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

Reference MG-MAMC/D/0002/001

File begins 01/06/1987

File ends 10/09/1987

Pages 104-121

TABLE 3

NON-DOLLAR CURRENCY ASSETS AND LIABILITIES AS AT 30. 6.87

MNS NOMINAL

Year	DM		SwFcs		Yen		DFls		BFcs	Aus Sch	FFs	CANS		ECU	
	A	L	A	L	A	L	A	L	L	L	L	A	L	A	L
1987	2307	309	104	7	26788	5984	49	70	18	19	3	27	29	16	
1988	475	272	13	13	18841	4669	15	88	14	41	7	31	29	-	
1989	450	232	4	14	15852	5097	39	91	9	37	8	80	30	9	
1990	458	413	18	14	7013	4212	19	97	10	-	8	75	30	5	
1991	519	264	20	45	13758	4085	136	92	-	-	9	47	31	2	
1992	294	858	14	13	10940	4102	89	65	-	-	5	26	32	8	
1993	404	334	3	14	5230	4062	104	72	-	-	1	32	32	11	
1994	427	216	-	15	5330	3085	43	43	-	-	1	53	33	3	
1995	530	203	-	16	3765	2344	28	33	-	-	1	15	34	4	
1996	212	190	-	16	11625	1368	1	25	-	-	-	1	34	7	[illegible]
1997	275	181	-	16	1600	1202	-	23	-	-	-	6	35	-	[illegible]
1998	-	164	-	18	-	278	-	10	-	-	-	-	35	-	[illegible]
1999	-	149	-	15	-	77	-	6	-	-	-	-	36	-	[illegible]
2000 onwards	-	327	-	11	-	103	-	9	-	-	-	-	132	-	[illegible]
TOTAL	6351	4112	176	227	119,142	40,668	523	724	51	97	43	393	552	65	1[illegible]
$equiv.	3453	2235	114	147	778	266	252	349	1	7	7	294	412	73	1[illegible]
(Assets settled book cost)	(3475)		(125)		(855)		(229)					(304)			

TABLE 4

US DOLLAR ASSETS AND LIABILITIES

as at 30. 6.87

$ mns
nominal

YEAR	LIABILITIES		ASSETS					TOTAL ASSETS
	Fixed rate	Floating rate	(2) LIQUID ASSETS	DEPOSITS	TN & FA's	FRN's	EUROBONDS & CB BONDS	
1987	544	166	6975	7550	-	447	56	15028
1988	485	379			959	32	187	1178
1989	386	242			591	-	119	710
1990	442	419			415	-	82	497
1991	368	373			232	33	71	336
1992	304	2852			49	14	83	146
1993	313	324			3	28	61	92
1994	261	692			-	31	31	62
1995	225	577			9	-	41	50
1996	200	4883			-	268	20	288
1997	199	420			1	-	4	5
1998	192				-	-	-	-
1999	205				-	-	-	-
2000 onwards	548				-	-	-	-
TOTAL (Assets/ settled book cost)	4672	11327	6975 (6726)	7550 (7550)	2259 (2325)	853 (863)	755 (833)	18392

c.c.b. 30.6.87

$ Million

COUNTRY/INSTITUTION RISK

	Bonds and FRNS (1)	Short-Term Paper (2)	Total
Australia	141	153	294
Austria	132	220	352
Belgium	110	168	278
Canada	340	17	357
Denmark	120	70	190
Finland	35	155	190
France	351	718	1069
Italy	97	331	428
Germany	1394	-	1394
Japan	265	-	265
Malaysia	13	-	13
New Zealand	61	25	86
Netherlands	199	-	199
Norway	79	15	94
Spain		77	77
Sweden	154	371	525
US (inc. Federal Agencies)	2,276	2,965	5,527
ECSC	70	-	70
EEC	108	-	108
EIB	333	106	439
Eurofima	47	-	47
Euratom	9	-	9
Europarat (Council of Europe)	76	-	76
Asian Dev Bank	32	-	32
Nordic Investment Bank	29	50	79
IADB	56	-	56
IBRD	525		525
IBRD CB	22	-	22
ADB CB	2	-	2
IADB CB	2	-	2
TOTAL	7,078	5,441	12,519

1 Wilt over 6 months to run

2 Includes short FRN

1780.82

FROM: I POLIN

DATE: 29 July 1987

1. MR KELLY cwk 29.7
2. MR CULPIN

cc: Mr Cassell
Mr Peretz
Mr Bottrill
Ms Goodman
Mr Owen
Mr Richardson
Mr Brook
Mr Flitton

Mr Gill)
Mr Reid)
Mr Bailey) Bank
Mr Milne)
Mr Chetwin)
Mrs Jupp)

J3

THE RESERVES IN JULY 1987

I attach the draft press notice, Q and A briefing and the press material for next Tuesday's announcement.

