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From : D L C Peretz
Date : 27 January 1988

SIR G LITTLER

cc Miss O'Mara
Mr Grice
Ms Goodman

INVESTMENT OF THE RESERVES

I attach a draft letter to send to Mr George, recording the decisions reached at your meeting on 15 January.

D L C PERETZ

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~~DRAFT~~ LETTER

FROM : SIR G LITTLER

TO : MR E A J GEORGE
Executive Director
Bank of England

INVESTMENT OF THE RESERVES

We discussed your six-monthly review paper of 15 January at my meeting on 20 January, and I am writing to confirm the decisions we took. A more detailed note of the meeting will be circulated later.

2. We agreed that it was sensible to plan on the basis that the dollar was likely to fall further, with movements probably more sudden and sharp than the smooth progression projected in the forecasts. I agreed with your suggestion that the yen may well rise less than the DM. In the light of this we agreed your proposal that, at current exchange rates or if the dollar were to strengthen, and depending on market conditions, we should switch dollars first into yen and then a further amount into DM, up to a total of between $½ billion and $2 billion. As you say in paragraph 20 of your paper, the scope for achieving this is likely to be circumscribed by political considerations, and we must take advantage of whatever opportunities arise to move in the desired direction.

3. We also agreed that if and when the dollar fell below DM 1.55 and Y 120 you should begin to lengthen the dollar position, and be prepared to switch progressively larger

amounts at rates below those levels within a ceiling of $1 billion.

4. We agreed that you should acquire a French franc bond portfolio as proposed in paragraph 39; and, as circumstances allowed, acquire further ecu deposits.

5. We also agreed to do what we can to reduce further the exposure to bank risk, although the position has already improved somewhat since the end of 1987. It would help in this respect if we were to decide to call the $2½ billion FRN this October, and thereby reduce our gross dollar holdings. You explained that at present this looked like the right decision to make on cost grounds. Although a final decision need not be made until the summer, we agreed it would be sensible to consult the Chancellor in the late spring, at the same time as taking his mind again on the proposal for a sovereign note programme.

6. You explained that the yield gap between US Treasuries and bank deposits was greatest at short maturities, so that to the extent you switch out of dollar bank deposits it might be sensible to buy longer maturity Treasury bills. That apart, we agreed that at current yields you should seek to reduce the EEA's overall short position in fixed interest markets, principally by lengthening the long position in DM markets, as envisaged in paragraph 43 of your paper. If yields rise sharply we should be prepared to increase interest rate exposure further, and if they fall sharply we

should reduce interest rate exposure, as proposed in paragraph 45.

7. I said I hoped to let the Chancellor have a note shortly about our gold holdings, on the basis of the draft that was prepared some months ago, once this has been updated.

8. We discussed how best, and when, to approach the Germans about whether or not they envisaged their new withholding tax would apply to sovereign holders. We agreed that as a first step we would ask the Bonn Embassy to let us have details of what the current proposals are. If necessary, I will have a word later on with Tietmeyer, if that seems appropriate.

We have done this, taking advantage of a visit to London by Adrian Thorpe from the Embassy.

9. Finally, we touched on two other points not covered by your paper :-

i) we agreed that we need to develop better measures of profitability and changes in value of the reserves, in sterling terms. You said it would take some time to incorporate anything sophisticated into the EEA computer system. We agreed to see what could be done in advance of that. Messrs. Foot and Page are to give urgent thought to this, and will discuss with us what would be sensible and feasible.

ii) as I told you, we have had an informal approach from the NAO about the way the EEA accounts are

certified at present. We discussed various possible changes in the arrangements, agreeing that it was in any case too late for any changes to be made to apply to the 1987-88 accounts. We are due to have a further word about this next week, after which we in the Treasury will explore further with the NAO precisely what they are looking for.

