Approved For Release 2009/10/06 : CIA-RDP85T00875R00160001

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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

International Finance Series, No. 2

Prospects for Resumption of South African Gold Sales

Secret
ER IM 68-75
June 1968

Copy Nº 86

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Foreword

25X1 This memorandum is the second of a series of occasional publications on international financial problems. [redacted] 25X1

CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
June 1968

INTELLIGENCE MEMORANDUM

Prospects for Resumption of South African Gold Sales

Summary

There is no firm evidence that South Africa has yet sold gold since the two-tier market was established in mid-March, although it is actively probing central banks and international monetary institutions, including the IMF, to find outlets. While South Africa has the economic capability to maintain its embargo well into 1969, it will sell gold if it can find outlets that it considers attractive.

South Africa would prefer to have the option of selling on either the official market at $35 an ounce or the free market, hopefully at a higher price. This arrangement would permit South Africa to maximize revenue from gold sales by choosing the market that yielded the better return. At the present time the official market comprised of major central banks probably will not take newly mined gold, and the free market price is threatened by the overhang of more than $2 billion bought by speculators since the sterling devaluation in November 1967. South Africa's withdrawal from the market thus appears to be primarily defensive. A further marked deterioration of the international monetary system, however, might encourage South Africa to play for higher stakes, holding its gold off the market for a considerable period in hopes of a permanent increase in the official price.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research.

Normally, South Africa must sell gold in order to cover deficits in its balance of payments. During the four years 1964-67, gold sales financed about 43 percent of total imports, and during the same period accumulated balance-of-payments deficits amounted to only $21 million. In the first quarter of 1968, South Africa's balance of payments improved appreciably in spite of only minimal gold sales because of an improved trade balance and the inflow of some $280 million in foreign exchange, much of which was used to purchase shares of gold mining stock on the South African stock exchange. Consequently, South Africa had a surplus of $196 million in its balance of payments in the first quarter. This surplus should nearly cover the expected deficit in the second quarter. After mid-year, however, deficits of about $200 million per quarter will necessitate either borrowing or the sale of gold.

If South Africa decided to borrow money abroad to meet current needs, it could probably refrain from selling gold through the remainder of the year and beyond. This would necessitate borrowing from $250 million to $650 million abroad by the end of the year. In view of its mounting gold reserves, which totaled an estimated $900 million by the end of May and would in the absence of sales amount to some $1.55 billion by the end of the year, South Africa should have little difficulty obtaining loans of this size.

Background

1. South Africa's current production of more than $1 billion of gold annually amounts to about 65 percent of the world total and to about 75 percent of the supply of new gold outside the USSR. South African gold sales of almost $9 billion during the last ten years have been equivalent in value to 64 percent of South Africa's merchandise exports during the period and to 47 percent of the country's merchandise imports f.o.b. (see Table 2).

2. South Africa normally exports almost all its gold production; during 1967, exports were about $90 million monthly. From 1958 through 1965, gold sales kept pace with the 74-percent growth of manufacturing output, rising from $616 million to $1,081 million. In the last two years, however, gold production has stabilized at slightly over $1 billion a year and is expected to begin to decline in the early 1970's, unless South Africa can sell its gold for more than $35 an ounce.

3. South Africa has normally maintained a surplus on current account by means of gold sales. In the last four years, however, imports rose rapidly, resulting in a deficit on merchandise trade alone amounting to an average of $836 million a year. Service payments, which in South African accounting include c.i.f. on imports, remained well ahead of service receipts, adding $487 million a year to the current account deficit. Gold sales, averaging $1 billion a year, financed part of the deficit, but in spite of earnings of $4 billion from gold, the deficit on current account totaled $719 million during 1964-67, ranging from as much as $412 million in 1965 to only $18 million in 1966. Surpluses on capital account resulting from an inflow of capital into the private sector began in 1965 and in the last three years have largely offset deficits on current account. During the period 1964-67, the surplus on capital account totaled $699 million, leaving a net deficit in the balance of payments for the period of only $21 million (see Table 1).*

* *A further drawdown of gold and foreign exchange reserves of almost $20 million occurred as a result of the devaluation of sterling and certain other currencies in November 1967.*

