st rates are now extremely low in … case, the new regime is likely to encourage investment in shares. And the …ums involved are impressive: m… add up to about Y300 trillion, or $1,875bn out of total personal savings of $3,200bn.

Only a fraction of these savings will be moved into shares in the near future, and private investors will go first to the Tokyo and Osaka stockmarkets – driving them to even dizzier heights. But Japanese brokers are known for their ability to sell almost anything, from home or abroad, to respectful customers. What's more, as deposits are deregulated, Japanese banks and deposit takers will have to produce more competitive savings schemes for more demanding customers. Hoare Govett's Japan economist, Frans Jonkers, argues that to give them a higher return institutions will have to buy more shares.

At least some of the money switched to equities is likely to find its way into foreign shares. The spree has already started: Japanese buying of overseas bonds was still riding high in 1986, at over $8bn net a month on average, but monthly share purchases rose from just $1/4bn early in the year to around $2bn by the end.

Although the Japanese complain about sterling's behaviour over the last year, the UK hasn't been missing out. One Japanese broker says that buying of UK equities by December was ten times its level a year earlier – helped, of course, by the British Gas privatisation. Asked if UK holdings had doubled over the last year, an institutional investor answered inscrutably, "At least".

The reason the Japanese have not dived deeper into shares is not just sterling worries. The ultra-conservative Japanese investor has simply been unfamiliar with European equity markets. Gilts work much like government debt markets in any major financial centre: they are highly marketable and have a guaranteed rate of return. But when it comes to shares, says Francis Connor of BZW's Tokyo office, "the Japanese are still at the far end of the diving board looking at the water".

American companies, usually highly marketable and often well known to the Japanese, have drawn the majority of equity investors. They've also bought into the larger German corporations, such as Daimler/Benz, Volkswagen and Allianz. But the strong D-mark is turning into a double edged sword. Originally an attraction, it now looks set to cut German exporters' profits. Kazuo Konta, the head of Daiwa's non-Japanese equity department in London, reckons that "interest should soon shift to the UK, though for the moment I'm saying 'Wait and see'".

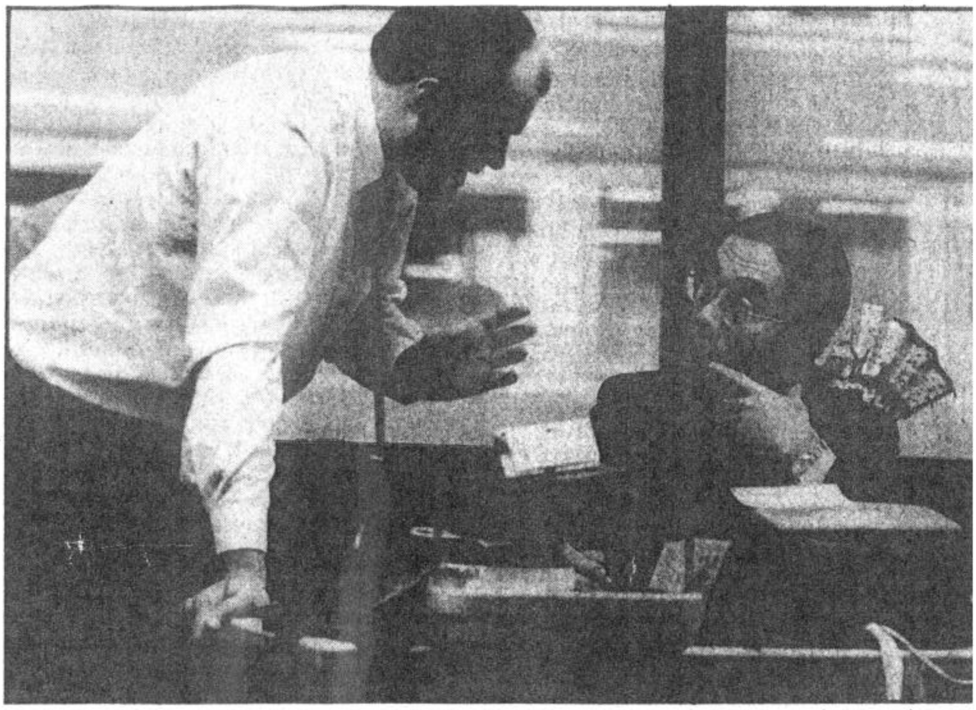
Konta also believes that cheaper and more transparent dealing methods since Big Bang make the London stockmarket seem less of a maze to the Japanese. Yet share buying is still generally for the short term. Yasushi Yamada, Sumitomo Life's UK managing director, says that his company's investment in the UK is still only on a trading basis.