THE RESERVES: SIX MONTHS TO END- DECEMBER 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) at current or higher exchange rates for the dollar, a further diversification when conditions allow, of between $½ bn and $2 bn into Yen and DM (para 18);
(2) at exchange rates below DM1.55 and ¥120 respectively, a switch back from Yen and DM into dollars of up to $1bn (para 19);
(3) a reduction in exposure to bank risk (para 24);
(4) the acquisition of a bond portfolio in French Francs, if further investigation suggests this is desirable (para 39);
(5) a reduction in the EEA's overall short position in fixed income markets, principally through the acquisition of DM bloc securities (para 43);
(6) the acquisition of further interest rate exposure if yields rise sharply; and conversely a reduction in interest rate exposure if yields fall sharply (para 45).

2 The paper is arranged as follows:

Section		Paragraphs
B	Changes in the level of the reserves	3 - 6
	(THE CURRENCY DECISION)	
C	Changes in the currency composition of the Reserves	7 - 8
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	(THE MATURITY DECISION)	
F	Changes in holdings of marketable assets	22 - 25
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B Changes in the level of the Reserves

3. The spot and forward currency reserves rose by a combined \$12.4 bn (at end-March 1987 exchange rates) over the six months under review, with the spot currency reserves up by \$10.2 bn. This follows a combined rise of \$13.2 bn in the first half of 1987 and brings currency reserves to \$40.1 bn. SDR holdings fell (\$0.5 bn), and gold was unchanged; total reserves rose by \$11.9 bn, to \$50.2 bn.

4. Sterling threatened to rise above 3DM in October and again in December, leading to heavy official sales of sterling for foreign currencies. The true underlying rise in the spot and forward reserves amounted to \$12.9 bn over the period.

(\$bn)

	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Total
True underlying rise	+0.8	-0.9	+1.0	+8.3	0	+3.7	12.9
Capital transactions (+ equals net new borrowing)	0	-0.1	+0.1	-0.2	-0.1	-0.7	- 1.0
							11.9

5. There was a small offset (\$1 bn) to this rise over the period (see table above) in the form of net repayment of official borrowing. New borrowing under the Exchange Cover Scheme tailed off (a total of only \$0.5 bn in the last six months of 1987, after \$0.9 bn in the first six months). Following the abandonment of the subsidy to borrowing under the ECS, gross receipts from this source are likely to be still more modest in 1988.

6. The effect of intervention on the reserves was also reduced by further sales of forward US dollars (\$0.5 bn) and DM (\$0.9 bn) to the MoD (\$3 bn had already been sold in June). These sales were on top of 'normal' MoD requirements for spending abroad, and thus represented an additional but temporary drain on the reserves. The MoD has now completed its program of providing

for future disbursements, however; the reserves will in future only be affected each month by the need to cover anticipated expenditures for the month, 18 months ahead, with current spending covered by the maturity of existing MoD currency forwards.

C. Changes in the Currency Composition of the Reserves

7. The following table outlines how the composition of the reserves has changed since June; further details are given in Tables A and B of the statistical annex.

Table 1 ($bn)

	End June 1987	End December 1987	
	(March 1987 parities)	(March 1987 parities)	(current rates)
Spot Reserves			
US dollars	18.3	22.6	22.6
DM bloc	3.9	8.5	9.8
Yen	0.9	1.8	2.2
Canadian dollars	0.3	0.7	0.7
	23.4	33.6	35.3
Gold	7.2	7.2	8.5
SDRs	3.3	2.8	3.1
Total	33.9	43.6	47.1
Market Forwards			
US dollars	3.0	4.0	4.0
DM bloc	1.0	2.2	2.5
Yen	0.1	0.1	0.1
Canadian dollars	0	0	0
Other (chiefly SDR)	0.2	0.2	0.2
Total	4.3	6.5	6.8

Notes: (1) The following exchange rates against the US dollar have been assumed in the "current rates" column: DM 1.60; Yen 125; C$1.30; Gold $360.

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

8. At March 1987 parities, non-dollar currencies accounted for $7.1 bn (or over 55%) of the rise in currency reserves; most of this was in DM (up by $4.6 bn), but there were also significant additions to Yen and French Franc holdings.

D Overall Currency Exposure

9. It is agreed that currency exposures are probably best assessed after taking into account the structure of the UK's official liabilities. This comparison is shown in Table 2 below.

