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

Reference MG-MAMC/D/0002/001

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Pages 81-99

Policy targets:	Growth, employment, inflation and the current account.
Policy instruments:	Fiscal policy, monetary policy (either interest rates or monetary growth).
Intermediate targets:	Exchange rate.
Longstops:	Reserves, interest rates or monetary growth (whichever is not treated as a policy instrument).
Redundant:	Trade balance.

It seems that the primary focus of the G-5 in its initial development of indicators has been in trying to ensure that the policy targets being pursued by individual countries are mutually consistent and compatible with a satisfactory evolution of the global economy. It remains to be seen whether the group will in future have more success in their endeavor than it did in the initial stages. My own view in that this is unlikely unless and until an attempt is made to develop a greater measure of agreement on the fundamental principles of economic management, such as:

-- robust feedback rules in preference to either pure discretion aimed at policy optimization or an automatic pilot
-- an assignment of the world level of interest rates to the state of the world conjuncture, of interest rate differentials to the management of exchange rates, and of fiscal policy to national nominal income growth
-- a target rate of nominal income growth equal to the sum of the rate of growth of productive potential, a term

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related to the size of the deflationary gap, and a fraction of the inherited rate of inflation.

If those principles were to be endorsed, the resulting indicator system would look distinctly similar to the sort of extended target zone system discussed above (Williamson 1986).

In terms of the monitoring function of indicators, the crucial question is whether to give priority to monitoring the behavior of the <u>instruments</u> of policy, the <u>targets</u>, or the <u>intermediate targets</u>. That is, if a country were fulfilling its declared (and internationally accepted) intentions regarding fiscal and monetary policy, but it were nonetheless failing to approach its targets for growth, inflation, and the external sector, would it be appropriate to regard it as having satisfied its international obligations? Conversely, if a country was growing as fast as planned and reducing unemployment on schedule, while inflation was falling as intended and the balance of payments was at a level internationally agreed to be satisfactory, should a country be urged to adjust its policies just [4/] because the money supply was growing faster or slower than expected or the budget deficit was off-target?

This choice raises some of the issues that were debated at length in the Keynesian-monetarist controversy. Those who believe that the best policy is for governments to precommit themselves to fiscal and monetary policies will presumably wish to monitor indicators for those two variables rather than for desired outcomes, in the spirit of Margaret Thatcher's attempt to impose a medium-term financial strategy on the British economy.

But the evident failure of this approach to policy formation, as exemplified most recently by the Chancellor's decision to raise the target range for sterling M3 in the latest British budget, suggests that it would be preferable to concentrate on monitoring outcomes and/or intermediate variables.

There is an obvious advantage in monitoring the exchange rate as an intermediate variable rather than just the performance of the current account, since the exchange rate is immediately, continuously and accurately available whereas current account statistics are produced with a lag, only occasionally, and subject to substantial error. To complement the exchange rate on the internal side, one might monitor either two of the target variables (growth and inflation), or else, for reasons argued earlier, the growth of nominal income (which may be classified as another intermediate variable).

Thus one possible approach to monitoring would be for the monitoring authority to concentrate in its routine activities on two intermediate variables, the exchange rate and the growth of nominal income. The policy adjustments that would be expected in response to deviations from the target paths of these two variables are shown in table 1. As noted previously, this begins to look quite like the extended target zone proposal outlined above.

Concluding Remarks

Some crucial issues are at stake in the current debate on improving international economic policy coordination, but the choice between target zones and indicators is not one of them. A natural extension of the target zone proposal would lead to much the same set of presumptive rules as an enlightened interpretation of the indicator proposal.

The central issues are, rather, the following.

(1) Can ad hoc discussions of policy intentions persuade countries to modify their policies with a view to securing international consistency in the absence of agreement on the basic principles of economic management?

(2) If the answer to that question is in the negative, can the principles suggested in this paper--feedback rules, the proposed assignment, and a flexible form of nominal income targeting--provide a basis for agreement?

Table 1

Presumptive Policy Reactions to Deviations of Indicators from Targets

Nominal income growth	Domestic currency: Appreciated above target	Domestic currency: Depreciated below target
Above target	Monetary expansion Fiscal contraction	Monetary contraction
Below target	Monetary expansion	Monetary contraction Fiscal expansion

Footnotes

1. A good example is provided by Japan in early 1986, when the oil price fall first raised the possibility of a dramatic positive shock to the Japanese current account.

