Swiss National Bank Sales—Lessons and Experiences

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Introduction

I am pleased to be in Washington today and would like to thank Fred Bergsten and his colleagues at the Institute for International Economics for providing me with this opportunity to talk about the recently completed gold sales of the Swiss National Bank (SNB).

In June 1999, the Governing Board of the SNB decided that half of its then gold reserves of 2,590 tons were no longer required for monetary purposes and that it would inform the market and the public accordingly. This decision contributed to the process that eventually led to the first central bank agreement on gold sales. This so-called Washington Agreement provided the framework for the subsequent gold sales of the Swiss National Bank, the European Central Bank (ECB), and 13 European national central banks. Under this agreement, the SNB's realized sales of 1,170 tons, which represented the bulk of the total sales of 2,000 tons for all participating central banks. The SNB completed its gold selling program on March 30, 2005, after selling a residual 130 tons under the second central bank agreement on gold sales. After completion of the gold sales and the distribution of the proceeds from the sales to the Swiss government and the 26 cantons, the SNB's balance sheet will consist of approximately CHF90 billion. With the remaining 1,290 tons of gold reserves, the SNB retains roughly 20 percent of its assets in gold. By international comparison, the SNB continues to hold a very significant stock of gold.

During the remainder of my talk, I would like to address what strikes me as the most relevant issues that came up in connection with these gold sales. I will begin by outlining the historical context of the SNB's Governing Board's decision to declare 50 percent of its then gold reserves as no longer necessary for monetary purposes. As you will see, a number of constitutional and legislative changes were necessary for that policy decision to result in actual gold sales. I will then outline how the SNB designed, revised, and implemented its selling strategy. Finally, I will attempt to draw some tentative lessons from these gold sales, some of which might be of interest to those central banks or international institutions that are considering gold sales or have recently begun to sell gold.

Historical Context

In 1999, the SNB held 2,590 tons of gold on its balance sheet. At that time, the SNB's gold stock represented 30 percent of US gold reserves. In relative terms, Switzerland's position was extreme among the G10 countries. As you can see in figures 1 and 2, Switzerland held more than five times the amount of gold on a per capita basis than the second-ranked Netherlands. Similarly, its gold holdings as a proportion to imports also far exceeded those of any other G10 country. In light of this extreme position, it is legitimate to ask why the issue of gold sales did not arise much earlier in Switzerland.

For one thing, public opinion in Switzerland generally held gold in high esteem as a symbol of monetary stability. More importantly, however, a reduction in the gold stock required a fundamental reform of the legal framework of the Swiss monetary system. The process leading up to this reform was lengthy and complex. As you know, Switzerland is proud of its political system of direct democracy and consensual government. On the whole, these traditions have served the country well. Comprehensive legal reforms, however, often require substantially more time than in other democratic traditions.

Despite the fact that Switzerland had been under a flexible exchange rate regime since the breakdown of Bretton Woods, the Swiss franc remained legally linked to gold. For practical reasons, this legal link of the Swiss franc to gold had lost its monetary policy relevance. Nonetheless, it prevented the Swiss National Bank from buying or selling gold at any other price than the official parity of CHF4,595 per kilogram. In the late 1990s, this parity was three times lower than the price of gold on the open market. The official parity also determined the valuation of the gold stock on the SNB's balance sheet. In order to eliminate these residual relics of the gold standard and enable a change in the SNB's gold policy, the Swiss Constitution as well as the Coinage Act needed to be amended first.

Whereas during the 1980s and the early 1990s, the political climate did not permit such constitutional and legal amendments, the situation finally evolved in the late 1990s. The deterioration of Switzerland's public finances led to a growing awareness of the opportunity costs of maintaining the existing structure of the SNB's assets. The vast gold holdings increasingly gave rise to concern in the context of bearish market sentiments and of gold sales by other central banks. In November 1997, a partial revision of the Swiss National Bank Law increased the flexibility of the SNB's reserve management activities. However, further legislative reforms were required to enable gold sales.