Table 1

South Africa: Annual Balance of Payments a/
1964-67

Million US $

	1964	1965	1966	1967
Current Account				
Merchandise exports, f.o.b.	1,516	1,490	1,679	1,859
Gold sales	1,030	1,085	1,075	1,081
Service receipts	301	333	344	461
Merchandise imports, f.o.b.	-2,233	-2,552	-2,349	-2,755
Service payments	-741	-825	-858	-963
Transfers	48	57	91	106
Balance on current account	-78	-412	-18	-211
Capital Movements				
Total capital movements	-46	361	209	175
Changes in gold and foreign exchange reserves	*-125*	*-50*	*190*	*-36*

a. Because of rounding, components may not add to the totals shown.

4. By and large, South Africa has been conservative in its international economic relations, generally maintaining a favorable balance of payments. The foreign debt has averaged only $225 million over the last ten years and was reduced to $129 million in 1967. South Africa's Reserve Bank's gold holdings fluctuated from $210 million in 1958 to a low of $176 million at the time of the Sharpesville incident in 1960, when there was an extraordinary outflow of capital. Gold reserves recovered rapidly, however, to $624 million by the end of 1963 because of large surpluses on current account. Reserves

declined slightly in the following two years but recovered again in 1966 as the balance of trade improved and foreign capital was attracted by investment opportunities. An increase of more than $400 million in imports in 1967, however, reduced gold reserves to $578 million at the end of 1967. Hard currency reserves have fluctuated around $100 million, standing at $102 million at the end of 1967 (see Table 5).

Recent Developments

5. South Africa's reaction to the international monetary crisis, which began with the devaluation of sterling in November 1967, was first to reduce its gold sales and then to withdraw from the market completely. December's sales were less than 75 percent of normal levels, and in January and February 1968 a total of only $70 million was sold -- less than one-half the normal rate. Sales, if any, in the first half of March have not been reported, and no gold has been sold abroad since mid-March when the two-tier market was established.

6. South Africa has been able to withhold its gold output from the market without significant financial strain, principally because of an improvement in the trade balance and heavy capital inflows in the first quarter of 1968. During the first quarter of this year, imports declined by 11 percent from the first quarter of 1967. The decline was a continuation of a downward trend that began after mid-1967, following an unusually high level of imports in the first half of the year that added $286 million to industrial and commercial inventories. The major decreases in the second half of 1967 occurred in the statistical classes "machinery and transport equipment" and "manufactured goods" reflecting a downturn in the investment cycle, a reduction of consumer liquidity, and a decrease in the growth rate of economic activity in general. Also, in the first quarter of 1968, food imports declined as the result of a good harvest. There is no evidence that the decline in imports has any direct relationship to the international monetary crisis.

7. Non-gold exports, which rose by almost 11 percent in 1967, continued their upward trend in the first quarter of 1968, when they were 23 percent

above the first quarter of the previous year. Most of the increase was due to improved harvests and livestock exports. Service receipts were also up as the result of the increased use of South Africa's port facilities, since the closure of the Suez Canal, by ships rounding the Cape of Good Hope. Service payments have been held down somewhat by the reduction in commodity imports (see Tables 3 and 4).

8. Although gold sales during the first quarter of 1968 were nearly $200 million below the normal level, the deficit on current account totaled only about $125 million. The deficit on merchandise trade amounted to about $111 million, and service payments exceeded service receipts by $108 million. Gold sales of $70 million in the first two months of the year and net transfers of $24 million reduced the deficit to the $125 million total.

9. South Africa had no difficulty financing the deficit on current account without resort to selling gold, because of a massive capital inflow of some $280 million in the private sector during the quarter. Much of these funds were used to buy gold mining shares on the South African stock exchange, raising the total capital inflow during the first quarter of 1968 in the private sector to an estimated $350 million. This was reduced only slightly by an outflow of $25 million from the central government and the banking sector, leaving a net surplus on the capital account of about $320 million. As a result, there was an increase of about $190 million in foreign exchange reserves.

10. The withholding of all but $70 million of gold production from the market in the first quarter added $158 million to gold reserves, raising them from $578 million at the close of 1967 to $736 million at the end of March. By the end of May, gold reserves probably exceeded $900 million.

