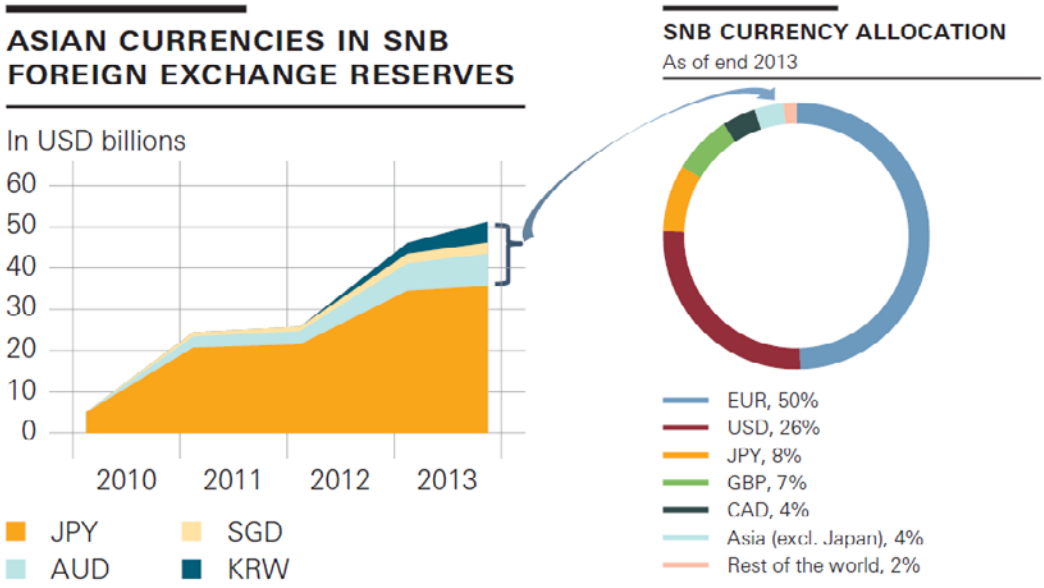
FOREIGN EXCHANGE TURNOVER BY COUNTRY

Over the counter trades



Sources: SNB, BIS

Share of Asia-Pacific currencies in the SNB's foreign exchange reserves has grown



Source: SNB

Source: SNB

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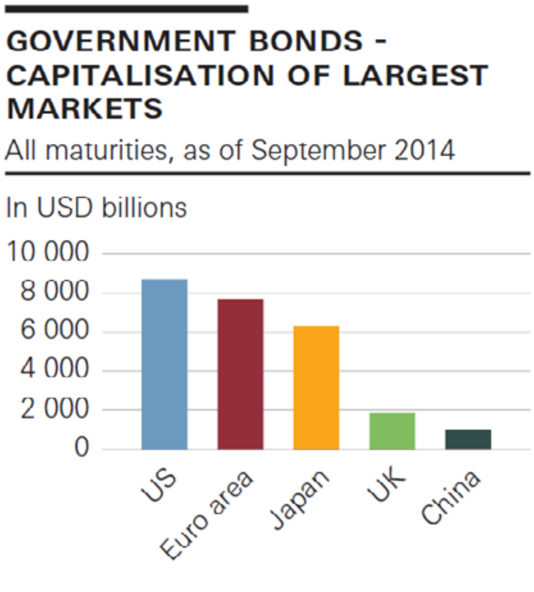
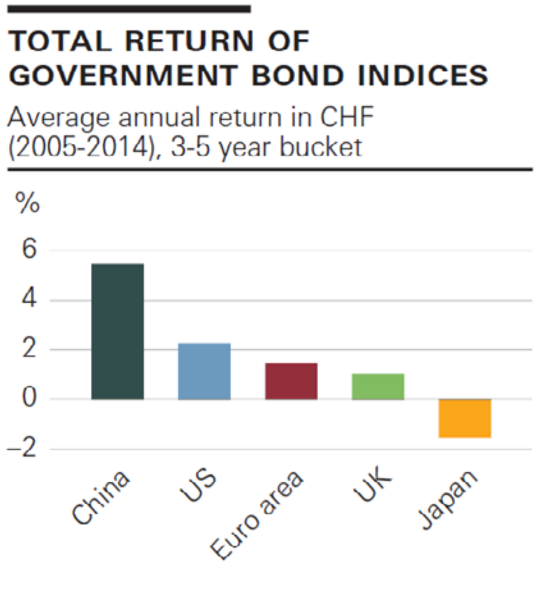
China: fifth largest government bond market, attractive yields



