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

Reference MG-MAMC/D/0002/001

File begins 03/05/1988

Pages 161-181

Start date shifted

DM/US$ CHART for DMY -- DEUTSCHE MARK SPOT

RANGE 1/ 4/88 TO 7/25/88 PERIOD D (D-W-M-Q-Y) 2 (1=PRICE,2=DM/US$)

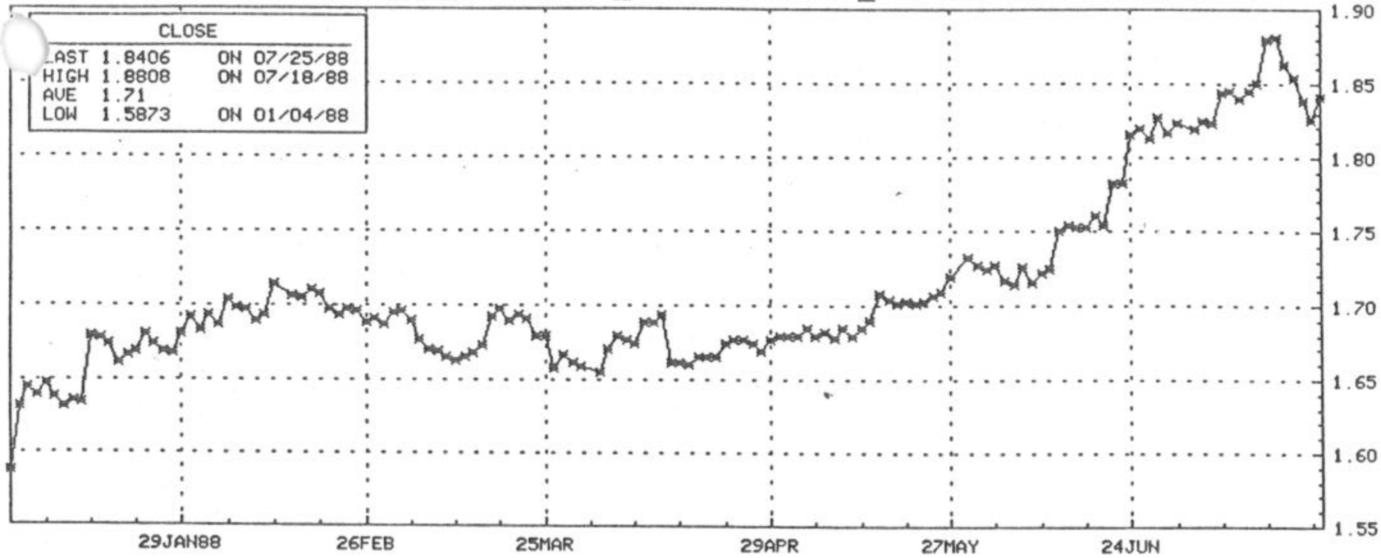


CHART 2

Start date shifted

¥/US$ CHART for JYY -- JAPANESE YEN SPOT

RANGE 1/ 4/88 TO 7/25/88 PERIOD D (D-W-M-Q-Y) 2 (1=PRICE,2=¥/US$)

