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

Reference MG-MAMC/D/0002/001

File begins 03/05/1988

Pages 201-222

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DRAFT PRESS NOTICE

THE RESERVES IN JULY 1988

The UK official reserves rose by $1,307 million in July. Repayments of borrowing under the exchange cover scheme amounted to $47 million. There was no borrowing under the exchange cover scheme this month. The valuation change arising out of the quarterly rollover of the EMCF swap amounted to a rise of $444 million. After taking account of the repayments of foreign currency borrowing, the underlying change in the reserves during July, was a rise of $910 million. At the end of July, the reserves stood at $49,826 million (£29,112 million*) compared with $48,519 million (£28,449 million+) at the end of June.

2. See separate Treasury Press Notice on UK Government's foreign currency borrowing programme.

Note to Editors

3. 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).

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

\+ When converted at the closing market rate on Thursday 30 June £1=$1.7055

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

British Coal, $16 million; Electricity Council, $14 million; British Telecommunications PLC, $5 million; Northumbrian Water Authority, $4 million; South of Scotland Electricity Board, $3 million; North West Water Authority, $1 million; Yorkshire Water Authority, $1 million; Others, $3 million.

5. The quarterly rollover of the EMCF swap, ie 20 per cent of the UK's gold and US dollar reserves, entailed a valuation increase of $444 million. This mainly reflects the appreciation of the dollar against the ECU in the last quarter, as valued by the EMCF. For the purpose 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.

THE RESERVES IN JULY 1988 : PRESS BRIEFING

Factual : Main features of markets in July

	1 July (cob)*	Month's High		Month's Low		29 July (cob)*
£ ERI	75.0	77.1	(28th)	74.6	(15th)	76.5
$/£	1.7015	1.7422	(25th)	1.6567	(18th)	1.7115
DM/£	3.0984	3.2260	(29th)	3.0770	(4th)	3.2031
$ ERI	97.9	99.4	(15th/18th)	97.0	(7th/22nd)	98.6
DM/$	1.8210	1.8925	(18th)	1.8135	(6th/7th)	1.8715
Yen/$	134.07	135.45	(4th/15th)	130.15	(25th)	132.80

*cob = close of business.

Underpinned by two further increases in UK base rates, sterling saw periods of strong demand during July and recorded significant gains, particularly against the continental currencies. It began the month quietly but as the market adjusted to the 1/2% increase in UK base rates on 4 July, a firmer trend emerged and, with dealers concluding that sterling had reached a natural floor against the deutschemark, it recovered well. The pound lost ground to the dollar in the wake of the 8 July US employment data, but, remained relatively steady around DM 3.12. It fell sharply against the rising dollar following the publication of US trade figures on 15 July, but amid expectations of a full 1% rise in UK base rates it reached DM 3.14 on 18 July. When only a 1/2% increase was announced on 18 July, sterling dipped to the month's low of $1.6567, but, with the dollar subsequently easing, attention shifted to high-yielding currencies and sterling benefited accordingly. Although it dipped briefly to $1.7044 on 27 July following disappointing UK trade figures for June, the softness of the deutschemark enabled sterling to remain steady in cross-rate terms and, when the dollar itself fell back, sterling was the main beneficiary. It subsequently surrendered some of its gains, but ended the month on a steady note.

In the wake of increased tension in the Gulf, the bullish sentiment towards <u>the dollar</u> continued in early July. It then began to feel the effects of persistent reported intervention by the Bundesbank and a reluctance to push it higher in advance of the US trade figures, but stronger-than-anticipated US employment data caused a significant rise and the removal of uncertainty, as the trade figures matched expectations, provided a renewed incentive to buy the dollar which reached the month's highs on 15/18 July. It then fell steeply following a rise in Japanese domestic interest rates and reports of further central bank intervention. After a brief rally, the dollar fell away sharply on announcement of the weaker-than-expected US GNP figures but subsequently steadily recovered its losses (particularly against the deutschemark), ending the month bullishly.

