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

Reference MG-MAMC/D/0002/001

File begins 03/05/1988

Pages 81-101

5. **Tactics:** As Prime Minister reminded House on 17 May, available instruments - interest rates and intervention - will be used as seems right in circumstances. But not sensible to reveal operational details or be more precise.

6. **Is Government operating floor and/or ceiling for sterling/deutschemark rate?** Not helpful to talk about any particular level.

7. **Confidence in sterling likely to deteriorate as result of growth in current account deficit?** Government's position perfectly clear. Will not bail out excessive increases in domestic costs by allowing exchange rate depreciation.

8. **Current account deficit could be reduced by depreciation of sterling?** Not Government policy to depreciate exchange rate to try to increase UK competitiveness. Restraint of unit costs - which is in industry's own hands - key to competitiveness.

9. **Were dollar exchange rate targets and/or a budget for intervention set at Toronto?** No comment. Toronto Summit endorsed G7's statement in April that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to adjustment process, could be counterproductive by damaging growth prospects in world economy.

10. **Increased international monetary co-ordination?** Toronto Summit communique stated that to sustain present non-inflationary growth a commitment to enhanced co-operation would be required. Key to credibility and confidence. Progress in international co-ordination is contributing to process of further improving functioning of international monetary system.

(B) **INTERVENTION**

11. **Why raise interest rates four times in June rather than intervene?** Judgement of best course at time.

12. **Value of intervention as instrument?** Has important role to play in checking unsustainable fluctuations in exchange rates which do not reflect underlying fundamentals.

13. **Intervention inflationary?** Only poses inflationary threat if not funded. Government made clear intervention will be fully funded as in 1987-88 so that effect on liquidity sterilised.

14. **Details of intervention?** Policy never to discuss.

15. **Have other countries been intervening over last month/recently?** Never discuss details but well known there has been concerted intervention over recent days.

16. **Have Bank been switching out of dollars?** Never discuss detailed reserves transactions.

17. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, recommended "intervention should not be used to maintain an exchange rate incompatible with underlying economic forces".** As Treasury's reply to Select Committee made clear, Government agrees exchange rates should reflect fundamentals, as G7 communique in April made clear. Under Plaza Agreement and Louvre Accord, intervention aimed first at achieving this position, then maintaining it. Fluctuations in foreign exchange markets do not necessarily reflect fundamentals. Position of G7 endorsed at Toronto Summit on 20/21 June.

(C) INTEREST RATES/MONETARY POLICY

18. **Monetary policy:** Object of monetary policy to maintain monetary conditions that keep downward pressure on money GDP and hence inflation. Inflation now down to levels of 20 years ago, despite strong and sustained upswing in real growth. Short term interest rates will continue to be held at levels necessary to keep monetary conditions on track. Will not take risks with inflation.

19. **Interest rate policy?** As Chancellor said in Budget speech: "Within continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

20. **Why raise interest rates on 28 June?** A further tightening of monetary conditions in line with action taken earlier this month. Interest rates risen 2 per cent since beginning of June.

21. **Increase in interest rates on 28 June response to record trade deficit?** Deficit not a problem. Readily financeable. Interest rate decisions not taken on basis of any single factor.

22. **Why taken steps which will put upward pressure on sterling at time of record trade deficit?** No sign of overwhelming upward pressure on sterling following interest rate moves. But Government has stated repeatedly its determination to keep monetary policy tight in order to bear down on inflation.

23. **Recent interest rates increases will damage industry?** [Comments by Director General of CBI, on 22 June.] Industry has more to fear from resurgence of inflation. 1% rise in interest rates, even if sustained for whole year, raises costs by only quarter of amount of 1% rise in pay settlements.

24. **Further interest rate increases on the way?** Never speculate.

25. **Government applies formula whereby interest rates moved by 1 per cent for each 4 per cent opposite change in exchange rate, or 1/2% for each 5 pfennig change in DM/£ rate?** No. Interest rate decisions taken within continuous and comprehensive assessment of monetary conditions, taking all evidence into account. Exchange rate key indicator of monetary conditions, but not only factor.

(D) EUROPEAN MONETARY INTEGRATION

26. **UK membership of exchange rate mechanism (ERM)?** Matter kept under continual review. Will join when Government considers time is right.

27. **Recent interest rate moves would not have been necessary if UK had been in ERM?** Joining ERM would not be soft option. Countries within ERM frequently change their interest rates.

28. **Sterling's recent fluctuations would not have occurred if UK had been in ERM?** Countries within ERM not protected from realignments.

29. **Join ERM by 1992?** No fixed timetable. Will join when time is right.

30. **Proposals for European Central Bank and common European currency?** [European Council 27/28 June set up Committee to study and propose concrete stages leading towards economic and monetary union. No specific reference to European Central Bank or common currency.]

UK's own position perfectly clear. Proposals for common currency/ European Central Bank presuppose readiness to surrender national control over monetary policy and that all Member States pursuing same economic policy. Not in prospect. Should focus on useful technical ideas for strengthening the EMS and promoting wider use of private ecu already under consideraton.

31. **Capital liberalisation Directive adopted on 24 June brings UK membership of the ERM closer?** No. Position on ERM membership made clear by both Chancellor and Prime Minister on numerous occasions.

