

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 82-103

I' Other Issues

56 Gold Occasional surges in the premium on sovereigns above 2% opened brief windows of demand which resulted in sales of 30,000 coins in the half-year, compared with 32,000 in the second-half of 1986 but only 6,000 in the first half of that year. However, demand for half-sovereigns fell away in the face of our requirement of a 15% premium, and only 15,000 coins were sold, compared with 49,000 in the second half of last year.

EEA Issuer Limits: Developments January - June 1987

57 In March Standard and Poor's downgraded Denmark's credit rating from AA+ to AA. The EEA's bond holdings credit limit of \$500mn was reduced to \$100mn as a temporary measure, pending a stabilisation in Denmark's economic situation. No forced sales by the EEA were necessary. The bond holdings limit of \$25mn for New Zealand was judged to be unduly restrictive and was raised to \$50mn, also in March. Moody's announced in May that Norway (rated Aaa) was to be watchlisted for potential downgrading. (This in fact happened on 13 July.) As a precaution the operational limit was reduced immediately; and the credit limit has now been revised to \$250mn. No forced sales were necessary. Finally, the list of limits for Bankers' Acceptances has been combined with those for each bank covering BAs, market deposits and unsettled spot foreign exchange transactions. Consistent with this approach, the range of banks whose BAs are acceptable was broadened to include all overseas banks for which spot overnight limits of £50mn or over are in place.

## Assessment of Strategic Decisions

58 We agreed at January's meeting to consider how the efficacy of strategic decisions might best be assessed. A number of complicated issues arise, which suggest that there is no obvious 'best' means of proceeding. The following notes indicate the direction in which our thoughts are progressing.

59 The discussion in earlier sections will indicate that we have made some progress in assessing what might be meant by a neutral disposition of assets in the context of official foreign currency liabilities. To summarise that discussion:

- it is helpful to separate the currency decision from the yield curve decision
- this separation is possible because the net currency exposure can be altered by forward transactions, without the need for change in the composition of spot assets such as money market instruments and bonds. (For example, the EEA could in principle be long DM bonds without being long DM currency by owning DM bonds, hedged into US dollars by forward sales of DM)
- thus currency allocation decisions can be evaluated in the light of expected (and realised) US dollar returns on money market instruments in each currency
- neutrality of currency allocation needs to be approached differently according to whether total net currency assets are positive and negative. In both cases, we have discussed possible frameworks for assessing departures from neutrality
- yield curve decisions can be made in the light of calculations of net exposure, measured in terms of changed market value following a parallel shift in the yield curve.
- neutrality with respect to the yield curve may be defined as zero net exposure, in the sense that the change in the market value of liabilities is the same as the change in the market value of assets in the event of a parallel shift in the yield curve.

60 If this framework is acceptable, it is possible in principle to assess the returns gained from departing from a strategy which is neutral as regards asset and liability allocations. Several significant practical problems remain, however.

- the horizon over which returns should be calculated
- strategies tend to be modified as time passes, in the light of further developments.
- strategies are often blown off course; the influx of reserves this spring provides an obvious example.
- rapid changes in the level of gross reserves and liabilities make immediate 'neutral' allocations unwise.

61 Subject to resolution of these difficulties, however, we are considering an approach along the following lines:

(1) At the time of each allocation decision, design three alternative allocations of assets and liabilities:

- the 'neutral' allocation (as discussed above)
- the 'no change' allocation
- the 'actual' allocation, agreed at the meeting

(2) To circumvent the practical difficulties of calculating total returns on a whole range of assets, allocation will be assumed to be between a restricted set of assets:

- 'cash' in each currency
- a US dollar liquidity portfolio, with a 3 month average maturity
- a two year US note portfolio
- four year bond portfolios in US dollars, DM, Yen and Canadian dollars

(The security portfolios correspond with those currently run for the EEA.)

(3) We already calculate the total return in local currency on each security portfolio, for performance monitoring purposes. It should thus be possible to calculate the total return in US dollars, over several horizons, from each strategy.

62 This approach makes a considerable number of simplifying assumptions. We feel, however, that it might provide an adequate basis for the assessment of strategic decisions. Clearly, further discussion will be required before we embark on the task of

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calculating returns; and the existing, rather tightly stretched, resources are not likely to be able to produce any very quick answers.

## Annex

Securities Markets Review: January - June 1987

1 The following material reviews developments in the major security markets where the EEA has an interest:

- Short term US market (US Treasury bills, sovereign paper, bankers' acceptances and FRNs)
- US Treasury notes and Federal Agencies
- Eurodollar markets
- DM bond markets
- Yen bond markets
- Canadian dollar markets

## SHORT-TERM US MARKETS

2 Eurodollar rates traded up slightly during the first quarter, after recovering from an unusually sharp end-year seasonal spike. At the end of March, the markets lost faith in the prospects for the dollar, and rates rose more sharply amid resurgent inflation fears, and concerns about the banking system following substantial provisioning by US banks against LDC lending. By end-May, the dollar seemed to have stabilised and inflation fears had subsided somewhat (with the CRB index falling as the weather in the US improved); the three month LIBID rate ended the period at about 7%, a full 100 basis points up on January's low (Graph 1).

3 Treasury bill rates outperformed Eurodollar rates during the period, with bills benefitting from the banking system's debt problems and from the appetite of foreign central banks, with large inflows of dollars to invest. Reductions in the supply of bills were also a factor. The 3 month 'TED spread' (Treasury bill to Eurodollar spread) widened from around 85 basis points early in the year to about 100 basis points at end-March, and peaked at over 150 basis points in late May. It ended the period at about 130 basis points, much higher than its typical level in recent years (Graph 2).

