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

Reference MG-MAMC/D/0002/001

File begins 04/01/1988

File ends 22/04/1988

Pages 226-235

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	+ 0.1 (end February)	43
Japan	+ 0.4 (end February)	84
Germany	+ 1.0 (w/e 11 March)	60
France	- (end February)	69
Italy	- (end February)	63
Canada	+ 0.9 (end February)	10
United Kingdom	+ 1.7 (end March)	45

Notes

1. The figures for Germany, France and Italy were originally published in local currencies; they have been converted to dollars at appropriate exchange rates.

2. Figures not strictly comparable because of different valuation conventions for eg gold.

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External Forecast April-June

00 External and foreign currency finance of the public sector is modestly contractionary in April, due to the offsetting influences of a small rise in the reserves (due to intervention) and a slightly larger volume of debt sales to overseas. In May and June zero public externals are projected, as there is no intervention or sales of public sector debt to overseas.

00 Banking externals are projected to be contractionary throughout, driven principally by the current account deficit which is only partially offset by net capital inflows. There is a risk that April's banking externals may be much more positive if January's suspected bill arbitrage unwinds. However, this would not feed through to money as domestic bank lending would be correspondingly reduced.

6/5/88

THREE MONTH EXTERNALS FORECAST

Factors contributing to the externals
£ millions sa

	APR	MAY	JUN
EX-ANTE EXTERNAL AND FOREIGN CURRENCY FLOWS			
(by domestic sector involved)			
1 NON-BANK PRIVATE SECTOR	-350	-350	-350
a Current Balance	-450	-450	-450
b Underlying Capital Outflows	-1000	-1000	-1000
c Underlying Capital Inflows	1100	1100	1100
d Ex-ante demand for net ST currency as	0	0	0
2 BANKS	100	100	100
a Sterling Lending Overseas (inc -)	-300	-300	-300
b Sterling Deposits From O'seas (inc +)	400	400	400
3 PUBLIC (exc intervention; 5a below)	150	0	0
a Contributing to PSBR	0	0	0
b Financing PSBR -gilts(sales=+)	150	0	0
-other	0	0	0
4 TOTAL EX ANTE FLOWS (1+2+3)	-100	-250	-250
= TOTAL EQUILIBRIATING FLOWS			
o/w			
5 a Intervention (res. inc.= -)	-100	0	0
b Other flows (= -2/3(4+5a); shows up (in overseas net £ claims) (on UK banks & nbps flows)	130	170	170
6 UNDERLYING BANKING EXTERNALS (1+3+5)	-170	-180	-180
7 a PSBR Offset	0	0	0
b other(fc nndls)	0	0	0
8 BANKING EXTERNALS(6+7)	-170	-180	-180
9 PUBLIC EXTERNALS (-3b-5a)	-50	0	0
10 TOTAL EXTERNALS(8+9)	-220	-180	-180
[*RESERVES, [illegible]] [	-22[illegible]] [	[illegible]] [	-6[illegible]]

THREE MONTH EXTERNALS FORECAST READY RECKONER

[Fac]tors contributing to the externals
£ millions sa

EX-ANTE EXTERNAL AND FOREIGN CURRENCY FLOWS (by domestic sector involved)	CHANGES TO:- 1	2	3a	3b	5a	7
1 NON-BANK PRIVATE SECTOR	100	0	0	0	0	0
a Current Balance	0	0	0	0	0	0
b Underlying Capital Outflows	0	0	0	0	0	0
c Underlying Capital Inflows	0	0	0	0	0	0
d Ex-ante demand for net ST currenc	0	0	0	0	0	0
2 BANKS	0	100	0	0	0	0
a Sterling Lending Overseas (inc -)	0	0	0	0	0	0
b Sterling Deposits From Overseas (	0	0	0	0	0	0
3 PUBLIC (exc intervention; 5a below)	0	0	100	100	0	0
a Contributing to PSBR	0	0	100	0	0	0
b Financing PSBR -gilts	0	0	0	100	0	0
-other	0	0	0	0	0	0
4 TOTAL EX ANTE FLOWS (1+2+3) = TOTAL EQUILIBRIATING FLOWS	100	100	100	100	0	0
o/w 5 a Intervention	0	0	0	0	100	0
b Other flows (= -2/3(4+5a); shows (in overseas net £ claims) (on UK banks & nbps flows)	-70	-70	-70	-70	-70	0
6 UNDERLYING BANKING EXTERNALS (1+3+5)	30	-70	30	30	30	0
7 a PSBR Offset	0	0	0	0	0	0
b other(fc nndls)	0	0	0	0	0	100
8 BANKING EXTERNALS(6+7)	30	-70	30	30	30	100
9 PUBLIC EXTERNALS (-3b-5a)	0	0	0	-100	-100	0
10 TOTAL EXTERNALS(8+9)	30	-70	30	-70	-70	100
["RESERVES, ETC"]	0	0	0	0	100	0

230

From : D L C Peretz
Date : 7 April 1988

MR MONCK

1. Ms Goodman
2. Ms Ryding

cc PPS
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar o/r
Mr Burgner
Mr R I G Allen
Mr Pickford
Miss O'Mara
Mr Cropper

CBI

I received a visit yesterday afternoon, at his request, from Mr Caff of the CBI. He was accompanied by Mr Andrew Sentance.

