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

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25 July 1988

A T O'Donnell
British Embassy
3100 Massachusetts Avenue NW
Washington
DC 20008
USA

Dear Gus,

FEDERAL RESERVE EXPERIMENTAL MONETARY AGGREGATES

You asked in your letter to me of the 30 June, whether we would like to go on receiving the tables of experimental monetary aggregates. So far as we have been able to determine, no one here at the Treasury makes any use of this material and we would therefore be quite happy for you to stop sending them.

Best wishes

Joe

J W GRICE

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From : Miss M O'Mara
Date : 25 July 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester o/r
Mr ~~Scholar~~
Mr Peretz o/r
Mr Gieve
Mr Grice
Mr N P Williams
Mr Cropper

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JULY RESERVES ANNOUNCEMENT : CALLING THE $2.5 BILLION FRN

I attach a draft minute to the Prime Minister along the lines we discussed this morning.

2. The Bank's best guess is that we might aim at an ecu bill programme of around $1½ billion but they regard any total in the range $1-2 billion as feasible from their initial contact with the investment houses. They would prefer not to mention any figures publicly at this stage, although we may well be pressed to give them in the context of the reserves announcement, not least to dampen speculation about the size of the drain on the forward book. In any case, we have thought it better in the minute to the Prime Minister to focus on the monthly totals, building up over a period. We should be able to report the outcome of the Bank's discussions to you by the weekend.

3. We have included in the draft minute a brief reference to the fact that at present we do not acknowledge the existence of the forward book. No. 10 should be well aware of this and the absence of any comment on this aspect of your proposals could well raise more questions than it would avoid.

4. You also asked for further advice on the figure we might publish for the underlying change in the reserves in July (Mr Allan's minute of 21 July), in the light of our recent market operations.

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5. The "true" underlying figure is now a rise of around $850 million, after our intervention on Friday night and early this morning. We see no problem in publishing a figure of this size and the Bank agree, but in view of the future calls on the forward book would not want to publish anything higher.

6. Finally, you enquired about our treatment of MOD forward purchases. Each month, as you assumed, these are in effect financed from the spot reserves as we swap spot reserves forward to meet requirements 18 months out. But since the MOD programme is a rolling one, we are also swapping out of the forward book into the spot reserves to meet MOD's current needs. The net effect on the forward book will usually be very small and does not therefore affect our neutral assumption of no change in the forwards from month to month. (I attach for you only a copy of Sir G Littler's minute of 25 February which explains this aspect of our forward operations in more detail). Thus, if MOD's requirements in July were $200 million and those in 18 months' time were $210 million, the effect on the spot and forward books in July would be as follows :

$ million

	Spot	Forward
	+ 200 (from forwards)	- 200 (maturing forwards)
	- 200 (to MOD's customers)	
	- 210 (swapped forward)	+ 210 (swapped from spot)
Net change	- 210	+ 10

Whereas in the past, the fall in the spot reserves (other things being equal) reflected MOD's requirements in that month, it now reflects their requirements 18 months hence.

7. We have been showing MOD's forward currency needs as a separate item on the evening report but now that the programme is up and running at full strength, think this is probably misleading and we shall delete it from the end of this month.

MOM

MISS M O'MARA

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DRAFT MINUTE TO PRIME MINISTER

FUTURE OF THE UK'S $2.5 BILLION FLOATING RATE NOTES

Under the terms on which we issued our $2.5 billion Floating Rate Notes (FRN) in September 1985, we have the option of repaying ahead of schedule at three monthly intervals from October of this year until the FRN finally matures in 1992. In order to manage our reserves as cost-effectively as possible, I propose we should notify our agent at the beginning of August that we intend to call the notes in this autumn, financing the prepayment in part from the proceeds of a new ecu bill programme, with the remainder being met from our forward foreign currency reserves. The obvious date to announce our intentions is 2 August, when we shall be publishing the July reserves figures.