Sources: SNB, Bloomberg



Sources: SNB, Bloomberg

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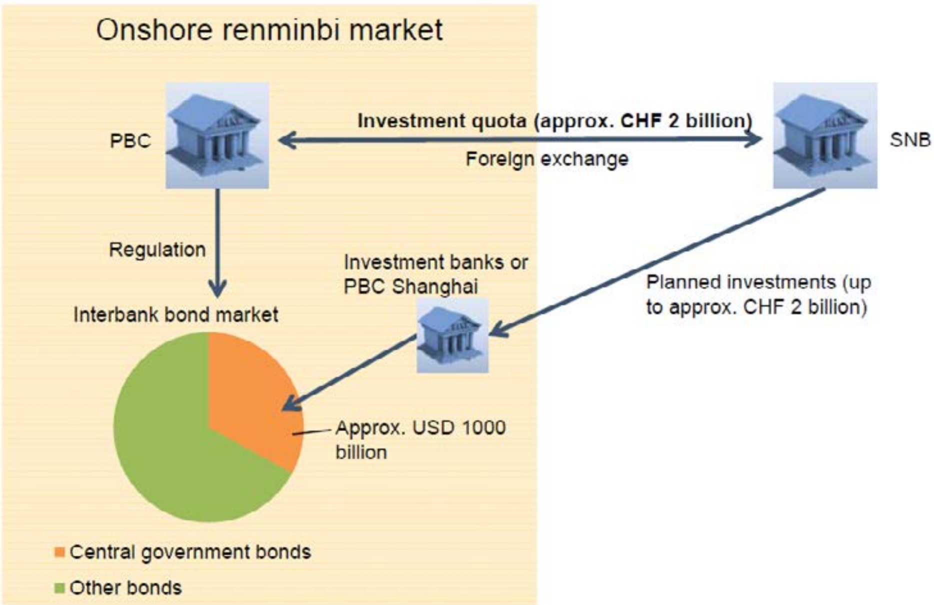
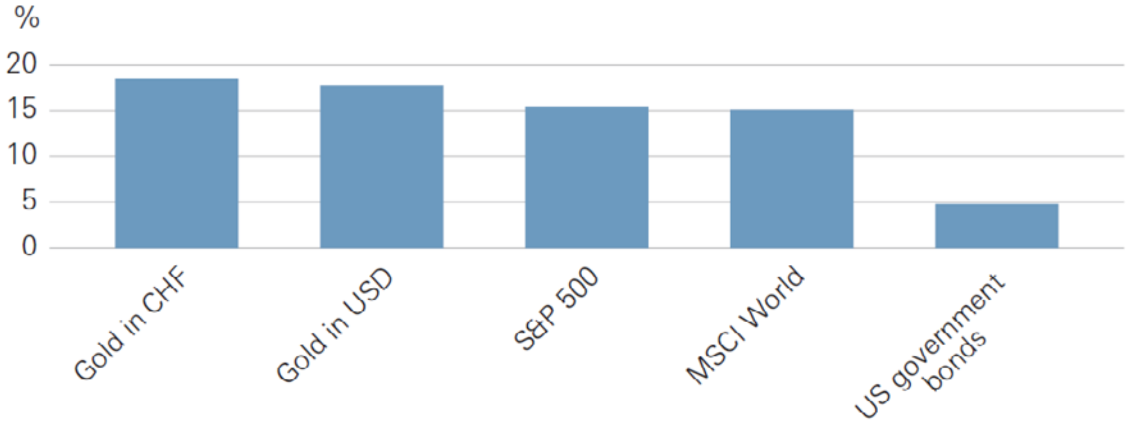
The SNB's renminbi investment quota



Gold is one of the most volatile investment classes

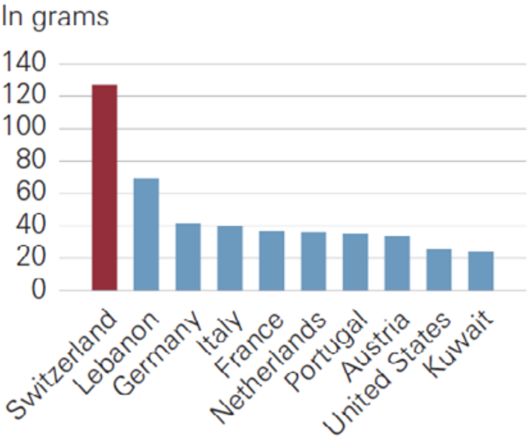
ANNUALISED STANDARD DEVIATION OF MONTHLY RETURNS SINCE 1980



Sources: SNB, Datastream

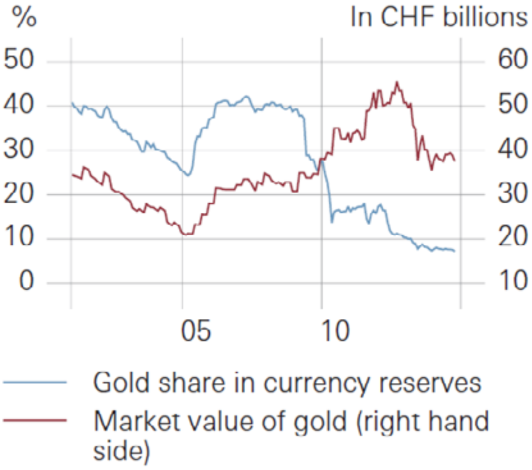
SNB's gold holdings versus those of other countries and as a share of currency reserves

GOLD RESERVES PER CAPITA
As of September 2014



Sources: SNB, World Gold Council, Bloomberg

GOLD IN SNB CURRENCY RESERVES



Source: SNB

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