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

Reference MG-MAMC/D/0002/001

File begins 11/09/1987

File ends 23/12/1987

Pages 140-162

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16/12

From : D L C Peretz
Date : 15 December 1987

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CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Miss O'Mara
Ms Goodman
Mr Cropper

Ms Ryding

**DECEMBER RESERVE FIGURE**

Although it may seem somewhat early in the month, we need to begin to think about what figure to publish for the underlying increase in the December reserves. There are not that many effective dealing days left before the end of the month, and the market for swaps may become a little thin before Christmas and in the one available dealing day after Christmas.

2. The "true" position at present suggests an underlying increase over the month of around $4½ billion, assuming no further intervention. However there is a (final) "catching up" forward deal (broadly half in DM, half in dollars) to be carried out for MOD, which we are hoping to do this month. That would reduce the true underlying increase to around $3¾ billion.

3. I have discussed this both with the foreign exchange and gilt-edged sides of the Bank of England. Both markets are expecting a fairly large figure; it is common knowledge that we have been intervening reasonably substantially this month. We doubt whether a figure of $3½-4 billion would come as a surprise. The announcement (4 January) will be in the run up to the 14 January gilt auction : but we think a substantial figure will simply help to explain why we are pressing ahead with funding.

4. As to whether the figure published will raise new questions about the profitability of intervention, I think that in our exchanges with the TCSC we have now managed to muddy the waters sufficiently to make this less of a worry.

5. Starting with a bias towards honesty, my inclination would be to aim for a figure somewhere above $3½ billion but below

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$4 billion. I think it is just worth trying to avoid a four figure number starting with a 4. This would make it the third largest monthly increase published in 1987. (Previous large figures are $2.9 billion in April, $4.8 billion in May and $6.7 billion in October).

6. Obviously if there are any developments over the next few days we can think again. But subject to your views I would like to give the Bank provisional guidance on these lines.

D L C PERETZ

DM 2

MS GOODMAN

FROM P EDMONDS
DATE 16 DECEMBER 1987

cc Mr Matthews
Ms Symes
Mr Holgate
Mr Nelson
C/2

DMARK EXCHANGE RATE

You asked Ms Symes for figures on the DM/Sterling real exchange rate that might throw some light on Bryan Gould's puzzling reference that "the real exchange rate as against the DMark has risen in this country since September last year well into double figures." She asked me to reply, and I enclose series for

a) the nominal exchange rate
b) the real exchange rate index, 1980 = 100
c) the real exchange rate before indexation, ie the nominal exchange rate multiplied by the ratio of price indices.

2. Between September 1986 and September 1987 the real exchange rate deflated by producer prices appreciated by 2.5%, and the appreciation from September 1986 to November 1987 will probably be in the range 2.5% - 3.5%. The last two figures in the series are of course forecasts and subject to revision.

3. From looking at the index, the series before indexation, and the appreciation since September 1986, I cannot find a measure that fits Mr Gould's remarks. I hope this minute and the attached series are helpful.

