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

Reference MG-MAMC/D/0002/001

File begins 21/01/1987

File ends 02/04/1987

Pages 120-140

3889/003

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FROM: C W KELLY

DATE: 23 March 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Peretz
Mr Ross Goobey
Ms Goodman
Mr Richardson

END MARCH RESERVES

The true underlying reserve change in March as at 3.00 pm this afternoon is now forecast at $3.2 billion.

2. We have hitherto been working on the assumption that we would publish a figure of just under $1 billion. This would have been the largest rise since July 1979 ($1,356 million). The peak before that was $3,036 million in October 1977. There were four other months in 1977 when the published figure exceeded $1 billion:

January	1,915
March	1,075
July	1,794
September	1,768

3. Events have obviously moved on since we last discussed the March figure with you. There may now be a case for publishing rather more than $1 billion. A substantial figure would be good for confidence, would be consistent with other signals about resisting further falls in interest rates for the time being, and would make it possible to show that we have recouped, by a substantial margin, the reserves spent last autumn.

4. But there are a number of reasons for not wanting to go too far above $1 billion:

105/87

(21)

(i) The markets must be expecting a fairly substantial figure (though few have yet got round to producing forecasts). But I doubt if they have any inkling how large the true figure really is. If we publish a figure too far in excess of expectations we risk a reaction that we are trying <u>too</u> hard to resist a further fall in interest rates, which may prove to be counter-productive.

(ii) The intervention we have done has not been conspiciously successful in preventing the rate from strengthening significantly. Too high a figure will remind the markets how ineffective intervention really is, which weakens its future usefulness to us.

5. We also now have a reason for wanting to build up the forward book. Adding a substantial amount to it will enable us to offer the Ministry of Defence the chance to make an early start on their objective of forward buying their $2.4 billion equivalent foreign currency requirements. We had thought that we would have to delay this until after the election, and then build up to it over a two year period.

6. A further factor is the funding arithmetic. I doubt that any of us feel that hitting the funding target on the nose is so important as to warrant sacrifying any of our other objectives. But, other things being equal, there is clearly a case for trying to get as close to it as we can.

7. Our present assessment is that we are curerntly around £150 million overfunded. Assuming that the figures show no further change (which may be optimistic), and that no new gilts are brought, increasing the published reserve change to something of the order of $1,250 million ought to be enough to bring us fairly close to a full fund.

8. This is a fairly long dealing month. The Bank will be able to go on undertaking transactions for value in March until Friday, and will have some limited scope for last minute adjustments on Monday and Tuesday of next week. But there is a limit to the amount

hey can expect to shift into the forward book on any one day without attracting attention. So far they have swapped out about $1.3 billion and will continue to add to this as the week progresses. At present they still think it possible to get the published figure down to $1 billion, if that should be your decision, by the end of the month. But it could become more difficult if we continue to take in as much over the rest of the week as we have done so far today.

9. As always, this is very much a balanced judgement. As things stand at present, however, my recommendation would be to go for a figure somewhere between $1 billion and $1.5 billion, leaving the precise figure to be determined mainly by what happens to the funding arithmetic over the rest of the week but with a preference for somewhere in the middle of the range.

10. The Bank, with whom I have discussed this submission, take a similar view but with a bias towards the bottom of the range.

11. A complication is that March is also the month in which we make the annual revaluation of the reserves. On present figures it looks as if the effect will be to increase them by something like $2.7 billion. Net borrowing will add a further $200 million.

S S Duggins
for **C W KELLY**

1780.3

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FROM: I POLIN
DATE: 24th March 1987

MR KELLY

cc: Mr Peretz
Mr Sedgwick
Mr Bottrill
Ms Goodman
Mr Richardson
Mr Flitton

THE RESERVES IN MARCH 1987

The reserves figures for March will be published on Thursday 2 April at 11.30am. I attach a draft of the press notice, Q and A briefing and the press material on exchange rate developments. May I have comments please by noon on Friday 27th March?

Ian Polin

I POLIN

Note for record
Nothing to add
27/3

Qs on i-rates.
no add.