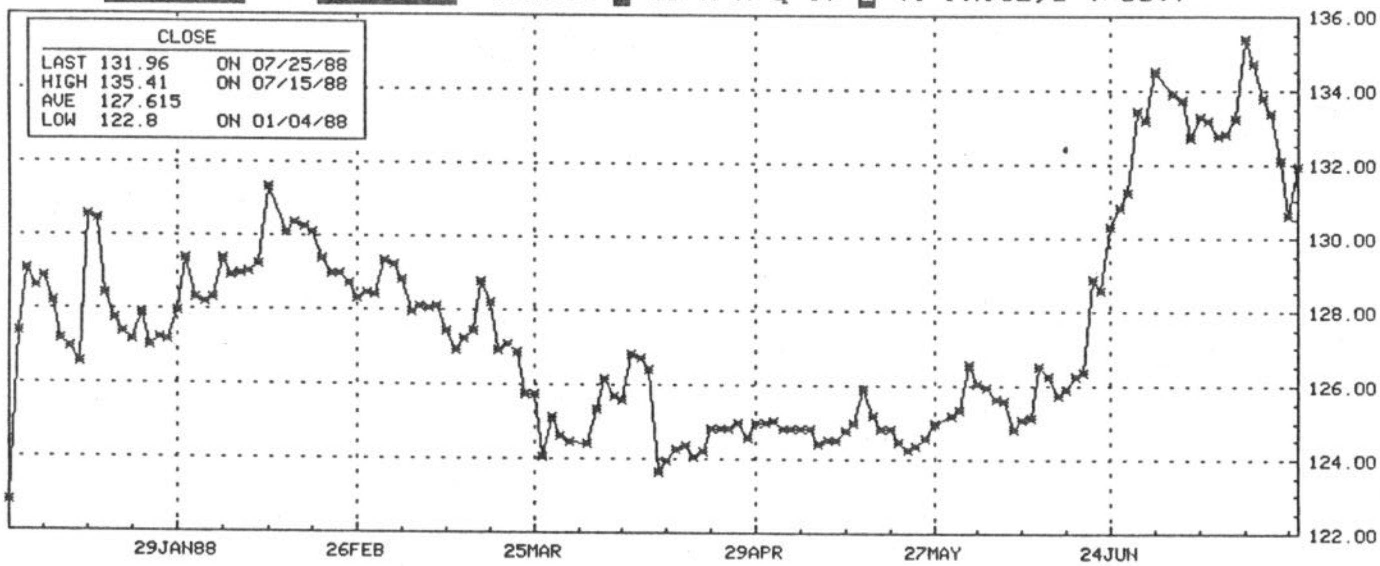


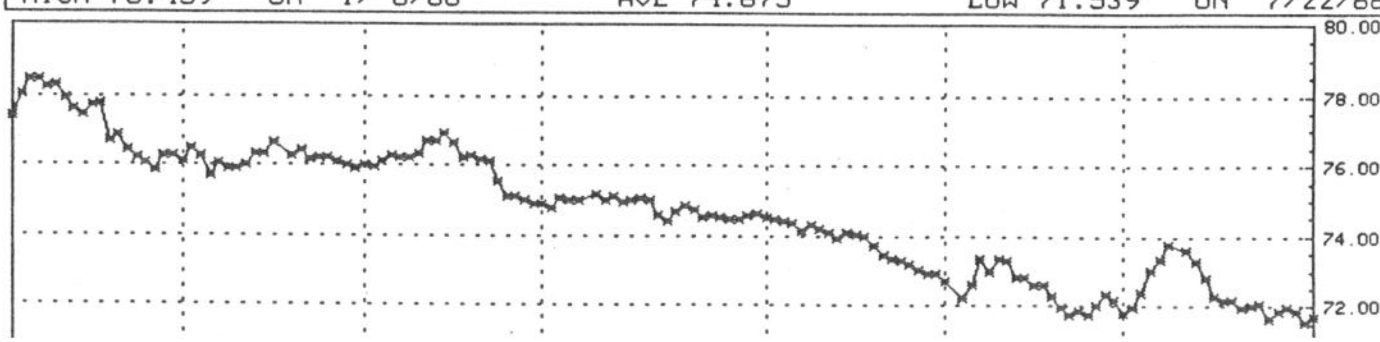
CHART 3

HISTORICAL YIELD RATIO

SELL JYY -- JAPANESE YEN SPOT	LAST 75.78 (131.96)	MTY, CALL, PUT
BUY DMY -- DEUTSCHE MARK SPOT	LAST 54.33 (1.841)	

RANGE 1/ 4/88 TO 7/25/88	SELL BUY
PERIOD D (D-W-M-Q-Y)	TIME FRAME N N (N=NY,F=NY 9-3,L=LONDON,T=TOKYO)
RATIO Y P=PRICE OR Y=YIELD	VALUE C C (O=OPEN,H=HIGH,L=LOW,C=CLOSE)
YIELD C CONV/SEMI-ANN/ANN	MARKET M M (B=BID,A=ASK,M=MID)

HIGH 78.459 ON 1/ 6/88 AVE 74.675 LOW 71.539 ON 7/22/88



The EEA's overall currency position lost money in the first quarter of this year, since sterling strengthened on average against the major currencies and sterling interest rates were higher than the average of these abroad. However, this loss was recovered at the end of the second quarter when sterling weakened substantially against the dollar, and somewhat against the Yen.

13. The second section of the table allocates the total return into two components:

- the "intervention component" is the return that would have been earned if the EEA had owned the same aggregate amount of foreign currency month-by-month, but held in the form of a diversified basket containing constant shares of the major currencies. (The weights used were 40% for the US dollar and DM, and 20% for the Yen.)

- the "currency mix component" is the return from owning (as the EEA in fact did) a <u>different</u> mix of currencies from the diversified basket

The figures suggest a large intervention loss in the first quarter from being increasingly short sterling while sterling appreciated; there was only a modest offset from holding <u>more</u> than 40% of net assets in the US dollar, which appreciated against the DM and Yen. Nearly all this intervention loss was recouped in the second quarter, as sterling weakened against the dollar and Yen. Over the entire half year that intervention made a modest loss overall (£20 mn), but the chosen currency mix made £60 mn more than the "neutral" 40/40/20.

14. The final part of the table shows, for completeness, how the total return of £40 mn would split up if one regarded the US dollar as the natural currency for intervention, so that any holding of other currencies was regarded as the result of active management of the currency mix. On that basis, there were intervention losses in the first quarter (from being long low yielding dollars out of higher-yielding sterling), and also currency mix losses since the DM and Yen depreciated against the dollar. The second quarter saw an enormous intervention gain

from being long US dollars out of sterling, offset by almost equally large losses from being switched out of US dollars into DM and Yen. These figures are, however, of principally academic interest in view of the strong arguments for diversification.

15. The calculation has been extended back to cover the period since June 1985. There were losses to intervention in 1986, when the reserves were short foreign currencies (which appreciated against sterling). The rate of loss increased in 1987, when the reserves moved from being long sterling (since net currency assets were less than currency liabilities) to a substantial short sterling position while sterling appreciated.

Table 4: The Return on Currency Exposures: 1985 H2 - 1988 H1

(£mn)

	1985 H2	1986	1987	1988 H1
Total return	+ 390	+ 420	- 440	+ 40
of which				
Intervention component	- 10	- 140	- 480	- 20
Currency mix component	+ 400	+ 560	+ 40	+ 60

But there were considerable offsetting gains from the currency mix, particularly in 1985 H2 and 1986. These arose because the EEA's short position in foreign currencies involved being particularly short the US dollar, which depreciated sharply against the DM and Yen over the period. It is of interest to note that, if all the net reserves accumulated in 1987 and 1988 had been in DM, net returns would have been £1400 mn worse than the figures in this table.

