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

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FROM: I POLIN

DATE: 3 May 1988

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Version as amended by the Chancellor and the Economic Secretary

Ian Polin
4/5/88

THE RESERVES IN APRIL 1988

The reserves announcement for April will be made on Wednesday 4 May at 11.30 am. This month's announcement reports a rise in the reserves of \$338 million and an underlying rise of \$514 million.

Ian Polin

I POLIN

Mr Gray - No 10
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DRAFT PRESS NOTICE

THE RESERVES IN APRIL 1988

The UK official reserves rose by $338 million in April. Repayments of borrowing under the exchange cover scheme amounted to $228 million. There was no new borrowing under the exchange cover scheme this month. The valuation change arising out of the quarterly rollover of the EMCF swap amounted to a rise $52 million. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during April, was a rise of $514 million. At the end of April, the reserves stood at $47,857 million (£25,467 million*) compared with $47,519 million (£25,216 million+) at the end of March.

Note to Editors

2. The underlying change 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).

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* When converted at the closing market rate on Friday 29 April £1=$1.8792

\+ When converted at the closing market rate on Thursday 31 March £1=$1.8845

3. There was no new borrowing under the public sector exchange cover scheme this month but repayments of such borrowing were as follows:

> British Coal, $105 million; British Nuclear Fuels plc, $40 million; British Steel Corporation, $32 million; Welsh Water Authority, $28 million; Electricity Council, $9 million; British Rail, $2 million; British Telecommunications plc, $2 million; North of Scotland Hydro Electricity Board, $2 million; Strathclyde Regional Council, $2 million; Dumfries Regional Council, $1 million; Grampian Regional Council, $1 million; Humberside County Council, $1 million; Northumbrian Water Authority, $1 million; Others, $2 million.

4. The quarterly rollover of the EMCF swap, ie 20 per cent of the UK's gold and US dollar reserves, entailed a valuation increase of $52 million. This mainly reflects the appreciation of the dollar against the ECU in the last quarter, as valued by the EMCF. For the purposes of the swap, the EMCF values gold and dollars in terms of ecus at rates determined quarterly, whereas the UK values, gold and ecus held in the reserves on an annual basis.

THE RESERVES IN APRIL 1988 : PRESS BRIEFING

Factual : Main features of markets in April

	5 April (cob)*	Month's High		Month's Low		29 April (cob)*
£ ERI	78.3	78.8	(22nd)	77.4	(14th)	78.4
$/£	1.8802	1.9065	(18th)	1.8400	(14th)	1.8792
DM/£	3.1362	3.1610	(22nd)	3.1145	(14th)	3.1490
$ ERI	92.7	93.5	(13th)	92.1	(20th)	92.7
DM/$	1.6680	1.6935	(13th)	1.6565	(5th)	1.6757
Yen/$	125.12	127.05	(11th)	123.50	(14th)	124.95

*cob = close of business.

Bullish sentiment towards sterling was evident for much of April and, although the upward pressure subsided on precautionary profit-taking ahead of UK trade figures for March, sterling rose sharply upon publication of an improved deficit.

Strong underlying demand over the Easter holiday carried sterling up to $1.8950 in New York on Easter Monday although it subsequently eased but remained firm in cross-rate terms reaching DM 3.1455 on 7 April. A ½% cut in UK base rates on 8 April took the market by surprise. Sterling initially held its ground, but fell to the month's lows on 14 April. Nevertheless, it firmed in the wake of poor US trade figures, and with firmer oil prices it rose to a new six-year high of $1.9065 on 18 April. The publication of worse than expected UK money figures for March caused sterling to firm further, as the market considered they ruled out another cut in UK base rates in the near term. The Chancellor's television interview on 24 April prompted bouts of precautionary profit-taking ahead of the UK trade figures and sterling fell to $1.8725 and DM 3.1235 on the morning of 29 April. However, it quickly recovered much of these losses on news of the improved deficit and ended the month on a firmer note.

ith sterling as the main focus of attention, the dollar was restricted to narrow trading ranges. It began the month nervously, falling to DM 1.6840 and Yen 123.65 on Easter Monday but rumours of central bank intervention and a slight tightening of US interest rates by the Fed lifted the dollar off its lows and it moved up sharply on reports that the G7 meeting on 13 April would set a floor of Y125. Benefiting from growing optimism about the US trade figures for February; from news that Japan's March trade surplus was lower-than-expected and from the general belief that G7 would be supportive of exchange rate stability, the dollar edged up steadily to highs of Yen 127.05 and DM 1.6935 on 11 and 13 April respectively. However, the publication of an increased trade deficit of $13.8bn on 14 April caused it to fall sharply. Concerted central bank intervention steadied the fall, but the dollar dipped to Yen 123.50 on 14 April and DM 1.6570 on 18 April. Increased tension in the Gulf subsequently caused it to rally and it firmed by DM 1.6800 and Yen 125.40 before easing a little amid concern that interest rates in Germany might rise.