Mr Brook
Can you see what we might add to Q 8-9 (after today)
26/III

COVERING CONFIDENTIAL

ERMP C/8

FROM: I POLIN
DATE: 1 April 1987

1. MR KELLY
2. ECONOMIC SECRETARY

Distribution

PPS
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Bottrill
Mr Grice
Mr Culpin
Ms Goodman
Mr Pickford
Mr Ross Goobey

THE RESERVES IN MARCH 1987

The reserves announcement for March will be made on Thursday 2 April at 11.30 am. This month's announcement reports a rise in the reserves of $ million and an underlying rise of $ million. The annual revaluation of the reserves carried out at end-March gave rise to an increase in the published reserves of $ billion.

I POLIN

Mr Norgrove - No 10
Mr Lankester - Washington (after publication)

Mr Gill)
Mr D J Reid)
Mr J Milne) - B/E
Mr D J Chetwin)
Mrs Jupp)

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DRAFT PRESS NOTICE

THE RESERVES IN MARCH 1987

The UK official reserves rose by $~~105~~ million in March. Accruals of borrowing under the exchange cover scheme amounted to $~~36~~ million; repayments of such borrowing amounted to $~~16~~ million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $~~2~~ million. At the end of March, the reserves on the old ~~de~~valuation stood at $ million (£ million*) compared with $22,257 million (£14,392 million+) at the end of February.

2. After the annual valuation the reserves stood at $ million (£ million*) on 31 March.

Note to Editors

3. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during March was $ million. The underlying change in the reserves is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

4. New borrowing under the public sector exchange cover scheme was as follows:

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* When converted at the closing market rate on Tuesday 31 March £1=$1.

\+ When converted at the closing market rate on Friday 27 February £1=$1.5465

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Re[illegible]yments of such borrowing were:

5. The UK reserves are conventionally revalued once a year at end-March as follows:

(a) gold (other than that swapped for ecus under the EMCF arrangements) is valued at 75 per cent of the average London fixing prices over the three months up to 31 March, or 75 per cent of the final fixing price on 31 March, whichever is less.

(b) SDRs and assets in non-dollar foreign currencies are converted to dollar equivalents at the average of the relevant dollar exchange rate over the 3 months up to 31 March, or the actual exchange rate on 31 March, whichever is the less.

X The same gold price and exchange rates are then used to value the assets in successive monthly reserves announcements until the next revaluation. Securities are valued at historic cost.

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THE RESERVES IN MARCH 1987 : PRESS BRIEFING

Factual : main features of markets in March

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
x 2 March	70.7	1.56½	2.86	103.8	1.83¼	153½
11 March	72.7	1.59	2.97½	104.6	1.87	153½
16 March	71.4	1.58	2.90	103.4	1.84	151½
18 March	72.6	1.61	2.95½	103.3	1.84	152
23 March	72.5	1.61½	2.94	102.5	1.82	150½
30 March						

[The main focus of market attention was on Sterling this month].

Sterling rose steadily at the beginning of the month trading around 70½-72½ in effective terms. It reached a high ~~peak~~ of 72.7 and ~~of~~ DM 2.97½ on 11 March, despite a ½ per cent cut in bank base rates on 9 March, ~~but~~ helped by strong investment demand. The Budget on 17 March and, in particular, the PSBR forecast for 1987-88, was well received by the markets and sterling continued to rise pushing firmly through the key level of $1.60, despite the less-than-expected ½ per cent cut in bank base rates on 18 March. Market sentiment continues to be bullish with optimism about the political outlook and the UK economy continuing helped by further firmness in oil prices to well above $18 a barrel.

The Dollar was generally stable in quiet trading this month although it reached a high ~~peaked~~ on 11 March ~~t~~of 104.6 and DM 1.87 helped by Sterling's strength against most Continental currencies and better than expected US economic data. However, the markets remain reluctant to severely test the recent G6 agreement for fear of inciting central bank intervention. It gained ground ~~later~~ on release of good February economic data but fell again going through ~~later through~~

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~~to~~ the key levels of Yen 149 and DM 1.81 ~~on~~ following Baker's comments in a C4 TV interview that there was no exchange rate target for the currency and Yeutter's comments that the US $ and Japan were on the brink of a serious trade conflict.

