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SIR G LITTLER

cc: Mr Peretz
Mr Grice
Mr Flitton

INVESTMENT OF THE RESERVES

I attach the Bank's paper for your meeting on 23 July. A brief will follow.

C W KELLY

enc

THE RESERVES: SIX MONTHS TO END-JUNE 1987

A Introduction

1 This paper analyses changes in the reserves in the last six months, and discusses likely developments in the period ahead. The recommendations for the next six months are:

(1) An immediate switch of around $¾bn into DM-bloc currencies out of US dollars.
(2) An immediate switch of around $¼bn into Yen, and $0.2bn into Canadian dollars.
(3) Further cautious acquisitions of North American and DM-bloc fixed income securities.

2 The paper is arranged as follows:

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B Changes in the Reserves

3 The spot and forward reserves rose by a combined $13.2bn (at end-March 1987 exchange rates) over the six months to end June, with spot reserves up by $10.0bn.

4 The major influence was heavy intervention, as the value of sterling threatened to rise unduly fast in the run up to the election: the true underlying rise in the three months to end-May was almost $16bn.

($bn)

	Jan	Feb	Mar	Apr	May	June
True underlying rise (spot plus forward)	+0.1	+0.4	+3.8	+4.5	+7.4	-3.4

The bulk of the fall in June was a forward sale of DM ($1.8bn) and US dollars ($1.2bn) to the MoD, rather than currency transactions with the market. Even so, the forward book was rebuilt to a level of over $4bn (principally in US dollars), from December's level of $0.9bn.

5 The published reserves were also swollen by revaluations resulting from the use of March 1987 parities in the stead of March 1986 parities. These increased the value of non-dollar holdings and gold, and are responsible for about $2½bn of the measured rise in the reserves over the six month period. Net new borrowing added only $0.1bn to the reserves.

C The Currency Composition of the Reserves

6 The following table gives some detail of how the composition of the reserves has changed since December. (End-March 1987 currency values - "parity rates" - were used in constructing the dollar values in the second and third columns, whereas the first column reports the 1986 parity values for last December, as shown in our previous report.)

Table 1

($bn)

	End-December 1986		End-June 1987
	1986 parities	1987 parities	1987 parities
Spot Reserves			
US dollars	9.4	9.4	18.3
DM bloc	2.1	2.7	3.9
Yen	0.7	0.8	0.9
Canadian dollars	0.2	0.2	0.3
	12.4	13.1	23.4
Gold	6.1	7.2	7.2
SDRs	3.2	3.6	3.3
Total	21.7	23.9	33.9
Market Forwards			
US dollars	- 0.4	- 0.4	3.0
DM bloc	0.6	0.8	1.0
Yen	0.3	0.3	0.1
Canadian dollars	0.1	0.1	0
Other	0.3	0.3	0.2
Total	0.9	1.1	4.3

Notes: (1) EMCF valuation differences are omitted.

(2) The 'other' market forward is principally an SDR position arising through a guarantee to the BIS, and offset by a negative position in US$ market forwards.

(3) The DM bloc is defined to include Swiss Francs, Dutch Guilders and ECUs.

D Overall Currency Exposure

7 For the purpose of assessing exchange rate risk, it is appropriate to take into account the UK's official liabilities, and to amalgamate spot and forward assets in each currency. The following table sets out the position at 30 June:

Table 2 Currency Exposure: 30 June

	Assets	Liabilities	Net assets	$bn (Net assets at end December*)
US dollar	21.32 (77%)	16.00 (82%)	5.32	-6.96
DM bloc	4.90 (18%)	2.75 (14%)	2.15	1.19
Yen	1.00 (4%)	0.27 (1%)	0.73	0.88
Canadian dollar	0.34 (1%)	0.41 (2%)	- 0.07	-0.12
	27.56 (100%)	19.43 (100%)	8.13	-5.01

* using March 1987 parities.