In February 1997, a initial decision regarding the demonetization of gold was taken by the Committee for Economic Affairs and Taxation of the National Council, the lower chamber of the Swiss Parliament. Two months later, against the backdrop of mounting international criticism about Switzerland's role in World War II, the President of the Confederation proposed to allocate some of the gains in the likely event of a gold revaluation to fund a Swiss Foundation for Solidarity, which would provide assistance to persons in need in Switzerland and abroad. According to this proposal, the initial contribution to the foundation would be in the form of a 500-ton gold donation by the SNB.[1]

In 1997, the SNB was not only a special case with respect to the size of its gold holdings but also with respect to the amount of its capital reserves. The extreme level of

[1] The idea of a Swiss Foundation of Solidarity was suggested to the President of the Swiss Confederation by the then President of the Governing Board of the SNB.

capital reserves was the result of the restrictive profit distribution of the previous decades. In April 1997, the Swiss government commissioned a group of experts to draft a proposal for a new monetary constitution and to estimate, among others things, the excess capital reserves of the bank. The report, which was presented to the public in October 1997, came to the conclusion that capital reserves equivalent to 1,300 tons of gold were no longer necessary for monetary purposes and could therefore be withdrawn from the SNB's balance sheet and used for other purposes. In May 1998, this proposal was incorporated in the government's message concerning the new monetary article of the federal constitution.

Two further legislative steps were required for actual gold sales to begin. First, the Swiss people had to ratify the reform of the constitution. This occurred in April 1999. Second, the Swiss Parliament needed to adopt the new federal law on currency and payment instruments that replaced the old Coinage Act. The new law came into force in May 2000. Hence, it was only 27 years after the collapse of Bretton Woods that the SNB was legally in a position to start selling gold. The first gold sales by the SNB were promptly executed the day after the new law came into force.

Meanwhile, the market environment was far from optimal for the SNB's gold sales. While the SNB had merely announced its intention to sell gold, the central banks of Argentina, Austria, Australia, Belgium, Canada, Luxembourg, the Czech Republic, and India had all initiated actual sales. Against this backdrop, the gold market had been under pressure since 1996. Here in Washington, intense discussion revolved around the question of whether the International Monetary Fund (IMF) should sell gold. Moreover, the gold policy of the future European monetary area had been subject to intense speculations. The market feared that once the European Monetary Union came into force, the participating central banks or governments would lose their inhibition about selling off parts of their 12,000 tons of total reserves. In May 1999, the announcement by the UK Treasury that it planned to sell 415 tons set a new wave of producers hedging activity and front running speculation. The gold price dropped by 10 percent, to $252 per ounce, a 20-year record low (see figure 3).

It is against this background of heightened speculation about wide-ranging central bank gold sales and corresponding market anxiety that the joint statement on gold was signed at the IMF meeting in Washington on September 26, 1999. The participating central banks undertook to sell a total amount of no more than 2,000 tons of gold in the next five years, with annual sales limited to approximately 400 tons. The 15 central banks furthermore agreed not to expand their gold lending and gold forward transactions during this period. While the United States and Japan were not part of the joint statement, they declared that they had no intention of changing their "passive" gold policy. Furthermore, the IMF announced that it would abandon its plan to sell some of its gold reserves on the market. These declarations had a big impact on the market for two reasons. First, they removed the uncertainty about the behavior of the holders of 85 percent of the world's official gold reserves. Second, the planned annual total sales (400 tons) compared favorably with the sales and increases of gold lending activity of the previous years (700 tons).

The Washington joint statement on gold was a coordinated effort aiming at clarifying the intentions of the participants in a market prone to rumours and secrecy. Of the 1,300 tons of gold that the Swiss National Bank intended to sell, 1,170 tons were included in the 2000-ton total sales quota of the Washington Agreement. In other words, the SNB ended up being the main beneficiary of the agreement. Formally, the initiative for the Washington Agreement did not come from the SNB. Nonetheless, the SNB's unilateral announcement in June 1999 of its intention to sell 1,300 tons of its gold reserves certainly contributed to setting in motion the process that led to the September 1999 joint statement issued by the 15 European central banks.

Selling Strategy

The Washington Agreement now set the parameters for the SNB's selling program. The practical details were negotiated in the months following the signature of the agreement. Annual quotas were assigned for each period going from October to the following September. As you can see in figure 4, the SNB was allowed to sell 120 tons of gold between October 1999 and September 2000, 200 tons for the next 12 months, 283 tons between October 2001 and September 2002, 283 tons again between October 2002 and September 2003, 284 tons between October 2003 and September 2004, and 130 tons after September 2004. The participating central banks agreed to eliminate the possibility of hedging the gold price risk for the entire five-year period. However, flexibility was maintained in hedging the gold price risk for the selling quota within each current 12-month subperiod. In other words, forward sales or option programs were possible for the annual allocations only. On the other hand, there were no limitations on hedging currency risk. The SNB was therefore free to hedge the expected US dollar proceeds from the sales against the Swiss franc.

