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

Reference MG-MAMC/D/0002/001

File begins 04/01/1988

File ends 22/04/1988

Pages 138-157

## POSITIVE

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

2. Sterling has remained comparatively stable, especially against deutschemark since last Budget. [The dollar has been weak against most currencies].

## DEFENSIVE

### (A) POLICY

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

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

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

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

5. **<u>Why is present DM/£ level right?</u>** Matter of judgement. After Louvre Accord, Chancellor noted sizeable fall in exchange rate against non-dollar currencies which followed oil price collapse had gone far enough. Said that, by same token, no wish to see substantial rise. DM/£ rate was then 2.79. Highest rate since has been just under DM3.00. Now 2.99.

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

## (B) <u>G7</u>

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

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

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

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

(C) **INTERVENTION**

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

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

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

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

14. **Is intervention profitable?** Profitability is not main reason for intervention. Primary reason is to support exchange rate policy. However, for intervention to be profitable, the authorities would need to sell sterling when markets were rising and buy it back when markets were falling. This is, of course, what the authorities aim to do when smoothing undue fluctuations and such operations have generally proved profitable in the past.

[N.B. See also the Bank of England Quarterly Bulletin, September 1983 pgs 384-391].

15. **What is effect of dollar's recent depreciation on value of Reserves?** Because reserves are published in dollars and holdings of gold and non-dollar currencies are valued at 'parity rates' fixed at end of ~~the~~ previous financial year, the recent depreciation of the dollar will make no difference to published value of reserves

at this stage of the year. However, it is likely to mean that, when parity rates are fixed (beginning of April) for 1988-89 (end-March reserves are published on both old and new parity rates), i.e. Reserves will need to be revalued upwards. This is because non-dollar elements of the reserves will be worth more in dollar terms on basis of new parity rates.

16. **Will there be a capital loss on dollar element of Reserves?** No. But, in principle a loss in sterling terms would only be realised if dollar element of reserves were sold at a lower exchange rate than that at which the dollars were purchased. However, it may be some time for intervention to be unwound, if at all.

17. **Do capital losses or gains on Reserves affect size of PSBR (of Germany)?** No. L~~k~~ike other changes in mix of Government's assets and liabilities they finance the PSBR and then only when the gain or loss is realised and reflected in a flow of sterling into o~~u~~r out of reserves.

18. **Will you publish data on currency composition of Reserves?** No. Long standing practice of successive governments not to publish details of currency composition of reserves.

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

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

20. **Effect on exchange rates?** Still committed to exchange rate stability.

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

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

23. **½ per cent rise in interest rates would not have been necessary if we had been in the ERM?** No. Joining the ERM is not a soft option. The exchange rate can be a tough discipline: countries within ERM frequently change their interest rates.

(E) **EXCHANGE RATE MECHANISM (ERM)**

2~~3~~4. **UK membership of ERM?** [Chancellor reported widely in press as saying after 9 February ECOFIN in Brussels that UK had not changed view on joining ERM, but Government was pursuing deliberate aim of keeping sterling in line with EMS. Inaccurate Reuters report. Chancellor sai~~s~~d as "matter of fact" sterling had been held close to currencies participating in ERM]. No change in Government position. Matter kept under continual review. Will join when time is right.

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

2~~5~~6. **Balladur's proposals for Central Bank of Europe?** M Balladur simply calling for consideration of connected issues and looking to time after completion of internal market.

(F) **DEBT**

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

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

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

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

29. **Details of MOD forward purchase?** Not practice to discuss.

30. ~~**Is there a foreign exchange exposure for the Treasury?** No.~~

D3

cc Mrs Lomax
Miss Sinclair
Mr Riley
~~Miss~~ O'Mara
Ms Goodman

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D L C Peretz
Under Secretary

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26 February 1988

Dear Mike

**EXCHANGE RATE FLUCTUATIONS**

Thank you for your letter of 23 February.

2. As I have already mentioned, we in the Treasury are quite happy for the submission to go forward in its present form. We agreed that you would send a copy to the Bank of England as you put it forward (you had some comments from them on the earlier version).