32. **When will capital liberalisation be implemented?** By 30 June 1990 for most countries. Some, including UK, already completely liberalised. Spain, Ireland, Portugal and Greece have until 1992, with possibility of extension to 1995 for last two.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month		Level at end of month
USA	- 0.8	(end May)	42
Japan	+ 0.4	(end May)	87
Germany	- 6.1	(w/e 15 June)	54
France	- 1.1	(end May)	68
Italy	- 2.7	(end April)	58
Canada	- 0.2	(end May)	13
United Kingdom	Negligible	(end June)	49

Notes

1. The figures for Germany, France and Italy were originally published in local currencies; they have been converted to dollars at appropriate exchange rates.

2. Figures not strictly comparable because of different valuation conventions for eg gold.

FROM: I POLIN
DATE: 19 JULY 1988

MISS O'MARA

cc Mr Peretz o/r
Mr Grice
Mrs Ryding
Mr Williams
Mr Nelson
Mr Wheatley

WORLD RESERVES AND UK GOLD

I spotted the two articles attached below in last week's Economist.

2. We would welcome any comments that you and copy recipients may have on these articles. We suspect that their is nothing here to worry about.

Ian Polin

I POLIN

FINANCE BRIEF

Awash with reserves

International non-gold reserves have almost doubled in the past three years. Will this extra liquidity spill over into inflation?

GOVERNMENTS' non-gold reserves (ie, foreign exchange, SDRs and their reserve positions with the IMF) rose by 42% in dollar terms last year—the biggest annual rise since 1971, when governments intervened heavily to shore up the crumbling Bretton Woods system of fixed exchange rates. In relation to world trade, reserves are now at their highest ever.

The increase has admittedly been inflated by the dollar's decline. This boosted the dollar value of the one-third of total foreign-exchange reserves that is held in other currencies. Measured in SDRs, the rise last year was a more modest 23%. In 1988 reserves have continued to grow, though more slowly, at an annual rate of 14% in SDR terms.

Foreign exchange (which makes up 90% of non-gold reserves) accounted for more than the whole of the increase in reserves last year. SDRs (4%) remained roughly unchanged. Reserve holdings with the IMF (6%) fell by $5 billion, because debtors repaid large loans made in the early 1980s. This reduced the IMF reserve position of member countries whose currencies were used in the loans.

Industrial countries took most of the growth in reserves, lifting their share of the total to 64%. The big exception was the United States, whose reserves fell by $3 billion. The big rises were in Japan, with reserves up by $39 billion, Taiwan ($31 billion), West Germany ($27 billion) and Britain ($23 billion). Most developing countries saw little or no increase.

Why?

What has caused the explosion in international liquidity?

- The biggest factor last year was the huge buying of dollar securities by governments outside America, all in the cause of sustaining the dollar. The OECD estimates that about $130 billion of the $200 billion increase in foreign-exchange reserves last year was in dollars.

This suggests that official transactions financed the bulk of America's current-account deficit of $160 billion in 1987. Yet American balance-of-payments figures suggest that only a third of the deficit was financed by official purchases of American securities. Why the difference? Probably because other countries' central banks placed a significant share of their dollar purchases through private financial intermediaries or in Eurodollar deposits and other dollar-denominated securities issued by institutions outside America. Such transactions are not recorded in the balance of payments as an increase in America's identified liabilities to foreign governments, but appear as private capital inflows.

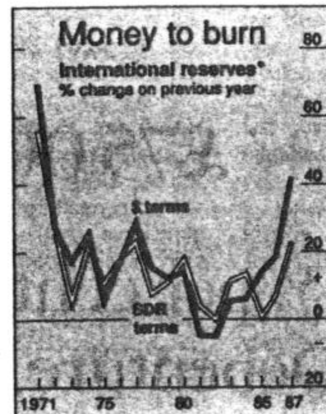
In 1988 private investors have regained their appetite for dollar assets, and have taken over the job of financing America's external deficit. Indeed in the past two months central banks have been modestly selling dollars to check the currency's rise. This explains part of the $8 billion drop in the Bundesbank's reserves in the five months to May.

- In recent years there has been considerable diversification out of dollar reserves into other currencies. That increases non-dollar reserves without necessarily reducing official dollar holdings. This is because portfolio shifts put upward pressure on currencies such as the yen and the D-mark; to limit the appreciation, the Bank of Japan and the Bundesbank are forced to take the dollars sold by other governments; so their reserves rise.
- As well as intervention to steady the dollar, there has also been non-dollar intervention within the EMS to support currencies against the D-mark.
- The rise in the gold price last year increased the amount of official ecus issued against gold. EEC central banks receive ecus in return for depositing 20% of their gold with the European Monetary Co-operation Fund. So when, for example, Spain first swapped its gold reserves for ecus in 1987, this boosted non-gold reserves.
- Taiwan has accounted for almost 30% of the total rise in reserves during the past three years—more than any other country. Its reserves reached $77 billion at the end of last year—second only to Japan's. By May of this year the total had fallen to $70 billion as the government swapped some dollars for gold. The government's refusal to let its currency float freely upwards, coupled with restrictions on private-sector investment abroad, have forced virtually all of Taiwan's huge current-account surplus into investment in American Treasury bonds.

Liquidity overflow

Does the increase in international liquidity carry the same risks for world inflation as an expansion in domestic money supplies? In the past, big rises in world reserves have been followed by periods of accelerating inflation, such as 1977-79. Today's news may be better.

In theory, the right level of international liquidity is that at which the balance-of-payments constraints on countries' policies are neither so strong as to deflate the world economy nor too weak to check inflationary pressures. However, official reserves are only one component of a country's international liquidity position. This also depends upon the ability of a government to borrow abroad or to induce the private sector to borrow or repatriate foreign assets. This is difficult to measure.



