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 121-139

POSITIVE

1. Further substantial rise this month. Reserves now very strong after substantial underlying increase of $17 billion in year so far. Reserves now stand at record level of $41.4 billion.

2. Since the Budget sterling has remained ~~br~~oadly stable, particularly against the deutschemark.

3. Recent statements by Baker, Stoltenberg and Poehl have reaffirmed continued support for Louvre Accord.

DEFENSIVE

(A) POLICY

1. **Is sterling pegged to the DM?** Under Louvre Accord agreed to seek a period of stability in major currencies (including yen and dollar). ~~Bound to affect bilateral rates.~~ Chancellor has made it clear that cross-rate against the deutschemark is of particular importance.

(B) LOUVRE/G7/WASHINGTON

2. **Louvre Accord coming unstuck?** No. Both US Treasury Secretary Baker and German Finance Minister Stoltenberg have reaffirmed commitment to cooperate on monetary and exchange rate policies.

3. **Recent dollar fall means Louvre Accord falling to pieces?** See above. Concept of managed floating does not rule out adjustments from time to time in response to significant events.

4. **Will there be another G7 meeting in the near future to discuss recent market events?** No present plans for a meeting. But Chancellor said on 30 October in radio interview that he was in favour of holding a G7 meeting to discuss falling stock exchanges and the weak US dollar if a "sensible package" was prepared beforehand. G7 countries have been in constant communication with each other about recent events.

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

Have other countries been intervening over the last month/recently? Ask them. Don't discuss details, but statements by other authorities do indicate this.

7. **Concerted intervention in foreign exchange markets pointless before underlying fundamentals have been resolved?** Intervention is 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."

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

8. **Prospects of further co-ordinated interest rate cuts?** Wait and see. Unhelpful to speculate.

9. **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 [~~unhelpful consequences of~~] undue monetary tightening."

10. **Is exchange rate now only thing driving UK interest rates?** Not at all. Interest rates continue to be set in the light of a range of factors affecting financial conditions including asset prices. But for all G7 countries exchange rate stability is an ~~increasingly~~ important objective.

11. **Interest rate cut made because sterling near DM 3 level?** No change in policy. ~~No explicit target;~~ Decision on interest rate taken in the light of monetary conditions as a whole, and to give a signal to the market.

12. **Why did Government act to lower interest rates on 23 October?** Sharp falls in share prices throughout world will tighten monetary conditions somewhat. Judged ½ per cent reduction in interest rates consistent with prudent policy, and an appropriate signal to the market at that time.

13. **Implication of recent heavy intervention for UK monetary conditions/funding?** Policy is full fund of PSBR over financial ear as a whole. Intervention will be sterilised.

14. **Aren't you going to make a loss buying dollars on this scale in a falling market?** Much to early to tell. [Smoothing intervention has been profitable in the past, although that of course is not the reason it is undertaken].

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

(D) **IMF SPEECH**

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

17. **Return to Bretton Woods?** No: in his speech Chancellor explicitly spelt out why he was not advocating return to Bretton Woods. Good idea if you were to read the speech. In it he 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."

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

18. **UK membership of ERM?** No change in Government position. Matter kept under continual review. Will join when satisfied that balance clearly favours doing so.

19. **Conditions required for UK participation?** Not possible to specify precisely. Number of factors and their interaction need to be taken into account. It would be wrong to commit Government in advance; circumstances change, nor would it help conditions in the foreign exchange market to be too specific.

(F) **RECENT MARKET EVENTS**

20. **Stock market collapse due to "volatility" shifting out of forex markets?** No reason to think so. Stability in all markets desirable.

(G) **SALE OF BP SHARES**

21. **Did all the underwriters from Japan, Canada and the US meet their obligations?** Yes.

22. **Why aren't sales to Europe included?** Paid in sterling and will be received in November.

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

24. **What does the ~~Bank BP arrangement~~ Authorities' safety net for BP mean for the Reserves?** Nothing, it is a sterling transaction.

TABLE 3 - TOTAL PUBLISHED RESERVES

	Total reserve changes during month	$ billion Level at end of month
USA	- 0.9 (end September)	45
Japan	+ 1.4 "	72
Germany	+ 1.0 (w/e 23 October)	50
France	- 0.4 (end August)	69
Italy	- 3.3 "	46
Canada	+ 0.1 "	6
United Kingdom	+ 6.~~7~~6 (end October)	41

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.

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DL.

ERMP C/8

FROM: I POLIN

DATE: 1 December 1987

1. MISS O'MARA approved in draft. HL Goodman 1/xii
2. ECONOMIC SECRETARY

Version as amended by the Chancellor and Economic Secretary
Ian Polin
2/12/87

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THE RESERVES IN NOVEMBER 1987

The reserves announcement for November will be made on Wednesday 2 December at 11.30 am. This month's announcement reports a fall in the reserves of $118 million and an underlying rise of $31 million.