8 It was agreed at January's meeting that we should seek to switch between $½bn and $1bn into US dollars from DM and Yen, some of which might be seen as a contribution to co-ordinated intervention. As the dollar weakened in March and April, $0.2bn was switched out of Yen at an average rate of about ¥1.45. (This trade is on a modest profit at today's exchange rates.) But January's strategy rapidly came to be overtaken by large rises in the reserves as sterling strengthened.

9 The bulk of the inflow was in dollars, given the dollar's weakness against the DM and Yen. Accordingly, US dollar assets rose by $12.3bn in the period under review; with a small fall in dollar liabilities, the effect was to turn the position in dollars from net liabilities of $7bn into net assets of $5bn. (With purchases at an average rate of $1.66, intervention at present shows a profit.) There was also a rise of $1½bn in DM bloc assets, partially offset by an extra $½bn of DM liabilities. Gross and net Yen and Canadian dollar positions were little changed, however.

10 In our last paper, we suggested that, when there was a shortfall of assets against liabilities, it was appropriate to assess currency exposures against a 'neutral' strategy involving allocating available assets across currencies in the same proportion as liabilities. This analysis indicated that we had a substantial short in US

dollars, matched by longs in DM and Yen; and January's proposal to switch to dollars thus involved a planned move towards neutrality, in the sense of reducing the short position.

11 The EEA's net position has, however, now swung into substantial surplus, with net assets of more than $8bn. This seems to require a modification of approach as regards what allocation can be regarded as neutral. First, we judge that neutrality would require that the currency composition of liabilities be fully hedged, leaving the currency allocation of net assets for consideration.

12 The key consideration in this appears to be how much "froth" there is in the surplus position; how likely is it to disappear as the result of the reversal of some recent developments. To the extent that the surplus is temporary, it makes obvious sense to keep it in dollars, so as to preserve the liquidity of the reserves; dollars are the EEA's natural intervention currency.

13 If, however, the surplus were expected to persist for a substantial period, some diversification (on risk-reduction grounds) might well be appropriate. The portion of the surplus which is thought to be permanent might then be allocated more evenly among the major currencies.

14 The extent to which diversification is appropriate is thus a difficult judgement to make, and one which is likely to alter as time passes and events unfold. In present circumstances, only a limited amount of diversification seems warranted. But prospects for returns in the various currencies will also have an influence, as discussed next.

E Currency developments, prospects and recommendations

Developments

15 The dollar effective rate continued last year's downward trend for the first four months of the year, but moved up quite steadily in May and June (Chart 1). The dollar depreciated by about 15% (at the trough) against the Yen (but by only half as much against the DM, following last year's particularly sharp DM appreciation).

16 Sterling performed well in the first half of 1987, rising by 5% in effective terms in the aftermath of the Louvre agreement late in February. Interest rates fell by 1% (in two stages) in March; this, with intervention, took some of the steam out of the rise towards the end of March. But growing expectations of a Conservative victory in an early General Election kept sterling in demand in April and (despite further ½% base rate cuts on 28 April and 8 May) the pound remained generally strong until the election, which was followed by some profit taking.

Prospects

17 We consider that the currency allocation decision should be based on the following outlook:

- the dollar is likely eventually to resume its fall against the DM and Yen (reflecting higher inflation as well as continuing US deficits)

- but approximate dollar stability is likely for the rest of this year (since the dollar has already fallen very fast, and now seems underpinned for a period by the prospect of co-ordinated intervention). Thereafter, the dollar may fall by a modest amount

- there is however a risk that the dollar might plunge later this year (following a loss of confidence triggered either by political events or by renewed inflation fears).

