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FROM: I POLIN

DATE: 1 February 1988

1. MISS O'MARA
2. ECONOMIC SECRETARY

As amended by Chancellor and EST.

Distribution

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THE RESERVES IN JANUARY 1988

The reserves announcement for January will be made on Tuesday 2 February at 11.30 am. This month's announcement reports a fall in the reserves of $1233 million and an underlying rise of $38 million.

pp I POLIN

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

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

DRAFT PRESS NOTICE

THE RESERVES IN JANUARY 1988

The UK official reserves fell by $1233 million in January. Accruals of borrowing under the exchange cover scheme amounted to $93 million; repayments of such borrowing amounted to $538 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $166 million. The valuation change arising out of the quarterly rollover of the EMCF swap amounted to a fall of $660 million. At the end of January, the reserves stood at $43,093 million (£24,346 million*) compared with $44,326 million (£23,490 million+) at the end of December.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying ~~rise~~ change in the reserves during January, was a rise of $38 million. Th~~e~~is underlying change ~~in the reserves~~ 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 Friday 29 January £1=$1.7700

\+ When converted at the closing market rate on Thursday 31 December £1=$1.8870

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

> Wessex Water Authority, $18 million; Grampian Regional Council, $17 million; South West Water Authority, $16 million; Lothian Regional Council, $13 million; Welsh Water Authority, $13 million; Oldham Borough Council, $8 million; Trafford Borough Council, $8 million.

Repayments of such borrowing were:

> Electricity Council, $113 million; British Telecommunications plc, $104 million; Anglian Water Authority, $77 million; South of Scotland Electricity Board, $76 million; British Coal, $52 million; North West Water Authority, $40 million; Northumbrian Water Authority, $29 million; Welsh Water Authority, $25 million; Southern Water Authority, $13 million; North of Scotland Hydro Electricity Board, $4 million; Lothian Regional Council, $1 million; Shetlands Islands Council, $1 million; Yorkshire Water Authority, $1 million; Others, $2 million.

4. The quarterly rollover of the EMCF swap, ie 20 per cent of the UK's gold and US dollar reserves, entailed a valuation decrease of $660 million. This mainly reflects the decline in the dollar against the ecu. For the purposes of the swap, the EMCF values gold and dollars in terms of ecus at rates determined quarterly, whereas the UK values gold and ecus held in the reserves on an annual basis.

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THE RESERVES IN JANUARY 1988 : PRESS BRIEFING

Factual : Main features of markets in January

	£ ERI	\$/£	DM/£	\$ ERI	DM/\$	Yen/\$
4 January	75.9	1.87½	2.97¼	91.3	1.58½	123
11 January	75.5	1.82¼	2.98	93.5	1.63¾	128¼
18 January	74.7	1.77	2.98¼	95.1	1.68½	130¼
25 January	74.4	1.77¼	2.97¼	94.4	1.67¾	127¾
29 January	74.3	1.77	2.96¾	93.9	1.67¾	127¾

Although January saw periods of volatility on the foreign exchanges, sterling was for the most part on the sidelines, its movements being strongly influenced by the dollar's recovery.

After touching a high of \$1.8785 on 4 January, the pound began to lose ground to the dollar and, consequently, in effective terms. A fall in market oil prices steadied sterling's initial rise in cross-rate terms from a low of DM2.96. As a result of the encouraging US trade figures for November and the subsequent rise in the dollar, the pound dipped to \$1.7620 on 15 January. It subsequently benefited more than the continental currencies from profit-taking flows out of the dollar, moving up to \$1.7990 and DM2.98½ on 21 January.

Publication of a record rise of \$4.9 billion in bank lending in December prompted suggestions that UK base rates would need to rise to curb overheating in the UK economy. Expectations of an early base rate rise then receded and, with the market becoming cautious ahead of last week's UK trade figures, sterling saw modest bouts of selling which caused it to fall back to DM2.96¼ on 26 January. It ended the month on a much steadier note at \$1.77, DM2.96¾ and ERI 74.3.

The dollar reached new post-war lows of DM1.5620 and Y120.25 in Far East markets on 4 January. Some well-publicised concerted intervention by central banks, and a report from Tokyo that ~~G3~~ The US, Japanese and Germans monetary authorities had secretly agreed intervention levels for the dollar of just below Y130 and just above Y140, caused the dollar to rise to DM1.6710 and Y131.87 on 6 January. It subsequently eased a little in quiet trading as dealers awaited the US trade figures for November. When a better-than-expected deficit of $13.2 billion was published, the dollar saw highs of Y131.12 and DM1.6920 on 15 and 18 January respectively.

