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Robert Solomon

SOUTH AFRICAN GOLD AND THE TWO-TIER SYSTEM

The Problem

The two-tier gold system, established at the Washington meeting of March 16-17, is threatened in two ways: (1) by South Africa's offer to sell gold to the International Monetary Fund and (2) by the desire of some European central banks to purchase gold from South Africa for addition to monetary gold stocks.

The U.S. response to this problem ought to preserve the essential character of the two-tier system as the U.S. views it, while avoiding either a breakdown of international monetary cooperation or a divisive battle in the IMF over its legal obligation to purchase gold from members.

The two-tier system may be said to have both a short-term and a long-term significance. For the short-run, it was intended to discourage upward pressures on the market price of gold, by saying to the market that central banks would not be contributing to the demand for gold. All the participants in the Washington meeting were in agreement that the smaller the margin by which the market price of gold exceeded the official price, the greater were the prospects for international monetary stability. If the market price of gold remained relatively low, it was less likely (1) that central banks

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would convert foreign exchange into gold out of fear of a rise in the official price of gold and (2) that private parties would speculate on a change in relative exchange rates by moving their funds into what they regard as strong currencies.

The longer-term significance of the Washington Agreement--and on this there is less than full unanimity among the participants--is that the two-tier system represents an important step toward diminishing the role of gold in the international monetary system. In particular, if monetary authorities would act upon the statement that, in view of the prospective creation of the SDR facility, the amount of gold in monetary stocks is sufficient, gold would play no significant role in the future growth of monetary reserves. In effect, gold would have been demonetized at the margin. This interpretation of the two-tier system has not been accepted by some European central banks and it is not possible at present to persuade them to accept it. In fact a public airing of this interpretation by U.S. officials would probably lead some European central bank officials to disagree publicly. The best the United States can do in present circumstances is to avoid an open breakdown of the Washington Agreement while seeing to it that any new policy agreements are not inconsistent with our preferred interpretation of its longer-term significance.

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Solution to Problem

It is believed, within the U.S. Government, that the best way to meet the present challenge to the two-tier system is to agree to provide through the IMF a floor price at $35 per ounce for newly-mined gold that South Africa (and other gold producers) need to sell to meet their balance of payments requirements. As another concession, South Africa would be permitted to count its gold holdings as of July 1, 1968 as monetary gold.

In exchange for these concessions, South Africa would be expected to sell newly-mined gold in the market, as its payments position requires, and to avoid special efforts to withhold such sales. South Africa would not offer monetary gold to central banks or the IMF unless it had disposed of all of its supplies of newly-mined gold. Finally, South Africa would withdraw its present offer to sell gold to the Fund.

Advantages of this Solution

1. This solution provides for an accommodation with South Africa and makes it possible to end the existing uncertainties in South Africa's dealings with the market, monetary authorities, and the IMF. The alternative proposal for ending these uncertainties--

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agreement on central bank purchases of some amount of newly-mined gold even when the market price is above $35--would constitute an open break with the Washington Agreement and would make it much less likely that the longer-term significance of that Agreement would be realized.

2. The proposed solution assures the market of a resumption of South African sales and prevents South Africa from choosing between market sales and sales to monetary authorities or the Fund as a way of maximizing the market price.

3. Central bank purchases of newly-mined gold continue to be precluded. Additional gold can enter the monetary system only if and when the market price falls to $35 per ounce or below. An opening of the system to additional gold in these circumstances would clearly be consistent with the short-run significance of the Washington Agreement. Purchases by the Fund when the price is at $35 or below would not be in conflict with the objective of minimizing the margin between the official and market prices, since such purchases would occur only when this margin were zero (or negative). (It should be noted that while the proposal would provide a floor price for sales of gold by South Africa as its payments position requires, the proposal would not put an institutional floor under the market price and would not therefore assure speculators that there is no risk at all of the market price falling below $35.)

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Additions to IMF gold holdings (and the possibility that the Fund would sell such gold to members) under this proposed solution would not be inconsistent with the desire to see a diminished emphasis on gold in the long run. Gold would enter the official reserve circuit only if and when the market is placing a valuation on gold equal to or less than the official price. In the longer run, present expectations are that the market price is likely to rise above $35, as private non-speculative demand grows relative to supply. Thus, little gold would be bought by the Fund over the years.

As time goes on, the market price will have less and less significance for the monetary system, assuming the U.S. balance of payments improves and the SDR facility is activated. But during the present transition period, it is vital to avoid any sort of shock that would give the market price an upward push.

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