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:

		$ million		
		Underlying change	**Total change**	**Level of reserves at end period**
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
	Totals	+ 4,560	+ 2,649	

+after revaluation of + $2,879 million.

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

(v) Reserves in July of $49,826 million were highest ever.

Level of official debt

Now stands at $16.7 billion at end July*. Latest published figure, $17.6 billion at end March in Financial Statistics, July 1988, Table 10.6. (In May 1979 was $22 billion.)

*at end July market rates.

See also separate Q and A briefing on FRN prepayment and ECU bill programme

POSITIVE

1. Reserves remain very strong. Now stand at record level of $50 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.)

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. **Government no longer interested in exchange rate stability?** Government's main priority is to bear down on inflation. But within context of anti-inflationary strategy, policy remains to seek to achieve reasonable exchange rate stability. Toronto Summit endorsed need to coordinate policies to strengthen economic fundamentals and to reinforce conditions for 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 operating ceiling for sterling/deutschemark rate?** Not helpful to talk about any particular level.

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

6. **Current account deficit could be reduced by depreciation of sterling?** Not Government policy to allow exchange rate to depreciate to increase UK competitiveness. Would be inflationary. Holding down unit costs - which is in industry's own hands - key to improved competitiveness.

7. **International monetary co-ordination not working?** [Press reports on 21 June of French Finance Minister's, M Beregovoy's, criticism of Bundesbank for failing to consult adequately with partners over last month.]

International cooperation is alive and well; commentators should not always look for headline catching responses to exchange rate fluctuations. Essence of coordination lies in consultation and that has been taking place.

(B) **INTERVENTION**

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

9. **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.

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

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

12. **Have Bank been switching out of dollars?** ['Financial Times' article, 23 July 1988.]

Never discuss detailed reserves transactions.

(C) **INTEREST RATES/MONETARY POLICY**

13. **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 short term interest rates as essential instrument of monetary policy.

14. **Will Government reduce interest rates to ease upward pressure on sterling?** Never speculate.

15. **Why taken steps which will put upward pressure on sterling at time of record trade deficit?** Government has stated repeatedly its determination to keep monetary policy tight in order to bear down on inflation. Interest rate decisions take account of all factors influencing monetary conditions, including exchange rate.

16. **Why raise interest rates when exchange rate against deutschemark so high?** Do not focus exclusive attention on deutschemark; rate against dollar also important, and rather lower now than in June. All part of process of monetary tightening since beginning of June.

(D) **EUROPEAN MONETARY INTEGRATION**

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

18. **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.

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

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

21. **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 useful technical ideas for strengthening the EMS and promoting wider use of private ecu already under consideration. UK's new ecu bill programme will contribute to that aim.

22. **EC capital liberalisation proposals**. [Directive providing for complete removal of exchange controls by those countries that still retain them adopted on 24 June.]
"Blow for freedom in Europe", essential for completion of single market by 1992, with effects that will be highly beneficial, enabling financial services industry within Community to develop fully in competition with those in Japan and US.

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

24. **Capital liberalisation Directive adopted on 24 June brings UK membership of the ERM closer?** Position on ERM membership made clear by both Chancellor and Prime Minister on numerous occasions.

(E) EUROPEAN MONETARY COOPERATION FUND (EMCF) SWAP

25. **What is EMCF swap?** As member of EMS, UK required to put at disposal of European Monetary Co-operation Fund 20% of its gold holdings and 20% of its gross dollar reserves in return for right to use equivalent value of Ecus. Each of these swaps is for three months, at end of which swap is unwound and a new one (with whatever quantities of gold and dollars then comprise 20% of its total holdings) is entered into.

