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 119-137

MAMC: D3 119

FROM: MISS M O'MARA
DATE: 5 FEBRUARY 1988

PRINCIPAL PRIVATE SECRETARY

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler o.r
Mr Scholar
Mr Peretz
Mr Grice
Ms Goodman
Mr Cropper

ACCOUNTING FOR THE RESERVES IN THE UK AND GERMANY

You attached to your minute of 4 February a slightly revised version of the letter to No. 10 on this subject.

2. On the two queries the Chancellor raised:

(i) On the end-January breakdown of our dollar assets and liabilities, completed by the Bank after we submitted our draft letter, the figures are \$26 billion and \$14 billion respectively. The net figure, of course, remains the same.

(ii) To clarify the first sentence, we suggest redrafting to read "and in fact made a small overall profit transfer, taking into account its domestic operations".

3. As I explained to you, our draft initially covered only the UK's net US dollar position, since that is the only foreign currency the Bundesbank holds. The Bank cannot easily provide calculations of the book profit or loss we have made on our holdings of other currencies and we have assumed that the Chancellor would not want to delay the letter to No. 10 much longer. However, we suggest you might like to add a new final paragraph to the letter along the following lines:

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5/2/88

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"Unlike the Bundesbank, the EEA holds a number of currencies other than US dollars and now has a long position in all its major holdings (deutschemarks, yen and Canadian dollars). Broadly speaking, we probably made a small book profit in 1987 on our yen holdings in sterling terms but a small loss on our deutschemarks, with no significant profit or loss on Canadian dollars. [However, we deliberately decided to switch from US to Canadian dollars in 1986 and, taken in isolation, that decision has proved profitable: our Canadian dollars have earned a higher running yield and the Canadian dollar has appreciated about 6 per cent against the US dollar.]"

MOM

MISS M O'MARA

MAMC: D3[12]

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

01 601 4123

10 February 1988

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

Mr Peretz o/r.
Mr Grice

You may be
interested to see.

Mary
11/2

Dear Margaret,

RELEASING STATISTICS ON INTERVENTION

For good order I should report that at the recent meeting in Basle the Italian request to release data on intervention was duly rejected (your letter of 25 January refers). Unfortunately, the rejection occurred not so much because we took a general decision to keep such information secret but because the Bundesbank had decided that the Italian academics were going to write something hostile to the Germans. A vague idea was therefore left on the table that somebody (probably the Italians) might try and think up a general policy for future cases which started from the premise that historical data (say no more than two years old) could be released. I tried hard to pour cold water on even that in bilateral discussions; and I think in practice nothing is likely to happen until another specific case comes up. So for the time being this subject is dead but I can't promise that it will always remain so.

Yours sincerely

Michael

M D K W FOOT
HEAD OF FOREIGN EXCHANGE DIVISION

15/80

MAMC: D3 122

FROM: COLIN MOWL
DATE: 10 February 1988

MISS O'MARA

cc Mr Peretz
Mr Sedgwick
Mr Bottrill
Mr Grice
Mrs Todd
Ms Goodman
Mr Owen
Mr Westaway
Mr McLaren

FORECASTING INTEREST RECEIPTS ON THE FOREIGN EXCHANGE RESERVES

Thank you for your minute of 20 January.

2. I have not yet heard from anyone at the Bank. I attach a table giving the assumptions we wish the Bank to use for the Budget Forecast. Strictly we require a forecast back by the end of the week. I imagine that the Bank should be able to turn this round fairly quickly.

3. We have looked at the accuracy of our forecasts of interest payments on foreign currency debt and concluded that there is no need to ask the Bank to provide a forecast. The main requirement is for you and EA2 to agree the assumptions about the stock of debt outstanding so that our own forecast is well based.

