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

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DRAFT PRESS NOTICE

THE RESERVES IN AUGUST 1988

The UK official reserves rose by $813 million in August of which US and Canadian dollar receipts from second call of BP shares amounted to $495 million. Repayments of borrowing under the exchange cover scheme amounted to $14 million. There was no borrowing under the exchange cover scheme this month. After taking account of the repayments of foreign currency borrowing, the underlying change in the reserves during August, including the BP receipts was a rise of $827 million. At the end of August, the reserves stood at $50,639 million (£30,124 million*) compared with $49,826 million (£29,112 million+) at the end of July.

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).

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* When converted at the closing market rate on Wednesday 31 August £1=$1.6810

+ When converted at the closing market rate on Friday 29 July £1=$1.7115

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

Electricity Council, $6 million; British Railways Board, $2 million; South of Scotland Electricity Board, $2 million; Northern Ireland Department of Finance, $1 million; West Midlands County Council, $1 million; Others, $2 million.

THE RESERVES IN AUGUST 1988 : PRESS BRIEFING

Factual : Main features of markets in August

	1 August (cob)*	Month's High		Month's Low		31 August (Cob)*
£ ERI	76.6	77.1	(16th)	75.5	(26th)	75.8
$/£	1.7127	1.7350	(16th)	1.6725	(25th)	1.6810
DM/£	3.2142	3.2425	(10th)	3.1350	(26th)	3.1573
$ ERI	98.7	100.6	(10th)	98.6	(2nd/3rd)	100.2
DM/$	1.8767	1.9250	(10th)	1.8565	(2nd)	1.8782
Yen/$	132.80	136.77	(31st)	131.50	(16th)	136.62

*cob = close of business.

Sterling made a very steady start to the month helped by overseas investment. It lost ground against the dollar following strong US employment data and an increase in the Fed's discount rate (falling to $1.6827 on 9 August), balanced by gains against the deutschemark, reaching the month's high on 10 August following an unexpected 1/2% increase in UK base rates on 8 August. Strong July retail sales and weak industrial production figures prompted some selling, but sterling made a swift recovery and, following release of US trade figures for June, it touched the month's high against the dollar on 16 August. Publication of UK Balance of Payments 1988, which showed Britain's 1987 current account deficit revised up by nearly £1bn and a £24bn fall in net overseas assets, caused sterling to fall and, following release of July UK trade figures on 25 August showing a record current account deficit of £2.15bn, it fell further touching the month's lows on 25/26 August. It was however steadied on 25 August by a 1% increase (to 12%) in UK base rates and since then has recovered a little in quiet trading conditions.

Buoyed by the prospect of rising US interest rates, the dollar began the month bullishly, rising significantly after US employment data were published on 5 August. These figures were interpreted as signs of strong US economic growth and confirmation that US interest rates would have to rise soon in

order to control inflation. After a 1/2% increase (to 6½%) in the Fed's discount rate on 9 August the dollar reached highs of DM1.9250 (its best level since January 1987) and Yen 135.10 on 10 August. However, following a warning from Stoltenberg of the problems for the trade deficit of a higher dollar the dollar fell despite a 1/2% rise (to 10%) in US prime rates. On release of figures showing a US trade deficit of $12.5bn in June the dollar fell abruptly to DM1.8600 and Yen 131.50 on 16 August. However, it recovered helped by the general underlying strength of the US economy and with a Bush opinion poll lead over Dukakis, it reached DM1.9215 on 22 August despite reports of concerted central bank intervention. In the wake of further reports of central bank sales and a round of interest rate increases in Europe the dollar drifted lower. However, it advanced strongly against the yen when the Bank of Japan stated that it would not raise its discount rate and ended the month on firm note.

Previous reserve changes

(i) At beginning of January 1987, reserves stood at $21,923 million; at end of December 1987, they stood at $44,326 million, a rise of $22,403 million (<u>including</u> 1987 revaluation of + $2,879 million).

(ii) The <u>underlying</u> rise in reserves in 1987 totalled $20,475 million.

