File- Monetary Policy Issues-Exchange Rate Intervention – Part D

Reference MG-MAMC/D/0002/001

File begins 04/01/1988

File ends 22/04/1988

Pages 21-40

164/1

21

FROM: C J RILEY
DATE: 8 JANUARY 1987

MISS SINCLAIR

cc Mr Peretz
Ms Goodman
Mr Michie
Ms Munro
Mr Scotter

EXCHANGE RATE FLUCTUATIONS

I have a number of comments on the draft submission sent to David Peretz on 23 December (though not the specific issue of the cost of cover). I think there is a need to clarify the analytical framework underlying the discussion.

2. It seems to me there are two separate issues to be considered, which are not distinguished as clearly as they might in the present draft:

- whether exchange differences on liabilities should be recognised for tax purposes, and whether this should depend on the context in which they are acquired;

- whether, if they are recognised, they should be treated as interest or capital gains.

There may well be a case in principle for distinguishing real exchange rate changes from changes due to inflation differentials.

3. I think the case in principle for recognising exchange differences on liabilities is overwhelming. If they are not, this implies unequal treatment of overseas borrowing (contrary to what is asserted at the bottom of page 15 of the draft); and the present unequal treatment of assets and liabilities provides a further distortion. It would be useful to have some discussion of these issues, with suitable examples, early on in the paper.

4. Whether the effects of exchange rate differences on liabilities should be treated as gains or interest is more complex. There is certainly a case for treating them as interest: exchange rate changes which reflect inflation differentials are likely to be

22

accompanied by differences in nominal interest rates, so neutrality between domestic and overseas borrowing can only be achieved by treating exchange rate differences as interest.

5. The discussion on page 15 (paragraph 25) is quite misleading because it ignores interest. Assume, for simplicity, that interest rates equal the inflation rate in both countries. The domestic company borrowing £100 to buy a domestic asset does <u>not</u> make a profit, because it has to pay interest on its loan. But because only <u>indexed gains</u> are subject to CGT while <u>nominal interest</u> payments are deductible for CT, the company makes a post-tax profit. But if the same company borrows in DM and invests in a DM asset, it makes a smaller post-tax profit even though the pre-tax position is the same. This is because the nominal interest on the DM loan is smaller, and hence so is the CT deduction. Only if the effects of the nominal exchange rate change are deductible in the same way as nominal interest will the post-tax position be the same as for domestic borrowing/investment.

6. In principle, real exchange rate changes perhaps ought to be treated differently. They should arguably be treated as capital gains, in the same way as changes in domestic asset prices, because they tend not to be related very systematically to interest rate differentials. However, distinguishing between real and nominal exchange rate changes is clearly impossible in practice, and it is not clear to me which treatment is on balance to be preferred. Since real exchange rate changes tend to cancel out in the medium term (but not in the short term) one might argue for treating them as interest, though clearly this would have to apply to both assets and liabilities.

7. In any event, the paper ought to draw more attention to the unequal treatment of gains and interest under the present system. With different tax rates, indexation provisions, and thresholds, some non-neutralities are inevitable. We need to consider whether the aim should be to ensure equal treatment for domestic and overseas borrowing, or a consistent treatment of overseas assets and liabilities. I think it is impossible to achieve both.

8. My own tentative view is that on balance the least unsatisfactory approach would be to treat foreign currency assets and liabilities the same as far as exchange rate differences are concerned. Capital gains tax treatment for both, with indexation, would not remove differences in the treatment of domestic and overseas borrowing, but I think it would be a step in the right direction.

9. Paragraphs 22-24 consider whether exchange differences should be recognised on a translation basis or a realisation basis. Paragraph 23 asserts that it would certainly be wrong to give relief to non-financial concerns on a translation basis since tax relief on losses would be available before tax payable on the corresponding assets. However this is not unlike the way domestic transactions are treated: tax relief is available on borrowings before tax is due on gains. So where do we draw the line? Some asymmetry is inevitable when tax is deferred on gains but not on interest. It is not clear to me that tax relief should be given for exchange losses only when the corresponding asset is sold.

10. If the exchange rate change is effectively in lieu of interest there is a good case for the translation basis, with no deferral of the relief, and of course the same applies to assets. But once again the situation is rather different for real exchange rate changes. The domestic analogue is changes in real asset prices, and this suggests a realisation basis.