Colin Mowl

COLIN MOWL

18/78

	Sterling/Dollar exchange rate (End quarter)	Sterling/Dollar exchange rate (Quarterly average)	US Treasury bill rate (Quarterly average)	Level of Reserves $ million (End quarter)
1987 Q2	1.614	1.645	5.87	34,364
Q3	1.630	1.619	6.08	34,808
Q4	1.887	1.751	5.92	44,326
1988 Q1	1.777	1.777	5.70	43,093
Q2	1.784	1.784	6.18	43,093
Q3	1.793	1.793	6.58	41,300
Q4	1.806	1.806	7.03	39,494
1989 Q1	1.823	1.823	7.74	37,671

MAMC: P3 124

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

10 February 1988

Paul Gray Esq
10 Downing Street
London SW1

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Ms Goodman
Mr Cropper

Dear Paul,

ACCOUNTING FOR THE RESERVES IN THE UK AND GERMANY

... You wrote to me on 9 January, enclosing the attached article from the Financial Times on the profitability of German intervention. You asked what the results of a similar calculation for the UK reserves would show. I am sorry we have not been able to let you have a reply before now, but we have found it difficult to establish exactly what method the Germans use.

The short answer is that, on a comparable 'net dollar assets' basis, we think the Bundesbank probably scored a book loss equivalent to about £3 billion in 1987 and our Exchange Equalisation Account (EEA) a book loss of £0.4 billion.

There are, of course, several important differences between the position in Germany and in the UK, as the Prime Minister recognised

First, the German reserves are owned by the Bundesbank, whereas the British reserves are a Treasury account. This difference in ownership is reflected in a difference of treatment of the reserves in relation to the borrowing requirement.

The Bundesbank's profit transfer (generally heavily influenced by changes in the deutschemark valuation of their foreign exchange reserves) is scored along with tax receipts as an item <u>reducing</u> the German Government's Borrowing Requirement.

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In the UK, the EEA's purchases and sales of foreign currency do not affect the size of the PSBR but, like other changes in the mix of the Government's assets and liabilities, are treated as financing it. Valuation changes to the UK reserves affect the financing of the PSBR only when the gain or loss is realised and is reflected in a flow of sterling into or out of the reserves. Receipts of interest on the UK's foreign currency reserve assets do reduce the PSBR as they are treated as central government current income. Similarly, payments of interest on foreign currency borrowing form part of gross debt interest and so increase the PSBR. (In both these cases, the sterling sums involved will, of course, be affected by exchange rate movements.)

Second, the Germans have very much larger net dollar assets than we do. Theirs total about $43 billion. Ours are currently $12 billion, since our dollar assets of about $26 billion are offset by dollar loans of about $14 billion.

Finally, the UK has actively shifted substantial amounts of dollars into other currencies and we have on occasions bought deutschemarks against sterling in intervention operations on a considerable scale. As a result, the non-dollar proportion of our net foreign currency reserves has increased from 35 per cent in mid-year to 48 per cent at the end of 1987.

It is by no means straightforward to assess the effect of the dollar's fall on the Bundesbank's profit transfer and hence on the German Government's borrowing requirement. The Bundesbank's accounting principles are complex and contain a large element of discretion. Currency gains and losses are generally treated as contributing to profit, but there is considerable use of provisions to smooth the payment made to central government.

For example, the Bundesbank absorbed the losses on its substantial stocks of foreign exchange during the long period of deutschemark appreciation from 1968 to 1979 and in fact made a small overall profit transfer, taking into account its domestic operations. When the dollar started to appreciate in the 1980s, much of the profit was initially 'used' to offset earlier losses, but from 1982 there were annual transfers of profits of DM 10 - 13 billion (transfers relate to results a year earlier). At the same time, a substantial reserve (peaking at DM 7 billion at end 1984) was created.

The present phase of dollar weakness started in 1985. Even so, the Bundesbank managed to declare sizeable - though diminishing - overall profits in 1985 and 1986, despite dollar holdings averaging around $22 billion.

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This will have been possible principally because of the use of profits carried over from earlier years (but also because interest earnings on the reserves are credited to profit, whereas there is no interest charge for the corresponding deutschemarks used to acquire the reserves). The transfer to central government was sharply reduced to DM7 billion in 1987 (reflecting 1986's lower overall profits, but after a transfer from the "provisions" reserve). Nevertheless, this was still enough to reduce the borrowing requirement by 20 per cent below the level it would otherwise have been.

