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 101-120

17.8

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ERMP C/8

FROM: I POLIN

DATE: 1 December 1987

1. MISS O'MARA

2. CHANCELLOR OF THE EXCHEQUER

Distribution

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Sir P Middleton
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Ms Goodman
Mr Call

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

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until 11.30 Wednesday 2 December 1987
thereafter UNCLASSIFIED

DRAFT PR[ESS] NOTICE

THE RESERVES IN NOVEMBER 1987

The UK official reserves rose by $ million in November. 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 November, the reserves stood at $ million (£ 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 $ 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).

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

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

until 11.30 Wednesday 2 December 1987
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3. New borrowing under the public sector exchange cover scheme was as follows:

Repayments of such borrowing were:

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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						

With the market's attention focused on the outcome of the US budget talks, sterling for the most part was rather 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 [$1.8085 (its highest level since May 1982) and ERI 76.0 on 27 November.] Against the continental currencies, movements were restricted to a narrow range and were generally influenced by fluctuations in interest rates. Upward~~s~~ pressure 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 DM2.97 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 by 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 not be matched here, it 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 seemed 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 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 DM1.6485 and Y133.20 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. In spite of co-ordinated interest rate cuts in West Germany, France and Holland and a statement from Stoltenburg that he was considering ways of stimulating the German economy, the dollar ended the month on a ~~week~~ easier note, but above its worst levels at (DM1.65¾) and (Y133¾).

Previous reserve changes

(i) Reserve changes this year have been:

$ million

		Underlying Change	**Total Change**
1987	January	+ 72	+ 29
	February	+ 287	+ 305
	March	+ 1785	+ 1892
	April	+ 2912	+ 2768
	May	+ 4760	+ 4872
	June	- 230	- 315
	July	+ 499	+ 551
	August	- 457	- 550
	September	+ 380	+ 443
	October	+ 6699	+ 6591
	November		
	Totals		

(ii) Last month's underlying change was the largest ever. The previous largest before last month was in May this year ($4,760 million). Before that the largest underlying change was in October 1977 ($3,036 million).

(iii) Previous monthly underlying increases exceeding $1 billion were:

	$ million
October 1987	+ 6,699
May 1987	+ 4,760
October 1977	+ 3,036
April 1987	+ 2,912
January 1977	+ 1,915
July 1977	+ 1,794
March 1987	+ 1,785
September 1977	+ 1,768
March 1977	+ 1,075

(iv) Previous highest levels of spot reserves were:

	$ million
November 1987	
October 1987	41,399
July 1987	34,915
September 1987	34,808
May 1987	34,679
August 1987	34,365
June 1987	34,364
April 1987	29,807
March 1981	28,469
February 1981	28,434
January 1981	28,394
August 1980	28,291
May 1980	28,284

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%

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POSITIVE

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

2. Since the Budget sterling has remained broadly stable, particularly against the deutschemark.

DEFENSIVE

(A) **POLICY**

1. **Is sterling pegged to the DM?** [As Prime Minister said in interview reported in 'Financial Times' on 23 November - there is no specific target]. Would not be helpful in market management terms now to discuss specific ranges.

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

2. **Exchange rate policy for sterling?** Under Louvre Accord G7 agreed to seek, a period of stability in major currencies ~~x~~(including yen and dollar). Chancellor made clear that ~~g~~cross-rate against the deutschemark is of particular importance. This is consistent with aim for money GDP and inflation.

3. **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. Ecofin Council on 16 November reaffirmed importance of Louvre Accord, and all European countries are to cooperate with other countries in decisions to ensure more stable development of world financial and foreign exchange markets.

4. **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.

5. **Will there be another G7 meeting in the near future to discuss recent market events?** No present plans for a meeting. But Chancellor said in House on 26 November that he hopes a G7 meeting will be held before Christmas. But he also said US Congress needs to agree budget deficit package. ~~and~~ All G7 parties should agree that conditions are right for stabilisation of the dollar which is necessary element to avoid recessionary dangers. G7 countries are in constant communication with each other about recent events.

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

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

8. **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**

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

10. **Recent moves by Germans/French/Dutch in cutting interest rates helpful?** Yes. Only first step in preparing right conditions for necessary stabilisation of dollar [Also had a calming effect on the exchange rate mechanism (ERM) of the European Monetary System].

11. **Why not cut interest rates like Germans to support dollar?** UK has already brought ~~a~~ (A) full 1% [which is more than most countries] since stock markets fall.

(A) its interest rates down by

12. **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 important objective.

