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

Reference MG-MAMC/D/0002/001

File begins 03/05/1988

Pages 182-200

14. Gold deposit business has grown considerably over the past year or so and we currently have some sixteen tons outstanding (value £150mn.). Earnings this year have so far amounted to £250,000, compared with £330,000 in the whole of 1987. We see the scope for modest further growth in this business as the number of active market participants in London increases. We should therefore like HMT's agreement to another annual renewal of the total limit of £300 mn (described above) for this business.

15. We have been approached by a leading member of the market with a proposal that we should be prepared to provide longer-term standbys (eg, for three years) to them in gold in return for a commitment fee. However, having considered the matter, we are not sure that the commitment fees proposed are adequate return for the long-term risks involved and we do not recommend pursuing the suggestion.

(iii) Gold options

16. Another possibility is that the Bank should become involved in writing gold options in bullion.

17. The over-the-counter options market in bullion in London has grown rapidly and is now capable of absorbing sizeable transactions of up to one ton ($14mn.) at a single price. All options are European-style ie, exerciseable only on a single date. The principal users of the market are speculative accounts, mainly from the Middle East, Far East and US and the mining companies who are seeking to ensure a basic floor price for their product. Our dealing counterparties would, however, be the active market makers in London.

18. Unless we sought to hedge our own risk, to write gold options would be to act in an entirely speculative capacity ourselves. (We would not accept that holding gold is itself a speculative activity but, rather, a proper one for a major central bank, as explained in the Bank's paper of 1 March 1988.) Our presence in the market would undoubtedly become public knowledge and generate widespread press interest. While we would generate some premium income, in the event that our view of the likely movement in the

gold price proved incorrect and the price of gold rose to trigger our call, we should be selling gold at below the then market price. Unless we took our loss and covered the gold sold back in the market, the fall in the gold reserves would become public knowledge, as mentioned in the March paper. Thus, it would seem, that unless we are very confident of our bearish view on the gold price, a decision to write naked gold options is little different from a decision to sell gold outright, a possibility we argued against in the Bank's paper. Our view would be that, if we were to enter the gold options market, we should seek to hedge the risks assumed through writing options by buying puts and calls as necessary. This would require the allocation of considerable management resources if we were to feel confident of dealing in such a professional market. The possibility could however be explored if it is felt that the benefits are likely to outweigh the inevitable public interest.

(iv) SDR facility with the IMF

19. The agreement to buy and sell SDRs with the IMF within certain limits on an automatic basis was introduced with effect from the beginning of February and seems to have worked smoothly. So far some twenty transactions have been undertaken involving US dollars, French francs and deutschemarks. Our SDR holdings have risen by SDR 110 mn net (against the limit we set of a maximum change of SDRs 150 mn) since the commencement of the scheme. Our involvement has been welcomed within the Fund and is likely to encourage several other major central banks to enter into similar arrangements.

(v) German Withholding Tax

20. Proposals to impose a 10% withholding tax in Germany have received Parliamentary approval. The formal document detailing the method of implementation is to be released in the coming weeks but is expected to be extremely complex. In the meantime, a letter from Secretary of State Tietmeyer (to Sir G Littler) has confirmed the tax exempt status of the EEA. Tax will be initially withheld at source but will be refunded on application to the Federal Finance Office.

21. The market's response has been to trade DM eurobonds on a large premium over government bonds to the extent that eurobonds have lost the 25-30 bp yield spread over governments which they offered before the tax was first mooted and negative spreads of similar magnitude are now common. With the EEA's tax exempt status now confirmed, the process of switching from euros into governments has been started. By the end of June the EEA's holding of euros had been reduced to under DM 1 bn from the DM 1.4 bn level at the end of 1987.

(vi) <u>Futures Trading</u>

22. In certain market conditions it can be advantageous for the EEA to have the ability to change its position in a bond market quickly. However, lack of liquidity in cash markets can limit our ability to make such a change on acceptable terms. In particular, in the Japanese Government Bond (JGB) market, where 95% of trading is in a single benchmark issue, there is very little liquidity in the majority of issues; such issues are considerably better fundamental value, however, and form the bulk of the EEA's holdings. The JGB futures market, in contrast, is highly liquid with the largest turnover of any futures contract, larger even than the Chicago Treasury-bond contract. Trading in the JGB futures market would give us the ability to adjust the EEA's position quickly and, in particular, to hedge the EEA's Yen bond portfolio by sales of futures if yields should again - as last spring - drop to unsustainable levels. It is therefore proposed that the Bank should commence trading in futures on behalf of the EEA. The World Bank and the Bank of Finland are known already to participate in futures markets.