2. I would appreciate any comments or suggestions from recipients by close of play this Friday (31st).

Ian Polin

I POLIN

COVERING CONFIDENTIAL

TH RESERVES IN JULY 1987 : PRESS BRIEFING

Factual : main features of markets in July

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
1 July	72.3	1.61½	2.95	102.2	1.82½	146½
6 July	72.8	1.61½	2.97½	103.1	1.84	149
13 July	73.1	1.62	2.98	103.2	1.84	15~~5~~1
22 July	72.6	1.59½	2.97	104.0	1.86½	152½
27 July	72.5	1.60	2.96½	103.7	1.85½	150
31 July						

Sterling traded mainly on the sidelines in the first half of the month but rose from 72 to 73 in effective terms as the oil price rose above $20 a barrel for the first time in nineteen months. After publication of US trade data on 15 July sterling rose against the dollar and the deutschemark to touch highs for the month of $1.6~~2~~4 and DM2.99¾. Towards the end of the month, sterling dipped below $1.60 after publication of worse than expected UK trade figures but ended the month on a steady note, around 72.5 in effective terms.

The dollar opened the month trading steadily around DM1.82½ and Yen 146½. It rose to reach ~~highs of~~ DM 1.85 and Yen 151 helped by comments from Nakasone that the yen's recent decline was in accordance with G7's wishes and publication of a reduced Japanese trade surplus. Rumours of central bank intervention prevented any further substantial rise in the dollar. Following publication of worse-than-expected US trade data on 15 July the dollar fell sharply to around DM1.82¾ and Yen 148. It closed the month on a quieter note around DM1.85½ and Yen 150½ with senate testimony by Volcker and Greenspan having little impact.

Previous reserve changes

(i) Reserve changes in recent months have been:

$ million

		Underlying Change	Total Change
1986	September	- 372	+ 3502
	October	- 668	- 434
	November	+ 35	+ 14
	December	+ 96	- 83
1987	January	+ 72	+ 29
	February	+ 287	+ 305
	March	+ 1785	+ 1892
	April	+ 2912	+ 2768
	May	+ 4760	+ 4872
	June	- 230	- 315
	July		

(ii) Reserve transactions have shown a healthy profit.

Bank Base Rates

Base rate changes in recent months have been:

		Base Rate	Change
1987	10 March	10½	Down ½%
	18 March	10	Down ½%
	29 April	9½	Down ½%
	11 May	9	Down ½%

POSITIVE

1. Sterling has remained broadly stable, in line with February agreement at the Lovvre, which is holding well.

2. Reserves still very strong after recent months of substantial underlying increases. ~~, despite small fall last month~~.

DEFENSIVE

1. **Exchange rate target.** Chancellor made clear now that period of stability for sterling and other currencies desirable. But no explicit target or target ranges.

2. **Latest position on Louvre accord?** Reaffirmed at Venice Summit: communique said "substantial shifts in exchange rates could prove counter productive to efforts to increase growth and facilitate adjustment".

3. **May trade deficit show fall in exchange rate needed to maintain industry's competitiveness?** No. Non-oil visible trade responding to 1986 exchange rate adjustment. Chancellor already said period of stability desirable. Vital that pay settlements are kept under control if existing gains in competitiveness are to be maintained.

[4. **Recent intervention show holding interest rates higher than necessary, damaging to British industry?** Base rates down by 2% since beginning of March. Interest rates set at level necessary to keep monetary conditions on track. As confirmed by the latest CBI trends survey, industry clearly doing very well, with buoyant prospects for output, investment, orders, exports etc.]

5. **At what point in month did intervention take place?** Policy never to discuss intervention details.

6. **Implications for funding?** Policy is full fund of PSBR over financial year as a whole by debt sales to non-bank private sector and external and foreign currency finance of public sector (efcfps). Change in underlying reserves is part of latter. Other things being equal increases in reserves require additional sales of debt outside monetary sector to achieve a given quantity of funding.