11. A few more detailed points on the text.

Paragraph 10

The last line argues that it is no function of the tax code to provide companies with a safety net of tax relief for their exchange losses. But it does so for gains and losses on domestic assets. Why is the situation different for overseas assets?

Paragraph 11

Surely all that needs to be said here is that measures to deal with "thin capitalisation" would need to take account of any change in the tax treatment of exchange rate gains and loses.

Paragraphs 13-15

The problems inherent in the present system are most obvious in the case of currency swaps, as this section makes clear (at the end of paragraph 14). I would be inclined to have a rather fuller discussion here.

Paragraphs 20-27

Many of the issues in this section should arguably come earlier in the paper. Also, as I have already indicated, I think paragraph 25 is misleading and/or incorrect. It is certainly very difficult to understand: I favour putting numerical examples of this sort into tables, rather than trying to spell out the arithmetic in detail in the text.

12. The conclusion that it would be helpful to issue a consultative document seems unobjectionable.

C J RILEY

91G.SCB.1779.8

25

MAMC: D2

FROM: H C GOODMAN
DATE: 13 January 1988

SIR G LITTLER

cc: Mr Peretz
Mr Grice
Miss O'Mara
Mr Walsh
Mr Hyett - T Sol

TRANSACTIONS IN SDRs WITH THE IMF

We thought that as Accounting Officer for the EEA you should be aware of a proposed change to the way in which transactions are carried out with the Fund in SDRs currently held in the Reserves.

2. Up to now the Bank of England has been prepared to consider requests from the IMF to sell SDRs to the Fund for other currencies and in practice it has usually suited us to agree to the transactions.

3. The Fund has now asked the Bank of England, along with a number of other central banks, to stand ready to buy or sell SDRs on a semi-automatic basis. The transaction would mean some change in the currency composition of the Reserves, except in those rare instances where payment is in sterling, which would change the level of the Reserves and the funding target.

4. To limit the side effects on the money markets and currency composition of the Reserves, the Bank intend to impose the following conditions on the scheme:-

(i) No variation in SDRs in total by more than SDR 150m either way from the current holding.

(ii) Transactions would be acceptable against US dollars, yen, Dmarks or French francs. Transactions in sterling would be considered on a case by case basis.

ılsu

(iii) Transactions should be in the range SDRs2 -50m.

(iv) 2/3 days notice to be given.

(v) The arrangement will be reviewed in a year, but we could opt out at any time.

In addition the Bank will report to the Treasury quarterly on the transactions.

5. IF support this change and the Treasury Solicitor accept that it meets the legal requirements of the EEA.

6. May we presume that you are content?

HC Goodman.
H C GOODMAN

16/1

27

FROM: SIR T BURNS
DATE: 13 JANUARY 1988

CHANCELLOR

cc Miss O'Mara
Ms Goodman
Mr Hilgate

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Davies
Mr Matthews
Mr Grice
Mr Cropper

THE DOLLAR

You asked for an analysis of the implications of a "free fall" of the dollar; and what our policy response might be. I attach a note prepared by IF and MP after discussion with a number of us. I have not yet consulted the Bank of England. It seemed to me that the most straightforward approach was to send you the note in its present form and then to ask the Bank for their views after taking account of any comments you might have.

2. Since you asked for the note the dollar has fallen by 2.2 per cent in effective terms. In addition the forecast we will be presenting later this month will show a further 12 per cent depreciation by the fourth quarter of this year. The fall is only expected to come to an end when the dollar is very low by past standards and the US authorities respond by tightening monetary policy.

3. The direct effects of the dollar fall on the world economy would probably be contractionary in the first year or so. The US policy response would work in the same direction, perhaps having a bigger impact in 1989 than in 1988. If there was a further substantial, sharp fall, beyond what is in the forecast, we would expect an even bigger policy response from the US, and bigger effects in the world economy.

7\54

4. The most worrying prospect is "free fall" towards the end of this year. It would impose an additional contractionary force on the world economy just when it is likely to be slowing anyway. This possibility strengthens the case for seeking to avoid a similar domestic demand cycle in the UK coinciding with the cycle of world activity, such as might happen if the economy continued to grow rapidly this year and monetary policy here had to be tightened at the same time as US policy. There is only a limited amount that can be done. But it does point to an early tightening of monetary policy (if there is scope without disturbing the DM-link) and a cautious budgetary policy. This would reduce the likelihood of having to tighten monetary policy later in the year, for example because of weakness of sterling against the DM at the time of sharp dollar depreciation.