Ian Polin

I POLIN

Mr Norgrove - No 10
Mr Lankester - Washington (after publication)

Mr Gill)
Mr D J Reid)
Mr J Milne) - B/E
Miss J Plumbly)
Mrs Jupp)

until 11.30 Wednesday 2 December 1987
thereafter UNCLASSIFIED

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DRAFT PRESS NOTICE

THE RESERVES IN NOVEMBER 1987

The UK official reserves fell by $118 million in November. Accruals of borrowing under the exchange cover scheme amounted to $100 million; repayments of such borrowing amounted to $187 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $62 million. At the end of November, the reserves stood at $41,281 million (£22,533 million*) compared with $41,399 million (£24,027 million+) at the end of October.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during November, was $31 million. The underlying change in the reserves 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).

3. New borrowing under the public sector exchange cover scheme was as follows:

British Nuclear Fuels plc, $100 million.

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* When converted at the closing market rate on Monday 30 November £1=$1.8320

\+ When converted at the closing market rate on Friday 30 October £1=$1.7230

until 11.30 Wednesday 2 December 1987
thereafter UNCLASSIFIED

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Repayments of such borrowing were:

British Airways plc, $105 million; North West Water Authority, $22 million; British Telecommunications plc, $10 million; North of Scotland Hydro Electricity Board, $10 million; Lothian Regional Council, $9 million; Electricity Council, $8 million; Northumbrian Water Authority, $4 million; Civil Aviation Authority, $3 million; South of Scotland Electricity Board, $3 million; Welsh Water Authority, $3 million; British Steel Corporation, $2 million; British Nuclear Fuels plc, $1 million; Lancashire County Council, $1 million; Severn Trent Water Authority, $1 million; Strathclyde Regional Council, $1 million; Yorkshire Water Authority, $1 million; Others, $3 million.

THE RESERVES IN NOVEMBER 1987 : PRESS BRIEFING

Factual : main features of markets in November

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
2 November	74.6	1.73	2.97½	98.0	1.72	137½
4 November	75.0	1.74½	2.98½	97.8	1.71	137
9 November	75.6	1.79	2.98	95.9	1.66¼	134½
16 November	74.8	1.74	2.98½	97.7	1.71½	137
23 November	75.7	1.79	2.98½	95.9	1.66½	134½
30 November	76.4	1.83	2.99½	94.4	1.63½	132

With the market's attention focused on the outcome of the US budget talks, sterling for the most part was on the sidelines. It benefited from the dollar's weakness moving up from $1.7270 and ERI 74.6 at the beginning of the month to $1.8320 (its highest level since May 1982) and ERI 76.4 on 30 November. P Against the continental currencies, movements were restricted to a narrow range and were generally influenced by fluctuations in interest rates. Upward pressure on sterling was eased by a ½% cut in UK base rates (to 9%) on 4 November and, when further falls in equity markets raised expectations of another cut, a low of DM 2.97 was noted on 10 November. However, ~~as share prices recovered a little and the downward pressure on interest rates abated, sterling was in good professional and commercial demand. News of a rise in the inflation rate (to 4.5% in October) temporarily subdued activity, but sterling was pulled higher with the firmer dollar immediately after the US budget package announcement and,~~ when ~~the market realised that~~ the cuts in West German, French and Dutch interest rates ~~would~~ were not ~~be~~ matched here, ~~it~~ sterling moved up to a high of DM2.99½ on 25 November and ended the month on a firm note.

The difficulties encountered in resolving America's fiscal problems tended to dominate proceedings on the foreign exchanges, causing the dollar to fall rapidly. Following remarks from Baker and Mulford which were taken to imply that the US were prepared to acquiesce in a lower dollar and reports that the budget negotiations were unlikely to agree on any cuts over and above the Gramm-Rudman-Hollings requirement, the dollar's decline gathered pace and, when no new initiatives on currency stability emerged from the regular meeting of central bankers in Basle, the US unit fell to post-war lows of DM 1.6485 and Y 133.20 on 10 November. Speculation that a budget package was imminent subsequently provided the dollar with some respite and it received further boosts from the publication of a slightly better-than-expected trade deficit for September of $14.08bn and from strong indicators for retail sales and wholesale prices. Nevertheless, underlying sentiment remained bearish and, although the dollar moved up in the immediate aftermath of the budget announcement on 23 November, the rally was short-lived as the markets were disappointed with the package and worries persisted over ratification of the agreement and about prospects for a new international currency understanding. Despite co-ordinated interest rate cuts in West Germany, France and Holland and statements from Stoltenberg and Kohl that they were considering ways of stimulating the German economy, the dollar ended the month on an easier note. Following speculation during weekend of 28/29 November that Baker was prepared to see the dollar continue to fall, the dollar closed the month at post-war record lows of DM 1.6350 and Yen 132.17.

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
	Totals	+ 16738	+16468	

+after revaluation

(ii) Last month'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%

POSITIVE

1. Little change in reserves this month. Reserves remain very strong after substantial underlying increase of $17 billion in year so far. Reserves now stand at $41.3 billion.

2. Apart from recent weakness of dollar ~~S~~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 ~~governments' commitment to~~ maintaining a stable exchange rate with ~~cross~~ rate against deutschemark of particular importance. This is consistent with Governments' aim for money GDP and hence inflation. Policy has been made clear not merely by Chancellor's statement, but also by what has actually happened.