POSITIVE

1. G6 accord going with the grain of the markets. Agreement to cooperate to achieve period of stability.

2. Strong productivity growth and present pattern of exchange rates offer industry best selling opportunity abroad for years, provided pay costs controlled. Sterling index down 11 per cent in year to January 1987; in recent quarters UK unit labour costs have risen broadly in line with those of competitors so that sterling's depreciation has been reflected in improved competitiveness.

3. Fifth successive month of underlying plus on reserves, after underlying fall in October.

DEFENSIVE

1. **Exchange rate target.** No exchange rate target but agreed at Paris in February that period of stability desirable. After Budget Chancellor said current level of sterling about right to benefit British industry.

2. **The large underlying increase in the Reserves shows desire to hold down sterling?** The Chancellor's views on the exchange rate were put firmly on the record after the Paris Accord. Evidence (increase in rate) shows we are not intent on stopping any rise in exchange rates; sensible to take opportunity of strong demand to rebuild reserves.

3. **Implications of Paris Accord for role of exchange rate in monetary policy?** No change in policy. G6 Accord is a pragmatic international agreement specifically to deal with current circumstances.

4. **Support for Sterling at present levels?** Paris Accord applies to all six currencies. All agreed on present broad pattern of exchange rates and stand ready to intervene. Chancellor has stressed value of period of stability.

5. **What happens if exchange rates depart from acceptable levels?** G6 stand ready to use all available instruments, including co-ordinated intervention.

6. **What value is Paris Accord to UK?** As major trading nation, UK has at least as much to gain as anyone from anything which lessens international trade tensions and pressures for protectionism.

7. **Can Paris Accord be implemented in practice?** Does not solve all problems but communique contains clear declarations of political will. All G6 agree that, with policies in communique, present pattern of exchange rates reflects economic fundamentals.

8. **Implications of Paris Accord for interest rates?** Interest rates not part of Paris Accord. Interest rates will continue to be held at whatever levels are necessary to maintain downward pressure on inflation.

9. **Delay in cutting interest rates costly?** No. Real cost would come from discarding prudent monetary policies.

10. **Intervention costly?** No. Smoothing intervention tends to be profitable over time.

11. **UK membership of ERM.** Matter kept under continual review. Government always said arguments both in favour and against joining the ERM. Will only join when satisfied that balance clearly favours doing so.

12. **Lower DM/£ exchange rate provides UK with opportunity to join ERM at favourable rate.** Not prepared to speculate on what [illegible]es might or might not be appropriate. In any case not merely matter of achieving appropriate rate; number of technical questions about how sterling would operate within ERM also need to be considered.

13. **Details of revaluation of the reserves?** The revaluation of holdings of gold, SDRs, ECUs and non-dollar currencies has increased our reserves by [$2,776 million]. The figures break down broadly as follows:

$ million

	Holdings on old valuation	Effect of revaluation	Revalued holdings
(a) Gold [valued at $400 per ounce]	[4,897]	[+807]	[5,704]
(b) SDRs, ECUs, and convertible currencies [using exchange rates as at 20 March]	[19,396]	[+1,969]	[21,365]
Total	[24,293]	[+2,776]	[27,069]

15. **1987 current account forecast.** Emergence of small deficit not surprising given deterioration in oil balance and rise in domestic demand in 1986. But volume of non oil exports now growing again and set to continue in 1987 reflecting growth in UK markets, UK's improved competitiveness and continuing surplus on invisibles.

14. What principles govern revaluation of reserves?

The basic principle is that the annual revaluation of the reserves should be realistic but prudent. Other countries follow ~~[illegible]~~ similar policies.

3889/020

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FROM: C W KELLY

DATE: 27 March 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Ms Goodman
Mr Richardson
Mr Ross Goobey

MARCH RESERVES

The funding arithmetic continues to be very uncertain. But at present our best guess is that to achieve a more or less exact full fund we ought to publish a reserve figure of around $1,400 million.

2. On this basis a reserve figure of $1,600 million would imply underfunding of around £100 million. A reserve figure of $1,800 million would imply underfunding of around £250 million.

