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THE SECRETARY OF THE TREASURY
WASHINGTON

AUG 9 1972

Dear Mr. Chairman:

In your letter of July 20 you make a number of comments on the arrangements made with South Africa concerning gold transactions with the International Monetary Fund. The letter concludes with several specific questions you would like answered.

Before turning to those questions, I would like to make some general comments. You are correct in stating that we would like to see the monetary role of gold diminished. We agree that wide price fluctuations, which derive in part from shifts in South African gold sales due to shifts in its balance of payments, are undesirable. Moreover, we believe that these movements in the gold price due to shifts in supply and the market's sensitivity to rumors simply provide further evidence of the need to build a monetary system not dependent on that commodity.

While agreeing that the shifts in supply increase the volatility of the gold price, I do not agree with any implication that the agreement reached with South Africa creates this problem. The opposite is the case; the agreement provides that South Africa cannot hold back more of its newly-mined gold from the market than that equal to its balance of payments surplus. In addition, its balance of payments position will not be artificially improved by unusual or nontraditional foreign borrowing or other special transactions. Thus, while fluctuations are not eliminated, they are limited and the agreement rules out shifts in supply that might be made for the purpose of influencing the market price, regardless of balance of payments conditions.

From this standpoint the present arrangement is clearly preferable to no arrangement at all. I would note that, in the absence of the agreement, there would be no means of forcing South Africa to sell gold or any other commodity it produces if it had no need to do so from the standpoint of its current foreign exchange requirements.

With respect to the "floor" price for gold, which appears to be your primary concern, this provision was operative for about two months in the first quarter of 1970. No gold sales have been made by South Africa to the IMF under that provision since that time. In fact, no sales to the IMF have been made for over one year under any provision.

It may be assumed that South Africa derives some comfort from the existence of the floor price for its newly-mined gold, which becomes available to it in certain situations and with certain limitations.

Turning to your specific questions, the answers are:

1. No, I see no reason why we should encourage South African gold production more enthusiastically than domestic production, nor do I see that in any practical way we do. Our gold producers can, and do, receive such higher market prices as may prevail, as do South African or other producers. In practice, our gold producers have not had to sell their gold below the monetary price even during that short period of time that South Africa did sell newly-mined gold to the IMF at 1/4 percent below market.

2. We have made no representation to South Africa over its decision to withhold gold from the private market because such withholding as has taken place has been well within the limits that might have been withheld due to its present surplus balance of payments position. We have discussed with a Representative of the South African Government in general terms the desirability of eliminating the floor price, a proposal they do not favor.

3. Conceptually, I see no justification for a floor price for gold whether or not there is a ceiling. I see no practical way in which a ceiling could be enforced through agreement with South Africa alone. Rather than moving toward adding a ceiling to a floor price the United States itself sees no need for a floor price but a number of countries do grow concerned if they believe the market value of an asset they hold in their reserves might decline below its book value. This in fact was the case as recently as late 1969. The continued concern over a floor price seems applicable only in terms of an expectation that experience could be repeated. The matter is consequently not one for a unilateral determination by the United States.

4. There is no reason why we should protect South Africa's balance of payments and the gold arrangements with South Africa are not directed to South Africa's balance of payments problems. In fact, South Africa had a sizable deficit during much of the period of the agreement.

5. As you state, the agreement with South Africa does permit the parties to review the arrangement in the event of a major change in circumstances. I think the developments beginning with last August 15 and the continuing developments with respect to monetary reform could be viewed as a major change in circumstances and the arrangement reviewed, should it be considered desirable to do so. I would emphasize that in important respects, the Agreement limits South African freedom of action. The floor price provision, which is of interest to South Africa, is not now operative. The provisions that limit the amount of gold that South Africa can withhold from the market are.

Sincerely yours,

George P. Shultz

George P. Shultz

The Honorable
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