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

Reference MG-MAMC/D/0002/001

File begins 03/05/1988

Pages 305-322

Table 1: Composition of Personal Sector Income in 1987

	£m	%
Income from employment	226,343	65
Income from self employment	32,959	9½
Rent, dividends and net interest	33,894	10
Social security and other current grants from general government	52,478	15
Other personal income	2,254	½
Total personal income	**347,928**	**100**
less UK taxes on income	44,074	
less Social security contributions	28,449	
less other deductions	2,099	
Total personal disposable income	**273,306**	
Consumers' expenditure	258,431	
Saving	14,875	
Saving ratio[1]		5.4%

Source: Blue Book, 1988 edition.

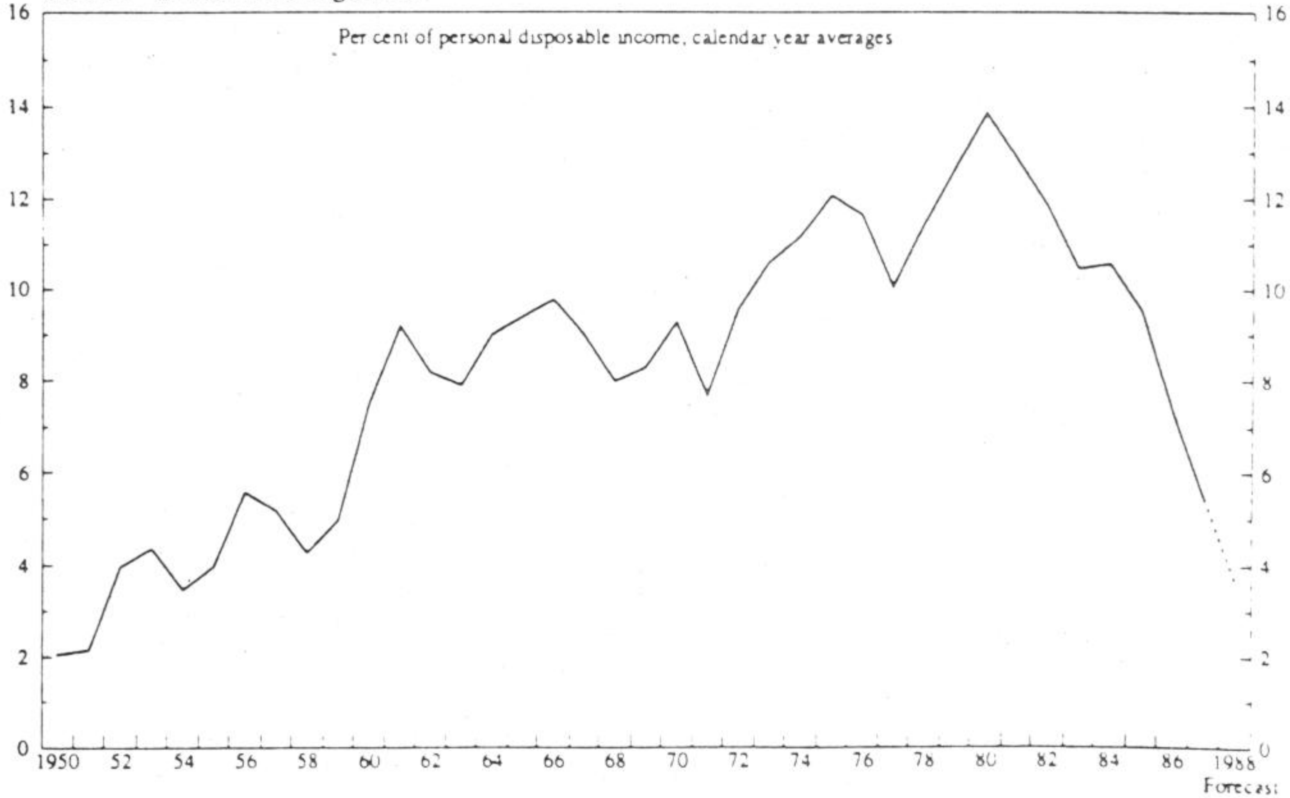
[1]Savings as a percentage of personal disposable income