11. Thus the South African economy has been little affected by the gold crisis. The decline in imports has been due to other causes and would have occurred in any event. Gold production has continued as usual so that incomes generated in gold mining have not changed, and all gold has been purchased by the South African Reserve Bank in the

normal way. The absence of gold exports has not been inflationary, because there was no difficulty financing imports, and gold production has gone into the government account and has not been available for credit expansion. The main monetary problem for South Africa during the gold crisis has been the influx of foreign capital to buy gold shares. This influx does add to bank reserves and is therefore potentially inflationary. Since South Africa's control of inflationary forces in the economy in recent years has been quite effective, the effects of this inflow appear to be manageable.

Prospects

12. South Africa's gold policy is not yet clear. It has made efforts to market its gold to central banks and international monetary institutions, such as the International Monetary Fund, but has remained largely unresponsive to efforts of the free market. The few inquiries South Africa has made as to possibilities for free market sales have been very discreet and have involved small amounts that would not disrupt the market.

13. South Africa appears able to hold its gold off the world market for months without having to make any significant adjustment in its domestic economy. Its foreign currency reserves were adequate to cover or nearly cover deficits through June. From now on, deficits will have to be covered by borrowing unless there continues to be an unusually large capital inflow. Depending on the capital inflow and on when a new cyclical upswing in investment resumes, borrowing needs could amount to as little as $200 million to $300 million or as much as $600 million to $700 million during the second half of 1968. There seems to be no question as to South Africa's ability to obtain this much credit, or more. South Africa is considered an excellent credit risk, and if it does not sell gold, its gold reserves would exceed one and one-half billion dollars at the end of 1968.

South African Policy Options

14. The fact that South Africa can refrain from selling gold does not mean that it will do so. The decision will depend on its assessment of (1) prospects for the international monetary system, (2) the

possibilities of an increase in the official price of gold, and (3) the supply and demand for gold in the free market. At the present time, South Africa fears that its resumption of sales might prompt speculators who bought more than $2 billion in gold following devaluation of sterling in November 1967 to dump their holdings on the market. Such an influx of large quantities of gold could drive the free market price below $35 an ounce.

15. South Africa would prefer to have the option of selling on either the official market at $35 an ounce or on the free market, hopefully at a higher price. This arrangement would permit South Africa to maximize revenue from gold sales by choosing the market that yielded the better return. But if the official market continues to refuse to buy newly mined gold and the dollar remains strong, South Africa will eventually enter the free market. As time passes, industry and hoarders will absorb the overhang held by short-term speculators and the market will strengthen. In addition, small amounts might be bought by the Bank for International Settlement.

16. If, however, the international monetary crisis intensifies (for example, because of a new sterling crisis or the failure of US measures to reduce the dollar drain), South Africa may judge that it can force an increase in the official price of gold by refraining from any sales at all. If it should decide on this course, it probably could continue to withhold gold well into 1969 if necessary by borrowing abroad with relatively minor interest costs.

Table 2

South Africa: Annual Balance of Payments a/
1958-67

Million US $

	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
Current Account										
Merchandise exports, f.o.b.	1,084	1,228	1,231	1,303	1,333	1,424	1,516	1,490	1,679	1,859
Gold sales	616	706	742	806	885	963	1,030	1,085	1,075	1,081
Service receipts	216	223	235	231	255	260	301	333	344	461
Merchandise imports, f.o.b.	-1,581	-1,393	-1,578	-1,431	-1,467	-1,823	-2,233	-2,552	-2,349	-2,755
Service payments	-584	-563	-594	-626	-601	-654	-741	-825	-858	-963
Total goods and services (net receipts +)	-249	200	36	284	405	171	-126	-469	-109	-318
Transfers (net receipts +)	35	32	-7	--	27	36	48	57	91	106
Balance on current account	-214	232	29	284	431	207	-78	-412	-16	-211
Capital Movements										
Private sector	115	-76	-231	-116	-90	-104	-57	227	224	277
Central government and banking sector	111	-45	17	-18	-78	18	11	134	-15	-102
Total capital movements (net inflow +)	225	-120	-214	-134	-168	-85	-46	361	209	175
Change in gold and foreign exchange reserves	11	112	-185	150	263	122	-125	-50	190	-36

a. Because of rounding, components may not add to the totals shown.