3. I guess there will need to be some Revenue/Treasury/Bank of England discussion when it comes to drafting the consultative document.

Yours sincerely

David Peretz

**D L C PERETZ**

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FROM: A C S ALLAN
DATE: 26 February 1988

MR PERETZ

MG 1/6

cc PS/Economic Secretary
Sir P Middleton
Sir P Burns
Sir G Littler
Mr Scholar
Miss O'Mara

**INTERVENTION : ECUS**

The Chancellor was grateful for your minute of 25 February.

He had two comments:

(i) First, he doubts if it is wise - at least at this stage - to stir things up by raising the issue of the EMS agreement (discussed in your paragraph 3), although he has no objection if the <u>French</u> do so.

(ii) Second, in relation to your comment that the market in ecu's is still pretty thin, he still believes the banks would do more if they were told there was likely to be an increased demand for ecu's (from the authorities). He would be grateful for advice on this.

ACSA

**A C S ALLAN**

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MG1/6
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FROM: D L C PERETZ
DATE: 2 March 1988

PRINCIPAL PRIVATE SECRETARY

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

DZ

**INTERVENTION: ECUS**

I should record what I have agreed with the Bank of England (Michael Foot) following your minute of this morning.

(a) I have assumed, I hope rightly, that the new instruction is <u>not</u> intended to mean that the Bank should be prepared to let the pound rise above DM3 if they cannot buy sufficient ecus to hold it down.

(b) In London, the Bank will do any significant intervention (other than any currency purchases to cover specific customer needs) in ecu. They will normally do this by buying dollars and simultaneously selling the dollars for ecu. In practice, because the second transaction is harder to do, there will frequently be a gap of a few minutes while we hold the dollars.

(c) In New York and the Far East, although it may prove possible to buy some ecu, and the Bank will do so if they can, they are more likely to buy dollars, and then switch them into ecu once the European market opens the following morning.

(d) In normal working hours the Bank will, of course, keep us closely in touch with what is going on; and we will keep you in touch similarly. If it looks as if more intervention will be required to hold the rate than can be made in ecu alone, we will need



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to be ready to make a rapid decision about what the Bank should do next.

2. The only remaining operational question is what we should do if in the early hours of the morning the Bank of England find themselves buying more dollars than they think they are likely to be able to swap easily into ecu once the European market opens. The occasions on which the Bank have had to buy more than $300-400 million worth of foreign currency overnight to protect the cap have, however, been very rare (about three times this year) and have not come without warning. So I have left it that except in really exceptional circumstances the Bank will not wake us all up in the middle of the night, but will report the situation first thing in the morning.

DLCP

D L C PERETZ

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FROM: A C S ALLAN
DATE: 2 March 1988

MR PERETZ

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

**INTERVENTION: ECUS**

The Chancellor was grateful for your minute of 1 March. Given that the Bank now say that maximum possible ecu purchases can amount to $\$\frac{1}{4}$-$\frac{1}{2}$ billion in one day, followed by $100 million a day for four days thereafter, the Chancellor feels that any further intervention required to hold down the pound should henceforth, and until further notice, be in ecus.

2. There may, I presume, be occasions (eg in Tokyo) when intervention has to be in other currencies which would subsequently be swapped into ecus at the first opportunity.

ACSA

A C S ALLAN

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**NOTE OF A MEETING HELD AT 10.30am ON THURSDAY 3 MARCH 1988**

**EXCHANGE RATE SYSTEMS: NEXT STEPS**

Those present: Sir Terence Burns
Sir Geoffrey Littler
Mr Lankester
Mr H P Evans
Mr Peretz
Mr Grice
Mr Matthews
Mr Hood
Ms Symes
Mr Edmonds

1 Miss O'Mara
You may like to see
JWG
2a Ms Goodman
2 MAMC

2b Mr Peretz
I would have liked to have been at the meeting, actually.
HC
11/

The meeting had before it Mr Evans' paper to Sir Terence Burns of 24 February entitled 'Exchange rate system; next steps'.