Table 2: Personal Sector Saving by subsector

	Households	LAPFs	Other	Personal Sector
1980	6262	12846	3005	22113
81	4579	14863	3076	22518
82	4103	15556	2877	22536
83	1551	16622	3163	21336
84	1746	18523	3001	23270
85	66	19133	3336	22535
86	- 4075	19640	3178	18743
87	- 9144	20574	3445	14875

Source: Blue Book, 1988 edition

Chart 1 Personal savings ratio



Annex: Extract from Industry Act Forecast

30. Several factors may explain the substantial fall in the savings ratio since 1980. Most important has been greater confidence in the future, with people having lower inflation expectations and greater wealth, especially following the large rise in house prices. In addition, employers' contributions to pension funds have been falling in recent years as companies have reacted to the surpluses that many funds have been running; this scores in the official statistics as lower personal saving.

31. The fall in the savings ratio has been associated with an increase in borrowing - particularly mortgage borrowing - following the ending of mortgage rationing and other restrictions. But householders will not wish to go on accumulating debt at the same rate as recently: levels of borrowing are already high relative to income. Moreover, households are now, for the first time, substantial net payers of interest, and higher interest rates are therefore particularly likely to reduce consumer spending. This should be reinforced by a slow-down in the growth of house prices and hence of housing wealth. Consumer spending is expected to rise by 3½ per cent in 1989 with a deceleration through the year. The savings ratio should recover slowly during 1989.

INTERVENTION AND STERILISATION

1. The foreign exchange market is just like any other market in that the exchange rate, which is the price of foreign exchange, is determined by supply and demand. If at the current exchange rate there are more sellers of sterling than buyers, the exchange rate will fall so that sterling becomes cheaper in terms of foreign currency; if, conversely, there are more buyers than sellers of sterling, the exchange rate will rise and the pound appreciates in terms of foreign currencies. The exchange market differs from the market for goods because, in general, goods are bought to be consumed or used, while currencies are to a large extent bought with an eye to their resale value at some future date. A fall in the currency's value could offset any gain from a currently favourable interest differential. Thus the current supply and demand for sterling depend on how market participants perceive the prospects for the currency over the future.

2. Governments intervene to influence their currencies' exchange rates when they think that, left to its own devices, the market would produce an inappropriate exchange rate. For example, intervention may be intended to curb excessive volatility of exchange rate movements if market participants misinterpret the importance of recent economic and political news. A full discussion of the pros and cons of intervention is beyond the scope of this note. But as background reading you might be interested in the attached MG paper and subsequent correspondence with the Chancellor.

3. When the authorities intervene, for example to prevent or slow down a rise in the pound, the Bank of England buys foreign exchange in exchange for sterling. By doing this it increases the demand for foreign exchange which tends to increase its price in terms of sterling and so holds the pound's exchange rate down. Apart from its direct effect on demand, the Bank's action may affect the perceptions of other market participants and cause them to be more cautious in their view that sterling will rise, thus tending to reduce the demand for sterling. The foreign exchange purchased by the Bank of England goes to increase the foreign

exchange reserves. The sterling which the Bank has issued to pay for the foreign exchange winds up in the hands of the previous owners of the foreign currency, some of whom will be UK residents. To the extent that UK residents deposit this with UK banks (or building societies) M4 will rise.

4. If the authorities intervene to support sterling, the Bank sells foreign exchange which tends to reduce M4 as UK residents run down their sterling deposits to pay for it.

5. 'Sterilisation' of intervention is a technique for preventing intervention from adding to or subtracting from M4. It involves funding intervention by net sales or purchases of gilts from the non-bank non-building society private sector. For example, if the authorities have been intervening to hold sterling down, tending to increase M4, the Bank will sell gilts. In order to buy these securities the purchasers will have to run down their sterling deposits which reduces M4. Thus a policy of selling gilts will offset the effects of intervention on the money supply.