The prospects for transfers in 1988 and 1989 are hard to judge, given the Bundesbank's discretion over how declared profit is struck and the existence of a further DM2.7 billion of "provisions" reserve. But with net dollar holdings of about $29 billion at end-1986 and $43 billion at end-1987, the Bundesbank must have suffered substantial deutschemark valuation losses, not fully offset by interest income. The Bank of England guess their losses, as calculated on their standard basis but before allowing for transfers from reserves, might have totalled some DM 9 billion (£3 billion) for calendar 1987. The press therefore seems correct in judging that any profit transfer in 1988 is likely to be small.

By contrast, the UK reserves have been much less exposed to dollar depreciation. Our dollar liabilities substantially exceeded our dollar assets for most of the recent period of dollar weakness, leading to substantial book profits as the dollar fell against sterling since the January 1985 peak. Only in April 1987 did we move into a position where dollar assets exceeded liabilities. Using the same method as the Bundesbank, the Bank of England calculate there would have been a book loss on the EEA's net dollar position in 1987 of about £0.4 billion, before allowing for any transfer from reserves. On the other main currencies held by the EEA, we probably made a small book profit in 1987 on our yen holdings in sterling terms, but a small loss on our deutschemark holdings, with no significant profit or loss on Canadian dollars.

These calculations are inevitably dependent on the assumptions used and not too much weight should be put on the precise figures. It is also important to remember that the £0.4 billion figure for the EEA represents only a book loss: whether a loss or a profit is eventually realised depends on the exchange rate if and when intervention during 1987 comes to be reversed.

Yours
Alex

ALEX ALLAN

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W Germany to raise taxes and cut spending

BY DAVID MARSH IN BONN AND ANDREW FISHER IN FRANKFURT

THE WEST GERMAN coalition yesterday decided to cut federal government borrowing by at least DM10bn ($3.36bn) next year through a mixture of increases in consumer taxes and cuts in budget spending.

The move comes in reaction to a much sharper than planned increase in the federal deficit this year. It is now expected to be DM40bn compared with DM29.5bn set down in the 1988 budget approved by parliament at the end of last year.

The tightening of fiscal policy now planned for 1989 runs completely counter to persistent calls from home and abroad for West Germany to cut taxes next year in order to bolster sluggish economic growth.

Mr Gerhard Stoltenberg, the Finance Minister, told the press after yesterday's cabinet meeting: "There is no room for further tax cuts (in 1989)."

At the same time the Bundesbank in Frankfurt announced action to reduce banking liquidity through a DM6bn cut in banks' rediscount quotas, effective February 1. The move, which will cut the amounts banks can borrow from the central bank at the 2.5 per cent discount rate, came in response to big increases in liquidity through currency inflows.

The Bundesbank said the decision did not imply any change in its basic monetary stance. However, it underlines how the central bank is reacting cautiously to ward off possible inflationary dangers from currency inflows – DM25bn since October – accompanying the latest rise of the D-Mark.

Yesterday's cabinet decision on the deficit underlines how West German fiscal policies have been severely blown off course by the fall of the dollar and the weakening economy.

The admission by Mr Stoltenberg that the 1988 deficit will be much larger than expected is likely to expose him to a fresh wave of criticism at home from both Left and Right over the consequences of rising public borrowing.

It casts a considerable question mark over whether the Government will be able to proceed with promised net tax cuts of DM20bn in 1990, conceived as a fundamental part of its economic strategy.

The immediate causes of the jump in the 1988 deficit are higher West German contributions to the European Community and the near-disappearance of 1987 profits from the Bundesbank, due to be paid over to Bonn this year. The Bundesbank profit will fall to "near zero" from the DM6bn which had been written into the 1988 budget, the Finance Minister said.

This is because the central bank will have to write off between DM6.5bn and DM7bn on the D-Mark value of its foreign exchange reserves. This is

Continued on Back Page
Details, Page 2

West Germany to raise taxes Continued from Page 1

because of the sharp fall in the dollar to DM1.5815 at the end of last year, the value the Bundesbank will use for its 1987 accounts.