13. **Interest rate cut made because sterling near DM 3 level?** No change in policy. Decision on interest rate taken in the light of monetary conditions as a whole. Clearly right in market circumstances of ~~talk~~ late October/early November both to reduce interest rates and to allow some expansion in ~~equity~~ liquidity.

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

15. **Implication of recent heavy intervention for UK monetary conditions/funding?** Policy to ensure, over time, any net intervention funded so effect on liquidity sterilised. That will be done as and when appropriate, though not necessarily within same financial year.

16. **Aren't you going to make a loss buying dollars 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].

17. **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**

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

19. **Return to Bretton Woods?** No: in his speech Chancellor explicitly spelt out why he was <u>not</u> 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)**

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

21. **Conditions required for UK participation?** [In FT interview reported in 'Financial Times' on 23 November the Prime Minister said it was] not possible to specify precisely what conditions would have to be fulfilled before UK joined ERM. 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.

22. **Role of European Monetary System (EMS) in preserving stable exchange rates?** ECOFIN Council on 16 November agreed that the EMS has played important role in coordination of policies between member countries and in preserving stable relationships between European countries including (foreign exchange markets). ~~Barsk~~ Basle/Nyborg (decisions) prove~~d~~ EMS has been strengthened.

(F) **RECENT MARKET EVENTS**

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

(G) **US BUDGET DEFICIT PACKAGE**

24. **UK view on US budget deficit package?** Welcome budget deficit agreement as first step. Further action by other countries still necessary.

25. **Reduction too little too late.** No. US package ~~would~~ will do what ~~was~~ is necessary and is perfectly adequate for time being.

26. **Cuts in US budget deficit could cause recession?** No. Package of cuts necessary to restore, market confidence and is necessary part of reduction of trade imbalances. Gives lead to other countries to take action.

27. **World situation will send UK ~~rates~~ into recession?** No. Government's sound economic and financial policies has led to strong growth in UK.

1777.10

DZ 113

FROM: I POLIN

DATE: 4 November 1987

MR BENT

cc: Mr D Moore
Mr Grice
Mr Richardson
Mr Brook
Mr Nelson

RESERVES IN OCTOBER 1987

I attach a copy of the amended briefing for you and copy recipients.

2. The Chancellor's amendments are marked in manuscript. You should particularly note the change he made to Defensive G 24. His office have already mentioned to me that we should draft questions on the "BP safety net" very diplomatically.

Ian Polin

I POLIN

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EA&P C/8

FROM: I POLIN
DATE: 2 November 1987

1. MR KELLY ~~KELLY~~ 2u

2. CHANCELLOR OF THE EXCHEQUER

Version as amended by the Chancellor.

Ian Polin
3/11/87

Distribution

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Mr Cassell
Mr Peretz
Mr Sedgwick
Mr R Allen
Mr Botttrill
Mr Hibberd
Mr Grice
Miss O'Mara
Mr Pickford
Ms Goodman
Mr Call

THE RESERVES IN OCTOBER 1987

The reserves announcement for October will be made on Tuesday 3 November at 11.30 am. This month's announcement reports a rise in the reserves of $6591 million and an underlying rise of $6699 million. Foreign currency receipts from the US, Canadian and Japanese offers of BP shares amounted to $1537 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)

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DRAFT PRESS NOTICE

THE RESERVES IN OCTOBER 1987

The UK official reserves rose by $6591 million in October. Foreign currency receipts from the US, Canadian and Japanese offers of BP shares amounted to $1537 million. Accruals of borrowing under the exchange cover scheme amounted to $51 million; repayments of such borrowing amounted to $284 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $3 million. The valuation change arising out if the quarterly rollover of the EMCF swap amounted to a rise of $128 million. At the end of October, the reserves stood at $41,399 million (£24,027 million*) compared with $34,808 million (£21,368 million+) at the end of September.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during October, including the BP receipts, was $6699 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).

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

\+ When converted at the closing market rate on Wednesday 30 September £1=1.6290

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

> South of Scotland Electricity Board, $29 million; Manchester City Council, $16 million; Staffordshire County Council, $3 million, Powys County Council, $2 million; Cheshire County Council, $1 million.

Repayments of such borrowing were:

> Electricity Council, $105 million; British Coal, $56 million; British Airways plc, $37 million; Yorkshire Water Authority, $25 million; North West Water Authority, $20 million; Northumbrian Water Authority, $19 million; British Nuclear Fuels plc, $5 million; Grampian Regional Council, $5 million; Lothian Regional Council, $3 million; North of Scotland Hydro Electricity Board, $3 million; British Rail, $2 million; British Telecommunications plc, $1 million; Humberside County Council, $1 million; Port of Tyne, $1 million; Others, $1 million.