Previous reserve changes

(i) At the beginning of January 1987, the reserves stood at $21,923 million; at the end of December 1987, they stood at $44,326 million, a rise of $22,403 million (including effect of 1987 revaluation).

(ii) The underlying rise in the reserves in 1987 totalled $20,475 million.

(iii) Reserve changes from the last calendar quarter of 1987 have been:

		$ million		
		Underlying change	Total change	Level of reserves at end period
1987	October	+ 6,699	+ 6,591	41,399
	November	+ 31	- 118	41,281
	December	+ 3,737	+ 3,045	44,326
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519+
	April	+ 514	+ 338	47,857

+after revaluation

(iv) October 1987 underlying change of $6,699 million was largest ever.

(v) Reserves now ~~stood~~ stands at highest ever level.

Level of official debt

Now stands at $19.1 billion at end December* (latest published figure, Financial Statistics, April 1988, Table 10.6). (In May 1979 was $22 billion.)

*at end December market rates.

POSITIVE

1. Reserves remain very strong after substantial underlying increase of $20 billion in 1987. Reserves now stand at highest ever level of $48 billion.

~~2. Objective remains, as always, battle against inflation.~~

DEFENSIVE

(A) **POLICY**

1. **Exchange rate policy:** As Chancellor said in Budget Speech [See 15 March, OR Vol 129 No 1442 Cols 995-1015.], "exchange rates play a central role in domestic monetary decisions as well as in international policy co-operation". Exchange rate stability will bring advantages to economy. At recent international meetings, UK along with other major industrialised nations reaffirmed commitment to currency stability.

2. **Tactics:** All instruments will be used as and when appropriate. But not sensible to reveal operational details or be more precise.

3. **Exchange rate stability runs counter to anti-inflation strategy?** Not alternative strategy. ~~Normally~~ Most of the time exchange rate stability reinforces anti-inflationary strategy. As the Chancellor said in his interview on 'This Week Next Week' BBC1 on 24 April "we are certainly - and the Prime Minister has said this as well - .... interested in the maximum possible exchange rate stability within the context of sound anti-inflationary policy". As Chancellor told Interim Committee on 14 April, if a conflict between objectives for inflation and exchange rates emerges priority must be given to inflation - but, in practice, this dilemma occurs only infrequently.

Industry's criticism of sterling appreciation? British industry suffering from exchange rate rise? [CBI Council endorsed and wholeheartedly supported Government's commitment to low inflation, 'Financial Times', 14 April. TUC's economic committee claimed, 'Financial Times', 14 April, recent rise in sterling putting 60,000-100,000 jobs at risk. Letter from Director General CBI, in 'Daily Telegraph' 21 April, suggested rise in sterling reduces profits and companies' ability to increase productivity.]

If firms accept financial discipline inherent in Government's strategy and contain their costs, no need for any loss of competitiveness. Greatest threat to output and employment would come if Government relaxed its anti-inflationary stance. Industry has welcomed greater exchange rate stability over past year.

5. **Current account deficit in first quarter suggests exchange rate against deutschemark too high?** Trade figures highly volatile. Given uncertainties about recent figures must wait some months to assess trends. Maintaining competitive position largely in hands of industry. But, as the Chancellor said on 'This Week Next Week' on 24 April, "I certainly do not want to see the exchange rate appreciate further. I think that would be, as I have said on a previous occasion, unsustainable. And an unsustainable appreciation does nobody any good and is damaging for business and industry."

6. **Will Government be prepared to let sterling fall if recent pressures reversed?** Consistently made clear will not allow sterling to depreciate to accommodate excessive increases in domestic costs.

(B) G7

7. **G7 meeting in Washington, 12/13 April.** G7 Ministers and Central Bank Governors had useful discussion. In communique, reaffirmed commitment to continued growth with low inflation: entirely consistent with policies UK has been following.

