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

Reference MG-MAMC/D/0002/001

File begins 03/05/1988

Pages 39-60

DRAFT PRESS NOTICE

THE RESERVES IN MAY 1988

The UK official reserves rose by million in May. Repayments of borrowing under the exchange cover scheme amounted to million. There was no new borrowing under the exchange cover scheme this month. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during May, was a rise of million. At the end of May, the reserves stood at million (million*) compared with $47,857 million (£25,467 million+) at the end of April.

Note to Editors

2. The underlying change is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

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* When converted at the closing market rate on Tuesday 31 May £1=$1.

\+ When converted at the closing market rate on Friday 29 April £1=$1.8792

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

~~E RESERVES IN MAY 1988 : PRESS BRIEFING

Factual : Main features of markets in May

	3 May (cob)*	Month's High	Month's Low	31 May (cob)*
£ ERI	78.1			
$/£	1.8700			
DM/£	3.1382			
$ ERI	92.7			
DM/$	1.6782			
Yen/$	124.87			

*cob = close of business.

[illegible]evious reserve changes

(i) At the beginning of January 1987, the reserves stood at $21,923 million; at the end of December 1987, they stood at $44,326 million, a rise of $22,403 million (including effect of 1987 revaluation).

(ii) The underlying rise in the reserves in 1987 totalled $20,475 million.

(iii) Reserve changes from the last calendar quarter of 1987 have been:

		Underlying change	Total change	Level of reserves at end period
			$ million	
1987	October	+ 6,699	+ 6,591	41,399
	November	+ 31	- 118	41,281
	December	+ 3,737	+ 3,045	44,326
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519+
	April	+ 514	+ 338	47,857
	May			

+after revaluation

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

(v) Reserves now stands at highest ever level.

Level of official debt

Now stands at $18.2 billion at end January* (latest published figure, Bank of England Quarterly Bulletin, May 1988, Table 17.2). (In May 1979 was $22 billion.)

*at end January market rates.

POSITIVE

1. Reserves remain very strong after substantial underlying increase of $20 billion in 1987. Reserves now stand at highest ever level of $ billion.

DEFENSIVE

(A) **POLICY**

1. **Exchange rate policy:** As Prime Minister told House on 17 May [OR Vol 133 No 152 Cols 794-798],

"My right hon Friend and I entirely agree that we must maintain a firm monetary policy and a downward pull on inflation. I totally agree with all my right hon Friend's Budget Speech, every bit of it.....The right hon Gentleman asked about exchange rate policy. It is a part of total economic policy. As I indicated a moment ago, he will note that we have taken interest rates down three times in the last two months. That was clearly intended to affect the exchange rate. We use the available levers, both interest rates and intervention, as seems right in the circumstances.....it would be a great mistake for any speculator to think at any time that sterling was a one-way bet."

2. **Tactics:** As Prime Minister reminded House on 17 May, all instruments (including interest rates and intervention) will be used as and when appropriate. But not sensible to reveal operational details or be more precise.

3. **Exchange rate stability runs counter to anti-inflation strategy?** Not alternative strategy. Most of the time exchange rate stability reinforces anti-inflationary strategy. As the Chancellor said in his interview on 'This Week Next Week' BBC1 on 24 April "we are certainly - and the Prime Minister has said this as well - .... interested in the maximum possible exchange rate stability within the context of sound anti-inflationary policy". As Chancellor told Interim Committee of International Monetary Fund (IMF) on 14 April, if a conflict between objectives for inflation and exchange rates emerges priority must be given to inflation - but, in practice, this dilemma occurs only infrequently.

4. **Action to counter any further rise in sterling?** As Prime Minister told the Leader of the Opposition on 17 May [OR Vol 133 No 152 Col 795],
"Anyone who is asking to know precisely what will happen is the friend of the speculator and aiding and abetting him."

5. **Sterling shadowing deutschemark?** ['Wall Street Journal', 11 May, reported Chancellor's renewed support for close link between sterling and DM.]
Exchange rate against deutschemark important to industry given proportion of UK trade with EC, so Government naturally pays attention to it.

6. **Industry's criticism of sterling appreciation? British industry suffering from exchange rate rise?** [CBI Council endorsed and wholeheartedly supported Government's commitment to low inflation, 'Financial Times', 14 April. CBI Annual Dinner, 12 May, President Sir David Nickson called for exchange rate stability. Letter from Director General CBI, in 'Daily Telegraph' 21 April, suggested rise in sterling reduces profits and companies' ability to increase productivity. TUC's economic committee claimed, 'Financial Times', 14 April, recent rise in sterling putting 60,000-100,000 jobs at risk.]