16. The net outcome over the whole period is a total positive return of £410 mn. The volatility of returns within the period, and within components, illustrates the desirability of assessing intervention and currency mix decisions - beset with uncertainty and with political constraints - over a rather lengthy horizon.

E. CURRENCY PROSPECTS AND SUGGESTED STRATEGY

17. The present strength of the dollar (charts 1 & 2) seems rather overdone, in view of the USA's continuing difficulties with trade and fiscal deficits. Since our last meeting the USA has (in common with the other major economies) grown rather more strongly than we - and financial markets - expected, but has nevertheless made considerably more progress in reducing its trade deficit than we thought likely. However, markets are, in our view, now too optimistic about the future spread of improvement in the US trade position; and, in addition, the current strength of the dollar may, after the long decline, have a considerable self-sustaining component. We thus expect the dollar to weaken eventually from today's levels, and by more than sufficient to make up for the running yield loss suffered from being short dollars.

18. The dollar is however in sight of a bottom. At our last meeting we suggested that the dollar had fallen - at the end of 1987 - close to levels (DM 1.55 and Yen 120) - which made some fundamental sense.

19. The yen has - against the view presented in our last paper - performed well against the DM this year (Chart 3), perhaps reflecting the greater appetite for funds of a considerably more dynamic economy. While we feel that this trend may have further to go in the longer run, the DM now seems relatively undervalued to the extent of warranting a long position in DM matched by a short in Yen. We would suggest that such a position be reversed as the Yen/DM cross rate moves above 75. (It is currently 71 1/2). We consider, however, that the likely volatility of the Yen/DM cross is less than that of other major exchange rates; positions between Yen and DM are therefore likely to have less risk than positions involving the US dollar.

20. The EEA's DM bloc holdings include considerable quantities of French francs ($1.9 bn at parity), and ECU ($1.5 bn). With almost no liabilities in these currencies, the EEA's net asset position in those currencies amounts to 30% of total DM bloc net assets. These continue to seem good value in view of the

considerably higher yields available on deposits in these currencies (over 2% higher) and the relatively small probability of EMS realignment. The current position seems at about the right level, in view of the risks, however.

21. We have come to consider that it would be reasonable to regard some diversification across currencies as being required for a 'neutral' allocation of the EEA's net assets in foreign currencies. Although there can be no very exact or scientific basis for such a calculation, a 40:40:20 allocation between the US dollar, the DM bloc and Yen seem to represent an acceptable balance between such factors as diversification to reduce risk and the relative importance of different currencies in world markets. (This is the basis on which returns to currency mix were calculated earlier.)

22. If this is acceptable, the EEA should seek to attain a 40:40:20 allocation at times when exchange rates are expected to move at the rates implied (and compensated for) by short-term interest rate differentials. On this basis, the EEA's exposures at end-June were:

	(% of total net assets)
US dollar	- 3
DM bloc	+ 6
Yen	- 5
Canadian dollar	+ 1

These exposures seem reasonably consistent with the view of exchange rate prospects presented above.

23. It is however difficult to assess whether the exposures are sufficiently large, given our view of the prospects, until one has established what maximum exposures might be acceptable (in the absence of overriding political factors). We suggest that (at today's level of net assets), the maximum exposures in dollars and DM might be of the order of plus or minus 10% of net assets, with 5% in the case of Yen.

Recommendations

24. This implies that the EEA's dollar short is not particularly large, whereas the DM long and Yen short have less room for increase.

25. In the event of renewed dollar strength, we would suggest increasing the size of the total dollar short position. Levels of above DM 1.90 and Yen 150 would seem to justify a switch up to the suggested maximum dollar short, a further $1 3/4 bn.

26. In the event of a sharp fall in the dollar, we should look to reduce the dollar short, principally by sales of DM. In view of the improvement in the US trade position, we consider that DM 1.70 and Yen 130 are reasonable levels at which to be willing to start going short DM and Yen. Levels only 10% below these would probably represent good value in the longer run, and should be used to establish a significant long position in dollars. Such moves may well be compatible with international pressures if the dollar weakens so far.

27. The sizeable long position in DM against Yen looks reasonable at current levels. However, we suggested earlier that DM should be sold into Yen if the DM strengthens significantly against the Yen from current levels. This switch is likely to prove difficult to achieve at all quickly, partly for political reasons. We suggest, however, that we should aim to unwind the short Yen/long DM position as the DM strengthens from its present rate against the Yen of 71 1/2. At cross rates above 75, we would prefer to own mostly Yen against the dollar short, but the sheer scale of such a move - about $2 bn in total given the current dollar short - is likely to prove difficult in political terms.

28. There are also implications for intervention. Where possible, intervention to restrain sterling should concentrate on Yen, with DM a second best, at current exchange rates in view of the large Yen short. If there should be purchases of sterling, we should aim to sell dollars, with DM as second choice. If intervention in either direction should become very large, the currency mix should, where possible, be designed to be consistent with the pattern of desired exposures set out above at various

INTEREST RATE EXPOSURES

F DEVELOPMENTS SINCE DECEMBER.