5. If there is to be a sharp dollar collapse followed by a tightening of US monetary policy it would be less of a problem for us if it came sooner rather than later. It would slow the growth of UK activity this year and reduce inflationary pressures, and possibly mean less deflationary pressure next year.

6. There is much to be said for continuing with the DM-link even though it could cause difficult pressures should the dollar fall sharply. At a time of dollar instability it must be some comfort for industry to have stability against non-dollar currencies. And it ensures that we are not tempted into an excessive easing of policy by wayward fluctuations in the dollar.

7. Obviously it is impossible to predict the chances of a sharp dollar "free fall", although it seems reasonable to assume a US policy response were it to happen. This analysis suggests that the implications for our own policy depend on its timing; but that in general the appropriate action is consistent with the current approach to policy, reinforcing the message of our current assessment.

T BURNS

ENC

THE DOLLAR

This note attempts to analyse the effects and policy implications of a "free fall" in the dollar, interpreted here as a further sharp slide in the dollar (exceeding in rapidity and/or extent that already incorporated in our forecasts).

2. There are various reasons for expecting that the effects of a sharp further depreciation of the dollar would not in the short term net out at a world level. The first section of the note examines the nature of these asymmetries and considers the effects of a slide in the dollar in the absence of any policy response. The second section looks at the pressures that will be generated for policy changes and the final section discusses the implications for our own policy response.

3. The main conclusions are that a dollar slide would do little to help the balance of payments adjustment process, unless accompanied by strong actions to slow down domestic demand in the US. Indeed, inflationary pressures would be built up in the US, and the risk of a major slowdown in the world economy in 1989 would be increased. The US seems unlikely at present to make significant changes to its fiscal and monetary policies in order to stabilise the dollar, Japan may be able to do no more than lean into the wind with intervention and an early EMS realignment may be provoked. The UK's options would be limited, but the dollar fall would pose greater problems if it occurred later in 1988 than if it occurred fairly soon. As far as the UK is concerned, an early fall in the dollar would probably be less destabilising than a sharp fall later in the year.

4. Our latest assessment of recent economic developments and prospects is set out in the paper for Chevening circulated by Peter Sedgwick on 7 January. Although there is little information relating to the behaviour of demand since the October stock market collapse, there is considerable evidence that activity in the major countries in 1987 was stronger than perceived at the time of the Autumn Statement. This strength is likely to continue on into 1988, although with some slowdown in growth through the year. The

latest WEP assumes that the US administration's desire to avoid the risks of growth slowing before the Presidential election will override its concern about the dollar and inflation, and projects a substantial further decline in the dollar in 1988 and only modest rises in US interest rates. The analysis below thus applies to the WEP main case and, a fortiori, to the steeper and/or greater fall in the dollar that we are considering here.

I Effects on economic prospects

(a) The US economy.

5. The current cyclical position of the US economy will influence the effects of further dollar depreciation on output, prices and the current account. Activity has been expanding strongly and industrial production is some 5 per cent higher than a year ago. Capacity utilisation is high and unemployment low. So far, however, the tightening of labour market conditions has not shown up in faster earnings growth; but there are signs, e.g. in the auto workers' settlement, that the situation is changing. While this suggests that a major inflationary surge is unlikely in 1988, there would be a risk of a substantial rise in inflation in subsequent years if demand continues to grow strongly.

6. The US has experienced less inflationary pressure from the depreciation of the dollar to date than might have been expected. Between 1985 (average level) and September 1987 dollar import prices (of manufactures) rose by 13 per cent, compared with a depreciation of the dollar of 28 per cent. The difference principally reflects the reduction in profit margins that foreign exporters were prepared to accept in order to maintain sales. In the early stages of depreciatior there was considerable scope to squeeze margins as they had risen to an extremely high level in the final stages of the dollar's appreciation.

7. There is now less scope to shave margins and the impact of a further fall in the dollar on domestic prices is likely to be proportionately greater. The higher pressure of demand may also encourage a stronger feed through on to domestic prices. Even so,

the low share of imports in GNP means that a 10 per cent dollar depreciation now would raise the price level by 1988Q4 (about the time of the Presidential election) by only about 1 per cent.

8. Although export volumes have been rising quickly, the continued strength of US domestic demand has prevented imports from falling and the current account from improving. A sharp dollar depreciation would mean a further deterioration in the US current balance in the short term - the fact that imports are still some 60 per cent higher than exports compounding the usual J curve effect. With the US economy operating close to capacity the volume responses to dollar depreciation, which would anyway be lagged, are likely to be more modest than usual.