Case for calling the FRN

2. Our dollar reserves currently earn slightly below LIBID less ¼ per cent at the margin. We pay LIBID on the $2.5 billion FRN itself, so at present we are incurring a slight loss. This would be warranted if, as at the time we took up the loan, we thought we might need to use the dollars for intervention in support of sterling in the near future. But the reserves, which then stood at $14 billion, have now grown to just below $50 billion and the balance of argument has changed.

3. The market equally realises that prepayment would save us a substantial sum (around $30 million over the remaining life of the FRN) and that it should still be possible to make significant interest savings, even if we refinanced the borrowing in order to

maintain the reserves at their current level. The price at which the notes are currently trading - marginally above par - reflects investors' firm belief that we will exercise our call.

4. If we do not call the notes now, there must be a risk that the market will suspect we believe that the external position is considerably worse than we have acknowledged publicly - the weakness of a borrower's financial position is the main reason why FRNs are not repaid ahead of schedule. We clearly want to avoid sowing any such doubts.

Financing the call

5. The FRN would not actually be repaid until October but the market will be keenly interested in how we plan to finance the prepayment. I believe we should therefore announce our intentions at the time we exercise the call itself.

6. We could simply repay the loan out of the spot reserves which now stand at record levels. But there is a risk that might be regarded as imprudent at a time when the monthly trade figures are revealing the current deficit for 1988 is likely to be well in excess of our Budget forecast of £4 billion. We could finance the prepayment from fresh foreign currency borrowing in the Government's own name but I think it would be most unwise to launch a new issue of anything approaching $2.5 billion in size, either as a fixed-rate Eurodollar bond or in the form of floating rate US short term notes - the two markets which should currently offer us a substantial interest rate saving. Issues of this size, even by a sovereign borrower, would be unprecedented and thus

focus unwelcome attention on the UK's external position. In any case, we would not want to make an issue in present market conditions.

7. However, I am attracted to the possibility of launching an ecu bill programme in London in the early autumn. I want to discuss this in more detail with the Bank but I have in mind issues of around, say, \$200-250 million equivalent a month which might build up over a period of six months and could be varied flexibly later, as we wished. I do not see this programme as justified primarily in terms of saving money: we should probably break even on it, having to pay on the notes roughly what we should earn by investing the proceeds. Nor do I see this mainly as a means of raising foreign currency for the reserves; rather as a practical step towards completion of the single market in 1992 and thus very much in line with your own comments at Hanover on the need to develop the role of the private ecu. There is also no doubt that the City would benefit from a decision to set up such a programme here: the ecu market is at present located principally on the Continent and a London-based programme, dependent on the active involvement of UK houses, should generate greater domestic interest in the ecu and help to focus the market firmly in London.

8. The remainder of the FRN call could then be financed by running down our (unpublished) forward book which at the end of June stood at around \$5½ billion, rather than by a reduction in the spot reserves.

<u>Presentation</u>

9. We need to tell our principal paying agent (Morgan Guaranty)

by 3 August, if we intend to call the FRN in October. While the decision should remain confidential until the agent informs the note holders at the beginning of September, there is, as always, some risk of a leak. I therefore propose we should announce we are calling the FRN at the time we publish the July reserve figures on 2 August. Since we shall be showing an underlying rise in the reserves of around [$850 million], the decision to prepay should not give rise to any fears in the market. However, to allay any potential concern in the wake of the June trade figures, we would make it clear that we intend to finance the repayment by means both of an ecu bill programme to be launched in the autumn and by running down our forward reserves. Since we have never acknowledged the existence of the forward book in the past, this might arouse some press attention but we should, of course, refuse to give any details of our forward operations, as usual. Similarly, we should ask the media to reserve all questions about the ecu bill programme until we announced details of its launch later in August or early in September.

10. I am copying this minute to the Governor of the Bank of England.

FROM: A C S ALLAN

DATE: 26 July 1988

MISS O'MARA

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mr Peretz
Mr Gieve
Mr Grice
Mr N P Williams
Mr Cropper

D2

JULY RESERVES ANNOUNCEMENT: CALLING THE $2.5 BILLION FRN

The Chancellor was grateful for your minute of 25 July. He has slightly amended your draft minute to the Prime Minister, and I attach a copy of the final version.