Looking from our side of the globe the attitude seems puzzling. British shares appear incredibly good value, on PE ratios in the mid teens compared with, the Japanese average of over 50. But the Japanese don't see it that way. David Dible, who analyses the healthcare sector for Hoare Govett in Tokyo, points out that Japanese companies in his sector can hope to post 20 per cent profits increases with nil inflation. Which makes heady PE ratios seem almost reasonable.

But in any case, the Japanese don't have the Anglo-Saxon fixation with earning multiples. And they are traders by instinct. This bias towards short term performance means that one foreign offer which the Japanese institutional investor does find hard to resist is the new issue. And much hyped privatisations are received enthusiastically. Not just UK issues – Japanese investors piled into St Gobain and Paribas – but Rothschilds claimed that the whole of the British Gas share offer could have been underwritten in Japan and the US.

The publicity drives accompanying privatisations serve to lure Japanese investors into the London market. Favourite shares include British Telecom, British Gas and Cable & Wireless. Sometimes they are looking beyond the short term. The arguments for staying with, say, British Gas, which is highly marketable and bears direct comparison with Japanese utilities, are compelling. Nomura, Japan's biggest securities house, could have handled four times its initial 2½ per cent Gas allotment – and, astonishingly, it has already been instrumental in buying over 10 per cent of the shares.

"What's needed is education," comments Yamaichi's head of UK and European equities Mark Vanoli. "Japanese investors always look at currency first, and they're used to capital growth and minimal yield from a stock". A 7 per cent yield at issue from British Gas must have seemed almost too good to be true. So far, according to Vanoli, Japanese interest has centred on the very biggest companies in the FT-100, such as ICI and Glaxo. But he confesses that they tend to trade out within six months.



Yamaichi's Vanoli agrues that we need to tell Japanese investors more about British companies

Now that Japan's big four – Nomura, Daiwa, Nikko and Yamaichi – are established in London, attitudes could change. Nomura's sales team, for instance, can tap a four million strong customer base in Japan. As for British securities firms, Warburgs and Vickers are already members of Tokyo's stock exchange. Others are beefing up their representation – BZW's five-strong international equities team in Tokyo is being boosted to seventeen.

Brokers expect a gradual increase in Japanese purchases of UK shares, but most of the characteristic Japanese "wait and sees" seem to have an eye on the forthcoming election. The Japanese are cautious but tend to act like sheep when one of them starts moving. A Tory victory could be the trigger. *Simon Gompertz*

1778.24

105

FROM: P H BROOK

DATE: 25 February 1987

MR FLITTON

cc: Ms Goodman
Mr Richardson
Ms Bronk
Mr Collins) - B of E
Mrs Jupp)

EXTERNAL AND FOREIGN CURRENCY FINANCE OF PUBLIC SECTOR

Your minute of 18 February to Mr Richardson prompts a couple of further comments particularly on paragraph (d) which may have implications for current funding arithmetic.

2. Your suggestion that Table E is incorrect is based on a misunderstanding. The Table does not indicate that EMCF swaps are not counted in the total reserve change, rather it shows that EMCF swaps are excluded from the official reserves (Financial Statistics Table 1.3 Col 18) as defined in the externals. Setting out an extra step in the development of the reserves equation in Table E might clarify matters. A full definition of underlying change in the reserves would be as follows:

Total change in reserves
(consists of)
+ Total change (excluding EMCF swaps)
+ EMCF swaps

- Repayments of HMG assigned debt, FRN etc

- Public sector borrowing under ECS

- Non public sector borrowing under ECS
- EMCF swaps

= **Total underlying change in reserves**

For the purpose of Table E I have simplified this equation by cancelling out the two oppositely signed EMCF swaps terms.