The dollar then lost some of its gains after the Japanese trade figures showed an increased surplus with the US and after a claim from Mr Clayton Yeutter, US trade representative, that a major drop in the US trade deficit was unlikely before the latter half of the year. Although the dollar was subsequently boosted by a better-than-expected rise of 6.7% in US durable goods orders, this was offset by renewed talk that the US economy was slowing down and the dollar ended the month at DM1.67¾ and 127¾ yen

Previous reserve changes

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

(ii) Reserve changes over 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

(iii) October 1987 underlying change was largest ever.

Bank base rates

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 $19.6 billion at end September (latest published figure*) compared with $22 billion in May 1979. [Updated figures for end October 1987 will be published (11 February) in the next Bank of England Quarterly Bulletin]

*in Financial Statistics, January 1988, No 309, Table 10.6

POSITIVE

1. Reserves remain very strong after substantial underlying increase of $20 billion in 1987. Now stand at $43 billion.

2. ~~Apart from recent weakness of dollar,~~ Sterling has remained comparatively stable ~~since the Budget~~ since last Budget, especially against deutschemark. The dollar has been weak against most currencies.

DEFENSIVE

(A) POLICY

1. Exchange rate policy for sterling? Chancellor repeatedly made clear that sensible to continue to pursue policy of seeking stability for sterling, with exchange rate against deutschemark being of particular importance. This is what British industry wants and at same time provides anchor against inflation which markets can readily understand. Government has demonstrated commitment to this aim throughout past year. [See Chancellor's 'Financial Times' interview, 4 January, and speech in Autumn Statement debate, 14 January, OR vol 125 no 72 cols 465-474.]

2. Why stability against deutschemark? Stability against deutschemark is what industry has asked for ~~is seeking~~. (In 1986, nearly 50% of UK exports went to EC: under 15% to US.) It also provides necessary financial discipline as guarantee against resurgence of inflation.

3. Why is exchange rate stability so important? Gyrations in exchange rates create grave uncertainty and damage business confidence throughout world. Need to ensure that exchange rate risk does not distract companies from seeking improvements in performance as they plan for future. Commitment to some form of exchange rate stability is only feasible way of securing wider international cooperation on economic policy.

4. **Are authorities keeping £/DM rate stable or supporting $?** Following Louvre, amounted to same thing for several months. More recently, dollar has fallen. Very much hope dollar stability will be re-established and some signs that this has indeed occurred, but meanwhile, keeping £/DM rate stable.

5. **Why is present DM/£ level right?** Matter of judgement. After Louvre meeting in February, Chancellor noted sizeable fall in exchange rate against non-dollar currencies which followed oil price collapse had gone far enough. Said that by same token, no wish to see substantial rise. DM/£ rate was then 2.79. Highest rate since has been just under DM3.00. Now 2.97.

6. **Let sterling fall to keep UK industry competitive?** Responsibility for competitiveness lies primarily with industry. Authorities will not allow sterling to fall to offset failure of British firms to keep costs under control.

(B) **G7**

7. **G7 statement issued on 23 December** Reaffirmed basic objectives and economic policy directions of Louvre. Stressed need to strengthen underlying economic fundamentals and to continue policy cooperation. Agreed either excessive fluctuation of exchange rates, further decline of dollar or rise in dollar to extent that becomes destablising to adjustment process could be counterproductive to growth prospects for world economy. Re-emphasised common interest in more stable exchange rates and agreed to continue close cooperation.

8. **When will G7 meet again?** G7 meets when it is useful to do so.

9. **Is it US policy to drive dollar down?** No. Joint statement by President Reagan and Japanese Prime Minister Takeshita issued on 13 January stated that US and Japan "believe that the close cooperation of their policies within the framework of arrangements

a[illegible]pted by the Venice Summit is establishing the fundamental economic conditions for greater stability of exchange rates and that a further decline of the dollar could be counter productive". This statement indicates US does not want to see further dollar decline.

(C) INTERVENTION

10. Value of intervention as an instrument? As Chancellor told House on 14 January (OR vol 125 no 72 col 470), ".... it is idle to suppose that official intervention on its own .... amounts to a coherent policy. But intervention is an important tactical weapon and it would be foolish not to use it as appropriate".

11. Details of intervention? Policy never to discuss.

12. Is it true that Bank have been switching dollars into deutschemarks and yen to limit risk of losses on intervention? ['Financial Times' article, 2 November 1987.]
Never discuss detailed reserves transactions.

13. Will authorities make loss from buying dollars in falling market? Intervention carried out to support exchange rate policy. As to profitability, much too early to tell. Depends on exchange rate at which intervention is unwound (if and when it is) but stabilising intervention has been profitable in past.

14. Have other countries been intervening over last month/recently? Must ask them. UK does not discuss details of other countries' intervention.