23. We would envisage trading through a short list of existing counterparties. Trades in JGB futures could be executed on either LIFFE or the Tokyo Stock Exchange; the former has the advantage of being open during London trading hours while the latter is an extremely liquid market which can easily accommodate the maximum size we might want to execute.

24. For the purposes of market analysis and risk management, a futures contract is just like any other security; functions are

available on the front office computer system to analyse the market and the interest rate exposure of futures contracts. Our futures positions would be included in our in-house analysis programs, as part of our normal daily monitoring of market exposure. Futures trading would thus be subject to the same monitoring and management control as trading in the cash bond market.

(vii) Protecting the EEA

25. In a letter on 4 May from Loehnis to Borrie, the Bank noted that the reference of the KIO's acquisition of BP shares to the Monopolies & Merger Commission had possible implications for the operations of the Exchange Equalisation Account in its management of the UK reserves. The point at issue was whether the activity of managing a country's reserves constituted a business enterprise and if so whether this might jeopardise the protection of the EEA's assets provided by the application of sovereign immunity. This letter and the FCO's reaction to it have drawn Juliet Wheldon (Treasury Solicitors) into the correspondence. Although not directly related to the KIO reference as such, she suggests that the Bank might wish to take advice in the US (and by implication elsewhere) on whether EEA assets are held in a manner which allows the EEA to take maximum advantage of sovereign immunity. While we have had no problems in the past in relation to the application of sovereign immunity to the EEA, it seems sensible to follow Miss Wheldon's suggestion and seek legal advice on behalf of the EEA.

BANK OF ENGLAND
20 JULY 1988.

C O B 13. 7.88

186

$ mn nominal

COUNTRY/INSTITUTION EXPOSURES

	BONDS		SHORT-TERM PAPER + FRNS		TOTAL
	Holdings	Credit Limit	Holdings	Credit Limit	Holdings
Australia	75	150	195	225	270
Austria	92	500	341	750	433
Belgium	157	300	353	750	510
Canada	75	500	380	750	455
Denmark	79	100	145	150	224
Finland	24	500	10	750	34
France	373	1,500	2,030	2,250	2,403
Italy	88	750	308	1,125	396
Japan	32	750	–	1,125	32
Malaysia	6	–	–	–	6
New Zealand	27	50	69	75	96
Norway	66	250	94	375	160
Spain	55	500	340	750	395
Sweden	129	750	595	1,125	724
ECSC	46	500	–	750	46
EEC	180	500	–	750	180
EIB	197	500	301	750	498
Eurofima	56	250	84	375	140
Euratom	6	250	–	375	6
Coun. of Europe	67	250	15	375	82
African Dev Bank	2	–	–	–	2
Asian Dev Bank	62	250	–	375	62
Nordic Inv Bank	25	250	190	375	215
IADB	88	250	–	375	88
IBRD	475	750	8	750	483
FHLB	260	550	–	–	260
FFCB	36	180	–	–	36
FNMA	347	420	–	–	347
SLMA	4	250	–	–	4
TOTAL	3,129		5,458		8,587

NOTES:

(1) Table excludes government bonds issued in that government's domestic currency.

(2) Non-dollar bonds are converted to US dollars at current parity rates.

FROM: N P WILLIAMS

DATE: 28 July 1988

SIR G LITTLER

cc Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mr Brooks
Mr Polin

INVESTMENT OF THE RESERVES: PART TWO

I attach some comments on the Bank's main paper which arrived on Tuesday night.

2. Since it arrived so late we would not have had time to analyse it properly even without other work demands. We understand the Bank's wish for this paper not to be overtaken by events, but we think this argument can be overdone. It would be extremely helpful for us to prepare for your meeting if we could have the paper at least a week in advance. That said, the Bank merit a complimentary word for the considerable amount of work put into the papers, which are generally on the lines that we want.

3. There is in addition a considerable overlap (for good reasons) between the Bank's paper on conceptual aspects of the measurement of profitability and their main paper. There are two unfortunate results - first, it will be harder than usual to structure the meeting logically; and, second, since the Bank's main paper arrived so late, our comments to you have not helped as much as we would like to provide that structure. Rather than preparing an integrated minute which might have been too late to be useful to you, we chose instead to put up a separate minute on the first two papers in good time yesterday morning. With your meeting taking the paper on profitability this time, we hope that such overlaps do not occur again - and if the Bank's main paper is circulated earlier we could structure our comments more logically even in the event of overlap.

