A view on Switzerland in the run up to the demonetisation of gold

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I would like to thank you for inviting me to participate in this gold conference and for the opportunity to give you some insight into the present state of the discussions on the demonetisation of gold in Switzerland. I must admit that I have accepted your invitation with mixed feelings: why play the role of trouble shooter here among people worried about the activity of central banks on the gold market? How to communicate the SNB's intentions when its room for manoeuvre depends on a complicated political process? All this makes me dream of comfortable situation of my colleagues in Belgium and Holland who were able to implement their strategy without outside interference and could communicate their sales as a *fait accompli*. I also look with envy at the Bank of England which will be able to proceed with sales shortly after the Treasury has made its intentions public.

Let me address the following issues:

- Firstly, I will show you the importance of gold in the National Bank's monetary reserves;
- Then I will outline why the revaluation of our gold holdings will necessarily lead to disposals:
- In a third part, I will describe the different political stages down the road, the uncertainties surrounding this process, and the timetable we can expect to adhere to.
- Finally, I will conclude by indicating in what spirit we plan to tackle the delicate task of disposing of an important part of our gold holdings.

1. Switzerland's gold reserves

The situation in Switzerland is completely transparent. With 2590 tonnes of gold in its reserves, Switzerland is one of the major holders of the yellow metal. Its holdings are comparable to those of Italy, slightly lower than those of France, and significantly higher than those of Great Britain (see graph 1).

In relative terms, however, Switzerland is the largest holder of gold reserves: per capita, per GDP unit, in proportion to imports or relative to currency in circulation (see graph 2).

As you can see, Switzerland probably represents an extreme case with regard to gold holdings. The fact that the question of possible gold sales by the SNB in the market has not arisen until recently is due to several technical and psychological factors:

- Gold is still valued at its last official price of 1971 in the SNB's balance sheet, only one-third of its market value is shown;

- In the past, the SNB was required to back 40 per cent of the banknotes in circulation with gold, which did not leave any room for action;
- The sale of gold requires a fundamental reform of the Swiss monetary system, which, because of our direct democracy, is a long and complex process;
- Finally, in the public's mind, the Swiss franc and gold were so closely linked that the idea of selling gold seemed to be rather unrealistic.

Things started to move in February 1997. At that time, a first decision regarding demonetisation of gold was taken by the Economic Committee of the National Council, one of our two houses of our parliament. Two months later, in May 1997, the market became fully aware of the gold issue, when the President of the Confederation proposed to parliament to allocate a part of the revaluation gain on gold to fund a Swiss Foundation for Solidarity which would provide assistance to persons in need in Switzerland and abroad. It was established from the outset that the initial contribution to the foundation would be in the form of a 500 tonnes gold donation by the SNB. It thus became fully clear that Switzerland was going to demonetise gold and to progressively transform a part of its stock into interest bearing assets.

But why did we decide to fund the Foundation with gold and not with other assets? In order to understand this, one must take a closer look at the structure of the SNB's balance sheet.

2. From revaluation of the gold stock to gold sales

2.1. The SNB's balance sheet

If, in relative terms, Switzerland is leading among all industrialised countries as far as gold holdings are concerned, the Swiss National Bank is also a special case with respect to the structure of its balance sheet.

The bulk of the SNB's assets consist of foreign exchange and gold. Swiss franc denominated assets constitute a mere 20% of the total. Compared to the balance sheets of the Bundesbank prior to the introduction of the euro, the SNB's balance sheet exhibits only a small proportion of domestic assets (see graph 3).

On the liabilities side, the most striking feature are the bank's own capital and reserves to which will be added the revaluation gain on the gold stock (see graph 4).

Two arguments justify a transfer of gold reserves:

Firstly, the existence of considerable capital resources within the SNB balance sheet shows that we are endowed with more reserve assets than necessary from a monetary point of view. There is no example of a central bank of a G10 country with such a proportion of capital and undistributed profits in its balance sheet (see graph 5).

The question therefore naturally arises whether the moment has not come to allocate a part of the Bank's own wealth to other purposes than monetary policy.