2. Clearly analogous rules could be devised if a more rigidly monetarist, Keynesian or supply-side stabilization policy were preferred.

3. The non-accelerating inflation rate of unemployment. An unacceptably high estimate of the NAIRU would signify the need for changed labor market policies to permit a reduction in unemployment.

4. The word "just" is important, for one would wish to ensure that the unplanned behavior of the policy instruments did not signify that the satisfactory behavior of the policy targets was unsustainable.

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FROM: P H BROOK

DATE: 10 February 1987

MR RICHARDSON

cc: Ms Goodman
Mr Pike
Mr Westaway
Mr Heath
Mr Flitton

Mr Collins)
Mr M Wright) B of E
Ms Jupp)
Ms Plumbly)

EXTERNALS AND FOREIGN CURRENCY FINANCE OF THE PUBLIC SECTOR

You asked that I prepare a note on external and foreign currency finance of the public sector and its relationship with the reserves, in the light of our meeting on 15 January. Inevitably, when looking in detail at such subjects, the relationship did not turn out to be as straightforward as we had thought and tying up the loose ends has taken longer than I had hoped.

2. The attached draft note has been prepared in consultation with others in MG. I would be grateful for any comments. In particular I would welcome confirmation from Ms Goodman/Mr Flitton that:

(a) the relationships shown in Table E are correct;

(b) all LA and PC UK foreign currency bank borrowing is under the ECS;

(c) no other items apart from EMCF swaps and non-public sector ECS covered borrowing appear in the published reserves but not in those relevant items identified in the public sector externals in Table E;

(d) non-public sector ECS covered borrowing in 1986 Q2 was about £35 million (this cannot be confirmed from Financial Statistics); and

(e) underlying spot intervention (plus any non-public sector ECS covered borrowing) can be monitored in sterling converted on a daily basis.

P H BROOK

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NOTE ON FUNDING AND EXTERNAL AND FOREIGN CURRENCY FINANCE OF THE PUBLIC SECTOR

£M3 Counterparts

Table A shows the counterparts to £M3 as presented in the Bank's monthly back-up tables (Table B shows where each counterpart series can be found in Financial Statistics). In this presentation the counterparts to £M3 are viewed as bank lending in sterling to the public sector (row J), to the private sector (K), and to overseas, together with other externals and foreign currency transactions of UK banks (L) and changes in their net non-deposit liabilities (M).

2. Bank lending to the public sector is derived by subtracting from the PSBR (row F), the amount of funding from the non-bank private sector (G and H) and the external and foreign currency finance of the public sector (I). Implicit in this is the assumption that the difference represents bank lending in sterling to the public sector. It is important to note that this presentation of the counterparts represents one arrangement of an accounting identity.

3. Table C shows a breakdown of external and foreign currency finance of the public sector. The simplest way of looking at the sign convention is that all increases in public sector assets have positive signs whereas all increases in liabilities have negative signs. Looking at one liability and one asset a little further might help explain this convention. First take sales of British Government Stock overseas (BGS in Table C). Any change in the net overseas demand for sterling assets will not lead directly to an offsetting change in total supply (assuming the authorities are not intervening). To the extent that overseas holdings of sterling assets increase there must be a corresponding switch out of sterling assets by the UK private sector. It is generally assumed that most of the switch will be with the UK nbps. Hence an increase in sales of British Government Stock overseas has a contractionary influence in £M3. If the banks' net foreign currency position did in fact change there would be an offsetting change in other counterparts.

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Turning to an asset, take an increase in Central Government foreign currency deposits. This will be reflected by an outflow of sterling assets from Central Government. Given the assumption that the UK banks' net position changes little, the foreign currency will be purchased either from the UK nbps or overseas. In the former case £M3 will increase, in the latter the transaction will be offset in other counterparts. As before if the banks' net foreign currency position did in fact change this would also be reflected in changes in other counterparts. In any case the outward flow of sterling assets from Central Government has an expansionary influence on £M3 which may or may not be offset elsewhere in the counterparts.