At the outset, the SNB decided to use the Bank for International Settlements (BIS) as its selling agent. Between May 2000 and March 2001, the BIS sold 220 tons on behalf of the SNB. For the first 120 tons, the SNB paid the BIS a fixed commission while the performance risk resided with the SNB. For the next 100 tons, the BIS agreed to pay the average price of the AM and PM London gold fixing plus a small fixed premium.

In April 2001, the Governing Board decided that there was no reason to continue to sell through the BIS. The SNB now had the necessary professionals, know-how, trading resources, and contacts to the international gold market to trade directly. Two types of selling operations were subsequently pursued: spot sales in the market and sales programs with price caps.

Over the next three and a half years, 730 tons were sold directly in the spot market. For these sales, the SNB used 25 counterparties on four different continents. In an effort to receive consistently competitive pricing, the Governing Board allowed the SNB traders to become two-way participants in the market. In other words, traders were allowed to buy gold up to two-thirds of the daily allocated sales volume on an intraday basis. Overall, the sales had to be conducted within a clearly defined corridor that was structured around daily sales volumes of approximately one ton (figure 5). Typically, the Bank of England was used for the physical settlement of these operations.

Apart from spot operations, 350 tons were sold through option programs. In a typical program, the buyer committed to buy 50 tons of gold spread evenly over several months and to pay the daily average AM and PM London Fixing plus a premium. In order to increase this premium, the SNB accepted to fix a cap to the maximum selling price. In other words, the programs were based on the idea of selling gold on a spot basis and writing out-of-the-money call options. In an effort to obtain competitive premiums, each program was allotted in an auction between three major dealers. Considering the high variance of the bids we received, this auction procedure proved suitable. The realized premium varied between $1.40 and

$3.50 per ounce. These modest premiums reflected the SNB's prudence in choosing the caps. At the time of the relevant auctions, these were far above the market price. This explains why, despite an overall bullish market, the strike levels were only attained on two occasions, namely in February 2003.

While the possibility of hedging the gold price risk was limited by the Washington agreement, the SNB was allowed to hedge the dollar-Swiss franc risk associated with the expected proceeds of the gold sales. Originally, the Governing Board decided to hedge 20 percent of the expected proceeds in US dollar. In December 2000, it increased this hedging proportion to 35 percent and maintained it throughout the entire sales program.

Overall, the gold sales proceeds amounted to CHF21.1 billion, or CHF16.241 per kilogram. Expressed in US dollars, the average selling price was $351.40 per ounce, which was $17.20 higher than the average London fixing price between May 2000 and March 2005 ($334.20). The bulk of this excess performance ($13.40) resulted from the currency hedge of the expected dollar proceeds (CHF829 billion). In the context of increasing gold prices, the profile of the yearly quotas, with their overweight at the end of period, contributed with $3.10 to the excess performance. The residual performance ($0.70) was related to the combined effects of the option programs, the spot sales, and the sales through the BIS. SNB spot sales were realized at a price corresponding to the fixing plus 22 cents, whereas the average premium over the fixing for the cap sales was $1.90.

Lessons and Conclusions

Last week, the SNB's General Assembly approved the 2,004 accounts of the SNB, thereby formalizing the disbursement of the CHF21.1 billion proceeds of the 1,300 tons of gold. One-third of that amount will go to the federal government and two-thirds to the 26 cantons. Beginning on May 12, the SNB will disburse the money in ten weekly tranches. The disbursements will have no impact on the Swiss yield curve or the exchange rate, as the necessary portfolio adjustments were made in the run-up to the pay out. With the final tranche on July 14, the disbursement of the proceeds from the gold sales will have been completed, representing the largest financial transaction in the history of the Swiss National Bank.

