

# Half-yearly Media News Conference, Geneva, 15 June 2000

**Introductory remarks by Bruno Gehrig,  
Member of the Governing Board of the Swiss National Bank**

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During the first half-year, the Swiss franc exchange rate was characterised by two contrary movements: on the one hand, the Swiss franc again softened somewhat against the US dollar. On the other hand, it firmed vis-à-vis the euro, in whose tracks it had followed since the beginning of 1999 (cf. annex 1: Swiss franc exchange rate). As a result, the downward trend of the export-weighted Swiss franc exchange rate gave way to a slight movement in the other direction. The export-driven stimulus to our economy which emanates from the Swiss franc exchange rate has therefore lost some power. Because the momentum gathered by our economic upswing is quite vigorous, this is an entirely welcome development.

The euro's trend on the exchange markets has caused disappointment or even concern among many market participants. Since its introduction, there were times when the euro lost more than 25% vis-à-vis the US dollar. It is only recently that it has recovered somewhat. In addition to economic factors, political considerations are likely to have played a role as well. Apparently, confidence in the new currency is not building up as quickly as the optimists had assumed prior to the launch of the euro.

From a historical vantage point, such exchange rate fluctuations are nothing out of the ordinary. During the dollar rally between 1982 and 1985, for example, the exchange rate changes - both in terms of their magnitude and dynamics - were just as violent. At that time, the D-Mark lost 35% versus the dollar within the space of three years. In March 1985, it fell to such low levels that, if these rates were applied to the euro, they would have corresponded to 0.55 dollars to the euro. At the time, this distortion was short-lived, however. (Cf. annex 1: dollar/euro exchange rate).

Both then and now, the underlying causes of such shifts in the exchange rates were considerable macroeconomic divergences. The dollar rally of the eighties, like the one we are experiencing today, was accompanied by a structural, fast-growing US current account deficit. Such a development presupposes foreign investors' willingness to continuously make new direct investments in the US and to accumulate securities denominated in US dollars. The flow of capital to the United States reflects a high level of trust in the US economy and in its financial markets.

There is another remarkable parallel to the eighties. At that time, the dollar rally was also preceded by a vigorous growth spurt in the United States. However - and I will now point out the significant differences - the lead in growth vis-à-vis Europe was less pronounced than it is today. In addition, the expansion in the US was due in large part to the massive tax incentives by the Reagan administration, resulting in rapidly swelling government debt and gradual pressure on interest rates. The US economy in the last few years, by contrast, saw decisive growth in the private sector. At the same time, the national budget was balanced and inflation remained moderate. It hardly comes as a surprise that financial markets react favourably to such a performance.

In the meantime, positive changes are also emerging in Europe, albeit with a certain time lag and to a lesser degree. In the last few weeks, the euro has at least managed to disengage from its low levels to a considerable degree. Without a doubt, the economic picture on both sides of the Atlantic appears in a considerably more positive light than in the eighties.

From a structural viewpoint, foreign exchange trade is undergoing profound changes. The times of record volumes are long gone. Numerous market makers are no longer in business; others have drastically curtailed the resources committed to this activity. This is no cause for concern, however. The collapse in the volume of interbank trade is contrasted by a significant improvement in market and price transparency, which is an advantage for market users. Such transparency is mainly the result of electronic trade platforms which continuously display the best offers. From an economic point of view, this change has led to greater efficiency in that the market performs its function today by expending fewer resources.

The National Bank has quite considerable assets (cf. annex 2: balance sheet). Of primary significance are Switzerland's currency reserves. These comprise foreign exchange reserves, currently worth approximately Sfr 50 billion, and gold reserves with a market value of currently almost Sfr 40 billion. To these must be added some Sfr 10 billion Swiss franc assets in net terms (i.e. less short-term liabilities vis-à-vis the Confederation), which are used mainly for steering the money market.

Once half of the Bank's gold holdings have been sold and the proceeds have been allocated to future beneficiaries, the gold reserves will decrease by Sfr 20 billion calculated at today's market price. Moreover, due to accumulated currency gains, the foreign exchange reserves currently exceed the level aimed at in agreement with the Federal Government by a little more than Sfr 10 billion. This excess of reserves, if it remains stable and is not cancelled out by currency losses, will gradually be able to be reduced in the form of profit distribution from 2003 onwards. In the long term, the National Bank may thus be expected to continue holding currency reserves of approximately Sfr 60 billion.