P. Edmonds

P EDMONDS

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Dm/Sterling Exchange Rates

| | Nominal Exchange Rate | Real Exchange Rates: Index 1980=100. | Real Exchange Rates: Not Indexed |
|---|---|---|---|
| 1976M1 | 5.27900 | 84.4869 | 3.57386 |
| 1976M2 | 5.18800 | 83.5094 | 3.53252 |
| 1976M3 | 4.97600 | 80.5081 | 3.40556 |
| 1976M4 | 4.68600 | 76.3628 | 3.23021 |
| 1976M5 | 4.63100 | 76.3143 | 3.22816 |
| 1976M6 | 4.54700 | 75.3320 | 3.18661 |
| 1976M7 | 4.59900 | 76.6334 | 3.24166 |
| 1976M8 | 4.51100 | 76.1017 | 3.21917 |
| 1976M9 | 4.31100 | 73.8516 | 3.12399 |
| 1976M10 | 3.98300 | 69.6146 | 2.94476 |
| 1976M11 | 3.94800 | 70.0256 | 2.96214 |
| 1976M12 | 4.00200 | 71.7490 | 3.03504 |
| 1977M1 | 4.10200 | 75.0895 | 3.17635 |
| 1977M2 | 4.11200 | 75.8160 | 3.20708 |
| 1977M3 | 4.10700 | 76.0412 | 3.21661 |
| 1977M4 | 4.08000 | 76.7034 | 3.24462 |
| 1977M5 | 4.05200 | 77.1733 | 3.26449 |
| 1977M6 | 4.04800 | 78.0702 | 3.30244 |
| 1977M7 | 3.93400 | 76.8174 | 3.24944 |
| 1977M8 | 4.02800 | 79.3702 | 3.35743 |
| 1977M9 | 4.05000 | 80.3459 | 3.39870 |
| 1977M10 | 4.03200 | 80.4206 | 3.40186 |
| 1977M11 | 4.07300 | 81.5488 | 3.44958 |
| 1977M12 | 3.98700 | 80.3455 | 3.39868 |
| 1978M1 | 4.09500 | 83.5409 | 3.53385 |
| 1978M2 | 4.02800 | 82.7133 | 3.49884 |
| 1978M3 | 3.88000 | 80.0123 | 3.38459 |
| 1978M4 | 3.77700 | 78.4173 | 3.31712 |
| 1978M5 | 3.82800 | 79.9081 | 3.38018 |
| 1978M6 | 3.83000 | 80.3573 | 3.39918 |
| 1978M7 | 3.89200 | 82.2791 | 3.48047 |
| 1978M8 | 3.87300 | 82.3923 | 3.48526 |
| 1978M9 | 3.85900 | 82.6076 | 3.49437 |
| 1978M10 | 3.69300 | 79.4469 | 3.36067 |
| 1978M11 | 3.73200 | 80.3126 | 3.39729 |
| 1978M12 | 3.73100 | 80.5147 | 3.40584 |
| 1979M1 | 3.70800 | 80.6530 | 3.41169 |
| 1979M2 | 3.72000 | 80.8636 | 3.42060 |
| 1979M3 | 3.79000 | 82.2524 | 3.47934 |
| 1979M4 | 3.92600 | 85.6721 | 3.62400 |
| 1979M5 | 3.92600 | 86.2106 | 3.64678 |

| | | | | |
|---|---|---|---|---|
| 1979M6 | . | 3.97700 | 88.1725 | 3.72977 |
| 1979M7 | . | 4.12200 | 91.7494 | 3.88108 |
| 1979M8 | . | 4.09500 | 91.4740 | 3.86943 |
| 1979M9 | . | 3.94900 | 88.5349 | 3.74510 |
| 1979M10 | . | 3.83600 | 86.5921 | 3.66292 |
| 1979M11 | . | 3.78100 | 85.7372 | 3.62675 |
| 1979M12 | . | 3.81300 | 86.7633 | 3.67016 |
| 1980M1 | . | 3.90700 | 89.4286 | 3.78290 |
| 1980M2 | . | 4.00100 | 91.8985 | 3.88738 |
| 1980M3 | . | 4.08100 | 94.6260 | 4.00276 |
| 1980M4 | . | 4.14200 | 96.9366 | 4.10050 |
| 1980M5 | . | 4.12500 | 97.2236 | 4.11264 |
| 1980M6 | . | 4.12800 | 97.7815 | 4.13624 |
| 1980M7 | . | 4.14500 | 98.6718 | 4.17390 |
| 1980M8 | . | 4.24200 | 101.281 | 4.28425 |
| 1980M9 | . | 4.29700 | 103.304 | 4.36983 |
| 1980M10 | . | 4.45000 | 107.186 | 4.53405 |
| 1980M11 | . | 4.59300 | 110.403 | 4.67016 |
| 1980M12 | . | 4.62000 | 111.260 | 4.70640 |
| 1981M1 | . | 4.82900 | 116.500 | 4.92803 |
| 1981M2 | . | 4.92100 | 118.701 | 5.02114 |
| 1981M3 | . | 4.70300 | 114.491 | 4.84305 |
| 1981M4 | . | 4.70700 | 115.199 | 4.87302 |
| 1981M5 | . | 4.79300 | 117.281 | 4.96110 |
| 1981M6 | . | 4.69100 | 114.767 | 4.85474 |
| 1981M7 | . | 4.57700 | 111.548 | 4.71856 |
| 1981M8 | . | 4.55800 | 110.659 | 4.68096 |
| 1981M9 | . | 4.27900 | 104.347 | 4.41396 |
| 1981M10 | . | 4.14500 | 101.897 | 4.31034 |
| 1981M11 | . | 4.23700 | 104.518 | 4.42122 |
| 1981M12 | . | 4.30000 | 106.534 | 4.50646 |
| 1982M1 | . | 4.32600 | 107.217 | 4.53539 |
| 1982M2 | . | 4.37200 | 109.008 | 4.61112 |
| 1982M3 | . | 4.29900 | 107.831 | 4.56133 |
| 1982M4 | . | 4.24200 | 106.549 | 4.50712 |
| 1982M5 | . | 4.18300 | 105.140 | 4.44751 |
| 1982M6 | . | 4.26500 | 106.533 | 4.50642 |
| 1982M7 | . | 4.27700 | 107.083 | 4.52971 |
| 1982M8 | . | 4.27700 | 107.259 | 4.53714 |
| 1982M9 | . | 4.28800 | 107.976 | 4.56749 |
| 1982M10 | . | 4.29300 | 108.175 | 4.57589 |
| 1982M11 | . | 4.17300 | 105.415 | 4.45913 |
| 1982M12 | . | 3.91900 | 99.6708 | 4.21616 |
| 1983M1 | . | 3.75900 | 96.1630 | 4.06777 |
| 1983M2 | . | 3.71700 | 95.6516 | 4.04614 |
| 1983M3 | . | 3.58900 | 93.1389 | 3.93985 |
| 1983M4 | . | 3.76200 | 98.1455 | 4.15164 |
| 1983M5 | . | 3.87900 | 101.680 | 4.30116 |
| 1983M6 | . | 3.94800 | 103.462 | 4.37652 |
| 1983M7 | . | 3.95400 | 103.610 | 4.38279 |
| 1983M8 | . | 4.01500 | 104.633 | 4.42607 |
| 1983M9 | . | 3.99800 | 104.581 | 4.42384 |
| 1983M10 | . | 3.89600 | 102.138 | 4.32052 |
| 1983M11 | . | 3.96500 | 104.258 | 4.41019 |
| 1983M12 | . | 3.94400 | 103.841 | 4.39257 |
| 1984M1 | . | 3.95800 | 104.327 | 4.41310 |
| 1984M2 | . | 3.88900 | 102.880 | 4.35190 |

