Speech

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Comments on the SNB's monetary and investment policy

109th Ordinary General Meeting of Shareholders
of the Swiss National Bank

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Swiss National Bank
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Mr President of the Bank Council
Dear Shareholders
Dear Guests

I am delighted to be able to spend some time here with you today looking back over an eventful year and also casting a glance into the future. In the last 12 months, the international environment has been marked by two contrary developments – increasingly robust growth in the global economy on the one hand, and heightened political uncertainty on the other. In Switzerland, the moderate economic recovery continued over the course of the year, but inflation remains low and the Swiss franc is still under pressure. Overall, considerable challenges remain, both for our economy and for the Swiss National Bank.

In the first part of my speech, I will outline our assessment of the current economic situation at international level and in Switzerland. I will also talk about our monetary policy and show you why our expansionary course with the negative interest rate and our willingness to intervene in the foreign exchange market remains essential in the current environment.

In the second part of my speech, I will go on to talk about the SNB's investment policy, which has become very important in the light of our interventions in the market. I will explain our objectives and the criteria we use for investing the foreign currency purchased in the context of these interventions. The investment policy must support our monetary policy and give us the necessary room for manoeuvre.

The economic situation and SNB's monetary policy

Current economic situation

I shall begin by reviewing the current economic situation and the SNB's monetary policy.

Global economic developments have been largely positive. Real GDP of our trading partners grew by some 2% over the past year (cf. chart 1). The US has recovered from the financial crisis; full employment has been reached and the economy is expanding. Recovery also continues in the euro area. Unemployment is falling and GDP is growing in almost all member states. Nevertheless, recovery is not yet as advanced as in the US. Solid growth will still be needed in the future to make up for the setbacks suffered over the last decade.

Inflation trends also vary among the various economies (cf. chart 2). The global rise in inflation over recent months is largely attributable to oil prices. However, core inflation – which excludes oil and food prices – has not increased across the board. While it has stabilised in the US, it remains low in other regions, particularly in Japan and the euro area. The ongoing recovery of the real economy, however, is likely to produce higher core inflation in these economies, too, in the near future.

Against the backdrop of an expanding economy and higher inflation, the US Federal Reserve raised its key interest rate in March – the third interest rate hike since the end of 2015. The normalisation of US monetary policy is therefore continuing. By contrast, the European Central Bank and the Bank of Japan are maintaining their expansionary monetary policy.

Does this mean there is cause for optimism for the period ahead? Global economic sentiment is really quite positive. Nonetheless, significant political uncertainties remain. Within the euro area, the French elections are currently dominating the headlines. Uncertainty persists about how Brexit will unfold. Looking across the Atlantic, there are still a number of questions concerning the new US administration's future economic and trading policy. New political directions which influence the growth of our trading partners are of course highly relevant for a small open economy like Switzerland.

And what about the economic situation here at home? The Swiss economy is still recording moderate growth (cf. chart 3). Following the discontinuation of the minimum exchange rate, GDP contracted as a result of Swiss franc appreciation in the first quarter of 2015. However, since then, the economy has grown, and current economic data indicate that this growth will sustain. For 2017, we are forecasting an increase in GDP of some 1.5%. Nevertheless, production capacity is still not fully utilised. Furthermore, recovery varies from one industry to another.

Overall, the situation today is much better than many observers had expected at the beginning of 2015. The Swiss economy has once again demonstrated its flexibility by, for example, making swift adjustments to working hours and taking measures to improve production processes. In view of the structural changes taking place, this adaptability will remain key, regardless of developments in the international economy and exchange rates. I'm thinking here of traditional retailing, which increasingly has to compete with internet trading. Digitalisation, too, presents new challenges for manufacturing and finance that will continue to call for major efforts on the part of companies and staff in all the industries concerned.

Current monetary policy

What challenges does this situation pose for our monetary policy? We have the statutory mandate to ensure price stability. In so doing, we must take due account of economic developments. Since the beginning of the year, the inflation rate in Switzerland has climbed above zero again (cf. chart 4). As is the case with our trading partners, this is largely driven by oil and food prices. Core inflation is somewhat lower, primarily because of underutilised production capacity. Our current forecast puts inflation in mid-2019 at around 1%.