Table 2

	31 December				30 June	
	Assets*	Liabilities*	Net Assets		Net Assets	
	$bn	$bn	$bn	(% of total)	$bn	(% of total)
US dollars	26.7	14.4	12.3	(52)	5.3	(65)
DM bloc	12.5	3.7	8.9	(38)	2.2	(27)
Yen	2.4	0.4	2.0	(8)	0.7	(9)
Canadian $	0.7	0.3	0.5	(2)	- 0.1	(-1)
Total	42.4	18.7	23.7		8.1	

*Assets and liabilities are shown at estimated market values and at current exchange rates.

10. It was agreed in July that $1.2 bn should be switched out of US dollars into DM ($0.75 bn), Yen ($0.25 bn) and Canadian dollars ($0.2 bn). This program was completed before the massive inflows of October, and before the bulk of the dollar's fall in the last six months; it will thus have generated a respectable profit. Shifts in net exposures were however dominated by the episodes of sterling strength (and dollar weakness) in October and December. Approximately half of the total inflow ($12 bn) was in US dollars, and about $5 bn (at March 1987 parities) was in DM bloc currencies. Net positions were further influenced by changes in exchange rates (increasing

non-dollar net assets, measured in US dollars) and by the pattern of new borrowing and repayments (acting to increase DM liabilities, and to reduce US dollar liabilities). The resulting end-December position showed some reduction in the share of net assets accounted for by US dollars (from 65% to 52%), with a corresponding rise in the DM bloc share.

E Currency developments, prospects and recommendations

Developments

11. The dollar remained remarkably stable until mid-August but came under increasing pressure thereafter (Chart 1). By end-year the dollar had depreciated by about 20% against the Yen, and by 17% against the DM, from its local peak in July.

12. Sterling appreciated by about 4% in effective terms between August and the end of the year, as the dollar came under pressure. Sterling remained close to 3DM throughout the period.

Prospects

13. We consider that the currency allocation decision should be based on the following outlook for the next six months:

- the dollar is more likely to weaken than strengthen against the deutschemark and yen
- in between the deutschemark and yen the former should appreciate by more than the latter.

14. The main reason for pessimism about the dollar is the continuing growth of internal demand in the US. Following the stock market crash in October it was generally expected that the resulting decline in the US would slow even further an economy whose growth rate already appeared set to decline. Subsequent information, however, has shown that the US economy, going into the crash, was in fact growing quite strongly and that - as yet - the crash has had little impact on US domestic demand. And the likelihood must be that, in an election year, the US administration and the Federal Reserve will act to reverse any slowdown which occurs. While demand remains buoyant in the US

(particularly in relation to other countries), the improvement in the US external trade position will be limited and the dollar will remain under pressure.

15. Thus the view is no longer based on the idea that the dollar is still substantially overvalued against the major currencies. Indeed this no longer appears to be the case. However, the fact that the dollar has depreciated rather less against many of the important NICs, despite the political pressure to adjust exerted on them by the US administration, is another cause for concern. With the pressure on the NICs likely to prove even less effective in 1988 - another consequence of the impending US election - the needed adjustment in their exchange rates may translate into further depreciation of the dollar against the major currencies.

16. The reason for preferring DM to Yen is also relative demand conditions in the two economies. While domestic demand in Japan has picked up sharply in recent months and latest forecasts suggest GNP growth in 1988 of 3½%, growth remains sluggish in Germany at around 1½%.

Recommendations

17. On the basis of the above we should aim, were it to be politically acceptable, to diversify more of our dollar holdings into DM and Yen. Table 2 in paragraph 9 above shows that at present our net assets position is substantially larger in DM ($8.9 bn) than in Yen ($2.0 bn). This suggests that the initial emphasis should be to acquire more Yen.

18. We would therefore recommend that at around the present level (¥130), we should aim to transfer $½ bn into Yen. Were the dollar to strengthen, we should switch a further $½ bn - at say ¥135 - and begin to switch into DM bloc currencies. In total we would look to switch a maximum of $2 bn to take the net dollar asset positions down to around $10 bn.