| | | | | |
|---|---|---|---|---|
| 1984M3 | . | 3.78100 | 101.012 | 4.27289 |
| 1984M4 | . | 3.76000 | 101.267 | 4.28367 |
| 1984M5 | . | 3.81900 | 102.990 | 4.35656 |
| 1984M6 | . | 3.77200 | 101.800 | 4.30620 |
| 1984M7 | . | 3.76100 | 101.558 | 4.29597 |
| 1984M8 | . | 3.79100 | 102.533 | 4.33724 |
| 1984M9 | . | 3.80800 | 103.015 | 4.35761 |
| 1984M10 | . | 3.74400 | 101.456 | 4.29167 |
| 1984M11 | . | 3.71400 | 101.018 | 4.27317 |
| 1984M12 | . | 3.68900 | 100.551 | 4.25339 |
| 1985M1 | . | 3.57700 | 97.4820 | 4.12357 |
| 1985M2 | . | 3.60800 | 98.4881 | 4.16613 |
| 1985M3 | . | 3.70100 | 101.521 | 4.29441 |
| 1985M4 | . | 3.83000 | 106.103 | 4.48823 |
| 1985M5 | . | 3.88200 | 107.762 | 4.55841 |
| 1985M6 | . | 3.92300 | 109.162 | 4.61763 |
| 1985M7 | . | 4.01400 | 112.028 | 4.73889 |
| 1985M8 | . | 3.86500 | 108.298 | 4.58110 |
| 1985M9 | . | 3.87100 | 108.501 | 4.58967 |
| 1985M10 | . | 3.75800 | 105.901 | 4.47971 |
| 1985M11 | . | 3.73400 | 105.673 | 4.47006 |
| 1985M12 | . | 3.63200 | 103.515 | 4.37877 |
| 1986M1 | . | 3.47300 | 99.7957 | 4.22144 |
| 1986M2 | . | 3.33500 | 96.8105 | 4.09516 |
| 1986M3 | . | 3.32500 | 97.6960 | 4.13262 |
| 1986M4 | . | 3.40300 | 101.186 | 4.28024 |
| 1986M5 | . | 3.38700 | 101.584 | 4.29707 |
| 1986M6 | . | 3.36900 | 101.150 | 4.27875 |
| 1986M7 | . | 3.24800 | 98.3366 | 4.15972 |
| 1986M8 | . | 3.06600 | 93.0988 | 3.93815 |
| 1986M9 | . | 3.00300 | 91.3549 | 3.86439 |
| 1986M10 | . | 2.86100 | 87.4432 | 3.69892 |
| 1986M11 | . | 2.88400 | 88.4638 | 3.74209 |
| 1986M12 | . | 2.86000 | 88.1027 | 3.72682 |
| 1987M1 | . | 2.79700 | 86.2129 | 3.64688 |
| 1987M2 | . | 2.78500 | 86.4521 | 3.65700 |
| 1987M3 | . | 2.92100 | 90.9168 | 3.84585 |
| 1987M4 | . | 2.95200 | 92.1296 | 3.89716 |
| 1987M5 | . | 2.98000 | 93.1490 | 3.94028 |
| 1987M6 | . | 2.96200 | 92.5864 | 3.91648 |
| 1987M7 | . | 2.97400 | 92.9218 | 3.93067 |
| 1987M8 | . | 2.96700 | 92.7862 | 3.92493 |
| 1987M9 | . | 2.98200 | 93.6032 | 3.95949 |
| 1987M10 | . | 2.99200 | 94.3292 * | 3.99020 * |
| 1987M11 | . | 2.98600 | 94.3659 * | 3.99176 * |

