NATIONAL ASSEMBLY

QUESTION FOR ORAL REPLY

QUESTION NUMBER 42

2 MARCH 2005

MR S N SWART (ACDP) TO ASK THE MINISTER OF FINANCE:

Whether the National Treasury will support proposals for using International Monetary Fund gold reserves to write off debts of the fund's poorest borrowers; if not, why not; if so, what effect will the sale of such gold reserves have on the local gold-mining industry? **N234E**

REPLY:

The National Treasury supports the use of IMF gold sales to finance debt relief for poor countries.

The IMF has an obligation to ensure that its gold transactions do not disrupt the gold market. The sale of IMF gold, when done in a managed manner that is transparent, clearly communicated to the market, and ideally along the Central Bank Gold Agreement, will mean that the market can price in the IMF gold sales and thus cause no disruptions to the market price of gold.

The IMF's policy on gold is governed by the following principles:

- As an undervalued asset held by the IMF, gold provides fundamental strength to its balance sheet. Any mobilization of IMF gold should avoid weakening its overall financial position.
- The IMF should continue to hold a relatively large amount of gold among its assets, not only for prudential reasons, but also to meet unforeseen contingencies.
- The IMF has a systemic responsibility to avoid causing disruptions to the functioning of the gold market.
- Profits from any gold sales should be used whenever feasible to create an investment fund, of which only the income should be used.

In the past, gold sales announcements, detailing scheduled sales and volumes, have in fact removed uncertainty in the gold market and caused the market price of gold to rise.

In this regard it should be noted that the major central banks agreed in 1999 to sell 2000 tons of gold to the market in a transparent way with the result that the market priced this information into the gold price; hence the impact on the market was minimized. This agreement was renewed in 2004 and it was agreed that 2500 tons of gold will be sold over the next five years, and again the market has priced this fact into the calculation of the future price of gold.

If the IMF decides to sell some of its gold it could negotiate with the major central banks to include the sale of IMF gold to pay for the debt of poor countries in this framework, in order to minimize the price effect of the sale of additional gold in the market.

The IMF gold sales should therefore not depress the gold market and as a result the transaction should not adversely affect the local gold-mining industry.

BACKGROUND INFORMATION: MINISTER

Note
Gold Sales by the IMF

- The IMF staff are working on proposals to be considered in the Board, however, the issue has not yet been brought to the agenda.
- The possible sale of IMF gold will only be sold to cover low-income country debt owed to the IMF.
- This debt is at present "roughly valued" to about $15 billion, which means if any gold were to be sold, it would have to cover about this amount.
- The $15 billion worth of gold to be sold to cover IMF debt would not cover the debt of low-income countries owed to the World Bank, AfDB or other bilateral creditors.
- The impact of the gold on the mining industry will depend on the time frame proposed to sell the gold, which we do not know, and also the tonnage of gold to be sold in today's value to cover the $15 billion worth of debt to the IMF. We do not expect this to be a once-off transaction to cover the whole commitment
- The IMF has an obligation to ensure that its gold transactions do not disrupt the gold market. The sale of IMF gold, when done in a managed manner that is transparent, clearly communicated to the market -and ideally along the Central Bank Gold Agreement- will mean that the market can price in the IMF gold sales and thus cause no disruptions to the market price of gold.
- In the past, gold sales announcements – detailing scheduled sales and volumes - have in fact removed uncertainty in the gold market and caused the market price of gold to rise.
- The IMF gold sales should not depress the gold market and therefore the transaction should not adversely affect the local gold-mining industry.
- A note on Central Bank Gold Agreement and a fact sheet containing information from the IMF’s Finance Department on the sale of gold are enclosed as Annexure I and Annexure II respectively.