4. Having seen all the papers, we are inclined to agree with the Bank (Mr Page) that the paper on profitability might sensibly be taken first.

NPW

N P WILLIAMS

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

1. Issues for discussion are at paras 13 and 19.

The last meeting

2. The conclusion of your last meeting was that "at current exchange rates or if the dollar were to strengthen, and depending on market conditions, we should switch dollars first into yen, and then a further amount into DM, up to a total of between $½ billion and $2 billion". It was also agreed that "if and when the dollar fell below DM 1.55 and yen 120 we should begin to lengthen the dollar position and be prepared to switch progressively larger amounts at rates below these levels with a ceiling of $1 billion".

3. The DM/$ rate was then around 1.67 - roughly where it stayed until it moved above 1.70 in mid-May. The yen/$ rate at the time was 127½. The yen subsequently rose against the dollar but only to 124/125 - it did not fall below its mid-January level until late June.

4. The Bank reached the $2 billion limit in late June, and you agreed with Mr George that they may go further, in advance of the next investment of the reserves meeting.

CURRENCY DECISION

Developments: first half-year

5. The main features are:-

(i) a true underlying inflow into the reserves of $2.8 billion;

(ii) an increase of $1.3 billion in the total currency reserves (spot and forward). There was a $4.7 billion fall in US dollar holdings, almost wholly taken on the forward book in order to maintain liquidity. Holdings of DM bloc currencies rose by $4.3 billion and yen holdings rose by $2 billion.

(iii) repayments of official foreign currency borrowing amounted to \$1.7 billion;

(iv) a net currency position at end-June 1988 (Table 2 of the Bank's paper), and proposed neutral currency positions and normal ranges for actual currency positions, of:-

	Actual position	Proposed neutral position	Proposed normal range
US dollar	\$ 9.4 billion (37%)	40%	30-50%
DM bloc	\$11.6 billion (46%)	40%	30-50%
Yen	\$ 3.8 billion (15%)	20%	15-25%
Canadian dollar	\$ 0.4 billion (1%)		
	\$25.1 billion		

6. The change in allocation principally reflected intervention in the Spring, principally into DM and other DM bloc currencies, and a sizeable switch out of US dollars into yen. The Bank argue that political factors circumscribed the investment managers' freedom of action, both (until rather recently) in limiting their ability to diversify out of the dollar and in obliging a build-up of DM.

Currency returns

7. Table 3 shows a currency return of £40 million in the first half year - losses in the first quarter resulting from being short of sterling while sterling appreciated were more than offset by profits in the second quarter as sterling weakened. The table also shows the sensitivity of the split of the currency return between the intervention and currency mix components to differences in the neutrality assumption.

8. The Bank have extended the calculations back to June 1985 and calculated a total profit of £410 million over the subsequent three years.

Currency exposures - suggested strategy

9. The Bank base their recommendations on the following view:-

(i) the present strength of the dollar is rather overdone, and the levels they suggested at your last six-monthly meeting (DM 1.55 and Yen 120) make sense in terms of fundamentals;

(ii) the DM is relatively undervalued against the yen in the short term and could strengthen, although in the longer term the yen may strengthen further.

(iii) substantial net holdings of DM bloc currencies (notably French francs and ECUs) make sense in view of the yield pick-up and little prospect of an EMS realignment. The current position is about right.

10. The Bank argue that current net asset exposures, relative to the 40:40:20 split (see below), are consistent with their view of exchange rate prospects:-

Exchange rate prospects:-

		(% of total net assets)
US dollar	- 3	(ie a net currency exposure of 37%)
DM bloc	+ 6	
Yen	- 5	
Canadian dollar	+ 1	

11. It is however difficult to establish whether these exposures are large enough. The Bank suggest that at today's level of assets a sensible range for exposures would be 30-50% US dollars, 30-50% DM bloc and 15-25% yen.

12. The recommendations are:-

(i) levels of DM 1.90 and yen 150 justify the suggested maximum dollar short, a further $1¾ billion;

(ii) in the event of a sharp fall in the dollar, a reduction in the dollar short, principally by sales of DM. DM 1.70 and Yen 130 would be reasonable levels to go long of dollars and short of DM and yen;

(iii) to unwind the short yen/long DM position as it strengthens from its present cross rate of 71½. At cross rates above 75, the Bank would prefer to hold mostly yen against the dollar short, although the implied $2 billion shift could be difficult in political terms;

(iv) intervention to restrain sterling should concentrate on Yen with DM a second choice at current exchange rates. Purchases of sterling should involve dollar sales with DM as second choice.