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

8. **<u>FSBR forecast of £2½ billion current account deficit in 1987 too optimistic</u>.** No. Current account of balance of payments shows surplus of £2~~10~~01 million so far this year.

4317.020

FROM: B NELSON

DATE: 26 August 1987

1. MS GOODMAN
2. MR PICKFORD

cc: Sir G Littler
Mr Cassell - or
Mr Peretz - or
Mr Bottrill
Mr Owen
Mr Richardson
~~Mr Brook~~

Mr Gill)
Mr Reid)
Mr Smeeton) Bank
Mr Milne)
Miss Plumbly)
Mrs Jupp)

THE RESERVES IN AUGUST 1987

In Ian Polin's absence on leave and as a way of easing myself into my new job I am circulating the draft press notice, Q and A briefing and press material for Wednesday 2 September announcement. It also means that it is being circulated earlier than usual.

2. As usual, I would appreciate any comments or suggestions from recipients by close of play this Thursday (27th).

BARRY NELSON

COVERING CONFIDENTIAL

4317.8

DRAFT

EMMP C/8

FROM: I POLIN
DATE: 1 September 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 Sedgwick
Mr Bottrill
Mr Grice
Mr Culpin
Ms Goodman
Mr Pickford
Mr Call

THE RESERVES IN AUGUST 1987

The reserves announcement for August will be made on Wednesday 2 September at 11.30 am. This month's announcement reports a fall in the reserves of $ million and an underlying fall 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)

4317.3

until 11.30 Wednesday 2 September 1987
thereafter UNCLASSIFIED

DRAFT PRESS NOTICE

THE RESERVES IN AUGUST 1987

The UK official reserves fell by $ million in August. 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 August, the reserves stood at $ million (£ million*) compared with $34,915 million (£21,915 million+) at the end of July.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying fall in the reserves during August 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:

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* When converted at the closing market rate on Friday 28 August £1=$1.

\+ When converted at the closing market rate on Friday 31 July £1=1.5932

CONFIDENTIAL
until 11.30 Wednesday 2 September
thereafter UNCLASSIFIED

THE RESERVES IN AUGUST 1987 : PRESS BRIEFING

Factual : main features of markets in August

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
3 August	72.1	1.58½	2.95½	103.8	1.86½	150½
6 August	72.1	1.57½	2.96½	104.5	1.88	151
11 August	72.2	1.57	2.98	105.1	1.89½	151½
17 August	72.6	1.59	2.98	104.2	1.87½	150
24 August	72.7	1.63	2.97	101.1	1.82	142
28 August						

Last month's fall against the dollar was continued in the first half of the month with sterling opening at $1.58½ easing to $1.57 by the middle of the month. This reflecting the dollar's early strength sterling improving against DM from DM 2.95½ to DM 2.98 mid month but falling away slightly as the month closed. With attention on the dollar, sterling was on the sidelines and a series of important UK economic indicators; July trade figures, employment rates, average earnings, manufacturing costs and UKRPI had little or no impact. Sterling closed the month improving from 72.1 to   in effective terms.

At the beginning of the month the dollar~~s~~ rose strongly as continuing concern about the Middle East to DM 1.89¾ and Yen 152. Central Bank intervention during the first week steadied the dollar at DM 1.89, but the publication of very disappointing US trade figures for June at the end of the second week led to a sharp decline against DM and Yen which carried through into the second half of the month following the downward revision of US second quarter's ~~E~~GNP figure. Despite substantial Bank of Japan intervention the dollar closed the month....

Previous reserve changes

(i) Reserve changes in recent months 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		

Bank Base Rates

Base rate changes in recent months 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%

POSITIVE

1. Reserves strong after substantial underlying increases in first half of the year.

2. Sterling has remained broadly stable, in line with February agreement at the Louvre, which is holding well.

DEFENSIVE

1. **Exchange rate policy.** Chancellor made clear that period of stability for sterling and other currencies highly desirable. Actions in recent months bear this out.

[Chancellor said in speech to CBI annual dinner on 19 May:

> "I allowed, last year, a proper adjustment in the exchange rate as we lost, in short order, half the value of our oil. I made clear in the autumn that the adjustment had gone far enough. I have made equally clear this Spring that I do not want to see it reversed. And I have shown, as plainly as possible, that I share the overwhelming view of British industry that a period of exchange rate stability is now highly desirable".]