Recommendations

18 This outlook suggests that, over a horizon as long as 6-12 months, there may be little benefit to be expected from owning money market instruments in one currency rather than another; the higher

Chart 1
US DOLLAR EXCHANGE RATES

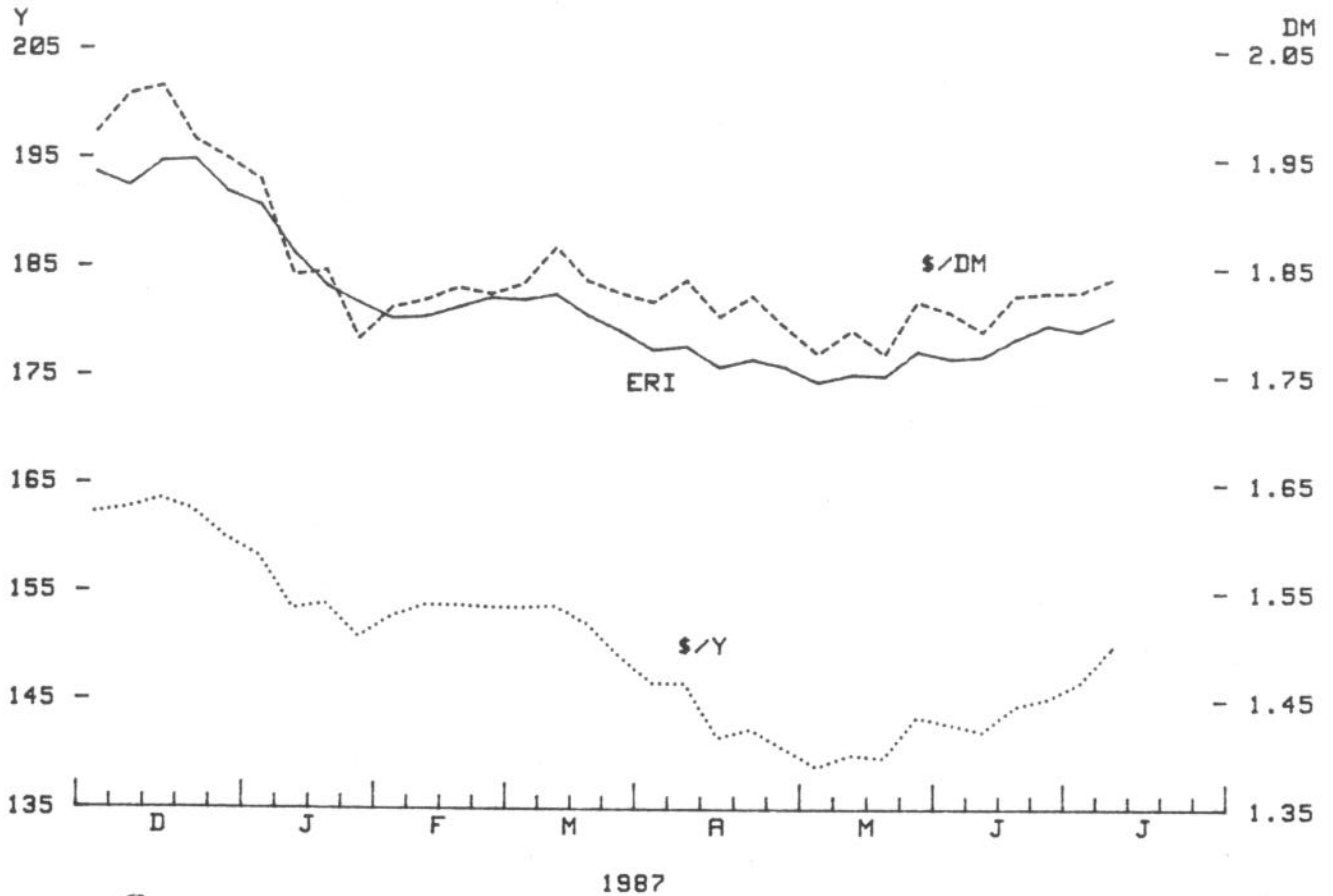
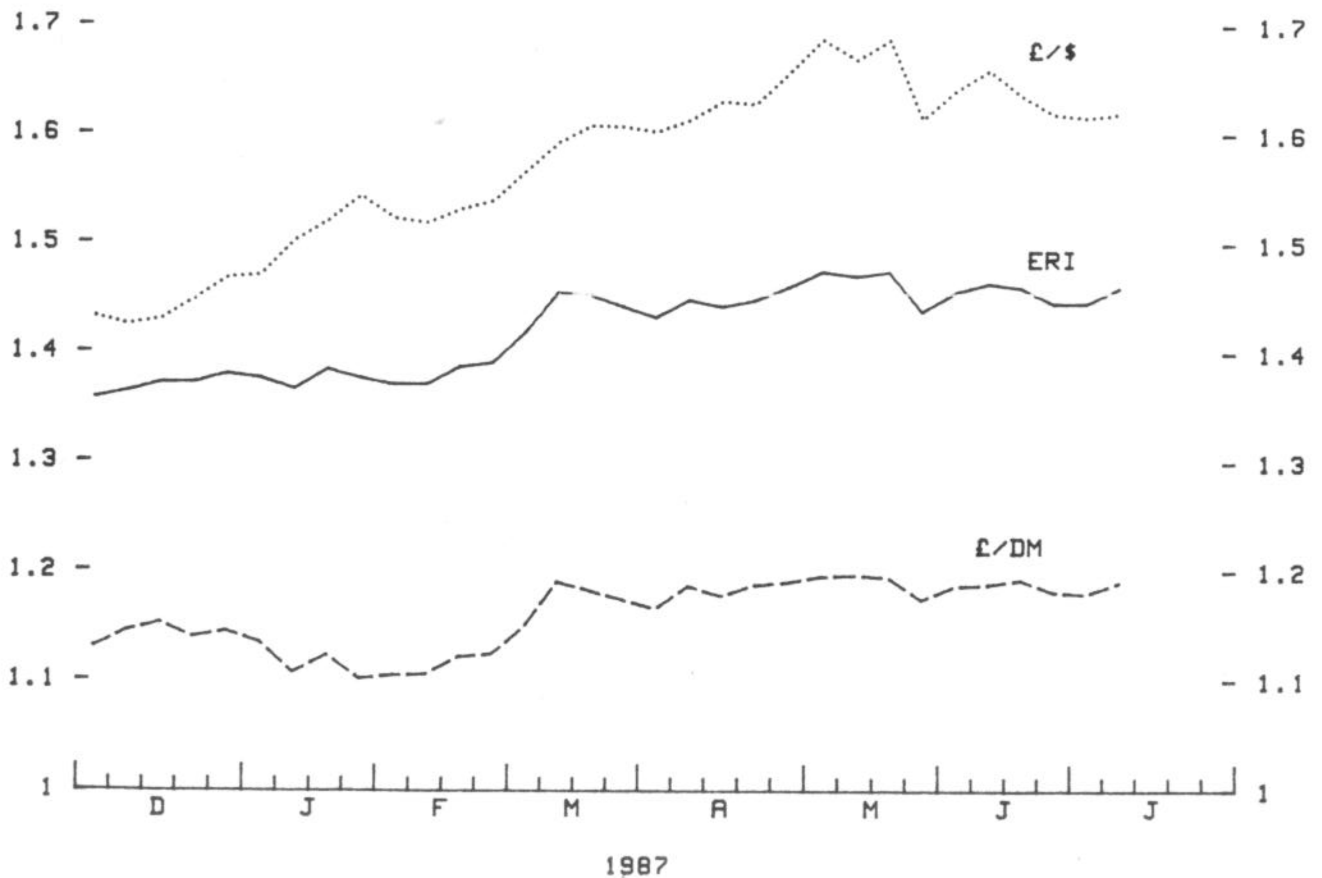