* These real exchange rate values are based on tentative forecasts of the producer price indices for these countries, and will be subsequently revised.

psl/57A

4/1. D2

FROM: A C S ALLAN

DATE: 18 December 1987

MR PERETZ

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Miss O'Mara
Mr Cropper

**INTERVENTION IN ECUs**

The Chancellor would be grateful for advice on the scope for switching as much as possible of our intervention in European currencies into intervention in ecus instead. As he understands it, this would not be contrary to the 1979 EMS agreement.

2. He noted that the Bank managed to purchase a substantial quantity of ecus on the day when we bought a range of European currencies. He wonders whether if we bid for ecus, banks would in practice manufacture them for us. He would be grateful if you could discuss this with the Bank technicians.

A C S ALLAN

Reference

FROM: I. POLIN
DATE: 21 DECEMBER 1987

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MS. GOODMAN }
MR. BUSH } Copy to each

c Mr. Cassell
Mr. Scholar
Mr. Peretz
Mr. Sedgwick
Miss O'Mara
Ms. Ryding
Mr. Holgate
Mr. Nelson

DL

Mr. Gill
Mr. Reid
Mr. Smeeton
Mr. Milne
Miss Plumbly
Mrs. Jupp
} Bank.

THE RESERVES IN DECEMBER 1987

I attach the draft press briefing for the announcement on Tuesday 5 January 1988

2. I have circulated this early as I am about to go on leave and shall not return until Wednesday 30 December. Also, the holidays in-between are fairly lengthy, and therefore I will require comments from recipients earlier than normal.

3. The press briefing is only meant as a

Reference ......................................

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rough first shot, so early in the month. However I would appreciate comments, additions and/or deletions by lunchtime on Thursday 31 December (New Years Eve) at the very latest and preferably prior to that date.

4. A submission to Ministers will be made on Monday 4 January as normal.

5. Please excuse the handwriting and the manuscript changes to the briefing.

Ian Polin

I.C POLIN
MG1 DIVISION
Extn 5556.

CODE 18-77

THE RESERVES IN DECEMBER 1987 : PRESS BRIEFING

Factual : main features of markets in December

| | £ ERI | $/£ | DM/£ | $ ERI | DM/$ | Yen/$ |
|---|---|---|---|---|---|---|
| 1 December | 76.2 | 1.82 | 2.99½ | 95.0 | 1.64¾ | 132¾ |
| 7 December | 75.7 | 1.79½ | 2.99½ | 95.6 | 1.67 | 132¾ |
| 10 December | 76.0 | 1.82½ | 2.99¾ | 94.2 | 1.64 | 129¾ |
| 14 December | 76.1 | 1.84 | 2.9~~4~~9¼ | 93.3 | 1.62½ | 127¾ |
| 21 December | | | | | | |
| 29 December | | | | | | |
| 31 December | | | | | | |