2. **Louvre accord?** Reaffirmed at Venice Summit. Has now successfully produced six months of exchange rate stability. Recorded intervention of G7 countries shows commitment translated into action.

3. **June trade deficit shows fall in exchange rate needed to maintain competitiveness?** Current account deficit only to be expected at a time when UK growth well above slow world growth. In any case, should not read too much into one month's figures.

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

5. **Implications for funding?** Policy is full fund of PSBR over financial year as a whole. Other things being equal increases in reserves require additional sales of debt to achieve a given quantity of funding. Funding programme well on course.

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

COMMISSION
DES COMMUNAUTÉS
EUROPÉENNES

Direction générale
des affaires économiques et financières

Bruxelles, le 26.8.87

II/317/87-EN (Rev. 1)

II-D-1/II-D-3

EXCHANGE RATE AND INTEREST RATE DEVELOPMENTS
FROM MID-JULY UNTIL LATE AUGUST 1987

- MAIN ISSUES FOR DISCUSSION -

(Note for the attention of the Monetary Committee)

The present note examines the main exchange rate and interest rate developments from mid-July until late August 1987. It concludes with a series of issues for discussion.

1. Exchange Rate Developments

Exchange rate developments during the last six weeks have been marked by a period of temporary firmness of the US \$ and by some tensions within the EMS.

The US \$ gained strength, particularly against the DM, over most of the period under review, reaching DM 1.90 and 153 yen at its peak. The reasons behind this unexpected bout of strength of the US currency probably lie in a combination of heightened tension in the Gulf as well as signs interpreted as an improvement in US fundamentals. In early August, the firmness of the US \$ even gave rise to some token amount of **official intervention** to slow its climb. This market confidence in the \$ was broken by the announcement of an unexpected increase in the June US trade deficit to \$ 15.7 bn from \$ 14 bn in May. Since then market sentiment appears to have turned around, with the \$ falling steadily especially against the yen. As a result the DM-yen cross-rate moved to well under 80 yen.

Within the EMS, trading has shown the first signs of generalized tensions since the January realignment. Speculation concentrated on two currencies, the DKR and the LIT, although it spread to the FFR, the BFR and to a lesser extent the IRL when the markets began to play with the idea of a possible realignment in the autumn. Developments concerning the divergence indicator were mainly characterized by a fall for the DKR from around +10 during July to below -50 now. The DKR has fallen by over 2% against the DM since mid-June, due mainly to the expectations of a deteriorating current account position next year and to political uncertainties. The Danish authorities appear to have reacted by letting their currency fall within the band rather than by intervening in response to the speculation. The **LIT** has only declined slightly against the DM during the period; its weakness was triggered interalia by the sharp deterioration of the current account, itself induced by strong domestic demand. The pressure on the LIT was tempered by official intervention and by the rise in domestic interest rates.

The fact that the speculation on these two currencies spilled into **generalized EMS tensions** is a cause for concern. Economic fundamentals do not appear to warrant such speculation. In addition, the strength of the $ during the period under review would normally be expected to help the cohesion of the EMS, although small official purchases of DM against US $ might have counteracted this effect.

As regards **non-ERM countries, sterling** has moved in a relatively narrow range against the DM of between DM 2.95 and DM 3.00, with worse-than-expected trade figures for May counteracted by a firm oil price. Later, a one percent rise in interest rates did not provoke a movement by sterling out of its trading range with the DM in spite of some improvement in the June trade figures.

2. Interest Rate developments

The most noticeable short-term interest rate development since mid-July, both in Europe and in Japan, has been a halt in the downward trend of the previous months, with signs even of a "creeping rise" of interest rates. At the same time, the upward trend of US short-term rates was confirmed. Among ERM countries, differentials tended to stabilize, except for a rise between Italian and German rates. The spread between the UK and German rates continued to rise as a result of a marked increase in money market rates in the UK. At the international level, the spreads between short-term US rates, and German and Japanese rates rose from mid-July to mid-August as a whole, although they shrank during the period of US $ firmness in early August. The spread between long-term rates in the USA, on one hand, and in the Fed Rep of Germany and in Japan, on the other hand, narrowed temporarily until early August but increased again subsequently.