3. I do not think that anyone would feel that being underfunded by £250 million was anything to worry about - if indeed that was what we achieved. The margins of error in forecasting the PSBR at this stage are much greater than that.

4. Since these figures were calculated we have bought £250 million of IG tranchettes for sale on Monday. To the extent that any of these are sold on Monday, the underfunding implied by chosing a reserve figure at the top of the range would be reduced. Sales on Tuesday would count as funding for next year.

5. Neither the Bank nor we think that there is much to chose between $1.6 billion, $1.7 billion or $1.8 billion on market reaction grounds. As the Deputy Governor said at your meeting earlier this week, these are all big figures likely to produce much the same

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reaction. Our difficulty at this stage is that we do not really know what that reaction is likely to be. Much will depend upon what else is going on next Thursday.

6. Where I think this leave us is that you have a fairly free hand in chosing a figure anywhere within your range of $1.6 billion to $1.8 billion. I suggest, however, that we do not try to tie the Bank down too precisely. The size of possible flows at present, and the potential difficulties of swapping in and out of the forward book right at the end of the month, are likely to cause them considerable difficulties in trying to hit a precise target - to no obvious benefit.

7. My suggestion would be that we ask them to aim somewhere in the middle of the range $1.7 billion to $1.8 billion, depending upon circumstances.

CWK

C W KELLY

ps2/1R

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FROM: CATHY RYDING
DATE: 30 March 1987

MR C W KELLY

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Ms Goodman
Mr Richardson
Mr Ross Goobey

MARCH RESERVES

The Chancellor was grateful for your minute of 27 March.

2. The Chancellor thinks that all things considered (including the fact that the PSBR is likely to be below £4.1 billion), the Bank should be asked to aim for an unrounded figure as close as it practicable to $1.8 billion.

CR

CATHY RYDING

106/87

3889/028

① Mr. Richardson
② Mr. Brook. 1/4
Does the revaluation score for funding purposes?

FROM: C W KELLY

DATE: 1 April 1987

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Ms Goodman
Mr Ross Goobey

RESERVES IN MARCH

I attach for your approval the draft press notice and accompanying briefing on the March reserves, prepared by Mr Polin.

2. The underlying increase is +$1785 million. The true figure is $3861 million. We added more than $2 billion to the (unpublished) forward book.

3. Even so, the published underlying increase is still the largest since October 1977 (when it was $3036 million) and well above market expectations. Most of the forecasts we have seen are for somewhere between $500 million and $800 million.

4. It is difficult to predict what the reaction to the figures will be. But after the weakening of the exchange rate in the last few days, and the firming of money market rates which has accompanied it, the chances of the figure causing irresistible pressure for a further base rate fall must be considerably less than we feared at one stage last week.

5. That does not, of course, mean that we will not still get the Beaumont-Dark criticism, that we are trying too hard to prevent further falls in interest rates at the expense of British industry. The press briefing suggests a response to that along the usual lines.

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6. Net borrowing was also positive for this month, at $121 million. The most substantial borrower was British Coal, who took just under $250 million equivalent in deutschemark from the European institutions.

7. The annual revaluation added $2.9 billion, reflecting increases since this time last year in both the price of gold and in the value of non-dollar currencies expressed in dollars. Massive though these figures are, they seldom attract much comment.

8. Table 2 attached shows other countries intervention during the month. The most striking feature is the $8.5 billion bought by Japan and $2.4 billion by the US in an attempt to resist the rise of the yen. Token amounts of dollars against yen were also bought by the French and Germans as well as ourselves.

9. Other interesting points in the table are the substantial dollar purchases against their own currencies by Canada ($1.6 billion) and Sweden ($2.1 billion) and the fact that a number of the EMS currencies have taken advantage of the spotlight being taken off the ERM to continue to rebuild their DM reserves after the last realignment. The French in particular bought $4.1 billion equivalent.