Secondly, our balance sheet shows clearly that any transfer of the revaluation gain or part thereof cannot take place in Swiss francs or in foreign exchange. Our domestic assets are too low and a transfer of foreign reserves would have a negative impact on the Bank's operations:

- the SNB would be impeded in conducting its monetary operations (interventions, money market operations)
- the bank's profitability and liquidity would diminish drastically.

Consequently, a transfer in gold of a part of the valuation gain is the obvious solution. A group of experts has been asked to make an estimate of the excess reserve of the bank.

2.2 The proposals

The Group of Experts has come to the conclusion that a capital corresponding to 1300 tonnes of gold could be withdrawn from the SNB's balance sheet to be used for other purposes than monetary policy. Of these 1300 tonnes, 500 tonnes are to be set aside for financing the Swiss Foundation for Solidarity previously announced.

What to do with the remaining 800 tonnes ?

A first idea would consist in transferring the remaining excess reserves to a public investment fund having more extensive investment possibilities than the SNB. Currently, our asset management policy is basically limited to fixed-income investments. The fund's regulations should provide for investment in shares in order to achieve a higher long-term yield.

But there is usually no limit to the imagination of politicians when money is to be distributed! Other concrete proposals exist. Some would like the excess gold reserves to be earmarked for specific goals such as improving the capitalisation of our social security schemes or for educational purposes.

But regardless of the projects, the aim is always to transfer our excess reserves outside the SNB in order to manage them more effectively than within the central bank and its relatively restrictive framework. On our side, we are not keen about by the idea of being in charge of managing a large reserve portfolio. We do not wish to wear two hats, one as central bank in charge of monetary policy and that of asset manager for the country. We could run the risk of being caught in the crossfire of criticism when it comes to executing a mandate which is not a part of our basic responsibility.

One way or another, the transfer of excess reserves by the SNB to one or several outside entities is not just a simple accounting problem. Even though the National Bank is independent it does not have the legal power to dispose of a part of its own resources for other purpose than monetary policy. Legislative and constitutional steps are necessary and they are currently under way. It is important to have them in mind because they may hold a few surprises.

3. The political process

3.1 First stage: demonetisation of gold

The first stage, which aims at demonetising gold, is already well under way.

The demonetisation of gold required two legal adjustments:

- a revision of the Swiss Constitution
- a revision of the current Coinage Act.

On 18 April 1999, the Swiss voters approved a total revision of the Constitution. In this revision, the requirement that a certain percentage of banknotes be backed by gold was removed. The abolition of this backing requirement constitutes the first step in the dismantling of the old gold standard order. The new Constitution will enter into effect on 1 January 2000.

In the course of the next few months the Swiss parliament will debate on the revision of the Federal Coinage Act, which will henceforth be known as the Federal Law on Currency and Payment Instruments. The Coinage Act vested the right to fix the gold parity of the Swiss franc in the Federal Council. In future, no reference will be made to a gold parity. In this respect, too, one of the chief characteristics of the gold standard will disappear.

Parliament is expected to pass the new Federal Law on Currency and Payment Instruments before the end of this year. The Law will enter into force in spring 2000 unless, in the meantime, 50,000 citizens would request for a referendum on the subject. If a referendum is to be held, it would probably take place in autumn 2000. To my mind, however, the probability that signatures will be collected for a referendum is slight indeed. I am fairly confident that the new law will enter into effect in spring 2000 without delay.

By the time the law on payment instruments will be in place in early 2000, gold will have been demonetised. The SNB will be allowed to evaluate its gold holdings at their market price, and a revaluation surplus will appear on our balance sheet. Technically, the SNB will also be able to buy or sell gold on the market.

3.2. Second stage: transfer of excess reserves

The recent revision of the Constitution and the new Federal Law on Currency and Payment Instruments are not sufficient as a legal basis for allowing the National Bank to transfer excess reserves to external funds. A special constitutional basis must be created for this purpose and then specific legislation will have to allow the realisation of concrete projects (law on the Swiss Foundation for Solidarity, for example).