3. I am content to change the title of the second item in the reserves in Table E which I had simply taken from the table in Mr Kelly's reserves submission.

4. I am grateful to Mrs Jupp for unearthing the case of public sector non-ECS covered foreign exchange borrowing from the monetary sector. I shall amend Table E accordingly for the sake of posterity.

5. I am interested in your explanation of an error in the figure for non-ECS covered foreign currency borrowing by LAs and PCs in the table in paragraph 8 of my note. You say, and I have no reason to doubt you, that the figure in Financial Statistics of £135 million for PCs overseas foreign currency borrowing in 1986 Q2 is wrong. £20 million of borrowing by BT has been eroneously included and the correct figure should be £115 million. This has a knock on effect in my table where the non-ECS covered foreign currency borrowing by LAs and PCs should be £14 million not £35 million. This has no implications for the closeness of the correlation between the externals derived from reserves figures, and the externals calculated from back-up sheets and Financial Statistics. This is because the figure for PCs overseas borrowing in the back-up sheets I used also included the £20 million BT borrowing and therefore both totals should be reduced by £20 milion, giving £398 million and £405 million respectively.

6. What is of more concern is that the error in Financial Statistics has, I understand, only recently been discovered and is still in the February 1987 version. It seems likely, therefore, that the latest back-up sheets also contain this error, in which case we are currently underestimating the funding requirement by £20 million.

7. I cannot verify this as the latest back-up sheets do not contain a breakdown of 1986 Q2 externals but perhaps Mr Collins can check whether this is the case or not.

P Brook

P H BROOK

4317/010

107

FROM: I POLIN
DATE: 25 February 1987

MR KELLY

Mr Peretz
Mr Sedgwick
Mr Bottrill
Ms Goodman
Mr Richardson
Mr Flitton

Mr Gill)
Mr DJ Reid)
Mr J Milne) Bank
Mr DJ Chetwin)
Mrs J Jupp)

THE RESERVES IN FEBRUARY 1987

The reserves figures for February will be published on Tuesday 3 March at 11.30am. I attach a draft of the press notice, Q and A briefing and the press material on exchange rate developments. May I have comments please by 2pm on Friday 27th January?

Ian Polin

I POLIN

P.S.
I apologise for the tight deadline this month.
I C Polin
25/2

4317.8

108

?RMP C/8

FROM: I POLIN
DATE: 2 March 1987

1. MR KELLY
2. ECONOMIC SECRETARY

Distribution

PPS
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Grice
Mr Culpin
Ms Goodman
Mr Pickford
Mr Ross Goobey

THE RESERVES IN FEBRUARY 1987

The reserves announcement for February will be made on Tuesday 3 March at 11.30 am. This month's announcement reports a [rise] in the reserves of $ million and an underlying [rise] of $ million.

I POLIN

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

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

109

until 11.30 Tuesday 3 March 1987
thereafter UNCLASSIFIED

DRAFT PRESS NOTICE

THE RESERVES IN FEBRUARY 1987

The UK official reserves rose by $ million in February. Accruals of borrowing under the exchange cover scheme amounted to $ million; repayments of such borrowing amounted to $ million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $ million. At the end of February the reserves stood at $ million (£ million*) compared with $21,952 million (£14,495 million+) at the end of January.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during February was $ 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:

---

* When converted at the closing market rate on Friday 27 February £1=$1.