5. It can be seen therefore that a net increase in external and foreign currency finance of the public sector has a contractionary influence on £M3 which may in part be offset by changes in the UK banks' or overseas' positions.

Funding

6. Table D sets out a breakdown of funding of the PSBR. External and foreign currency finance of the public sector in the counterparts equates to public sector externals excluding BGS. Overseas sales of British Government Stock are included as part of gross gilt sales.

7. Monitoring of the public sector externals might be simplified by separating out those elements which affect the reserves and monitoring these via changes in the underlying change in the reserves (underlying spot intervention). In order to do this it is necessary first to expand the public sector externals and then identify the relevant elements. Table E shows the link between published reserve figures and the expanded public sector externals. All items which make up the published reserves figures (either total change in reserves or underlying spot intervention) are reflected in the public sector externals apart from two. First non-public sector borrowing (eg by BNFL) under the exchange cover scheme (ECS). In terms of the published reserves this borrowing is included in the total change in the reserves but excluded from

underlying spot intervention, as with all other borrowing under the ECS. As far as funding is concerned, the inflow of foreign currency into the reserves increases the funding requirement but because the sterling is passing into the private sector, the increase is not offset in the other public sector counterparts. ECS covered borrowing by the LAs and PCs has no net effect on funding because both sides of the transaction are within the public sector. The second reserves item excluded from public sector externals is the European Monetary (EMCF) Cooperation Fund swaps. This is a quarterly revolving swap in which the UK gives 20 per cent of its gold and dollars in return for ECU. The swap has an affect upon the reserves because of the different way the EMCF and the UK values gold and dollars. The valuation change is included in the total change in the reserves; it is not part of the underlying spot intervention. These valuation changes do not affect the funding requirement. For this reason official reserves in the public sector externals does not exactly equate to published total change in the reserves. In Financial Statistics EMCF swaps are incorporated in Table 10.3, revaluations and other changes in official reserves.

8. Simplifying the term for the public sector externals by substituting underlying spot intervention (plus any non-public sector borrowing under the ECS) in the equation gives the following:

	1986 (£ million) Q2
+ <u>Total underlying spot intervention</u> (plus any non-public sector borrowing under ECS)	+419
<u>Central Government</u>	
- TBS (Treasury Bills)	-2
- O/S Holdings of notes and coins	-56
+ foreign currency deposits	-1
<u>LAs and FCs</u>	
- Overseas borrowing	
in sterling	+12
in foreign currency (non-ECS covered)	+35
+ foreign currency deposits	+8
+ PCs liquid assets	+8
= <u>Total Public Sector Externals (excluding BGS)</u>	+423

<u>nb</u> sign indicates the effect of an increase

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9. The figure of £419 million for total underlying spot intervention in 1986 Q2 is derived from the published underlying spot intervention figures for April-June converted to sterling at the average monthly exchange rate and adjusted for known non-public sector borrowing under the Exchange Cover Scheme (ECS). The other terms are extracted from Financial Statistics or the Bank's back-up sheets. Deriving public sector externals purely from the counterpart equation (Table E left hand equation) using Financial Statistics and back-up sheets gives a figure of £425 million. The difference of £2 million between this and the total in paragraph 8 is likely to be due to difficulties in converting dollar spot underlying intervention into sterling. The official reserves figures in Financial Statistics translate dollar value transactions into sterling on a daily basis. For the purposes of this note, published underlying spot intervention figures have been converted to sterling using average monthly \$/£ exchange rates.

10. I have attempted to use consistent rather than latest available data in preparing the above comparison. The sources used are Financial Statistics (December 1986), Quarterly back-up tables for Q3 1986 (25 November 1986) and published reserve figures.

11. Looking at items other than underlying spot intervention in the public sector externals equation in paragraph 8 shows that while individually the elements were not insignificant, none was equivalent to more than 14 per cent of the intervention term, and taken together the effect on public sector externals was minimal. Looking quickly at previous quarters this analysis generally holds true and a working assumption that the residual elements will have a neutral effect over the period to the end of the financial year is probably sufficiently for funding arithmetic purposes, subject to revision in the light of monitoring.