Consequently, a second revision of the constitutional article concerning the SNB is now being drafted. Among other things, this new article provides for the possibility to transfer, outside the SNB, excess reserves deriving from the revaluation of the gold stock.

Deliberations on this article have just begun in parliament. If everything goes well, the article could be approved by both houses before this summer. Afterwards, in compliance with Swiss regulations, the draft of the new article of the Constitution will be submitted to the voters and the cantons for approval. In Switzerland, every amendment to the Constitution must reach two majority votes: a majority of the citizens' vote and a majority of the cantons approving the revision. This vote could take place in the spring of the year 2000, i.e. at the time the Federal Law on Currency and Payment Instruments enters into force. If the revision of the Constitution is approved, it will become effective immediately, which means that the SNB will be able to transfer its excess reserves as soon as the implementing bills will be ready.

Should the revision of the Constitution fail to pass, the excess reserves would remain on the SNB's books, and the Bank would then have the responsibility of managing them with the objective of generating more profit for the government. Nothing fundamental would change as far as the possible selling of gold is concerned : gold sales would remain on the agenda.

With regard to the sale of gold, the essential element is thus that the Federal Law on Currency and Payment Instruments be passed. The amendment to the Constitution is only important to the extent that it determines where the excess reserves will be administered.

4. Perspectives for the SNB's gold policy

Ladies and gentlemen, I have been talking to you for twenty minutes now without actually giving you an idea what the SNB will concretely do. Given the political uncertainty which still exists regarding the process of demonetisation of gold and the transfer of excess reserves, you will understand that this is neither the time nor the place to set out a sales programme.

Listening to my presentation, you will no doubt have concluded that the process of demonetisation of gold is well under way and that one can reasonably expect that the gold parity of the Swiss franc will be abandoned in the spring of next year.

Formally, the demonetisation of gold will give the SNB sufficient room for manoeuvre to become active on the market. Gold transactions could thus be scheduled to begin next year when the legal framework will be in place. Greater uncertainty surrounds the question of the allocation of excess reserves, but this will have no impact on our sales intentions.

As no precise date for the beginning of our sales activities could be set, I will limit myself to indicate to you in what spirit we plan to approach this question. In my opinion, two observations seem essential:

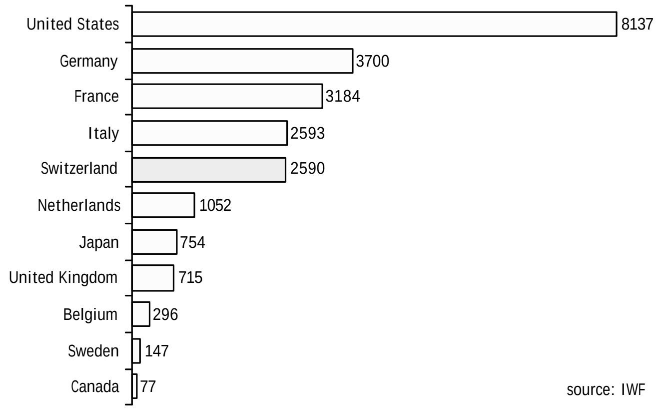
Firstly, as a major holder of gold, the Swiss National Bank has no interest in adopting a strategy which would push the gold price down. We know that 1300 tonnes of gold cannot be absorbed by the market in a short period of time. We therefore are considering distributing the sales over a period of several years.

Secondly, we intend to keep important gold holdings. Once the sales programme has come to an end, gold will continue to play an important role in our monetary reserves. The recent revision of the Constitution has led to the stipulation that we should maintain "sufficient" gold reserves. The fact that this precision was introduced at the initiative of our parliament indicates that the Swiss people wish to keep ample gold reserves. Consequently, we do not envisage going beyond the announced plan of selling 1300 tonnes.

