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Introductory remarks by Philipp Hildebrand

1. Developments in the international financial markets

Looking back at the year gone by, it becomes evident that two opposing price movements have dominated the markets: the strong depreciation of the US dollar on the one hand and the sharp rise in oil prices on the other hand. Developments in the bond and equity markets were, by comparison, rather restrained.

In the past few weeks, the dollar has continued its downtrend that commenced three years ago, at which time the greenback was still worth over CHF 1.70. Given the structurally inflated US current account deficit, the sustained downward revision comes as no surprise. However, the fact that the revision to date has been relatively one-sided vis-à-vis the European currencies and the Canadian dollar is problematic. Major Asian currencies have either remained completely pegged to the dollar, such as the Chinese renminbi, or joined the dollar in its slide – at least to some extent – like the Japanese yen. This was only possible, however, at a price, namely huge dollar-buying efforts on the part of the central banks and governments in question. As a result of this asymmetric trend, European exporters are currently bearing the brunt of the additional competitive pressures stemming from the weaker dollar. The Swiss export industry is understandably especially keen to see that the franc is not exposed to any further revaluations against the euro. Sudden and precipitous adjustments to the exchange rates are also undesirable from a monetary policy perspective.

The unrelenting rise in oil prices surprised many market analysts. Since the beginning of 2004, the dollar price of West Texas Intermediate crude oil has climbed by more than 50%. In real terms, however, the ascent was not nearly as sharp as in earlier oil price shocks. In Europe, the hike was further cushioned by the erosion of the dollar. The reasons behind the bullish oil prices are manifold. The main trigger, however, is likely to have been the structural increase in demand coming from the emerging economies, particularly from China and India. In addition, supply flexibility is currently quite weak, as investment spending in the drilling, transportation and storage of oil was somewhat neglected in the years when oil prices were low. Potential geopolitical risks also push up the prices. Last but not least, raw materials – such as gold traditionally – are playing an ever greater role in international investors' asset allocation, which also tends to generate an increase in demand. That notwithstanding, the influence of financial players on the

price of oil should not be overestimated. The development of the long-term futures prices of crude oil indicates that the price spike was primarily triggered by a sustained increase in consumer demand. The price of five-year futures contracts for West Texas Intermediate crude has almost doubled in the last three years.

Following the sudden rise last spring, US capital market rates have since dropped back to the year-earlier level. The temporary increase in capital market rates in Europe was slightly less pronounced. As a result of the opposing movements of the US and European interest rates of the past few weeks, the long-term dollar interest rates now exceed the corresponding interest rates in the euro area by approximately 50 basis points. On the one hand, the general interest rate development in the capital markets reflects market participants' misgivings concerning the strength of the economic upswing. On the other hand, the historically low nominal interest rates are testimony to the markets' confidence in the ability and determination of central banks to further ensure price stability. Moreover, the interest rate structure in the US is characterised by the sizeable dollar investments from Asia.

International equity markets trended sideways for much of the year, although some emerging market indices in particular were able to generate significant profits.

2. Managing the National Bank's assets

The National Bank manages monetary reserves slightly in excess of CHF 60 billion, two-thirds of which are held in foreign currency investments and one-third in gold. In addition to this are approximately 25-30 billion Swiss franc assets in the form of balances from repo transactions in the money market and bond investments in the domestic capital market. The monetary reserves and Swiss franc assets combine to make up the monetary assets, which are required for monetary policy. In addition to these assets, the National Bank also manages the proceeds from the sale of the surplus gold reserves. The portfolio of these so-called free assets amounts to slightly more than CHF 20 billion.

In the management of the monetary assets, monetary policy objectives and restrictions have priority. In compliance with the primacy of monetary policy, the investments are optimised according to security, liquidity and return. Important in this regard are the concentration on liquid investments, in other words readily marketable investments, and on the greatest possible risk diversification by holding different currencies and investment categories.

The National Bank's leeway for investment has extended considerably since the entry into force of the new National Bank Act in May 2004. Risk diversification options in particular were also increased as a result. The concrete investment structure of the different portfolios and their yields are published quarterly in an updated appendix to the Investment Policy Guidelines of the Swiss National Bank. The current investment structure and the risk/earnings profile of the National Bank's assets, in particular the foreign currency reserves and free assets, can be summarised as follows:

The portfolio adjustments made under the new Act aim to increase diversification in terms of currency and investment category. Within the context of the 2004 strategy, the dollar share was reduced in favour of the pound sterling and the yen. The weakening of the US currency resulted in a further decrease in the dollar's share of foreign currency reserves. Recently, in an effort to prevent the dollar's share from dropping too low and with a view to rebalancing, we bought dollars again on a number of occasions. Furthermore, as part of the 2004 strategy, the proportion of government bonds was also reduced in favour of other borrowers' bonds. The required minimum rating for bond investments was lowered from A2 to BBB, thus covering the entire "investment grade" range. Corporate bonds have now also been added to the National Bank's investment universe, albeit only those of foreign companies. Currently, roughly 4% of both foreign currency reserves and free assets are invested in corporate bonds. The credit quality of all our investments is still very high. Borrowers with the top rating AAA account for over 70% of the investments. Close to 20% bear the AA rating. The remaining investments have an A or a BBB. The average residual maturity (duration) of all bonds held by the National Bank was kept at 4-5 years. The first investments in equities issued exclusively by foreign companies will be made at the beginning of 2005. The addition of equities and corporate bonds is likely to improve the degree of diversification of the investments and will contribute to the achievement of slightly higher returns in the medium term.

The main difference between the investment structures of foreign currency reserves and free assets is their currency profile. In the case of free assets, foreign currency investments are more diversified and are also partially hedged against exchange rate risks. Around half of the free assets are currently exposed to currency risks.

The risks relating to the National Bank's assets are primarily assessed and monitored using the value-at-risk method. Moreover, a number of different stress analyses are increasingly being carried out. In risk measurement, it is taken into account that the investment horizon, in particular for the monetary reserves, is a long-term one. Where monetary assets are concerned, gold price and exchange rate risks – notably those on the dollar – play a decisive role. Interest rate risks, while significant in their own right, are quite small by comparison. The overall risk with free assets is considerably lower. On the whole, the credit risks are relatively small.

The National Bank's investments are valued daily at market prices, thus making it possible to form an up-to-date impression of the earnings situation. Owing to the high degree of risk exposure to the gold price, the exchange rate and the interest rate level, the earnings situation can change dramatically from quarter to quarter and year to year. In this year alone, the quarterly returns on total assets fluctuated between +2.7% and -3.2%. So far this year, the National Bank's assets have yielded 1.3% overall. Given its long-term investment horizon, short-term fluctuations generally do not present a problem to the National Bank. The long-run yield is of greater importance. In the past five years, the National Bank has achieved an average yield of 2.9%. This more or less corresponds to the earnings forecasts underlying the agreement between the Swiss Confederation and the National Bank regarding the distribution of profits.