If firms accept financial discipline inherent in Government's strategy and contain their costs, no need for any loss of competitiveness. Greatest threat to output and employment would come if Government relaxed its anti-inflationary stance.

7. **Current account deficit in first quarter suggests exchange rate against deutschemark too high?** Trade figures highly volatile. Given uncertainties about recent figures must wait some months to assess trends. Maintaining competitive position largely in hands of industry. But, as the Chancellor said on 'This Week Next Week' on 24 April, "I certainly do not want to see the exchange rate appreciate further. I think that would be, as I have said on a previous occasion, unsustainable. And an unsustainable appreciation does nobody any good and is damaging for business and industry."
NB. April Trade figures published 27 May.

8. **Will Government be prepared to let sterling fall if recent pressures reversed?** Consistently made clear will not allow sterling to depreciate to accommodate excessive increases in domestic costs.

(B) **G7**

9. **G7 meeting in Washington, 12/13 April**. G7 Ministers and Central Bank Governors had useful discussion. In communique, reaffirmed commitment to continued growth with low inflation: entirely consistent with policies UK has been following.

10. **G7 commitment to exchange rate stability**? G7 expressed renewed determination to coordinate policies to strengthen underlying fundamentals and reinforce conditions for exchange rate stability.

11. **Were dollar exchange rate targets and/or a budget for intervention set ~~up~~ at Plaza/Louvre**? [Book - "Managing the dollar: from the Plaza to the Louvre" by Yoichi Funabashi claimed (Pgs 183-192) narrow exchange rate targets were set at Plaza and revised at Louvre and a budget set for intervention at the limits of the agreed ranges.]

No Comment.

(C) **INTERVENTION**

12. **Why cut interest rates on 17 May rather than intervene?** As Prime Minister said in House on 17 May use available levers - interest rates and intervention - as seems right in circumstances.

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

14. **Prime Minister made great play of growth in Reserves in House on 17 May, but earlier ruled out further intervention as it is inflationary?** [OR Vol 129 no 110 col 184 and OR Vol 133 No 152 Vols 794-798].

Prime Minister earlier arguing against excessive intervention: only poses inflationary threat if not funded. Government made clear intervention will be fully funded.

15. **Implication of recent intervention for UK monetary conditions/funding?** Policy to ensure, over time, any net intervention fully funded so that effect on liquidity sterilised. 1987/88 intervention was fully funded within financial year.

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

17. **Have other countries been intervening over last month/recently?** Never discuss details [but well known there was concerted intervention after US trade figures on 13 April.]

18. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, recommended "intervention should not be used to maintain an exchange rate incompatible with underlying economic forces".** Agree exchange rates should reflect fundamentals, as G7 communique on 13 April made clear. Under Plaza Agreement and Louvre Accord, intervention aimed first at achieving this position, then maintaining it. Fluctuations in foreign exchange markets do not necessarily reflect fundamentals.

19. **Is intervention profitable?** Intervention undertaken to support exchange rate policy - not primarily to make profit. For intervention to be profitable, authorities would need to sell sterling when firm and buy it back when soft. This is, of course, what tends to happen over longer term. [N.B. See also BEQB, September 1983 pgs 384-391.]

Treasury and Civil Service Select Committee (TCSC) report, published 25 April, suggested £1.3 billion loss on intervention in 1987.

No comment on actual figure.

- Any appreciation of sterling necessarily causes a book loss on reserves, just as any depreciation causes a book gain. Absurd to make book-loss (or gain) calculations over a period as short as a year.

- Gain or loss only realised when intervention unwound.

- Sterling book value of whole of reserves, not just last year's intervention, affected by appreciation or depreciation of sterling. Impossible to say whether last year's intervention has increased total book loss: without intervention sterling might have been higher, and hence book loss on rest of reserves larger.

- TCSC also failed to look at other side of the account - our foreign currency indebtedness. Just as a rise in sterling creates a book loss on the reserves, so it creates a book profit on our foreign currency debt.

21. **Will Government publish data on currency composition of reserves?** No. Long standing practice of successive Governments not to publish details of currency composition of reserves.

22. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, suggested Government should provide more information about intervention.** Would disclose Government tactics and thus undermine effectiveness of intervention in future. As Chancellor made clear to TCSC, Government perfectly willing to participate in secret inquiry by PAC as in 1979.