This year's federal deficit is also being driven up by DM14bn of tax cuts which came into effect at the beginning of the year. Additionally, tax revenues have fallen well below earlier projected levels because of economic growth of only 1.5 per cent last year.

Mr Stoltenberg said a supplementary budget would be introduced before the summer to take account of the extra 1988 deficit. Additionally, around May or June, detailed decisions would be taken on finding the budgetary savings of at least DM10bn planned for 1989, Mr Stoltenberg said.

Mr Stoltenberg said the Government faced no substantial risks on the spending side for 1988, although this year's deficit could plainly be driven higher if the economic downturn eats further into tax revenues and d… up subsidies.

At present, Mr Stoltenbe… projecting a growth of bet… 1.5 and 2 per cent in … national product this … although some more gloomy … vate sector forecasters are … dicting only around 1 per ce…

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MAMC: D3

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 15 February 1988

Dear Alex,

VALUATION OF THE RESERVES

The Prime Minister was most grateful for the material provided with your letters of 9 February, concerning the revaluation of the EMCF swap, and 10 February, concerning the valuation of dollar reserves in the UK and Germany.

16/2

Yours,
Paul

PAUL GRAY

EST, Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Perez
Miss O'Mara

Alex Allan, Esq.,
H M Treasury

Mr Grice
Ms Goodman
Mr Cropper

SECRET

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MAMC : D3

From : Ms V Bronk
Date : 17 February 1988 129

PS/CHANCELLOR

cc Sir T Burns
Mr Peretz
Miss O'Mara
Mr Grice

STERILISATION OF INTERVENTION

You asked how much of this year's intervention had been sterilised to date, and how much we expect to have funded by the end of the financial year.

2. As is noted in today's minute about tomorrow's money figures, the current position is that the PSBR and the increase in the reserves between March 1987 and end-January 1988 have together been <u>overfunded</u> by £4.2 billion. Over the financial year as a whole, assuming no further intervention, we are now aiming for an exact full fund (including funding all the year's intervention and to offset the £400 million underfund in 1986-87). These figures are shown in the attached updated version of our regular funding table (lines 3, 8 and 12).

Vyvien Bronk

MS V BRONK

S73/88

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FUNDING : FINANCIAL YEAR POSITION 1987/88 17/2/88

£ million

	FORECAST Financial Year 87/88	OUTTURN April 87 - Jan 88	RESIDUAL February - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	2139	-1895	4034	
2 Asset sales (sales-)	-5011	-5070	59	
3 PSBR	-2872	-6965	4093	
FINANCED BY:				
4 OPS debt sales to nbps (sales-)	1491	1191	300	
5 National Savings (sales-)	-2120	-1630	-490	* -245
6 CTDs (sales-)	149	-126	275	
7 Treasury bills etc (sales-)	0	-52	52	
8 Intervention (reserves inc+)	10130	10130	0	
9 Public sector externals excl intervention and gilts (inc-)	416	416	0	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	7194	2964		
11 Adjustment for 1986/87 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	-4153	3753	
GILT SALES:				
13 Net purchases by nbps and overseas (purchases+)	7594	7117	477	
14 Net purchases by monetary and other public sector (purchases+)	-217	-467	250	
15 Maturities	6950	5439	1511	
16 GROSS OFFICIAL SALES	14327	12089	2238	
17 Monthly average gross gilt sales	1194	1209	1119	

@ Modified PSBR only
* average per month
Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

91G.SCB.1780.30

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D3

Nicholas

Looks fine to me
- any comments?

FROM: I POLIN
DATE: 25 February 1988

MISS O'MARA) COPY
) TO
MR BUSH) EACH

cc: Mr Peretz
Mr Sedgwick
Ms Goodman O/R
Mrs Ryding
Mr Holgate
Mr Nelson

Mr Foot)
Mr Reid)
Mr Bailey) BANK
Mr Milne)
Miss Plumby)
Mrs Jupp)

RESERVES IN FEBRUARY 1988

I attach the draft press notice and press briefing for the Reserves announcement on Wednesday 2 March.