Chart 2
STERLING EXCHANGE RATES



yield on US dollars may be offset by the probability of mild dollar depreciation on average. But over a shorter horizon , dollar instruments seem likely (on balance) to outperform DM and Yen instruments; it thus seems reasonable to hold a large share of what must still be judged a somewhat "temporary" net asset position in dollars for the next few months. On the other hand, there remains a significant risk of an episode of renewed and considerable dollar weakness; this (particularly if the diversification argument has any force) suggests that the present dollar proportion may be too high, and that we should look to shift the balance of net assets towards DM and Yen to a modest extent.

Table 4 Recommended Currency Allocation of Net Assets

	Actual ($bn) %	Proposal ($bn) %	Proposed switch ($bn)
US dollars	5.32 (66%)	4.1 (50%)	- 1.2
DM bloc	2.15 (26%)	2.9 (36%)	+ 0.75
Yen	0.73 (9%)	1.0 (12%)	+ 0.25
Canadian dollar	- 0.07 (-1%)	0.13 (2%)	+ 0.2
	8.13	8.13	

19 The proposal involves in the first instance shifting about $1bn into DM and Yen, at current levels of exchange rates

- switch $¾bn into DM

- switch $¼bn into Yen

The immediate effect would be to reduce the dollar share in net assets from ⅔ to ½. The DM bloc share would rise from 20% to 36%, and the Yen share from 9% to 12%, the balance reflecting the greater usefulness of DM as an intervention currency as much as the prospects for the DM vis-a-vis the Yen.

20 The suggested new position (in column 2 of Table 4) would leave us well placed to respond to events, given the rather neutral outlook outlined above. The responses suggested below would also be consistent with the post-Louvre accord.

- If the dollar were to continue to strengthen short-term (as seems quite possible), we would suggest switching a further $1bn into DM and Yen during the rest of 1987.

- If the dollar were to weaken markedly, we would suggest reversing the initial switch of $1bn, possibly as part of any co-ordinated intervention.

21 Finally, we recommend a modest switch ($0.2bn) into Canadian dollars. This would cover our Canadian dollar liabilities, and establish a modest long position. The Canadian dollar is undervalued against the US dollar in fundamental terms, and money market yields are around 50 basis points higher. The prospects for a trade agreement look good, and are likely to attract foreign investment to Canada, adding to the effects of recent market reforms. Canadian policy has been successful in restraining inflation close to US rates, and the Canadian dollar is now at around 76 cents, having touched 77 cents in April.

F Changes in Marketable Assets

22 The following table indicates the disposition of US dollar assets at 30 June. There were very substantial additions to US dollar liquidity and to deposits in the period under review. The rise in the reserves seems to warrant at least some rise in what was arguably unduly low liquidity, particularly in view of the possibly temporary nature of some of the inflows. Thus holdings of Treasury bills and of short-term marketable paper have both been increased to about $3bn.

Table 5 US Dollar Assets: 30 June ($bn)

	December	June	Change
Treasury bills	1.4	2.8	+ 1.4
Current accounts	0.8	1.3	+ 0.5
Short-term paper	0.9	3.0	+ 2.1
Liquidity	3.1	7.1	+ 4.0
Other deposits	2.5	7.6	+ 5.1
Treasuries and Agencies	2.7	2.3	- 0.4
Longer-dated FRNs	0.3	0.4	+ 0.1
Eurobonds	0.7	0.8	+ 0.1
Total	9.4	18.3	+ 8.9

23 At the time of our last meeting in January, we were not able to present any very systematic analysis of our exposure in net terms (taking account of assets and liabilities) to changes in interest rates in the majors. In view of the prospects for interest rates, we did not feel able to recommend any further addition to US dollar fixed income assets. Thus the increase in dollar holdings was concentrated in liquidity and in time deposits. With dollar interest rates having risen over the six months, this turned out to have been a sensible decision.

24 We were, however, more sanguine about other bond markets. It was agreed that the EEA should acquire:

- about $150mn of Canadian dollar bonds

- $100mn of DM bonds

- $50mn of ECU bonds

- $30mn of Yen bonds

25 The Canadian dollar bond market also saw rises in yields for the period under review. It did however outperform the US market somewhat, and there was the additional bonus of a 150bp increment in running yields at an annual rate.

26 There was little net movement in DM bond yields at longer maturities, but shorter yields (at 4 years) fell by close to 1%. When the steepness of the yield curve is taken into account, bonds at all maturities will have outperformed money market instruments by a reasonable margin.