6. We have undertaken publicly to fund fully any exchange rate intervention by net sales of public debt outside the bank and building society sector - generally gilts. But the Chancellor's 1987 Mansion House speech stated that the intervention and the sterilisation are not necessarily synchronised. If upward pressure on the exchange rate arises from a demand for sterling liquidity (rather than from a more general demand for sterling assets) at the current exchange rate, intervention meets this demand directly by creating more liquid assets. When the funding of the intervention takes place, the Bank swaps these liquid assets (sterling deposits) for less liquid assets (gilts). This would frustrate the private sector's desires for sterling liquidity and could therefore offset the effect of intervention on the exchange rate. For this reason it may not always be appropriate to fund the intervention immediately. But the exact response would have to depend on the circumstances at the time.

2 File

3.11

CATHY RYDING

DATE: 11 November 1988

1. ~~MISS~~ O'MARA

2. CHANCELLOR

cc Sir T Burns
Mr Grice
Mr N P Williams

I am sorry this has taken us so long to produce. We needed to construct a special exchange rate index and resources in MG1 have been very stretched. The graph shows that although the annual average change in the exchange rate over the period as a whole has been quite close to the annual average interest differential, sterling was appreciating in the early period, when the interest differential was positive and over the period since 198[illegible] when the interest differential has again been consistently high the exchange rate has fluctuated quite markedly

MOM
[illegible]/11

STERLING

Alex Allan's minute of 12 October asked for figures showing, over the whole period since 1979, the average percentage fall in sterling's value, and the average amount by which our interest rates have exceeded the average of those of other major countries. As Mr Allan suggested, the interest rate calculations are based on an average of G5 interest rates, weighted by their shares in the ERI. The exchange rate is a specially weighted index of sterling against other G5 currencies, again using the ERI weights. We have calculated the figures from 1979 Q2 - the election quarter.

2. On this basis, the average of the annual average changes in sterling is -2.5 per cent. (The average annual change calculated as the whole period change over the number of years is -2.8 per cent p.a.) UK interest rates have exceeded the G5 average by an average of 3.2 per cent per year.

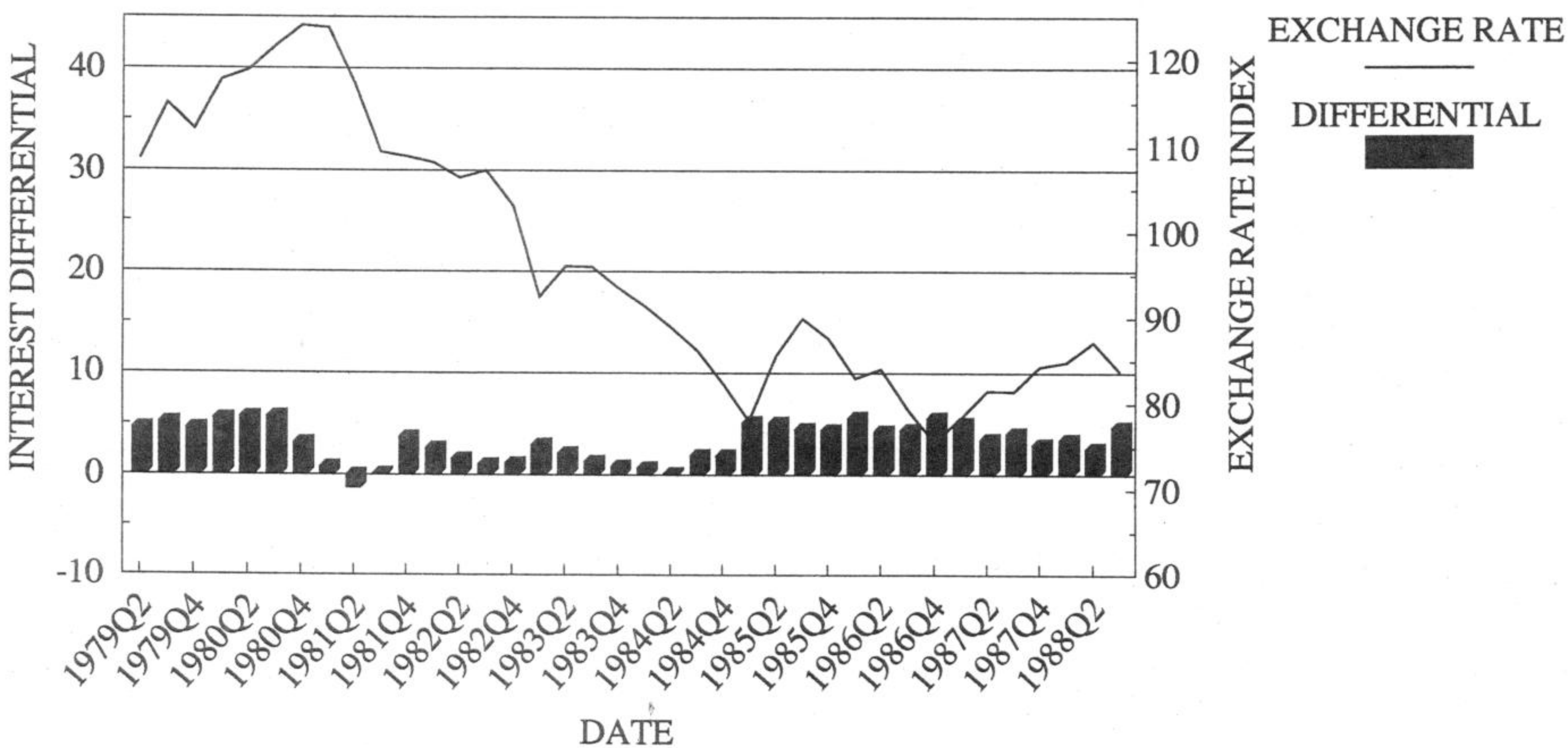
3. We also thought you might be interested to see the movement of the series over time, and a graph is attached.