Conclusion

12. Public sector externals can be expressed in terms of underlying spot intervention (plus any non-public sector ECS borrowing) together with a number of minor elements (see Table F for a revised

akdown of funding of the PSBR). For funding arithmetic purposes an assumption of the amount of underlying spot intervention until the end of the financial year is necessary but the effect of the other minor elements of the public sector externals can be assumed to be neutral. Monitoring of both underlying spot intervention (in sterling converted on a daily basis) together with the minor elements, as far as data are available, should take place.

P H BROOK
MG1
HM TREASURY
FEBRUARY 1987

TABLE A95

SECRET RUN ON: 28/01/87

MONTHLY COUNTERPARTS TO CHANGES IN £M3 *** SECRET ***
£ MILLIONS, UNADJUSTED

	1986 DEC	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
A CG OWN ACCOUNT	+ 1192	- 4594	- 24	+ 1365	+ 169	+ 1718	+ 1167	- 3	+ 1175	+ 2472	- 324	+ 786	- 1664
B CG ON LENDING TO LA'S	+ 384	- 236	+ 135	+ 1887	+ 2409	+ 811	+ 196	+ 109	- 95	+ 200	+ 56	- 66	- 19
C CG ON LENDING TO PC'S	- 45	- 301	- 268	+ 122	- 274	+ 73	+ 117	+ 159	+ 57	- 101	+ 90	- 216	+ 239
D OTHER LA CONTRIBUTION TO PSBR	- 122	- 145	- 154	- 663	- 1718	- 1089	- 712	- 103	+ 368	- 349	- 200	- 277	+ 119
E OTHER PC CONTRIBUTION TO PSBR	+ 245	- 309	- 80	+ 338	+ 112	- 499	- 305	- 482	+ 204	- 32	+ 307	- 161	- 69
F PSBR (A+B+C+D+E)	+ 1654	- 4511	- 391	+ 3049	+ 698	+ 1014	+ 463	- 320	+ 1709	+ 2190	- 71	+ 66	- 1394
G OP DEBT SALES TO NBPS (NET) (INC-)	+ 271	+ 13	+ 13	+ 13	+ 583	+ 583	+ 584	+ 39	+ 39	+ 38	- 116	+ 317	- 109
OF WHICH: LOCAL AUTHORITIES	- 262	- 91	+ 19	- 1224	- 691	+ 278	+ 516	- 8	- 275	+ 147	- 137	+ 316	- 107
PUBLIC CORPORATIONS											+ 21	+ 1	- 2
H CG DEBT SALES TO NBPS (INC-)	- 19	+ 506	- 1	- 682	- 1217	+ 703	- 1491	- 590	- 1512	+ 406	- 1207	- 948	- 16
O/W BGS	(+182)	(- 387)	(+615)	(-352)	(-779)	(+989)	(-1065)	(-142)	(-1037)	(+285)	(-1129)	(-614)	(- 12)
TBS	(+128)	(+ 30)	(- 56)	(- 24)	(- 37)	(+ 43)	(+ 14)	(+ 44)	(+ 4)	(+ 7)	(+ 13)	(+ 27)	(- 82)
NAT SAVINGS					(-128)	(-211)	(- 320)	(-357)	(- 274)	(-232)	(- 303)	(-257)	(-236)
NI DEBT											(- 8)	(- 4)	(+ 7)
CTDS	(-255)	(+1015)	(-496)	(-247)	(-275)	(-110)	(- 125)	(-157)	(- 131)	(+278)	(+ 218)	(-102)	(+302)
GOVT LIABILITY UNDER ECS										0	(+ 2)	(+ 2)	(+ 5)
I EXTERNAL AND FC FINANCE OF THE PUBLIC SECTOR (INC-)	- 378	- 22	+ 30	+ 340	- 410	+ 19	+ 86	- 699	- 218	+ 133	- 486	- 308	- 70
J "OVERFUNDING" (-) ON WIDE DEFINITION (F+G+H+I)	+ 1528	- 4014	- 349	+ 2720	- 346	+ 2319	- 358	- 1570	+ 18	+ 2767	- 1880	- 873	- 1589
K £ LENDING TO PRIVATE SECTOR	+ 2127	+ 417	+ 3073	+ 4020	+ 83	+ 1483	+ 4072	+ 2895	+ 1746	+ 1942	+ 3378	+ 3325	+ 3533
O/W: ISSUE DEPT'S BILLS										0	+ 1598	+ 1311	+ 1969
SHIPBUILDING REPOS										0	0	0	0
L BANKS' EXT & FC TRANSACTIONS											+ 647	+ 140	- 2297
NET £ DEPS FROM BANKS ABROAD											+ 601	- 781	- 619
OTHER OVERSEAS £ DEPOSITS											- 423	+ 245	- 277
£ LENDING TO OVERSEAS NON BANKS											+ 697	- 5	+ 727
BANKS'NET FC DEPOSIT LIABILITIES											- 103	+ 672	- 1406
CNETNDL											- 125	+ 9	- 72
O/W CHANGE IN REPORTED STOCKS											- 297	+ 99	- 479
VALUATION ADJUSTMENT											(+ 172)	(- 90)	(-243)
M £NNDL (INC-)											- 929	- 422	+ 619
N OTHER COUNTERPARTS (L+M)	- 2814	+ 3048	- 1716	- 1077	+ 1308	+ 680	- 2394	+ 241	- 1278	- 132	- 281	- 281	- 1678
£M3 (J+K+N)	+ 841	- 549	+ 1008	+ 5663	+ 1045	+ 4482	+ 1320	+ 1566	+ 486	+ 4577	+ 1216	+ 2170	+ 266
MEMORANDUM ITEMS:													
CGBR (A+B+C)	+ 1531	- 4057	- 157	+ 3374	+ 2304	+ 2602	+ 1480	+ 265	+ 1137	+ 2571	- 178	+ 504	- 1444
LABR (B+D)	+ 262	+ 91	- 19	+ 1224	+ 691	- 278	- 516	+ 6	+ 273	- 149	- 144	- 343	+ 100
PCBR (C+E)	+ 200	- 8	- 348	+ 460	- 162	- 426	- 188	- 323	+ 261	- 133	+ 397	- 377	+ 170