26. **Why is valuation adjustment necessary?** Because of different valuation practices by UK and EMCF. UK revalues its assets only once a year (at end March), but EMCF values dollars and gold at prices based on current market values. EEA will therefore provide gold and dollars at its own valuation; will receive Ecus to an equivalent value at current exchange rates but which will be held in EEA at EEA's own valuation rate. Valuation difference which arises does not represent loss (or profit) since EEA's underlying holdings of gold and dollars are unchanged when swap expires; adjustment made purely for accounting purposes. EEA continues to earn dollar income in underlying dollar assets. July change of $444 million represents valuation difference on April's swap, less valuation difference on new swap undertaken in July.

(F) FORWARD PURCHASES

[NB Avoid any reference to forward book.]

27. **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 make forward purchases of deutschemarks and dollars from Bank.]

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

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

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

31. **Have forward purchases distorted underlying change in reserves?**
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.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month		Level at end of month
USA	- 0.9	(end June)	41
Japan	+ 0.5	(end June)	88
Germany	- 9.5	(w/e 22 July)	45
France	- 3.6	(end June)	64
Italy	- 1.5	(end June)	55
Canada	+ 2.8	(end June)	16
United Kingdom	+ 1.3	(end July)	50

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: N P WILLIAMS

DATE: 15 AUGUST 1988

SIR G LITTLER O/R

cc Mr Scholar - o/r
Mr Peretz
Mr Grice - o/r
Miss O'Mara - o/r
Mr Brooks
Mr Nelson

INVESTMENT OF THE RESERVES

1. I attach a draft letter to send to Mr George, recording the decisions reached at your meeting on 28 July, and the minutes of the meeting. You may like to enclose the minutes with your letter to Mr George.

NPW

N P WILLIAMS

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DRAFT LETTER

FROM: Sir G Littler

TO: Mr E A J George
Executive Director
Bank of England
Threadneedle Street
LONDON

INVESTMENT OF THE RESERVES

1. We discussed your six-monthly review paper of 26 July, and two background papers, on 28 July and I am writing to confirm the decisions we took. I also attach a more detailed note of the meeting.

2. We agreed that it was sensible to plan on the basis that the dollar would weaken from current levels, although the timing is uncertain. I agreed with your suggestion that the yen may well rise less than the DM in the short term. In the light of these considerations we agreed that the EEA's exposures shown in paragraph 22 of your paper are broadly appropriate in current circumstances.

3. We also agreed the various recommendations set out in the introduction to your paper.. We will switch up to a further $1¾ billion out of the dollar at levels above DM 1.90 and Y 150. We also agreed that, in the event of a sharp fall in the dollar, we should look to reduce the short dollar position , principally by sales of DM, and that we should be willing to start going short of DM and yen at around DM 1.70 and Y 130. I agreed with your

proposal that we should switch from DM into Yen as the DM strengthens so that we hold mostly Yen against the short dollar position at cross rates above 75.

4. You explained that your view of interest rate prospects was more tentative than for exchange rates. We agreed to begin to reduce progressively the short position in the US market as yields rise from current levels and consider the establishment of a long position in the US market at 4-year yields above 9½%. We also agreed with your proposals for the DM and Yen markets in paragraphs 51-53 of your paper.

5. Since both the dollar interest rate and exchange rate prospects are more clouded than usual, because of the US election, we agreed we should keep all these conclusions under careful review in the light of developments.

6. We had a useful discussion of your paper of 6 July on the profitability of reserves management. I am particularly pleased to note the progress in this area since our last meeting, and we agreed that the work is broadly on the right lines. We agreed that a neutral currency exposure of 40% dollars, 40% DM bloc and 20% yen is appropriate in present circumstances. We envisaged circumstances in which the ratio might change, but agreed that it is not useful to alter the ratio by small amounts frequently. We also agreed that the normal ranges for net currency exposures are a useful basis for currency decisions, but the ranges should have soft edges. We agreed that while we would not wish to change these assumptions very often it would be helpful to review these

in six months' time and thereafter at successive six monthly meetings. I was interested to hear of your work on developing an interest rate neutral assumption, and ranges, to mirror the treatment of currency exposures. It would be helpful to discuss progress in this area at the next meeting..