Cathy Ryding

CATHY RYDING

312

UK Weighted Exchange Rate against other G5 Countries and the Differential between UK and G5 Weighted Average Interest Rates



Exchange Rate Index 1978Q4=100

DJH

FROM: I POLIN

DATE: 1 December 1988

MOM 1/12

1. MISS O'MARA
2. ECONOMIC SECRETARY

cc Distribution
Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mr H Evans
Mr Odling-Smee
Mr Sedgwick
Mr Gieve
Mr Grice
Mr Pickford
Mr Bush
Mrs Ryding
Mr N P Williams
Mr Hudson
Mr Segal
Mrs Chaplin
Mr Call

THE RESERVES IN NOVEMBER 1988

The reserves announcement for November will be made on Friday 2 December at 11.30 am. This month's announcement reports a rise in the reserves of $992 million and an underlying rise of $428 million.

2. The second tender of UK ECU Treasury Bills held on 8 November raised the equivalent of $908 million. Maturities totalled $246 million. This gave a net inflow of $662 million.

Ian Polin

I POLIN

Also copies to:

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

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

DRAFT PRESS NOTICE

THE RESERVES IN NOVEMBER 1988

The UK official reserves rose by $992 million in November. Proceeds from the second tender of UK ECU Treasury Bills amounted to $908 million whereas maturing UK ECU Treasury Bills were $246 million. Repayments of borrowing under the exchange cover scheme amounted to $98 million. There was no new borrowing under the exchange cover scheme this month. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during November was a rise of $428 million. At the end of November, the reserves stood at $51,040 million (£27,619 million*) compared with $50,048 million (£28,284 million**) at the end of October.

Note to Editors

2. The 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) and on the Telerate Monitor (Code 22494).

---

* When converted at the closing market rate on Wednesday 30 November £1=$1.8480

+ When converted at the closing market rate on Monday 31 October £1=$1.7695

3. There was no new borrowing under the public sector exchange cover scheme this month but repayments of such borrowing were as follows:

South of Scotland Electricity Board, \$52 million; British Telecommunications PLC, \$13 million; Electricity Council, \$10 million; Northumbrian Water Authority, \$4 million; Welsh Water Authority, \$4 million; North West Water Authority, \$3 million; Lancashire County Council, \$2 million; Lothiam Regional Council, \$2 million; Severn Trent Water Authority, \$2 million; Yorkshire Water Authority, \$2 million; British Nuclear Fuels PLC, \$1 million; Northern Ireland Electricity Council, \$1 million; Others, \$2 million.