Sources: IMF; Phillips & Drew *Excluding gold

In most developed countries easier access to international financial markets has reduced the significance of reserves as an influence on domestic policies. But in developing countries with payments problems, an increase in reserves permits an easing of economic policy. The monetary consequences of larger reserves will therefore depend on how they are shared out geographically. In the 1970s the growth in reserves was fairly evenly spread. But last year's rise was heavily concentrated in a few industrial economies, and therefore has a smaller multiplier effect on world output.

A second encouraging thought is that the foreign reserves of central banks in Japan and West Germany are smaller in relation to their total balance sheets than in the 1970s. Reserves accounted for over half the total assets of the Bank of Japan and the Bundesbank in the early 1970s, but for only around a quarter today.

Third, central banks have become more sophisticated at sterilising intervention through sales of government securities. Central banks have the advantages of larger markets for government bonds and a wider range of instruments. But they may not do this for ever. Witness Britain's decision this year to let the pound rise against the D-mark.

Fourth, central-bank intervention in the 1980s has not been the same as in the 1970s. The dollar crisis of the early 1970s was not just the result of a big current-account deficit, but of capital flight out of the dollar as well. That required intervention two to three times the size of the current-account deficit.

The economic effects of central-bank financing of current-account deficits is likely to be different from those of capital-account deficits. When central banks finance a capital outflow, this causes an expansion in liquidity which is unconnected with any increase in real economic activity. When they finance a current-account deficit, the accompanying growth in economic activity should absorb some of the extra liquidity and so limit the inflationary risk.

In its recent annual report, the BIS concluded that the rapid expansion of monetary reserves presents little danger of inflation. Excessive growth in international liquidity is a symptom of the huge external imbalances and poor macroeconomic policies rather than a cause.

sc[illegible] certainly owes the government a favou[illegible]ast week it won several billion pounds-worth of new orders from a huge arms deal negotiated with Saudi Arabia. Mr Clarke was visibly seething in the Commons; he dismissed the points over which BAe was haggling as "not particularly material or important". Mr Sutherland, too, was livid, having spent months negotiating in the belief that the British government knew what it was up to.

The final deal reduced by £253m the amount of state aid that Rover would be allowed to receive, bringing it down to £547m (including £78m of EEC regional aid). The purchase price remains at £150m. Mr Sutherland said that much of the so-called debt that the government wanted to write off was in fact working capital. For instance, £156m was set aside for financing unsold cars sitting in dealers' garages. That, in Mr Sutherland's eyes, is not a liability, but a normal operating cost. And the government will not be allowed to write off the whole debt. Instead, Rover will be left with £100m, as befits a company already making a small profit.

As the Labour party immediately pointed out, without the commission's interference the British government would have handed over an additional £250m of taxpayers' money to BAe. The fact that the government could lop that much money off the subsidy, said the opposition, shows that it was giving the private sector (yet again) a bumper bargain when disposing of state assets. The unofficial reply is that, because of the government's past experience with the commission, it had padded the figures in the expectation that the commission would cut the subsidy. Up to a point, Lord Young. Last year the commission ordered the government to cut £70m from a planned £750m aid package for Rover Group as part of the sale of Leyland Trucks to DAF of Holland. In the case of the BAe deal, the cut was nearly four times greater.

If BAe decides to go ahead after all, it will also be allowed to set £500m of Rover's past losses against future Rover profits for tax purposes (but not against BAe profits). And it can transfer between £17m and £25m of capital losses to set against any capital gains that BAe might incur. If, instead, it decides to pull out of the deal, the government will be faced, yet again, with the difficulty of what to do with Rover; a problem which has plagued it now for two parliamentary terms.

Sir Percy Cradock. The diplomats remain triumphantly in charge. Compare America, where the president's appointees on the National Security Council delight in over-ruling the State Department.

The diplomacy of British diplomats is still legendary. Though its members rarely admit it—"we're just people sloping about in cardigans really"—the FCO has the highest complement of articulate charmers of any Whitehall department. Meet a British diplomat and within half an hour you will genuinely believe that you have made friends. Those charms have worked on some Conservative ministers. One, who has now moved on, says nostalgically: "It's the only place I've ever worked in my life in which everybody knew I had a First [-class degree] before I arrived—and what's more, they thought it was important."

Diplomacy instead of power

Stung by the criticisms in a 1977 report by Sir Kenneth Berrill, who recommended that a lot of the FCO be closed down and its functions shared among other Whitehall departments, the Foreign Office has been becoming more streamlined and businesslike. Since 1979 it has pruned a tenth of its staff and more than a quarter of its costs. Britain's diplomacy is conducted increasingly through multilateral bodies, particularly the European Community. That may eventually be reflected at the top: the present permanent under-secretary, Sir Patrick Wright, is an Arabist, as was his predecessor, Sir Antony Acland. But of the three most likely successors to Sir Patrick, Sir Michael Alexander is ambassador to NATO, Sir David Hannay is ambassador to the EEC, and Sir Christopher Mallaby is ambassador to West Germany.

Little has come of the Berrill report's main argument—that Britain no longer needs excellence in its diplomats. The FCO retorts that the opposite is true: the more Britain's real power declines, the more its ability to influence other countries depends on the quality of its diplomacy. One American diplomat confirms this self-serving claim: "Part of the reason that Britain wields an influence disproportionate to its real power is that its diplomats are so good. Along with the French, they're the best in the world." A former FCO minister explains: "It's the trick of pretending you've got a pair of tens when really you only have a couple of twos . . . or maybe threes or fours."