Annexure I

The Central Bank Gold Agreement (CBGA) and Gold Price

The Central Bank Gold Agreement came into being to address volatility and uncertainty in the gold market induced by sporadic and unpredictable central banks' gold sales. Financial markets do not like uncertainty. Prior to the CBGA, there was no way of knowing when a central bank could suddenly announce the sale of significant stocks of gold. Central banks were leasing increasing amounts of gold to financial institutions - (in particular to gold dealers involved in ***producer hedging)*** - such as gold dealers, banks and hedge funds in return for an income.

A note on producer hedging

- While the sale price of gold in the market fluctuates significantly – in certain instances by as much as 30% or more in a year the costs of mining and producing gold are much less viable. Gold producers derive profits from the difference between this eventual sale price and the costs of mining.

- However, this profit is uncertain and very volatile. In order to reduce this uncertainty gold producers with proven reserves in the ground sell a portion of these reserves forward (enter into long-term contracts for selling future gold at a fixed price mutually agreed with gold dealers). This is called producer hedging.

- Central banks hold stocks of reserve assets, mostly liquid foreign currencies such as dollars, yen or euro. They however also hold gold which constitutes a significant part of their total reserve holdings. Current total foreign exchange reserve holdings of central banks stand at about $2.500 billion of which gold accounts for about $400 billion at current market price.

- Most foreign currency holdings are not held as cash but are instead invested in safe liquid securities such as government bonds. It should be noted that holding gold does not generate any income. There is thus an opportunity cost to holding reserves of gold.

- In order to try and earn some income on their holdings of gold, some central banks started leasing their gold reserves to financial institutions such as gold dealers, banks and hedge funds in return for an income.

- The gold dealers who buy forward gold from producers are exposed to possible losses if gold price falls in the future. So, in order to hedge their position, they lease gold from central banks and sell it in the spot market.

- Hence, leasing of gold increases current supply and makes it easier to “short sell” gold. This can help depress the current gold price. Producer hedging **-** selling gold forward to lock in prices for future gold production also helps keep future gold prices low.

1. While no one was of the view that central banks could sell large amounts of their gold holdings, there were real concerns that gold leasing could increase exponentially and depress gold prices.

2. It was in this context that all major central banks that had been significant sellers of gold signed the first Central Bank Gold Agreement (CBGA) on 26 September 1999 declaring that the agreement was “In the interest of clarifying their intentions with respect to their gold holdings…” which essentially meant they wanted to reduce uncertainty surrounding gold sales and leasing by central banks.

3. The CBGA did not limit gold sales instead it aggregated the gold sales that were planned by the signatories and disclosed the number to the market, thereby reducing uncertainty. However, what the CBGA did limit the further leasing of gold to financial market players, signatories agreed “…not to expand their gold leasing and their use of gold futures and options…”. This meant freezing gold leasing, futures and options at levels prevailing in 1999. The growth in gold leasing was depressing gold prices and there was also concern that leased gold could be used for speculative purposes.

4. The CBGA helped alleviate market concerns of an exponential growth in gold leasing and the gold price rose instantly. It is indeed interesting to note that the gold price rose while the CBGA announced that the signatories would sell 65 million ounces of gold over the five-year period (13 million ounces every year.

5. The rise in gold price can be attributed to two things: first, the increased certainty environment with respect to gold sales and second, a limit on further leasing of gold.

6. The CBGA renewal on 8 March 2004 did not have much impact on the market despite its provision for expansion of gold sales to approximately 80 million ounces over five year or approximately 16 million ounces every year. The agreement maintains a freeze on gold leasing, futures and options.

7. The price of gold did not fall as a result of a planned increase in gold sales. This shows that the gold market can absorb sales of significant amounts of gold as long as they are carried in an open and transparent manner with the planned sale timetable released into the public domain. This helps curb speculation and uncertainty in the market.