19. However, as noted above, the dollar may now no longer be significantly overvalued against the major currencies. Were a further dollar plunge to occur, it should be seen as an opportunity to move into a long dollar position, which would earn profits over a longish horizon as the dollar recovers to a more tenable real exchange rate. (It is assumed that money market yields will broadly compensate for the effect of differential rates of inflation on exchange rates). Such a move might well take the form of willing involvement, on a rather larger scale than recently, in a dollar stabilisation package via sales of DM and Yen for dollars. We suggest that DM 1.55 and ¥ 120 represent levels at which the EEA should be willing to begin to acquire extra dollar exposure. Such an operation might be limited to say $1 bn in total.

20. The above proposals represent what we would like to be able to do. In fact the scope for achieving the above currency moves is currently heavily circumscribed by political considerations. The approach must be to take advantage of whatever oportunities arise to move in the desired direction.

21. The EEA owns about $0.9 bn of French Francs, bought as a substitute for DM during December. It might be preferable to hold DM rather than French Francs, but this is currently impossible. However, while an EMS realignment may well occur following the French elections in the Spring, the size of any movement between the market DM/French Franc rate should be small, particularly in view of the French authorities' present determination to restrain inflation. An extra 5% return available on 3 month deposits compared with DM deposits and perhaps more significantly an extra 3½% return available on bonds therefore seems to provide reasonable compensation for the risk of exchange loss.

THE MATURITY DECISION

F The composition of assets

22. Of the total increase in the spot currency reserves of $11.9 bn (at current exchange rates) half went into banking sector instruments, principally time deposits. As a result the total bank exposure rose sharply to $14.9 bn at end December and the share of the spot currency reserves held with banks rose to 42%. About 40% of bank deposits were held with the BIS which offers better security but a slightly lower return. Table 3 below shows the changes since end June. It should be noted that at end June 1986 - one year earlier - deposits held with the banking system were under $3 bn, and of this nearly $2 bn was held through the BIS. Thus over the last eighteen months the EEA's direct exposure to banks has risen from under $1 bn to $9 bn, while exposure through the BIS has risen from $2 bn to $6 bn.

Table 3 Bank Risk

($bn)

	June 1987 (March 1987 parities)	December 1987 (current exchange rates)	Change
US dollars	7.8	8.5	+ 0.7
DM bloc	1.2	5.3	+ 4.1
Yen	0.1	1.1	+ 1.0
Canadian dollars	0	-	-
Total	9.1	14.9	+ 5.8
(of which, held with BIS)	4.2	5.8	+ 1.6
Total spot currency reserves	23.4	[illegible]5.3	+11.9

23. The EEA has an additional exposure to bank risk as regards the forward book, the net size of which expanded (in the major currencies) by over $2½bn in the six months under review. In this case the full principal is not at risk, the exposure is the effect on the principal of any adverse change between the rate at which the forward contract was struck, and the current spot exchange rate when the contract matures.

24. While the EEA's bank risk is widely spread and closely monitored, it is still more than we feel comfortable with. In order to contain the exposure we have already added a further $1 bn to the holdings of short term $ paper and $2 bn to holdings of Treasury Bills. A reduction of a further $1 bn or so in bank deposits should result if they are used to finance the bond purchases recommended later in this paper. Otherwise as we have for the present reached the limit of what can be invested in short term $ paper, the only remaining alternative to bank deposits is effectively US government short-term securities, particularly Treasury Bills. If the reserves were to rise further, it would therefore seem necessary to add further to our TB holdings - despite their lower yield. Correspondingly, we would propose that reductions in the reserves should be financed primarily by running down bank deposits.

25. The remainder ($6.1 bn) of the increase in the spot currency reserves went into marketable securities, as set out in Table 4. Nearly half went into floating rate US dollar assets (as noted above); but there were also additions to fixed income holdings in all major markets. These are discussed in the next section.

Table 4

($bn)

Market	Increase at March 1987 parity	Exchange rate effects	Total Increase*
US	+ 3.9	0	+ 3.9
DM	+ 0.9	+ 0.5	+ 1.4
Dutch Florins	+ 0.3	+ 0.1	+ 0.4
Canadian dollar	+ 0.2	0	+ 0.3
Yen	+ 0.1	+ 0.2	+ 0.3
			+ 6.1

* At current exchange rates
Assets valued at book cost in local currency.