2. On the reserves figure for July, he is content to publish a figure in the $850 million to $950 million range, though not, of course, a round number.

9/36/88

ACSA

A C S ALLAN

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

FOREIGN CURRENCY BORROWING

I have been considering the management of our foreign exchange reserves and our official foreign currency debts. I propose that we should repay early the $2.5 billion Floating Rate Notes (FRN) which we issued in September 1985 and which now looks expensive borrowing; and that we should finance this partly from the proceeds of a new ecu bill programme, and partly from our forward foreign currency reserves. We would need to notify our agent at the beginning of August if we are to prepay the FRN this Autumn, and the obvious date to announce our plans is 2 August, when we shall be publishing the July reserves figures.

Case for repaying FRN early

Under the terms on which we issued the FRN, we have the option of repaying ahead of schedule ("calling" the notes) at three monthly intervals from October of this year until the FRN finally matures in 1992.

Our dollar reserves currently earn at the margin around ¼ per cent below the London Interbank Bid rate (LIBID) for dollar deposits. We pay LIBID on the $2.5 billion FRN itself, so at present by borrowing via the FRN and holding the dollars in the reserves we are incurring a slight loss. When we took up the loan, we thought this cost was warranted in the interests of strengthening our reserves. But the reserves, which then stood at $14 billion, have now grown to just below $50 billion.

The market itself realises that prepayment would theoretically save us a significant sum (around $30 million over the remaining life of the FRN) and that it should still be possible to make worthwhile interest savings even if we were to re-finance the borrowing so as to maintain the reserves at their current level. The price at which the notes are trading - around par - reflects investors' belief that we will exercise our call option. I believe it is sensible to do so.

Financing the repayment

The FRN would not actually be repaid until October, but I believe we should announce our intentions on how the repayment would be financed at the same time as we announced that we are planning to exercise the call option.

We could repay the loan out of the spot reserves, which now stand at record levels. But that might well be regarded as imprudent at a time when we are in substantial current account deficit. An alternative would be to finance the prepayment from fresh foreign currency borrowing in the Government's own name. But it would be unattractive to launch a new issue of anything approaching $2.5 billion in size, either as a fixed rate Eurodollar bond or in the form of floating rate US short-term notes - the two markets in which we could get a substantial interest rate saving. Issues of this size, even by a sovereign borrower, would give quite the wrong signals about the UK's external position and our need for finance. In any case, present market conditions are far from ideal for launching a dollar issue.

However, I am attracted to the possibility of launching a more modest ecu bill programme in London in the early Autumn. I want to discuss this in more detail with the Bank, but I have in mind issues of around the equivalent of $200-250 million a month building up over a period of six months to something over $1 billion; the amounts could be varied flexibly later, as we wished.

There are two main reasons for undertaking an ecu bill programme of this kind. First, it should help establish London as the centre of

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the ecu market, which is at present located principally on the Continent; a London-based programme, dependent on the active involvement of UK houses, should generate greater domestic interest in the ecu and help focus the market firmly in London. Second, we could present it as a practical step towards greater European co-operation in monetary affairs, and very much in line with your own comments at Hanover on the need to develop the role of the private ecu. There would be no net cost from undertaking an ecu bill programme: we should earn roughly as much from investing the proceeds as we have to pay on the borrowing.

I propose that the notes should be called "UK Ecu Treasury Bills". This should help in marketing, by underlining their quality. It will require an Order subject to negative resolution.

The remainder of the prepayment of the FRN would then be financed by running down our (unpublished) forward book, which at the end of June stood at around $5\frac{1}{2}$ billion. We would explain that we had deliberately built up the forward book in anticipation of prepaying the FRN, as a sensible act of reserves management. We would, as usual, refuse to answer any other questions about our operations in the forward market.