Annexure II

Information from the IMF's Finance Department on the Sale of Gold

According the IMF's Finance Department, three ways exist that are consistent with the Articles to sell IMF's gold, and at the same time minimize the impact of the market price of gold. These are:

(i) Sell the gold within the framework agreed to by major central banks

The major central banks agreed in 1999 to sell 2000 tons of gold to the market in a transparent way with the result that the market priced this information into the gold price; hence the impact on the market was minimized. This agreement was renewed in 2004 and it was agreed that 2500 tons of gold will be sold over the next five years, and again the market has priced this fact into the calculation of the future price of gold. The Fund said that it could negotiate with the major central banks to include the sale of IMF gold to pay for the debt of poor countries in this framework, in order to minimize the price effect of the sale of additional gold in the market.

(ii) 'Revaluation' of IMF gold: Off-market transactions in gold (1999–2000).

In December 1999, the Executive Board authorized off-market transactions in gold of up to 14 million ounces to help finance IMF participation in the Heavily Indebted Poor Countries (HIPC) Initiative. Between December 1999 and April 2000, separate but closely linked transactions involving a total of 12.9 million ounces of gold were carried out between the IMF and two members (Brazil and Mexico) that had financial obligations falling due to the IMF. In the first step, the IMF sold gold to the member at the prevailing market price and the profits were placed in a special account invested for the benefit of the HIPC Initiative. In the second step, the IMF immediately accepted back, at the same market price, the same amount of gold from the member in settlement of that member's financial obligations. The net effect of these transactions was to leave the balance of the IMF's holdings of physical gold unchanged.

(iii) Sell gold back to original contributors at original price

The IMF could sell back (exchange) gold to the original contributors of the gold at the original price, and then allow the members to pay their subscription fees to the IMF in SDRs[1]. These countries could than sell the gold at market prices and contribute to the financing of the debt relief of poor countries. This route is obviously not desirable, since it could have a negative impact on the market.

Gold in the IMF

Gold played a central role in the international monetary system until the collapse of the Bretton Woods system of fixed exchange rates in 1973. Since then, the role of gold has been gradually reduced. However, it is still an important asset in the reserve holdings of a number of countries, and the IMF remains one of the largest official holders of gold in the world.

The IMF's gold holdings

The IMF holds 103.4 million ounces (3,217 metric tons) of gold at designated depositories. The IMF's total gold holdings are valued on its balance sheet at SDR 5.9 billion (about $8.5 billion) on the basis of historical cost. As of August 31, 2004, the IMF's holdings amounted to $42.2 billion (at then current market prices).

The IMF acquired virtually all its gold holdings through four main types of transactions under the original Articles of Agreement. First, the original Articles prescribed that 25 percent of initial quota subscriptions and subsequent quota increases were to be paid in gold. This represented the largest source of the IMF's gold. Second, all payment of charges (i.e., interest on members' use of IMF credit) were normally made in gold. Third, a member wishing to purchase the currency of another member could acquire it by selling gold to the IMF. The major use of this provision was sales of gold to the IMF by South Africa in 1970–71. And finally, members could use gold to repay the IMF for credit previously extended.

The IMF's policy on gold today

The Second Amendment to the Articles of Agreement in April 1978 eliminated the use of gold as the common denominator of the post-World War II exchange rate system and as the basis of the value of the Special Drawing Right (SDR). It also abolished the official price of gold and abrogated the obligatory use of gold in transactions between the IMF and its members. It furthermore required that the IMF, when dealing in gold, avoid managing its price or establishing a fixed price.

The Articles of Agreement now limit the use of gold in the IMF's operations and transactions. The IMF may sell gold outright on the basis of prevailing

[1] In 1945 members paid for their shares in the IMF in gold – the gold will now be given back to members at the original price - which they would now be able to sell at the market price - using the proceeds from the difference in value to finance debt relief.

market prices, and may accept gold in the discharge of a member's obligations at an agreed price, based on market prices at the time of acceptance. These transactions in gold require an 85 percent majority of total voting power. The IMF does not have the authority to engage in any other gold transactions—such as loans, leases, swaps, or use of gold as collateral—nor does it have the authority to buy gold.