2. A ~~**Specific range for sterling?** See 1. But as Prime Minister said in interview reported in 'Financial Times' on 23 November - sterling is not tied to a specific range against the deutschemark~~ and as it would be were we ~~members of the EMS exchange rate mechanism.~~ A Prime Minister's FT interview? Prime Minister is pointing out that we are not at present ERM member and us not formally tied to DM within a published range.

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

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

4. **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."

5. **Louvre Accord coming unstuck?** ~~No.~~ 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.

6. **Is it US policy to drive the dollar down?** Recent statement~~s~~ by President Reagan ~~Secretary Baker~~ indicate US does not want to see further dollar fall. [Reagan 10 November "I don't want further decline in dollar value".]

7. **Will there be another G7 meeting in the near future to discuss recent market events?** Chancellor said in House on 26 November that he hopes a G7 meeting will be held before Christmas. ~~But necessary pre-conditions are: US Congress needs to ratify budget deficit package; the largest surplus countries, Germany and Japan should commit themselves to further action to improve their economic momentum; and parties should agree that conditions are right for stabilisation of the dollar which is an essential element to avoid recessionary dangers.~~ G7 finance ministers ~~countries~~ are, of course, in constant telephone communication with each other about recent events.

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

9. **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.

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

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

12. **<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) **<u>INTEREST RATES/MONETARY POLICY</u>**

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

14. **<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.

15. **Why not cut interest rates like Germans to support dollar?** UK has already brought its interest rates down by full 1% since stock markets fall. ~~Chancellor said in the House on 26 November that, rates having come down by a full point, he did not think any further reduction was called for at the present time. Though concerned by the recessionary influences that may come from the stock market collapse, still inflationary forces to be kept under control.~~

16. **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.

17. **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. ~~monetary conditions as a whole.~~ But, clearly right in disturbed financial market ~~circumstances~~ conditions of late October/early November to reduce interest rates in order to allow some expansion in liquidity.

~~18. **Why did Government act to lower interest rates on 5 November?**~~ Sharp falls in share prices ~~throughout world will~~ equivalent to tighten monetary conditions somewhat. ~~Judged ½ per cent reduction in interest rates consistent with prudent policy after consultation with international partners. In market circumstances, clearly right to reduce interest rates.~~

19. **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.

20. **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)

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

22. **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. ~~Would be wrong to commit Government in advance; circumstances change, nor would it help conditions in foreign exchange market~~ to be too speci~~fic~~.

23. **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

Collapse triggered by fears of Louvre Accord breaking down.

24. **Stock market collapse due to "volatility" shifting out of forex markets?** No. ~~reason to think so.~~ As Chancellor said in his Mansion House speech this idea is "manifest poppycock" ~~Stability in all markets~~ desirable. as recent events have demonstrated.

(F) US BUDGET DEFICIT PACKAGE

25. **UK view on US budget deficit package?** Welcome budget deficit agreement. ~~as first step.~~ Await ratification ~~agreement of~~ by Congress. Further action by ~~other~~ surplus countries still necessary.

26. **Reduction too little too late.** ~~No. Welcome agreement which has been reached. Now await Congress approval. But other countries need to play their part too.~~ Substantial reductions of $73 billion already achieved in financial year 1987.

27. **Cuts in US budget deficit could cause recession?** No. Package [illegible] cuts necessary to restore market confidence and is necessary step towards reduction of trade imbalances. ~~Gives lead to other countries to take action~~.

28. **World situation will send UK into recession?** No. Government's sound economic and financial policies have enabled UK to weather (A) ~~recent gyrations in stock markets and fall of dollar~~. 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."

(A) year-long coal strike and collapse of oil price. Have shown capacity to grow more strongly than other major countries.

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TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	+ 1.1 (end October)	46
Japan	+ 0.9 "	73
Germany	+ 13.0 (w/e 23 November)	63
France	- 2.0 (end September)	67
Italy	+ 0.5 "	46
Canada	+ 0.1 (end August)	6
United Kingdom	- 0.1 (end November)	41

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.

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From : D L C Peretz
Date : 14 December 1987

SIR G LITTLER

cc PPS
Sir P Middleton
Sir T Burns
Miss O'Mara

I should record that, as you know, at the request of the Chancellor I told Mr Gill today that following this morning's purchase of French francs for dollars we would not for the time being wish the Bank of England to carry out further transactions selling dollars for other foreign currencies.

2. I agreed with Mr Gill this did not apply in the case specifically allowed for in the Chancellor's letters last week : ie when the Bank found they had to sell sterling for dollars, for technical reasons, and subsequently sought to switch those dollars into other currencies. That would be the second leg of a transaction that involved selling sterling. But where we have bought deutschemarks, and are trying to acquire an equivalent quantity of French francs, we should in future do so by buying French francs for either deutschemarks or sterling.

3. Mr Gill accepted this instruction, and quite understands the reason for it : that we do not want to lay ourselves open to the charge of undermining the dollar.

DLCP

D L C PERETZ

Mr Peretz
Good.
GL 15/12

Mr [illegible] file

S62/85