

Speech given by Mr Philipp M. Hildebrand,
Chairman of the Governing Board,
at the General Meeting of Shareholders
of the Swiss National Bank on 29 April 2011

Mr President of the Bank Council

Dear Shareholders

Dear Guests

Last year was, once again, a time of severe turbulence. It is therefore all the more gratifying that we can look back on a positive year overall for the Swiss economy. According to initial estimates, our economy grew by 2.6%. The situation on the labour market improved significantly. And inflation, which had been negative in 2009, amounted to 0.7% on average. Price stability was thus assured.

The greatest risk for the Swiss economy was posed by exchange rate movements. The Swiss franc remained subject to upward pressure in 2010. In the view of the Swiss National Bank, a risk of deflation persisted during the first half of the year. In order to counter the deflation risk, the SNB followed a policy of preventing an excessive appreciation of the Swiss franc up to the monetary policy assessment in mid-June. It implemented this policy by purchasing foreign currency on a large scale. During this period, the Swiss franc only appreciated by roughly 2.5% in export-weighted terms. In June, the SNB discontinued its foreign exchange market interventions. In export-weighted terms, the Swiss franc has since firmed by nearly 13%. This appreciation of the Swiss franc resulted in high valuation losses on the SNB's foreign currency holdings.

The foreign exchange purchases met with public criticism, some of it severe. Some quite legitimate and important questions were raised in the process. In my review of monetary policy over the past year, I will therefore once again explain the reasons for our action.

From the viewpoint of financial stability, the past year can be viewed as encouraging, even though the global financial system remains vulnerable. It is thus all the more important that financial sector reforms are carried forward swiftly and that the financial

system is sustainably strengthened. At international level, the release of the new regulatory framework for banks, Basel III, marked an important milestone. Basel III raises the global minimum capital and liquidity requirements for banks, with a significant increase as regards both the quantity and the quality of capital. The implementation of Basel III will strengthen the resilience of the global financial system.

However, Basel III does not offer any solution to the 'too big to fail' issue. A financial institution is defined as 'too big to fail' if its failure would pose an existential threat to the financial system and the real economy. Here in Switzerland, the 'too big to fail' issue is particularly pronounced. The balance sheet total of the two big banks still represents a multiple of Swiss GDP. Against this background, the Federal Council appointed a commission of experts in the autumn of 2009. Last October, the commission presented its final report on how to alleviate problems associated with this issue. The SNB and the two big banks were represented in this commission at the highest level. The report with its recommendations was unanimously approved by the commission's members.

In order to achieve a clear alleviation of the 'too big to fail' issue, the recommendations of the commission of experts must now be implemented. Last week, the Federal Council formulated the relevant Message to Parliament. The responsibility now lies with the Swiss parliament.

Let me now describe economic developments and monetary policy in 2010 in more detail.

Review of monetary policy in 2010

As I mentioned at the beginning of my remarks, 2010 was a year of recovery for the Swiss economy. Yet it was also a difficult year, characterised by high exchange rate volatility and enormous uncertainties.

Allow me to take a brief look further back, to the year 2009. At that time, the severe downturn in the global economy threatened to trigger a deflationary trend in Switzerland. Not only the SNB, but also other institutions such as the International Monetary Fund (IMF) shared this view. These circumstances called for a swift and decisive monetary policy response. The main aim was to rule out the possibility that monetary conditions in

this very critical phase might be exacerbated by an appreciation of the Swiss franc. Consequently, in March 2009, the SNB decided to bring about a de facto zero interest rate, and to prevent any further appreciation of the Swiss franc against the euro.

At the end of 2009, the SNB considered that, given the continuing recovery in the economy, the threat of deflation had receded. The main indicator used in monetary policy decision-making by the SNB is the conditional inflation forecast. It reflects the scenario considered the most likely at the time of the assessment. It does not, however, reflect the risks that may lead to a different path for inflation, or to the emergence of a deflationary trend. In making its decisions, the SNB does take into account the probability of inflation taking another, different course and the associated repercussions for the economy. Thus, in December 2009, the SNB observed an ongoing economic recovery, but at the same time regarded this recovery as still fragile and associated with considerable uncertainties. It therefore concluded that a moderate appreciation of the Swiss franc would be acceptable. An excessive appreciation, however, would still carry a risk of deflation. Consequently, in December 2009 the SNB announced that it would act decisively only in the event of an excessive appreciation of the Swiss franc against the euro. This stance was confirmed at the assessment in March 2010.