8. **G7 commitment to exchange rate stability**? G7 expressed renewed determination to coordinate policies to strengthen underlying fundamentals and reinforce conditions for exchange rate stability.

(C) INTERVENTION

9. **Why cut interest rates on 8 April rather than intervene?** ~~Short term interest rates essential instrument of monetary policy~~. Judgement of best course at the time.

10. **Value of intervention as instrument?** ~~Is beneficial~~ Has role to play in preventing unsustainable fluctuations in exchange rates which do not reflect underlying fundamentals.

11. **Prime Minister ruled out further intervention as it is inflationary?** [OR Vol 129 no 110 col 184].

No. Prime Minister argued against excessive intervention: only poses inflationary threat if not funded. Government made clear intervention will be fully funded.

12. **Implication of recent intervention for UK monetary conditions/funding?** Policy to ensure, over time, any net intervention fully funded so that effect on liquidity sterilised. 1987/88 intervention was fully funded, within financial year.

13. **Details of intervention?** Policy never to discuss.

14. **Have other countries been intervening over last month/recently?** Never discuss details but well known there was concerted intervention after US trade figures on 13 April.

15. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, recommended "intervention should not be used to maintain an exchange rate incompatible with underlying economic forces".** Agree exchange rates should reflect fundamentals, as G7 communique on 13 April made clear. Under Plaza Agreement and Louvre Accord, intervention aimed first at achieving this position, then maintaining it. Fluctuations in foreign exchange markets do not necessarily reflect fundamentals.

. **Is intervention profitable?** Intervention undertaken to support exchange rate policy - not primarily to make profit. For intervention to be profitable, authorities would need to sell sterling when firm and buy it back when soft. This is, of course, what tends to happen over longer term. [N.B. See also BEQB, September 1983 pgs 384-391.]

17. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, suggested £1.3 billion loss on intervention in 1987.**

No comment on actual figure.

- Any appreciation of sterling necessarily causes a book loss on reserves, just as any depreciation causes a book gain. Absurd to make book-loss (or gain) calculations over a period as short as a year.

- Gain or loss only realised when intervention unwound.

- Sterling book value of whole of reserves, not just last year's intervention, affected by appreciation or depreciation of sterling. Impossible to say whether last year's intervention has increased total book loss: without intervention sterling might have been higher, and hence book loss on rest of reserves larger.

- TCSC also failed to look at other side of the account - our foreign currency indebtedness. Just as a rise in sterling creates a book loss on the reserves, so it creates a book profit on our foreign currency debt.

18. **Will Government publish data on currency composition of reserves?** No. Long standing practice of successive Governments not to publish details of currency composition of reserves.

[illegible]. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, suggested Government should provide more information about intervention.** Would disclose Government tactics and thus undermine effectiveness of intervention in future. As Chancellor made clear to TCSC, Government perfectly willing to participate in secret inquiry by PAC as in 1979.

(D) **INTEREST RATES/MONETARY POLICY**

20. **Interest rates policy?** As Chancellor said in Budget speech: "Within continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

21. **Monetary policy:** Object of monetary policy to maintain monetary conditions that keep downward pressure on money GDP and hence inflation. Inflation now down to levels of 20 years ago, despite strong and sustained upswing in real growth. Short term interest rates will continue to be held at levels necessary to keep monetary conditions on track. Will not take risks with inflation.

(E) **EXCHANGE RATE MECHANISM (ERM)**

22. **UK membership of ERM?** Matter kept under continual review. Will join when ~~time is right.~~ when Government considers time is right.

23. **Recent interest rates moves would not have been necessary if UK had been in ERM?** ~~Nonsense.~~ Joining ERM would not be soft option. Countries within ERM frequently change their interest rates.

24. **Sterling's rise would not have occurred if UK had been in ERM?** ~~Not at all.~~ Countries within ERM not protected from realignments.

25. **Join ERM by 1992?** [Secretary of State for Trade and Industry reported to have said to conference launching DTI Single European Market campaign on 18 April that when single market comes into being, time for full UK membership of EMS might have arrived.] Lord Young made clear he suspected that by 1992, time would be ripe for UK to join, but that he was not making forecast.

26. **Proposals for Central Bank of Europe?** Finance Ministers who have put forward these proposals have recognised they are very much for longer term. Immediate priority is to achieve liberalisation of capital movements throughout Community.