Given low inflation and underutilisation of production capacity, maintaining an expansionary monetary policy in Switzerland is the right course of action to take. The Swiss franc is still significantly overvalued. The negative interest rate and the SNB's willingness to intervene in the foreign exchange market if necessary are intended to ease pressure on the Swiss franc. Negative interest does so by at least partially restoring the traditional interest rate differential against other countries. What effect does our willingness to intervene in the foreign exchange market have? With our foreign currency purchases, we supply the market with additional Swiss francs when demand for our currency is particularly strong. Without the negative interest rate and our willingness to intervene, the Swiss franc would be even stronger, inflation would fall once again, and unemployment would rise.

We will continue to make the most of our monetary policy latitude in the future. If necessary, we can lower the negative interest rate further or buy additional foreign currency. Of course, careful consideration always precedes any decision we make, based on the maxim that the expected benefit of a monetary policy measure must outweigh the associated costs.

Over the past financial year, the implementation of our monetary policy has led us to make foreign currency purchases totalling some CHF 67 billion. With valuation changes as well as interest and dividend income, the SNB's foreign exchange reserves increased by CHF 86 billion in 2016 (cf. chart 5). The current size of our balance sheet reflects our crisis management over the last ten years. What does this expansion of the balance sheet mean for our investment policy? Let's look at this more closely now in the second part of my speech.

The SNB's investment policy

The SNB's investment policy outlines the principles governing its asset management. Our assets chiefly consist of currency reserves, namely foreign currency investments and gold. A small proportion are Swiss franc assets. In principle, the SNB is able to define its own investment policy. However, due to its monetary policy mandate, the SNB's investment policy is subject to certain restrictions. It has to be designed in a way that helps the SNB fulfil its mandate. To a certain degree, the function of our investment policy is to serve monetary policy. What does this mean exactly?

Objectives

In applying its investment policy, the SNB has two main objectives. The first is to ensure that its balance sheet can be used at any time for monetary policy purposes. Investment policy may not restrict monetary policy in terms of either a possible expansion or a possible reduction of the balance sheet. The investment universe must be designed in such a way that we are able to purchase foreign currency and invest it quickly when necessary. But we must also be able to sell the investments again quickly if monetary policy requires it.

The second objective of investment policy is to ensure that the currency reserves preserve their value over the long term. Currency reserves serve to build confidence. They are used not just to overcome, but to also to prevent potential crises. Currency reserves allow us to intervene in the market if the Swiss franc weakens. Moreover, irrespective of such extreme situations, we have to manage our currency reserves in the best interests of the country and thus make investments that retain their real value over the long term.

Implementation

So, we pursue two objectives with our investment policy – ensuring the availability of the balance sheet for monetary policy purposes and preserving the value of our currency reserves.

In order to achieve these two objectives, the SNB's investment policy is guided by a number of criteria. In addition, it has to meet two important requirements.

Let's start with these requirements. First, we cannot hedge currency risks against the Swiss franc. Such hedging transactions would trigger additional demand for Swiss francs, thereby increasing upward pressure on the currency. This would run counter to our current monetary policy, which is geared at reducing pressure on the Swiss franc.

Second, in implementing our investment policy, we aim for minimal market impact. This is the fundamental distinction between investment policy and monetary policy. Monetary policy measures are deliberately targeted to change market prices. They are intended to nudge monetary conditions in Switzerland – interest rates or Swiss franc exchange rates – in the desired direction. By contrast, the SNB's investment activity should not trigger any price changes. For this reason, when investing, we always take into account the absorption capacity of the markets. When restructuring our investments, whether between different investment instruments or between different currencies, we exercise prudence and caution.

Bearing these two requirements in mind, we invest our assets according to the criteria of liquidity, security and return. What does that mean specifically?

First, our portfolio must be as liquid as possible. This is crucial, particularly as regards our objective of being able to use the balance sheet for monetary policy purposes. We have to be in a position to buy and sell assets quickly in crisis situations. It should always be possible to expand or reduce the SNB's balance sheet if necessary. At the end of 2016, the SNB held approximately 70% of its foreign exchange reserves in foreign government bonds. A substantial proportion was invested in the world's most liquid bond markets, where liquidity does not dry up even during a crisis. This ensures the SNB's ability to act at any time.

