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Introductory remarks by Niklaus Blattner

Gold sales

Since May 2000, the National Bank has been selling gold that is no longer required for monetary policy purposes. A total of 1,300 tonnes of gold is planned to be disposed of under the agreement on gold sales concluded on 26 September 1999 between fifteen European central banks. This agreement limits the total quantity of gold that can be sold by the signatories until September 2004 to 2,000 tonnes.

To date, we have sold almost 520 tonnes of gold, which corresponds to 40% of the total quantity earmarked for sale. As shown in our periodic Bank returns, we are conducting regular sales of approximately one tonne a day. We consider this method more flexible, less costly and better suited to the characteristics of the market than the strategy chosen by the Bank of England, which is holding gold auctions of its own.

Our average selling price has by now reached USD 279.4 per ounce (level of 31 May 2002), which is USD 2 higher than the average London gold fixing price, the benchmark price for gold. This performance has, to some degree, been realised thanks to the National Bank having been allocated a somewhat higher portion of the central banks' total annual quota of 400 tonnes since September 2001. Due to the bullish gold market, this slight increase in our sales quota has had favourable effects. Translated into Swiss francs, the average selling price has settled at over Sfr 15,140 per kilogram.

Since the sales began, the price per ounce has fluctuated between USD 256 and USD 330 (see graph). Recently, it has again surpassed the level of USD 320 per ounce. Such high levels had been recorded only during short periods in recent years, for example in reaction to the central bank gold sales agreement of September 1999. What is striking about the current gold rally is how persistent it has proved so far. Several factors have contributed to this new trend:

- A key factor supporting the high gold price is the mines' changed hedging policy. In order to reduce part of the price risk on their future production, the mining companies may engage in forward sales of gold and in similar hedging transactions. The commercial banks, in turn, which act as counterparties in these transactions hedge against the risk by borrowing gold from the central banks and reselling it immediately. This increases the amount of gold offered directly on the market. The gold lent by the central banks flows back to the lender upon expiration of the forward contract. If the mining companies hedge less, the gold on offer is reduced correspondingly. In the second half of the 1990s, gold producers massively expanded their hedge positions, which led to an increase in supply and thus contributed to depressing the gold price. Since 2000, and especially in recent months, the picture has changed. The mines have opted for another strategy and have cut back on price hedging. This strategy change can be partly attributed to more positive expectations regarding the gold price. As a result of the central bank agreement on gold sales, producers no longer fear large-scale sales by the central banks. Moreover, it seems that producers have recently become more upbeat in their assessment of private investment demand. It is interesting, in this respect, that gold producers' hedging activity tends to accelerate market trends. When they expect price decreases, prices do in fact decrease faster as a result of hedging, and when they expect price rises, prices do rise faster owing to the decrease in hedging. Such strategy changes, which are always due to changed market expectations, have to be reckoned with in future as well.

- Reviving private investment demand in the industrialised countries has also contributed to giving the gold price a boost. This phenomenon has been particularly pronounced in Japan, but Europe and the United States have also seen gold demand booming. Economic imponderables, concern over the financial health of some companies, heightened political tension in different parts of the world, the terror attacks of September 2001 and concomitantly subdued stock markets have caused investors to increase their holdings of the yellow metal. It seems as if gold is, for the time being, once again assuming its role of a safe haven investment.
- Fabrication demand for gold, by contrast, for jewellery as well as for industrial uses, has contracted in recent months. In the industrialised countries, this decline has been mainly brought about by the economic slowdown. The high gold price, however, has also played a role, especially in developing countries. In countries such as India, which accounts for a quarter of gold demand, the precious metal is held in the first place for saving purposes. Investors use a more or less fixed portion of their disposable income to purchase gold. In times of rising gold prices, investors buy correspondingly less gold.

From these developments we can draw two conclusions:

- In the long term, the main elements influencing gold price expectations are changes in private investors' demand, mines' production costs as well as the central banks' fundamental attitude towards their gold reserves.
- In the short and medium term, any change in producers' hedging policies and in the central banks' gold holdings, as well as speculative demand can trigger noticeable shifts in the gold price. These price movements, both upward and downward, may be relatively significant because the gold market is not very liquid, as experience has shown. Under this point of view, the central bank gold sales agreement of September 1999 has had a stabilising effect, since it has made the operations of central banks transparent and eliminated an important source of uncertainty.

Our sales will continue until we have completed our programme, i.e. until we have sold 1,300 tonnes of gold. I will not take the risk and predict the development of the gold price, but one thing is certain: it will remain volatile.

Our possibilities to actively hedge the gold risk are restricted by the agreement of September 1999. In particular, we may conduct hedging transactions only in the amount of the sales quota allocated to us for the current year. We are therefore all the more convinced that our strategy of regular sales remains appropriate. The principles that have guided our operations for the past two years – namely fulfilment of our commitments under the central bank agreement, transparency in communication and situation-adapted handling of day-to-day business – remain relevant.

Management of the free assets

The market value of the free asset portfolio – consisting of the as yet unsold portion of the 1,300 tonnes of gold and the proceeds from the already effected gold sales – amounted to Sfr 21 billion at the end of May. The free asset portfolio is managed separately from our other reserves, which will facilitate its transfer to the future beneficiaries once the legal framework has been put in place.

As I mentioned earlier on, our possibilities of actively hedging the gold risk against an unfavourable development of the gold price are restricted by the agreement on gold sales of September 1999. However, we limited the risks of a weak US dollar that might reduce the value of our future sales by hedging 35% of the future proceeds in US dollars against the Swiss franc.

The proceeds from the gold sales are placed in a bond portfolio, whose composition differs from that of our currency reserves. Approximately 65% of the portfolio is invested in Swiss franc bonds or hedged against exchange rate risks. The rest consists of bonds denominated in euros (25%), US dollars (3%) and other currencies (7%). The average duration of the portfolio is about three years. This investment profile takes account of the SNB's legal framework and of the fact that future beneficiaries will want their return denominated in Swiss francs. The market value of the gold proceeds amounts to approximately Sfr 8 billion. Since it was created in May 2000, this portfolio generated an average annual yield of 4.3%. The legal provision still prohibiting the National Bank from acquiring equities has in fact rather well served the interests of the future beneficiaries of the free assets, as stock markets have been on a decline since May 2000.

Next September, the Swiss people will have to decide on the appropriation of the free assets. There are several conceivable scenarios: either the so-called gold initiative is accepted, or the counter-proposal of the Federal Council is accepted, or both proposals are rejected. Each scenario has different implications for the date of transfer of the free assets and for the SNB's balance sheet.

Whatever the outcome of the vote, we believe that the funds allocated to the free assets are no longer needed for conducting monetary policy and that, therefore, they have to be assigned for other purposes. As soon as one of the proposals put to the vote is accepted and the operational framework allowing such a transfer has been put in place, the National Bank can transfer these assets to the future beneficiaries. Should both proposals be rejected, this will not be interpreted as a mandate for the SNB to reintegrate the free assets into its monetary reserves. In this case, we will instead continue to manage the free assets separately until a new allocation has been decided on. The income from this portfolio will be recorded in the SNB's ordinary income statement and will become distributable only once the profit distribution agreement between the SNB and the Confederation has been revised. In this case, the income might lead to an increase in the SNB's annual distribution of currently Sfr 2.5 billion.

Gold price in CHF per kilogram (red) and in USD per ounce (green)