Timing

We need to tell our principal paying agent (Morgan Guaranty) by 3 August, if we intend to call the FRN in October. While the decision should remain confidential until the agent informs the note holders at the beginning of September, there is, as always, some risk of a leak. I therefore propose we should announce we are calling the FRN at the time we publish the July reserve figures on 2 August, making it clear that we intend to finance the repayment by means both of an ecu bill programme to be launched in the Autumn and by running down our forward reserves.

If you have any queries about these proposals, we can discuss them at our bilateral on Wednesday. I am copying this minute to the Governor of the Bank of England.

[N.L.]

26 July 1988

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THE EEA'S RISK POSITIONS: SIX MONTHS TO END-JUNE 1988

A. INTRODUCTION

1. This paper analyses developments in EEA's currency and interest rate exposures over the last six months, and presents figures for the returns made on these exposures. It discusses likely developments in the period ahead, and makes the following recommendations for the next six months:

(Currency Exposures - paragraphs 24-27)
The recommendations on currency can be set out in the following table:

	$	DM	Yen
Neutral currency composition	40%	40%	20%
Normal range	30-50%	30-50%	15-25%
End June position	37%	46%	15%

Recommendations:

	DM	Yen
go short maximum	1.60-	120-
start going short	1.70	130
start going long	1.80	140
go long maximum	1.90+	150+
current position	1.85	132

Thus (a) if the DM weakened below 1.90, the existing long DM position should be increased towards its maximum; while if the DM strengthened towards 1.70, the long position should be reduced.

(b) if the Yen weakened from present levels, the existing short position should be reduced, and replaced by a long position at levels above 140; while if the Yen strengthened there should be little change in Yen holdings until the Yen moved towards 120;

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(c) finally, as the DM strengthens from its present rate against the Yen of 71 1/2, the short Yen/long DM position should be reduced, and reversed at cross rates above 75.

(Interest Rate Exposures - paragraphs 51 - 53)

(d) begin to reduce the short position in the US market as yields rise from today's levels and consider the establishment of a long position in the US market at 4-year yields above 9 1/2%, 100 basis points above current levels;

(e) purchase DM bloc securities at 10-year yields above 6 3/4%, and make sales at yields below 6 1/4%;

(f) make sales of Yen securities at 10-year yields below 5 1/4%, and purchases at yields above 6%.

2. The paper is arranged as follows:

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B. RESERVE FLOWS

3. There was a true underlying inflow into the reserves of $2.8 bn in the first half of 1988 (after $12.9 bn in the previous six months). The rise was concentrated in March ($2.2bn) and May ($0.8 bn) when sterling was under upward pressure.

4. Total currency reserves (spot and forward) rose by $1.3 bn, when measured at March 1988 parities, with no change in holdings of gold and SDRs. Holdings of DM bloc currencies (principally DM, but also including Dutch guilders, ECU and French francs) rose substantially more, by $4.3bn, and Yen holdings rose by $2 bn. Reflecting this switch, holdings of US dollars fell by $4.7 bn; in order to maintain liquidity, almost all of this fall was taken on the forward book.

5. There were substantial early repayments of expensive US dollar floating rate debt, and only modest new borrowings. Total repayments of new borrowing amounted to $1.7 bn over the period.

6. The foregoing figures are compiled using the conventional reserves methodology, which is useful principally in considering the size and composition of flows. For the purpose of calculating the EEA's exposures, and the return on those exposures, it is however preferable to include the EEA's liabilities, and to value securities and currencies at market value. In subsequent sections of this note all figures are on this basis.

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Table 1

THE RESERVES (MARCH 1988 PARITIES) ($ bn)

	Dec 1987	June 1988	Change
Spot currency reserves			
US dollars	22.6	22.0	- 0.6
DM bloc	9.4	12.1	+ 2.7
(of which, DM	7.6	8.3	+0.7)
Yen	2.1	1.9	- 0.2
Can dollar	0.7	0.6	- 0.1
	34.8	36.6	+ 1.8
Forward currency reserves			
US dollars	3.8	- 0.5	- 4.3
DM bloc	2.6	4.2	+ 1.6
(of which, DM	2.6	3.9	+1.3)
Yen	0.2	2.4	+ 2.2
Canadian dollar	0	0	0
	6.6	6.1	- 0.5
Total currency reserves	41.4	42.7	+ 1.3
Gold	8.1	8.1	0
SDR (spot and forward)	3.3	3.3	0
Total reserves	52.8	54.1	+ 1.3

Note (1) These figures are compiled on the same basis as the reserves announcement figures. Securities are at historic book costs; holdings are on a settled basis; and parity exchange rates are used (DM 1.68 and Yen 128 against the US dollar).