## Previous reserve changes

(i) Reserve changes this year have been:

$ million

| | | Underlying Change | Total Change | Level of Spot Reserves At the end period |
|---|---|---|---|---|
| 1987 | January | + 72 | + 29 | 21,952 |
| | February | + 287 | + 305 | 22,257 |
| | March | + 1785 | + 1892 | 27,039+ |
| | April | + 2912 | + 2768 | 29,807 |
| | May | + 4760 | + 4872 | 34,679 |
| | June | - 230 | - 315 | 34,364 |
| | July | + 499 | + 551 | 34,915 |
| | August | - 457 | - 550 | 34,365 |
| | September | + 380 | + 443 | 34,808 |
| | October | + 6699 | + 6591 | 41,399 |
| | November | + 31 | - 118 | 41,281 |
| | December | | | |
| | Totals | ~~+ 16738~~ | ~~+ 16468~~ | |

+after revaluation

(ii) October's underlying change was the largest ever.

(iii) **Bank Base Rates**

Base rate changes this year 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% |

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POSITIVE

1. Further substantial rise this month. Reserves remain very strong after substantial underlying increase of $ billion in year so far. Reserves now stand at $ billion.

against major currencies ?

2. Apart from recent weakness of dollar, sterling remained comparatively stable since Budget, especially against the deutschemark, despite recent stock market fluctuations.

DEFENSIVE

(A) POLICY

1. **Exchange rate policy for sterling?** Under Louvre Accord on February 20 1987 G7 agreed to seek period of stability in major currencies. Chancellor made clear in Mansion House speech policy of maintaining a stable exchange rate with rate against deutschemark of particular importance. This is consistent with Governments' aim to reduce inflation. Policy has been made clear not merely by Chancellor's statement, but also by what has actually happened.

2. **Prime Minister's FT interview?** Prime Minister was pointing out that we are not at present ERM member and thus not formally tied to DM within a published range.

3. **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 but meanwhile, keeping £/DM rate stable. Exchange rate stability not principally a question of intervention policy, but rather of monetary (interest rate) policy.

4. **Stability against deutschemark deflationary?** Stability against deutschemark is what industry is seeking and in present situation, particularly important that industrial confidence maintained. In 1986, nearly 50% of UK exports went to EC: under 15% to US.

5. **Why is present DM/£ level right?** Industry would not welcome a rise in the rate against the deutschemark nor would it be justified by economic fundamentals.

(B). **LOUVRE/G7/WASHINGTON**

6. **What are current exchange rate bands for dollar?** Not helpful to comment.

7. **Return to Bretton Woods?** No: in his IMF speech Chancellor explicitly spelt out why he was not advocating return to Bretton Woods. In it, defined objective as .... "to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way."

8. **Louvre Accord coming unstuck?** Both US Treasury Secretary Baker and German Finance Minister Stoltenberg have reaffirmed commitment to cooperate on monetary and exchange rate policies. At ECOFIN Council on 16 November EC Finance Ministers reaffirmed importance of Louvre Accord, and agreed to cooperate with other countries in decisions to ensure more stable development of world financial and foreign exchange markets.

9. **Is it US policy to drive the dollar down?** Recent statement by President Reagan [and the White House] indicate US does not want to see further dollar fall. [Reagan 10 November: "I don't want further decline in dollar value."; Fitzwater (White House, 11 December): "US is not seeking a decline in the dollar."]

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10. **Will there be another G7 meeting in the near future to discuss recent market events?** Chancellor said to Welsh CBI on 11 December that there is a need to reach an international agreement to secure further period of exchange rate stability. G7 finance ministers are, of course, in constant telephone communication with each other about recent events.

11. **UK giving up on $?** Re-establishing wider currency stability involves action by US authorities as well as other countries.

12. **How is exchange rate stability to be maintained?** Individual countries clearly need to take action on underlying problems. UK welcomed US budget deficit agreement and called on countries in substantial current surplus on balance of payments to reduce imbalances. Some action already taken (UK, Germans and French and others reduced interest rates on 3 December) but further action needed.

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

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

15. **Aren't you going to make a loss buying dollars in a falling market?** Much to early to tell. Depends on exchange rate at which intervention is unwound (if and when it is). (Stabilising intervention has been profitable in past, although that of course is not reason it is undertaken).

