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

Reference MG-MAMC/D/0002/001

File begins 03/05/1988

Pages 61-80

b) EUROPEAN MONETARY INTEGRATION

24. **UK membership of exchange rate mechanism (ERM)?** [Sir Nicholas Goodison, Chairman of Stock Exchange, called on 27 May in speech to Royal Institute of International Affairs, for Government to join ERM immediately, as did National Institute Economic Review, May 1988.] As Prime Minister made clear in answering questions in House on 17 May, matter kept under continual review. Will join when Government considers time is right.

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

26. **Sterling's recent rise would not have occurred if UK had been in ERM?** Countries within ERM not protected from realignments.

27. **Join ERM by 1992?** No timetable. Will join when time is right.

28. **Proposals for Central Bank of Europe and common European currency?** [Chancellor said at Conservative Women's Conference, 24 May, difficult to see development of European Central Bank and European currency .... would mean end of independence in economic policy. UK wants to see more development on financial plane: development of common currency already in existence (ecu) and more cooperation in Europe. Not worth pursuing visionary ideas where even those advancing them are not sure of what they mean.] 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. Making swift progress under German Presidency.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month		Level at end of month
USA	- 0.4	(end April)	43
Japan	+ 1.9	(end April)	87
Germany	Negligible	(w/e 13 May)	60
France	- 1.0	(end April)	69
Italy	- 1.9	(end March)	61
Canada	+ 1.1	(end April)	14
United Kingdom	+ 0.7	(end May)	48½

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.

(A) <u>EXCHANGE RATE POLICY</u>

D2

1. **Exchange rate policy:** Both the Prime Minister and Chancellor have made the Government's position perfectly clear on a number of occasions. Nothing to add.

2. **Tactics:** As Prime Minister reminded House on 17 May, all instruments - interest rates and intervention - will be used as seems right in circumstances. But not sensible to reveal operational details or be more precise.

3. **Exchange rate stability runs counter to anti-inflation strategy?** Not alternatives. As Chancellor told Interim Committee of International Monetary Fund (IMF) on 14 April, if conflict between objectives for inflation and exchange rates emerges, priority must be given to inflation - but, in practice, this dilemma occurs only infrequently, and over the medium term, exchange rate stability <u>reinforces</u> anti-inflation strategy.

4. **Continuing confusion over Government's exchange rate policy?** No. Remarks by Prime Minister in House on 17 May, in conjunction with Government actions, clearly demonstrate agreed Government policy of seeking greater exchange rate stability within context of firm monetary policy designed to ensure steady downward pressure on inflation.

5. **Government pushed around by market?** No. As Prime Minister said on 17 May "it would be a great mistake for any speculator to think at any time that sterling was a one way bet". Events have proved her right.

6. **Sterling shadowing deutschemark**? Exchange rate against deutschemark important to industry given proportion of UK trade with EC (50%), so Government naturally pays attention to it.

7. **Is government operating a floor at DM3.08 [or any other level?]** Not helpful to talk about any particular level. But Government has made it clear on numerous occasions that it will not accommodate inflationary pressures through excessive depreciation of sterling.

8. <u>**Falling pound increases inflationary pressures**</u>? No. Overall tightness of monetary policy remains appropriate for exerting downward pressure on inflation. Helpful move towards better mix authorities indicated was appropriate.

9. <u>**High exchange rate destroys competitiveness**</u>? Maintaining competitive position largely in hands of industry. But reasonable degree of exchange rate stability desirable.

10. <u>**April current account deficit suggests exchange rate against deutschemark too high**</u>? No difficulty in financing temporary period of current account deficit. Up to industry to maintain its international competitiveness by containing its costs.

11. <u>**CBI May monthly trends survey [published 31 May] attributes weakening export order books to recent strength of sterling**</u>

British exporters continue to do well in world markets, but have to contain their costs including wage costs.

12. <u>**Will Government be prepared to let sterling fall if recent pressures reversed?**</u> Never comment on market tactics. Have consistently made clear will not accommodate excessive increases in domestic costs by sterling depreciations.

13. <u>**G7 meeting in Washington, 12/13 April**</u>. 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.

(B) <u>INTEREST RATES</u>

14. <u>**Interest rate policy?**</u> 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."