7. I noted your proposal to introduce a further component - the cost of liquidity - into the calculations of profitability. We also agreed that the enhancement of your computer systems would mean that the calculations take account of the prices of individual deals.

8. We agreed that in future gold will not be purchased to cover publicly explainable sales (for coinage, medals, etc.). We also agreed to keep the idea of gold sales in mind if other opportunities for sale arise, especially if and when we go through a period of reduction of reserves. However, there is no need for immediate action on this last idea, and we should ensure that our operations remain low profile.

9. Finally, we agreed to your proposals on:-

(i) renewal of the existing annual limit on our gold deposit business;

(ii) EEA issuer limits;

(iii) limited trading in futures; and

(iv) seeking legal advice on whether EEA assets are held in a manner which takes maximum advantage of sovereign immunity.

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FROM: N P WILLIAMS

DATE: 16 August 1988

NOTE OF A MEETING HELD IN ROOM 113/2 TREASURY AT 2.30PM ON THURSDAY 28 JULY 1988

Present:	Sir G Littler (chair)	Mr George - BoE
	Mr Peretz	Mr Page - BoE
	Mr Grice	Mr Saville - BoE
	Miss O'Mara	
	Mr Williams	
	Mr Brooks	

INVESTMENT OF THE RESERVES

Profitability of reserves management

1. Sir G Littler began by saying that the Bank's paper of 6 July showed that good progress was being made. The value of the approach outlined in the paper is that it was analytically related to the currency decisions made. Mr George said the work provided a useful management information structure.

2. Sir G Littler said he understood that the Bank proposed to modify the approach in the 6 July paper by including a fifth component. Mr Page said that since the EEA holds liquidity in the form of, for example, US Treasury Bills and BIS deposits which earn a sub-LIBID return, its investment decisions were sub-optimal. Hence the cost of holding liquid assets, which might be assessed by reference to the difference between the EEA's short-term assets and LIBID, should be an additional component of the total sterling return on the EEA balance sheet described in the 6 July paper.

3. Sir G Littler said he was content with the 40:40:20 neutrality assumption in present circumstances. If the reserves were lower a 50% dollar weight might be chosen. He did not at present want further work on other neutrality assumptions - nor did he think it useful to change the assumption by small amounts frequently. Mr Page said that ERM membership might require a change in the weights. He also noted that the weights related to

net currency assets - different proportions of gross assets could be achieved by adjusting the currency composition of borrowing. Sir G Littler said that changes in the international monetary field-in particular, in the G7 context - might call for a modification. Mr George said that the useability of the dollar in all conceivable circumstances is a very important consideration in choosing neutral exposures. It had also to be remembered that different assumptions on neutral exposures had large effects on the split of profitability between the intervention and currency mix decisions. Mr Grice thought that the proposed neutrality assumption was the best for now, but it needed further consideration. Sir G Littler said that the next meeting should review the neutral weights.

4. Sir G Littler said it is useful to think in terms of "normal" ranges around neutral exposures and that the Bank's proposals (eg 30-50% for the dollar) seem reasonable in current circumstances. He noted that there could be no scientific basis to them and agreed with Mr Peretz's suggestion that more thought could be given to the ranges. Mr George said the absence of any science was a reason why the ranges could not have hard edges. However the approach proposed a more comprehensive framework for currency decisions than was available 6 months ago. Sir G Littler agreed that the ranges should have soft edges.

5. Sir G Littler asked if he was correct in understanding that the Bank's results did not take account of the prices of individual deals. He recalled some calculations based on actual dealing prices in a month when there was smoothing both ways - the analysis showed that the Bank had bought more cheaply than it had sold. Profitability was thus understated. Mr Page agreed that the end-month exchange rates used in the Bank's paper should in general understate profitability, and said that the enhancement of computer systems would take account of dealing prices.