Second, the SNB's portfolio must be as secure as possible. We regard security in this context as a comprehensive concept, aimed at preserving the value of the currency reserves in the long term. One of the first prerequisites for ensuring that a portfolio is as secure as possible is to make sure we invest in bonds with a high credit rating. In this way, we minimise the risk of large-scale defaults. Another prerequisite is to diversify as broadly as possible. This is why we spread our investments, not just over different currencies, but also over different investment categories. We are continuously expanding our investment universe. Our foreign currency investments used to be primarily government bonds until we added the corporate bonds in 2004, and then equities in 2005. The equity portfolio today accounts for 20% of the foreign exchange reserves (cf. chart 6).

For the long-term value preservation of currency reserves, the return on assets is also a key criterion. It is important to achieve an adequate return in local currency, particularly in view of potential currency losses in the case of Swiss franc appreciation. The SNB's investment policy therefore aims for an appropriate security/return ratio, while still taking into account the criterion of liquidity.

What does this actually mean for the implementation of our investment policy? The Governing Board sets specific bandwidths for the various currencies and investment categories employed in the management of bonds. Working within these bandwidths, our portfolio managers aim to ensure the best allocation of bonds according to current market conditions. The equity portfolio, by contrast, is managed as neutrally and passively as possible. We buy and hold equities of a particular company in proportion to its weighting in the country's stock index. In this way, we ensure that our activities have as small an impact as possible on the relative share prices of individual companies or sectors. Equally, this prevents specific biases towards or against certain companies or sectors from influencing our investment policy.

In order to guarantee this neutral approach as fully as possible, we are very wary of making any exceptions. To avoid potential conflicts of interest, we do not invest in equities of international mid-cap and large-cap banks or bank-like institutions.

The SNB also does not buy any shares of companies that produce internationally condemned weapons. Furthermore, we exclude companies which seriously violate fundamental human rights or systematically cause severe environmental damage. Our exclusion policy is based on clearly defined principles and is applied unequivocally. To identify the relevant companies, we rely on the recommendations of recognised external experts.

As you can see, the SNB pursues a clear policy in its investment activity and takes into account a long list of criteria and requirements. These are geared towards helping us to fulfil our monetary policy mandate. They are intended to ensure that our balance sheet can be used at any time for monetary policy reasons, and that our currency reserves retain their real value.

Current challenges

To conclude the subject of investment policy, I would now like to look at two key challenges facing us.

The first is to cope with the present growth in the balance sheet and to facilitate further growth, should this be necessary. The SNB has continuously adapted its investment policy to changing circumstances. It has steadily expanded its investment universe in terms of investment category, investment market and currency. This means that foreign currency purchases can be quickly absorbed. Furthermore, the addition of new investment categories enables broad diversification, which helps to preserve the value of the currency reserves. This is particularly true of equities. Since 2005, they have had an above-average impact on investment performance with an annual return measured in Swiss francs of 2.8%.

The second challenge comes from the large fluctuations in our annual results. An expanding balance sheet increases both absolute potential profit and absolute potential loss. Given the current size of our balance sheet, a small loss in percentage terms can mean a large amount in Swiss francs. Moreover, the share of our balance sheet represented by our currency reserves has grown. As a result, the balance sheet is more exposed than before to the volatility of the financial markets, especially to exchange rate fluctuations. We cannot hedge against these fluctuations because this would lead to an appreciation of the Swiss franc. Losses, therefore, cannot always be ruled out.

What implications does this have? Occasional losses, however substantial, are not fundamentally a problem for our monetary policy. As a central bank, we could still operate even if our equity capital were to become negative for a certain period. Nevertheless, this is something we are determined to avoid. Our policy on provisions and the profit distribution agreement are therefore geared towards ensuring a sound capital base.

Concluding remarks

Ladies and gentlemen, to end my speech, let me summarise my main points.

We are maintaining our expansionary monetary policy. Inflation in Switzerland is still low. Production capacity continues to be underutilised and the Swiss franc remains significantly overvalued. Many companies are still facing strong pressure to adapt. The negative interest rate and our willingness to intervene in the foreign exchange market remain necessary to ensure appropriate monetary conditions. These measures reduce pressure on the Swiss franc and support economic activity, thereby stabilising price developments.