\+ When converted at the closing market rate on Friday 30 January £1=$1.5145

Repayments of such borrowing were:

111

x THE RESERVES IN FEBRUARY 1987 : PRESS BRIEFING

x Factual : main features of markets in February

	£ ERI	\$/£	DM/£	\$ ERI	DM/\$	Yen/\$
2 February	68.4	1.5168	2.7556	103.8	1.8167	152.95
9 February	68.5	1.5150	2.7702	104.1	1.8285	153.17
20 February	69.1	1.5283	2.7914	104.0	1.8265	153.55
23 February	69.7	1.5397	2.8183	104.1	1.8304	153.55
27 February						

Sterling was generally steady in the first half of the month around 68½-69 in effective terms. It rose after the G5/G6 meetings to touch 70, \$1.54, DM2.83 helped by the low PSBR figure for January. The oil price fell from \$18 to [\$16.50.]

x The dollar has fluctuated widely over the month. It rose following good US economic data and speculation of a Japanese discount rate cut, but fell later as the prospect of a G5 meeting receded and on comments by US officials. The ½ per cent cut in the Japanese discount rate had little impact. When the G5 meeting was confirmed, the dollar rose again to around DM1.82½ and Y153½ on 20 February.

The markets were cautious and generally quiet after the G5/G6 meetings on 21-22 February with the dollar little changed from its levels immediately before the discussions.

POSITIVE

(1) Agreed 18 months ago that exchange rates out of line. Have cooperated to help move them in right direction. Big
SPACE > success.

(2) Agree present pattern of exchange rates satisfactory. Have been large changes but will take time for full effects on trade balances to work through.

(3) Agree that period of stability is desirable. Over-shooting is in no-one's interest. G6 agreed to cooperate to achieve this.

(4) Rise in sterling this week shows market assessment - as Chancellor said at weekend Paris Accord working with grain of market.

(5) Strong productivity growth and present pattern of exchange rates offer industry best selling opportunity abroad for years, provided pay costs controlled.

(6) Fourth successive month of underlying plus on reserves, after underlying fall in October.

DEFENSIVE

1. **Exchange rate policy.** Chancellor has said on many occasions that do not want sterling to fall further. No wish to see substantial rise either. Period of stability desirable. Paris accord entirely consistent with that.

2. **Are there specific agreements on intervention etc?** Yes certainly, but I am not going to tell you what they are.

3. **Do they establish target zones?** No.

4. **What's the difference?** This is a pragmatic judgement about current circumstances - an agreement that the current levels of exchange rates are broadly acceptable and worth trying to consolidate. It's Plaza 2.

5. **How long will it last?** As long as we decide.

6. **Are there intervention limits?** Nothing to add to communique.

7. **What happens if exchange rates depart from acceptable levels?** We stand ready to use the instruments at our disposal, including co-ordinated intervention.

8. **Can exchange rate moves trigger automatic policy adjustments, as suggested by Baker?** Purpose is to avoid substantial exchange rate movements. Policy commitments are in the communique.

9. **Why are you doing this when the markets have calmed down anyway?** Going with the grain, as at Plaza.

10. **Does this mean the Americans will intervene this time?** Of course. They did after Plaza and they are parties to this.

11. **Can anyone deliver? US have whopping deficit and lame duck government, Japanese have troubles in Diet, etc, etc.** Doesn't solve all problems, but clear declarations of political will.
SPACE > All agree that, with policies in communique, present pattern of exchange rates reflects economic fundamentals.

12. **Have you or have you not a collective agreement to support sterling at present levels?** Agreement applies to all six currencies. We are all agreed on the present broad pattern of exchange rates, and stand ready to intervene. That reinforces what I have been saying about sterling.

13. **What's in it for Britain?** As a major trading nation, we have at least as much to gain as anyone from anything which lessens international trade tensions and pressures for protectionism.

14. **Implications for interest rates?** Interest rates not part of the agreement. Will continue to be held at whatever levels are necessary to maintain downward pressure on inflation.

X 15. **UK membership of ERM** Matter kept under continual review. Gover: has always said that there are arguments both in favour and against joining the ERM and that we will only join when satisfied that the balance clearly favours doing so.

16. **Lower DM/£ exchange rate provides UK with opportunity to join ERM at a favourable rate.** Not prepared to speculate on X what rates might or might not be appropriate ~~(see Q6)~~. In any case not merely a matter of achieving an appropriate rate; a number of technical questions about how sterling would operate within ERM also need to be considered.