29. The preceding analysis assumed - counterfactually - that all assets and liabilities were held in short bank deposits in the relevant currency. This assumption is in practice true, for all but the largest changes in the scale of the reserves and for switches between currencies, since holdings of fixed income securities are relatively small (see annex table A). It also has the advantage of allowing us to separate out the decision regarding interest rate exposure in each currency, in the form of a choice between fixed income securities and short bank deposits in that currency. This section thus describes developments in and proposes a strategy for each major fixed-income market, each leg of which may be evaluated in isolation both from other legs and from the currency strategy proposed above.

30. The following table summarises our net exposures in each major fixed income market in the usual way. (Each holding of a particular security owned by the EEA, and each of its fixed income liabilities, is converted to an equivalent amount of a standard 4-year security, on the basis of how much its value changes if yields move by a given amount: the figures are thus most relevant in assessing the gain or loss from a uniform shift in the yield curve).

Table 5: Net Interest Rate Exposures ($bn in 4-year equivalents at then current exchange rates)

	Dec 1987	March 1988	June 1988
US dollar	- 2.5	- 2.40	- 2.20
DM bloc	0.3	0.90	0.75
Yen	0.5	0.60	0.45
Canadian dollar	0	0.10	- 0.05
	- 1.70	- 1.0	- 1.05

Note: A 1% change in yields is worth about $30 mn on a $1 bn position.

31. We agreed in January that we should seek to reduce our fixed income exposure, principally by additions to holdings in the DM bloc. As the table indicates, the EEA's aggregate short in fixed income markets has been reduced by $650 mn, of which $450 mn was by additions to DM bloc holdings. This program is significantly smaller than the total of up to $1,350 mn suggested in our last paper.

32. As charts 4-6 indicate, interest rates fell sharply in most markets in the early spring (continuing the post-crash fall of late autumn), and have since climbed steeply, with US yields leading the way.

33. The EEA's holdings of US securities rose slightly in January, but were reduced by $200 mn in February; this position was bought back in March (at a profit of $2 mn), and there were further additions of $100 mn in April. Since then the net short position has fallen slightly (at still higher yield levels).

34. The additions to the net DM bloc position were principally in DM securities, in January and March. These were not particularly well timed, with hindsight, though we did avoid purchases at the low yields of February. There were also (as agreed) modest purchases of French government securities, amounting to $100 mn, in April and May, delayed by the difficulty of establishing an account with the Banque de France. By that point yields were around 50 bp lower than when we advocated their purchase, at around 9%. Our French government holdings were all sold in June at an average yield of about 8 1/2%, realising a profit of about $1 1/2 mn.

35. Finally, there were modest sales of Yen bonds and Canadian dollar bonds in February. The latter was reversed, at a profit, in June. There was a further sale of $100 mn of Yen bonds (partly reversed at a profit of $1 mn in June) in May.

G. RETURNS ON INTEREST RATE EXPOSURE

36. The following table indicates the total return from the EEA's changing interest rate exposures over the six months under review. It makes the realistic assumption that any excess of assets over liabilities in a particular currency is financed by borrowing at interbank rates. The figures thus include the income earned (with a steep yield curve) from owning securities rather than cash, as well as the effect on security valuations of yield changes over the period.

Table 6: Strategic Interest Rate Exposure Returns ($mn)

	1988 Q1	1988 Q2
Total return on assets	241	- 5
Total return on liabilities	225	+ 3
	+16	- 2

37. The EEA made a total profit of $16 mn in the first quarter. With yields ending the quarter a little lower in all markets, there were substantial profits on the long position in DM and Yen markets ($29 mn), offset by a loss of $13 mn on the short position in US securities. The loss on this short might have been expected to be about $25 mn given a fall in yields of about 35 basis points.

38. The second quarter saw a substantial back up in US 4-year yields, of about 40 basis points. This produced only a small gain ($10 mn) on the substantial short in US dollar markets, because the yield curve flattened very substantially. Yields on 7 year securities rose by only 30 basis points, compared with 60 basis points at 2 years. Since the EEA has relatively long liabilities hedged by assets with an average maturity of 2 years, there were substantial losses on this score to offset most of the gains from the general rise in rates. There were modest losses on DM ($12 mn) and Yen ($9 mn); and the Canadian position produced a small profit ($2 mn).

39. The EEA made a net total gain on strategic exposures over the first half of $14 mn, despite net rises in yields of 30-40 bp in the markets in which the EEA was long, and despite the flattening of the US yield curve. This gain is calculated on the basis that the EEA held its interest rate exposure in the form of passive 'benchmark' portfolios. In practice, the Bank's investment managers actively managed the EEA's holding, without incurring additional interest rate or credit risk. Their activities produced additional returns of $24 mn in the half year. These will be described more fully in our regular report. However, it should be noted that additional returns were strong in the aftermath of the crash, and have since fallen back sharply in more stable market conditions; this exceptional performance is unlikely to be repeated except in similarly exceptional circumstances. Including returns to active management brings total profits on strategic and tactical interest rate risk to $38 mn for the half year.

H. PROSPECTS FOR INTEREST RATES, AND SUGGESTED STRATEGY

40. In summary, we think the prospects are:

- for modest rises in short term rates worldwide. If however the dollar falls sharply (as we expect), the rises in Germany and (in particular) Japan will be reduced, or even reversed
- for rises in US longer term rates, particularly if the dollar turns; for a degree of stability in DM longer term rates; and for some volatility in Yen longer term rates.