We will continue to exploit our monetary policy latitude where necessary in order to guarantee price stability and support the economy. In so doing, we carefully weigh up the costs and benefits of possible measures. Our investment policy ensures that we retain our room for manoeuvre in the implementation of monetary policy, even with an expanding balance sheet. At the same time, we invest the currency reserves with maximum value preservation and minimum market impact.

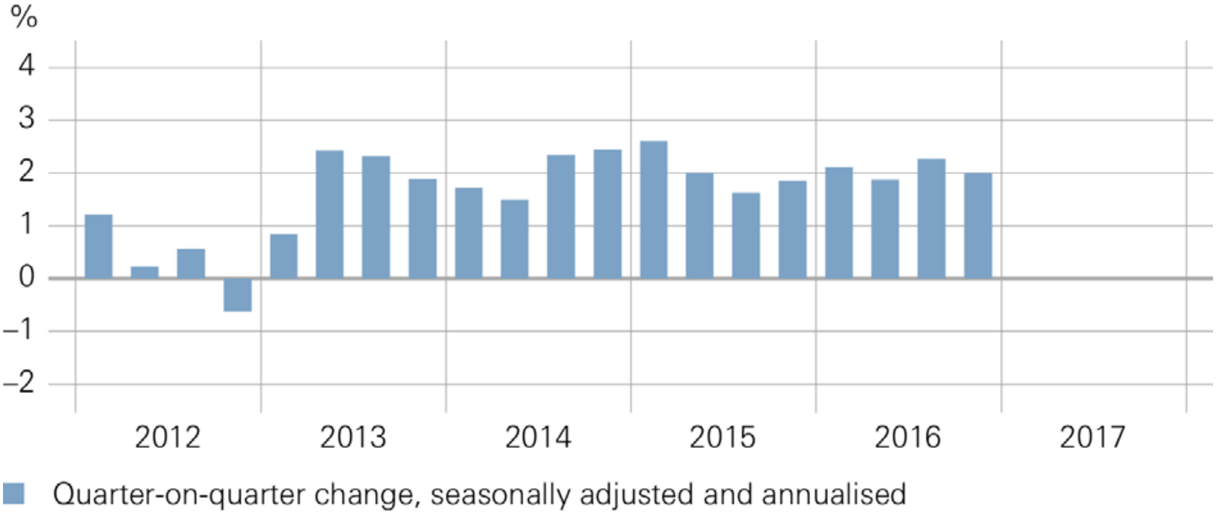
A growing balance sheet, however, inevitably leads to greater fluctuations in annual results: increasing both absolute potential profit and absolute potential loss. It is therefore vitally important that we ensure a sound capital base through our policy on provisions and our profit distribution agreement.

Overall, the SNB continues to face major challenges. We are experiencing an unusually long period filled with difficult tasks and decisions. So let me conclude by taking this opportunity, also on behalf of my Governing Board colleagues, Fritz Zurbrügg and Andréa Maechler, to thank our employees for their hard work and dedication. We also thank you, our shareholders, for your loyalty to the SNB and your faithful support. Let me also thank our young guests from the Kantonsschule Solothurn and the Gymnase cantonal de Nyon for their interest in monetary policy and the SNB. Thank you all for your attention.