2. On the first point in the opening paragraph, it was agreed that it was important to stress the need for co-operation and the exchange of information. However, we did not want to encourage the use of objective indicators, since this might lead too far in the direction of global demand management. It was important that other countries understood the UK's position; there appeared to be some confusion over whether the lack of UK support for indicators implied that we were against all forms of co-operation.

3. There was a long discussion over whether exchange rates should be the focal point for co-operation. Mr Lankester suggested that any exchange rate system would ultimately collapse if it were not accompanied by mutually consistent policies. Sir Geoffrey Littler was not sure if this view was worth encouraging; in particular, he was against any form of trigger mechanism, whereby a change of policy in one country was met by reinforcing policy changes elsewhere. Mr Lankester agreed that this was not desirable, but thought that policy 'trade-offs' might be helpful. For example, policy changes in one country might be contingent on changes taking place in other countries. In this situation, policy negotiations might provide a better outcome. Mr Grice strongly disagreed with this view; he did not like the idea of authorities being presented as omniscient planners, and felt that such negotiations could lead to third-best solutions.

4. A limited amount of policy co-ordination might, however, be desirable. Mr Evans pointed out that any exchange rate system was likely to require some co-ordination of interest rate movements. Sir Geoffrey Littler accepted this, but felt that to go any further would end in frustration. Most enforced domestic policy changes were the result of excessive pressure in, for example, the foreign exchange markets. In the absence of this form of arm twisting domestic policies were unlikely to be changed, even if potential benefits for the international economy were recognized. An exchange rate system was likely to impose its own form of discipline, forcing countries to rethink their policies if and when they came under external pressures. Sir Terence Burns agreed

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with this view, and commented that it was important to avoid fiscal fine tuning on a global scale.

5. It became obvious as the meeting progressed that there was agreement over the need for some form of co-ordination, but disagreements centred on the extent required. Mr Matthews suggested that the degree of co-ordination depended on the starting point for an exchange rate system. In the present situation, more co-ordination might be required than if the starting point were a steady state equilibrium. Sir Terence Burns thought that statements of medium-term intent were acceptable, but that recommendations of short-term policy adjustments would be dangerous. It would be inconceivable, for example, that the UK would agree to relax its fiscal stance in response to a promise of a tighter fiscal policy in the US.

6. It was agreed to go through the rest of the paper step by step. Sir Terence Burns thought the Chancellor might want to make some form of statement at the April G7 meeting. Consequently, it was necessary to sort out which aspects of the proposals needed re-stating and developing, and which were already clear.

7. Any view on the likely success of an exchange rate system depended on a view about exchange rate determination. Sir Terence Burns argued that if exchange rate movements were largely driven by expectations, and only loosely related to fundamentals, there was more scope for influencing them than if they were always driven by fundamentals. If driven by expectations, it was important that Governments established credibility, so that they could be influenced. This credibility was likely to be strengthened if Governments were perceived to be taking explicit action on exchange rates. Statements alone were unlikely to exert an influence, as had probably been the case with the appreciation of the US dollar (although some commentators had argued that the dollar's appreciation had been a necessary condition for preventing a resurgence of inflation in the US). However, there was disagreement at the international level over the extent of speculative influence on exchange rate movements.

8. A separate question was whether exchange rate misalignments were costly. Paul Krugman had recently argued that there was not a great effect. However, it was difficult to assess the extent to which people changed their behaviour in the light of exchange rate fluctuations. It was possible that the worry about exchange rate misalignments and variations could be more important than the misalignments themselves.

9. There was little point in providing any more material on section c ("Circumstances are now more propitious for managed exchange rates than in the 1970s and early 1980s") of the 'stylised facts', since there seemed to be general agreement on this point.

