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How a well-managed country can face adverse financial conditions?

All economic indicators in Switzerland look positive with one great exception: the value of its currency. This leads to a deep concern that, despite of its balanced budget and its recognized industrial qualities, the country could enter into a new, externally driven recession.

Facts:

- In the period 2003-2006 the Swiss National Bank held on average 52.5 billion Swiss francs in foreign currencies[1].
- Following the SNB interventions on the monetary markets since the beginning of the crisis these foreign currency reserves were 197 billion Swiss francs at the end of July 2011[2].
- World gold reserves held by central banks and international institutions are currently at 30'700 metric tons, of which the SNB holds 1'070 ton in its vaults (3.39% of the total) for a value of approx. 43 billion Swiss francs (valued at 1'505 USD/ounce and 0.843 CHF/USD)[3].
- Countries having larger gold reserves than Switzerland are USA, the Euro area, the IMF, and China. These five reserves holders concentrate 77% of all World gold reserves.
- In the USA gold accounts for 74.2% of this country's reserves; in the Euro area this coverage is 62.2%. China holds mostly its reserves in US Dollars and only 1.6% are held in gold.

Current threat:

- The Swiss franc is grossly overvalued[4], despite of the low interest policy of the SNB. This is the consequence of:
  - The safe harbour status that this currency has in times of crisis
  - The confidence of international markets on the economic, financial and political stability of the country.
- A strong Swiss franc has positive effects in the country: low cost for imported goods and services, as well as attractive conditions for investments abroad.
- But it has overwhelming negatives ones: the Swiss export industry and tourism suffer a competitive price bias that they cannot meet with short term structural adaptations. As about 50% of the GNP depends on export, the most important threat is the loss of jobs.
- Also the low interest situation may initiate a bout of inflation; this seems to be already the case in the real estate sector where high property prices are steadily increasing.
- So far SNB interventions have had a short lived impact, probably because they are highly diluted in traded volumes[5] that are orders of magnitude higher than the underlying reserve assets.

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[1] Average holding during the 2003-2006 period: 35.7% USD, 48.3% EUR, 1.5% JPY, 8.4% GBP, 2.1% CAD, 4.0% others (Source: BNS)

[2] Current distribution: 24.8% USD, 55.3% EUR, 9.8% JPY, 3.1% GBP, 4.0% CAD, 2.9% others (Source: BNS).

[3] Source : World Gold Council

[4] Big Mac Index adjusted for GDP per person : +63% (The Economist, July 28, 2011)

Action needed.

"The SNB is obliged by the Constitution and by statute to act in accordance with the interests of the country as a whole. Its primary goal is to ensure price stability, while taking due account of economic developments. In so doing, it creates an appropriate environment for economic growth." (www.snb.ch)

Action on the part of the SNB is expected, since the price stability and the conditions for economic growth are already greatly endangered. But which action?

Many contradicting demands and proposals are made to the SNB, motivated by economic self-interest of various groups, or by political orientation, or both. But there is a consensus that the goal should be to get relief from the artificial pressure on the CHF by attenuating its exchange rate volatility and by adjusting its value to a level that reflects better the economic situation of the country.

Proposal:

Let's assume that during the "calm" period 2003-2006 the level of foreign currency reserves were at a correct operational level.

Now these reserves have increased by 158 bn CHF: we can speak of "reserves in excess". They are denominated in those same currencies with which the CHF is in unbalance.

What should be done with them?

a) Buy more to show the SNB determination to stop the overvaluation of the Swiss franc. Risk: to have reached the financial limits of the SNB, and of the country as a whole, before achieving the desired turnaround. Probability: very high!
b) Wait.
   Then, over time, these reserves will be sold back on the market to re-purchase Swiss francs. And eventually these Swiss francs will be driven out of the market by the SNB. Risk: continuing over-evaluation of the Swiss franc, Recession for the Swiss export industry, Job losses. Probability: high!
c) Peg the Swiss franc exchange rate to the EUR.
   Benefit: exchange rate stability (at least with the EUR)
   Risk: SNB will be left without monetary instruments and depend solely of what the ECB will be dictating. Probability: certain!
d) Change the rules of the game!
   See below.