15. <u>**Why raise interest rates on 2 and 6 June**</u>? Decided it was appropriate to tighten monetary conditions a little.

16. **Why move twice in quick succession? Why not a full 1% all at once? Exchange rate not very different from then.** Interest rate movements are normally ½ (12 out of last 13), and exchange market conditions changed very suddenly at the beginning of June: it was only sensible to see how conditions developed.

17. **Future movements in interest rates** Never speculate.

18. **Why defend present high level of sterling which is damaging industry?** If firms accept financial discipline inherent in Government 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.

19. **Government applies formula whereby interest rates moved by 1 per cent for each 4 per cent opposite change in exchange rate?** No. Interest rate decisions taken within continuous and comprehensive assessment of monetary conditions, taking all evidence into account. Exchange rate a key indicator of monetary conditions, but not the only factor.

20. **Interest rate increases will damage industry.** Industry has far more to fear from resurgence in inflation. 1% increase in interest rates, even if sustained for a full year, only adds to costs quarter of amount 1% increase in wage settlements adds.

21. **Combination of high exchange rates and low interest rates not ideal; Government move to remedy this?** Government's objective is to maintain reasonable exchange rate stability within context of overall anti-inflationary policy.

22. **UK's real interest rates out of line with competitors?** No. Deflating current three month money rates by recent price indices suggests UK only just above G7 average.

23. **Interest rate increase will damage industry.** Industry has far more to fear from resurgence in inflation. 1% increase in interest rates, even if sustained for a full year, only adds to costs quarter of amount 1% increase in wage settlements adds.

Economy overheating?

- If anything, latest figures from real economy show some slight slowing in growth (though indicators are mixed). CBI quarterly survey shows "few signs of overheating".

- Judgement must take account of whole range of factors including effect of exchange rate on monetary conditions.

- Experience of number of years shown that high rate of growth of lending and liquidity consistent with lower inflation because increased liquidity willingly held ie held as savings rather than for spending.

- No signs of resurgence of inflation.

25. **Consumer credit boom?**

- No evidence that rate of lending to consumers accelerating in recent months: 12 month growth rate close to its average since 1982 of 18 per cent. (Some credit simply displacing cash and cheque payments - over 40 per cent of credit card users pay no interest.)

- Vast bulk of personal borrowing takes form of mortgages which represented 2/3 of outstanding personal debt at end of 1987. Mortgage lending accounts for almost half of all of bank and building society lending. Increase overall as percentage of GDP in 1980s mainly attributable to growth in mortgage borrowing, as result of 2½ million increase in households buying own home.

- Consumer credit only 15 per cent of total personal debt. Less than 5 per cent of personal debt takes form of credit card lending (including interest-free component).

(c) EXCHANGE RATE MECHANISM (ERM)

26. **UK membership of ERM?** As Prime Minister made clear in answering questions in House on 17 May, matter kept under continual review. Will join when Government considers time is right.

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

28. **Sterling's rise would not have occurred if UK had been in ERM?** Countries within ERM not protected from realignments.

29. **Join ERM by 1992?** See 29 above.

30. **Proposals for Central Bank of Europe?** Most of those 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.

31. **Now that agreement reached on Capital Liberalisation Directive at ECOFIN, 13 June - UK membership of ERM more likely?** See 26 above.

1 Mr. Williams
2 Mr [illegible]
see over. [illegible]

M. Nelson
Cd you answer & PL? NHW 12/7

Mr Williams
Did anything ever happen to this? It looks more like NEDC than normal briefing material MOM 11/7

Mr Nelson
I agree this is too dated! MOM 12/7

Bcm.

FROM: M H WHEATLEY
DATE: 8 June 1988

MR NELSON

cc: Miss O'Mara O/R
Mrs Ryding O/R
Mr Williams O/R

Mr. Wheatley.
see over and Miss O'Mara's comment
PL. 13/7

EXCHANGE RATES AND EXPORTING COMPETITIVENESS: PAPER BY BOTB

I have obtained a copy of the paper by the British Overseas Trade Board entitled "Into Active Exporting". It is an edited version of a research study carried out for the BOTB by Graham Bannock and Partners, largely based on a postal questionnaire survey and interviews with smaller and medium sized manufacturing companies. It contains some material which I think we could usefully include in our briefing lines on competitiveness and the exchange rate.