41. The Fed has - somewhat to our surprise - raised <u>short-term rates</u> quite considerably in the last six months. Unexpectedly strong economic growth has probably lessened the political pressures that might otherwise have surfaced in election year. With the currency still relatively strong, and some concerns about domestic inflation pressures, the Fed seems likely to sustain current rates until the election, and may even be able to tighten further after the election. The rise has been echoed to some extent in Germany and (less so) in Japan. There is concern about monetary growth in both economies, reinforced by very rapid economic growth in the Japanese case. We expect their short term

rates to drift up (though the Japanese may lag, in the hope that dollar strength will allay protectionism in the US ahead of the election) so long as the dollar remains strong. Any such move could be partially reversed following a slide in the dollar.

43. Longer term US bond yields rose modestly, a little earlier than we expected. US inflation has, as we thought, turned out to be rather moderate, and does not look likely to accelerate very much in the period ahead. Thus yields continue to offer a reasonable real return.

43. The imbalances remain serious, however. Although improved, the trade deficit is still running at well over $100 bn annually, and will continue to do so for several years if forecasts are to be believed. And the fiscal deficit remains at a level where action is needed.

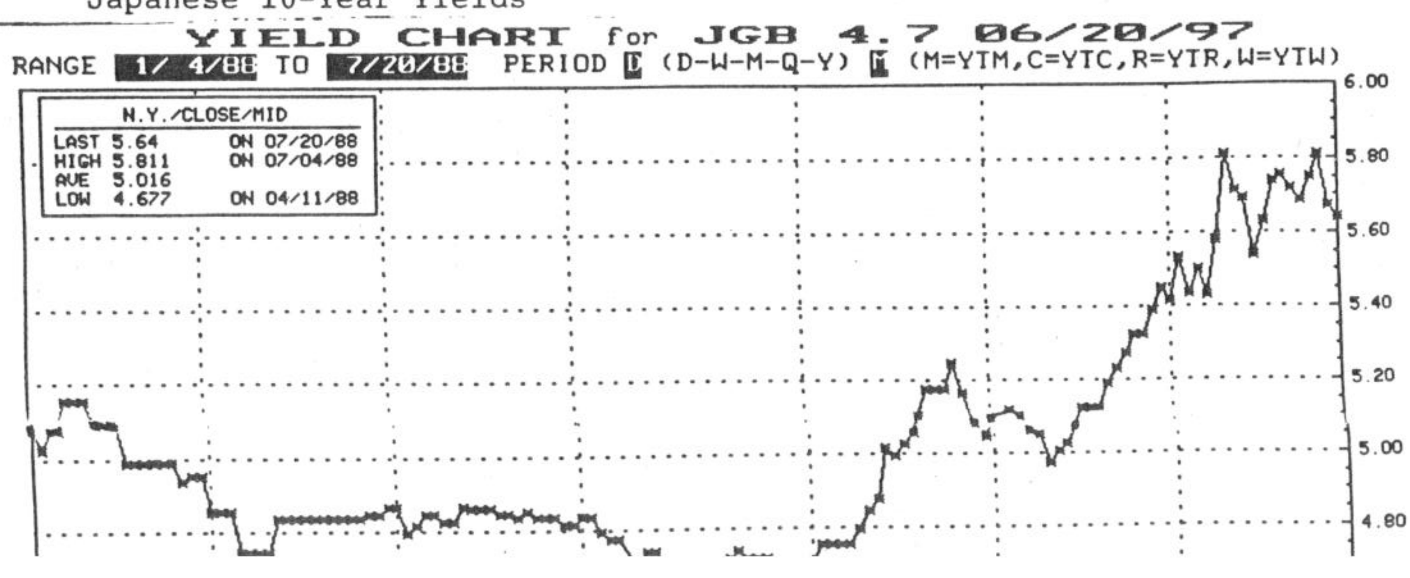
44. We continue to believe that the US trade deficit will have to be reduced - more rapidly than by the normal working of the past dollar depreciation - by a sharp deflation in US demand. The combination of a rather fully-employed domestic economy, emerging inflationary pressures, an accepted need for fiscal tightening, and heavy reliance on continuing inflows of foreign capital combine to suggest that US demand is indeed very likely to be deflated; but the complex circumstances make it hard to guess how the recession will be initiated. In such a recession, inflation is likely to fall back, and present yield levels would look rather attractive.

45. One possibility is that a sharp market-induced rise in US yields could precipitate adjustment; but it is also possible that investors might, like us, look ahead to the recession and thus keep bond yields down even during the adjustment to recession. This suggests that a strong rise in US yields should be seen as an opportunity to acquire a sizeable long position in US securities. (Indeed, even if we were neutral about US yields, the extra returns from extending along the yield curve should encourage us to be structurally somewhat long the US market.) Moreover, if there were a marked steepening of the yield curve it would be desirable to buy longer-dated securities to hedge the EEA's long-dated liabilities.

CHART 4
US 4-Year Yields

CHART 5
German 10-Year Yields

CHART 6
Japanese 10-Year Yields



46. There is however a risk (from our narrow point of view) that the US will manage a smooth transition to somewhat lower growth levels and somewhat higher inflation, without any upsets in financial markets. In those circumstances, US yields might trend up in a gradual way. Again, purchases at a somewhat higher yield level than today's would - if inflation prospects seemed under reasonable control - seem likely to be profitable once the market had fully adjusted to the rest of the inflation news. On present reckoning, that level might be only 50 bp higher than today's - just over 9% at 4 year maturities, say.

