PO-CH/NL/0079

PART D

Part D.

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 4/3/87
Ends: 23/10/87.

PO -CH /NL/0079

PART D

Chancellor's (Lawson) Papers:

THE EXCHANGE MARKETS AND FOREIGN CURRENCY BORROWING

Disposal Directions: 25 Years

D Anderson
26/7/95

PO -CH /NL/0079
PART D

3887/040

SECRET

FROM: C W KELLY

DATE: 4 March 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Ms Goodman

INTERVENTION YESTERDAY

You asked if we knew how the stories about the Bank of England sales of sterling against deutschemark yesterday had arisen.

2. The Bank have not bought any DM since last week. The amounts then were trivial and the transactions were with overseas banks.

3. What seems to have happened yesterday is that circumstances arose in which it would have been fairly natural for the Bank to intervene in DM if they were going to intervene at all. Sterling had moved up against the dollar, met a resistance point at $1.5680 and failed to break through. But meantime it was continuing to move up against the DM, as the dollar itself strengthened. Just at this point, Barclays put through a substantial order for an unknown but probably commercial customer, and a journalist thinking about intervention because of the publication of the reserve figures put two and two together and made five. The story appeared on Reuters, was given a semblance of credibility by the reserves figures showing that we had been doing slightly more intervention that people had realised, and was quickly picked up elsewhere.

4. The Bank did try and pour cold water on it. They asked a number of dealers if they knew where the story was coming from, since it did not reflect anything they were actually then doing. But this had no noticeable effect.

5. We discussed with IDT whether there was a case for saying something specific to the press, in breach of our normal rule about refusing to say anything. But/we decided against. In retrospect perhaps we should have asked Barclays to say something.

6. In practice, despite the stories in the papers this morning, the incident does not appear to have any noticeable effect on the exchange rate. Sterling has been stronger again today against both the dollar and the deutschemark. In money market terms it might even have been helpful, making it unnecessary to give further signals about interest rates.

7. The Telegraph story is particularly silly. If we had wanted to give a signal, the Bank would not have placed a single large order through a clearer. The normal tactics would have been to have gone through the brokers, allowing them to let it be known who we were. In that way we get many more bang for our buck.

C W KELLY

From: R B SAUNDERS

Date: 25 March 1987

PRINCIPAL PRIVATE SECRETARY

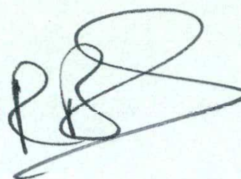
cc PS/Chief Secretary
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mrs R Butler
Mr S Davies
Mr Mowl
Mr Riley

C/ See Sir Peter's comment below. Are you still content with assumptions as they stand. CR 27/3

PEM has a good point. Let's have an answer to it before approving the assumptions, but all other assumptions OK.

ECONOMIC ASSUMPTIONS FOR PUBLIC EXPENDITURE

Sir Peter Middleton has seen Mr Davies' minute of 24 March. He has commented that the long rates in paragraph 19 look on the high side.



R B SAUNDERS
Private Secretary

C23/010

FROM: A C S ALLAN
DATE: 1 MAY 1987

CHANCELLOR

POSSIBLE STATEMENT ON EXCHANGE RATE ON MONDAY

I attach the draft statement which Peter has prepared. The difficulty is finding a peg, so as to handle the implications of your taking the unusual step of issuing a statement on a Bank Holiday Monday.

2. The two obvious pegs are something from Reagan/Nakasone, or (I hope unlikely) the rate powering through DM3. If the former, you will need some sort of preamble, depending on what comes out. If the latter, the global perspective in the first paragraph of Peter's draft looks a bit odd, but may be better than baldly saying we didn't want £ to get this high.

3. On the mechanics, David Peretz will be keeping in close touch with the Bank dealers (and with me). One or other of us will be in touch with you as necessary. If you want to get us, David will be on 0300-20656 and I shall be on 0703-812273. We will liaise with the Duty Press Officer, Simon Woodall.

4. If the rate does wobble around but you decide not to issue a statement, Robert and I felt the best line was "ignore these continentals mucking around with our currency: what matters is what happens in London tomorrow".