TABLE B

EXTERNAL AND FOREIGN CURRENCY FINANCE OF PUBLIC SECTOR

Counterpart	Financial Statistics: Table	Column No	Column title
Central Govt			
Official reserves	1.3	18	Official reserves excluding EMCF swaps (broken down in Table 10.3)
Other Official Finance	1.3	16 + 17	Govt foreign currency debt and other Govt overseas financing
BGS	1.11	8	British Govt securities
TBS	1.11	7	Market Treasury Bills
O/S holdings notes and coins	1.11	6	Notes and coins
Foreign currency deposits	1.3	21.3	Deposits with banks - foreign currency
Local Authorities			
LA's UK FC Bank borrowing	4.4		Monetary sector - total (borrowing) (part only)
LA's overseas borrowing	4.4		Overseas sector - total (borrowing)
LA's foreign currency deposits	1.4	21.3	Deposits with banks and foriegn currency
Public Corporations			
PC's UK FC Bank borrowing	5.4		Monetary sector - foreign currency (borrowing)
PC's overseas borrowing	5.4		Overseas sector - foreign currency (borrowing)
PC's foreign currency deposits	1.5	21.3	Deposits with banks - foreign currency
PC's currency liquid assets	1.5	14.2	Other public sector financing -short term asset (part only)

