Swiss referendum could effectively re-launch the ‘gold standard’

Last week the price of gold dropped 0.5% at a price of USD$ 1,230/oz., after experiencing a bit of a rally the previous week that pushed it from an annual low of USD$ 1,183/oz. to USD$ 1,255 an ounce, reaching the highest level in over a month. It is likely that gold’s rebound was prompted by continued demand in Asia and to the slowdown in the US Dollar’s bullish ride. The risk of another drop remains, given the high market volatility worldwide; however, there is also the chance for a sustained and bullish correction, which could push the value of gold to new heights. This is because Swiss voters will decide in a referendum whether or not the Swiss National Bank (SNB) will be prohibited to sell gold, which would end up forcing to maintain at least 20% of its reserves is in gold. The three referendum questions that Swiss citizen will have to address are:

1. Should the Swiss National Bank increase its gold reserves to 20%

2. Should the central bank should stop selling its precious metals

3. Should all the gold currently stored overseas should be repatriated to the country.

The chances of the ‘yes’ vote winning are rather bullish, even though polls show that many are still undecided. A poll organized by GFS Bern showed that 44% would vote ‘yes’, 39% would vote “no” and 17% remain undecided. Swiss citizens, while not enflamed by passion over the issue, appear to favor the increase in gold reserves. Another poll conducted by the Swiss newspaper ‘20 Minutes’ suggests that 45% are in favor of

restoring the gold standard while only 28% of respondents oppose it. A ‘yes’ victory would force the Swiss National Bank to purchase 1,500 tons of gold ingots, almost certainly causing a boom in gold prices in international markets. It is still too early to determine the popularity of the pro-gold initiative among the Swiss population. The conservative Swiss People’s Party launched the idea in April 2013 after collecting more than 100,000 signatures to force the referendum; the campaign actually got underway last week.

Although it is still too early to assess the general feeling of the Swiss people, many have had concerns about the SNB deciding to weaken the Swiss Franc (CHF) to stimulate growth. Since 2011, the SNB pegged the CHF to the Euro at a threshold of 1.20 Francs to 1 euro. The Swiss Franc has a long tradition of being associated with gold. Switzerland had the largest gold reserves per capita in the world until about 10 years ago and many of its citizens continue to consider gold as the basis of a strong currency (Liechtenstein uses the Swiss franc as its currency). Many economists believe that if the ‘yes’ voters prevail, the price of gold itself will soar while the Euro currency will suffer. The referendum will carry significant implications for the gold price and for the capital markets in general. Indeed, the referendum represents a not so veiled attempt to restore or to resume some version of the gold standard. The Swiss appear to mistrust ‘paper’ currency wanting it to be backed by gold. Economists, for that matter, have not presented adequate evidence to prove that a weak currency leads to economic growth in the long term. A weak currency may lead to short-term benefits such as increased exports, but it also ends up outweighing these by lowering purchasing power and raising the cost of imported fuel.

Whether or not the referendum passes or not, the coming weeks will be interesting for gold; in a sense, Swiss people are actually getting an opportunity to ‘comment’ on its global

future and not just the SNBs monetary policy. Switzerland currently has about 1,040 tons of gold, which amounts to about 7.8% of its foreign exchange reserves. If the referendum passes, Switzerland will triple its reserves over the next five years to meet its commitment of 20% of its reserves in gold. Nevertheless, there are major international implications. The most obvious one is that the a victory of the ‘yes’ could even prompt a return of the ‘gold standard’, abandoned in 1971 at a time when US President Richard Nixon secured the position of the American dollar as a pillar of monetary stability around the world, suspending the convertibility of the dollar into gold or other reserve assets, heralding the end of the gold standard or Bretton-Woods system that had been in place since 1958 (formally since 1944), which entailed the US government pegging its currency to gold and all other currencies pegged to the Dollar.

The international implications of the Swiss referendum are already being felt. The Swiss initiative is not an isolated case. For years, Asia has been building up its bullion. China may have accumulated as much or more bullion than the United States while Russia is following suit. Despite the collapse of the ruble due both to the financial sanctions imposed on Moscow by the US and EU, as well as the decline in crude oil prices, the Bank of Russia backed its currency by buying another 37 tons of gold in September alone – that is a large amount considering world monthly production is about 220 tons. Three of the BRICS alone (Russia, China and India) bought 270 tons of gold. In fact, even if the Swiss vote against the higher gold reserves, the trend for the yellow metal’s prices points to higher prices in the medium and long term.