In my view, the most important lesson to be drawn from the SNB's gold sales is that the decision to sell official gold holdings should be made separately from any consideration on how to use the proceeds. The history of the SNB sales shows that, notwithstanding the constitutional and legal complexities I referred to earlier, the time between the expert opinion about the SNB's excess reserve capital and the first sales was two and a half years. Switzerland's politicians, on the other hand, failed to reach a consensus on what to do with the proceeds. After eight years of relentless debates and a squarely rejected referendum on the Swiss Foundation for Solidarity in 2002, the funds will be disbursed according to the constitutional distribution key for the SNB's regular profits. I don't want to burden you with the intricacies of the Swiss political debate around the gold proceeds. Let me simply say that it was not for lack of creative ideas that a consensus failed to emerge. This lesson strikes me as relevant with regard to potential renewed discussions about IMF gold sales. Such discussions should be conducted exclusively on the basis of a thorough examination of the solidity of the IMF's financial position and not become entangled with proposals on how to allocate any expected proceeds.

Finally, let me offer a couple of specific lessons from the SNB's gold sales that underline the benefits of transparency. Total official gold holdings by central banks and governments today account for approximately 10 times the annual worldwide production of gold. Prospects of official gold sales therefore have an inherent ability to destabilize the gold market. The initial Washington Agreement and the follow-up agreement have demonstrated that official sales are best conducted in the context of a clear and transparent overall framework. While the terms of the agreement were not rigid in their nature, they provided sufficient guidance to the gold market to prevent excessive market volatility. In the event that official gold sales continue to be meaningful beyond the current central bank agreement, a new set of parameters will have to be established upon its expiry. Moreover, should the IMF or any other official institution decide to sell substantial gold reserves during the next couple of year, it strikes me as essential that such additional sales get incorporated into the existing framework.

Even within a broad international framework, national sales are best conducted on the basis of a clear and transparent sales strategy. In the case of the SNB, the specific sales programs evolved over time but the principles of regularity and transparency were maintained throughout. Market participants knew at all times what the SNB was doing with regard to its gold sales. Moreover, the market knew how the sales were conducted. Finally, while there were a number of adjustments over the five and a half year period, the SNB never departed from the principle of regular and transparent sales. As a result, market rumors and price volatility associated with SNB's sales practices were virtually nonexistent.

In a similar light, the SNB's experience as a gold seller suggests that it is best to consider ex ante to what extent performance considerations should play a role in how the sales are conducted. In the case of the SNB, the Governing Board made a number of key performance-related decisions at the outset: to limit the foreign exchange risk associated with the dollar proceeds of the sales, to allow clearly defined active trading around the daily sales quotas, to use a conservative option strategy to achieve a modest outperformance, and to assure competitive pricing from the dealer community. Once these parameters were set, little room was left for discretion by the Governing Board or the SNB's trading desk. Human nature being what it is, we all know that too much discretion can quickly turn into room for judgmental error, particularly at times of heightened market pressure. A central bank in particular has every incentive to minimize such room for error in all its activities as its all-important reputation is ultimately indivisible.

Contrary to initial expectations, the SNB was able to conduct its gold sales in a relatively favorable market environment. A former federal reserve governor once said that the recipe for successful monetary policy is one part skill, one part art, and one part luck. Presumably, there was nothing artistic about the SNB sales. On the other hand, good fortune may have indeed played a role. I will let you be the judge of whether or not the SNB conducted its sales skillfully.