15. Further bout of concerted intervention? Concerted support for dollar was widely reported in early January with number of major central banks including the Federal Reserve Bank participating.

16. Has UK participated in concerted intervention? UK practice not to discuss operations in foreign exchange markets.

17. Is there a secret clause on intervention in G7 agreement [as claimed by M Balladur]? No comment.

(D) INTEREST RATES/MONETARY POLICY

18. Why raise interest rates on 1 February? ½ per cent rise was normal adjustment made from time to time as appropriate ~~circumstances change~~. Range of factors ~~(non decisive in itself)~~ indicated time to act. In particular, rates cut after 19 October partly made to sustain market confidence in aftermath of equity market fall. Equity market now much more stable.

19. Effect on exchange rates? Still committed to exchange rate stability.

20. End of international co-operation? Not at all. UK continues to play full part in policies set out in G7 communique of 23 December.

21. Implication of recent intervention for UK monetary conditions/funding? Policy to ensure, over time, any net intervention funded so that effect on liquidity sterilised.

(E) EXCHANGE RATE MECHANISM (ERM)

22. UK membership of ERM? No change in Government position. Matter kept under continual review. Will join when time is right.

23. Action Committee for Europe call for strengthening EMS?
[ACE declaration reported in 'Financial Times', 20 January].
EMS was strengthened following EC Finance Ministers' meeting at Nyborg, Denmark, September 1987.

2 Balladur's proposals for Central Bank of Europe? Not on agenda for immediate decision. M Balladur simply calling for consideration of connected issues. Looking to time after completion of internal market (1992).

(F) DEBT

27. Why is level of repayments of borrowing under exchange cover scheme so high? [For use only if asked: Partly reflects prepayment of loans taken out under exchange cover scheme. Continues policy of prepaying loans where suitable opportunities arise, given healthy level of reserves.]

(G) NATIONAL AUDIT OFFICE (NAO) REPORT ON MINISTRY OF DEFENCE: COSTS AND FINANCIAL CONTROL OF BRITISH FORCES GERMANY

[NAO report, published 11 January, recommended "MOD should, as they propose, make their forward purchases of deutschemarks and dollars from the Bank of England who, with the Treasury, are in a position to judge the most appropriate way of meeting the demand in the interests of the taxpayer and the Government's exchange rate strategy".]

26. Why foward purchase? As NAO recognised [in paragraph 6.11 of Report], reduces uncertainty about MOD's commitments in terms of sterling. Not aiming directly to save money.

27. Details of MOD forward purchase? Not practice to discuss.

28. Is there a foreign exchange exposure for the Treasury? No.

(H) EUROPEAN MONETARY COOPERATION FUND (EMCF) SWAP

29. Why was there a large valuation decrease as result of EMCF swap? See Press Notice, paragraph 4.

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TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	+ 0.6 (end November)	47
Japan	+ 3.4 (end December)	81
Germany	- 3.4 (w/e 22 January)	63
France	- 0.3 (end November)	68
Italy	+ 5.2 (end December)	65
Canada	+ 0.3 (end December)	8
United Kingdom	- 1.2 (end January)	43

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.

MI/2 Mr Grice 109

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

MAMC : D3

01-601 4123

2 February 1988

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

c Mr Peretz
Mr Grice
Ms Goodman

Mr Gy Little
you asked
about this at
your meeting.

MOM 3/2

OFFICIAL RESERVES CURRENCY COMPOSITION

A couple of weeks ago I asked one of my staff to see what an analyst or intelligent member of the public could get out of our published monthly reserve figures. The result of that request is a short note which I attach. Its conclusion is the not unsurprising one that the annual revaluation (which is coming up at the end of March) can tell outsiders a good deal about the split between our dollar and non-dollar holdings.

I am sure this exercise has been done several times before but it was new to me; and I thought that as this is a fairly new area for you too you might be interested. If it is worth doing so please feel free to copy it on further round the Treasury.

Yours sincerely

M D K W FOOT
HEAD OF FOREIGN EXCHANGE DIVISION

Miss O'Mara cc as above

But in fact no one did the calculation, as far as I know. So perhaps we will get away with it again this year. Moreover to get at the <u>net</u> dollar position would take some further research, ie to the currency composition of our borrowing

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MR FOOT

Copies to Mr Gill
Mr Smeeton
Mr Bailey

OFFICIAL RESERVES - CURRENCY COMPOSITION

1 You asked whether it would be possible for a member of the general public to calculate the currency composition of the official reserves from:- (a) the Treasury's monthly announcement; and/or (b) Information published in April in respect of the annual revaluation.