(b) Europe and Japan

9. A weaker dollar implies greater downward pressure on inflation in appreciating countries and a boost to real incomes and domestic spending. Experience to date with the depreciation of the dollar, however, suggests that in the short run this is likely to be outweighed by the direct effects of weaker exports and by adverse effects on expectations about future sales and profitability leading to the postponement of investment. The net effect in the short run from a further sharp dollar depreciation is also likely to be deflationary. Indeed, the effects on confidence might be even more severe. On the other hand, the current buoyancy of the US economy points to both a relatively smaller fall in appreciating countries' net export volumes and less downward pressure on inflation.

10. One reason for the overall negative impact on activity in Europe and Japan from dollar depreciation has been that many other countries have appreciated much less against the dollar. Since 1985Q1 the real effective exchange rate of the G7 as a whole against the rest of the world has appreciated by some 25 per cent. Developing countries' exports are responding strongly (particularly those of the Asian NICs). A free fall of the dollar, given that many developing countries peg their exchange

rates to the dollar, is likely to mean further appreciation of the G7 effective exchange rate, adding to the competitive pressures on Europe and Japan and tending to reduce their output in the short run.

11. While activity has picked up strongly in Japan this year (largely through a boom in residential and infrastructure investment) and UK growth has been strong (particularly in manufacturing output), continental Europe has been much less buoyant. Output and confidence in France and Germany have been improving in recent months, but their economies could still be more vulnerable than others to a sharp further decline in the dollar. Their export industries have, for instance, proved less adaptable than Japan's to the loss of competitiveness due to the dollar's decline to date.

12. Although Germany's exports have continued to grow modestly, this has been achieved largely by expanding sales to other European countries, whose economies have been growing more quickly, to offset reduced sales elsewhere. There must be some doubts whether this trend is sustainable, and a sharp further dollar depreciation is likely to heighten the underlying tensions between Germany and other European countries, particularly EMS members.

II Policy response

13. While a "free fall" of the dollar would presumably be less dramatic than the stock market collapse of 19 October, there could conceivably be a rapid slide over a few days. While the current economic situation and the expected effects of a lower dollar (as discussed in the previous section) would condition the responses of the various monetary authorities, most of those effects would not actually be visible for several months (at least).

14. United States. The US is currently reluctant to tighten its monetary or fiscal policy to resist a slide in the dollar. The Administration's principal fear is recession rather than inflation. The limited inflationary consequences from the dollar

depreciation to date and the expectation of substantial wealth effects to come from the collapse in equity prices, provides some support for this view. However, as we have already discussed, the present buoyancy of the economy and falling margin of unused resources suggests that they may be misjudging the situation.

15. How quickly the US authorities change their view could depend on how far or fast the dollar fell. A sharp depreciation or substantial market-induced upward pressure on interest rates (particularly at the long end where, with weak domestic saving, foreign purchases of bonds have become increasingly important in financing the deficit) could persuade them to use monetary policy to stabilise the dollar. Another possibility is that the weakness of the dollar might become an election issue. On the other hand a large but drawn out depreciation could encourage them to delay even longer.

16. Japan. There is anecdotal evidence that Japanese industry is already planning on the basis of an exchange rate of $1 = 120 yen or less. The Japanese authorities might judge that, given time, Japan could live with a lower dollar, but, as in 1987, use intervention to resist this. The scope for using other measures in the short run is limited. Interest rates are already low and, while bond yields have fallen in recent weeks, the authorities have felt unable to reduce the discount rate below 2½ per cent.

17. Promises of further expansionary fiscal measures and structural reforms could have helpful announcement effects on exchange rates, but this is uncertain and their actual impact on demand would take time to come through. Arguably, the need for such measures is greater in Japan than in other countries as yen appreciation appears to give only a weak stimulus to consumers' expenditure: the distribution system discourages full passing on to consumers of the terms of trade gains, while the comparative flexibility of wages in Japan means that the squeeze on company profitability imposed by yen appreciation is passed on into lower nominal earnings growth to a greater degree than in other countries.

18. Europe. The potency of interest rates as a weapon to check a sliding dollar is also limited in Europe. The German discount rate is now at a historic low, and, of course, lower interest rates could do little anyway to deter capital inflows motivated by an expectation of a rapid, early exchange rate appreciation.