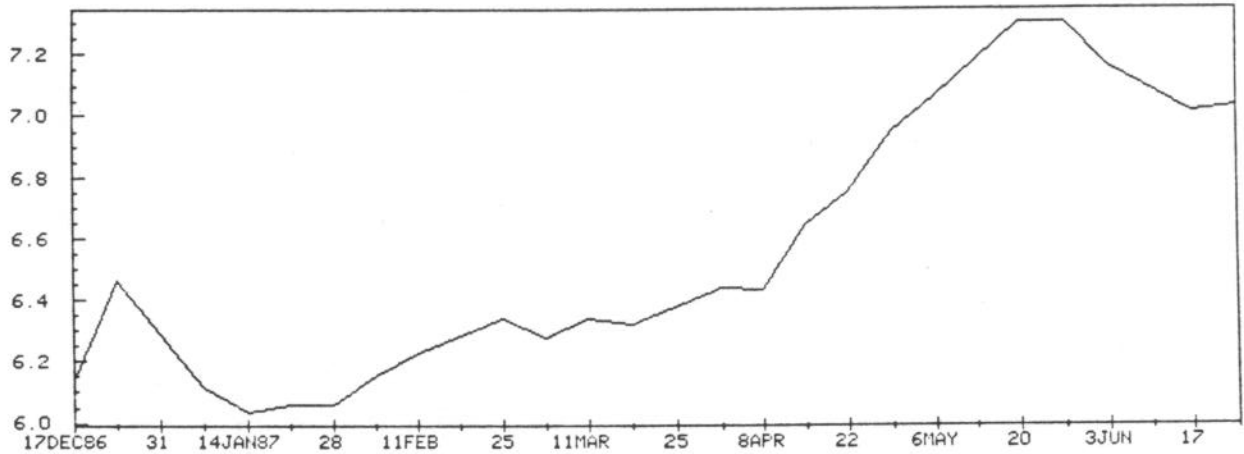
4 The widening of the TED spread had implications for the pricing of sovereign paper and of bankers' acceptances. Good quality sovereign paper tightened by 10 basis points against Eurodollar rates, in response to substitution out of Treasury bills, whereas bankers' acceptances continued to trade more in line with Eurodollar rates.

5 The collapse in the perpetual FRN market - provoked by Japanese selling of bank FRNs following indications that holdings would be deductible from any capital raised by FRN issues, and perhaps by the rise of competing instruments such as floating rate CMOs - led to some fall in the prices of sovereign FRNs. For example the new UK FRN was trading at 99.30 at the start of the year, fell to 98.25 in March and partially recovered to 98.90 at the end of June.

Short Term US Markets

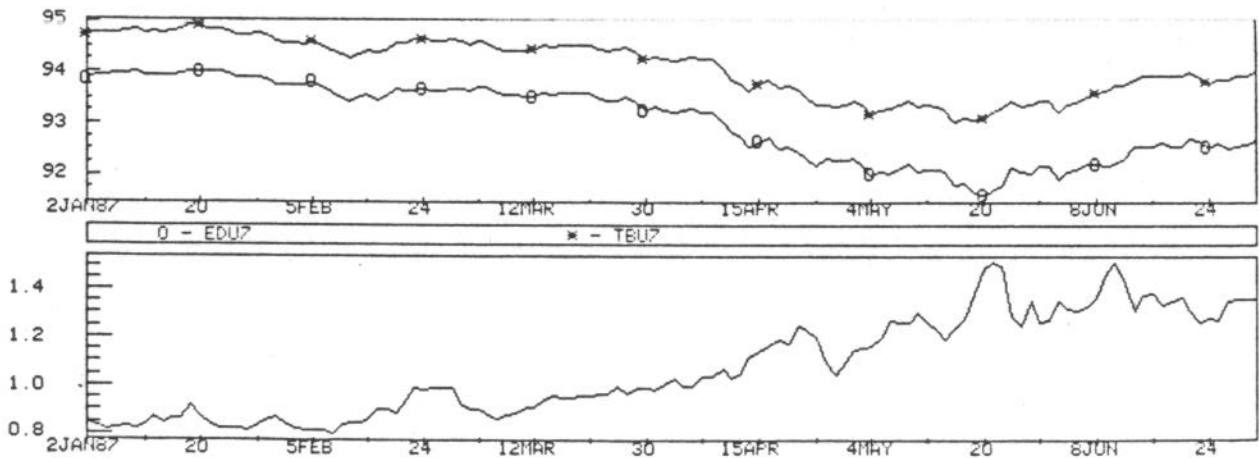
3 MONTH LIBID RATES

GRAPH 1



GRAPH 2

SPREAD ANALYSIS BETWEEN THE SEPTEMBER 1987 EURODOLLAR FUTURES CONTRACT AND THE TREASURY BILL FUTURES CONTRACT



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## US TREASURY NOTES AND AGENCIES

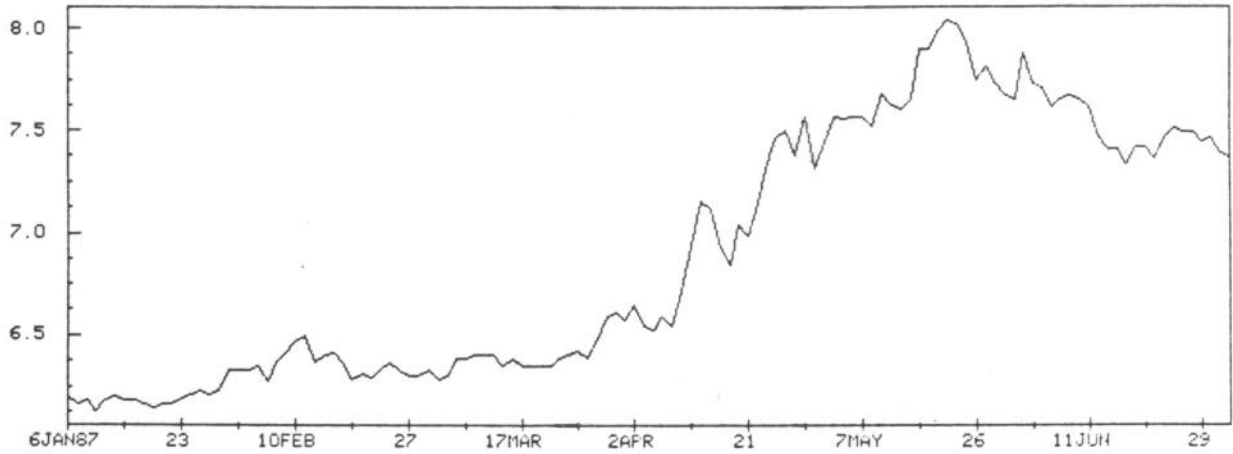
6 The market traded in a very narrow range for the first three months of the year, but traded off sharply at the end of March as the dollar came under severe pressures; yields (at 2 year maturities) rose by almost 200 basis points (at the peak in mid-May), but recovered by about 60 basis points as the dollar gained ground after mid-May.