27 There were modest additions to Yen bond holdings, as agreed at our last meeting in January, at an average yield of somewhat under 5%. Thereafter, 10% of the portfolio ($80mn) was sold at the end of March, and a further 10% in May, as yields fell to low levels (3.8% at end-March, and 3½% in May): and there were substantial switches out of Yen government bonds into other sovereign credits' Euroyen bonds, with a yield enhancement of about 100 basis points.

G Interest Rate Exposure

28 We have in the past assessed exposure to changes in US interest rates simply by comparing the size and average life of fixed income assets with those of fixed income liabilities. At end-December, the EEA had $3bn of fixed income assets, with an average life of 2.3 years, but $5bn of fixed income liabilities, with an average life of 6.1 years; there thus appeared likely to be a substantial exposure to loss in the event of falls in US interest rates, and prospect of gain should they rise.

29 This analysis has been taken a step further, as follows. The fixed income asset and liability streams have each been converted into a single number, representing the amount by which its market value would change if yields generally were to change.

30 In the case of liabilities, the stream of debt repayments (in each currency) is treated as a sequence of bonds, one maturing in each year from now until the final repayment. Once a fixed coupon of appropriate size has been imputed, each bond can be analysed in terms of the change in its value should yield levels change. On the assumption that yields change uniformly all along the yield curve (as is broadly appropriate if variations in the assessment of core inflation are responsible), it is possible to add up the changes in value, and standardise by the change in value of some numeraire (4-year) bond, so as to calculate the market risk (in 4-year bond equivalent terms) of the debt stream.

31 This approach mirrors the procedure we already use for assessing the total market risk associated with the EEA's fixed income assets, and allows a straightforward calculation of exposure in each separate currency. (The results are however somewhat approximate on the liability side, because of the diversity of loans and the complicated nature of many of them.)

Shd borrow shorter

Table 6: Fixed Income Exposure (in 4-year equivalents)

($bn)

	Assets	Liabilities	Net assets	
US dollar	2.1	4.9	- 2.8	
DM bloc	2.7	3.5	- 0.8	+.2
Yen	0.6	0.3	+ 0.4	
Canadian dollar	0.3	0.4	- 0.1	+.1

Note: All figures are recorded to nearest $0.1bn; rows do not always add.

32 These figures indicate that we are 'short' in all fixed income markets except Yen; thus we would stand to benefit in net terms from interest rate rises in dollar and DM bloc markets, but to lose if Yen rates rose.

33 The question of what would constitute a 'neutral' allocation of the EEA's assets and liabilities needs to be considered, as in the currency allocation decision. One approach is to regard floating rate instruments as riskless; then neutrality would suggest maintaining zero net asset positions in each currency's fixed income market. This would mean that the EEA would neither gain nor lose from swings in interest rates.

34 This approach would regard floating rate instruments as the neutral home for any inflows, and as the source of cash for outflows; since they are more capital-certain than fixed income instruments, the approach has obvious appeal. The following table indicates the asset and liability position in each currency in floating rate instruments. The bulk of floating rate assets are in US dollars, reflecting the EEA's need for dollar liquidity; but there are also some floating rate DMs (held as bank deposits and forward contracts).

Table 7: Floating Rate Instruments

($bn)

	Assets*	Liabilities
US dollar	18.1	11.3
DM bloc	2.2	0
Yen	0.2	0
Canadian dollar	0	0

* includes forward contracts

35 It is also possible to argue that the EEA can in general afford to be over-exposed to fixed income markets; longer dated instruments offer a higher average yield over the interest rate cycle than money-market instruments, but at the cost of some loss of capital certainty. Indeed, this argument had some influence in the choice of a two year average maturity for the US dollar Treasury note and Federal Agency portfolio, which is regarded as providing second line liquidity; such instruments preserve liquidity and offer high yield, but have the disadvantage of providing a more volatile stream of total returns than floating rate instruments. This argument is

likely to have relatively greater weight at times when the EEA looks to have a durable surplus of assets over liabilities, reducing the likelihood of forced sales of fixed income assets (to fund outflows) at times when capital losses might have to be taken.