Graphs

Graph 1

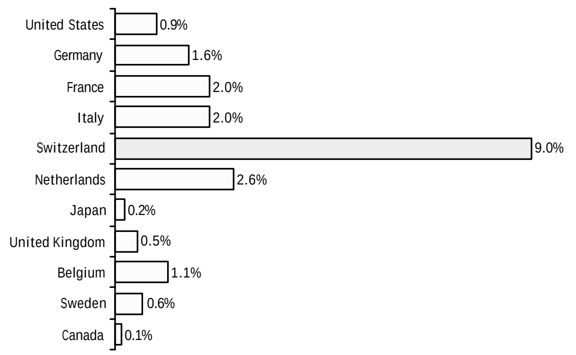
Gold Reserves of the G10 Countries as of December 1998 in Tonnes



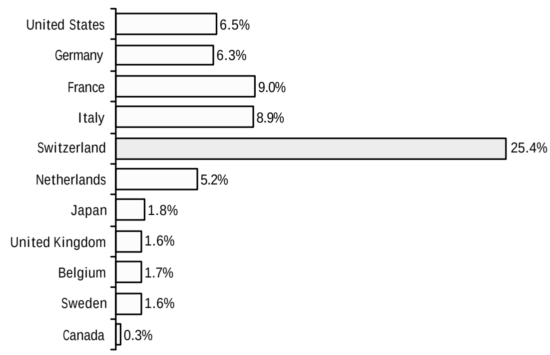
Graph 2

Gold Reserves in Relative Terms

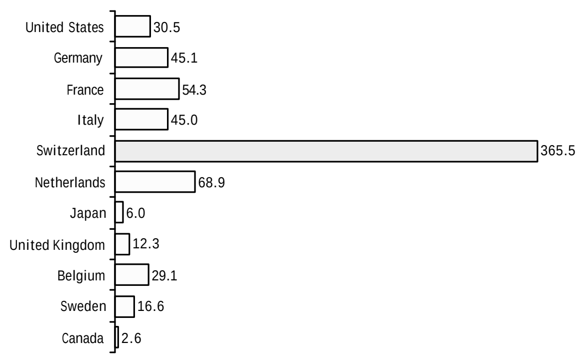
Gold per GDP Unit



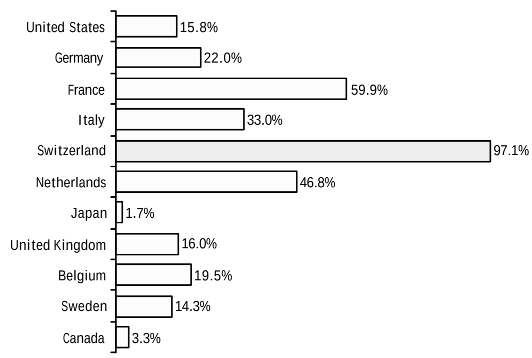
Gold / Imports



Grams of Gold per Capita

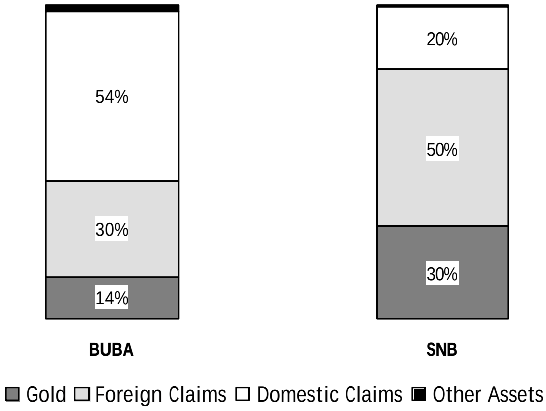


Gold / Currency in Circulation



Source : IWF, OECD

Graph 3
Assets Structure of the Bundesbank and the Swiss National Bank



Graph 4
Simplified Balance Sheet of SNB as of 31th December 1998 in Billion Dollars with Gold at Market Price

Assets		Liabilities	
Gold Holdings & Claims on Gold	24	Monetary Base	29
Claims in Foreign Currencies	41	Liabilities towards the Confederation	11
Claims in Swiss Francs	17	Gold Provision	15
		Capital, Reserve & Provisions	27
Total	82	Total	82

Graph 5
Estimate of G10 Central Banks' Net Wealth in Proportion of GDP