7 The down-trade in April and May was associated with a marked steepening of the yield curve. The 2-5 year spread rose from about 30 basis points to 60 basis points, and has remained at about that level since. The rise in yields in short coupons was, however, restrained by foreign central banks' growing demand for bills (as mentioned above); thus the 1-2 year spread in notes rose less than might have been expected - from 30bp to 60bp in mid-May, before falling back to 45bp. (Graph 3).

8 Agency spreads over notes rose somewhat in April and May, on concerns about the financial health of the farming and thrift sectors. By the end of June spreads had contracted to more normal levels, following reassuring signals about the likelihood of federal support.

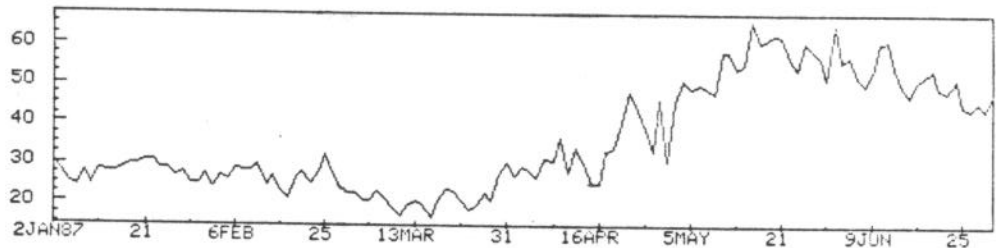
US Treasury and Agency Market

YIELD ON 2-YEAR NOTE



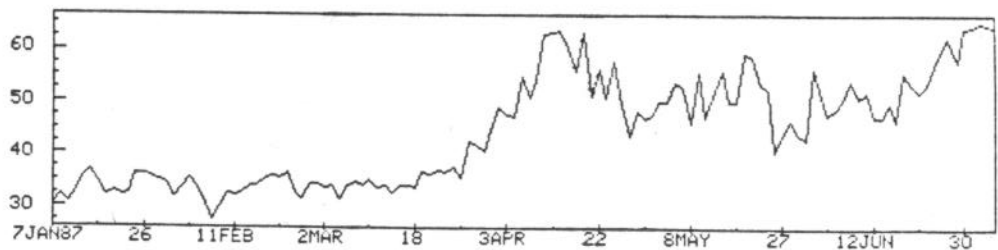
SPREAD BETWEEN YIELDS ON 1 AND 2-YEAR NOTES

SPREAD HISTORY  
 [MAX 6 MONTHS]  
 FROM 1/2/87  
 TO 7/1/87  
 HI 65.735  
 LOW 16.288  
 AVE 36.226



SPREAD BETWEEN YIELDS ON 2 AND 5-YEAR NOTES

SPREAD HISTORY  
 [MAX 6 MONTHS]  
 FROM 1/7/87  
 TO 7/7/87  
 HI 64.949  
 LOW 27.411  
 AVE 44.213



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## EURODOLLAR MARKET

9 As usual movements the Eurodollar market largely followed those in the US Treasury market, mirroring the rapid decline during April and the first half of May and the subsequent partial recovery. There were no major developments in the Euro\$ - Treasury spread which remained in the 30-60bp range for good quality sovereign and supranational issuers throughout the maturity range, with the best supranational issues out to 5 years in maturity trading at the tighter end of the range. The only major credit development was that Moody's put Denmark and Norway on credit watch. However, the former only followed S&P's downgrading of Denmark to AA and the latter was widely thought to be an overreaction to lower oil prices, although the Norway 7½% of 91 did trade around 10 bp cheaper following the announcement. Overall the Eurodollar market was subdued in the first half of 1987 and turnover was well down on 1986. There was little new issuance in the Sovereign and supranational section in the first quarter and none in the second quarter following the back-up in the market.

Graph 4

Eurodollar-Treasury spread: Sweden 7% 7/10/91 v TN 7½% 15/8/91  
(Dec 31 1986 - June 30 1987)

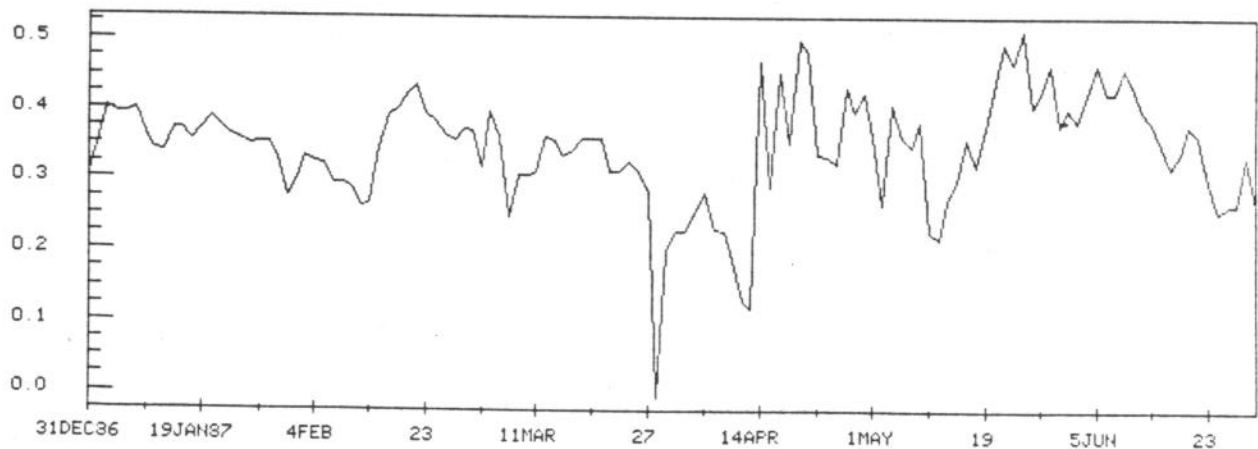


CHART 6: YIELD ON 10 YEAR SIDE ISSUE (JGB 79) (JUNE 30 1986 TO DATE)