(D) INTEREST RATES/MONETARY POLICY

23. **Interest rates policy?** As Chancellor said in Budget speech: "Within continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

24. **Monetary policy:** Object of monetary policy to maintain monetary conditions that keep downward pressure on money GDP and hence inflation. Inflation now down to levels of 20 years ago, despite strong and sustained upswing in real growth. Short term interest rates will continue to be held at levels necessary to keep monetary conditions on track. Will not take risks with inflation.

25. **May Bank of England Quarterly Bulletin (BEQB) said current combination of high exchange rates and low interest rates not ideal and different balance would be desirable. Hasn't interest rate cut made this worse?**

BEQB referred to an ideal policy mix. But Government has to act in light of market conditions at the time. Overall tightness of policy remains appropriate.

(E) EXCHANGE RATE MECHANISM (ERM)

26. **UK membership of ERM?** As Prime Minister made clear in answering questions in House on 17 May, matter kept under continual review. Will join when Government considers time is right.

27. **Recent interest rates moves would not have been necessary if UK had been in ERM?** Joining ERM would not be soft option. Countries within ERM frequently change their interest rates.

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

[illegible]. **Join ERM by 1992**? [Secretary of State for Trade and Industry reported to have said to conference launching DTI Single European Market campaign on 18 April that when single market comes into being, time for full UK membership of EMS might have arrived.] Lord Young made clear he suspected that by 1992, time would be ripe for UK to join, but that he was not making forecast.

30. **Proposals for Central Bank of Europe?** Finance Ministers who have put forward these proposals have recognised they are very much for longer term. Immediate priority is to achieve liberalisation of capital movements throughout Community.

FROM: I POLIN

DATE: 1 June 1988

D2

1. MISS O'MARA MOM 1/6
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THE RESERVES IN MAY 1988

The reserves announcement for May will be made on Thursday 2 June at 11.30 am. This month's announcement reports a rise in the reserves of $676 million and an underlying rise of $814 million.

Ian Polin.

I POLIN

Mr Gray - No 10
Mr Cassell - Washington (after publication)

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

until Thursday 2 June 1988
thereafter UNCLASSIFIED

DRAFT PRESS NOTICE

THE RESERVES IN MAY 1988

The UK official reserves rose by $676 million in May. Repayments of borrowing under the exchange cover scheme amounted to $105 million. There was no new borrowing under the exchange cover scheme this month. Repayments of HMG debt amounted to $33 million. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during May was a rise of $814 million. At the end of May, the reserves stood at $48,533 million (£26,374 million*) compared with $47,857 million (£25,467 million+) at the end of April.

Note to Editors

2. The underlying change is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

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* When converted at the closing market rate on Tuesday 31 May £1=$1.8402

\+ When converted at the closing market rate on Friday 29 April £1=$1.8792

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

> North West Water Authority, $32 million; North of Scotland Hydro Electricity Board, $25 million; Electricity Council, $15 million; British Telecommunications PLC, $12 million; Welsh Water Authority, $4 million; Lancashire County Council, $2 million; Lothian Regional Council, $2 million; Northern Ireland Electricity Services, $2 million; Northumbrian Water Authority, $2 million; Severn Trent Water Authority, $2 million; Strathclyde Regional Council, $2 million; Yorkshire Water Authority, $2 million; British Nuclear Fuels PLC, $1 million; Others, $2 million.

4. The repayment of $33 million of HMG debt represents a further sinking fund instalment in respect of the $150 million issue of the United Kingdom $8^7/_8$ per cent Bonds due 1993. This issue was made in New York in 1978.

THE RESERVES IN MAY 1988 : PRESS BRIEFING

Factual : Main features of markets in May

	3 May (cob)*	Month's High		Month's Low		31 May (cob)*
£ ERI	78.1	79.2	(16th)	77.8	(5th)	77.9
$/£	1.8700	1.8947	(16th)	1.8385	(31st)	1.8402
DM/£	3.1382	3.1945	(16th)	3.1270	(5th)	3.1743
$ ERI	92.7	93.7	(31st)	92.5	(11th)	93.7
DM/$	1.6782	1.7282	(31st)	1.6755	(5th)	1.7250
Yen/$	124.87	126.25	(17th)	124.00	(24th)	125.05

*cob = close of business.