(2) Annex tables A and B give full details of reserve holdings on the above basis.

LIABILITIES (MARCH 1988 PARITIES) ($ bn)

	Dec 1987	June 1988	Change
US dollars	15.1	13.3	- 1.7
DM bloc	3.3	3.3	0
(of which, DM	2.8	2.8	0)
Yen	0.3	0.3	0
Canadian dollar	0.5	0.5	0
	19.2	17.4	- 1.7

C. CURRENCY EXPOSURES

7. The following table sets out the EEA's net holdings of each major currency.

Table 2: Net currency positions ($ bn)

	June 1987	December 1987	June 1988
US dollar	5.3 (65%)	12.3 (52%)	9.4 (37%)
DM bloc	2.2 (27%)	8.9 (38%)	11.6 (46%)
Yen	0.7 (9%)	2.0 (8%)	3.8 (15%)
Canadian dollar	- 0.1 (-1%)	0.5 (2%)	0.4 (1%)
Total	8.1	23.7	25.1

Note: The major exchange rates used for the most recent figures are DM 1.84, Yen 132.5, Can$ 1.21.

8. The current position represents a substantial switch, compared with the end of last year, into the DM bloc and Yen out of US dollars. Although there were a large number of other factors influencing the outcome, this change in allocation had two principal causes:

- intervention in the Spring was, at the Chancellor's request, principally into DM and other DM bloc currencies

- there was a sizeable and deliberate switch out of US dollars into Yen.

9. There were two episodes of heavy intervention, early in March and again in May. The total effect was to add about $3 bn to the EEA's net holdings of DM bloc assets, with significant purchases of French francs and ECUs as well as DM. (The EEA now owns $1.9 bn of French francs, and $1.5 bn of ECUs).

10. The principal switches into Yen were early in this year (about $ 1/2 bn at just under Yen 130), and again in June ($0.9 bn at Yen 128).

11. At our previous meeting, we agreed to switch up to $2 bn into Yen and DM, as political considerations allowed, and so long as the dollar remained relatively strong. In the event, political factors circumscribed our freedom of action to a very considerable extent, both (until rather recently) in limiting our ability to diversify out of the dollar, and in obliging us to build up our holdings of DM bloc currencies at a time not entirely of our choosing. Moreover, the US dollar has strengthened to a remarkable extent against the DM (Chart 1), and has also outperformed the Yen (Chart 2). It is clear that the EEA's switch into DM, and the early portion of its switch into Yen, could - with hindsight - have been better timed; and that the DM acquisitions have performed worse than the Yen.

D. RETURNS ON CURRENCY EXPOSURES

12. While it is instructive to evaluate major past decisions in this case-by-case way, there is also advantage in analysing the return on the EEA's net currency exposures as a whole, in the way set out in our accompanying paper. The first line of the following table gives the return <u>in sterling</u> from the EEA's currency positions, matched by short positions in sterling. It is assumed that the EEA earns short interest rates on currency assets, and has to pay a comparable sterling rate on its sterling short position.

<u>Table 3: The Return on Currency Exposures: 1988</u> (£ mn)

	Q1	Q2	Total so far
1. Total return	- 410	+ 450	+ 40
<u>On diversified - 40,40,20 - basis</u>			
2. Intervention component	- 470	+ 450	- 20
3. Currency mix component	+ 60	0	+ 60.
<u>100% dollar basis</u>			
4 Intervention components	- 170	+1260	+ 1090
5. Currency mix components	- 240	- 810	- 1050