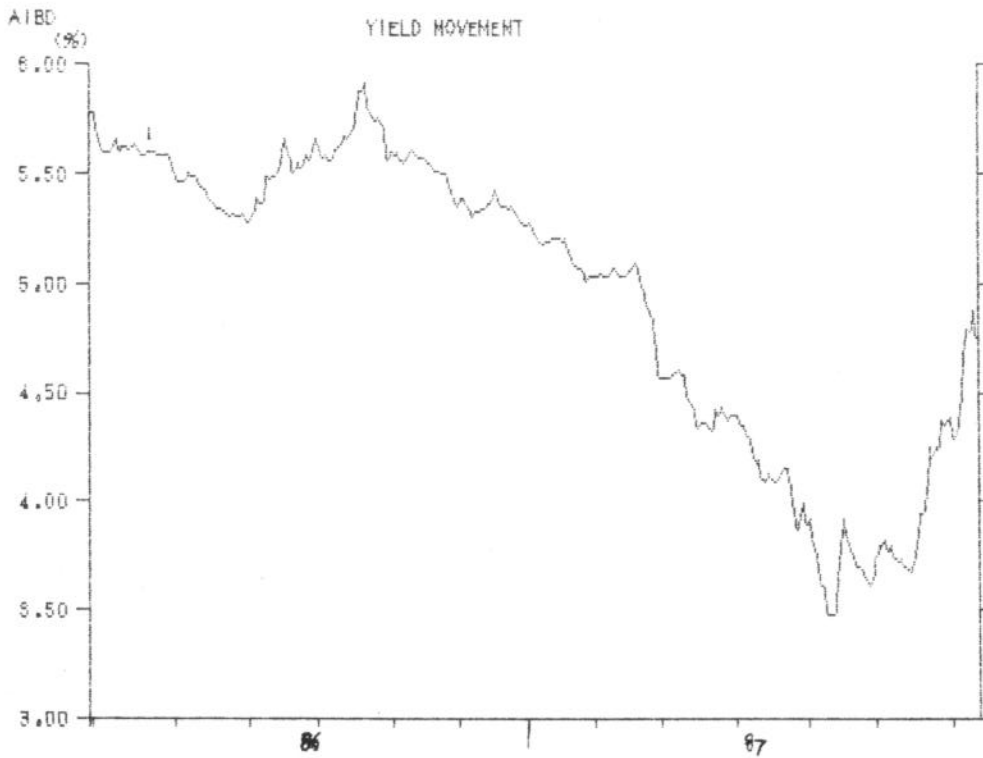


CHART 7: JGB YIELD CURVE: 2 to 10 YEAR SPREAD (JAN 1 1987 TO DATE)

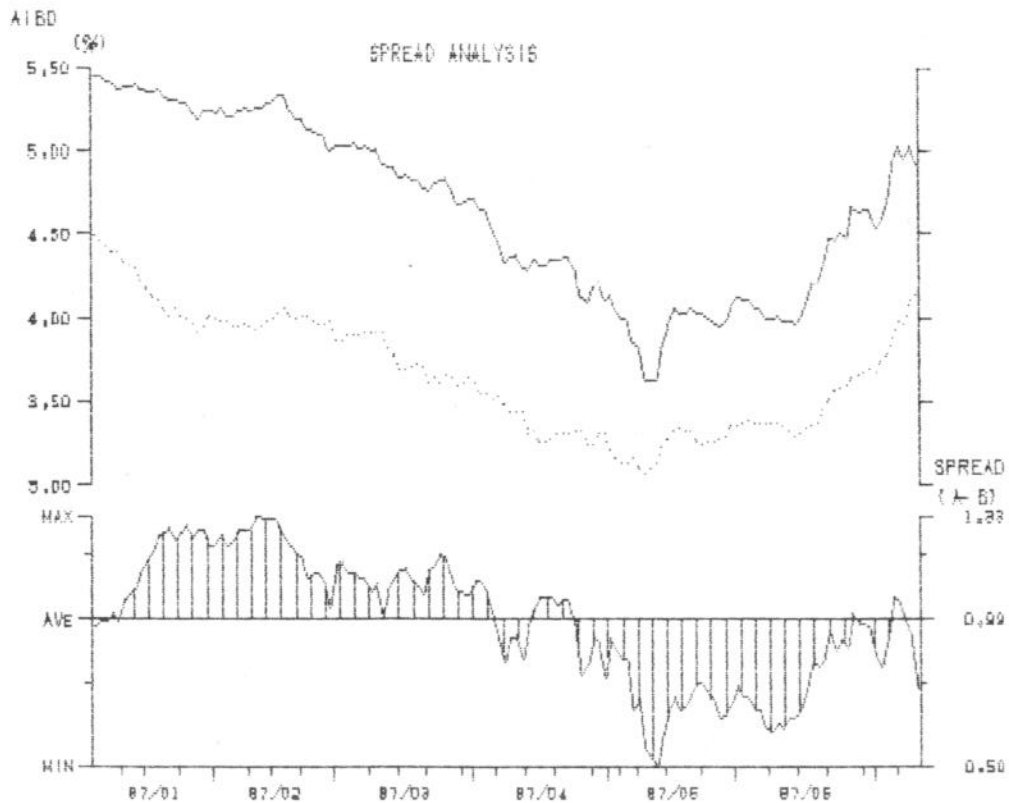


CHART 8: JGB COUPON EFFECT (JAN 1 1987 TO DATE)

