# Bruno Gehrig: Review of the Swiss economy

Introductory remarks by Prof Bruno Gehrig, Vice-Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Geneva, 14 June 2002.

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## Developments in the financial markets

From a Swiss vantage point, the situation on the financial markets in the first half of 2002 was predominantly influenced by the exchange rate development of the Swiss franc. The appreciation against the euro, which set in after 11 September 2001, has been arrested but has failed to bring about a sustained correction of the exchange rate. Moreover, the US dollar, too, has declined since April. At the beginning of June, it had fallen to its lowest level against the Swiss franc in two-and-a-half years.

There are several reasons for the decline of the US dollar – by approximately 7% against the euro and the Swiss franc since the end of March, by approximately 6% vis-à-vis the yen – : imponderables of global political significance, growing doubts concerning a sustained upswing in the United States and – exacerbated by the collapse of Enron – the scepticism of investors with respect to the future development of yields. The record US current account deficit is increasingly being financed by means of short-term capital flows from abroad, which, by their very nature, are volatile.

Against this background, high-risk investments generally showed a weaker trend. Equity markets and the US dollar lost in value while the gold price, bonds and the Swiss franc moved up. As may repeatedly be observed in uncertain times, higher demand for Swiss francs resulted from the greater attraction exerted by our currency on foreign and particularly also on domestic investors. One of the reasons for this is the extremely high international net creditor position of our country (139% of GDP). In times of instability, Swiss investors reduce the risks by investing a larger part of their holdings (or the yields thereon) in the home currency or by hedging their foreign-currency balances to a greater extent than previously. Both strategies strengthen the demand for Swiss francs. With interest rate differentials between Swiss franc and foreign currency investments having widened since spring, the «price» to be paid by investors for the «safe haven» offered by the Swiss franc has, however, risen. The yield differential between long-term investments in euros and those in Swiss francs again amounts to almost two percentage points; since the start of the year alone it has increased by approximately 40 basis points. Interest rates, which have reached a relatively lower level in this country, to some extent mitigate the economic burdens associated with the appreciation. They have probably also contributed to the slight recovery of the euro vis-à-vis the Swiss franc in the past few days.

In the first half of 2002, capital market rates were influenced by economic expectations in the United States. The positive economic data in March triggered a vigorous rise in long-term US interest rates by approximately 50 basis points within a very brief time. With economic indicators below expectations since April, long-term yields fell back to their mid-2001 level. The expectations reflected in the futures markets concerning the development of money market rates – and therefore also monetary policy – have undergone a marked downward adjustment, notably for the US dollar, but also for the euro and the Swiss franc. Hopes of a vigorous and rapid economic recovery have given way to a more realistic assessment.

## The SNB as asset manager

In the context of its statutory mandate, the National Bank manages sizeable assets (table 1). In May 2002, their market value exceeded Sfr 100 billion.

The **free assets** (Sfr 21 billion) are to be withdrawn from the National Bank and allocated to other purposes. Mr Blattner will provide details on the management of the free assets.

The **monetary assets** (Sfr 86 billion) serve monetary purposes. Claims from repo business (Sfr 16 billion) reflect our money market activities on the assets side of the balance sheet, while Swiss franc securities (Sfr 5 billion) are available for absorption repos if necessary. Foreign exchange reserves (Sfr 41 billion) are at the centre of our activity as asset managers. At the end of 1997, the leeway previously granted solely for money market investments was legally extended. This provided a possibility to spread fixed-interest investments more evenly across various maturities and currencies and to widen the range of instruments.

Among the currencies (graph 1), the US dollar and the euro predominate with shares of 42% and 46% respectively. The maturities of the investments extend over the entire interest rate curve, with the average maturity being around five years. In the debtor categories, government paper predominates, accounting for a share of more than 50%. The rest comprises claims against international organisations and banks or bank-like borrowers with an above-average rating. Aside from these traditional bonds, US mortgage-backed securities were introduced in 2000, a new investment category which represents an ideal addition to the portfolio.

In the context of the primary requirements specific to a central bank – extremely high liquidity, investment focus on the major currencies US dollar and euro, a mainly passive investment style – risk/return considerations are of prime concern. The goal is to achieve the highest possible return by means of all available concepts and techniques of modern asset management with adequate risk control. The investment strategy is developed by inhouse investment specialists. It is mostly implemented internally by a team of eight portfolio managers. We resort to external asset managers for the investment of approximately Sfr 4 billion (global bonds and mortgage-backed securities). Our entire investment activity is systematically monitored by risk specialists.

In 2001, a yield of 5.2% was achieved on foreign exchange reserves. The average yield in the past four years was 6.3%. A comparison with similar investments – for example, with the average yield on Swiss investment trusts and investment funds for foreign currency bonds – shows that this is a remarkable result. Gold holdings (Sfr 21 billion) and Swiss franc assets (Sfr 5 billion in securities, Sfr 16 billion in repos) also contribute to the earnings from monetary assets. The overall yield is largely determined by gold price and exchange rate fluctuations, while interest rate and credit risks play a lesser role.

In the past year, overall aggregate income on monetary assets amounted to approximately 4.5%. Other than in earlier years, the price of gold contributed to a positive yield. Still, the gold price is subject to strong fluctuations and its development is difficult to foresee. Moreover, as in the past, unfavourable currency movements are to be expected. These influences were clearly at work during the past year. The appreciation of the Swiss franc has had a noticeable adverse effect on yields. In the first quarter, the soaring gold price led to a yield of approximately 3% on monetary assets. In the second quarter, considerable losses resulted on the currencies; these losses have already cancelled out a part of the positive overall yield from the first quarter. This illustrates the strong yield fluctuations to which our assets are exposed. With the current composition of monetary assets, average returns of close to 3% per annum are to be expected in the long term, however accompanied by high annual fluctuations. These are liable to result in a negative overall yield in about three out of ten years.

Due to this fluctuation risk, but mainly because of the currency reserves required for the conduct of monetary policy, the National Bank has to rely on adequate provisions. Part of the earnings are to be allocated to provisions in order to enable these to grow in step with the Swiss economy. The remainder is available for distribution to the Confederation and the cantons. Currently, the provisions are well funded. Due in part to the high yields on foreign exchange reserves in the last few years, provisions exceeded the level aimed at by around Sfr 13 billion at the end of 2001. This cushion makes it possible to increase the distribution to the Confederation and the cantons over the next eleven years as agreed.

With a view to the future, various decisions relating to investment strategy are beginning to take shape, aside from the transfer of the free assets. Based on the consultation procedure it is becoming clear that the revision of the National Bank Law will again extend the leeway for investment. Particular attention is devoted to corporate bonds, a significant investment segment. Moreover, it must be examined whether and to what extent equities can improve the risk/return features of monetary assets in a meaningful way. In addition, the allocation of monetary assets to the various investment sectors must be optimised on an ongoing basis. Such questions are studied and clarified internally.

**Table 1**

| Structure of the SNB's assets (May 2002, in CHF billions) | |
|---|---|
| **Monetary assets** | |
| Foreign exchange reserves | 41 |
| Reserve position in the IMF | 3 |
| Gold holdings | 21 |
| Swiss franc securities | 5 |
| Claims from repo transactions (net) | 16 |
| **Total monetary assets** | **86** |
| **Free assets** | |
| Gold holdings | 13 |
| Investments | 8 |
| **Total** | **107** |

**Graph 1**