A C S ALLAN

Recent pressures in the foreign exchange markets have not altered the conviction of the Governments of the world's major countries that a period of exchange rate stability is desirable. Nor has it diminished the determination of their monetary authorities to bring it about. This was the continuing theme of the agreement among Finance Ministers when we met recently in Paris and Washington. A period of stability in sterling also meets the needs of our own economic strategy. I have said repeatedly that I do not wish to see the £ rise further."

USE THIS FOLLOWING IF REQ'D:

Your form of words this morning was:

"[Reagan/Nakasone intro]. So far as sterling is concerned, the adjustment that occurred last year has produced an exchange rate that is right for the British economy and right for British industry; and an extended period of stability around this level is highly desirable. ~~and British industry is benefitting from it.~~ We shall therefore, within the context of the Louvre accord, take whatever steps we can to prevent ~~unnecessary~~ unwanted and unnecessary fluctuations." In particular,

3882B/034

CONFIDENTIAL

FROM: C W KELLY
DATE: 10 June 1987

PRINCIPAL PRIVATE SECRETARY

cc: PS/Economic Secretary
Sir P Middleton
Sir G Littler o/r
Mr F E R Butler
Mr Cassell
Mr Peretz
Mr Robson
Miss Seammen
Ms Goodman

MOD FORWARD PURCHASES

You may like to know that the arrangement for selling forward to the MOD most of their dollar and DM requirements for 1988-89 has now been completed. The MOD were informed at the end last week about the releant rates, according to a monthly schedule agreed with us in advance.

2. The amounts involved total $1200 million and DM 3400 million.

3. To offset their liability the Bank have, as you know, been buying DM over the last few weeks. In the end a total of DM 500 million was bought against sterling and the remainder against dollars. The proceeds were swapped forward. The net result is therefore that both the DM and the dollar requirements were met off the existing forward book, which has been reduced by the equivalent of just over $3 billion.

4. Whether the fact that the Bank were buying DM in the market helped to relieve the upward pressure on the £/DM cross rate is difficult to judge. It cannot have done any harm. But the Bundesbank are said to have been surprised by how easily it was absorbed, which suggests that the impact may not have been very great.

5. The spot book was not significantly affected by the deal. The current forecast of the underlying reserve change in June,

on the usual conventional assumption about no further intervention, is $335 million.

C W KELLY

psl/10A

SECRET

BF ~~2/7~~ ~~7/7~~ 14/7

FROM: A C S ALLAN
DATE: 22 June 1987

MR KELLY

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman

FOREIGN CURRENCY BORROWING

The Chancellor would be grateful for a note setting out the pros and cons of launching a further foreign borrowing operation this summer. Even though our need is less great, our reserves are still low by international standards, and the start of a new Parliament is a good time to undertake a new borrowing operation. He would be grateful if the advice could include comments on what market we might most appropriately borrow in: the FRN market has been weak, while the scope may not be good for doing a large enough fixed rate borrowing to be worthwhile.

ACSA

A C S ALLAN

ACSA
↓
KELLY
22 JUNE

SECRET

From : D L C Peretz
Date : 25 June 1987

I disagree with this advice, but am prepared to compromise with something between 200 & 250. N.L.

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr C W Kelly
Mr Culpin

END MONTH RESERVES FIGURE

Mr Allan's note of earlier today records your preference for showing an underlying fall in the reserves this month of between $150 million and $200 million.

2. I have discussed this further with Eddie George. Neither of us feels very strongly, nor would we argue that there is likely to be a large difference in the market reaction. But we both still feel that on balance - and in the absence of any obvious arguments the other way - it would be better to go for a slightly larger negative figure.

3. The point, and this month the only point, is to do with the potential impact on the gilts market. A negative figure of less than $¼ billion looks a little like a normal random monthly fluctuation. A figure just slightly higher, eg one that rounds to $½ billion rather than zero, may carry slightly more of a flavour that we have unwound a little of our earlier intervention; and may therefore be marginally more encouraging to the gilts market - without carrying any implication that we had been doing anything other than very modest smoothing operations.