THE RESERVES IN NOVEMBER 1988 : PRESS BRIEFING

Factual : Main features of markets in November

	1 Nov (cob)*	Month's High		Month's Low		30 Nov (Cob)*
£ ERI	76.5	78.3	(30th)	76.5	(1st & 2nd)	78.3
$/£	1.7637	1.8515	(30th)	1.7560	(9th)	1.8480
DM/£	3.1606	3.2155	(30th)	3.1200	(25th)	3.2146
$ ERI	95.7	95.7	(1st & 8th)	92.0	(24th & 25th)	92.6
DM/$	1.7920	1.8035	(9th)	1.7130	(24th)	1.7395
Yen/$	125.60	126.00	(9th)	120.75	(24th)	122.12

*cob = close of business.

With attention focused on the dollar, sterling enjoyed a quiet month until UK interest rates were raised on 25 November. In common with other currencies, the pound improved steadily against the dollar after the month's low had been seen in the immediate aftermath of the US election but initially failed to keep pace with the deutschemark and the cross-rate drifted down. Sterling remained on the sidelines until it was immediately marked down to $1.8125 and DM3.1200 on news of a record UK trade deficit for October. However, as UK base rates were raised 1%, the pound advanced strongly, fuelled by a belief in the markets that the Government was pursuing a high exchange rate policy, despite official denials. It reached highs of $1.8515 and DM3.2155 on the 30th but following the Chancellor's appearance before the TCSC, sterling ended the month on a slightly easier note.

Sentiment for the US currency remained very bearish, despite persistent reports of central bank support. However, the dollar was boosted by unexpectedly strong US employment data for October and by anticipation of a Republican victory in the US election. Having reached highs for the month in the Far East when the election result became clear, the dollar then fell sharply. Amid market uncertainty about the incoming administration's intentions towards the dollar and the fiscal deficit, selling pressure intensified and the dollar drifted down to the month's lows on the 24th. On the 28th most US banks raised their prime rates by ½%, fuelling speculation of an imminent discount rate rise and the dollar rose slightly. It later steadied at these levels as markets awaited November employment data due on 2 December.

Previous reserve changes

(i) Reserves levels at key dates:

$ million

End-period	Level of reserves at end-period
Labour	
End-December 1976 (Low)	4,129
End-March 1979 (High)	21,947
Conservative	
End-March 1985 (Low)	13,528
End-November 1988 (High)	51,040
Recent levels	
End-December 1986	21,923
End-December 1987	44,326

(ii) Recent reserve changes:

		Underlying change	Total change	Level of reserves at end period ($ million)
1987	November	+ 31	- 118	41,281
	December	+ 3,737	+ 3,045	44,326
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519*
	April	+ 514	+ 338	47,857
	May	+ 814	+ 676	48,533
	June	+ 84	- 14	48,519
	July	+ 910	+ 1,307	49,826
	August	+ 827	+ 813	50,639
	September	- 143	- 157	50,482
	October	+ 1,124	- 434	50,048
	November	+ 428	+ 992	51,040
Total since November 1987		+10,564	+ 6,762	
Totals since December 1987		+ 6,796	+ 3,835	

*after revaluation of + $2,879 million.

(iii) Underlying rise in reserves in 1987 totalled $20,475 million.

(iv) October 1987 underlying change of $6,699 million was largest ever.

(v) Reserves in November of $51,040 million are highest ever.

Level of official debt

Latest published figure, $16.7 billion at end July* in Bank of England Quarterly Bulletin November 1988, Table 17.2. But among other items, subsequently repaid $2.5 billion floating rate notes and borrowed around $2 billion in Ecus. (In May 1979 debt outstanding was $22 billion.)

*at end July market rates.

UK Ecu Treasury Bills

(i) Second tender held 8 November oversubscribed at all three maturities. Ecu 750 million of Bills on offer allotted in full.