C W KELLY

enc

TABLE 1 - RESERVE TRANSACTIONS FOR MARCH 1987

		$ million	
		Spot	**Forward**
1.	End February levels	22,257	917
2.	Transactions in March		
(i)	Market	+4348	
(ii)	Swaps	-2296	+2296
(iii)	Maturities	+220	-220
(iv)	EC transactions	-	-
(v)	Other Bank customers	-37	-
(vi)	Government		
	(a) departments' expenditure	-344	
	(b) public sector debt interest	-69	
	(c) HMG debt interest	-70	
(vii)	Interest on the reserves	+33	
TOTAL INTERVENTION		+1785	+2076
(viii)	Public sector borrowing under ECS		
	(a) borrowing	+361	
	(b) repayment	-240	
	net	+121	
(ix)	Repayments of HMG assigned debt	-14	
CHANGE IN THE RESERVES		+1892	+2076
3.	End March levels (old valuation)	24,149	2,993

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

March 1987

	Dollars	EMS Currencies ($ million equivalent)
Ireland	+150	-41 DM
Belgium	+163	+1054 DM + 57 Guilders + 6 Swfr
France	+883 + 250 against Yen	+4084 DM
Italy	+37	+612 DM + 27 ECU
Netherlands	-	+36 DM
Germany	+200 against yen	-
Denmark	+320	+1454 DM
Spain	+792	-
Sweden	+2088	-
Norway	-8	-
Switzerland	+25 against Yen	-
Japan	+8533	-
Canada	+1578	-
US	+2395 against Yen -30 against DM	-
Greece	-15	-
Portugal	-	-

+ On a done date basis. UK figures in previous table are on a dealing month basis.

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ERMP C/8

FROM: I POLIN
DATE: 1 April 1987

1. MR KELLY
2. ECONOMIC SECRETARY

Distribution

PPS
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
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Mr Pickford
Mr Ross Goobey

THE RESERVES IN MARCH 1987

The reserves announcement for March will be made on Thursday 2 April at 11.30 am. This month's announcement reports a rise in the reserves of $1892 million and an underlying rise of $1785 million. The annual revaluation of the reserves carried out at end-March gave rise to an increase in the published reserves of $2.9 billion.

Ian Polin

I POLIN

Mr Norgrove - No 10
Mr Lankester - Washington (after publication)

Mr Gill)
Mr D J Reid)
Mr J Milne) - B/E
Mr D J Chetwin)
Mrs Jupp)

4317.3

until 11.30 Thursday 2 April 1987
thereafter UNCLASSIFIED

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DRAFT PRESS NOTICE

THE RESERVES IN MARCH 1987

The UK official reserves rose by $1892 million in March. Accruals of borrowing under the exchange cover scheme amounted to $361 million; repayments of such borrowing amounted to $240 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $14 million. At the end of March, the reserves on the old valuation stood at $24,149 million (£15,054 million*) compared with $22,257 million (£14,392 million+) at the end of February.

2. After the annual valuation the reserves stood at $27,039 million (£16,855 million*) on 31 March.

Note to Editors

3. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during March was $1785 million. The underlying change in the reserves is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

4. New borrowing under the public sector exchange cover scheme was as follows:

> British Coal, $248 million; Anglian Water Authority, $57 million; North West Water Authority, $25 million; North of Scotland Hydro-Electricity Board, $25 million; Civil Aviation Authority, $6 million.

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* When converted at the closing market rate on Tuesday 31 March £1=$1.6042

\+ When converted at the closing market rate on Friday 27 February £1=$1.5465

Repayments of such borrowing were:

> Electricity Council, $112 million; British Coal, $102 million; British Railways, $14 million; British Airways, $5 million; Welsh Water Authority, $2 million; Northumbrian Water Authority, $1 million; Yorkshire Water Authority, $1 million; Other, $3 million.

5. The UK reserves are conventionally revalued once a year at end-March as follows:

   (a) gold (other than that swapped for ecus under the EMCF arrangements) is valued at 75 per cent of the average London fixing prices over the three months up to 31 March, or 75 per cent of the final fixing price on 31 March, whichever is less.

   (b) SDRs and assets in non-dollar foreign currencies are converted to dollar equivalents at the average of the relevant dollar exchange rate over the 3 months up to 31 March, or the actual exchange rate on 31 March, whichever is the less.

The same gold price and exchange rates are then used to value the assets in successive monthly reserves announcements until the next revaluation. Securities are valued at historic cost.