The FCO is reputedly the most difficult government department to enter at the fast stream. More than enough high-powered graduates apply each year to fill the score of fast-stream jobs on offer. Recruits to the home civil service have to be bright, balanced and capable of holding their own in a meeting. Diplomats have to be diplomatic too.

About a quarter of each year's intake subsequently drops out, usually at the rank of first secretary—a depressing rank, because most people stay in it for about 12 years, roughly between the ages of 28 and 40. There are other drawbacks to a diplomatic career. It is extremely hierarchical. Large, compulsory and frequent parties, usually to welcome delegations of boring people, are not everybody's cup of wine. The diplomat's itinerant life—a new country roughly every three years—causes problems as more diplomats have career-minded spouses. Yet most get hooked on international relations—which has the fascination, they say, of a hundred pairs of players playing interlocking chess.

Mrs Thatcher sometimes undermines the FCO with unscripted remarks in the House of Commons or at press conferences. But the diplomats remain happy because their political boss, Sir Geoffrey Howe, shares so many of their prejudices. So far, under Thatcher governments, the FCO has been blessed with such foreign secretaries. How would the institution react if it were given a true Thatcherite at its head? It would behave diplomatically, *sans doute*.

Gold

But whose?

BRITAIN's gold trade in the first five months of this year was £700m in deficit. That may not sound much, but it is more than twice the deficit for the same period last year. In 1986 there was actually a surplus. The funny thing is, few specialists in the London gold market have noticed that the deficit is so big—and those who have cannot explain why. Here are four possible explanations, in diminishing order of plausibility.

- **South African sales.** The figures show that South Africa sent at least £393m-worth of gold bullion to Britain in May, bringing its total gold exports to Britain so far this year to £1.5 billion, or 194 tonnes. That is 10% of the western world's entire production last year. Nine Boeing 747s would have been required to ship it to London. The Reserve Bank of South Africa admits that it has been exchanging some of its gold reserves for cash; London would be the obvious place to do it. Odd that the selling has not moved the market, though.
- **Future gold embargo.** The South African government might be bringing gold to London not to sell now, but to keep away from home. If it suspects that there will be an international embargo on South African gold, it knows something Mrs Thatcher does not.
- **Fishy statistics.** In January Customs & Excise changed its entire import-export classification system. There has been much confusion; some traders have put the wrong reference numbers at the top of their forms, and so imports and exports have been re-

corded in the wrong columns. Statistics on gold might have been affected. For instance, the figures suggest that Britain imported £175m-worth of gold "waste and scrap" between January and May.

● **A cunning Treasury ploy.** The Bank of England has frequently said that it wants interest rates higher and sterling lower. A bigger current-account deficit makes that easier to achieve. Gold appears in the balance of payments in two places. As a commodity (eg, jewellery), it goes into the current account; as an asset (eg, bullion or coins), it appears in the capital account. To sort out which is which, the trade department makes "compensations" to the recorded gold-trade figures. Just suppose a little imported gold were to find its way into the current account rather than the capital account. Who would notice? And if anyone were to, it was only a mistake.

British Coal

Worse, but getting better

IN JUST three years a British business with annual sales of £4.4 billion has increased productivity by 60%, halved its workforce and trimmed its costs by 24% in real terms. It has cut real prices to customers by 15%. Unfortunately, it still made a thumping £540m loss in the year to March, up from £288m the year before. British Coal still has some way to go before it can cast aside its reputation as king of Britain's nationalised lost causes.

True, the size of British Coal's "overall loss" is deceptive. Its deep pits lost £100m in 1987-88, while its opencast mines made an operating profit of £252m. Add in profits from asset sales and non-mining activities, and British Coal made an operating profit of £216m (down from £369m the previous year—see chart) in 1987-88. That was turned into the corporation's biggest loss since the 1984-85 strike by £368m in interest charges on its government loans, and by the £387m cost of continuing to slim down its business.

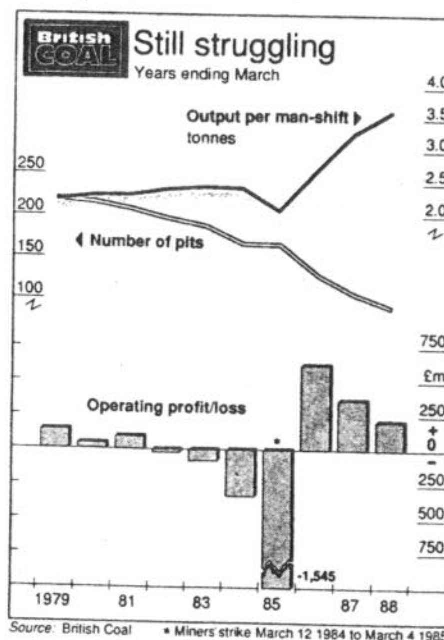
Yet the industry, which has cost British taxpayers £9 billion since Mrs Thatcher moved into Downing Street, is top of the Conservatives' privatisation wish-list, should they win another term of office in the 1990s. By then British Coal's biggest customer, the Central Electricity Generating Board (CEGB)—which buys three-quarters of the corporation's output—will have been split up and privatised. The sale will strip British Coal of the cosy "joint understanding" which has protected its sales to the CEGB against cheap coal imports, replacing it with formal supply contracts. British Coal will win a lot of these, but a rising share of its market will be snapped up by imported coal unless it can compete on price.