Ridiculous

4. As I say I could not pretend that this is going to make a great deal of difference. But there are some arguments for showing an underlying fall of slightly over $¼ billion rather than slightly under it, and I wondered how strongly you felt about your earlier conclusion that the figure should be between $150 and $200 million.

Y. Engledow (PS)

p.p. D L C PERETZ

3884B/010

CONFIDENTIAL

RD

FROM: C W KELLY

DATE: 6 July 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Mrs Case
Ms Goodman o/r

FOREIGN CURRENCY BORROWING : SCHULDSCHEINDARLEHEN

I hope to let you and the Chancellor have a note in the next few days which both discusses the overall foreign currency borrowing strategy and also responds to the Chancellor's request for a paper about the possibility of a further own-name operation this summer (Mr Allan's minute of 22 June). I discussed a draft with the Bank of England this morning.

2. In the meantime, you may like to be aware of the next piece of borrowing in the pipeline under the current strategy. This is a DM 125 million ($70 million) loan for British Coal taken out in the form of a certificate of indebtedness or Schuldscheindarlehen. It has been arranged by Deutsche Bank Capital Markets with their subsidiary Frankfurter Hypothekenbank. It is for five years, with a bullet maturity.

3. In accordance with out normal strategy for issues of this kind, the Bank of England are confident that it will receive no publicity. Deutsche Bank are well aware of our desire to be discreet and will have an eye on future business with us. No prospectus is necessary, and no tombstone. In principle the notes are transferrable (up to three times). But in practice Frankfurter Hypothekenbank are likely to hold them to maturity.

Kelly
↓
EST
6 July

4. We shall be paying 5.4 per cent. This is about 35 basis points above what the German government themselves were paying in the bond market at the time the rate was agreed. But the Bank of England believe it to be as good as we would have got for a public issue.

5. Signing is on Thursday, with drawdown the following day.

C W KELLY

3883B/035

SECRET

FROM: C W KELLY
DATE: 14 July 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell o/r
Mr Lavelle
Mr Hawtin
Mrs Lomax
Mr Moore
Mr Mountfield
Mr Peretz
Mrs Case
Mr Culpin
Mr Grice
Mr Watts
Ms Goodman
Mr Cropper

Ch
Do you want meeting on this now, or after further note on a 'note programme'? (If latter, presumably before summer hols if poss?)
AA

Thanks. The latter (but before summer break if poss) N.

KELLY → CH/EX 14 JULY

FOREIGN CURRENCY BORROWING

You asked for a note about the possibility of launching a further foreign currency borrowing operation this summer in our own name (Mr Allan's minute of 22 June).

2. We were, in fact, about to submit to the Economic Secretary about foreign currency borrowing strategy generally. This note, which has been discussed with the Bank of England, is therefore intended to serve both purposes. It is not concerned with the alternative method of changing the level of the reserves, intervention funded (or not) by sterling borrowing.

Current reserves position

3. The foreign currency reserves have increased substantially in the past few years, rising from $7.1 billion at end-1985 to $23.4 billion at the end of last month (with a further $4.3 billion in the forward book).

4. This increase brings them much more into line with those of other major countries, though still some way behind those of Japan and Germany. International comparisons are difficult because

of valuation and other differences. There are also delays in publishing some of the figures, which has obliged us to do a certain amount of estimation. But the current picture appears broadly to be as follows:

Estimated level of currency reserves

	$ billion	**Equivalent in numbers of weeks imports**
Japan	61	24½
Germany	55	14
France	35	13½
Italy	21	10
UK	23	9
Netherlands	11	7
Canada	4	2½
US	17	2

5. Whether we can feel comfortable with reserves at this level, or ought to be thinking of adding to them, depends partly upon whether or not a decision is taken to join the ERM. In current circumstances, however, I do not think that we feel that they are inadequate. Nor, in current market conditions, would it be easy to borrow substantial amounts on terms which would enable us to hold the additional reserves costlessly, because we were earning more on the corresponding assets than we were paying on the new liabilities.

6. However, points to bear in mind are:

i. We cannot yet be confident that the whole of the recent increment achieved through intervention will stick, or that we will want it to.

ii. Most of the countries in the table above have more substantial holdings than us of gold, which are also mobilisable in certain circumstances.

iii. Among the ERM currencies, we now appear to be roughly on a par with the Italians, and in rather a better position than the Dutch. But we still have lower holdings than the French, whose experience may perhaps provide the closest analogue to what we might expect were we to join the ERM.