47. German yields have also risen, somewhat against our expectation; and the yield curve has flattened considerably. We continue to expect slow growth and very modest inflation, and consider yields reasonable value at close to 7%. (This is particularly true since we - unlike many investors - are exempt from withholding tax, which has been partly responsible for the rise.) Dutch yields are now much more closely aligned to German yields (partly because of withholding tax). With somewhat better fundamentals, but lesser market depth, these too continue to look fair value.

48. French yields have fallen sharply, to about 9% at 10 years. The spread over German yields is now 100 basis points tighter than earlier this year, and does not seem to us to offer sufficient compensation for higher actual inflation and the inflationary risks. We shall however continue to watch the market for opportunities.

49. Japanese yields have risen most, by about 65 bp compared with the end of the year. In view of the strains evident in the Japanese economy (including the possible effects of indirect tax on inflation) we would view a 50 bp fall in yields as a selling opportunity, and would prefer (as discussed in the accompanying paper) to sell JGB futures in such a case.

50. Canadian yields have risen about 50 bp less than US yields at the long end, reflecting the Canadian dollar's strength and good inflation performance and prospects. This market continues to seem like a good alternative to the US market for part of our funds.

51. We continue to feel that the prospects are, overall, for deflation (except perhaps in Japan, though she may not be able to buck the emerging trend for long). Accordingly, we would like to reduce overall the short position (now $1.1 bn) as follows:

- additions of up to $ 1/2 bn to US dollar holdings at 4-year yields in the range 8 3/4% - 9%.

- further additions of up to $1 bn to US dollar holdings at 4 year yields in the range of 9 - 9 1/2%.

- the acquisition of a long US dollar position of up to $ 1 bn at 4-year yields in excess of 9 1/2%

- additions of up to $ 1/4 bn to DM bloc holdings at 10 year DM yields above 6 3/4%

- sales of up to $ 1/2 bn of Yen holdings at 10 year yields below 5 1/4%; purchases of up to $ 1/4 bn at 10 year yields above 6%.

52. The effect of this would be to produce a maximum overall long position of $1 1/2 bn if US yields rose above 9 1/2% at 4 years, Japanese yields were above 6% at 10 years, and German yields were above 6 3/4% at 10 years. This seems sufficiently modest in relation to the EEA's overall assets that there would be scope for further additions (to average in), if yields rose further without a fundamental change in inflation prospects.

53. Finally, if US yields fell sharply from today's levels without any fundamental change in prospects, we would wish to increase the short position, by sales of up to $ 1/2 bn. And if DM yields fell below 6 1/4%, we would wish to sell up to $ 1/2 bn of the existing long position.

[illegible]SSETS AS AT 30 JUNE 1988

		HOLDINGS US$ MNS.		TOTAL RESERVES		
US$:	CURRENT ACCOUNTS	1292.7		2.66		
	TREASURY BILLS	4660.8		9.61		
	SHORT TERM PAPER	4369.1		9.01		
	EURO DEPOSITS (MARKET)	2590.0		5.34		
	EURO DEPOSITS (BIS)	^ 3810.0		7.85		^3410 HELD O/A EMCF
	US TREASURY NOTES	# 2965.2		6.11		#925 HELD O/A EMCF
	FEDERAL AGENCIES	522.3		1.08		
	EUROBONDS	901.9		1.86		
	FRN'S	891.8		1.84		
	CENTRAL BANK BONDS	36.5		0.08		
			22040.3		45	
DM:	CURRENT ACCOUNTS	40.1		0.08		
	TREASURY BILLS	64.6		0.13		
	EURO DEPOSITS (MARKET)	1958.2		4.04		
	EURO DEPOSITS (BIS)	2327.0		4.80		
	GOVERNMENT BONDS	2945.6		6.07		
	SCHULDSCHEIN	182.7		0.38		
	EUROBONDS	779.4		1.61		
			8297.6		17	
£S:	CURRENT ACCOUNTS	2.0		0.00		
	EURO DEPOSITS (BIS)	13.3		0.03		
	GOVERNMENT BONDS	477.4		0.98		
	EUROBONDS	24.9		0.05		
			517.6		1	
FF:	CURRENT ACCOUNTS	370.5		0.76		
	EURO DEPOSITS (MARKET)	1236.9		2.55		
	EURO DEPOSITS (BIS)	220.5		0.45		
	GOVERNMENT BONDS	18.1		0.04		
	GOVT. M.T.N.	10.1		0.02		
			1856.1		4	
SWFC:	CURRENT ACCOUNTS	4.4		0.01		
	EURO DEPOSITS (BIS)	61.8		0.13		
	EUROBONDS	25.4		0.05		
	CENTRAL BANK BONDS	14.5		0.03		
			106.1		0	
ECU	CURRENT ACCOUNTS	47.3		0.10		
	EURO DEPOSITS (MARKET)	1083.3		2.23		
	EUROBONDS	79.7		0.16		
	FRN'S	69.7		0.14		
			1280.0		3	
YEN:	CURRENT ACCOUNTS	23.3		0.05		
	TREASURY BILLS	8.6		0.02		
	EURO DEPOSITS (MARKET)	792.1		1.63		
	EURO DEPOSITS (BIS)	203.2		0.42		
	GOVERNMENT BONDS	305.9		0.63		
	EUROBONDS	593.3		1.22		
	FRN'S	5.9		0.01		
			1932.3		4	
CAN$:	CURRENT ACCOUNTS	35.1		0.07		
	TREASURY BILLS	25.9		0.05		
	GOVERNMENT BONDS	554.2		1.14		
	EUROBONDS	18.2		0.04		
			633.4		1	
WORKING BALANCES			5.1		0	
CURRENCY TOTAL			36,668.5	75.6		
	GOLD	$	8,085.6		17	$1617 HELD O/A EMCF
	SDR RESERVE TRANCHE	1,762.5				
	BALANCE	1,525.0	3,287.5		7	