(iii) Reserve changes from beginning of 1988 have been:

		Underlying change	Total change	Level of reserves at end period ($ million)
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
	Totals	+ 5,387	+ 3,434	

+after revaluation of + $2,879 million.

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

(v) Reserves in August of $50,639 million are highest ever.

Level of official debt

Now stands at $16.7 billion at end July*. Latest published figure, $17.3 billion at end April in Bank of England Quarterly Bulletin, August 1988, Table 17.2. (In May 1979 was $22 billion.)

*at end July market rates.

POSITIVE

1. Reserves remain very strong. Now stand at record level of $51 billion.

2. Level of official debt has been reduced substantially. At beginning of 1987 was $19.3 billion and at end of July 1988 was $16.7 billion. (In May 1979 was $22 billion.) Government announced on 2 August intention to repay early the US $2.5 billion floating rate notes first issued in September 1985. Repayment will be made on 7 October 1988.

DEFENSIVE

(A) POLICY

1. **Exchange rate policy:** Government maintaining firm monetary policy to ensure downward pressure on inflation. Exchange rate policy is part of total economic policy. Government uses available levers, both interest rates and intervention, to affect rate as seems right in circumstances.

2. **Abandoned managed floating ideas?** No. But requires international agreement. Moreover, always made clear first priority must be defeat of inflation. Budget Speech etc. Normally will not be any conflict between domestic and external criteria. And exchange rate significantly lower than May peak. Within context of anti-inflationary strategy, policy remains to seek to achieve reasonable exchange rate stability.

3. **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.

4. **Is Government targetting sterling - deutschemark, sterling - dollar rate/sterling exchange rate index (£ERI)?** Not helpful to talk about any particular level/rate.

5. **Current account position means Government should let exchange rate fall?** No. Made it clear time and time again that Government will not accommodate inflation by exchange rate depreciation. Holding down unit costs - which is in industry's own hands - key to improved competitiveness.

6. **International monetary co-ordination not working?** International cooperation is alive and well, as recent events have shown.

7. **Were recent international interest rate rises coordinated?** G7 ministers keep in close touch with each other.

(B) **INTERVENTION**

8. **Why an underlying rise in reserves after fall of sterling last week?** Never discuss details of intervention but remember figure include BP proceeds.

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

10. **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.

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

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

13. **Have Bank been selling dollars for deutschemarks?** Never discuss detailed reserves transactions.

(C) INTEREST RATES/MONETARY POLICY

See also separate Q and A briefing on interest rate rise provided to IDT etc on 25 August.

14. **Monetary policy**: [Policy recently stated by Chancellor to Institute of Economic Affairs, 21 July.]

Ultimate objective of stable prices stands. Abolition of various controls within financial system, well justified on merits, has made it difficult to rely solely on monetary targets; inevitably places more weight on exchange rates. Short term interest rates essential instrument of monetary policy.

15. **Why raise interest rates when exchange rate against deutschemark so high? Interest rates now set on purely domestic criteria?** Aim was to achieve further monetary tightening (continuing process begun in February) taking account of all monetary indicators including the exchange rate (and not just sterling/deutschemark exchange rate).

(D) **EUROPEAN MONETARY INTEGRATION**

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

17. **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.

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

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

20. Proposals for European Central Bank and common European 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 practical developments. UK's new ecu Treasury Bill programme good example of what can be done.

(E) GOVERNMENT FOREIGN CURRENCY BORROWING PROGRAMME AND FORWARD PURCHASES

[NB Avoid any reference to forward book.]

See also separate Q and A briefing on FRN prepayment and ECU bill programme provided to IDT etc on 1 August 1988.

21. **When will further details be available for new UK ECU Treasury Bills?** Full details will be provided by Bank of England later this month.

22. **Is repayment of 1992 debt and refinancing by short-term bill programme sensible in view of recent events?** Reserves at record level of $51 billion (increased by $2.2 billion in last two months). Decision made as part of overall reserves management. New ECU bill programme will be secure and flexible source of funds.

23. **Have authorities bought forward currency other than that required to prepay FRN?** Never comment on operations in markets. [But National Audit Office (NAO) report published in January noted MOD now makes forward purchases of deutschemarks and dollars from Bank.]