4. The quarterly rollover of the EMCF swap, ie 20 per cent of the UK's gold and US dollar reserves, entailed a valuation increase of $128 million. This largely reflects the rise in the ECU value of gold, as valued by the EMCF. For the purposes of the swap, the EMCF values gold and dollars in terms of ecus at rates determined quarterly, whereas the UK values gold and ecus held in the reserves on an annual basis.

THE RESERVES IN OCTOBER 1987 : PRESS BRIEFING

Factual : main features of markets in October

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
1 October	72.8	1.61¼	2.98½	102.4	1.84½	147
8 October	73.3	1.64¼	2.99¼	101.3	1.82¼	145
14 October	73.3	1.65½	2.99½	100.5	1.81	142½
20 October	73.4	1.65½	2.99	100.8	1.80½	143¼
23 October	73.5	1.66	2.99½	100.7	1.80¼	143½
27 October	74.1	1.69¼	2.99½	99.6	1.77	142
30 October	74.6	1.72¼	2.98	98.5	1.73	138½

Sterling began the month around $1.62 and 73.0 in effective terms, but then it rose against the dollar with the markets continually testing the DM3 level. During the middle of the month it traded thinly and was mostly on the sidelines, as the markets focused their attention on the dollar and world equity markets. On publication of better-than-expected UK trade figures for September on 23 October it rose sharply to 73.5, $1.6615 and DM 2.99½. The Bank then signalled a ½% cut in their dealing rates. This signal had little immediate effect on the exchange rate, nor did the decision by most high street banks to lower their base rates. It reached a five-year high of $1.73 on 29 October but the deutschemark benefitted more than sterling from the dollar's decline, easing the cross rate to DM 2.97¼.

The dollar began the month trading around DM 1.84½ and Yen 147 showing a slightly firmer tendency evident since September's meeting of G7 ministers. Fears that US interest rates would have to rise in order to counter the rise in long-term rates in Japan and news of an improved US unemployment rate of 5.9% underpinned the currency. However failure to breach DM 1.85 and Yen 147½ and firming German and Japanese interest rates pushed the currency down to DM 1.8230 and Yen 145.30. News of a ½% rise in US prime rates on 7 October temporarily stabilised the currency. But publication of a worse-than-expected US trade deficit for August of $15.7Bn caused the dollar to fall sharply to DM 1.8090 and Yen 142.50. Following US Treasury Secretary Baker's criticism of other countries' interest rate levels the dollar fell to DM 1.77. However the Baker/Stoltenberg 19 October meeting and Stoltenberg's subsequent statement underscoring Louvre Accord brought a dollar rebound above DM 1.81. Initially falls in the equity markets had little impact on the foreign exchange markets. But they contributed to a very bearish nervous mood and rumours of a G7 meeting took the dollar to DM 1.8032 on 23 October and to a seven year low of DM 1.7210 on 29 October not helped by Delors' speech about the US being prepared to see a DM 1.60 level (subsequently denied by US Treasury). At the end of the month concerted intervention steadied it at DM 1.7285 and Yen 138.35.

Previous reserve changes

(i) Reserve changes this year have been:

			$ million
		Underlying Change	Total Change
1987	January	+ 72	+ 29
	February	+ 287	+ 305
	March	+ 1785	+ 1892
	April	+ 2912	+ 2768
	May	+ 4760	+ 4872
	June	- 230	- 315
	July	+ 499	+ 551
	August	- 457	- 550
	September	+ 380	+ 443
	October	+ 6699	+ 6591
	Totals	+16707	+16586

(ii) This month's underlying change is the largest ever. The previous largest was in May this year ($4,760 million). Before that the largest underlying change was in October 1977 ($3,036 million).

(iii) Previous monthly underlying increases exceeding $1 billion were:

	$ million
October 1987	+ 6,699
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April 1987	+ 2,912
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July 1977	+ 1,794
March 1987	+ 1,785
September 1977	+ 1,768
March 1977	+ 1,075

(iv) Previous highest levels of spot reserves were;

	$ million
July 1987	34,915
September 1987	34,808
May 1987	34,679
August 1987	34,365
June 1987	34,364
April 1987	29,807
March 1981	28,469
February 1981	28,434
January 1981	28,394
August 1980	28,291
May 1980	28,284

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%