10. Section d ("The size of current account deficits and surpluses of the US, Japan and Germany (and other imbalances in the world economy) are compatible with greater management of exchange rates") was important. There needed to be a justification for establishing a system aiming towards greater

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exchange rate stability in a situation where severe imbalances existed. If a system were established, there would also need to be decisions on the appropriate exchange rates. It could be argued that the present situation required a further substantial depreciation of the dollar, especially if US domestic policies did not adjust. However, this view depended on a fairly gloomy assessment of medium-term prospects, and experience had shown that apparently unsustainable positions had sometimes unexpectedly turned round. Mr Evans thought it might be worth producing a series of five-year scenarios, using different assumptions for, say, the saving ratio. This would help to establish whether a further fall in the dollar was a necessary condition for the correction of imbalances.

11. Section e ("Exchange rates should be the focal point of policy co-ordination") had already been discussed. However, some commentators argued that exchange rates could look after themselves if countries pursued mutually compatible domestic policies.

12. Since last October, the extent to which sections f ("Countries are prepared to give significant weight to exchange rates in the conduct of their monetary policy") and g ("They are willing to use intervention, as well as monetary policies, to support an exchange rate agreement") were generally accepted was uncertain. Although, for example, Germany was likely to accept g, it did not seem to have a very favourable view on f. There was also a questionmark over how formal and tightly drawn the system should be. Second order questions, which could be dealt with later, arose over attitudes towards sterilisation etc.

13. Part B, "A regime for the future", involved deciding whether to press on with current ideas, or whether to encourage further developments. Sir Geoffrey Littler had no difficulty with points (i)-(iii), but commented that there was no way at present of pinning down the suggested parity grid. The system could therefore have an inflationary or a deflationary bias. Sir Geoffrey's preference was to tie the currencies to some form of SDR basket. In the meantime it was possible that the global indicators could serve this purpose.

14. Summing up, Sir Terence Burns said that there was still a long way to go in terms of issues of principle, and the Chancellor's Speech last September went as far as it was sensible to go on details. Mr Evans said that there was a need to state the kind of system required, but not to go any further about details at present. As for the timetable, Mr Evans would try to get something to the Chancellor in the week beginning 21 March. In the meantime, MG and IF would do work on the Balladur European and world proposals.

**S D KING**
**Private Secretary**

**Circulation:** Those present
Mr Odling-Smee
Mr Sedgwick

Mrs Ryding ?
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8/3/88

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FROM: MISS M O'MARA
DATE: 3 MARCH 1988

Mr Grice cc Miss O'Mara

MR GRICE

Surely we fund the sterling value of the intervention, as it appears in the money numbers – which, for the reasons given, will be different from the reserves figure $ number valued in £s at the end month rate? NL 5/3

cc Mr Peretz
Ms Bronk o.r
Ms Goodman
Mrs Ryding

FUNDING INTERVENTION

As I understand it, under the "full fund" policy, we aim to fund each month's underlying change in the reserves over a period. Mrs Ryding and I assume that for that purpose, we fund the sterling equivalent of the dollar change published each month, converted at the end month closing market rate.

2. However, we are now increasingly intervening in currencies other than dollars. In publishing reserves changes, we value non-dollar currencies in dollar equivalents at the average dollar rates in the three months to the end of the preceding March or the actual rate on the last working day in March, whichever is the lower. In calculating what we have to fund, we are therefore converting any intervention we do in non-dollar currencies into and out of dollars at rates relating to quite different periods.

3. In theory, should we be valuing non-dollar intervention at current market rates for funding purposes, as we do dollars? Can we justify the fact that we do not, on the grounds that to alter the rules would introduce unnecessary complexity when the change might not be very significant in practice and when we have never claimed intervention has a one-for-one effect on the monetary aggregates anyway? Is it nevertheless worth trying to establish how significant the change might have been over the current financial year, when we have been intervening very substantially?

MOM

MISS M O'MARA

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FROM: M C SCHOLAR
DATE: 3 MARCH 1988

**MR PERETZ**

cc Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Miss O'Mara

**INTERVENTION**

Mr George told me this afternoon that when the Governor spoke to the Bundesbank and Banque de France earlier today the Germans said that they were happy for us to buy deutschemarks at the moment while the DM remained above 169½, provided the French were happy: this seemed to mean 50/50 purchases of DM/French francs. Mr George said that, in the light of this, the Bank were inclined to think it would be a good idea to give ecus a rest for a while and to buy deutschemark and French franc 50/50.