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SECRET RUN ON: 28/01/87

TABLE C

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MONTHLY EXTERNALS AND NNDLS ***SECRET***
£ MILLIONS, UNADJUSTED

	1986 OCT	NOV	DEC
EXT & FC FINANCE OF PUBLIC SECTOR (INC-)			
TOTAL O/W	- 486	- 308	- 70
CENTRAL GOVERNMENT			
OFFICIAL RESERVES (INC+)	- 221	- 21	- 64
OTHER OFFICIAL FINANCE (INC-)	+ 3	+ 5	+ 87
BGS (INC-)	- 258	- 267	- 94
TBS (INC-)	+ 41	- 112	- 110
O/S HOLDINGS OF NOTES & COIN (INC-)	0	0	0
FOREIGN CURRENCY DEPS (INC+)	0	0	0
TOTAL CG NET (INC-)	- 435	- 395	- 181
LOCAL AUTHORITIES			
LA'S UK FC BANK BORROWING (INC-)	0	0	0
LA'S OVERSEAS BORROWING (INC-)	+ 1	+ 2	+ 4
LA'S FOREIGN CURRENCY DEPOSITS(INC+)	- 17	+ 34	+ 32
TOTAL LA'S NET (INC-)	- 16	+ 36	+ 36
PUBLIC CORPORATIONS			
PC'S UK FC BANK BORROWING (INC-)	+ 6	+ 3	+ 9
PC'S OVERSEAS BORROWING (INC-)	- 23	+ 14	+ 34
PC'S FOREIGN CURRENCY DEPOSITS(INC+)	- 18	+ 34	+ 32
PC'S CURRENCY LIQUID ASSETS (INC+)			
TOTAL PC'S NET (INC-)	- 35	+ 51	+ 75
BANK DEPOSITS FROM OVERSEAS, ETC.			
(A) £ DEPOSITS FROM OVERSEAS:BANKS	+ 860	- 216	+ 734
:NON BANKS	+ 423	- 245	+ 277
(B) NET CURRENCY DEPOSITS OF OVERSEAS RESIDENTS (INC-)	+ 1,729	+ 474	- 1,031
(C) INTERBANK CURRENCY DIFFERENCE	- 246	+ 481	- 674
STERLING LENDING TO OVERSEAS			
(A) LENDING TO UNRELATED BANKS	+ 1,491	- 1,056	- 74
(B) LENDING TO RELATED BANKS	- 30	+ 59	+ 189
(C) SPECIAL EXPORT SCHEME LENDING (EXCL. REPOS)	- 31	+ 6	- 1
(D) ISSUE DEPT. EXPORT CREDIT REPOS	0	0	0
(E) LENDING TO OTHER OVERSEAS CUSTOMERS	+ 728	- 11	+ 728
(O/W £ COMMERCIAL PAPER)	(+ 37)	(+ 3)	(- 19)
TOTAL : £ LENDING OVERSEAS (INC. I.D)	+ 2,158	- 1,002	+ 842
NET £ NON DEPOSIT LIABILITIES(INC-)	- 929	- 422	+ 619
O/W UK BANKS £ DEPOSITS (INC-)	- 3,645	+ 1,137	- 233
£ LENDING TO UK BANKS (INC+)	+ 2,745	- 1,326	+ 928
SUBT : INTER BANK DIFFERENCE	- 900	- 189	+ 695
£ CAPITAL AND RESERVES (INC-)	- 51	- 313	- 387
£ INVESTMENTS & OTHER ASSETS (INC+)	+ 33	+ 89	+ 287
£ ASSETS LEASED TO CUSTOMERS (INC+)	- 10	- 10	+ 34
ROUNDING ADJUSTMENT	- 1	+ 1	- 10

TABLE D

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Fund..ng : Financial year position

£ Million u/a

	Financial Year 1986/87 (a)	Outturn To end of December (b)	Outturn + Forecast to End of January (c)	Rest of 1986/87 (a)-(c)
PSBR excluding asset sales				
Gilt redemptions/ buying in (+)				
Monetary sector purchase (+)				
Public sector Externals excluding BGS (-)				
Other public sector debt (-)				
National Savings/ CTDs etc (-)				
Gross Gilts Sales (-)				
Total				
Asset sales (-)				
Under(+)/Over(-) funding				

Assumes gross gilt sales of £800 million in January

TABLE E

	PUBLIC SECTOR EXTERNALS (EXCLUDING BGS)				RESERVES
	Central Government				
+	Official Reserves	______	=	______	+ change in reserves (excluding European Monetary Cooperation Fund swaps)
-	Other Official Finance	______	=	______	- repayments of HMG assigned debt, FRN etc
-	TBS				
-	O/S holding of notes and coin				
+	Foreign Currency Deps				
	LAs and PCs				
-	UK FC Bank borrowing				
-	Overseas borrowing				
	Sterling				
	Foreign Currency				
	ECS covered	______	=	______	- Public Sector Borrowing Under ECS
	Non-ECS covered				
+	Foreign Currency Deposits				
+	PC's Liquid Assets				
=	**Public Sector Externals**				- Non-Public Sector Borrowing Under ECS (eg BNFL)
					= **Total Underlying Spot Interventio**

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