Since the miners' strike ended in 1985, British Coal has performed some wonders in cutting its costs. It has closed or merged 78 high-cost pits. Its 104,000 miners produced around 100m tonnes of coal last year—only 5% less than the amount produced by 192,000 miners before the strike. Productivity rose by 10% last year alone, to 3.6 tonnes per man each shift, despite strikes which lost 4.5m tonnes of output and £100m of operating profit. This year British Coal expects productivity to rise by 16%.

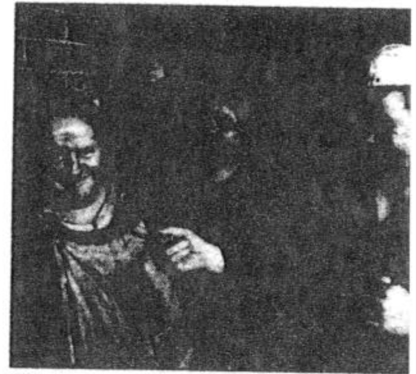
The corporation reckons that only a quarter of its productivity gains since the 1984-85 strike have come from closing uneconomic pits. More than half of the improvement is the result of long-term changes in the way the corporation mines coal. Today around 40% of its pits employ "retreat mining"—tunnelling deep into a seam and then mining back through the coal. That more efficient technique will be used in 60% of British Coal's pits by 1992. Heavy-duty mining equipment, stronger roof supports and computer control have all boosted efficiency. The corporation's aim is to work fewer, larger coal-faces more intensively: 245 today, compared with 520 before the strike. Output per pit is now 1m tonnes a year, double the pre-strike level.

British Coal is within a whisker of its short-term objective of reducing the cost of each tonne mined from last year's average of £42 to under £38. To compete with imported coal—which now costs just over £30 a tonne delivered to British power stations—it will need to do better still.

British Coal argues that such low import prices are unsustainable because many overseas producers, lured into coal production when prices were high, now barely



Source: British Coal • Miners' strike March 12 1984 to March 4 1985


We dig more

cover their operating costs. The feeble lar (in which traded coal is priced) has ad to imported coal's competitiveness. But corporation believes that by the mid-1 the cost of imported coal will be close that of British supplies—international prices have already risen by more tha quarter from their 1987 low. If it is wr and imported coal stays cheap, the corp tion will have much more cost-cutting to

Slumped coal prices have already British Coal £500m a year in lost reven Even so, the CEGB still pays British Co hefty £45 a tonne, on average, for suppl When their joint understanding is revie later this year, British Coal will probabl forced to trim its prices. That tussle come hard on the heels of a fierce battle w the South of Scotland Electricity Boar try to keep out coal imports, a battle wh will be restaged next spring.

British Coal reckons that it will make operating profit of more than £500m year, if there are no strikes. If it does, on handful of pits will be closed, but 20 co shut if strikes are as damaging as last y Hurdles remain: the biggest is to win un agreement to flexible six-day working British Coal's three new pits at Asford Margam and Hawkhurst Moor. That will low British Coal to use its mining equ ment some 30% more intensively. Six- working is vital if British Coal is to be att tive to investors when it is split up—as der the Tories it will be—and sold in ab five years' time.

Lawyers

A marred report

NINE years of Thatcherism have dc nothing to weaken lawyers' enthusi tic and ingenious defence of their restrict practices. So much is clear from this wee report of yet another inquiry into the le profession, this time chaired by a doug campaigner from the voluntary-serv world, Lady Marre. Though the report c tains enough proposals for change to

FROM: MISS M O'MARA
DATE: 22 JULY 1988

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler o/r
Mr Lankester o/r
Mr Scholar
Mr Peretz o/r
Mr Gieve
Mr Grice
Mr N P Williams
Mr Cropper

FOREIGN CURRENCY BORROWING STRATEGY: CALLING THE $2.5 BILLION FRN

You indicated (Mr Allan's minute of 12 July) that you did not want to refinance the $2.5 billion FRN by means of a eurodollar bond issue but asked us to consider either the possibility of calling the FRN with repayment financed out of the forward book or continuing our present policy of buying-in notes from the market, without exercising the call.

2. We have now received the Bank's advice (attached) which urges that we should call the FRN but that we should finance prepayment from the spot reserves, from a mix of bank deposits, deposits with the BIS and US Treasury bills. We agree with the Bank's recommendation.

Buying-in the FRN

3. This is not an option we could exercise on a large scale, without bidding up the price significantly. Once the date of the call had passed, we should be able to make further purchases for a time but they would be fairly limited, unless we announced the issue would be allowed to run to its final maturity. The Bank estimate that such an announcement could cause the price to rise sharply, by around 60bp, but even so, judge we could probably only buy-in around half of the $2½ billion total at most, spread over time. However, the benefits would be much reduced compared with prepayment, both as a result of the higher prices we should have to pay and the interest savings we should forgo.

934/88

4. It is difficult to judge how the price would be affected if we simply passed up our right to exercise the call this autumn. If the market thought we were merely postponing our decision for three months (when the call could next be made), the price might be little affected. If it suspected we were planning to hold the FRN much longer, the price rise would be much closer to 60 bp.