19. Strains within the EMS would be exacerbated by a further sharp fall in the dollar. The differential between French and German three-month interest rates is already nearly 5 percentage points, while their inflation rates differ by just 2 percentage points. The corresponding figures for Italy and Germany are 8 and 4 percentage points respectively. The chances of an early EMS realignment would be increased if there were a "free fall" of the dollar, unless France and others were prepared to accept even higher short term rates and intensify their exchange controls.

20. The medium term constraints on fiscal policy would be unchanged - i.e. achieving and then maintaining sustainable ratios for budget deficits, debt interest, public debt etc in relation to GDP - and it would be difficult to judge whether a departure from medium term plans would be justified, particularly as it would be unclear where exchange rates would settle. It would anyway take time for fiscal changes to influence domestic demand, and unless part of a co-operative Louvre-style package their announcement effects on exchange rates might be small. Nevertheless, the comparative sluggishness of growth in continental Europe and the tightening of monetary policy implied by exchange rate appreciation suggests that some temporary easing of fiscal policy might be appropriate.

III Implications for the UK

21. The implications for the UK of further dollar weakness - and the appropriate UK policy response - have to be assessed against the background of an underlying position of stronger economic growth in 1988 (both in the world and the UK) than was thought likely in the immediate aftermath of October's fall in world stock markets. Developments that would moderate UK growth in 1988 would

actually be welcome up to a certain point. There would be more cause for concern about developments that would ease monetary conditions this year but reduce growth in 1989. Next year there is anyway some likelihood of a cyclical slowdown in growth in the UK following the very strong growth of 1987 and the prospects for above average growth in 1988.

22. On the assumption that sterling remains in a range of, say, 2.9 to 3 deutschemarks a further sharp fall in the dollar will necessarily lead to a rise in the UK's effective exchange rate and imply a loss of UK competitiveness. On the illustrative assumption that sterling eases back gradually from around 3 to around 2.9 deutschemarks during the course of 1988, different dollar/deutschemark paths might imply something like the following sterling effective rates:

	$/DM rate	Sterling effective rate	$/DM rate	Sterling effective rate
Latest	1.64	75.3		
1	1.55	76¾	1.5	77½
2	1.46	77	1.35	79
3	1.42	77¼	1.3	79½
4	1.38	77½	1.3	79

23. If sterling were to stay at 3 deutschemarks as the dollar declined the rise in the sterling effective rate would obviously be greater: for the illustrative paths shown above the effective rate might be some 2½ points higher in 1988Q4. However, there is a tendency for the pound to fall relative to the deutschemark when the dollar falls, so the assumption of some decline in the sterling/deutschemark rate in the cases shown above is perhaps reasonable.

24. The effect on the UK economy of the overall loss of competitiveness caused by a rise in the effective rate will be damped by the relative movement of sterling against the dollar and other currencies given the relative cyclical position of the United States and Europe. The UK would be losing competitiveness

against the US where capacity utilisation is already high: US producers might thus not be in much of a position to take advantage of the weak dollar to gain market share from UK producers either in the US or in the UK or in third markets. Thus the deterioration in UK trade (and also the benefit to UK inflation) might be much less than if the loss of competitiveness were against Europe where there is much more spare capacity. The main threat to UK trade performance might come not from producers in the US but from producers in other countries whose currencies were tied to the dollar (particularly the Asian NICs).

25. Against the background of relatively fast growth in the UK in 1988, a further fall in the dollar soon would exercise a moderate restraining influence on the UK economy. It would mean that UK monetary conditions would be tightened even if a rise in UK interest rates were not required to keep a steady £/DM rate. We would want to be very confident of a significant slowdown in UK economic activity before taking any action to offset the effect of a dollar decline. This is unlikely to occur before 1989.

26. If we did conclude that conditions had tightened excessively monetary action would probably be more appropriate than fiscal action given the current balance of demand in the economy, particularly as any further rise in the effective exchange rate would be likely further to stimulate consumer spending at the expense of other components of demand, and worsen the current account. Maintaining the DM link may mean difficult pressures from time to time and could require either higher or lower interest rates. But when faced with a sharp dollar decline it could be important for industry to avoid a simultaneous appreciation against the DM. If the dollar collapse caused sterling to weaken against the DM there would be plenty of scope for higher interest rates given the projected strong growth of domestic demand.