2. A breakdown of reasons for not exporting reveals that only 11.1% of firms quoted reasons for not exporting which could be attributed to the strength of sterling (that exporting was unprofitable or that there was a lack of export demand). Of course, neither of these two reasons is necessarily attributable to the strength of sterling. In discussing price competitiveness, the report argues "that the influence of exchange rates on exports has been overstated in the past and the importance of quality, design and service neglected. Countries with continuously appreciating currencies like Germany and Switzerland have not found their parities an obstacle to increasing exports. As so often in economic questions, the direction of causality between export success and exchange rates is not obvious and other factors, notably capital movements, play a role in determining both." In its conclusions, the paper states "our study and other considerations do not suggest that exchange rates or other aspects of price competitiveness are critical barriers to bringing more firms into active exporting, particularly among smaller firms operating in niche markets where product characteristics and service are of prime importance".

9/202

3. My suggestion for a briefing line on this is as follows:-

"Study of exporting prepared for British Overseas Trade Board suggests that influence of exchange rates on exports has been overstated and importance of quality, design and service neglected. Exchange rates not critical barriers to bringing more firms into active exporting."

4. I attach our copy of the report (for you only).

MHW

M H WHEATLEY

The report, I would suggest, is not that useful. It was published in April 1987, from material gained in a survey carried out during the course of 1985. ~~I think the report's conclusion that it~~ I suppose this just reinforces, retrospectively so to speak, the line we've taken that cost isn't the only or the major consideration in export success. But that's not simply true for exports, the consumer movement generally has shifted people's attention from cost alone to value for money.* I frankly see little point in BOTB publishing material based on 2 year old evidence.

[signature] 12/7.

Pike

FROM: T PIKE

DATE: 17 June 1988

20/6

MR PERETZ

cc Mr Grice

COUNTY NATWEST: EXCHANGE RATE/INTEREST RATE TRADE-OFF CHARTS

You asked to see a chart comparable to the County Natwest Chart, using the DM/£ rate. Mr Grice also asked for a chart using the oil adjusted exchange rate. These are attached.

2. Both charts show a fairly poorly defined relationship between base rates and exchange rates post-Louvre, with the points generally scattered away from the regression line. The charts imply that a change in base rates of one point is equivalent to a change in the DM/£ rate of 12½ pfennigs and a change in the oil adjusted rate of 7 percentage points. (Both charts also show that current interest/exchange rates are 'above the line', although not very much.)

T. Pike

T PIKE

Not conclusive proof

Mr Scholar

You may be interested to see. (The charts of course show what we have done rather than what we ought to do.