Calling the FRN

5. The Bank put forward three reasons for calling the FRN now:

i) Cost: We are paying LIBID on the FRN but earning below LIBID less ¼ per cent at the margin on our short term assets. So prepayment without refinance would save us around $30 million over the remaining life of the FRN. Refinancing with a eurodollar bond issue would save us around $25 million over the same period, taking account of fees too.

ii) Credit risk: With the substantial rise in the reserves over the last 18 months, we are facing problems over an appropriate home for our dollar investments. We are holding most of the dollars which have accrued through intervention at short term because of the unfavourable outlook for bond markets but the EEA's exposure to banks is now rather greater than we should like. In order to avoid this, we should have to increase our holdings of US Treasury bills or our deposits with the BIS (there is no scope for holding more sovereign commercial paper) but accept a correspondingly lower return. If the FRN were called, that would lessen our credit risk - although the situation would not, of course, be eased if we were to refinance in dollars.

iii) Professionalism: The markets can perform the same calculations as we have done. They realise that we would make an interest saving by calling the FRN, whether or not we choose to refinance it. This is why it is currently trading on the basis that it will be called. If we do not call it, the Bank suspect they will be thought guilty of mismanagement. This in itself does not seem to me to be a major worry. Both we and the Bank have been besieged by callers for months, endeavouring to discover our intentions.

No responsible operator can seriously think we have overlooked the call, whatever they may believe possible in Italy. Similarly, I would not overplay the concern that without a call, investors will require an uncertainty premium on UK debt and that UK issues will in general become less liquid. Much more worrying is the risk that the markets will suspect our external position is considerably weaker than we have acknowledged.

6. We would support the Bank's recommendation for exercising the call on all three grounds.

7. It might appear superficially attractive to postpone the decision by three months but on reflection, we believe this would give us the worst of all possible worlds. The markets are expecting us to exercise the call, so we shall have in any case to explain why we have not done so. It is difficult to see how we would present such a decision, without raising alarms about the external outlook, given the likely rise in the reserves in July: not calling the FRN is in itself quite a high profile step to take. If we were then to exercise the call just three months later, it would be hard to explain why we had not acted earlier. It would be difficult to argue that the reserves at their present level could not stand a \$2½ billion outflow while we arranged refinance. We should therefore face all the presentational problems associated with not exercising the call now, for very little gain.

<u>Refinance</u>

8. You suggested we might refinance the call from the forward book. The Bank counsel against this and we agree. We should not be able to refinance discreetly by this method: rather the reverse. In the month in which we made the repayment, the markets would either conclude we had intervened to cream off an additional \$2½ billion, with all the consequent confusion this might cause about the operation of our exchange rate policy, or, more likely, deduce correctly that we were running a large forward book whose existence we never acknowledge publicly. Focussing attention on the forwards in this way could attract comment and constrain our future freedom of action.

9. Nevertheless, as the Bank note, we could finance the prepayment out of the forward book over a longer period (with an associated reduction in our room for manoeuvre over published reserve changes month by month). But this would not enable us to cloak the exercise of the call and in our internal assessment of the adequacy of the reserves, we always take the size of the forward book into account in any case.

10. We do not need to refinance the FRN at all and certainly not immediately. By the end of July, our reserves are likely to be significantly larger than when we last examined the options earlier this month. Indeed, there is something to be said presentationally for prepaying the FRN without any refinance, as an indication of the Government's confidence in the strength of our external position. This would also be the cheaper option.

11. If you nevertheless wished to replenish the dollar reserves, we could do so in tranches over a period. Any own-name borrowing is bound to attract some attention in the markets but issues of around $1 billion by sovereign borrowers are not unprecedented and would not carry quite the same high profile as the Bank's original proposal. (We could, of course, make smaller issues than this but that would mean going to the market more frequently and with such a good name, we would be expected to make large issues.) There is also a good chance, though no guarantee, that we could make a start on this process while Parliament is still in recess, market developments permitting. We shall in any case probably need to do some direct HMG borrowing in future, since privatisation has both involved us in a substantial programme of prepayment and left us with few nationalised industries to borrow on our behalf. There is therefore a case for accustoming the market to see us raising funds in our own name now, when we are clearly under no pressure to do so.

Timing

12. You asked when you would need to take a final decision on the call. The Bank might be able to persuade the fiscal agent to accept a shorter notification period than that provided in the documentation, permitting us to defer a decision until 2 September at the very latest. However, they would much prefer not to do so,

as it is not normal practice to try to change notice dates. Under the standard procedure, notification would have to be given by 3 August. Although we would not have to make our decision public at that stage, the timing would fit quite neatly with the July reserves announcement on 2 August. If you wished to shorten the notification period, the Bank would want to negotiate this with the agent before 3 August in any case.

13. The Bank would like to associate any public statement about the call with the announcement that the Government was launching an ecu bill programme. This seems premature. The Bank are looking to an announcement of the programme in principle during August, for a September launch. But they will not be in a position to report the outcome of their confidential discussions with the investment houses until the end of next week. That would give you virtually no time before the summer break both to consider their recommendations and minute the Prime Minister, if you decided to proceed. We therefore suggest the two subjects should be decoupled.

Recommendation

14. We recommend that you authorise the Bank to tell the fiscal agent by 3 August that we shall be calling the FRN in October. We see some advantage in announcing that the call is to be exercised when we publish the July reserves figure. We suggest that the prepayment is made out of the spot reserves initially and that we leave open for the present the extent to which they are replenished over time either by fresh own-name borrowing or by running down the forward book.

15. Subject to your decision, we can supply a draft minute to the Prime Minister in the course of Monday, if necessary.

MOM

MISS M O'MARA

Foreign Currency Borrowing Strategy
(Note by the Bank of England)

Introduction

1. This note responds to the Chancellor's request for further consideration of the options in relation to the call on the $2 1/2 bn FRN in October.