From mid-April 2010 onwards, the escalation of the sovereign debt crisis in Europe gave rise to major tensions on the financial markets, and there was a sharp increase in volatility. The markets lost confidence in the solvency of the Greek state. The European banking system came under renewed pressure. At the end of April, Greece had to seek international financial assistance. Although concerns initially centred on Greece, the crisis quickly spread. Tensions re-emerged on the interbank market. Swap agreements between the major central banks were reactivated, in order to ensure the supply of liquidity in the corresponding currencies.

This sharp increase in uncertainty on the financial markets swiftly prompted a widespread flight to the Swiss franc. In view of this extreme situation, there was no reason for the SNB to deviate from its specified policy of preventing a rapid and excessive appreciation of the Swiss franc. Against such a background, the SNB was not prepared to allow a sharp

tightening of monetary conditions, which might have triggered a deflationary trend. It therefore made a renewed round of large-scale foreign exchange purchases.

In May, the European Union (EU), the European Central Bank (ECB) and the IMF succeeded in gradually restoring calm to financial markets. A key measure was the establishment of the European financial stabilisation mechanism. In parallel, the ECB began buying government bonds of individual EU countries to support the securities markets. Volatility in the financial markets decreased as a result. Moreover, economic data indicated that the recovery in Switzerland had firmed. The outlook had improved for economic growth, the labour market and technical capacity utilisation.

At its June assessment, the SNB therefore concluded that a further appreciation of the Swiss franc no longer posed the same threat to price stability as it had only shortly beforehand. It thus refrained from carrying out any further interventions on the foreign exchange market.

Swiss franc liquidity in the banking system rose sharply in 2010 due to the SNB's extensive foreign exchange purchases. At the end of May, the monetary base reached a historical high. Conversely, the three-month Libor fell to a historical low.

In June, the SNB began to reduce liquidity in the banking system. At first, this was done by stepping up the issuance of the SNB's own debt certificates, SNB Bills. Since July 2010 this has been supplemented with liquidity-absorbing repo operations. In this way, the SNB laid the groundwork for a normalisation of monetary policy with the aim of ensuring price stability in the medium and long term.

Ladies and Gentlemen, last year we were able to assure price stability, and the Swiss economy enjoyed solid growth. Does this mean that there was never any risk of deflation? The answer is no. It simply means that this event did not occur. The SNB's policy – and that includes the foreign exchange purchases – undoubtedly contributed to this positive outcome. Yet the exceptional monetary policy measures were not without consequences. As our Bank Council President has explained in his presentation today, they are reflected in the balance sheet losses and in the SNB's increased balance sheet risks.

Let me now turn to the outlook for 2011.

Outlook for the current year

The global economic outlook is encouraging overall. The latest economic indicators suggest that growth in the emerging economies of Asia will continue to be dynamic. Export-oriented industrialised economies, in particular, are benefiting from brisk demand from Asian countries. In Europe, the main beneficiary is Germany, whose economic upturn stands out considerably from the European average. Thus, the pace of recovery within the euro area still varies significantly from one country to another. While developments in Germany and France are positive, the peripheral countries have not yet shaken off the crisis. In the US, consumer spending is picking up as the labour market continues to recover.

Despite the continued strength of the Swiss franc, the Swiss economy is growing more vigorously than anticipated. Business expectations still suggest continued favourable developments in the coming months.