Figure 1 Gold per Capita as of December 1998 in Grams

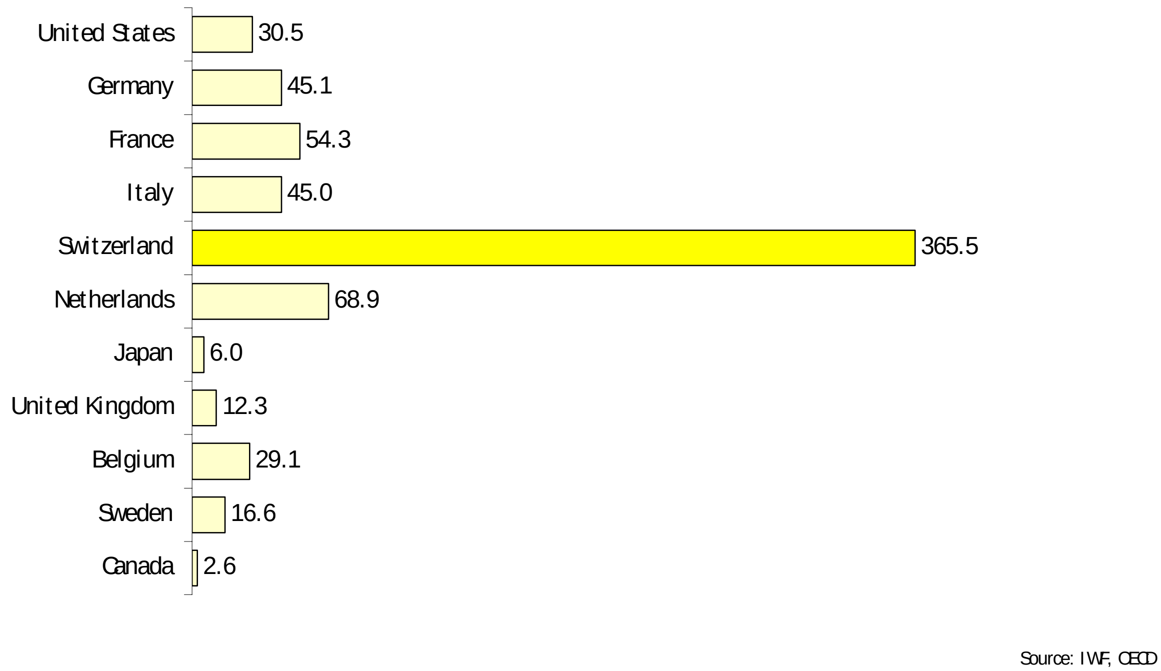

Figure 2 Gold Holdings in Percent of Annual Imports as of 1998

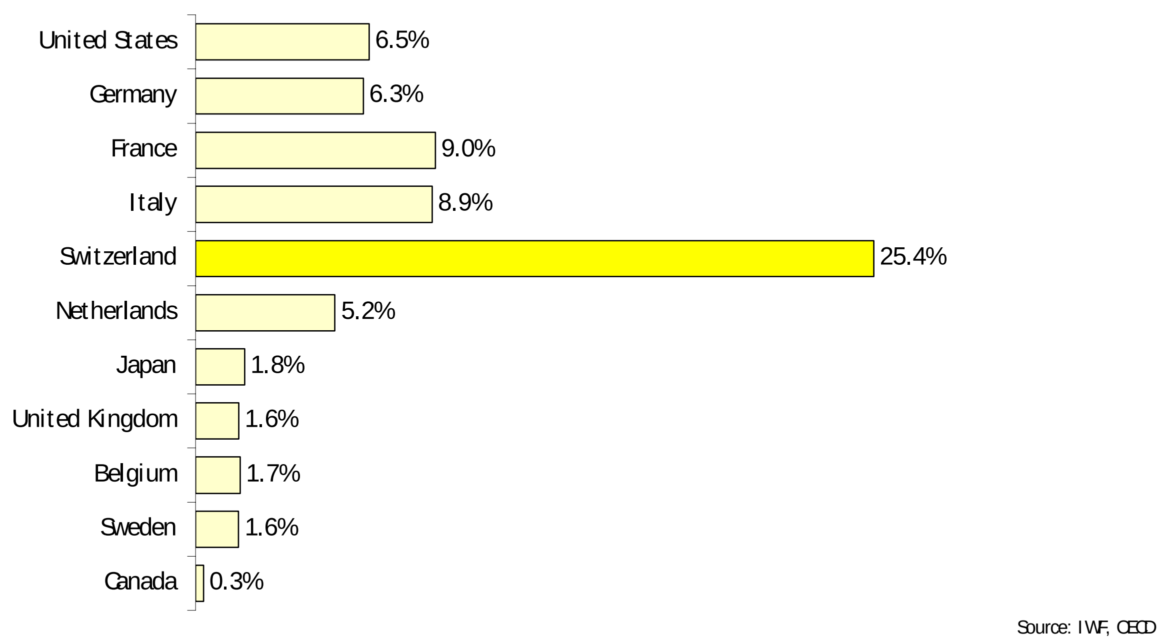