FORWARDS BY CURRENCY	$ MNS	FORWARDS BY MATURITY	$ MNS
US$	-476 #		
DM	3896		
DFLS	88	UP TO 1 MONTH [JULY 1988]	1107
FF		UP TO 2 MONTHS [AUG 1988]	755
ECU	201	UP TO 3 MONTHS [SEP 1988]	796
YEN	2354	OVER 3 MONTHS *	2958
CAN$	1		
BFCS	27		
SDR			
^ OTHERS	2		
VALUATION OF EMCF	-477		
	5616		5616

* INCLUDES EMCF SWAP VALUATION DIFFERENCE OF -477
# EXCLUDES T/N AND FTD'S OF US$ 4335 PLEDGED TO BIS
^ EXCLUDES EMCF SWAP ECU'S

CURRENCY COMPOSITION OF THE RESERVES 30 JUNE 1988 (Done Date Basis)

	ASSETS	LIABILITIES	NET ASSETS
US$	21.85	12.95	8.90
DM(BLOC)	16.57	3.32	13.25
YEN	4.29	0.28	4.01
CAN$	0.63	0.41	0.22
	43.34	16.96	26.38

GOLD AND FOREIGN EXCHANGE OFFICE
05-Jul-88

177

SECRET

EEA ASSETS AS AT 31 DECEMBER 1987 (AS REVISED 3/2/88)

TYPE		HOLDINGS US$ MNS.		TOTAL RESERVES		
US$:	CURRENT ACCOUNTS	927.8		2.09		
	TREASURY BILLS	4231.2		9.55		
	SHORT TERM PAPER	3922.8		8.85		
	EURO DEPOSITS (MARKET)	4450.0		10.04		
	EURO DEPOSITS (BIS)	* 3825.0		8.63		*3335 HELD O/A EMCF
	US TREASURY NOTES	2245.4		5.07		
	FEDERAL AGENCIES	1072.0		2.42		
	FRN'S	840.9		1.90		
	EUROBONDS	1063.8		2.40		
	CENTRAL BANK BONDS	36.4		0.08		
			22615.3		51	
CAN$:	CURRENT ACCOUNTS	131.3		0.30		
	TREASURY BILLS	12.9		0.03		
	GOVERNMENT BONDS	495.0		1.12		
	EUROBONDS	28.9		0.07		
			668.1		2	
DM:	CURRENT ACCOUNTS	30.5		0.07		
	TREASURY BILLS	63.7		0.14		
	EURO DEPOSITS (MARKET)	1920.1		4.33		
	EURO DEPOSITS (BIS)	1658.1		3.74		
	GOVERNMENT BONDS	2208.9		4.98		
	SCHULDSCHEIN	208.1		0.47		
	EUROBONDS	833.5		1.88		
			6922.9		16	
ECU	CURRENT ACCOUNTS	21.9		0.05		
	EURO DEPOSITS (MARKET)	204.6		0.46		
	EUROBONDS	53.9		0.12		
			280.4		1	
YEN:	CURRENT ACCOUNTS	25.9		0.06		
	EURO DEPOSITS (BIS)	39.2		0.09		
	EURO DEPOSITS (MARKET)	825.0				
	GOVERNMENT BONDS	451.9		1.02		
	EUROBONDS	422.5		0.95		
	TREASURY BILLS	0.3			0	
	FRN'S	4.9				
			1769.7		4	
DFLS:	CURRENT ACCOUNTS	1.9		0.00		
	EURO DEPOSITS (BIS)	12.0		0.03		
	GOVERNMENT BONDS	453.1		1.02		
	EUROBONDS	28.8		0.06		
			495.8		1	
SWFC:	CURRENT ACCOUNTS	3.9		0.01		
	EURO DEPOSITS (BIS)	55.0		0.12		
	EUROBONDS	29.8		0.07		
	CENTRAL BANK BONDS	12.9		0.03		
			101.6		0	
FF:	CURRENT ACCOUNTS	2.3				
	EURO DEPOSITS (MARKET)	745.9				
			748.2		2	
WORKING BALANCES			5.5		0	
CURRENCY TOTAL			33,607.6	72.3		

	GOLD	*	7,240.1	16	* 1448 HELD O/A EMCF
	SDR RESERVE TRANCHE	1,579.2			
	BALANCE	1,228.6			
			2,807.8	-6	
	VALUATION DIFFERENCE O/A EMCF)		670.7	2	
			---------	-------	
GRAND TOTAL			44,326.2	100	
			=========	=======	

PUBLIC SECTOR BONDS HELD OUTSIDE THE RESERVES - 41.6

FORWARDS BY CURRENCY	$ MNS	FORWARDS BY MATURITY	$ MNS
US$	3846 #		
CAN$	-1		
DM	2323	UP TO 1 MONTH [JANUARY 1987)*	1093
YEN	139	UP TO 2 MONTHS [FEBRUARY 1987]	523
SDR	192	UP TO 3 MONTHS [MARCH 1988]	822
ECU	0	OVER 3 MONTHS	3416
BFCS	25		
FF	-33		
LIRE	34		
^ OTHERS	0		
VALUATION OF EMCF	-671		
	---------		---------
	5854		5854
	=========		=========