13. Issues for discussion

(i) Neutrality - the 40:40:20 neutrality assumption may have been covered in the discussion of the profitability paper (para 7 (iii) of my minute of yesterday). The marked effect of different neutrality assumptions on the allocation of currency returns between intervention and currency mix components strengthen the case in our view for concentrating on the 40:40:20 split in the Bank's further analytical work. We should explore the Bank's thinking behind the "normal" ranges around neutral exposures (eg 30-50% for the dollar) and under what circumstances these might change, and discuss whether the net exposures relative to the 40:40:20 neutrality assumption (paragraph 10 above) are, as the Bank say, consistent with exchange rate prospects.

(ii) Exchange rate prospects - some discussion of exchange rate prospects is necessary, despite the obvious difficulties. The Bank's view that the dollar will fall seems a reasonable central case, against a background of little action on the federal deficit ahead of the election and the possibility that optimism on the trade account has been overdone. This is the key component of our currency view if the Bank are right in forecasting that the likely volatility of the yen/DM rate will be less than that of other major exchange rates. MG2 (Mr Brooks) has drawn on the WEP in preparing Annex 2 - however, it is worth noting the dollar currency stands around DM 1.85, against a WEP forecast Q3 average of 1.6860.

(iii) Intervention - the Bank's proposal to buy yen against sterling may make sense in reserve management terms, but it implies that we attach more importance to the £/yen rate than we have done hitherto.

(iv) Constraints on reserve management - the Bank's views might be sought on the effect of political constraints on their freedom of action (eg the switch into DM could have been better timed - paragraph 11 of the Bank's paper).

MATURITY DECISION

Interest rate exposure

14. Agreement was reached at your last meeting on reducing our fixed income exposure, mainly by addition to holdings in the DM bloc. Table 5 of the Bank's paper shows the change in net interest rate exposure over the last half-year.

Returns

15. Paragraphs 36-39 of the Bank paper give calculations of the returns resulting from strategic interest rate decisions (which are calculated on the assumption that net fixed income assets are financed by borrowing at interbank rates) and active investment management decisions (which are the returns earned over and above those earned by "benckmark" portfolios - defined in paragraph 1 of Annex 1).

16. The Bank calculate profits of $14 million in the first half-year from strategic interest rate decisions and $24 million from active investment management. Annex 1 summarises the results of an earlier detailed Bank paper - not circulated to you - on the returns active investment management during the six months in end-February 1988.

Prospects for interest rates and strategy

17. The Bank assume:-

(i) a modest rise in short-term rates worldwide. But if the dollar falls sharply, as the Bank expect, the rise in Germany and (in particular) Japan will be reduced, or even reversed;

(ii) rises in US longer term rates, particularly if the dollar falls; some stability in DM longer term rates and some volatility in Yen longer term rates.

18. The Bank envisage deflation in the US (see paragraph 44 of the main paper) and inflation thus falling back - hence present yield levels are rather attractive. If there is a sharp market - induced rise in US yields, the Bank believe this would be an opportunity to acquire a sizeable long position in US securities. In view of their expectation of deflation, the Bank would like to reduce the overall short position of $1.1 billion in a way described in paragraph 51.

19. Issues for discussion

(i) interest rate prospects - the Bank's views on the prospects for the US economy (paragraph 44) are crucial.

(ii) FRN call - has the Bank's main paper taken account of the FRN call, rundown of the forward book and ECU bill issue? If not, would the Bank modify their recommendations? The Bank might like to comment on whether these developments pose any technical difficulties for reserve management.

(iii) returns - the Bank's returns of $24 million in the latest half-year on active management decisions (see also Annex 1) suggest a substantial return in relation to the resources employed. The Bank might like to comment on the adverse effect of the unexpected announcement of the German withholding tax on profitability (Annex 1, paragraph 3).

ANNEX 1

EEA INVESTMENT PERFORMANCE

The Bank have produced their latest report on the returns on active management of the portfolios, relative to benchmarks, for the period end - August 1987 to end - February 1988. "Benchmark" portfolios are notional portfolios of actual securities which mirror the desired objectives for liquidity and credit risk. (Returns from active management are additional to those arising from strategic decisions on the currencies and maturities of EEA assets.)