In managing our currency reserves, we are obliged to fulfil central bank policy and statutory requirements. In conformity with these requirements, we invest our currency reserves according to risk and earnings aspects while at the same time benefiting from the extended statutory leeway for investment we have enjoyed since 1997. First, it is our endeavour to limit the currency risks by diversification as far as possible. To this end, we maintain, in addition to the key currencies US dollar (currently 40% of foreign exchange reserves) and euro (44%), portfolios in pounds sterling, Japanese yen, Canadian dollars and Danish kroner. Second, we select the maturity composition of our investments in a way that will permit us to benefit from potentially higher long-term interest rates, while at the same time not risking excessive price losses in the event of an unexpected interest rate rise. From this vantage point, we have set the average maturities of our investments at 2 to 4 years.

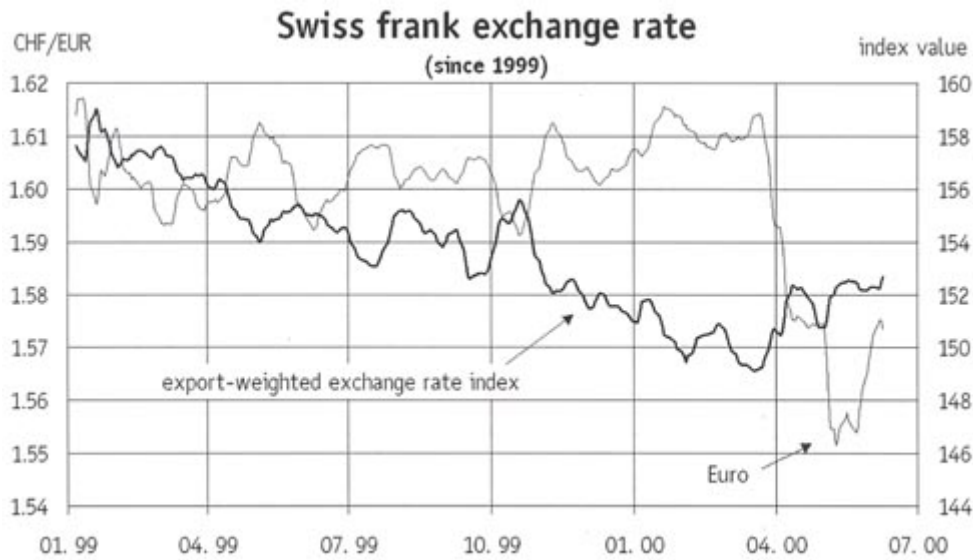
We systematically measure the success of our overall investment strategy as well as that of the individual portfolios based on representative market indexes. Moreover, for about 20 years now we have entrusted a small part of our foreign exchange reserves to a US asset management firm. Based on this experience, we recently appointed three further external portfolio managers. All in all, 7% of our foreign exchange reserves are currently being managed externally. In the case of the external mandates, we have extended our range of investments by segments that do not lend themselves easily to internal management, i.e. US mortgage-backed securities and global bonds (multi-currency portfolios). Naturally, the external asset management firms have to meet detailed performance targets; this is systematically checked by us.

What is the earnings potential of the National Bank's assets? First, it must be borne in mind that, aside from the income on gold lending business, gold reserves do not generate any interest yield. Swiss franc assets constitute primarily short-term repo agreements and securities investments; the average income on these assets is thus likely to be approximately 3% or around Sfr 300 million per year.

The earnings potential of foreign exchange reserves is more substantial. By applying the present investment strategy, which was made possible by the revision of the National Bank Law in 1997, we would have achieved an average yield on foreign exchange reserves of just under 6% in the past 15 years. A medium investment yield of 7.5% would have been matched by currency losses of just over 1.5% annually. The individual annual results would have fluctuated heavily in this case, i.e. between -7% (1994) and +16% (1996).

Since the foreign exchange reserves are invested in bonds, we would have fared relatively well with a long-term yield of almost 6%. Experience shows, however, that historical yields cannot be extrapolated uncritically. Due to the strength of the dollar and the present relatively low interest rates in an international comparison, yield prospects for foreign exchange reserves will remain rather depressed and the investment risks considerable in the medium term. In the long term, a return of just over 5% can be expected on foreign exchange investments; a volume of some Sfr 40 billion would thus yield a little over Sfr 2 billion annually.

Annex 1



Annex 2

**SNB balance sheet** in billion Sfr (as of May 2000)

<b>Assets</b>		<b>Liabilities</b>	
Gold holdings	40	Monetary base	34
Foreign currency reserves (incl. IMF position)	50		
Assets denominated in Sfr (incl. repos)	20	Liabilities towards the Confederation	10
		Other liabilities	66
<b>Total of assets and liabilities</b>	<b>110</b>		<b>110</b>