The existing foreign currency borrowing programme

7. Even to maintain the reserves at this level, we need to run a borrowing programme of a substantial size to refinance existing debt as it falls due - around $1.4 billion this year and $1.2 billion in 1988 (see Table 1). We would also like to be able to continue with the programme of repaying early some of the other debt which now looks a bit on the expensive side in current market conditions (around $0.5 billion this year and perhaps $0.2 billion next).

8. The strategy since 1981 has been to seek to do this in a low-key way, outside the public markets, in order to avoid the UK being seen as a regular borrower. This has meant relying on borrowing by the nationalised industries, and to a lesser extent the local authorities, through the exchange cover scheme (ECS). The borrowing has mainly come from the European institutions, from single bank credits, and from occasional one-off private deals with single lenders. Of total outstanding exchange cover scheme debt of around $10 billion, $6.9 billion equivalent is from the European institutions and $1.9 billion in the form of bank borrowing (see Table 2).

9. This approach has served us well in the past. But circumstances change, and we have become increasingly concerned both about the practical problems of continuing with it on the same scale and about the cost.

10. The practical problem is that the number of nationalised industries available as borrowers has continued to be sharply reduced by privatisation and by the improved financial position of most of those not yet privatised.

11. We do not anticipate any serious difficulty in meeting the target this year (see Table 3), largely because of the re-emergence of British Coal as a substantial borrower. But British Coal is not an ideal name with which to go to the markets; and both the other two substantial names in the list (British Nuclear Fuels and the South of Scotland Electricity Board) are unlikely to continue to need to borrow on the same scale in future years once their current capital programmes reach completion. Both are also privatisation candidates. The balance of this year's programme is made up mainly by the water authorities, who are also now to be privatised.

12. The need to make use of whatever opportunities exist to complete the programme has substantially complicated the administration of the scheme. We can no longer pick and choose among potential borrowers as used to be possible some years ago. Borrowings can no longer always be done at times of our own choosing, and in reasonably substantial amounts at one go. We are now dependent upon the timing of the needs of the few remaining borrowers which may not coincide with the times at which we would otherwise judge it right to approach the markets. We have had to enter into a number of complicated understandings with some of our lenders about what would happen to their loans in the event of privatisation; and the number of different loans covered by the scheme has multiplied alarmingly. Our portfolio now consist of as many as 350 different loans.

13. These problems are not necessarily overwhelming. If it otherwise seemed sensible we could probably continue to get by for a while, as we have for the last few years. British Coal is likely to have a substantial borrowing need for some time. We could continue to persevere with the water authorities until they actually reach the point of privatisation. We could even

think about making use of the local authorities on a more substantial scale, though that could draw us into requests to issue guarantees and is undesirable for this and other reasons.

14. But there is also a cost dimension. Borrowing indirectly, even with a guarantee, in less than ideal size, in a low-key way and at times not necessarily of our own choosing is inevitably more expensive than the terms which could be achieved by higher profile borrowing in our own name.

15. It is difficult to put a figure to this. But, by way of example, using the European Investment Bank as an intermediary probably costs us on average around ¼ per cent more than it would if we were do exactly the same deals in our own name because of their intermediation charge and the fact that they do not command such good terms as us. If we had done the deals in our own name we might well have also packaged them together or timed them differently. Similarly, on the $1.9 billion ECS bank credits we are now paying on average something like LIBOR +¼ per cent, compared with the sub-LIBOR terms we achieved on both the FRNs.

16. On top of this, we currently pay nationalised industry and local authority borrowers half a per cent as an inducement to participate in the scheme, since we have no powers to compel them. The payment remains within the public sector. But it is a cost to central government, and of a substantial size.