36 The maturity decision will also need to have regard to the slope of the yield curve in each currency, and to prospects for yields and for the slope of the curve. Section H considers recent developments and prospects, and Section I makes proposals in the light of the discussion above.

H Developments, Prospects and Recommendations

Developments

37 The annex to this paper discusses major developments in the principal securities markets in the last six months. All the markets except Yen (which boomed) traded in a rather narrow range for the first quarter; all backed up in the second quarter. The rise in yields was most marked in the US and Canada (up by 200 basis points, at the peak); but DM and Yen yields rose (by 50bp and 200bp, respectively, at 10 year maturities) in May and June, when US markets were starting to stabilise.

38 Short term rates in the USA also rose, but less sharply. Federal Funds rose by ½-¾%, as the Fed responded to the weaker dollar; and 3 month LIBID rose by over 100bp from January's level at the height of the market's depression in May. Accordingly the yield curve steepened markedly. The steepening was particularly marked in government securities because bills were in strong demand (partly by foreign central banks, and partly on account of concerns about the banking system) and in reduced supply because of higher-than-expected tax receipts in the spring.

Prospects

39 Prospects over the next 6-12 months are, as always, difficult to judge. We suggest the following:

- little change on average in short-term interest rates in the three major currencies (though there is a risk of rises in dollar rates if the dollar should weaken markedly)

- a rise in US dollar interest rates at long maturities in the next six months (as wage inflation comes to be a worry), reversed in 1988

- a fall in German bond rates

- little change in Yen bond rates

- some narrowing in the Canada-US differential, particularly at the shorter end of the yield curve.

(Short term rates)

40 In the USA, Federal Funds were raised a touch to protect the dollar; but now that the dollar looks to have stabilised (underpinned by the threat of further concerted intervention) there may be little prospect of substantial further rises. Concerns about financial fragility at home and in the LDCs (and an absence of strong output growth) are likely to balance concerns about inflation and the need to maintain confidence in the dollar.

41 In Germany, the growth of central bank money looks high against even the new, more relaxed, target; and the authorities appear to believe that reductions in short term rates - even if acceptable on monetary grounds - would have little effect in averting a slow-down in growth. And reductions in rates in Japan would run counter to the Bank of Japan's concerns about apparently inflated asset prices. Thus relatively high real short term interest rates seem likely to continue in both cases.

42 In Canada, however, some overall decline is likely in short-term interest rates over the next year or so, as confidence in the Canadian dollar recovers on the back of a strong trade position and direct investment inflows.

(Bond yields)

43 Prospects for US bond yields are much harder to evaluate, depending both on perceptions about the dollar/monetary policy nexus and on assessments of rather longer run inflation prospects. Inflation may well remain reasonably subdued in 1987 (less than 5%), with little pass-through from higher import prices into wages or into swollen profits on domestic production; high unemployment and low capacity utilisation should prove sufficient to ensure that the response falls more on supply than on price. In 1988, however, there should be some modest upturn in wage inflation as unemployment falls; with slower growth in import prices, the effect should be to keep inflation close to 5%.

44 To a substantial extent, this inflation outlook is built in to current yield levels of about 8.3% at 10 years, and 7.8% at 4 years. We would not rule out the possibility of a rise in yields at these

longer maturities early next year when wage inflation starts to accelerate; but believe that the rise will be reversed later in the year as consumer price inflation fails to accelerate in response, and as the wage acceleration comes to be seen as a spike rather than a shift to higher trend rate of wage growth. Accordingly longer maturities seem to represent fair value (yielding about 90 basis points more than 3 month bank deposits), but have no strong prospect of price appreciation.

45 Shorter maturities seem to us to have more to offer. In early July, two year Treasury notes yielded about 7.40% (50 basis points more than 3 month bank deposits, and around 70 basis points more than Federal Funds). With monetary ease a possibility, and little chance of tightness, paper of this maturity is likely to prove a good investment (compared with rolling short-term paper) over a horizon of 12 months or so. And US markets offer an excellent degree of liquidity.