20/6

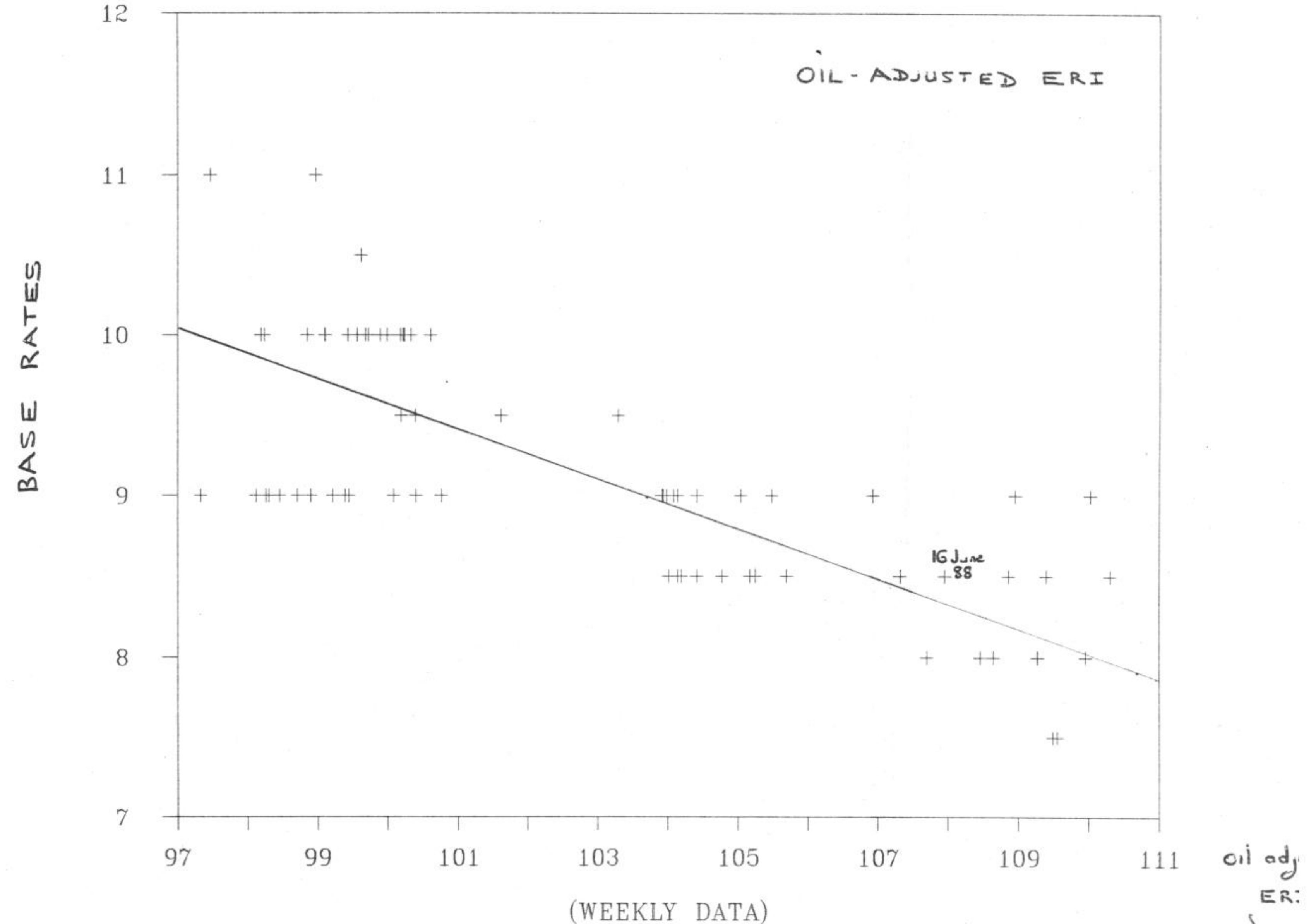
cc Sir P Middleton
Sir T Burns
Miss O'Mara
Mr Grice
Mr Pike } this page.