What if…

The SNB would purchase 3-4000 tons of gold with these excess foreign currency reserves? The SNB would then possess about 12% of the World financial gold reserves. This purchase action may take a long time but it would have an effect as soon as it would be communicated and initiated by the SNB: any pressure on the Swiss franc would be linked to a pressure on the gold value:

- a commodity with a 8-10x wider basis than the Swiss franc and that is held in reserve by many other countries.
- a commodity that cannot be traded easily on a short term basis.

In parallel the SNB should decree a fixed CHF value for gold, for example at CHF 1900 per troy ounce (on 5.9.2011: 1492). The EUR would establish itself in the 1.40 range and the USD at around 1.00.

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[5] In 2010 the average <u>daily</u> foreign exchange market turnover on the Swiss franc was USD 262.6 bn (source: BIS), while the official reserve assets and other foreign currency assets were USD 300 bn at the end of June 2011 (source: SNB). The Swiss GDP at official exchange rate in 2010 was USD 523 bn.

It would follow that the volatility of the Swiss franc would be greatly reduced, and that the Swiss industry would have a longer and more reliable planning horizon.

Potential reactions and risks:

- Continuing rally on the Swiss franc and on gold:
  Probability: reduced (as compared to other possible actions) because of the sheer size of the World gold bullion.
  Impact: somehow reduced by the fact that the US Federal Reserve and the EUR area hold large amounts of gold.
- Falling gold price: this would mean that confidence in the US and EUR institutions would be restored, and this would be good news! In this case, and if necessary, the SNB could gradually re-evaluate the CHF.
- Inflation. This is the most probable outcome of the multi-crisis in which we are since 4 years, whatever action is taken. The SNB will anyway have to meet this challenge by timely adjustments of the interest rate. A gold standard would give more leeway to the SNB to act on interest rates because the CHF would not get as attractive if the interest rates would increase as it would be if the currency would stand alone.
- Accusation of lack of solidarity, of grabbing gold as the standard for egoistic purpose by pundits from all over the indebted World (and immediately relayed by the Swiss media, Schadenfreude…).
  Probability: almost certain.
  Impact: dogs bark, the caravan moves on.
- Other countries would follow, such as EU states not in the EUR zone (Sweden, Poland, Romania), other countries with grossly overvalued currencies (Norway, Mexico, Brazil), countries interested to create an alternative to the duopoly USD-EUR (China, India, Turkey, Russia): they would be welcomed to the club!
  Probability: unknown but not zero.
  Impact: possible return of a significant part of the World to a fixed exchange rate economy with infrequent strategic devaluations and re-evaluations by single countries.
- Diplomatic protests: probably the UK, French, German and US government would not appreciate such Swiss move.
  Proability: medium.
  Impact: Sovereignty being what it is, what can they do actually? As much as they intervene in Syria, Myanmar, Cuba, North Korea, or even Greece? They did not invite Switzerland to the G20 and accused her of all evils. There is a hidden war going on between large financial market places. Switzerland has lost some battles in past years, why not gain some now?
- Protests by the financial sector: it would be time that this part of the Swiss economy would begin to share parts of the suffering, if any. For out of country traders: bad luck to them!

The author of these lines is in no way an economic and financial expert. Therefore this proposition may be readily dismissed as silly by those having experience and wisdom in this field.

But considering what experts could deliver over the past few years, it may well be worth some attention.

If nobody thought about it yet: it is time to give it a shot.

If it has been evaluated and not retained: it would be interesting to know the balance of arguments.

This spring, Steve Forbes was predicting the return of a gold standard within 5 years. The SNB has nothing to lose and a lot to gain to be the first mover and rule setter.

Mir müend luege! *Mir müend uufpasse!* *aber bitte schnell!*