(ii) Third tender will be held on Tuesday, 13 December. Details of amounts and maturities of Bills to be offered will be announced at 2.30 pm on Tuesday, 6 December.

POSITIVE

1. Reserves at record levels. Now stand at $51 billion, compared with $22 billion in May 1979.

1. Level of official debt has been reduced substantially.

Level at end-period		$ billion
May	1979	22.0
December	1986	19.3
December	1987	19.1
July	1988	16.7*

* latest published figure

2. Second tender of new ECU Treasury Bills was again very encouraging. Tender oversubscribed at all maturities (1, 3 and 6 months) and Bills on offer allotted in full. Bills issued at favourable price, 3/16 to ¼ per cent below LIBID.

DEFENSIVE

(A) POLICY

1. **Exchange rate policy:** Exchange rate an important consideration in formulating monetary policy but not overriding one. A firm exchange rate assists in the battle against inflation.

2. **Government views on future course of exchange rate?** Government does not want to see sharp upsurge in exchange rate. But in view of strength of economy and need to exert adequate discipline on wage settlements, concluded a very slightly higher exchange rate appropriate.[Chancellor at Treasury and Civil Service Committee (TCSC) hearing on 30 November.]

3. **Government abandoned policy of exchange rate stability?** Objective is to avoid depreciation of sterling but sharp rise (such as dollar underwent between 1982 and 1985) would also be highly undesirable.

4. **Is Government now deliberately seeking to raise both exchange rate and interest rates?** [Article, "Sunday Times", 27 November]

No. 25 November, interest rate increase not designed to push sterling up against other currencies but to dampen domestic demand.

5. **Government raised interest rates to prevent sterling collapse?** No. Government's strong fiscal stance and commitment to firm monetary policy will retain market confidence in sterling. But repeatedly made clear that will not pursue policy of exchange rate depreciation to accommodate higher inflation.

6. **Sterling one-way bet if interest rates remain high?** No. Nothing in financial markets ever one-way bet.

7. **Current account deficit will diminish confidence in sterling?** No reason why it should. As Chancellor told House on 29 November, sterling is strong and he is determined it shall stay so for indefinite future. Government's strong fiscal stance and commitment to firm monetary policy will retain market confidence.

8. **"Hot money" rather than long term investment financing current account deficit?** In today's global market, difficult to tell what is short term and what is long term, what is "hot money" and what is not. What matters is whether or not conditions within country make it hospitable home for investment. Depends on whole framework of economic policies, not just short-term interest rates. Government's strong fiscal stance and commitment to firm monetary policy well understood by markets.

[illegible]. **Current account position means Government should let exchange rate fall?** [Chancellor said in IMF speech, 28 September, "The exchange rate cannot be assigned the task of balancing the current account, and it is a mistake to think that the automatic response to a current account deficit should be a lower exchange rate."]

Policy of depreciation would be wholly inappropriate. Present deficit is associated partly with high investment spending by private sector and partly with over-rapid rise in domestic demand, not with public sector deficit. Private investment is adding to productive capacity, which will boost exports and displace imports in future. Interest rate rises since summer will rein back domestic demand.

10. **Will Government allow exchange rate to fall to ease pressure on industry?** [Chancellor said in speech to CBI Council on 23 November, "As far as pay and the economy is concerned, the position is very clear. I am not prepared to accommodate inflationary pressures generated by high pay increases. That means that I shall not allow the exchange rate to depreciate, to bail out British firms who do not keep their costs under control".]

No. Will not permit exchange rate to depreciate to accommodate inflation. Holding down unit costs - which is in industry's own hands - key to improved competitiveness.

11. **How is "depreciation" defined?** As Chancellor indicated in "Financial Times", 10 November, clear difference in practice between normal market fluctuations and sterling taking dive.

12. **Is Government targeting £/DM, £/$ or £ERI?** Never focus exclusively on single indicator when setting monetary policy. Exchange rate is one of these indicators but look at various measures of level of sterling.

13. **Government chosen to raise interest rates rather than intervene?** False dichotomy. Intervention primarily short-term instrument; not designed to tackle underlying problem of excessive growth in domestic demand.