2. Mr Caff's message was that :

- CBI members were worried by the recent rise in sterling, particularly the rate against the DM.

- they were most concerned about the speed at which the rate had risen. They did not rule out the case for a higher exchange rate but believed it should be seen as a reward for virtue rather than a stick with which to beat industry.

- the rise that had taken place so far was not in itself of major concern. Firms seem to be taking the strain on margins, and it had not yet had much of an effect on confidence and investment.

- but there was a worry (not shared by Mr Caff) that we might be about to see a re-run of 1980/81 : which could in itself come to undermine confidence and investment.

- the CBI shared the Government's wish to get inflation down, but saw increased investment as important in this context, given increasing labour and skill shortages.

29/78

- CBI members remained more worried about exchange rate instability than about interest rate instability.

3. He said the CBI welcomed the way the Chancellor had described exchange rate policy in the Budget speech.

4. I said that when it was published the Chancellor's evidence to the TCSC would provide a useful point of reference for CBI members on Government policy towards the exchange rate and interest rates. I mentioned that the Chancellor had gone out of his way to stress that we were <u>not</u> now facing a re-run of 1980/81, and that exchange rate stability remained an aim of policy.

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D L C PERETZ

File

D2
232

FROM: W WOOD
DATE: 11 April 1988

MS GOODMAN

cc Mr Grice
Miss O'Mara
Mr Owen
Mr Pike
Mr Ryding
Mr Savage
Ms Symes
Mr Conaty

EXCHANGE RATE TARGETS AND TRADE SHARES

Mr Savage has passed to me your minute of 18 March and explained some of the background.

2. I do not think that the currencies in which UK trade is invoiced provide a sensible basis for determining the appropriate weights for exchange rate targeting. The currency of invoicing is a short-term decision, and will change depending on the relative negotiation positions of the exporter and importer, and on the changing strengths of the various currencies. There are large swings, for example, in the proportion of UK imports from OPEC which are invoiced in dollars and these swings are (not surprisingly) highly correlated with the strength of the dollar. The appropriate basis is of course relative trade shares taking into account both imports and exports - because in most cases an exporter will be interested <u>ultimately</u> in receiving his own currency, whatever the currency of the invoice. Similarly, an importer will in most cases have to stump up his own currency in the first instance, whatever currency it eventually gets converted into for the purpose of settlement.

3. You recognise that the proper indicator of the effect of exchange rate changes on monetary conditions would be a

comprehensive exchange rate index. In order to determine appropriate relative weights for the dollar and DM, it is therefore necessary to look at the weights in such an index, and consider what range of other currencies the dollar and DM might respectively be said to represent. In paragraph 3 of your minute, you show that on the basis of the weights in the proposed MF new exchange rate index with 90 per cent truncation,the DM represents 50 per cent of UK trade (via the EMS currencies), while the dollar represents 23 per cent of the UK trade. I think you will find that any reasonably comprehensive index, ie one that at least includes the Asian NICs, gives similar relative proportions. The weights of the OECD index, which is based on UK trade with 21 countries but includes all four of the Asia NICs, yields figures of 55 per cent for the DM and 22 per cent for the dollar. (The latter figure underestimates the weight of the dollar, because some "dollar area" countries are not included in the index).

4. This all suggests that the dollar should be given 40-50 per cent of the weight of the DM in any assessment of the impact of exchange rates on UK monetary conditions - if you are not going to look at an overall index of exchange rates as ideally you should. However, you will need to continue to monitor the position as different currencies become more or less tied to either the dollar or the DM. Even currencies in the EMS are not precisely tied to the DM, and those currencies which you describe as being in the "dollar area" are even less tied to the dollar in practice.

P. Edwards

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234

FROM: J W GRICE

DATE: 22 April 1988

MR PERETZ

cc Sir T Burns
Mr Scholar
Miss O'Mara

File: MAMC D2

INTERVENTION

You asked me to look at point (iv) in your minute to Miss O'Mara of 20 April. I do not think that I have a great deal to add.

2. The main point seems to me to be the distinction between primary and secondary liquidity. When the Bundesbank itself intervenes - either directly or when acting as in effect the agent of an ERM central bank - it alters the deutschemark monetary base or primary liquidity. As we discovered last year, it has no immediate mechanism to offset these transactions. This is in contrast to the situation in the UK where the close relationship between the EEA and the NLF means that EEA effects on the monetary base are offset daily by Issue Department transactions - generally in Treasury or commercial bills.

3. By contrast, if the UK government buys (or sells) marks in the market then that will not alter primary liquidity. Nor, for that matter, will it affect the quantity of secondary liquidity. Furthermore, since the German M3 includes non-residents' deposits, as you point out, that, too, will be unchanged.

4. What these transactions do affect, of course, is the <u>demand</u> for German secondary liquidity. If the Bank of England buys deutschemarks, increasing demand, and there is no change in actual liquidity then that will put upward pressure on the deutschemark and downward pressure on German inflation. This is quite symmetrical; if the Bank of England sold marks there would be downward pressure on the mark and upward pressure on German inflation.

6/6/88

5. This conclusion is substantively the same as yours. But I think the contrast to make is not between official sales and official purchases of marks. Rather, it should be between official transactions with the Bundesbank as the counterparty - which affect the German monetary base - and official transactions with the market which affect only the demand for secondary mark liquidity. Even so, both will affect German monetary conditions, though by different routes.

JWG

J W GRICE