16. **Have other countries been intervening over last month/recently?** Ask them. Don't discuss details of other countries intervention.

17. <u>Concerted intervention in foreign exchange markets pointless before underlying fundamentals have been resolved?</u> Intervention is only one instrument in Louvre Accord. Chancellor said in House on 27 October "we did not intervene in order to stabilise markets until we had first intervened in a massive way following the Plaza agreement to drive the dollar down, and we only intervened to stabilise it after the deutschemark and yen had risen by as much as 50 per cent against the dollar in order to give that massive change in exchange rates time to work through." Another instrument is interest rates. The Chancellor said on 24 November in speech to American Chamber of Commerce, "interest rates in the US need to be set at level that can support dollar and finance the deficit" ..... "Surplus countries should give more attention to world interest rate differentials and monetary conditions in industrialised world ... when setting their interest rates".

(C) INTEREST RATES/MONETARY POLICY

18. <u>Prospects of further co-ordinated interest rate cuts?</u> Wait and see.

19. <u>½ per cent interest rate cut on 3 December?</u> Uk base rate cut reflected concerted move by number of European countries (Germany, French, Dutch, Swiss etc). Appropriate step to take in light of current monetary conditions.

20. <u>Cut interest rates again to ease pressure on £/DM rate?</u> Never speculate about future interest rate movements.

21. <u>Recent moves by Germans/French/Dutch in cutting interest rates helpful?</u> Yes. But only a step in preparing right conditions for necessary stabilisation of dollar. Actions also had calming effect on exchange rate mechanism (ERM) of European Monetary System. Other steps to stabilise dollar are; largest surplus countries, Germany and Japan take further action to improve internal economic momentum and Japan should open its markets more fully to imports.

22. **Why not cut interest rates further to support dollar?** UK has already brought its interest rates down by 1½% since stock markets fall.

23. **Is exchange rate now only factor driving UK interest rates?** Not at all. Interest rates continue to be set in light of range of factors affecting financial conditions. But period of stability for sterling of benefit both to industry and as firm counter-inflationary anchor.

24. **26 October/5 November interest rate cuts made because sterling near DM 3 level?** No change in policy. Decision on interest rate taken in light of need to maintain adequate downward pressure on inflation. Sharp falls in share prices equivalent to tighten monetary conditions somewhat. But, clearly right in disturbed financial market conditions of late October/early November to reduce interest rates in order to allow some expansion in liquidity.

25. **Implication of recent heavy intervention for UK monetary conditions/funding?** Policy to ensure, over time, any net intervention funded so that effect on liquidity sterilised. Will be done as and when appropriate, though not necessarily all within same financial year.

26. **German monetary policy not helpful?** Chancellor said in speech to Stock Exchange on 26 October: "It would be helpful if German monetary authorities were to show more awareness of [the need to avoid] undue monetary tightening." Germans have since cut their interest rates.

(D) **EXCHANGE RATE MECHANISM (ERM)**

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

28. **Conditions required for UK participation?** Not possible to specify precisely what conditions would have to be fulfilled before UK joined ERM (as Prime Minister reaffirmed in FT interview reported 23 November). Number of factors and their interaction need to be taken into account.

29. **Role of European Monetary System (EMS) in preserving stable exchange rates?** ECOFIN Council on 16 November agreed that EMS has played important role in coordination of policies between member countries and in preserving stable relationships between European countries including in foreign exchange markets. Basle/Nyborg decisions prove EMS has been strengthened.

(E) RECENT MARKET EVENTS

30. **Stock market collapse due to "volatility" shifting out of forex markets?** No. Collapse triggered by fears of Louvre Accord breaking down. As Chancellor said in his Mansion House speech this idea is "manifest poppycock" - as recent events have demonstrated.

31. **UK now in classic bear market?** Equity markets had clearly overshot over last year. Adjustment was very rapid, partly reflecting new nature of global market. But glad to see how well City responding.

(F) US BUDGET DEFICIT PACKAGE

32. **UK view on US budget deficit package?** Welcome budget deficit agreement. Await ratification by Congress. Further action by surplus countries still necessary.

33. **Reduction too little too late.** Substantial reductions of $73 billion already achieved in financial year 1987.