So far, exports have developed better than one might have feared. The negative consequences of the Swiss franc's strong appreciation are likely to have been partly offset by three factors. First, economic growth in Switzerland's major export destinations has risen sharply. This is especially true of Germany and the emerging economies in Asia. Owing to their stronger focus on these markets, this has benefited Swiss exporters. Second, Switzerland is specialised in the production of high-quality goods, where price plays a smaller role than is the case for other goods. The third factor is the impressive adaptability of Swiss exporters, who were extremely flexible in responding to the competitive disadvantages resulting from the stronger currency.

Over the course of 2011, the SNB nevertheless anticipates weakening growth for the Swiss economy. We are currently projecting GDP growth of roughly 2%. A closer look certainly reveals dampening effects of the stronger Swiss franc. For a long period during 2010, the recovery in goods exports almost came to a standstill. While exports have picked up again markedly since the end of last year as a result of strong global demand, they have yet to

exceed their pre-crisis levels. Were it not for the strength of the Swiss franc, they would certainly be much higher today. The appreciation has particularly affected the tourism industry. Foreign demand for tourism services has even declined over recent months. SNB surveys point to increased competitive pressure for many Swiss export firms. In addition, a great many are expressing concern about narrow margins. While it has, so far, been possible to absorb the stronger franc mainly through cost-cutting measures, a growing number of companies are beginning to consider transferring production abroad.

These signs are a reason for caution: the strong appreciation that the Swiss franc has undergone might cause more difficulties for the economy than previous data lead us to believe. Additional risks to growth arise as a result of the global environment, in particular the precarious debt situation of many sovereign states and the possible repercussions of such problems on the financial markets. This applies above all to the euro area, where, even after the recent progress achieved with the agreement on a euro stabilisation fund, we have not seen the end of debt problems in the peripheral countries. However, this also applies to the US and Japan, which will both face considerable fiscal challenges over the next few years. Moreover, a further rise in oil prices, not least as a result of the tensions in the Middle East, could seriously curb global economic growth. Finally, the consequences of the catastrophic earthquake in Japan and the nuclear crisis it triggered are also still difficult to assess.

The downside risks to growth are thus still substantial. Nevertheless, given the economic recovery in Switzerland and abroad, a new recession looks unlikely from the current perspective.

Meanwhile, certain upside risks are beginning to emerge with regard to price stability. Inflation has risen worldwide. In addition to oil prices, the prices of agricultural products have also risen. Moreover, the continued vigorous demand from the emerging economies is fuelling commodity prices across the board.

The inflation trend in Switzerland has been moderate so far. The very strong franc has made a significant contribution in this regard. The consumer price index rose by 1.0% in March. However, this rise overstates the actual inflation pressure in Switzerland. As of the

beginning of 2011, price data for clothing and shoes are now being collected on a monthly basis, and this has resulted in a temporary technical increase in the annual inflation rate. Survey data also show that, while inflation expectations for Switzerland have risen somewhat, they continue to be well within the range of price stability.

However, should the Swiss franc weaken again rapidly, rising commodity prices could also have an impact in our country. Furthermore, the expansionary monetary policy carries long-term risks for price stability. In Switzerland, these risks manifest themselves in the continued strong growth of the monetary aggregates and of mortgage lending. The SNB has frequently stated that the situation on the mortgage and real estate market requires particular attention. It is especially in these areas that imbalances with serious repercussions can occur if interest rates remain at a very low level for a long time.

Concluding remarks

Ladies and Gentlemen, allow me to make a few concluding remarks. The SNB will not hesitate to take all measures necessary to ensure price stability in our country, also in the future. Price stability is an important condition for a society's growth and prosperity. This is why it is the SNB's legal mandate to ensure price stability while taking due account of economic developments. In fulfilling its monetary policy tasks, it has been granted independence. Central bank independence is a valuable commodity, which has proved its worth remarkably throughout economic history.

Ladies and Gentlemen, as you are well aware, we continue to operate in a very challenging environment. On behalf of the Governing Board, I would like to thank our shareholders for their loyal support and for their continuing interest in our activities. I would also like to take this opportunity to mention the many staff members who have been faced with tremendous challenges since the beginning of the financial and economic crisis. They have performed superbly. On behalf of my colleagues in the Governing Board, my special thanks go to them.