Chart 1

ROBUST GROWTH OF SWISS TRADING PARTNERS

Real GDP growth, Swiss export-weighted

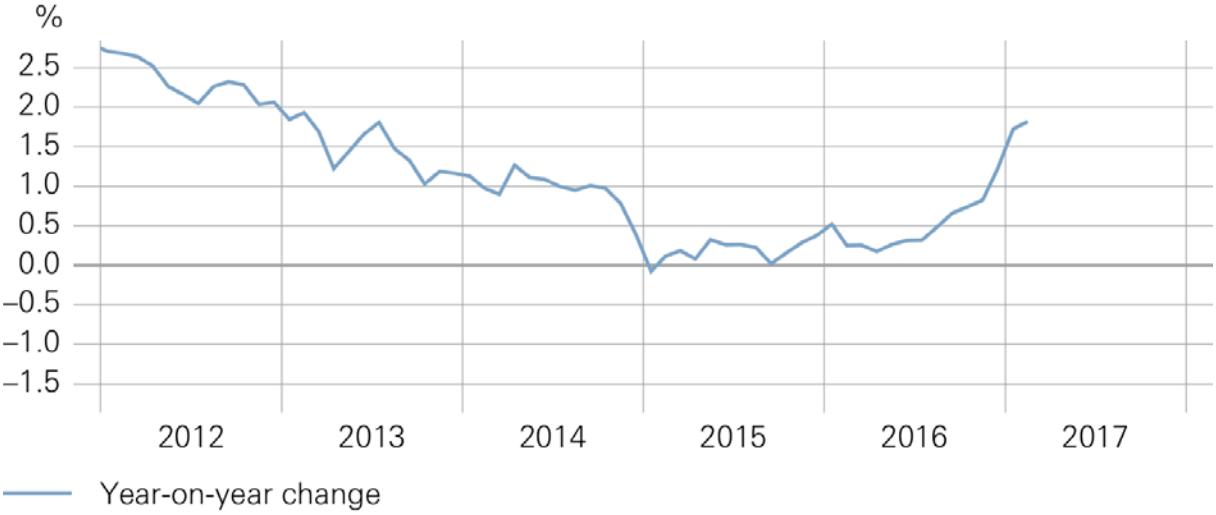


Source: SNB

Chart 2

RISING INFLATION OF SWISS TRADING PARTNERS

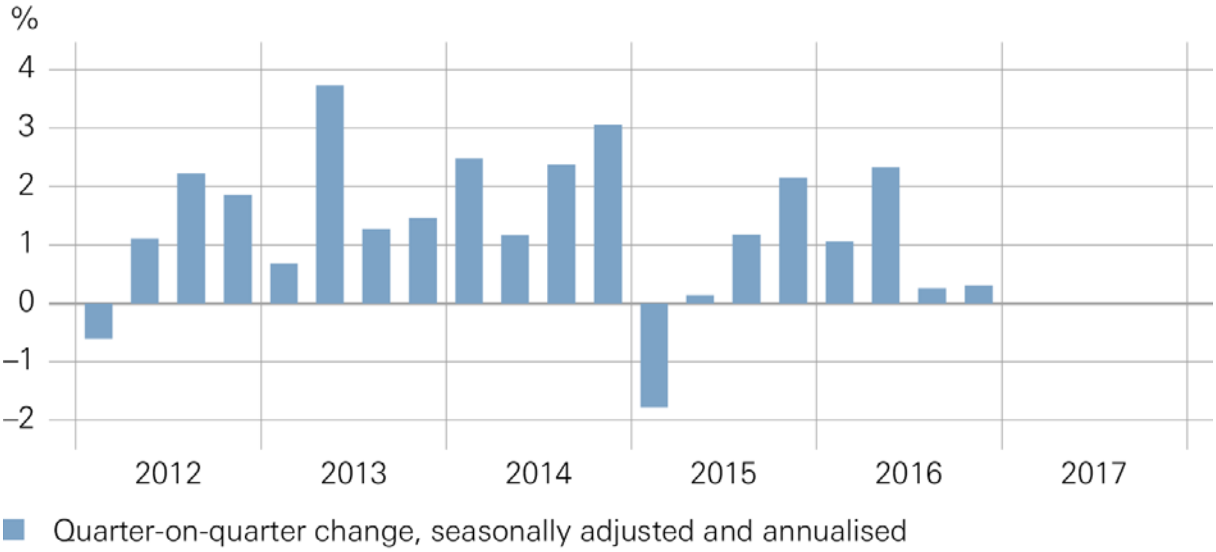
Consumer price inflation, Swiss export-weighted