34. **Cuts in US budget deficit could cause recession?** No. Package of cuts necessary to restore market confidence and is necessary step towards reduction of trade imbalances.

35. **World situation will send UK into recession?** No. Government's sound economic and financial policies have enabled UK to weather year long coal strike and collapse of oil price. Have shown capacity to grow more strongly than other major countries. Chancellor said in Weekend World interview on 8 November; "I will take whatever steps are necessary to make sure British economy is secure ... and is affected as little as possible by any difficulties outside."

91G.SCB.1865.22

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FROM: J L CARR
DATE: 21 December 1987

MR GRICE

cc: Mr Savage
Mr Conaty
File: MAMC M1

**MONETARY TARGETS AND THE EXCHANGE RATE: THE GERMANY AND SWISS EXPERIENCE IN 1977-78**

During the late 1970s both the DM and the Swiss franc were subject to substantial upward pressure. You asked how the German and Swiss authorities reacted to this pressure in the context of their overall monetary policies. This note deals mainly with the German experience:

(i) because this is more relevant to the dilemma facing Germany (and the UK) today;

and (ii) since many of the lessons from the German, apply equally to the Swiss case.

**Summary**

2. Both central banks had large reserve buffers in 1978; the decisions to drop monetary, for exchange rate, targets in 1978 reflected concern about the effect of overvalued currencies on domestic growth; evidence for this came in a fall in German capital investment in early 1978 as the tradeable goods sector became increasingly uncompetitive and in Switzerland in the form of a drying up of foreign orders.

Economic indicators suggested a significant degree of slack in both countries.

Large unsterilised intervention was undertaken - their combined reserves rose by $17bn in 1978 - followed by an easing of exchange rate pressure. This easing was due partly to the intervention (which helped break expectations) but also to the introduction of a dollar support package on 1 November 1978.

The Swiss and German authorities endeavoured throughout to explain why they had temporarily cast aside their monetary targets - as a result of such efforts, and proven anti-inflation track records, their credibility was not seriously damaged.

The subsequent modest rise in inflation in 1979-81 was due as much to OPEC II and, in Germany, a fiscal easing, as to the loosening of monetary policy associated with intervention in 1978.

The external outlook for both countries in 1978 was more inflationary than that today (eg OECD GDP growth was around 4 per cent, vis-a-vis 2½ per cent now).

Higher unemployment rates in both countries now than then provide one pointer that domestic inflationary pressures were also greater in 1978 than in 1987.

**Germany**

**Background**

3. Following the 1973 move to a floating exchange rate regime, German monetary policy was geared to the twin domestic goals of price stability and economic growth. Targets for Central Bank Money (CBM) were introduced in 1975. The exchange rate was allowed to float fairly freely (the prevailing European monetary arrangements permitted fairly frequent realignments) and intervention was conducted for smoothing purposes. The exchange rate was - and remains - an important determinant of German inflation and growth due to the high degree of openness of the economy (exports of goods and services accounted in 1978 for 26 per

cent of GDP as compared with 8 per cent for the US, and 11 per cent for Japan). Upward pressure on the DM in the early 1970s led to the maintenance of direct controls on foreign inflows; these however exercised only a modest restraining influence, and were hardly used from 1975 on, when the authorities exhibited instead a deep-seated commitmnent to free capital movements.

1977-78

6. Negative real interest rates and a more expansionary fiscal policy contributed to continued buoyant GDP growth in 1977 accompanied by a slight fall in unemployment.

**TABLE 1: GERMAN ECONOMIC INDICATORS**

| | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|
| GDP* | -1.7 | 5.5 | 3.1 | 3.1 | 4.2 |
| Unemployment+ | 4.0 | 4.0 | 3.9 | 3.7 | 3.3 |
| Current Accounts ($bns) | 4.1 | 3.9 | 4.1 | 9.2 | -6.2 |
| Reserves/Imports (months) | 4.1 | 3.7 | 3.6 | 3.8 | 3.4 |
| Consumer Prices* | 6.0 | 4.5 | 3.7 | 2.7 | 4.1 |
| Real Short-Term Interest Rate | -1.0 | 0.8 | 0.7 | -0.5 | 2.6 |

*Year to year percentage changes
+As a percentage of total labour force.