46 It remains a danger, however, that political or other risks will lead to a loss of confidence in the dollar, with the Japanese investors leading a flight from US securities. We feel that such an event is less likely to be permanent now that the dollar is closer to fundamental equilibrium, and with a substantial nominal yield advantage for dollar assets; and also because the recent downtrade failed to produce any permanent downward shift in the dollar, instead establishing more attractive relative yield levels in favour of the dollar. Nevertheless, a sharp fall remains a possibility; and adds to the arguments for caution as regards dollar securities.

47 Bond yields in Germany seem likely to fall in the next year or so. Yields have returned to about 6% (at 7-10 year maturities, on government bonds), having fallen to 5½% in mid-May. These bonds still seem likely to be good value, set against a 3% discount rate and the absence of inflation.

48 We have less confidence in our view of Japanese bond yields, now at just below 5% on less actively-traded 10 year bonds. This seems relatively sustainable in fundamental terms, with no inflation and short rates of around 4%; but the Japanese market has (as the annex suggests) been rather emotional in the last six months, with yields falling by 250 basis points up to mid-May, and rising by 130 basis points subsequently. On balance, we would regard a further marked rise in yields as a buying opportunity.

49 The prospects for Canadian bond yields largely mirror those in the USA, since there is (in our view) a good prospect of restraining Canadian inflation to levels similar to those in the USA. Four year Canadian governments yield about 130 basis points more than comparable US governments (about 30 basis points tighter than six months ago), and the yield advantage is greater at shorter maturities following the episode of Canadian dollar weakness in April. We expect some trend contraction in both spreads as the Canadian dollar strengthens and as foreign investors move into Canadian securities, attracted by the improved liquidity offered by a liberalised and recapitalised market as well as by the fundamentals.

50 Finally, the prospects for Dutch guilder yields need to be considered. As noted earlier, we have switched some DM exposure into Dutch guilder government bonds, in response to a yield enhancement of over 100 basis points in the 3-5 year sector. This seems likely to offer ample compensation for the small risk of small currency loss through ERM realignments; Dutch policy seems set on maintaining an unchanged exchange rate against the DM.

Recommendations

51 Our view of the prospects suggests that we would not wish to be short of DM-bloc bonds, but have a much less strongly positive attitude towards other fixed income markets.

52 In Yen markets, we do not recommend additions to our current net long position at present levels. If rates rise by more than 50 basis points, we would wish to buy back the $160mn of bonds sold this spring, and to add modest further amounts. And if rates fall substantially, we would wish to reduce our exposure.

53 In DM-bloc markets, we propose the following:

- additions to the portfolio sufficient to turn the short position of $0.8bn (4 year equivalents) into a small long position of say $0.2bn, spread over the next three months.

- matching the effects on the position of any new fixed income borrowing by further purchases.

54 In US markets, we consider that the present short position (almost $3bn in 4 year note terms) is unduly large, given that securities - in particular, two year notes - are likely to outperform short-dated instruments over the next year or so. Moroever, over 25% of the spot currency reserves are now held directly with the banking system (and a further 18% with the BIS). Accordingly we propose:

- up to $1bn be shifted into the two year US Treasury and Agency portfolio over the next six months, with acquisitions being accelerated if yields rise. This would reduce the short somewhat, to under $2bn in 4 year note terms by the end of the year, assuming that there is no new fixed income dollar borrowing.

- if the yield curve steepens as expected, and sovereign spreads remain favourable, additions of up to $250mn to the four year Eurodollar portfolio.

- the effect of the switches out of dollars into other currencies, and into Treasury notes, would be to reduce the liquidity of the reserves. We thus propose to maintain Treasury bill holdings at around $3bn, with similar holdings of other marketable short-term US dollar securities; deposits will take the brunt of the adjustment.

55 Finally, our favourable view of <u>Canadian</u> prospects suggests that we should seek to move into a modest long position. We propose:

- additions of Canadian $0.2bn to the Canadian dollar 4 year note position.