17. **Why agree to this fixed rate pact if not prepared to join ERM?** No change in policy. Accord is pragmatic international agreement specifically to deal with current circumstances.

18. **1987 current account forecast** Emergence of small deficit not surprising given deterioration in oil balance, sluggish world trade growth in 1986 and rise in domestic demand. But volume of non oil exports now growing again and set to continue in 1987 reflecting fast growth in UK markets, UK's improved competitiveness and buoyant invisibles.

Mr Richardson

1. Mr Grice
To see. I'm not keen
2. Mr Kelly
Maybe the answer is an MG visit to Japan.
JWG 2/3

Mr Peretz
I tend to agree with you. If we did want to talk to a Japanese institution, I would have expected to get more from Yamaichi (Mr O'Donnell). But I would not be all that enthusiastic over straight lunch.
2.3.

115

42/3070B

FROM: DAVID PERETZ
26 February 1987

Mr Kelly
We got practically nothing out of our last lunch at Nomura. And in my experience the Japanese rarely tell one anything interesting. So I'm not particularly enthusiastic about this. What do you think?
DLCP 1/3

MR CARR

cc Mr Cassell
Mrs Lomax
Mr Ilett
Mr Grice
Mr Kelly

JAPANESE FLOWS INTO STERLING

Do you like raw fish?
JWG 2-3-87

Thank you for your minute of 23 February.

2. Given all the talk there is around about Japanese institutional interest in both UK equities and gilts, I think this is an area we should keep a fairly close watch on. It would take only a fairly modest percentage switch of Japanese funds out of dollars into sterling to have some fairly significant effects on sterling financial markets: and as we know the herd instinct amongst Japanese investors is exceptionally strong.

3. The figures in your note are all for calendar years, though I note from the chart in the Investors' Chronicle article that at least some Japanese figures must be available on a quarterly basis. Is there anything about investment in the UK or in sterling available quarterly, and if so how quickly after the end of each quarter do we get it? It might be worth having a word with the CSO, if you have not done so already, to see if they have any figures for bilateral UK/Japan capital flows. And on gilts, could the Bank of England cull any information from their register on how many are passing into the hands of Japanese institutions?

DLCP

D L C PERETZ

Mr Peretz
cc Mr Kelly
It wd. be no bad idea to establish closer contact with the Japanese financial institutions, given your para 2.
2. It occurs to me that Douglas Warr cd. be a useful intermediary – he owes me a favour for talking (at length) to his colleagues 10/12 from Nomura. One option might be to invite him and a couple of his colleagues to lunch. What do you think?
JWG 27-2-87

5/80

9/10

Mr Richardson
116

42/3070B

FROM: DAVID PERETZ
26 February 1987

MR CARR

cc Mr Cassell
Mrs Lomax
Mr Ilett
Mr Grice
Mr Kelly

JAPANESE FLOWS INTO STERLING

Thank you for your minute of 23 February.

2. Given all the talk there is around about Japanese institutional interest in both UK equities and gilts, I think this is an area we should keep a fairly close watch on. It would take only a fairly modest percentage switch of Japanese funds out of dollars into sterling to have some fairly significant effects on sterling financial markets: and as we know the herd instinct amongst Japanese investors is exceptionally strong.

3. The figures in your note are all for calendar years, though I note from the chart in the Investors' Chronicle article that at least some Japanese figures must be available on a quarterly basis. Is there anything about investment in the UK or in sterling available quarterly, and if so how quickly after the end of each quarter do we get it? It might be worth having a word with the CSO, if you have not done so already, to see if they have any figures for bilateral UK/Japan capital flows. And on gilts, could the Bank of England cull any information from their register on how many are passing into the hands of Japanese institutions?

cc Mr Kelly

DLCP

D L C PERETZ

Mr Peretz

It wd. be no bad idea to establish closer contact with the Japanese financial institutions, given your para 2.