The IMF's policy on gold is governed by the following principles:

- As an undervalued asset held by the IMF, gold provides fundamental strength to its balance sheet. Any mobilization of IMF gold should avoid weakening its overall financial position.
- The IMF should continue to hold a relatively large amount of gold among its assets, not only for prudential reasons, but also to meet unforeseen contingencies.
- The IMF has a systemic responsibility to avoid causing disruptions to the functioning of the gold market.
- Profits from any gold sales should be used whenever feasible to create an investment fund, of which only the income should be used.

How and when the IMF used gold

Outflows of gold from the IMF's holdings occurred under the original Articles of Agreement through sales of gold for currency, and via payments of remuneration and interest. Since the Second Amendment of the Articles of Agreement, outflows of gold can only occur through outright sales. Key gold transactions included:

- Sales for replenishment (1957–70). The IMF sold gold on several occasions during this period to replenish its holdings of currencies.
- South African gold (1970–71). The IMF sold gold to members in amounts roughly corresponding to those purchased in these years from South Africa.
- Investment in U.S. government securities (1956–72). In order to generate income to offset operational deficits, some IMF gold was sold to the United States and the proceeds invested in U.S. government securities. Subsequently, a significant build-up of IMF reserves prompted the IMF to reacquire this gold from the U.S. government.
- Auctions and “restitution” sales (1976–80). The IMF sold approximately one third (50 million ounces) of its then-existing gold holdings following an agreement by its members to reduce the role of gold in the international monetary system. Half of this amount was sold in restitution to members at the then-official price of SDR 35 per ounce; the other half was auctioned to the market to finance the Trust Fund, which supported concessional lending by the IMF to low-income countries.

- Off-market transactions in gold (1999–2000). In December 1999, the Executive Board authorized off-market transactions in gold of up to 14 million ounces to help finance IMF participation in the Heavily Indebted Poor Countries (HIPC) Initiative. Between December 1999 and April 2000, separate but closely linked transactions involving a total of 12.9 million ounces of gold were carried out between the IMF and two members (Brazil and Mexico) that had financial obligations falling due to the IMF. In the first step, the IMF sold gold to the member at the prevailing market price and the profits were placed in a special account invested for the benefit of the HIPC Initiative. In the second step, the IMF immediately accepted back, at the same market price, the same amount of gold from the member in settlement of that member's financial obligations. The net effect of these transactions was to leave the balance of the IMF's holdings of physical gold unchanged.

IMF gold is currently valued at SDR 35 (approximately US$50). IMF gold could only be revalued if a central bank is willing to purchase a portion IMF gold at market prices.

Fourth Amendment of the Articles of Agreement.

A proposal for a special one-time allocation of SDRs was approved by the IMF's Board of Governors in September 1997 through the proposed Fourth Amendment of the Articles of Agreement. This allocation would double cumulative SDR allocations to SDR 42.8 billion. Its intent is to enable all members of the IMF to participate in the SDR system on an equitable basis and correct for the fact that countries that joined the Fund subsequent to 1981—more than one fifth of the current IMF membership—have never received an SDR allocation. The Fourth Amendment will become effective when three fifths of the IMF membership (111 members) with 85 percent of the total voting power accept it. As of end-September, 2004, 131 members with 77.3 percent of total voting power had accepted the proposed amendment. Approval by the United States, with 17.1 percent of total votes, would put the amendment into effect.

THE CENTRAL BANK GOLD AGREEMENT (CBGA) AND GOLD PRICE

8. The Central Bank Gold Agreement came into being to address volatility and uncertainty in the gold market induced by sporadic and unpredictable central banks' gold sales. Financial markets do not like uncertainty. Prior to the CBGA, there was no way of knowing when a central bank could suddenly announce the sale of significant stocks of gold. Central banks were leasing increasing amounts of gold to financial institutions - (in particular to gold dealers involved in ***producer hedging)***- such as gold dealers, banks and hedge funds in return for an income.