24. **How much currency have authorities bought forward?** No comment.

25. **How long have authorities been buying currency forward?** No comment.

26. **Have forward purchases been used to ease pressure on sterling?** No comment.

27. <u>Have forward purchases distorted underlying change in reserves</u>? Never comment on market operations. But in any case wrong to assume underlying change reflects market intervention in month; as Government has always made clear.

(F) **SALE OF BP SHARES**

28. **Why are you only receiving dollars and Canadian dollars from the overseas element of second call of the BP share issue?** Receipts cover partly paid BP shares in American Depositary Receipts (ADR) form held in US and Canada payable in dollars and Canadian dollars on 30 August. (An ADR is a certificate traded in dollar form, quoted and paid for in dollars representing an entitlement to securities in non-dollar currencies).

29. **Why aren't sales to Europe and Japan included?** Paid in sterling.

30. **Have previous privatisation issues with an overseas element added to level of Reserves?** Yes, in these cases where share issues made overseas were paid for in foreign currency eg British Gas, British Airways and British Telecommunications Plc.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month		Level at end of month
USA	+ 2.8	(end July)	44
Japan	+ 1.2	(end July)	89
Germany	- 4.7	(w/e 19 August)	40
France	- 3.6	(end June)	64
Italy	+ 1.9	(end July)	57
Canada	- 0.9	(end July)	15
United Kingdom	+ 0.8	(end August)	51

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: C J JARVIS
DATE: 31 AUGUST, 1988

MR MOORE

cc Mr Monck
Mr Peretz
Mrs Brown
Mr Bent OR

BP SECOND INSTALMENT: US DOLLAR PAYMENTS

Morgan Guaranty, who are responsible for the collection and payment to us of the second instalment on BP ADRs (American Depositary Receipts), told us this morning that they would be paying us some $494 million in respect of second instalments on ADRs rather than $611 million, as they had originally told us. After some discussion they satisfied us that $494 million was the correct sum, and they have now paid it into the Bank of England's account at the Federal Reserve Bank in New York. When the payment of CAN $1.7 million is added, this gives a total foreign curency payment on the BP second instalment of US $495 million.

2. Morgan Guaranty's miscalculation has caused inconvenience to both the Bank and to MG here, who used the larger sum in their calculation of the Reserves. We had questioned their figure when they first gave it, because it was larger than we expected, but we had no means of checking it because the number of ADRs in circulation, and therefore the Dollar ammount due on them, fluctuates from day to day. We therefore had to rely on Morgan Guaranty's calculations.

3. We have pressed Morgan Guaranty for an explanation of the error and they have offered the following account. ADRs are paper certificates, like share certificates, and are backed by ordinary shares. The ADR agents (Morgan Guaranty) can also issue new ADRs in exchange for ordinary shares. They therefore keep a substantial stock of ADR certificates ready for issue but not yet backed by shares and therefore of no value. Therefore, no second instalment was due on these paper ADRs. In their initial calculation of the ammount due to us, however, Morgan Guaranty included these ADRs. Thus they arrived at a much higher figure for the second instalment than that actually owed on the ADRs in circulation.

4. Morgan Guaranty have apologised for their error, and they are well aware of its significance and of our displeasure. They have offered to answer any further questions we have about the matter. I do not think that any further action is necessary at this stage, though you may wish to consider writing to Morgan Guaranty when the collection of the second instalment has been completed.

C J JARVIS

FROM: M H WHEATLEY
DATE: 9 September 1988

MISS O'MARA

cc: Mr N P Williams

D2

STERILISATION OF INTERVENTION

You asked (your manuscript note of 8 September) why the short term sterilisation of intervention through sales of Treasury Bills did not constitute full sterilisation for funding purposes.

2. As I understand it, the operations through Treasury Bills, while they X/ sterilise the monetary base, do not sterilise liquidity in a wider sense. The intervention must therefore be funded in the longer term by sales of gilts to keep liquidity constant as far as possible. This is analogous to the way that the PSBR is funded through sales of gilts to the non-bank private sector, while Treasury bills do not count for funding purposes.