EXCHANGE RATE/INTEREST RATE TRADE-OFF

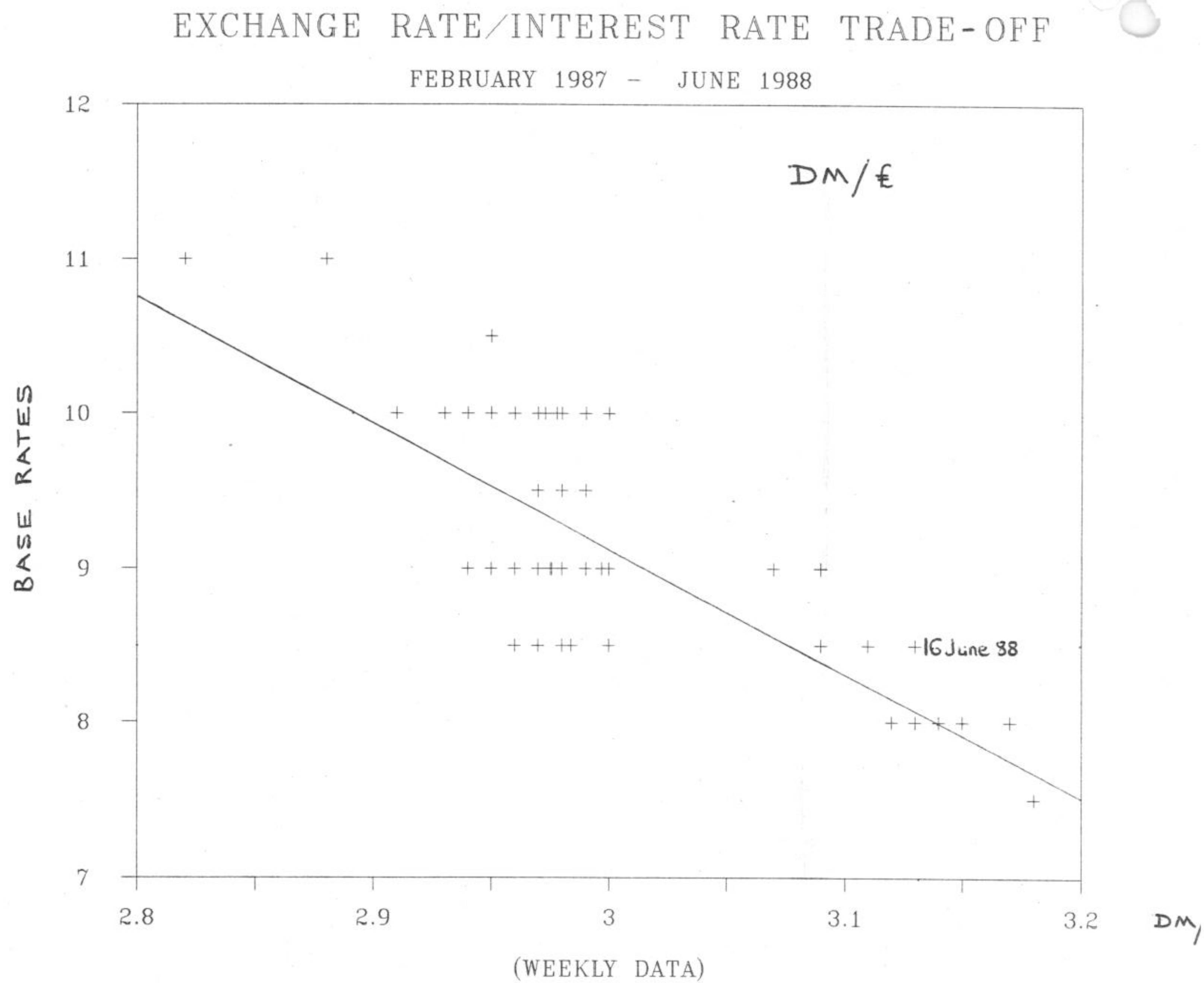
FEBRUARY 1987 - JUNE 1988

NOTE:

1 base rate point
= 7 percentage points
on oil adjusted ERI



NOTE:
1 base rate point
= 12½ pfennigs



2

Money Rates

- Downward pressures on sterling have seen a partial reversal of earlier cuts in short rates.
- The authorities deny a mechanical link between sterling and interest rate decisions. But recent experience points to a 1 point change in rates for each 4½% currency shift.
- Other monetary indicators continue to signal the need for tight policy, in particular M0 and house prices.
- The international background is unlikely to improve, with US rates rising to 8¾% by the year end.

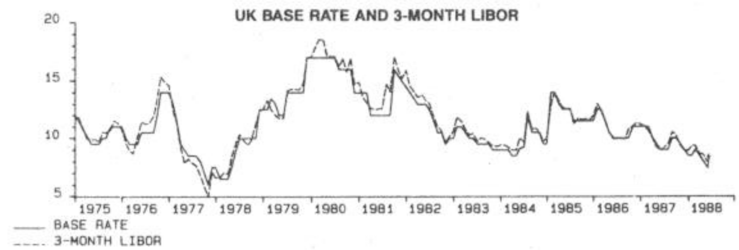
Recent trends: Another surge in sterling, encouraged by better-than-expected trade figures and bullish press comment, saw a further ½% cut in base rates – to 7½% – on 17th May. Subsequently, sterling has fallen out of favour (as analysed on pp 4-5) leading to two ½% reversals, base rates rising to 8%, on 2nd June and 8½% on 6th June. Although the authorities have denied any mechanical link between sterling and interest rate decisions the experience over the past few months suggests otherwise:

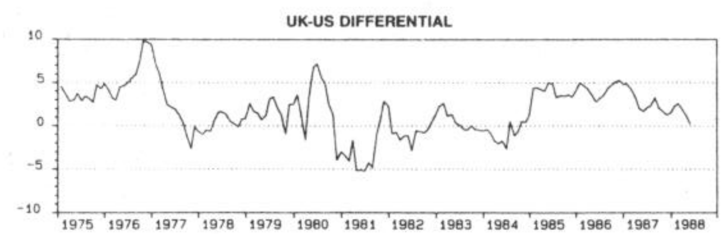
	Base rate change	(Level)	Previous day's exchange rate close DM/£	ERI
1st February	+ ½%	(9%)	2.968	74.3
17th March	– ½%	(8½%)	3.085	77.4
8th April	– ½%	(8%)	3.133	78.1
17th May	– ½%	(7½%)	3.192	79.2
2nd June	+ ½%	(8%)	3.153	77.3
6th June	+ ½%	(8½%)	3.102	76.2

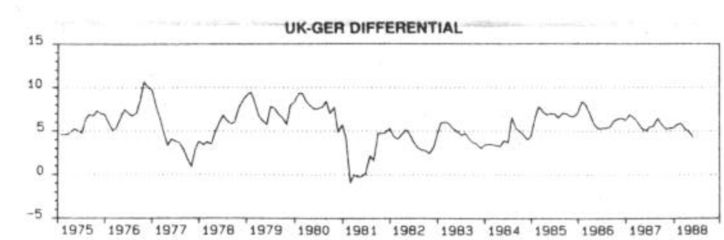
Since the Budget, each 4-6 pfennig change in the DM/£ rate has brought with it a ½% change in interest rates. Taking average % changes (and ignoring signs) the experience since February suggests an exchange rate/interest rate formula of 4% currency shift = 1 percentage point change in base rate.

The chart opposite considers a longer time horizon (the last 15 months) during which exchange rate "stability" has been practised more openly. The authorities' implicit "reaction function" is calculated by taking a best fit line of weekly observations of the exchange rate index and base rates. The ERI is still considered as the most appropriate exchange rate indicator given the occasional tendency for bilateral rates to give misleading signals. For example, the DM/£ rate was understating sterling's demise at the end of May since the German currency itself was generally weak.

What the tradeoff chart shows is that, on average, a 4¾% change in the ERI leads to a 1 percentage point change in base rates. However, around the







14

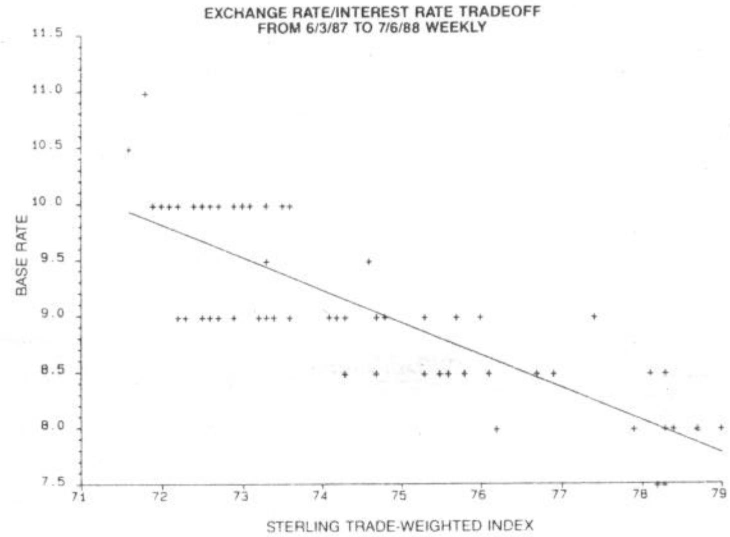
"central case" is clearly a tolerance zone which enables the authorities to keep the markets guessing, at least for the short term. At the time of writing the sterling index was 76.2 which, on this type of analysis, suggests a base rate of 8 – 9%, with the "central case" being 8½%.

Monetary conditions: Recent debate has tended to centre on the exchange rate as the key determinant of the authorities' interest rate decisions. Certainly the analysis above does not contradict such a view. But, as the authorities are often at pains to tell us, monetary conditions have to be assessed by reference to a wide range of factors – not just the exchange rate.