27. A fall in the dollar later in 1988 followed by a tightening of US policy after the presidential election would constitute a much more worrying set of developments for UK economic prospects. The sharper the fall and the sharper the subsequent US policy

action the more difficulties this would present. In this case the fall in the dollar and appreciation of sterling would come too late to help with restraining the growth in demand in 1988. But the combination of loss of competitiveness in the latter part of the year and restrictive measures in the US in 1989 would tend to weaken UK growth further in 1989 when the UK economy is likely to be slowing down in any case.

28. Here our objective would in principle be to try and smooth out the path of UK economic activity. But given on the one hand our uncertainty about the course that the US economy and the dollar will actually take and on the other hand the constraints on our freedom of action, our ability to smooth the path of UK economic activity is very limited. Taking fiscal policy as given perhaps the main point is that in the absence of an early further fall in the dollar we should be looking to take any opportunity that may present itself to raise UK interest rates: with a view possibly to reducing rates later in the year, or at least avoiding a further rise, if and when the dollar does actually fall sharply.

29. Tightening monetary conditions will not, of course, help to improve the balance of demand in the UK economy, and could involve an undesired strengthening in the £/DM exchange rate. So this scenario reinforces the need for fiscal caution in 1988-89; and the need to leave some flexibility for 1989-90, although the scope for flexibility will depend amongst other things on how the current account of the balance of payments is turning out. At all events we might want to allow the slowdown in the economy in 1989 to add to the PSBR in 1989-90 (or make it less negative) rather than take action to raise tax rates to offset the effect of the downturn in activity on tax revenue and expenditure.

30. Again, maintaining the DM link would be a useful discipline. The main worry would be a sharp weakening of the sterling DM rate at the time of dollar collapse and tightening of US monetary policy. An increase of UK interest rates to maintain the link might seem destabilising if industry was losing competitiveness through a rise in the sterling index and if domestic demand

was also showing signs of weakness. The risks of this happening would be reduced if a cautious monetary and fiscal stance is in place this year, so reducing the risk of a loss of confidence later in the year, for example because of difficult current account figures. The most awkward scenario of all would be if we had to raise interest rates to deal with that as well as any downward pressure on the £/DM link from a collapse in the dollar.

31. To summarise, a further decline in the dollar in the short-term, with or without a US policy response, might actually present less problems for UK policy than a delayed fall and a delayed policy response. So if there is no further significant fall in the dollar over the next few weeks but the risk of a late substantial fall remains, this reinforces the case for looking for an early opportunity to tighten monetary policy in the UK. In addition it would reinforce the case for caution on the 1988-89 fiscal stance. It would then leave open the possibility of reversing the interest rate action later following subsequent fall in the dollar and US policy response.

MAMC : D2 39

c Mr Grice

Ms Goodman
My reaction is exactly the same as the Bank's for the reasons at X. But can you dig out the files to check if, consulting MG2 I have a very hazy recollection of something similar from my own days in EF. This may well be a figment of my imagination!
Could you let me have a draft reply by 22/1 pl?
MOM 14/1

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

13 January 1988

Miss O'Mara
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Margaret,

Releasing Statistics on Intervention

The group of central bank "experts" on foreign exchange in Basle has had a rather unusual request put to it. Two Italian nationals (one of whom works for the National Bureau of Economic Research) wish to do some work on (among other things) the effects of intervention in the EMS.

They realise the confidentiality of the data in this area. Consequently, they have asked if the raw data on intervention between 1982 and 1986 for each country in EMS (including the UK) could be used by a 'safe' intermediary - such as the BIS or the Banca d'Italia - to run regression equations supplied by the two Italians. The intermediary would return the results to the academics who because of the nature of the regressions (see the attachment to this letter for the details) would be quite unable to recreate the raw data.

The academics' main purpose appears to be to establish whether the EMS has operated essentially as a deutschemark zone.

For this reason alone, the Bundesbank may refuse to agree. But, at a preliminary debate this week in Basle, the Belgians, Danes and Italians all said they could agree in principle; and only

14/1

11/34

the Swedes extended a note of caution (mainly because of the precedent this would create and the potential flood of requests from other academics that could follow when word got out that central banks were prepared to co-operate in this way).

Malcolm Gill and I said nothing at this week's Basle. We had been aware that the subject might come up but had thought that the request would be aimed solely at full EMS members and that the Bundesbank would squash it outright.

In the event, the issue was deferred for a discussion at the next Basle meeting on 8 February. Between now and then, we at the Bank will trawl our files for possible precedents and you may care to do the same. Unless this search reveals unexpected levels of past official co-operation with academics in this area, we would intend to oppose this request.

Yours sincerely

Michael Foot