(F) EUROPEAN MONETARY COOPERATION FUND (EMCF) SWAP

27. **What is the EMCF swap?** As a member of the EMS, the UK is required to put at the disposal of the European Monetary Co-operation Fund 20% of its gold holdings and 20% of its gross dollar reserves in return for the right to use an equivalent value of ECUs. Each of these swaps is for three months at the end of which the swap is unwound and a new one (with whatever quantities of gold and dollars then comprise 20% of its total holdings) is entered into.

28. **Why is valuation adjustment necessary?** Because of different valuation practices by UK and EMCF. UK revalues its assets only once a year (at end March), but EMCF values dollars and gold at prices based on current market values. EEA will therefore provide gold and dollars at its own valuation; will receive ECU to an equivalent value at current exchange rates but which will be held in the EEA at the EEA's own valuation rate. But valuation difference which arises does not represent loss (or profit) since EEA's underlying holdings of gold and dollars are unchanged when swap expires; adjustment made purely for accounting purposes. EEA continues to earn dollar income in underlying dollar assets. April change of $52 million represents valuation difference on January's swap less valuation difference on new swap undertaken in April.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month		Level at end of month
USA	+ 0.1	(end March)	43
Japan	+ 1.1	(end March)	85
Germany	Negligible	(w/e 23 April)	60
France	+ 1.3	(end March)	70
Italy	- 1.9	(end March)	61
Canada	+ 2.1	(end March)	13
United Kingdom	+ 0.~~5~~3	(end April)	48

Notes

1. The figures for Germany, France and Italy were originally published in local currencies; they have been converted to dollars at appropriate exchange rates.

2. Figures not strictly comparable because of different valuation conventions for eg gold.

FROM: J W GRICE

DATE: 10 May 1988

MISS GOODMAN

cc Mr Peretz
Miss O'Mara
Mr Conaty
Mr Nelson

File: MAMC D2

GOLD AND RISK REDUCTION

You will have seen Mr Conaty's minute to me of 6 May, which I am giving a slightly wider circulation.

2. I think that the essential point is that an asset, whose return is risky in its own right, may still have a role to play in reducing the overall risk of our Reserves portfolio if its rate of return is not perfectly correlated with that on the other assets in the portfolio. This is, indeed, the argument for diversification. Whether gold serves such a purpose or not is an empirical question. The answer depends both upon:

(i) how great the variability of its return is relative to that on alternative assets;

(ii) how much less than perfectly correlated is its rate of return with that on other assets.

The answer will depend upon the accounting currency that we are interested in. Assets which reduce risk valued in one currency may not do so when valued in a different currency or basket of currencies.

3. Nevertheless, Mr Conaty's paper shows that either in dollars or SDR terms, gold has little or no role to play in reducing risk. Its lack of correlation in return with that on other assets has not been sufficient to outweigh its own relatively high variability of return. The conclusion must be, therefore, that the decision to continue holding gold in our Reserves must be on grounds other than ones of diversification.

JWG

91/G.LCLD.4513.016

FROM: M CONATY

DATE: 6 May 1988

MR GRICE

cc Ms Goodman

You asked me to look at the proportion of our resources which should be held in gold, if our objective was to minimise risk.

2. The risk involved in holding an asset can be measured by the variability (measured in standard deviations) of its rate of return. As the table below shows the variability of the return on gold is significantly larger than that on dollar, yen and Deutschmark assets.

STANDARD DEVIATIONS OF RATES OF RETURN

	1968Q2-1987Q4	1972Q2-1987Q4	1982Q4-1987Q4
Dollar Asset	.6	.7	.7
DM Asset	5.9	6.4	6.0
Yen Asset	-	7.1	7.1
Gold	14.2	13.0	16.3

- the dollar, DM and Yen assets, are bank deposits paying the 3 month interbank rate. All assets are valued in dollars. Rates of return are calculated quarterly and expressed as percentages.

3. As intervention is not aimed exclusively at influencing the dollar/sterling exchange rate, nor do we trade solely with the US, an SDR valuation is probably more appropriate for calculating the variability of rates of return. The following table shows the variability of SDR rates of return, it can be seen that the above conclusion still holds.