G Interest Rate Exposure

The present position

26. This paper repeats the analysis first used in last July's paper in addressing the EEA's exposure to interest rate risk. The approach is to amalgamate all the EEA's fixed income assets (or liabilities) in a given currency into an equivalent quantity of a single representative asset (or liability). The asset is arbitrarily chosen to have a current coupon and a 4 year average life; and the assumption under which amalgamation is possible is that yields all along the yield curve typically change by an equal amount. On that assumption, the following table indicates how many 4 year securities in each currency have the same price response to yield changes as the existing stock of EEA assets or liabilities. (The liability figures are more accurate than in July's paper, since each separate loan is now priced individually; there are no very major changes to the figures however).

Table 5: Fixed Income Exposures - $ bn 4 year equivalents

	December 1987*			June 1987	Change in
	Assets	Liabilities	Net Assets	Net Assets	Net Assets
US Dollars	2.6	5.1	- 2.5	- 2.8	+ 0.3
D M bloc	4.9	4.6	0.3	- 0.8	+ 1.1
Yen	0.9	0.4	0.5	0.4	+ 0.1
Canadian dollar	0.5	0.5	0	- 0.1	+ 0.1
			- 1.7	- 3.3	+ 1.6

*At current exchange rates.

The figures in Table 5 indicate a substantial short in US markets, but modest long positions in the other markets. In the event of a 1% rise in interest rates worldwide, the EEA would stand to gain $75 mn from its US bond market position (but to lose $25 mn in other markets).

Developments since June:

27. Table 5 also indicates the progress in changing bond market exposures since July. In July we agreed to:

(1) reduce the US bond market short by purchases of up to $1 bn of two year Treasury notes, and up to $¼ bn of four year Eurodollar bonds.

(2) produce a long position in the DM market of $0.2 bn (including matching new borrowing by further bond purchases).

(3) buy back the $160 mn of Yen bonds sold early in 1987 if Yen yields rose past about 5½% on 10 year bonds.

(4) the creation of a modest long position in the Canadian bond market.

28. These plans were largely implemented by the end of 1987.

(1) Around $900 mn of 2 year US Treasury notes were acquired at an average yield of 8.1% (against 2 year yields currently at 7¾%). In addition, to benefit from the steeper yield curve, there were purchases of longer dated Treasuries ($30 mn at 7 years) and Eurodollar bonds ($200 mn at 4 years).

(2) The 'short' in DM bloc markets was covered by bond purchases in July and August, with additional purchases to cover new fixed income borrowing. A modest long position was acquired in November and December, at yields consistent with an average 10 year yield of about 6.40%. Ten year yields are currently around 6½%.

(3) In Yen, the ¥24 bn of Yen bonds sold early in 1987 were bought back in several stages at a significant profit. There was an additional purchase of ¥6 bn of securities to cover a fixed income borrowing in September, when yields were close to their peak.

(4) The EEA took off nearly all its short in Canadian dollar markets during the third quarter of 1987, at an average yield (at 4 years) of just under 10%. Canadian yields moved largely in line with US yields, and ended the year at about 9.7%.

H Interest Rate Developments Prospects and Recommendations

Developments.

29. The movements in interest rates in the dollar, deutschemark and Yen bond markets are shown in charts 3, 4 & 5 attached.

Prospects

30. We consider that the decisions on the EEA's bond portfolios should be based on the following outlook for the next six months

- short term interest rates are likely to change little over the next 6-12 months, although the risks are that in the US and Germany any change will be upwards;
- US longer term rates are more likely to rise than fall while German longer term rates are more likely to fall than rise. The present level of Japanese rates seems sustainable.

31. In the US, political pressures and fears of a marked slowing in growth should be sufficient to keep interest rates down in an election year. However, the danger is that rates may need to be raised to defend the dollar. Short term rates in Japan and Germany seem to have fallen as far as seems practicable, with