After having narrowed significantly during the first two weeks of July, the spread between **French** and **German short-term rates** remained until mid-August just around 400 basis points, the same level as in early April. In **France,** short-term money market rates began to rise slightly by the end of July. By mid-August, 3-month rates had reached their end of June level of 8%. In the **Fed Rep of Germany,** 3-month interbank rates rose also slightly until early August and stabilized subsequently around 4%. The monetary authorities switched in August, for the first time in three months, to a fixed-rate type of repurchase agreement. While this move was aimed at reducing uncertainty on the desired level of short-term rates, it was at least initially perceived on the markets as signalling a more restrictive policy as the rate was fixed at 3.6% for the three repurchase pacts conducted in August against the 3.55% which had prevailed since early May. In addition the Bundesbank met only a reduced fraction of total bids by banks. However a persisting high degree of liquidity in the banking system and a decline in the call money rate throughout July and until mid-August do not point towards tighter monetary conditions. These developments took place against the background of a very moderate growth of broad money in June as compared with the previous 12 months.

In **Italy** short-term interest rates rose substantially throughout the period : the 3-month interbank rate, at 12.5%, has now returned to its level of May 1986. This move was primarily due to problems in selling Treasury paper as fears of a rekindling of inflation developed and was reinforced by exchange rate tensions. The spread between Italian and German rates reached 8.50 points by mid-August, an unprecedented level so far this year. For the **other ERM countries**, the spread with respect to German rates decreased somewhat for Belgium and for the Netherlands where money market rates remained practically unchanged.

In the **UK**, 3-month interbank rates rose to slightly over 10%, after the decision by the Bank of England to raise its money market intervention rates by a full point early in August. The pace of economic growth, the rapid expansion of liquidity and credit and the development of domestic costs were presented as the main factors behind this policy tightening. The resulting rise in short-term rates reversed nearly all the decline that had taken place since early March. In **Spain**, as disinflation made further progress, with a rate of 4,9% year-on-year in July, the monetary authorities reduced twice their intervention rates in August.

At the **international level**, short-term interest rate developments were marked by a firming of US rates - the 3-month Treasury Bill rate rose to 6.25%, the highest level since June 1986. As a result, the spread with German and Japanese rates returned to their respective levels 220 and 235 basis points already reached by mid-June.

At the **long end of the market**, interest rates developments during the period under review were contrasted. Until August 10-12, long-term rates rose regularly both in Japan and in the Rep Fed of Germany, a move which extended to nearly all European countries. By mid-August, in the Fed Rep, the yield on the 1997 Federal Government issue reached nearly 6,5% and in Japan the 1996 Government issue was yielding at nearly 5,15%. During the same period US long-term interest rates were much less firm and the yield on the US Government Benchmark 30-year issue had declined to 8,75% by August 12. The US Treasury auction of August 11-13, with a total volume of some 28 bill US $, could thus take place against the background of stabilized US long-term rates. As a result of a high degree of Japanese participation together with a modest increase in the US wholesale price index, the auction was largely oversubscribed and the rate on the new 30-year bonds came out at 8,80%. **Those trends were soon reversed by the release of the poor US trade performance of June.** Since then, long-term rates declined in the Fed Rep of Germany to below 6% and in Japan to below 4,50%. Simultaneously US long-term rates firmed markedly with long-term Government paper yielding close to 9%. **At the end of this contrasted period, the steepening of the US yield curve appeared particularly marked while it remained little affected in the other large industrialized countries.**

3. Issues for discussion

3.1 Do the Members of the Committee consider that the large variations in the $ exchange rate of the recent past are worrying, in particular with regards to the commitments taken in February ? If so, how and at which conditions could such variations be avoided or at least coped with ?

3.2 What issues are raised by the tensions which have appeared within the EMS during the recent period ? Was the EMS adversely affected by the small amount of official intervention aiming at stopping the rise of the US $? Would interventions in ECU against $ have been, at least in principle, more appropriate ?

3.3 What is the view of the Members of the Committee on the reactions by the Danish and Italian authorities to recent exchange rate tensions ? Are more generally the interest rate reactions to recent generalized tensions within the EMS as a whole considered as adequate ?

3.4 What are the expected results of the rise in the Bank of England's money market intervention rate ? To what extent was it linked to exchange rate considerations ? What policy conclusions do the UK authorities intend to draw from the confirmation of a rapid rise of monetary and credit aggregates in July ?

3.5 What lessons should be drawn from the contrasted long-term interest rates developments since mid-July ? What appears to be at present the relative influence of inflationary vs exchange rate expectations in the determination of the term-structure of interest rates ? What policy conclusions should be derived ?

*

*   *