A note on producer hedging

- While the sale price of gold in the market fluctuates significantly- sometimes by as much as 30% or more in a year-the costs of mining and production gold are much less variable. Gold producers derive profits from the difference between this eventual sale price and the costs of mining.

- However, this profit is uncertain and very volatile. In order to reduce this uncertainty gold producers with proven reserves in the ground sell a portion of these reserves forward – enter into long-term contracts for selling future gold at a fixed price mutually agreed with gold dealers. This is called producer hedging.

- Central banks hold stocks of reserve assets, mostly liquid foreign currencies such as dollars, yen or euro. Gold too constitutes a significant part of the total reserve holdings. Current total foreign exchange reserve holdings of central banks stand at about $2.500 billion of which gold accounts for about $400 billion at current market price.

- Most foreign currency holdings are not held as cash but are instead invested in safe liquid securities such as government bonds. Depending on the interest rate between 1-6%. Meanwhile, holding gold does not generate any income. There is thus an opportunity cost to holding reserves of gold.

- In order to try and earn some income on their holdings of gold, some central banks started leasing their gold reserves to financial institutions such as gold dealers, banks and hedge funds in return for an income that has been around a meager 0.5-1.5% per annum.

- The gold dealers who buy forward gold from producers are exposed to possible losses if gold price falls in the future. So, in order to hedge their position, they lease gold from central banks and sell it in the spot market.

- Hence, leasing of gold increases current supply and makes it easier to “short sell” gold. This can help depress current gold price. Producer hedging- selling gold forward to lock in prices for future gold production also helps keep future gold prices low.

9. While no one was of the view that central banks could sell large amounts of their gold holdings, there were real concerns that gold leasing could increase exponentially and depress gold prices.

10. It was in this context that all major central banks [2]that had been significant sellers of gold signed the first Central Bank Gold Agreement (CBGA) on 26 September 1999 declaring that the agreement was “In the interest of clarifying their intentions with respect to their gold holdings…” which essentially meant they wanted to reduce uncertainty surrounding gold sales and leasing by central banks.

11. The CBGA did not limit gold sales instead it aggregated the gold sales that were planned by the signatories and disclosed the number to the market, thereby reducing uncertainty. However, what the CBGA did limit was the further leasing of gold to financial market players, signatories agreed “…not to expand their gold leasings and their use of gold futures and options…”. This meant freezing gold leasing, futures and options at levels prevailing in 1999. The growth in gold leasing was depressing gold prices and there was also concern that leased gold could be used for speculative purposes.

12. The CBGA helped alleviate market concerns of an exponential growth in gold leasing and the gold price rose instantly. It is indeed interesting to note that the gold price rose while the CBGA announced that the signatories would sell 65 million ounces of gold over the five year period, about 13 million ounces every year.

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[2] The European Central Bank and the central banks of Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, Switzerland, and England.

13. The rise in gold price can be attributed to two things: first, the increased certainty environment with respect to gold sales and second, a limit on further leasing of gold.

14. The CBGA renewal on 8 March 2004 did not have much impact on the market despite its provision for expansion of gold sales to approximately 80 million ounces over five year or approximately 16 million ounces every year. The agreement maintains a freeze on gold leasing, futures and options.

15. The price of gold did not fall as a result of a planned increase in planed gold sales and this shows that the gold market can absorb sales of significant amounts of gold as long as they are carried in an open and transparent manner with the planned sale timetable released into the public domain. This helps curb speculation and uncertainty in the market.

NATIONAL ASSEMBLY

QUESTION FOR ORAL REPLY

QUESTION NUMBER 14

MS J L FUBBS (ANC) TO ASK THE MINISTER OF FINANCE:

(a) What progress is being made in promoting the recommendations of the Commission for Africa's drive to achieve the millennium development goals and (b) how will the commission's recommendations on debt relief, development aid and market access advance African development? **N205E**

REPLY:

(a) The Commission for Africa will publish its recommendations in a report on 11th March 2005. While its recommendations will be largely consistent with those presented in the Consultation Document, published in November 2004, they also take into account the outcome of a series of consultations held by the Commission in November 2004 to January 2005 and from a number of substantive submissions received from stakeholders in Africa and elsewhere.