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Table 3

South Africa: Quarterly Balance of Payments a/
1966-67

Million US $

	1966					1967				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Current Account										
Merchandise exports, f.o.b.	379	421	480	398	1,679	437	449	501	472	1,859
Gold sales	274	265	270	266	1,075	269	276	272	265	1,081
Service receipts	78	83	81	102	344	95	108	113	144	461
Merchandise imports, f.o.b.	-563	-533	-610	-643	-2,349	-728	-735	-689	-603	-2,755
Service payments	-185	-203	-214	-256	-858	-220	-258	-234	-252	-963
Total goods and services (net receipts +)	-15	32	7	-133	-109	-147	-160	-36	25	-318
Transfers (net receipts +)	22	20	24	25	91	28	25	29	24	106
Balance on current account	7	52	31	-108	-18	-119	-134	-7	49	-211
Capital Movements										
Private sector	18	71	22	112	224	25	125	62	66	277
Central government and banking sector	15	11	-39	-3	-15	-11	-50	-15	-25	-102
Total capital movements (net inflow +)	34	83	-17	109	209	14	74	46	41	175
Changes in gold and foreign exchange reserves	41	134	14	1	190	-105	-60	39	90	-36

a. Because of rounding, components may not add to the totals shown.

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Table 4

South Africa: Estimated Quarterly Balance of Payments
1968

Million US $

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Total	
	Low Range a/	High Range b/	Low Range c/	High Range d/	Low Range c/	High Range d/	Low Range c/	High Range d/	Low Range	High Range
Current Account										
Merchandise exports, f.o.b.	539	539	539	465	539	465	539	465	2,156	1,934
Gold sales	70	70							70	70
Service receipts	144	115	144	115	144	115	144	115	576	460
Merchandise imports, f.o.b.	-650	-650	-650	-689	-650	-689	-650	-689	-2,600	-2,717
Service payments	-252	-241	-252	-241	-252	-241	-252	-241	-1,008	-964
Total goods and services (net receipts +)	-149	-167	-219	-350	-219	-350	-219	-350	-806	-1,217
Transfers (net receipts +)	24	27	24	27	24	27	24	27	96	108
Balance on current account	-125	-140	-195	-323	-195	-323	-195	-323	-710	-1,109
Capital Movements										
Private sector	346	349	66	69	66	69	66	69	544	556
Central government and banking sector	-25	-25	-25	-25	-25	-25	-25	-25	-100	-100
Total capital movements (net inflow +)	321	324	41	44	41	44	41	44	444	456
Change in gold and foreign exchange reserves	196	184	-154	-279	-154	-279	-154	-279	-266	-653

a. Merchandise exports, gold sales, and merchandise imports are reported for the first quarter. Capital movements in the private sector include the reported $280 million inflow of foreign capital used primarily to buy gold mining stock shares; to this is added $66 million, the inflow in the last quarter of 1967 believed to be representative of the normal inflow. Figures for the fourth quarter of 1967 are used for all other items in the balance of payments.

b. Estimates in the second column include all reported figures (see a, above), and the 1967 average for those items not reported.

c. Merchandise exports and merchandise imports are estimated at the same level in the last three quarters as in the first quarter of 1968. All other items are estimated at the level of the fourth quarter of 1967.

d. All items are estimated at the quarterly average in 1967.

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Table 5

South Africa: Gold and Foreign Exchange Reserves a/
1958 Through 17 May 1968

Million US $

End of Period	Total	Gold Reserves	Foreign Exchange Reserves
1958	314	210	104
1959	426	237	189
1960	239	176	63
1961	388	297	91
1962	603	494	109
1963	721	624	97
1964	659	570	90
1965	536	421	115
1966	729	631	98
1967	680	578	102
January 1968	725	620	106
February 1968	775	686	90
March 1968	861	736	126
12 April 1968	896	785	111
17 May 1968	994	902	92

a. Data are for the Reserve Bank only, and therefore changes in gold and foreign exchange reserves differ from those in Table 1. Because of rounding, components may not add to the totals shown.