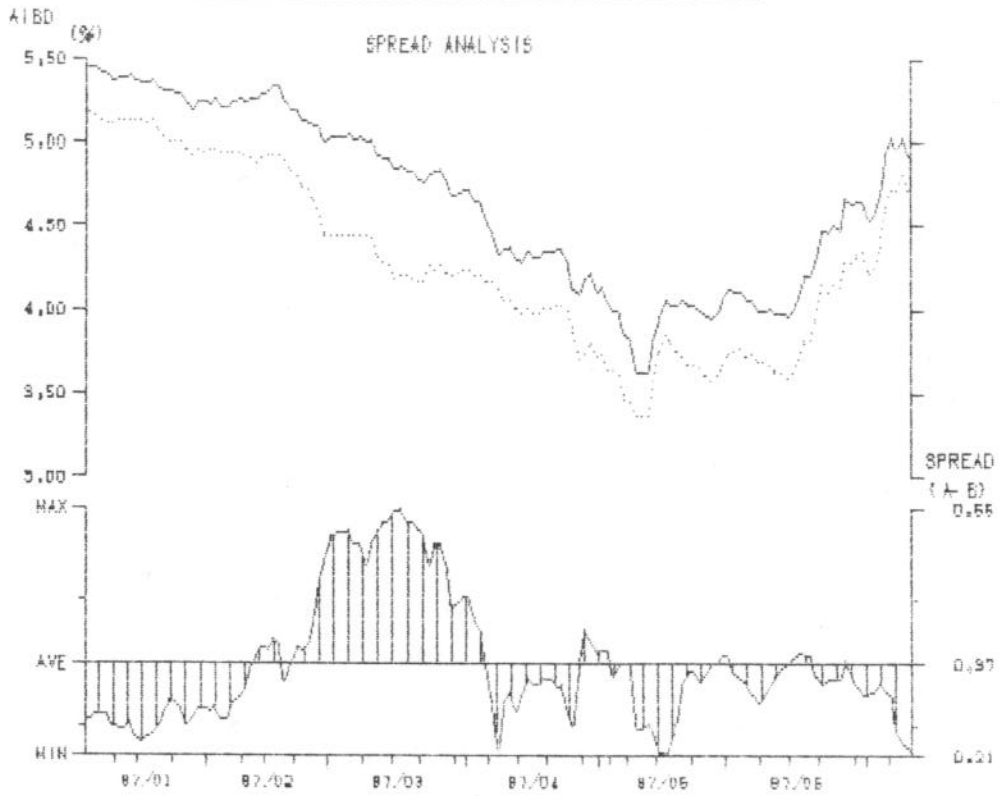
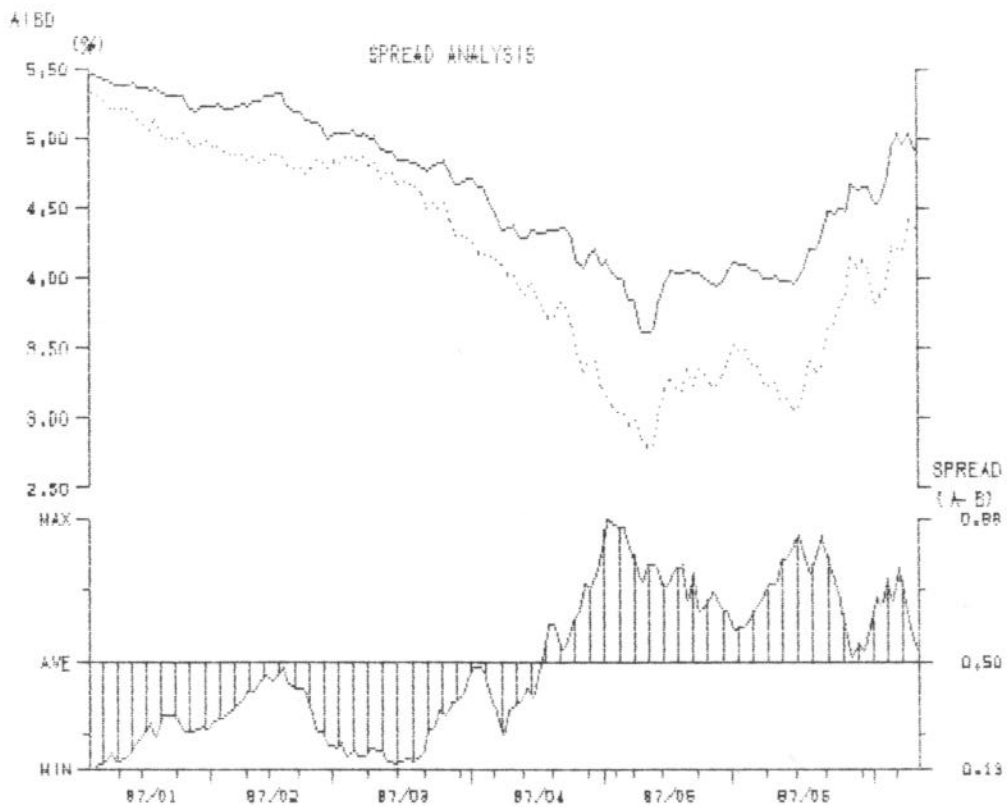


CHART 9: BENCHMARK PREMIUM: SPREAD OF JGB 89 v SIDE ISSUE  
(JAN 1 1987 TO DATE)



## DEUTSCHEMARK BOND MARKET

10 At the beginning of the year, 10-year German government bonds were yielding around 6%. In late January the discount rate was cut by  $\frac{1}{2}\%$  (to 3%) just before the general election which returned the Kohl coalition to power. A rally in the bond market which preceded these events soon lost momentum. The combination of lower yields in short maturities, reflecting the cut in money market rates, and selling pressure at the long end resulted in a dramatic steepening of the yield curve. The yield pick-up between 1 and 10 year maturities widened to 200bp in late February, having begun the year at 140bp.