2. The conclusions of the note are:

(i) We continue to recommend that the $2 1/2 bn FRN should be called in October on both reserves management and debt management grounds. Refinancing the repayment does not seem essential at this stage, but the ECU note programme which we are exploring further would provide a means of replenishing the reserves over a longer period.

(ii) The FRN could be repaid out of the forward book, but only over an extended period. Our preference would rather be to finance prepayment from a mix of bank deposits, deposits with the BIS and US Treasury bills. It does not seem possible to buy in very much of the issue from the market.

(iii) If we did not call the FRN, but instead announced that the issue would be allowed to run to its final maturity, its price would rise by around 60 bp. If no announcement were made, the price would rise, but by a lower amount - depending on what the market believed about the future call options.

(iv) If we partially refinanced the call on the FRN by issuing a fixed rate eurodollar bond issue, the cost of the new borrowing, after being swapped into floating rate dollars would be around LIBID less 1/4%. This is an estimate of the all-in cost, including fees. Refinancing the FRN from such funds would produce savings over the remaining life of the FRN, of around $25 mn.

[illegible] notify the Principal Paying Agent and the Agent Bank of a decision to call the FRN at least [illegible] days before the date of repayment, i.e. by Wednesday, 3 August 1988. The Principal Paying Agent must then notify the other agents and the note holders of the prepayment, between 45 days and 30 days prior to the prepayment date . The Principal Paying Agent might be persuaded to allow the UK a shorter notification period than provided in the documentation. The Principal Paying Agent could not, however, concede a shorter period than around 35 days, because of the need to notify note holders. Thus it might be possible to defer a decision on the call of the FRN until around 2 September. If the Chancellor would like, we will pursue this possibility. However unless there were overriding reasons for doing so, we would not recommend this course of action, as trying to change notice dates is not normal practice.

Background

4. The original recommendation to exercise the call on the FRN was put forward against the background that the large rise in the reserves over the last eighteen months is currently causing some problems for reserves management. The major part of the inflow has been held in short term investments because the outlook for world bond markets has not appeared favourable. The main short-term instruments available to the EEA are limited - they are bank deposits, deposits with the BIS, sovereign commercial paper, and US Treasury bills. Between these there is a conflict between return and credit risk, for example bank deposits earn the highest return but carry the greatest credit risk, while US Treasury bills earn the lowest return, but carry the least risk. Of the $22 bn rise in the spot reserves over the last eighteen months, $6 bn has been placed with banks, $5 bn with the BIS, $3 1/2 bn in sovereign commercial paper and $3 bn in US Treasury bills. The forward book, which is also managed through the banking system, has risen by $5 bn. In the current position some concern remains both about the level of the EEA's exposure to banks and also about the return being earned, at the margin, on short term assets (below LIBID less 1/4%).

5. The response to these concerns has been the proposals which the Chancellor approved in December 1987 to restrict the amount of new borrowing under the Exchange Cover Scheme (by making the scheme less attractive to borrowers), to seek to prepay existing expensive debt, and to buy in part of the two UK FRN issues. The result has been a fall in the debt outstanding by around $2.8 bn to $16 1/2 bn. This strategy has not only produced substantial savings, it has also helped to contain credit risk. Despite the prepayment of debt, the reserves are now higher than they were in December 1987.

6. The recent review of foreign currency borrowing strategy therefore recommended that the sovereign dollar note programme should again be deferred and that further foreign currency debt should be prepaid. The two prepayment proposals were the exercise of the call on the $ 2 1/2 bn FRN and the repayment of the Exchange Cover Scheme debts of the Electricity and Water industries as part of the preparation for their privatisation.

7. The major part of the debt which has already been prepaid or proposed for prepayment would have fallen due for repayment within the next four years. The effect of prepayment is thus to reduce the reserves now (though the 'underlying' change in reserves is not of course affected), from a level which is currently causing some problems for reserve management, to a level which repayment of borrowing in the ordinary course of events would anyway achieve in a few years' time.

8. Looking ahead it is possible that at some stage, we might need to consider new borrowing to avoid the currency reserves declining, for example because of repayment of debt or through intervention, to a level that would be regarded as inadequate. The minimum level that would be regarded as satisfactory is probably well above that reached in September 1985 of $7 1/2 bn (spot and forward). By comparison at present the currency reserves are $43 bn. It seems clear that such borrowing will have to be, in the main, direct borrowing by HMG, because there will be, indeed already are, too few nationalised industries left to borrow on HMG's behalf.

9. However, [illegible] foreign currency financing could have been provided [illegible], this would not seem appropriate. The UK's standing around the world is so high, that, if necessary, it would be able to conduct a major foreign currency borrowing programme over several years and still attract the finest terms.

10. When new borrowing is required, the choice would seem to lie between sovereign note programmes (in dollars or ECU or both), fixed rate issues of $ 1 bn plus (possibly swapped into floating rate) or further FRNs. The advantage of a note programme is that it could be increased in size subsequently if extra reserves were needed. The advantage of a large fixed rate deal is that it would set a benchmark against which subsequent issues could be made. And an advantage of both is that they would provide cheap funds. These were factors behind the proposal to launch an ECU Treasury bill programme in the Autumn (initial size $1 - 2 bn) and to support the idea of a fixed rate dollar issue as a partial refinance of the call on the $2 1/2 bn FRN.