2. It occurs to me that Douglas Warn cd. be a useful intermediary – he owes me a favour for talking (at length) to his colleagues 10/12 from Nomura. One option might be to invite him and a couple of his colleagues to lunch. What do you think?

JWG 27-2-87

File: MAMC: D3/07.
117

42/3070B

FROM: DAVID PERETZ
26 February 1987

MR CARR

cc Mr Cassell
Mrs Lomax
Mr Ilett
Mr Grice
Mr Kelly

JAPANESE FLOWS INTO STERLING

Thank you for your minute of 23 February.

2. Given all the talk there is around about Japanese institutional interest in both UK equities and gilts, I think this is an area we should keep a fairly close watch on. It would take only a fairly modest percentage switch of Japanese funds out of dollars into sterling to have some fairly significant effects on sterling financial markets: and as we know the herd instinct amongst Japanese investors is exceptionally strong.

3. The figures in your note are all for calendar years, though I note from the chart in the Investors' Chronicle article that at least some Japanese figures must be available on a quarterly basis. Is there anything about investment in the UK or in sterling available quarterly, and if so how quickly after the end of each quarter do we get it? It might be worth having a word with the CSO, if you have not done so already, to see if they have any figures for bilateral UK/Japan capital flows. And on gilts, could the Bank of England cull any information from their register on how many are passing into the hands of Japanese institutions?

DLCP

D L C PERETZ

210/01

118

Mr Carr

Thanks. Let me know if you discover anything more. On para 6, the Warburgs' GEMM told us they were hoping to do substantial business with the Japanese POS system, when we met them recently. as before (this page)

DLP 3/3

FROM: J L CARR
DATE: 2 MARCH 1987

MR PERETZ

cc: Mr Cassell
Mrs Lomax
Mr Ilett
Mr Grice
Mr Kelly

File: MAMC D3/D7

JAPANESE FLOWS INTO STERLING

You asked whether there was any more information, preferably on a quarterly basis, on Japanese flows into sterling than that presented in my recent (23 February) minute to you.

Equities and bonds

2. The only source here is the Monthly Review of the Security Dealers Association of Japan. This is apparently a monthly publication, the latest edition providing data to December 1986. My source for the Review, a very helpful Mr Kanno from the Bank of Japan, says it is not easily available in the UK. He obtained his copy from a contact in Nomura. Deborah Fowler, the Japanese expert at the Bank of England, is now trying to arrange for the Review to be sent to her and promises to let us know when she receives it.

Direct investment and banking flows

3. The CSO pointed me to the banking data presented in the Bank of England Quarterly Bulletin and the direct investment figures detailed in the DTI's Business Monitor MA4. The latter provides figures to 1984 with 1985 to be presented in May. These figures are as reported to the UK; those that are reported to Japan are already published for 1985 in the Bank of Japan's Balance of Payments Summary. 1986 figures - again on an annual basis - will appear in May or June.

3/164

Gilts

4. Stephen Collins at the Bank promises to see if any information can be extracted on Japanese gilts holdings. He holds out little hope, since many such holdings are likely to be by nominee companies (for reasons of anonymity, convenience etc). However he was able to pass on three interesting snippets on the subject gleaned over the last few days.

5. The fact that the latest tap stock, Treasury 9% 2008 - of which we have sold £750mns out of £800mns since it was issued on 11 February - is proving very hard to borrow, has led some to infer that the Japanese have been heavy buyers of the stock. However there is no hard evidence to support this.

6. Secondly, he mentioned that the Japanese Post Office Savings System will be able to invest abroad for the first time from April 1987. With this fund controlling 4½% of all Japanese savings, there is obviously scope for massive foreign investment. One report suggests that the amount will be limited to $500mns in the first year, though other reports are of a higher ceiling than this.

7. Finally he mentioned that a contact in the Tokyo office of a UK (bank owned) GEMM found very little interest amongst Japanese investors in UK gilts. The same contact conjectured however that the situation could be very different if there was a Japanese-owned GEMM. On this view it would seem to me that Japanese ownership is a necessary, rather than a sufficient condition for substantial Japanese interest.

J. L. Carr

J L CARR