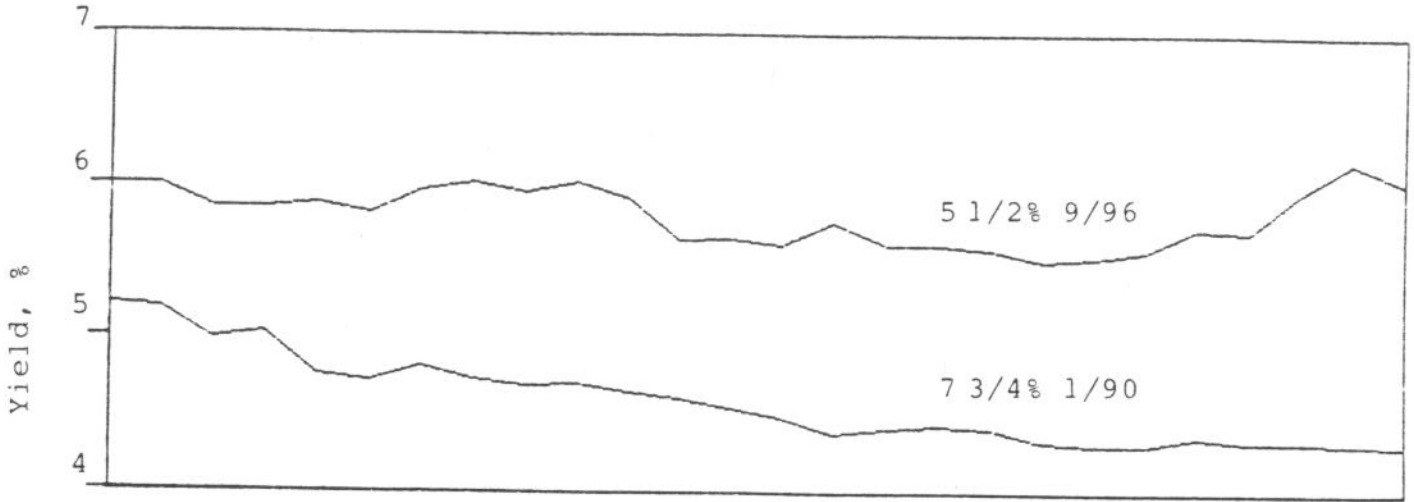
11 Renewed interest in the DM sparked off another rally in March, which continued through April and into early May. This marked a change in investor attitudes: whereas the German bond market had previously tended to adjust in sympathy with US bond prices, movements in cross exchange rates now became dominant. Dollar weakness and falling US bond prices were seen as partly reflecting shifts of funds into German bonds. By mid-May, 10-year German government bond yields had fallen to  $5\frac{1}{2}\%$ . As on previous occasions, this level proved to be a psychological barrier, and as the dollar began to strengthen against the mark and the US Treasury market began to recover, German government bonds slipped back, with fears of re-emerging inflation and higher public borrowing being cited as factors. By the end of June 10-year yields had reverted to their levels of six months previously and the yield curve had steepened further, the 1 to 10 year spread ending the period at 238bp. This characteristic is illustrated in Chart 5, which compares the yields on two representative government bonds (a 3 year and a 9 year).

12 Typical yield spreads between government and euro DM bonds had tightened in late 1986 and began the period at about 20bp. After an initial further narrowing, the spread trended wider as the market's rally progressed, reflecting increased issuance and international investors' preference for the more liquid government bond market. In mid-April spreads opened out to 45-50bp for a time but, as the market retreated, tightened in to 30-35bp, near the average for the six month period.

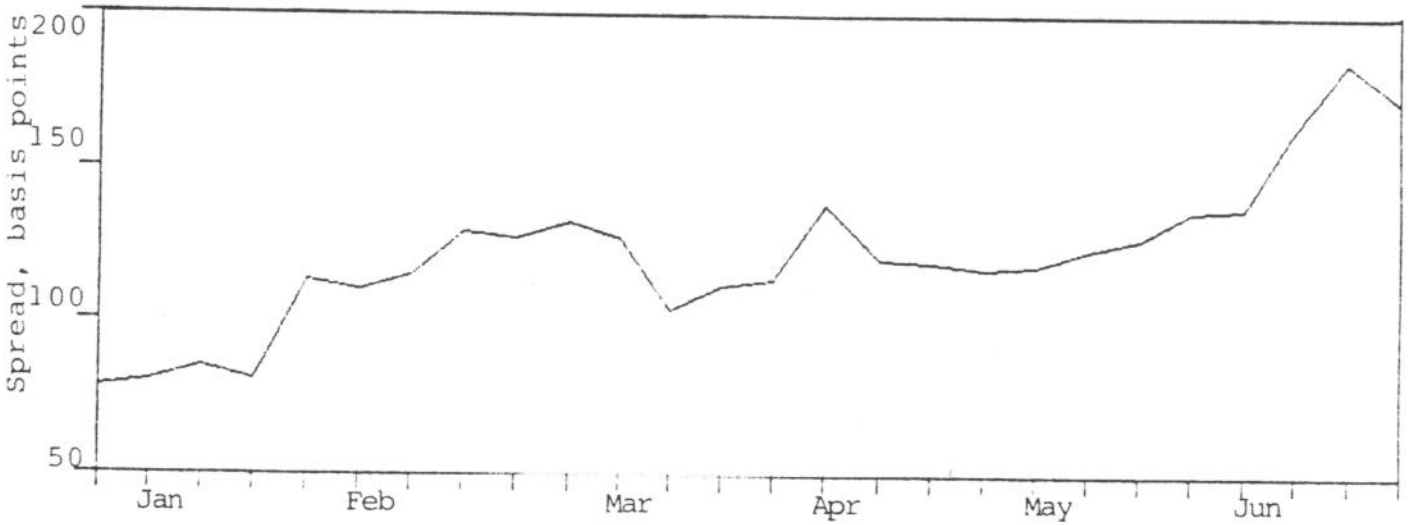
Graph 5

DM GOVERNMENT BOND YIELDS

Representative 1990 and 1996 bonds



Spread between 1990 and 1996 bonds



## YEN BOND MARKETS

### Japanese Government Bond Market

13 Having backed off in September and October 1986 the Japanese Government Bond (JGB) market began an advance which continued almost uninterrupted until May 13 1987. Yields on 10 year JGB side-issues fell from 6% in October 1987 to around 5½% at the turn of the year and to 3% at the top of the market in May (annual yields, Chart 6) assisted by the cut in the discount rate in January to 2½%. The yield on the JGB 89 benchmark issue hit an all time low in May of 2.80% annual yield (2.58% Japanese simple yield). The market then fell back sharply with yields on 10 year side-issues backing up to around 4.65% at the end of June; they are now around 5%. The Bank of Japan had been very worried about the overheating of the JGB market and the risk of a major collapse throughout April and early May, and had been trying, without success, to talk the market down. However their announcement of a change in the settlement system for JGBs in order to inhibit speculation was a major factor in the turn-around of the market. Certain houses which had been behind the run up in the JGB 89, Nomura in particular, are believed to have taken huge losses.

### Yield Curve and Coupon Spreads

14 The latter and most rapid part of the bull market was associated with a flattening of the JGB yield curve with the 2 to 10 year spread falling from 100 plus basis points in the first quarter to around 50 bp at the top of the market, before widening again as the market came off (Chart 7). In fact during the second half of February and March the yield curve was "U"-shaped. This was associated with the strong coupon effect at that time (see Chart 8): all JGBs of intermediate maturity (2-7 years) having coupons in excess of 7%. During May and early June commentators frequently stated that the yield curve was downward sloping, basing this statement on the yields of short JGBs and the JGB 89 (which at the peak of the market was almost 100bp more expensive than the side-issues, Chart 9), although in doing so they were not comparing like with like. Indeed the behaviour of the various 10 year JGBs has become increasingly complicated with the emergence of a number of "semi-benchmarks", the JGB 90, JGB 95 and JGB 99 in addition to the JGB 89 benchmark issue. The persistence of the benchmark system seems particularly strange given the existence of a



well-developed futures market, and the Bank of Japan has been putting pressure on the securities houses to reduce the size of the benchmark premium.