The current account remained, as in 1975-6, in large surplus, offset on the capital account by long term outflows. Continued short-term inflows exerted upward pressure on the DM, which the authorities allowed to rise (see Chart A). A strong DM was seen as a bulwark against inflation, itself a growing threat with CBM growth continuing to overshoot, and inflation still uncomfortably high.

7. By end-1977, however, there was growing evidence that the strength of the DM was damaging the economy. Domestic orders for capital fell sharply from late 1977, reflecting in part

exporters' expectations that the DM would remain overvalued and thus depress foreign demand for German exports. Relative normalised unit labour costs - one measure of competitiveness - had risen by nearly 5½ per cent in 1977 alone.

8. It was also becoming increasingly apparent that upward pressure on the DM would continue so long as the US pursued a weak and inconsistent anti-inflation policy. The three main non-dollar reserve currencies - the DM, Swiss franc and yen - were all experiencing strong upward pressure.

**The Authorities dilemma**

9. The authorities perceived themselves as faced with a limited set of options. That of:

(i) introducing draconian exchange controls was ruled out following the limited success of controls in the early 1970s, while

(ii) a policy of carrying out large scale sterilised intervention was seen as impossible given the magnitudes involved. The choice therefore came to be between either a

(iii) single-minded pursuit of the CBM target and acceptance of a rising DM, or,

(iv) large unsterilisied intervention to contain pressure on the DM, accompanied by a CBM overshoot.

10. The last of these was chosen in early 1978. The inflationary consequences of a CBM overshoot were not seen as serious given the consensus view that a considerable degree of slack existed in the economy (the unemployment rate eg - just under 4 per cent as against 1 per cent over 1968-73 - was historically high). In

addition inflation (see Table 1) seemed to be on a clear downward trend. It was expected that the upward pressure on the DM would soon unwind, allowing some of the excess liquidity released by intervention to be reabsorbed.

**Results**

11. Heavy intervention took place in early 1978 and again in the summer. Only following the unveiling of a dollar support operation on 1 November 1978 did pressure on the DM subside and by the end of the year the Bundesbank, net reserves had risen by $10bns. This rise contributed to rapid monetary growth and the CBM target for 1978 was suspended in the summer (see Table 2). The outturn for CBM was 11.4 per cent as against an initial target of 8 per cent. Interest rates were kept low as part of an international reflation package, while fiscal policy was loosened following the Bonn Summit. Against this background real GDP growth was maintained at just under 4 per cent while inflation turned out even lower than expected (at 2.7 per cent).

**TABLE 2: CBM AND M1 GROWTH RATES***

| | CBM Target | CBM Actual | M1 Actual |
|---|---|---|---|
| 1976 | 8 | 9.2 | 10.4 |
| 1977 | 8 | 9.0 | 8.2 |
| 1978 | 8 | 11.4 | 13.3 |
| 1979 | 6.9+ | 9.1 | 7.5 |

*Average annual growth rates
+Ranges first introduced for 1979.

**1979-80**

12. Investors' confidence in the DM turned full circle in 1979-80 and the control of inflation became the main policy goal. The threat to inflation stemmed from:

(i) the second round of OPEC oil price rises (accompanied by other commodity price increases);

(ii) the loosening of fiscal policy after the Bonn Summit;

and (iii) the liquidity overhang left by the 1978 CBM overshoot.

The authorities decided to run off some of this liquidity overhang by aiming for the lower half of the CBM target ranges announced for 1979-81. By explaining what they were doing they hoped to restore the credibility which had been tarnished in 1978, and thus avoid destabilising expectations cycles.

13. Inflation did indeed rise, peaking at 5.9 per cent in 1981, but the increase was much less than for the OECD as a whole (for which inflation rose from 8 per cent in 1978 to 13 per cent in 1980). The precise contribution of the liquidity overhang from 1978 to this rise is hard to disentangle from other factors. It seems clear however that OPEC II and German fiscal policy (which remained expansionary for too long in 1979) were the most important factors.

**Assessment**

14. The decision to intervene in 1978 was a sensible response to the upward pressure on the DM arising from its substitute (to the dollar) reserve currency role. It allowed the main policy goals - of low inflation and continued GDP growth - to be maintained and probably played only a minor role in the rise in inflation in 1980-1. The main alternative policy of allowing the DM to rise, and achieving the CBM target in 1978, would according to Bundesbank simulations, have severely dented GDP growth in 1978-9, although inflation would have turned out somewhat lower.