As the table opposite shows the domestic monetary indicators are giving mixed signals. Narrow money (M0) has accelerated over the past 3 months whereas broad money growth (M4) has slowed down. However, the balance is tipped towards the cautious side by house price inflation (which has leapt further upwards) and the surge in commodity prices. Moreover, as argued in this month's feature article, the M0 warning signal should not be lightly dismissed.

On the basis of this evidence interest rates should be higher than suggested by the exchange rate trade-off line illustrated below. In other words, given that other indicators are, on balance, flashing amber it would be appropriate for the authorities' interest/exchange rate "reaction function" to shift upwards and to the right in order to secure an inflation-neutral regime (indeed, given the Government's long-term objective of zero inflation, it would make sense to bias action towards "over-tightening").

Interest rate outlook: Recent events have been broadly consistent with our expectations and we have not made any significant changes to our interest rate forecasts (although, please note that our tables now relate to period averages, rather than end period, for purposes of consistency with other County NatWest publications). US interest rates are expected to move further upwards with German and Japanese rates showing relatively little change (though with an upward bias as 1989 approaches). This background, together with a further moderate weakening of sterling, should see base rates average 9½% in the second half of the year, with 10% an interim possibility.



Interest rate forecasts

Period averages		*Base rate*	*3 month interbank*	*$*	*3 month euros DM*	*Yen*
1985		12.3	12.2	8.4	5.4	6.6
1986		10.9	11.0	6.8	4.6	5.0
1987	Q1	10.8	10.6	6.4	4.2	4.2
	Q2	9.4	9.2	7.2	3.8	4.0
	Q3	9.6	9.8	7.2	3.9	4.3
	Q4	9.2	9.2	8.0	4.1	4.4
1988	Q1	8.8	9.0	7.0	3.4	4.2
	Q2	8.0	8.5	7.5	3.5	4.1
	Q3	9.5	9.6	8.3	3.6	4.5
	Q4	9.5	9.4	8.7	3.6	4.8
1989	H1	9.0	9.0	8.5	3.8	4.8
	H2	8.5	8.5	8.3	3.5	4.8

Monetary conditions

	6 mths ago	*3 mths ago*	*Latest*
M0	5.5%	4.8%	5.9%
M3	22.4%	22.4%	19.3%
M4	15.8%	16.6%	15.9%
Sterling Index	75.8	76.8	76.2
FT All-Share Index	845	928	935
House Price Inflation	15.2%	16.9%	22.0%
Short rates	8.8%	8.9%	8.8%
Long yields	9.6%	9.1%	9.1%
Commodity prices (Economist SDR industrials index)	114.0	132.7	156.0

75

FROM: I POLIN

DATE: 1 July 1988

1. MISS O'~~MARA~~ mom 1/7
2. ECONOMIC SECRETARY

1. Mr ~~Pike~~
2. MAMC : ? D2

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THE RESERVES IN JUNE 1988

The reserves announcement for June will be made on Monday 4 July at 11.30 am. This month's announcement reports a fall in the reserves of $14 million and an underlying rise of $84 million.

Ian Polin

I POLIN

Mr Gray - No 10
Mr Cassell - Washington (after publication)

Mr Foot)
Mr D J Reid)
Mr J Milne) - B/E
Miss J Plumbly)
Mrs Jupp)

16

DRAFT PRESS NOTICE

THE RESERVES IN JUNE 1988

The UK official reserves fell by \$14 million in June. Accruals of borrowing under the exchange cover scheme amounted to \$56 million; repayments of such borrowing amounted to \$154 million. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during June was a rise of \$84 million. At the end of June, the reserves stood at \$48,519 million (£28,449 million*) compared with \$48,533 million (£26,374 million+) at the end of May.

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 Thursday 30 June £1=\$1.7055

\+ When converted at the closing market rate on Tuesday 31 May £1=\$1.8402

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

British Nuclear Fuels PLC, $56 million.

Repayments of such borrowing were:

British Coal, $103 million; British Telecommunications PLC, $18 million; Electricity Council, $9 million; British Nuclear Fuels PLC, $8 million; North West Water Authority, $5 million; British Steel, $2 million; Strathclyde Regional Council, $2 million; Anglian Water Authority, $1 million; British Railways Board, $1 million; Fife Regional Council, $1 million; North of Scotland Hydro Electricity Board, $1 million; South West Water Authority, $1 million; Others, $2 million.