The global consequences of China’s higher than expected debt

China has recorded 250% debt according to Standard Chartered estimates. This figure, which essentially means that debt is 2.5 times greater than the size of its economy, suggests that China has also found it difficult to reconcile growth with ‘bubbles’. The 250% debt figure is not distressing in itself; what has raised economists’ concerns is the speed with which China’s debt level has risen: the ratio of debt to GDP in the second largest economy in the world was 251% in June 2014, while it stood at 147% at the end of 2008. Such an increase in the ratio between debt and growth in such a short period is worrisome because in other countries, increases of this magnitude in a short period of time have typically been followed by financial turmoil. China’s debt is not good for the world economy, and it is especially troubling for Europe’s economic recovery.

Europe’s recovery, according to recent statistics and to EU officials, is struggling to emerge. Even in Germany the IFO index, which reflects the level of business confidence, at the end of June fell to its lowest level since last fall. This summer, Germany’s recovery has been weaker than expected, despite the fact that it is the strongest economy in Europe. In fact, Germany’s first quarter of solid growth was driven more by domestic demand than exports; now it is starting to suffer from the slowdown of international markets. In particular, China is one of the main culprits accounting for the difficulties now faced by German exporters. The leadership of the People’s Republic seems to have chosen not to artificially inflate the rate of growth – at least not at the extreme levels of the past. In the second quarter, China grew at a respectable 7.5% (annualized), which was better than

expected, but there was a reduction in purchases of capital goods – often made in Germany – that will likely not resume in the short term.

Germany now faces weaker import markets in both the emerging markets and the Eurozone, which will no doubt lead to a contraction of the German economy, and with it, demand for goods made in other industrial powers such as Italy, France or the UK. Oh, and as for the United States, it is experiencing a weak economic cycle and the International Monetary Fund has reduced the United States' growth estimate to less than 2%. The IMF blames the increasing economic polarization whereby only to the richest 1% have seen their income increase, translating to a modest or insignificant increase in consumption. A collapse of the economy such as that seen since 2008 should have, in theory, produced an equally strong rebound, which has been slow in coming.

The tensions of war in Ukraine and in the Middle East may become more severe and further reduce chances for growth. The strong dollar does not help the European recovery and the stabilization of the spread between the weaker EU economies with Germany does not guarantee the low cost of debt. In 2015, the Fed may begin to raise interest rates even Europe and Italy will have to deal with a more expensive Dollar. Of course, in this scenario, commodities such as oil, gold and silver will experience higher valuations. Meanwhile, the recent BRICS (Brazil, Russia, India, China, and South Africa) countries summit in Fortaleza, Brazil, marked a further step towards the construction of a new international monetary architecture intended to break the unipolar dominance of the US Dollar and the old and the Bretton Woods system.

It is not all bad news. Resources and commodities should benefit from the new BRICS initiative designed to promote growth in regions that need it most. The heads of state of Brazil, China, India, Russia and South Africa have officially announced the creation of the new development bank and the

Contingent Reserve Arrangement (CRA), namely the creation of a specific money supply fund. This allows the BRICS “to be less dependent on the dollar and more equipped to fend off any turbulence in the currency markets.” The new development bank has an initial capital of $ 100 billion. Its mission is to finance investment not only in the BRICS countries, but above all promote projects and infrastructure in developing countries, particularly in Africa. The BRICS have taken an important political step in the ever more multi-polar global chessboard. However, in this scheme the BRICS intend to become the leading supplier of machinery and other goods, thus giving a boost to their industrial and technological sectors.

In this sense, BRICS countries will try to develop more self sufficient resource bases and some, like China, may become more reluctant to export key raw materials that will be needed for internal use. Of course, these would include rare earths. In this sector, China will continue its policy of getting more foreign companies investing in downstream rare earth activity in China. And it goes without saying that the BRICS are self sufficient in energy resources, also having strong alliances with oil producers beyond the BRICS circle (Iran for instance). In Fortaleza, the BRICS accused the IMF of intervening in the richer industrialized countries (OECD), particularly those in the euro because of their persistent sovereign debt crisis. Thus the BRICS have launched alternative institutions.