3. I suspect that this does not go into all the ins and outs of the matter (and Mr Williams may have something to add). I can research this all in more detail if you wish.

Martin H. Wheatley

M H WHEATLEY

Mr Wheatley
I certainly don't want a major exercise. This is what I understood but
a) it's what X actually means that I don't really understand
b) do we regard all gilts with under 1 year to run as outside "proper" funding?
c) for National Savings, is the Ordinary Account out but everything else in?

MOM 9/9

Ms Dodding

Could you give MOM a "tutorial" on sterilisation? MW

FROM: G J J YOUNG

DATE: 28 September 1888

MR PERETZ

cc Mr Grice
Miss O'Mara

PROFITABILITY OF INTERVENTION - PAPER FOR NAO

I attach a first attempt at my sections of the paper for the NAO. This covers sections d, e and f of the draft circulated at your meeting. Much of the material is copied from the relevant papers on the file. I would be grateful for comments and suggestions to arrive soon enough for me to have prepared and circulated a second draft before you go on your training course.

GARRY YOUNG

54|90

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PROFITABILITY OF INTERVENTION - PAPER FOR NAO

1. In spite of the difficulties in defining profitability, we have been developing measures for management purposes. The overall objective is to assess the total sterling return earned on the EEA and to divide that total into the contribution made from the different types of decisions involved.

2. The total sterling return on the EEA is assessed as reflecting decisions in four separate areas:

(i) the total switch to date between sterling and foreign currencies (the intervention decision);

(ii) the distribution across currencies of net foreign currency assets (the currency mix decision);

(iii) the net exposure to fixed income markets in each currency (the strategic interest rate decision); and

(iv) active versus passive management in each category of marketable asset (the active investment management decision).

3. The total sterling return is then allocated among these categories. To the extent that each of the decisions is independent of the other, this allocation of returns has the merit of allowing decision makers to see their own contribution to overall profitability as well as promoting a rigorous monitoring procedure for management purposes. However, it should be stressed that profitability is not the sole objective of any of these activities.

4. The basic objective of intervention is to stabilize the value of the currency so as to reduce uncertainty and promote international trade. The objective here is not to maximize profitability although to the extent that successful intervention requires selling sterling when it is expensive and buying

sterling when it is cheap profitability may be a by-product of a successful intervention strategy. The decisions with regard to currency mix and investment attempt to achieve a profitable outcome but at the same time ensuring that the account is not exposed to an excessive amount of risk.

5. The background to this decision making process is that a group meets at six-monthly intervals to evaluate previous decisions and recommend a course of action for the subsequent six month period. This typically takes the form of a contingency plan which details the foreign currency and investment positions that should be taken as currency values and yields change. Underlying this plan is a particular view of the world economic and political situation. Given the uncertainty surrounding any assessment of global conditions and the length of the planning horizon it is sensible to regard the recommendations of the group as provisional and liable to be revised. The group takes account of the latest information relevant to world currency and capital markets and also the latest forecasts prepared by the Bank and Treasury. It also has to be aware of the riskiness of any loans or deposits it authorises.

6. A crucial element in the process of managing the EEA is the calculation of the total sterling return and its attribution to the four distinct activities described earlier. The calculations are based on a sterling balance sheet for the EEA comprising foreign currency assets (spot and forward) matched by both HMG and ECS foreign currency of the EEA's surplus of foreign currency assets over liabilities. The basic calculation is to value the EEA's total assets at the end of each month at current market prices and exchange rates. This requires the valuation of every investment at a current market price and then the conversion of the total of these valuations in each currency to sterling at current exchange rates. After allowing for flows occurring during the month, a comparison before the end month valuation and the valuation at the end of the previous month produces the capital gain on the reserves. Interest accruing on assets and liabilities needs also be taken into account. Interest on the sterling liabilities which are the counterpart of the EEA's surplus of

foreign currency assets over liabilities is based on a sterling commercial bill rate of interest.