### Euroyen

15 The rapid rise of the JGB market left Euroyen behind and spreads widened to 100-130 bp during May and June. The lack of domestic Japanese interest in Euroyen combined with the huge volume of new issuance (aided by favourable swap markets) led to these record spreads, but they were unsustainable and had narrowed to 70 bp recently, though even this is wide by historical standards. The illiquid Samurai sector continued to be quoted 150-200 bp over JGBs.

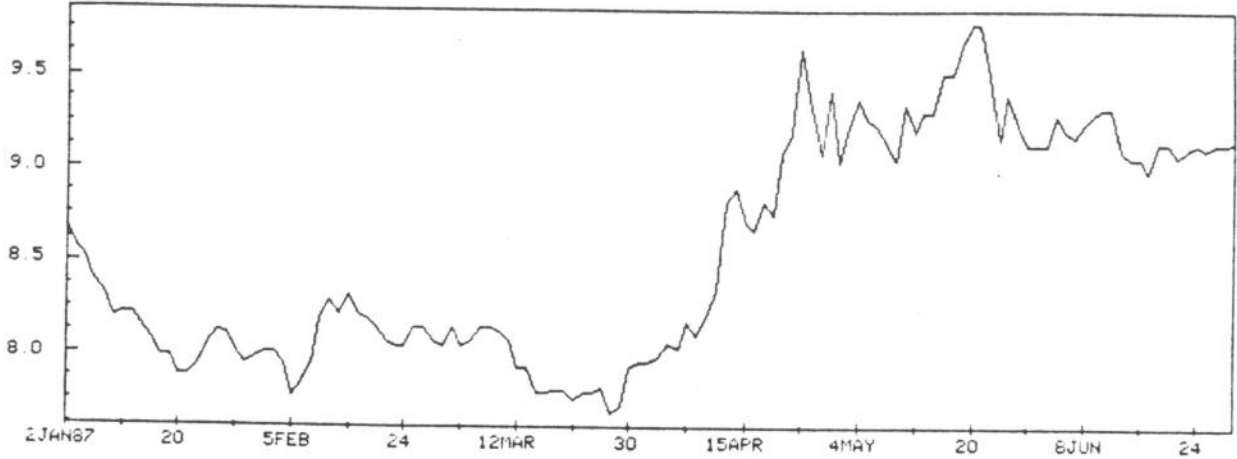
## CANADIAN \$ MARKET

16 For the first 3 months of the year, the Canadian \$ market - boosted by strong interest from the Far East - consistently outperformed New York, with spreads over US yields tightening throughout the curve. The currency was also very strong, rising to 76.5 US cents by end March.

17 Having gone up faster than the US market in Q1, prices in Toronto reacted more to the downturn at the end of March, with yields rising by about 200 basis points in little over a month and spreads over New York widening substantially at the trough. The C\$ currency also came under pressure, falling by over 2 cents in the second half of April before stabilising in the 74-75 cents range, where it stayed during May and June supported by very high yields in the 2 to 3 year sector. As a result of these defensive measures to support the C\$, the yield curve has been very flat from 2 to 7 years in recent months. Towards the end of June both the currency and the market strengthened; the C\$ stood at 75.2 cents and spreads over US Treasuries narrowed by 10-15 basis points.

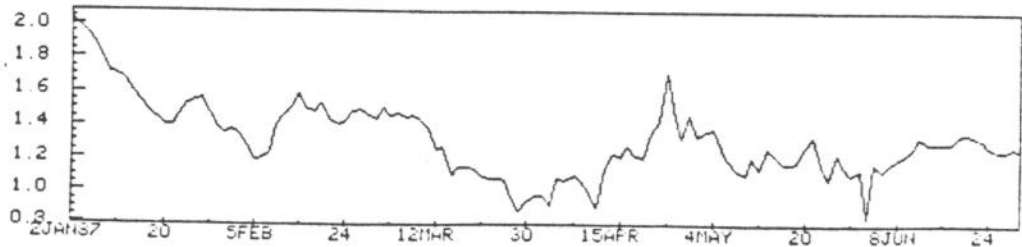
CANADIAN \$ MARKET

Representative 4-year yield  
(current coupon stocks only)