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STANDARD DEVIATION OF RATES OF RETURN (SDR VALUATION)

	1968Q2-1987Q4	1972Q2-1987Q4	1982Q4-1987Q4
Dollar Asset	3.0	3.7	3.5
DM Asset	3.9	3.3	3.5
Yen Asset	-	4.7	4.0
Gold	13	11.6	6.7

The variability of the rate of return on a portfolio of assets is not simply the sum of standard deviations of the component assets. This is because the movements in one direction in the return on one asset may be offset by movements in the opposite direction by the return on another asset. Therefore although the return on the two assets may move about a lot, they may tend to cancel each other out so that the overall return on the portfolio is fairly stable. Therefore when considering how to reduce the variability of the return on a portfolio of assets, the degree to which the return on individual assets tend to move in opposite directions is very important. This can be measured by the correlation coefficient between two assets. If this is equal to one, it means the returns always move together, ie when one goes up, so does the other and vice-versa. If it equals minus one, it implies that the rates of return on the two assets always moves in opposite directions. Therefore if a portfolio contains two assets and the objective is to minimise risk, the closer the correlation coefficient is to minus one the better.

4. The largest single group of assets in the reserves are those denominated in dollars. So when deciding which other assets to include to reduce risk, it is the correlation coefficients between those assets and the dollar that are important.

CORRELATION BETWEEN DOLLAR AND NON-DOLLAR ASSETS

DATE	**1968Q2-1987Q4**		**1977Q2-1987Q4**		**1982Q4-1987Q4**	
Valuation:	SDR	Dollar	SDR	Dollar	SDR	Dollar
DM Asset	- 43	- 24	- 77	- 35	- 82	- 23
Yen Asset	-	-	- 47	- 35	- 62	- 27
Gold	- 23	- 12	- 25	- 12	- 19	- 16

- the figures given are the correlation coefficient (%) between the dollar asset and the asset shown in the left hand column. The first figure for each period is based on an SDR valuation the second on a dollar valuation.

It can be seen from the table that gold is less negatively correlated with dollar assets than either Deutschmark or yen assets. Hence diversification into gold is the least effective way to reduce risk.

5. The above information on standard deviations and correlation coefficients can be used to derive the minimum risk portfolio (ie the portfolio for which the variability of its return has been minimised). The table below shows the minimum risk portfolios corresponding to standard deviations and correlation coefficient calculated over three different periods.

MINIMUM RISK PORTFOLIOS

(A) Dollar Valuation

ASSET:	1977Q2-1987Q4	1982Q4-1987Q4
DOLLAR	95.2	96.7
DM	3.1	5.3
YEN	2.0	- 3.5
GOLD	- .2	1.5

(B) SDR Valuation

ASSET:	1977Q2-1987Q4	1982Q4-1987Q4
DOLLAR	44.5	48.4
DM	39.9	39.4
YEN	14.3	12.6
GOLD	.1	- .4

- figures show weighting (as %) that each asset should have in the portfolio

6. It is clear from these figures that gold has a negligible role to play in risk reduction. It should be noted that when looking at risk and return the relevant portfolio is not just the gold and foreign currency reserves, it also includes foreign currency liabilities. The appropriate way to manage this portfolio is to match assets and liabilities within a currency, to form a portfolio of net assets (or liabilities). It is then this portfolio of net assets to which the minimum risk weightings should be applied.

M CONATY

FROM: J W GRICE

DATE: 20 May 1988

MISS GOODMAN

cc Mr Peretz
Miss O'Mara
Mr Ilett
Mr Batt
Mr Courtney
Mr Savage
Mr Conaty
Mr Nelson

File: MAMC D2

GOLD

I enjoyed reading your redraft of this paper. I have only a couple of minor points:

(a) (very minor) I think paragraph 4 got slightly carried away with the description of the advantages of the noble metal. It certainly isn't indestructible: on the contrary, because it is remarkably soft the metal is constantly being worn away. A major problem for dealers is the irrecoverable sheddings of gold dust each time bullion is handled. It is also rather heavy so that its mobility is much lower than many financial assets;

(b) in the section on earnings, I was surprised that we do not discuss - or for that matter, evidently, already undertake - operations in options. Since we are generally bearish about the outlook for the price, our obvious strategy is to write call options against some small part of our holdings. Such options are traded in fairly large volume on Comex, in Philadelphia, and on the Amsterdam Stock Exchange. There would obviously be a limit to the amount of business of this kind that we could undertake, but nevertheless we should be able to make a few million pounds a year on it.

J W GRICE