THE RESERVES IN JUNE 1988 : PRESS BRIEFING

Factual : Main features of markets in June

	1 June (cob)*	Month's High		Month's Low		30 June (cob)*
£ ERI	77.3	77.9	(1st)	74.7	(27th)	75.2
$/£	1.8255	1.8380	(1st)	1.6950	(27th)	1.7055
DM/£	3.1526	3.1745	(1st)	3.0930	(27th)	3.1044
$ ERI	93.8	97.7	(30th)	93.4	(8th)	97.7
DM/$	1.7270	1.8285	(27th)	1.7100	(7th)	1.8202
Yen/$	125.25	133.95	(30th)	124.75	(10th)	133.77

*cob = close of business.

The mood towards sterling became distinctly bearish at the beginning of June but confidence was partly restored by two increases in base rates (on 2 and 6 June). The pound initially bore the brunt of return flows to the dollar in the wake of better-than-expected US trade figures published on 14 June, but continued to be underpinned by the high level of UK interest rates and rose to DM3.1480 on 22 June when base rates were increased by a further 1/2%. UK trade data were much worse than expected and the pound dipped sharply following their publication on 27 June, reaching the month's lows before making a brisk recovery in anticipation of a further rise in UK base rates. The market was initially disappointed with the 1/2% increase announced on 28 June, but concluded a further rise could be expected in the wake of the increase in the Bundesbank's discount rate and sterling ended the month on a steadier note.

Although the dollar benefited from the weakness of sterling at the beginning of the month, its advance was restricted by press reports of large sales of dollars by the Bundesbank. A feeling developed that central banks did not wish to see the dollar move higher and, as a result, it drifted back to the month's lows in spite of a statement by Greenspan that a further decline would be harmful for US trade performance. The dollar advanced strongly on the significant improvement in the US trade deficit published on 14 June and reached the month's highs on 27 and 30 June, ending the month bullishly.

Previous reserve changes

(i) At beginning of January 1987, reserves stood at $21,923 million; at end of December 1987, they stood at $44,326 million, a rise of $22,403 million (including 1987 revaluation of + $2,879 million).

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

(iii) Reserve changes from beginning of 1988 have been:

			$ million	
		Underlying change	**Total change**	**Level of reserves at end period**
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519+
	April	+ 514	+ 338	47,857
	May	+ 814	+ 676	48,533
	June	+ 84	- 14	48,519

+after revaluation of + $2,879 million.

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

(v) Reserves peaked in May at $48,533 million.

Level of official debt

Now stands at $17.6 billion at end March* (latest published figure, Financial Statistics, June 1988, Table 10.6). (In May 1979 was $22 billion.)

*at end March market rates.

POSITIVE

1. Reserves remain very strong after substantial underlying increase of $20 billion in 1987. Reserves now stand at $49 billion, just below highest ever level seen last month.

2. Level of official debt has been reduced substantially. At beginning of 1987 was $19.3 billion and at end of March 1988 was $17.6 billion. (In May 1979 was $22 billion.)

DEFENSIVE

(A) **POLICY**

1. **Exchange rate policy:** Government maintaining firm monetary policy to ensure downward pressure on inflation. Exchange rate policy is part of total economic policy. Government uses available levers, both interest rates and intervention, to affect rate as seems right in circumstances.

2. **Exchange rate stability runs counter to anti-inflation strategy?** Not alternative strategy. Most of time exchange rate stability reinforces anti-inflationary strategy. As Chancellor told Interim Committee of International Monetary Fund (IMF) on 14 April, if conflict between objectives for inflation and exchange rates emerges, priority must be given to inflation - but, in practice, this dilemma occurs only infrequently, and over medium term, exchange rate stability reinforces anti-inflationary strategy.

3. **Has sterling passed its peak?** As Prime Minister told House, 17 May (OR Vol 133 No 152 cols 794-798) ".... it would be a great mistake for any speculator to think at any time that sterling was a one way bet."

4. **Recent gyrations in exchange rates show impossible to achieve genuine stability?** Government's main priority is to bear down on inflation. Within context of anti-inflationary strategy, policy remains to seek to achieve reasonable exchange rate stability.