Yield spread of Canadian 4-year over US Treasury 4-year

SPREAD HISTORY  
[MAX 6 MONTHS]  
FROM 11/2/87  
TO 6/30/87  
HI 2.035  
LOW 0.840  
AVE 1.308



TYPE	HOLDINGS US\$ MNS.	HOLDINGS AS A % OF TOTAL RESERVES	
US\$:			
CURRENT ACCOUNTS	1264.8	3.68	
TREASURY BILLS	2944.2	8.28	
SHORT TERM PAPER	2617.0	7.62	
EURO DEPOSITS (MARKET)	4025.0	11.71	
EURO DEPOSITS (BIS)	* 3525.0	10.26	* 2225 HELD O/A EMCF
US TREASURY NOTES	1309.0	3.81	
FEDERAL AGENCIES	1016.2	2.96	
FRN'S	862.7	2.51	
EUROBONDS	796.7	2.32	
CENTRAL BANK BONDS	36.4	0.11	
	-----		
	18297.0	53	
CAN\$:			
CURRENT ACCOUNTS	15.3	0.04	
TREASURY BILLS	1.4	0.00	
GOVERNMENT BONDS	277.9	0.81	
EUROBONDS	9.1	0.03	
	-----		
	303.7	1	
DM:			
CURRENT ACCOUNTS	52.3	0.15	
TREASURY BILLS	25.1	0.07	
EURO DEPOSITS (MARKET)	461.5	1.34	
EURO DEPOSITS (BIS)	600.7	1.75	
GOVERNMENT BONDS	1200.4	3.58	
SCHULDSCHEIN	260.9	0.76	
EUROBONDS	844.1	2.46	
	-----		
	3475.0	10	
ECU			
CURRENT ACCOUNTS	8.1	0.02	
EURO DEPOSITS (MARKET)	10.1	0.03	
EUROBONDS	51.8	0.15	
	-----		
	70.0		
YEN:			
CURRENT ACCOUNTS	37.8	0.11	
EURO DEPOSITS (BIS)	39.2	0.11	
GOVERNMENT BONDS	250.1	0.84	
EUROBONDS	487.8	1.42	
	-----		
	854.9	2	
DFLS:			
CURRENT ACCOUNTS	0.7	0.00	
EURO DEPOSITS (BIS)	21.7	0.06	
GOVERNMENT BONDS	178.2	0.52	
EUROBONDS	78.5	0.08	
	-----		
	279.1	1	
SWFC:			
CURRENT ACCOUNTS	6.1	0.02	
EURO DEPOSITS (BIS)	55.0	0.16	
EUROBONDS	51.1	0.15	
CENTRAL BANK BONDS	12.9	0.04	
	-----		
	125.1	0	
WORKING BALANCES	8.0	0	
CURRENCY TOTAL	-----	-----	
	23,362.8	68.0	
	-----	-----	
BOLD	* 7,240.2	21	* 1448 HELD O/A EMCF
SDR RESERVE TRANCHE	1,795.1		
BALANCE	1,479.7		
	-----	-----	
VALUATION DIFFERENCE O/A EMCF	3,275.8	10	
	485.0	1	
	-----	-----	
GRAND TOTAL	34,365.8	100	
	-----	-----	
	34,365.8	100	

<u>FORWARDS BY CURRENCY</u>	<u>\$ MNS</u>	<u>FORWARDS BY MATURITY</u>	<u>\$ MNS</u>
US\$	3021 #		
CAK\$	31		
DFLS	44		
DM	960	UP TO 1 MONTH (JULY 1987) #	179
YEN	140	UP TO 2 MONTHS (AUGUST 1987)	473
SCR	187	UP TO 3 MONTHS (SEPTEMBER 1987)	571
		OVER 3 MONTHS	2674
OTHERS	-1 ~		
VALUATION OF EMCF	-485		
	----- 3897 =====		----- 3897 =====

- \* INCLUDES EMCF SWAP VALUATION DIFFERENCE OF -485
- # EXCLUDES T/N'S AND FTD'S OF US\$ 2225 PLEDGED TO BIS
- ~ EXCLUDES EMCF SWAP ECU'S

GOLD AND FOREIGN EXCHANGE OFFICE

02-JUL-87

Table 2

TYPE	HOLDINGS USA MKS.	HOLDINGS AS A % OF TOTAL RESERVES	
US#:			
CURRENT ACCOUNTS	802.9	6.8%	
TREASURY BILLS	1409.0	11.4%	
SHORT TERM PAPER	940.9	7.7%	
EURD DEPOSITS (MARKET)	1350.0	11.1%	
EURD DEPOSITS (BIB)	* 1125.0	9.2%	* 1125 HELD O/W EMCF
US TREASURY NOTES	* 1852.1	15.2%	* 890 HELD O/W EMCF
FEDERAL AGENCIES	718.9	5.9%	
FRA'S	707.5	5.8%	
EUROBONDS	972.1	8.0%	
CENTRAL BANK BONDS	31.4	0.3%	
	-----	6389.7	40
CAN#:			
CURRENT ACCOUNTS	37.8	0.1%	
TREASURY BILLS	2.9	0.0%	
GOVERNMENT BONDS	155.0	0.7%	
EUROBONDS	8.0	0.0%	
	-----	203.7	1
L )			
CURRENT ACCOUNTS	19.4	0.3%	
TREASURY BILLS	8.0	0.0%	
EURD DEPOSITS (MARKET)	295.7	1.2%	
EURD DEPOSITS (BIB)	178.6	0.8%	
GOVERNMENT BONDS	704.1	3.2%	
SCHULDSCHEIN	200.1	1.0%	
EUROBONDS	500.1	2.1%	
	-----	1904.3	9
YEN#:			
CURRENT ACCOUNTS	30.5	0.1%	
EURD DEPOSITS (BIB)	32.5	0.1%	
GOVERNMENT BONDS	341.9	1.5%	
EUROBONDS	281.4	1.2%	
	-----	686.3	3
DFLB#:			
CURRENT ACCOUNTS	1.0	0.0%	
EURD DEPOSITS (BIB)	17.0	0.7%	
GOVERNMENT BONDS	71.9	0.3%	
EUROBONDS	18.1	0.1%	
	-----	108.0	1
BAFD#:			
CURRENT ACCOUNTS	12.9	0.1%	
EURD DEPOSITS (BIB)	40.0	0.3%	
EUROBONDS	47.6	0.2%	
CENTRAL BANK BONDS	10.1	0.0%	
	-----	110.6	0
WORKING BALANCES		0.1	0
	-----		
CURRENCY TOTAL		12,404.6	86.6
	-----		
GOLD	* 8,120.7	25	* 1024 HELD O/W EMCF
SDR RESERVE TRANCHE BALANCE	1,819.8		
	1,425.7	3,245.5	15
	-----		
VALUATION DIFFERENCE O/W EMCF		152.4	1
	-----		
GRAND TOTAL		21,928.2	101
	=====		=====

BA ASSETS AS OF DECEMBER 1966

PAGE 1

<u>SHARES BY CURRENCY</u>	<u># YNE</u>	<u>FORWAIRDS BY MATURITY</u>	<u># YNE</u>
UBA	440		
DANA	76		
DM	102	UP TO 3 MONTHS (JAN 1967)	102
YEN	272	UP TO 3 MONTHS (FEB 1967)	104
SDR	347	UP TO 3 MONTHS (MAR 1967)	201
OTHERS	0	OVER 3 MONTHS *	10
VALUATION OF EMCF	-150		
	<u>714</u>		<u>714</u>
	*****		*****

\* INCLUDES EMCF SWAP VALUATION DIFFERENCE OF -100

# EXCLUDES THE \$ AND FCY \$ OF UBA DUES PLEDGED TO S.S.

^ EXCLUDES EMCF SWAP EQUITY

GOLD AND FOREIGN EXCHANGE OFFICE

Co-Jan-67