6. Mr Peretz said that, since intervention was fully funded, it would be more appropriate to assume a gilt yield on the sterling liabilities issued to finance net foreign currency assets. Mr Page said that whether to fund intervention short or long was outside the framework of this analysis. Mr Saville said it was difficult to know which gilt yield to hypothecate - should it be an average yield? Sir G Littler said he did not want to propose changes to the work done so far.

7. Mr George said that we were now in a much better position to provide information on the profitability of reserves management. He thought we should be ready to reveal the results to a PAC investigation of the EEA, if one were to take place. Sir G Littler said that for the present, the work was for official use. He would want to consider how he would respond to the PAC when the time came. At present he was inclined to talk around the work to the PAC, but not to present it.

8. Sir G Littler noted that the Bank's calculations went back to June 1985. He did not want the starting date to be pushed back further. The BEQB, September 1983 article provided some earlier calculations of profitability, albeit calculated on a very different basis.

The EEA's Risk Positions

9. Sir G Littler agreed the Bank's recommendations. He then asked how a worldwide rise in interest rates would affect interest rate exposures. Mr George said that the view on interest rates in the paper was more tentative than the view on exchange rates, especially the dollar. If the dollar crashed with 4-year yields at 9½% then a long position in the US market should be considered - the word "considered" in recommendation (d) was important since interest rate prospects were uncertain. The meeting agreed that both interest rate and exchange rate prospects for the dollar were more uncertain than usual, because of the election, so that the conclusions of the meeting should be regarded as more provisional and subject to review than usual. Mr George added that it would be useful to establish an interest rate neutral assumption, and ranges, to mirror the treatment of currency exposures. That kind of thinking was implicit in the paper for this meeting. The work should be more refined 6 months from now.

Gold

10. Sir G Littler noted that gold is usable in current circumstances, as a pledge for immediate currency value. He saw no strong arguments for acquiring or keeping gold. In future the Bank should not purchase gold to cover publicly explainable sales

(for coinage, medals, etc). As for other opportunities of sale, the idea should be kept in mind, especially if and when we go through a period of reduction of reserves - but there should be no immediate action and the policy should be low profile. It should cause no embarrassment if small sales (of, say, 1 tonne per quarter) showed up in published statistics. Mr George said that we should focus attention on how to explain the policy, rather than a particular number.

11. Mr Peretz said that if we were prepared to sell gold, then one of the arguments against writing call options on our gold was removed. Mr Saville said that options would need to be written on a large scale (implying the possibility of large sales of gold) to generate much premium income. Mr Page asked how we would explain publicly the writing of options. Mr Grice said the policy would have to be public. Sir G Littler said that for the time being he was prepared to accept the case against writing call options, as put forward in the Bank's paper.

12. Sir G Littler agreed to the renewal of the existing annual limit on gold deposit business.

Other issues

13. Sir G Littler said he was content with the proposals on issuer limits. He asked about the EEAs credit exposure to the banks. Mr Page said that some reduction in exposure had been achieved but this needed to be seen in the context of a significant increase in currency reserves.

14. Sir G Littler agreed to the Bank's proposal for limited trading in futures.

15. Sir G Littler asked about the proposal to seek legal advice on behalf of the EEA. Mr George said that the question of whether EEA assets are held in a manner which allows it the maximum advantage of sovereign immunity occurred to Treasury Solicitors when the KIO/BP case came up. It seemed sensible to seek legal advice on behalf of the EEA. Miss O'Mara reported on a meeting at the Inland Revenue that morning. The Revenue were very aware of the EEA angle of the reciprocity problem and there was no question in their minds of doing anything that might compromise that immunity.

16. Mr George asked about the state of play on the informal approach from the NAO about the way the EEA accounts are certified. Miss O'Mara said there had been no new developments, but the NAO had not finished their work.

N P WILLIAMS

cc: Those present
Mr Scholar o/r