Source: SNB

Chart 3

RECOVERY OF SWISS GDP GROWTH



Source: SECO

Chart 4

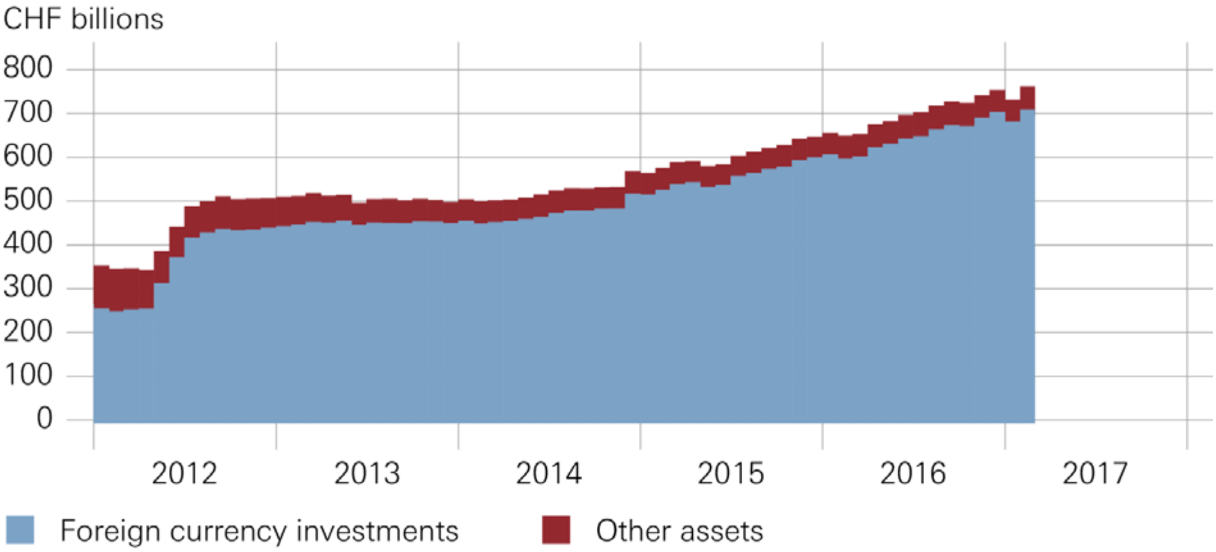
INFLATION IN SWITZERLAND CLIMBS ABOVE ZERO

Consumer price inflation

Source: SNB

Chart 5

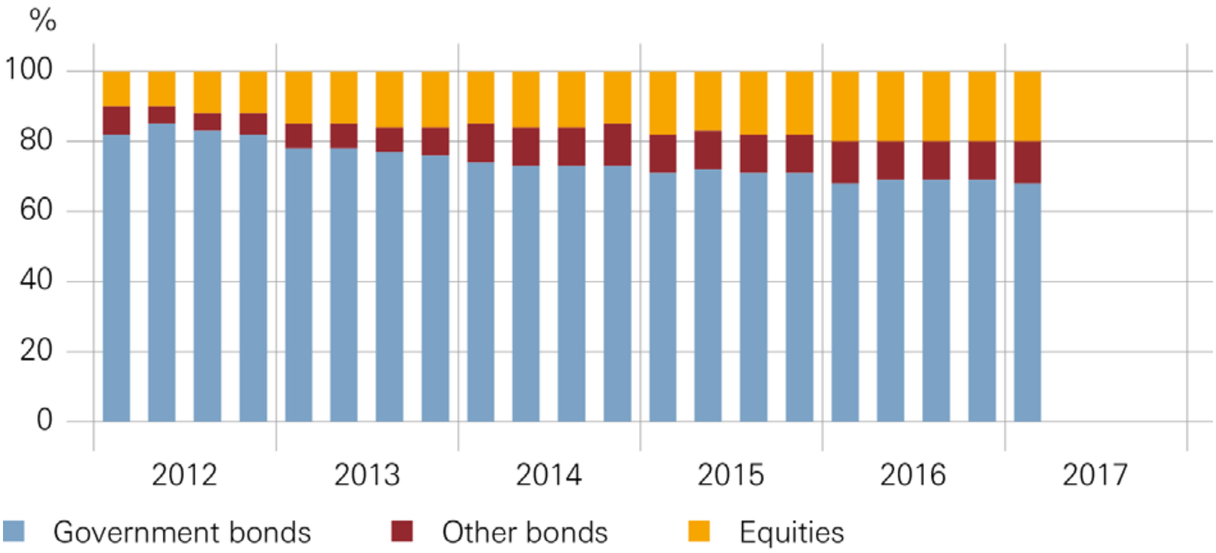
GROWTH IN SNB BALANCE SHEET



Source: SNB

Chart 6

GROWING DIVERSIFICATION OF FOREIGN EXCHANGE RESERVES



Source: SNB