Figure 3 Gold Price since 1996

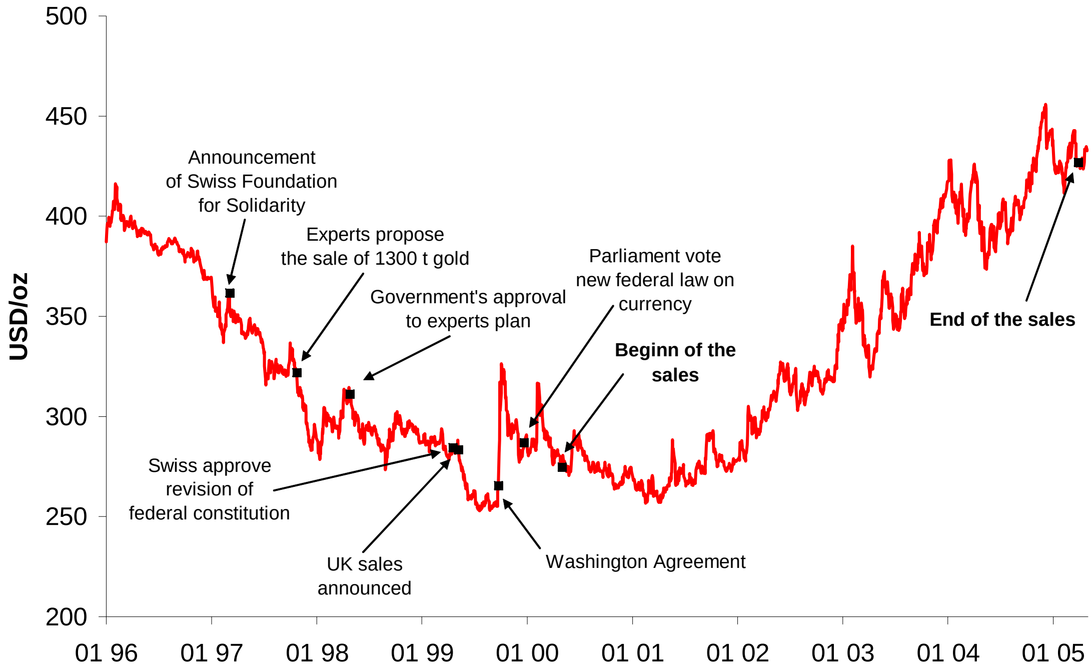

Figure 4 SNB's Quotas under the Washington Agreement in Tons

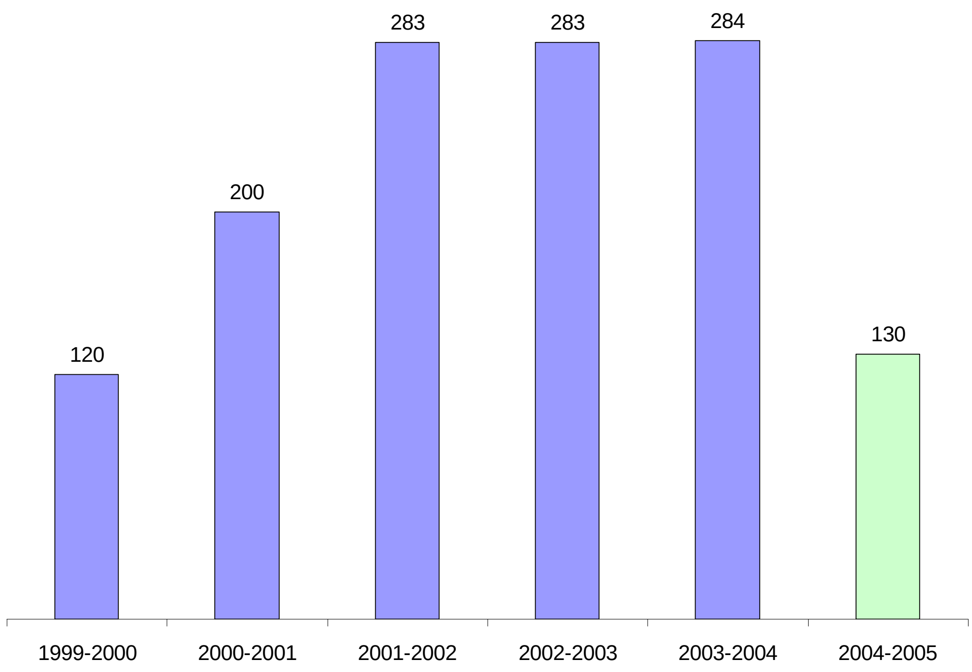

Figure 5 SNB's Cumulative Gold Sales