* INCLUDES EMCF SWAP VALUATION DIFFERENCE OF -671
\# EXCLUDES T/N'S AND FTD'S OF US$ 3385 PLEDGED TO BIS
^ EXCLUDES EMCF SWAP ECU'S

CURRENCY COMPOSITION OF THE RESERVES 31 DECEMBER 1987 (Done Date Basis)

	ASSETS	LIABILITIES	NET ASSETS
US$	26.50	14.80	11.70
DM(BLOC)	10.87	2.88	7.99
YEN	1.91	0.25	1.66
CAN$	0.67	0.39	0.28
	39.95	18.32	21.63

RESERVES MANAGEMENT - OTHER ISSUES

1. This paper discusses the following:

- (i) Issuer limits
  - (a) Bonds, short-term paper and FRNs
  - (b) Banks
- (ii) Gold deposits
- (iii) Gold options
- (iv) SDR facility with the IMF
- (v) German withholding tax
- (vi) Futures trading
- (vii) Protecting the EEA

Most of these items are for information only. However on item (ii) we are seeking renewal of the existing annual limit on our gold deposit business, on item (vi) we are seeking approval to undertake limited futures trading and on item (vii) we are recommending that we should seek legal advice on behalf of the EEA.

(i) EEA Issuer Limits

(a) Bonds, short-term paper and FRNs

2. Changes in the market perception of issuers on the EEA's approved list during the six months to end-June 1988 have been few. In only one case, that of Belgium, has it been felt necessary to revise the credit limit. The country was agency rated, for the first time, in March by Moody's as Aa1 (there is, as yet, no rating by Standard and Poor's). Even though some market analysts believed that the top quality rating (Aaa) was deserved, the EEA credit limits - $500 mn for bonds and $750 mn for short-term paper - were considered to be rather generous in the light of the Moody's assessment. New credit limits of, respectively, $300 mn and $500 mn have therefore been adopted. This change did not require any sales of securities.

3. Two new issuers have been added for short-term investment (maximum 6 months to redemption): Ireland and Portugal.

4. Ireland was rated Aa3 by Moody's in July 1987 and is not rated by S & P. Commercial paper programmes totalling $700 mn for Ireland and $100 mn guaranteed by Ireland are in place. An EEA credit limit of $100 mn has been introduced for short-term investments only.

5. Portugal is rated as A1 by Moody's and has been added to the EEA list for short-term investment only, with a credit limit of $75 mn. A new $500 mn euro commercial paper programme has recently been announced, which is expected to be placed at just above LIBID.

6. A table showing the current credit limits and existing holdings is attached.

(b) Limits on Exposure To Banks

7. At the last six monthly review it was agreed that the EEA's exposure to banks should be reduced. In fact the reduction achieved was quite small ($45 mn) but this should be seen in the context of a significant increase ($1.85 bn) in total currency reserves. (These changes are based on April 1988 parity exchange rates). The composition of bank exposure changed during the first half of 1988, as deposits placed directly with banks were reduced in favour of deposits with the BIS. Thus, direct market exposure fell by $0.9 bn to $7.7 bn and that to the BIS rose by a similar amount to $6.6 bn.

8. The rise in the general level of the reserves has prompted a reconsideration of the credit status of the BIS. Although the BIS's asset backing includes liquid, non-risk assets such as US$ Treasury bills, as well as gold, the bulk of the BIS's assets are in the form of commercial bank deposits. Maturity transformation between liabilities and assets is generally small. Thus the BIS's principal risk is that of default by the banks with which it places deposits.

9. Because the risk of the BIS reneging on its deposit liabilities is small, no credit limit has been imposed on the EEA's deposits with the BIS. However, credit limits have been set for all other entities with whom, on behalf of the EEA, we place deposits or whose securities we acquire . It therefore seems appropriate to establish some limit on the exposure to the BIS which we would regard as acceptable.

10. The strength of the BIS lies only partly in its existing balance sheet. This is expressed in gold francs and based on a gold price of $208 per ounce. Using a more realistic valuation for gold, paid-up capital and reserves amount to $4.0 bn and capital issued but unpaid would add a further $3.7 bn. The identities of its shareholders give additional comfort. For these reasons, we have set the limit on placements with the BIS at $10 bn.

(ii) Gold Deposits

11. In the 1950s it was agreed with HMT that modest amounts of gold, up to a total of £100mn., might be placed with the five members of the London fixing together with, in later years, Philipp Brothers. The facility was regarded as very much a "last resort" one by the six and relatively little use was made of it.

12. In 1986 it was agreed that we should try to make our gold work a little harder and as a result a number of counterparties with whom we were prepared to deal was increased to include additionally the banks with whom we had sizeable limits from Banking Supervision and who were also Associate Members of the London Gold Market. Initially there were eleven banks on this list but the circle has gradually widened as more banks joined the London Gold Market (now the London Bullion Market Association). A limit of an additional £200mn. which is renewed annually was agreed with HMT for this business.

13. The terms on which gold deposits are made are that deposits may be taken or extended to a maximum life of twelve months but thereafter they have to be repaid so that there is one month in thirteen in which the bank concerned has no deposits outstanding. Market rates of interest are charged.