In spite of a further reduction in UK base rates and a rise in the visible trade deficit, sentiment towards sterling this month remained bullish. It began the month on a softer note, when oil prices fell below $16 a barrel. However, after it had touched lows of $1.8585, DM3.1270 and ERI 77.8 on 5/6 May, the release of a report by Goldman Sachs suggesting that sterling was undervalued against the mark, and that British industry would still be competitive at DM3.27, re-established a bullish tone. However, having touched $1.8947 and DM3.1945 on 16 May, it fell sharply (to 1.8735 and DM3.1625) the following day when UK base rates were reduced to 7½%. Sterling later fell against the dollar on release of US trade data and the Prime Minister's statement of the Government's exchange rate policy, but retained a firm undertone, edging up to $1.8722 (23 May) and DM3.1830 (24 May). Despite the rise in the visible UK trade deficit to £1.1bn, sterling continued to rise against the mark reaching DM3.1870 on 31 May before seeing a bout of professional selling causing it to ease below DM3.18 before the close that day.

The dollar was restricted to a narrow trading range for much of the month. It fell to a low of DM1.6755 on 5 May, but quickly recovered. A ½% increase in US prime rates (9%) on 11 May tended to be offset by a statement from Fed Governor Angell that assumptions about further tightening by the FRBNY "could well be mistaken". It took news of a significant reduction in the US trade deficit to lift the dollar out of its narrow range advancing strongly to DM1.7070 and Yen 126.25. Although subsequently surrendering some ground to the yen, the dollar consolidated its gains against most currencies and ended the month on a firm note trading around DM1.725 and Yen 125 on 31 May, with rumours of a US discount rate hike likely in the immediate future.

Previous reserve changes

(i) At the beginning of January 1987, the reserves stood at $21,923 million; at the end of December 1987, they stood at $44,326 million, a rise of $22,403 million (including effect of 1987 revaluation).

(ii) The underlying rise in the reserves in 1987 totalled $20,475 million.

(iii) Reserve changes from the beginning of 1988 have been:

		$ million		
		Underlying change	Total change	Level of reserves at end period
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519+
	April	+ 514	+ 338	47,857
	May	+ 814	+ 676	48,533

+after revaluation

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

(v) Reserves now stand at highest ever level.

Level of official debt

Now stands at $18.2 billion at end January* (latest published figure, Bank of England Quarterly Bulletin, May 1988, Table 17.2). (In May 1979 was $22 billion.)

*at end January market rates.

POSITIVE

Reserves remain very strong after substantial underlying increase of \$20 billion in 1987. Reserves stand at highest ever level of \$48½ billion.

DEFENSIVE

(A) **POLICY**

1. **Exchange rate policy:** As Prime Minister told House on 17 May [OR Vol 133 No 152 Cols 794-798], "My right hon Friend and I entirely agree that we must maintain a firm monetary policy and a downward pull on inflation. I totally agree with all my right hon Friend's Budget Speech, every bit of it.....The right hon Gentleman asked about exchange rate policy. It is a part of total economic policy. As I indicated a moment ago, he will note that we have taken interest rates down three times in the last two months. That was clearly intended to affect the exchange rate. We use the available levers, both interest rates and intervention, as seems right in the circumstances.....it would be a great mistake for any speculator to think at any time that sterling was a one-way bet."

2. **Exchange rate stability runs counter to anti-inflation strategy?** Not alternative strategy. Most of time exchange rate stability reinforces anti-inflationary strategy. As Chancellor said in interview on 'This Week Next Week' BBC1 on 24 April "we are certainly .... interested in the maximum possible exchange rate stability within the context of sound anti-inflationary policy". Chancellor told Interim Committee of International Monetary Fund (IMF) on 14 April, if conflict between objectives for inflation and exchange rates emerges, priority must be given to inflation - but, in practice, this dilemma occurs only infrequently.

No mention of exchange rate stability in Prime Minister's statement to House on 17 May? Prime Minister explicitly endorsed all of Budget Speech [Chancellor said on 15 March "Exchange rates play a central role in domestic monetary decisions as well as in international policy co-operation. I believe that most businessmen have welcomed the greater exchange rate stability over the past year. It is important that they also accept the financial discipline inherent in this policy".]

4. **Continuing confusion over Government's exchange rate policy?** No. Remarks by Prime Minister in House on 17 May, in conjunction with ½ per cent cut in interest rates, clearly demonstrate agreed Government policy of seeking greater exchange rate stability within context of firm monetary policy designed to ensure steady downward pressure on inflation.