2 I don't think there is anything that can be gleaned from the monthly announcement so far as currency composition is concerned. Any published increase (or fall) in the reserves could be attributable to purchases (or sales) of dollars or other currencies. None of it (except in the month we do our annual revaluation - see below) will have anything to do with real-world changes in the month in the relative value of say dollars and DM. No knowledge about parity rates is going to be of assistance here.

3 The annual revaluation is a different story because the end-March reserves figure is given on the basis of both the old and the new parity exchange rates. Armed with readily obtainable data on exchange rates and the published explanation as to how parity rates are calculated (given by the Treasury in April each year), a member of the general public should be able to calculate these parity rates and thus assess in percentage terms the effect of the revaluation on the non-dollar currency element of the reserves. That assessment and details of the revaluation of the convertible currency element (which are also published by the Treasury in April and subsequently appear in slightly more detail in the Quarterly Bulletin) should enable someone to calculate approximately how much of the reserves are held in dollars and how much in other currencies.

4 For example, in April 1987 the effect of the new parity rates was to increase the dollar equivalents of holdings in the following currencies by the percentages indicated:-

ECU	22%	DFLS	28%
DM	28%	SWFC	28%
LIRE	22%	YEN	21%

On the assumption that a member of the public had sufficient information on exchange rates to calculate the new parity rates, he/she could conclude from these percentages that, in broad terms, the non-dollar element of the reserves was revalued upwards by say 25%. The interested party could then consult the Quarterly Bulletin and find that the convertible currency element of the reserves increased from $16,193mn to $17,812mn following the revaluation. They could then conclude that the increase, $1,619mn, represented 25% of the non-currency element of the reserves and that the overall non-currency element as at 31 March 1987 was therefore 1,619 x 4 = $6,476mn with the balance $16,193 - $6,476 = $9,717mn represented by holdings of US/Canadian dollars. As seen from the attached print-out, US and Canadian dollar holdings as at 31 March 1987 actually totalled $9,496mn.

5 I have done similar calculations in respect of the April 1986 revaluation and, once again, it is possible to hit upon figures which are very close to the real ones.

Foreign Exchange Division
Dealing Room
28 January 1988

David Fisher

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E E A RESERVES	$ MILLIONS	# MILLIONS
END MARCH FORWARDS	2,993	2076

GOLD	4,896,860	
E C U's	3,273,762	
S D R's	1,375,112	
RESERVE TRANCHE	1,684,185	
U S $	9,228,522	
CAN $	267,385	
OTHER CONVERTIBLE CURRENCIES	3,422,806	
	24,148,632	16,752,433
END PREVIOUS MONTH	22,256,456	15,439,789
CHANGE ON MONTH	1,892,176	1,312,644

PUBLISHED FIGURES

END MARCH	24,149	16,753
END FEBRUARY	22,257	15,440
CHANGE ON MONTH	1,892	1,313

BOOKS AND STATEMENTS

01-Apr-87

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MAMC: D3

FROM: A C S ALLAN
DATE: 4 February 1988

MISS O'MARA

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

ACCOUNTING FOR THE RESERVES IN THE UK AND GERMANY

The Chancellor was grateful for your minute of 29 January. He has slightly amended the draft, and I attach a revised version. There are two points which need checking:

(i) In paragraph 6, could you please check the figures for our dollar assets and liabilities.

(ii) In paragraph 9, the Chancellor did not understand the end of the first sentence. Should this say the Bundesbank "made almost no overall transfer of losses"? Or should it say "and in fact made a small net profit transfer"?

2. Finally, the Chancellor feels it looks very odd to cover only the "losses" on our net dollar position. He feels we must also include something about the book profit/losses on our holdings of Deutschemarks and other currencies. I should be grateful if you could provide a suitable paragraph.

ACSA

A C S ALLAN

569/88

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DRAFT LETTER TO:

Paul Gray Esq
10 Downing Street

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 proptability 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.

2. 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

3. 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.

4. 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.

5. 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 <u>financing</u> 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 <u>do</u> 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.)

6. 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 [$24 billion] offset by dollar loans of about [$12 billion].

7. Finally, the UK has actively shifted substantial amounts of dollars into other currencies and we have

on occasion 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.

8. 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.

9. 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 made [almost no overall profit transfer]. 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.

10. The present phase of dollar weakness started in 1985. Even so, the Bundesbank managed to achieve sizeable

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-though diminishing - overall profits in 1985 and 1986, despite dollar holdings averaging around $22 billion.

11. 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.

12. 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.

13. 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 gains as the dollar has fallen against sterling since 1985. 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.

14. These calculations are inevitably dependent on a number of assumptions and the Prime Minister will not want to put any weight on the precise figures. It is also important to remember that the £0.4 billion figure for the EEA only represents a valuation 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.