2. After speaking to Alex Allan I told Mr George that this was fine as far as we were concerned. We assumed that there was no implicit understanding with the Germans that we would not buy deutschemarks if the DM dollar rate fell below 169½ (Mr George said there was not); and we would also wish to keep closely in touch with events (Mr George thinks that we might find ourselves having to do quite a bit in New York, certainly if the pattern at the end of last year repeats itself).

MCS

M C SCHOLAR

FROM: J W GRICE
DATE: 4 March 1988

File

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MISS O'MARA

cc Mr Peretz
Ms Bronk o/r
Miss Goodman
Mrs Ryding

File: MAMC D 2

**FUNDING INTERVENTION**

Thank you for your minute of 3 March, which we spoke about on the telephone.

2. In principle, we should be seeking to fund the sterling borrowing which the EEA has to make via the NLF to finance its increase in foreign currency assets. That does indeed suggest that we should be using current market rates. Presumably someone, somewhere, has to calculate the amount of sterling borrowed each day and that is the number we would use.

3. The only potential complication is to ensure that this is consistent with the way that the CSO derive their published figures for the external financing of the PSBR, since it is against those published figures that our funding is judged. The relevant section of the Financial Statistics Explanatory Handbook, attached, suggests that there should be no inconsistency. But it might be as well to check with the CSO.

4. We agreed that Mrs Ryding would do this, but I am sure that Ms Bronk (either refreshed from her holiday or with a broken leg) would be pleased to help if that should turn out to be useful.

JWG

J W GRICE

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## Table 2.6
## Financing of the public sector borrowing requirement

This table analyses the PSBR according to the sources of the funds borrowed; it shows who takes up the net issues of debt whereas table **2.5** shows who issues them. The table is in two parts. The second part shows the three main ways in which the PSBR is financed: by sales of debt to the public outside the monetary sector (for example, gilts, national savings, local authority stocks and bonds); by borrowing from the banking system; and by transactions with the overseas sector, which include not only government borrowing but also the effect of changes in the reserves on the sterling value of the assets of the Exchange Equalisation Account. Financing also includ s issue department transactions in bills, repurchases and sales of ECGD-backed promissory notes and shipbuilding credit paper. The first part of the table is a summary of the second part but includes a breakdown of the non-bank private sector financing between other financial institutions, industrial and commercial companies and the personal sector. The data for this analysis are available one month later than data for the non-bank private sector as a whole.

Sales of debt to the public are influenced by a number of factors including the level of interest rates and expectations about future interest rates. The state of confidence can also be important.

The extent of overseas finance is largely the consequence of the balance of payments position (see table **11.6** and notes on page 110 for the statistical relationships). When an external deficit is financed by a fall in the foreign exchange reserves, the central government receives an inflow of sterling finance from sales of foreign currency. The fall in the reserves appears as overseas financing while the inflow of sterling reduces the finance that has to be raised domestically. Borrowing abroad by public corporations and local authorities usually increases the reserves since these bodies require sterling for mjd 3/16m

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FROM: MISS M P WALLACE
DATE: 4 March 1988

MR PERETZ

Miss O'Mara

Mr Davey

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara

**INTERVENTION**

The Chancellor was grateful for your minute of 3 March. He agrees that it is right not to make any immediate funding move to sterilise this intervention.

MPW

MOIRA WALLACE

574/88

File – Funding
+ Reserves

Good news – the "official reserves" change which we fund (and which is included in the balance of payments, CGBR financing etc) is derived by translating each transaction into sterling *daily* at *current* exchange rates (translating *each* deal ~~at~~ at ~~the~~ its appropriate exchange rate). If you need more details Jill Jupp (4489) is the person at the Bank.

Miss O'Mara

Vyvien Brenk has been investigating exactly how the intervention we fund is calculated – I think this means we have nothing to worry about. It is interesting that it's OK to calculate these numbers (which are published in Fin Stats) ~~as~~ at current rates, but not the reserves themselves.

Cathy Ryding
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