5. **Sterling shadowing deutschemark?** ['Wall Street Journal', 11 May, claimed to report Chancellor's support for close link between sterling and DM.]
Exchange rate against deutschemark important to industry given proportion of UK trade with EC (50%), so Government naturally pays attention to it.

6. **Tactics:** As Prime Minister reminded House on 17 May, all instruments - interest rates and intervention - will be used as and when appropriate. But not sensible to reveal operational details or be more precise.

7. **Action to counter any further rise in sterling?** As Prime Minister told Leader of Opposition on 17 May (OR Vol 133 No 152 Col 795), "Anyone who is asking to know precisely what will happen is the friend of the speculator and aiding and abetting him."

8. **British industry suffering from exchange rate rise?** [At CBI Annual Dinner, 12 May, President Sir David Nickson called for exchange rate stability. He also said: very considerable achievement .. by Government to keep sterling stable against Mark ... helpful to business; number one priority must remain continued reduction in inflation; devaluation to accommodate inflationary wage settlements, must not be in ... vocabulary; international competitiveness must remain paramount.]

If firms accept financial discipline inherent in Government's strategy and contain their costs, no need for any loss of competitiveness. Greatest threat to output and employment would come if Government relaxed its anti-inflationary stance.

9. **High exchange rate destroys competitiveness?** Maintaining competitive position largely in hands of industry. But, as Chancellor said (on 'This Week Next Week', 24 April), certainly do not want to see exchange rate appreciate further - that would be unsustainable, and as such, damaging for business and industry.

10. **April current account deficit suggests exchange rate against deutschemark too high?** Current account figures for 1988 need to be interpreted with even greater caution than usual because of changes in documentation and classification system. Prudent to await further months' data before deciding what extent pattern of trade distorted.

11. **CBI May monthly trends survey [published 31 May] attributes weakening export order books to recent strength of sterling.** CBI May survey indicates export order books actually risen and reports continuing strong growth in output.

12. **Will Government be prepared to let sterling fall if recent pressures reversed?** Consistently made clear will not allow sterling to depreciate to accommodate excessive increases in domestic costs.

13. **Were dollar exchange rate targets and/or a budget for intervention set at Plaza/Louvre**? ["Managing the dollar: from the Plaza to the Louvre" by Yoichi Funabashi claimed narrow exchange rate targets were set at Plaza and revised at Louvre and a budget set for intervention at limits of agreed ranges.]
No comment.

(B) **INTERVENTION**

14. **Why cut interest rates on 17 May rather than intervene?** As Prime Minister said in House on 17 May, use available levers - interest rates and intervention - as seems right in circumstances.

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

16. **Intervention inflationary?** Only poses inflationary threat if not funded. Government made clear intervention will be fully funded as in 1987-88 so that effect on liquidity sterilised [Prime Minister has argued against excessive intervention.]

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

18. **Have Bank been switching dollars into deutschemarks and yen?**
['Financial Times' article, 27 May 1988.]
Never discuss detailed reserves transactions.

19. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, recommended "intervention should not be used to maintain an exchange rate incompatible with underlying economic forces".** Agree exchange rates should reflect fundamentals, as G7 communique on 13 April made clear. Under Plaza Agreement and Louvre Accord, intervention aimed first at achieving this position, then maintaining it. Fluctuations in foreign exchange markets do not necessarily reflect fundamentals.

[illegible]. **Is intervention profitable?** Intervention undertaken to support exchange rate policy - not primarily to make profit. For intervention to be profitable, authorities would need to sell sterling when firm and buy it back when soft. This is, of course, what tends to happen over longer term. [N.B. See also BEQB, September 1983 pgs 384-391.]

(C) INTEREST RATES/MONETARY POLICY

21. **Monetary policy**: Object of monetary policy to maintain monetary conditions that keep downward pressure on money GDP and hence inflation. Inflation now down to levels of 20 years ago, despite strong and sustained upswing in real growth. Short term interest rates will continue to be held at levels necessary to keep monetary conditions on track. Will not take risks with inflation.

22. **Interest rate policy**; As Chancellor said in Budget speech: "Within continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

23. **May Bank of England Quarterly Bulletin (BEQB) said current combination of high exchange rates and low interest rates not ideal and different balance would be desirable. Position worsened by interest rate cut**?

BEQB referred to an ideal policy mix. But Government has to act in light of market conditions at time. Overall tightness of policy remains appropriate.