2. Active management produced extra returns of \$36 mn, an annualised return of almost ½% on funds managed, which rose to \$20bn during the period under review. This rate of return is only slightly lower than in the previous six months, a level which the Bank then thought was unsustainable. Profits were \$66mn in the latest year (a return of nearly ½%), up from \$21mn in the previous year (a return of just over ¼%). (An alternative yardstick is a comparison of actual returns against those that would have been earned by a non-traded portfolio ie one which is "frozen" on a specific start date. The Bank have not on this occasion presented a full comparison with the non-traded portfolio but the text of the paper indicates in places that profits have in fact been earned on actual trading rather than the maintenance of favourable exposures.)

3. The extra returns arose from the exploitation of exceptional opportunities over the past year as yields moved sharply in all markets, producing substantial changes in yield relationships within markets. In almost all cases, the EEA's portfolio were positioned to benefit from such changes. The main exception was in the DM markets, where the unexpected re-introduction of withholding tax found the EEA's portfolio holding less euro-DM bonds than the benchmark as a reaction to an earlier narrowing of spreads. Following the news, eurobonds outperformed Bunds, to the detriment of profitability in relation to the benchmark.

4. The Bank suggest that yields are unlikely to be so volatile in the period ahead, and as a result the profitability of active management of the portfolios is likely to fall to the more normal level of the previous year. But even at that level the Bank argue that the returns are exceptional in relation to the resources deployed in managing the assets.

	Profit ($mn)	Size of portfolio ($bn)[1]	% returns
US Treasury bills, etc	9.7	9.4	0.30
US Treasury notes and agencies	7.0	3.6	0.45
DM	1.9	3.9	0.10
Yen	7.9	1.0	1.75
Eurodollar	5.7	1.0	1.35
Canadian dollar	2.0	0.6	0.75
Dutch guilder	1.8[2]	0.5	1.45
	36.0	19.7	0.45

(1) Portfolio size at end February 1988.

(2) New portfolio - only established for 3 months.

ANNEX 2

THE WEP FORECAST

1. Table 1 shows the WEP forecast of interest rates and exchange rates. Table 2 compares the yields of six month investments based on the WEP forecasts of 3 month interbank rates and exchange rates. On this basis, investment in France and Germany looks a better bet than investment in the US or in Japan.

2. But the WEP forecast was completed some time ago, and subsequent developments imply some modifications. The forecasters now think interest rates may rise further in Germany and Japan, but not change much in the US.

Table 1 The WEP forecast

	Interest Rates (3 month interbank)				Exchange Rate (unit/$)			
	US	Germany	France	Japan	UK	Germany	France	Japan
1987Q1	6.05	4.18	8.26	4.07	.648	1.839	6.128	153.2
Q2	6.85	3.80	8.13	3.80	.608	1.805	6.025	142.2
Q3	6.98	3.97	7.89	3.74	.618	1.839	6.135	146.9
Q4	7.76	4.13	8.47	3.90	.571	1.705	5.754	135.8
1988Q1	6.74	3.41	7.94	3.84	.557	1.677	5.670	128.1
Q2	7.15	3.55	8.00	3.80	.545	1.715	5.831	125.5
Q3	8.00	3.65	8.00	4.00	.539	1.686	5.778	124.6
Q4	8.00	3.80	8.00	4.25	.534	1.656	5.724	123.6
1989Q1	8.50	4.00	8.00	4.25	.535	1.644	5.727	122.7

Table 2 Payoff for investing £1 for six months (1)

	%
US	2.5
Germany	3.5
Japan	3.9
France	3.9

(1) based on 3 month interbank rates in the WEP forecast, and WEP exchange rates.

Table 3

	Interest rates			Exchange rates			
	WEP (Q3)	25 July	Diff	WEP (Q3) Unit/$	25 July	WEP (Q3) Effective	25 July
US	8.00	8.10	+ .10			93.3	97.5
Germany	3.65	5.10	+ 1.45	1.686	1.85	148.8	144.1
France	8.00	7.38	- .62	5.778	5.62	71.0	69.4
Japan	4.00	4.02	+ .02	124.6	132	246.9	240.2

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FROM: I POLIN

DATE: 1 August 1988

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THE RESERVES IN JULY 1988

The reserves announcement for July will be made on Tuesday 2 August at 11.30 am. This month's announcement reports a rise in the reserves of $1,307 million and an underlying rise of $910 million.

Ian Polin

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