With regard to the MDGs', Governments across Africa have over the past ten years, taken critically important steps in meeting the these goals. More democratic states and fewer civil conflicts are just two signs of our progress. Africa has also achieved unprecedented macroeconomic stability, contributing to better economic growth rates than we have achieved in decades. But Africa also needs a new kind of partnership. Five years on, it is evident that progress towards the MDGs is not adequate On present trends, Africa will not only miss all the MDGs in 2015, but would likely take another 100 years to get near to halving poverty.

Africa's human development needs are vast. The number of people living in absolute poverty in Africa has risen from 227 million in 1990 to more than 300 million in 2001. Most estimates suggest that meeting the financing needs of the MDGs in Africa would require at least $25 billion annually. In spite of this, the net flow of resources continues to flow from the poor countries to the rich, not from the rich to the poor. In 2002, low-income countries received about $27 billion in aid but paid back $39 billion in debt repayment to rich country creditors – a net outflow of $12 billion. And these figures do not include the net draining of resources in the form of dividend flows from private sector firms operating in Africa.

The Commission for Africa initiative must be understood within the contact that NEPAD and the APRM require support. The Commission for Africa's report will look at what Africans can do in the areas of Governance as well as Peace and Security, and how the rich countries can demonstrate further supportive for the challenges facing Africa. It will set out concrete recommendations on what is needed to build human capital in Africa, most particularly in health and education, and how to make sure that the poorest people are brought into the mainstream economy of their countries. A central issue is how to make African economies grow. The report will therefore look at Trade to better understand what the impediments are to Africa accessing developed world markets, and how these obstacles can be removed. It will also look at the relationships between Africa and the rich world, in terms of Aid and Debt Relief – and how donors can alter the way they conduct themselves in Africa. In each of these areas the report will make specific costed and often time-bound recommendations. It will also emphasise that action on all these fronts will be important to ensure sustainable results.

In Africa, we know that aid and debt relief work and they work particularly well when given as predictable, untied support for national development strategies. As an example, debt relief to Tanzania enabled the Government to make primary education free. As a result, more than 2 million children go to school in Tanzania. In Benin, about 43 percent of debt relief went to education, where it financed the recruitment of teachers for empty posts in rural areas. Another 54 percent was spent on health, of which a fifth was used to recruit health staff for rural clinics and the remainder was allocated to implementing HIV and AIDS and anti-malarial programmes, improving access to safe water and increasing immunisation.

Though the report has not yet been published, the draft recommendations have already been discussed and are being integrated into the work programmes of various G7/G8 meetings which will precede the Gleneagles Summit in July 2005. As an example, when they met on 5 February 2005, G7 Finance Ministers agreed on a work programme in which they will consider the Commission's recommendations. These recommendations include 100 percent multilateral debt relief, a substantial increase in aid and the establishment of an International Financial Facility for vaccinations.

A more intensive lobbying and advocacy programme will commence following the publication of the Commission's report on 11 March 2005. This will include activities at the Spring Meetings of the World Bank and IMF and in the United Nations as well as consultations with Parliaments across Africa and the G8 countries.

(b) The Commission has estimated that, if implemented in its entirety, its package of proposals including a better investment climate, significant investments in infrastructure, enhanced market access for products from Africa to the rich countries, debt relief and more aid could increase the growth rate of African countries to at least 7-8 percent per annum on average. This would more than double the African economy within a decade. Further to that, as African governments make improvements to the governance and peace and security situation on the continent and more resources are channeled into investments in their people, supported by sufficient resources from donors, the package of recommendations should enable Africa to reach the Millennium Development Goals by 2015.