Questions relating to the call on the FRN

11. One of the questions raised by the Chancellor is the cost of borrowing via a fixed rate eurobond issue. As the note of 8 July on refinancing the UK $2 1/2 bn FRN indicated, against a rate of LIBID on the FRN, we would expect to be able to produce floating rate funds at 3/8% under LIBOR (i.e. 1/4% under LIBID). This was an all-in rate, including fees. Refinancing the FRN from such funds would produce savings, over the remaining life of the FRN, of around $25 mn.

12. However this is slightly less than the savings which would be made if prepayment were made out of the EEA's existing assets. We were planning to finance the call by running down $1 bn of bank deposits, $1 bn of deposits with the BIS and $1/2 bn of US Treasury bills. This would reduce the EEA's credit exposure to the banking system, and produce - as an alternative to the outturn in the previous paragraph - interest savings of around $30 mn over the remaining life of the FRN. Thus the recommendation to call the FRN was not dependent on a decision in favour of new borrowing at this stage. The call of the FRN would produce significant benefits to the EEA with or without any replacement finance.

13. There are additional arguments for calling the FRN which relate to the UK's reputation in the markets as a sovereign borrower. The FRN is a public issue, investors know the terms on which it was issued and are trading it on the basis that, as it is sensible to exercise the call, the UK will do so. If we did not exercise the call, the market would seek to understand why.

14. They would be drawn to one of two conclusions. The first is that the UK authorities had made a mistake in not exercising the call - that we had misunderstood the position, or overlooked the existence of the option, or merely forgotten to exercise it. Jokes circulate in the markets; when Italy failed to call one of its FRNs, it was said that the reason was that the person responsible had been on holiday. This sort of talk reflects badly on the professionalism of debt management. The second conclusion is that the UK's financial position is much worse than the markets thought. The weakness of a borrower's financial position is the main reason why borrowers do not prepay FRNs. A large part of the sovereign FRN market is made up of second tier sovereign issuers - Italy, Denmark, Australia, New Zealand. Although their issues have call options, they often do not exercise them because they do not have the reserves to do so, and because they need to use the limited opportunities the markets allow them for new borrowing to raise additional reserves. If investors even start to wonder whether we are in this group, then the cost of new debt will increase.

15. If the call were not exercised, speculative investors would gain, because the price of the issue would rise. In the main, however, the effect would be to confuse investors. They will currently be owning, buying, or selling UK debt on the basis that the UK authorities will act rationally. If it is sensible to call an issue, it will be called; if it is not, it will not be called. If we stop acting rationally, there must be a risk that investors will require an uncertainty premium on UK debt. UK issues would also become less liquid, again because of uncertainty, and this would also raise our borrowing costs.

16. As described above, the way we originally thought of financing the call on the FRN was from a mixture of bank deposits, deposits with the BIS and US Treasury bills. One of the questions raised by the Chancellor is whether prepayment could alternatively be financed out of the forward book. The answer is that the forward book is large enough at $5 1/2 bn to cover the prepayment, but that it would not be straightforward to use it to cover prepayment.

17. The monthly reserves announcement provides the change in the spot reserves during the previous month; it also provides the extent of any capital items - new borrowings or repayments - and directs attention to the change in the reserves excluding capital items. This is the underlying change and, despite disclaimers, is taken to indicate the rough extent of any intervention. There is no mention of the forward book or any changes in the forward book but our freedom to manage the reserves would be constrained if the fact that we ran a large forward book became public knowledge. If, during October, the FRN were prepaid, this would be referred to in the monthly reserves announcement. Were the repayment to be financed from the forward book, the spot reserves would not change (except to the extent that any intervention had taken place), but this would mean that commentators and analysts would see the underlying change in the reserves as a rise of $2 1/2 bn. Unless sterling was, by chance, very strong in October, and we were known to have been intervening very heavily, those same analysts would immediately deduce - correctly - that we had a sizeable forward book from which the repayment had been financed.

18. Over a longer period, however, it might be possible to finance the prepayment out of the forward book. Each month the market tries to estimate what the underlying change in the reserves will be, but there is no surprise if their best guess is wrong by $100 mn or $200 mn. It would therefore in principle be possible to repay the FRN initially from the spot reserves, but over time to replenish the spot reserves by a steady reduction in the forward book. In due course the spot book would be back to the level it would have been if the prepayment had been made immediately out of the forward book and the forward book would be

$2 1/2 bn lower. However, this approach too could at times be inconsistent with decisions about the reserve changes we might wish to show month by month for quite other expectational reasons.

19. A second question raised by the Chancellor is whether, in the absence of a call, the FRN could be bought in from the market. Before the date at which the call on 7 October should be announced there will be little opportunity to acquire more of the FRN. The issue is priced to this call. The normal spread between bid and offer means - because the call date is so close - that the yield at which the FRN could be bought is too low to make it a potentially attractive purchase and that the yield on which it could be sold is too high to make it a particularly attractive sale. For this reason little trading is occurring. If we wanted to acquire securities, we would have to bid up the price from what we would pay by exercising the call and the agent we used would deduce that we were not going to exercise the call.

20. After the date at which the call should have been announced, activity should pick up for a time, as speculative investors took their profit. However the level of trading would soon decline - because the next possible call date would be so close - unless we announced that we were not going to exercise any subsequent call either. Were we to do this, the price of the FRN would rise sharply - by around 60 bp. Some buying in from the market would then be possible, although, of course, purchases would be at a higher price. Even so, we could not acquire anything approaching the $2 1/2 bn of the issue. Thus the savings would be much lower - we would pay higher prices, and would forego interest savings.

BANK OF ENGLAND
21 July 1988.