7. There are a number of points which might be made about this method of measuring the profitability of reserves as a whole.

8. Firstly, this represents an attempt to measure the profitability of reserves management not just intervention which is only one of the activities affecting the reserves.

9. Secondly, by taking account of both sides of the balance sheet this measure provides a better picture of overall profitability than do measures based solely on the asset side of the balance sheet. The latter method was used by the Treasury and Civil Service Committee in their report [ ].

10. Thirdly, the sterling liabilities which are the counterpart of the EEA's surplus of foreign currency assets over liabilities do not actually exist. Rather, this represents the amount of sterling that would be raised if the assets and liabilities of the EEA could be liquidated at current prices. This provides a measure of the sterling net worth of the EEA and the notional interest on this gives a measure of the sterling return which would be obtained if the sterling value of the EEA were invested in the sterling markets. This "opportunity cost" must be taken into account to ensure that the actual investments of the EEA are not underperforming relative to what could be obtained in the sterling money markets.

11. Fourthly, and parenthetically, sterling flows into and out of the account are recorded as and when they occur for National Account purposes. In contrast to practice in some countries, eg Germany, any outflows from the account are seen as financing rather than reducing the PSBR.

12. Fifthly, this method suffers from the same shortcomings as the approach used formerly and outlined in the BEQB in 1983. That is, it values positions before profits have been realised and

implicitly assumes that positions can be closed at prevailing exchange rates.

13. The table below shows the total sterling return on the EEA over the period [ ].

Total sterling return on EEA

(£m)

1986	1987	1988H1
[ ]	[ ]	[ ]

14. To measure the return from the EEA's currency positions, it is assumed that the EEA earns a short interest rate on net foreign currency assets and has to pay a comparable sterling rate on its sterling short position. These counterfactual assumptions are made so as to enable currency decisions to be separated from investment decisions.

15. The profitability of currency decisions is subdivided into the profitability of the currency mix and the profitability of intervention. In order to measure the profitability of intervention the currency mix is assumed to be constant and it is assumed that the actual aggregate value of the net foreign currency portfolio is held in the pre-specified proportions. Changes in this value from month to month measure the profitability of intervention. The remaining profitability of currency decisions is attributed to decisions made about the currency mix.

16. The central difficulty here is in deciding on the numbers that are adopted for the neutral mix of net currency assets. This is bound to be somewhat arbitrary but it should be noted that this choice does not affect the calculation of the total return on the reserves nor of the total return to currency decisions, it only affects the calculations of the split between the part identified as resulting from intervention decisions and the part identified as resulting from currency mix decisions.

17. At present it is assumed that a neutral mix of net currency assets is a mix of dollars, deutschemark bloc currencies and yen in the ratio 40:40:20. This is a fairly realistic assessment of a diversified foreign currency portfolio.

18. This produces the following returns to intervention and currency mix decisions.

The Return on Currency Exposures: 1985 H2 - 1988H1

(£m)

	1985H2	1986	1987	1988H1
Total Return	+ 390	+ 420	- 440	+ 40
Intervention Component	- 10	- 140	- 480	- 20
Currency Mix Component	+ 400	+ 560	+ 40	+ 60

19. The measurement of the return to investment decisions and active management is relatively straightforward. The return to investment decisions is measured for each fixed income market, each leg of which is evaluated in isolation both from other legs and from the currency strategy described earlier.

20. Net exposures in each fixed increase market are described by converting assets and liabilities into an equivalent amount of a standard 4-year security. The measure of profitability makes the realistic assumption that any excess of assets over liabilities in a particular currency in financed by borrowing at interbank rates. The figures then include the income earned from owning securities as well as the effect on security valuations of yield changes over the period.

Strategic Interest Rate Exposure Returns

($mn)

	1988Q1	1988Q2
Total returns on assets	241	- 5
Total returns on liabilities	225	+ 3
	+ 16	- 2

21. Finally the profitability of active management of the EEA portfolio is measured by comparison of the returns with a benchmark portfolio. Benchmark portfolios are notional portfolios of actual securities which mirror the desired objectives of the EEA for liquidity and credit risk.