2. You and copy recipients will notice that a number of defensive questions have been added on intervention etc. Also, some words and phrases have been square bracketed in Positive 2 and Defensives 1, 3 and 9 as I am not sure whether these words are necessary.

3. I would appreciate any comments and/or amendments on the attached by, at the very latest, lunchtime on Monday 29 February, this will enable me to send the final version to type in good time before the submission to Ministers at lunchtime on Tuesday 1 March (as normal).

4. Please excuse any manuscript changes to the briefing.

Ian Polin

I POLIN

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ERMP C/8

FROM: I POLIN

DATE: 1 March 1988

1. MISS O'MARA
2. ECONOMIC SECRETARY

Distribution

PPS
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mr Culpin
Mr H Evans
Mr Peretz
Mr Sedgwick
Mr R Allen
Mr Bottrill
Mr Bush
Mr Grice
Mr Hibberd
Mr Pickford
Ms Goodman
Mr Segal
Mr Cropper
Mr Call

THE RESERVES IN FEBRUARY 1988

The reserves announcement for February will be made on Wednesday 2 March at 11.30 am. This month's announcement reports a fall in the reserves of $ million and an underlying fall of $ million.

I POLIN

Mr Gray - No 10
Mr Cassell - Washington (after publication)

Mr Foot)
Mr D J Reid)
Mr J Milne) - B/E
Miss J Plumbly)
Mrs Jupp)

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DRAFT PRESS NOTICE

THE RESERVES IN FEBRUARY 1988

The UK official reserves fell by $ million in February. Accruals of borrowing under the exchange cover scheme amounted to $ million; repayments of such borrowing amounted to $ million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $ million. At the end of February, the reserves stood at $ million (£ million*) compared with $43,093 million (£24,346 million+) at the end of January.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during February, was a fall of $ million. This underlying change is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

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* When converted at the closing market rate on Monday 29 February £1=$1.

\+ When converted at the closing market rate on Friday 29 January £1=$1.7700

3. New borrowing under the public sector exchange cover scheme was as follows:

Repayments of such borrowing were:

91G.SCB.4317.2

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THE RESERVES IN FEBRUARY 1988 : PRESS BRIEFING

Factual : Main features of markets in February

	£ ERI	\$/£	DM/£	\$ ERI	DM/\$	Yen/\$
1 February	74.2	1.75½	2.97¼	95.1	1.69½	129½
8 February	74.1	1.75½	2.97¾	94.9	1.69¾	128½
15 February	74.2	1.74½	2.98	95.5	1.70¾	130¼
22 February	74.5	1.76¼	2.99	95.0	1.69½	129¼
29 February						

[Text to be supplied by Bank].

Previous reserve changes

(i) In 1987 the underlying rise in the spot reserves totalled $20,475 million and the total rise in the spot reserves totalled $19,513 million (not including March revaluation changes).

(ii) At the beginning of January 1987, the spot reserves stood at $21,923 million; at the end of December 1987, they stood at $44,326 million.

(iii) Reserve changes since the last calendar quarter of 1987 were:

$ million

		Underlying change	Total change	Level of spot reserves at the end period
1987	October	+ 6,699	+ 6,591	41,399
	November	+ 31	- 118	41,281
	December	+ 3,737	+ 3,045	44,326
1988	January	- 38	- 1,233	43,093
	February			

(iv) October 1987 underlying change was largest ever.

Bank base rates

(i) Base rate changes since beginning of 1987 have been:

		Base Rate	Change
1987	10 March	10½	Down ½%
	19 March	10	Down ½%
	29 April	9½	Down ½%
	11 May	9	Down ½%
	7 August	10	Up 1%
	26 October	9½	Down ½%
	5 November	9	Down ½%
	4 December	8½	Down ½%
1988	1 February	9	Up ½%

Level of official debt

Now stands at $19.5 billion at end October (latest published figure*) compared with $22 billion in May 1979.

*in Financial Statistics, February 1988, No 309, Table 10.6 and in the Bank of England Quarterly Bulletin, February 1988, Volume 28, Number 1, Table 17.2