17. This raises obvious Accounting Officer questions.

18. Until now, we have always taken the view that the benefits we derive from the use of the exchange cover scheme outweighed these additional costs and justified continuing to use it. These benefits are of three main kinds:

i. The scheme enables us to tap some markets which we would not in practice choose, or be able, to tap directly in our own name, but which offer funds at an attractive rate. The main example of this has been the commercial paper market in New York.

ii. Keeping a substantial part of our borrowing off the public markets increases the appetite for the UK name, which is one of the reasons why when we do access the public markets we can command finer terms than other, more regular borrowers.

iii. It is prudent to spread our net as widely as possible, to maximise the number of potential sources on which we could draw if for any reason some markets were to become closed to us or our borrowing requirement were to increase. In the past there has also been the thought that in a time of difficulty the low-key nature of the programme might make it possible to increase our borrowings fairly discreetly. There has been a particular case here for maintaining a programme of borrowing from the EIB. If there were no existing programme and flow of new projects being assessed by the EIB it would be very difficult to step up borrowing from this source quickly.

19. These arguments still have some force. But they are now weaker than before:

i. Our sensitivity over the need for the privacy has probably lessened, following the public reception of the two FRNS.

ii. The markets are now much larger than they were before, which means that we ought to be able to expect to raise more substantial amounts in them without turning the terms against us.

iii. The increased size of the reserves probably means that we need be less concerned about maintaining the option of stepping up the programme very quickly; while the development of new instruments (like note programmes, on which see later) provide alternative means of achieving the same kind of flexibility.

iv. The longer the track record we establish for prudent operation of policy, the lower is the risk of suffering an unexpected fall in credit rating, or ability to access markets.

20. For all these reasons, we have come to doubt whether the present balance between direct and indirect borrowing continues to represent the best way of minimising our average borrowing cost over a period of years, even if it was sustainable in practical terms.

21. A new factor is the decision to allow ECGD to use its guarantee in the capital markets to reduce the cost of funding export finance. This borrowing, although undertaken through a vehicle or vehicles classified to the private sector will be viewed by investors as a UK sovereign credit. Indeed we will have to take steps to ensure that they perceive it as such if we are to obtain the terms we want.

22. So far, ECGD have guaranteed only one issue, $150 million via a specially constituted vehicle company (GEFCO). But on present plans they are expected to become a regular and sizeable "borrower" in both sterling and foreign currencies. If they were allowed full scope for their ambitions, their demands on the foreign currency markets alone could amount to as much as $2-$3 billion a year for a mixture of FREF and debtor refinancings and pure cover cases. Even if this is reined back to avoid saturating the markets with ECGD guaranteed paper, we are still probably talking about a programme of between $1 billion and $2 billion a year.

23. The two programmes will have to be carefully co-ordinated if we are not to get in each others way. It would also, to say the least, be an odd situation if we continued to refrain from tapping the public markets in our own name, and paid additional costs in so doing, while the benefits go to ECGD and their customers in terms of larger appetite for their own paper (though most of the savings from this will still go to the Exchequer indirectly). This would be particularly so since the terms likely to be achieved by ECGD guaranteed issues, because of the complication of the vehicle(s) and the less satisfactory nature of the ECGD guarantee, are unlikely to be as good as those which we could achieve in the same markets. The Bank think the difference could be as much as 1/8 to ¼ per cent.

24. We would like to establish the presumption that we set our own strategy first, and ECGD fitted round us. But that may be easier said than done. To the extent that some of the ECGD guaranteed foreign currency issues are intended ultimately to provide sterling finance, we will want to try to find a way to capture the foreign currency proceeds for the reserves, thus reducing our own borrowing need.

A revised strategy

25. Against this background, we suggest that the aim should continue to be to refinance maturities, but not to be too fussed if we fall short in a particular year. We should also continue to seek opportunities to renegotiate the more expensive outstanding debt, and, failing satisfactory renegotiation, to pay down and refinance.

26. In order to help achieve this aim, we would want to keep the exchange cover scheme in being. There may continue to be instances where it make sense to borrow in a nationalised industry name, as a number of other sovereign borrowers do from time to time. We might, for example, want to introduce a new borrower to the US commercial paper market (though British Coal is the only current candidate). We would also want to make sure that we were in a position to take advantage of any subsidies that may become available from eg the ECSC (limited though these may be); and we do not entirely discount the continued value of keeping sources open on a care and maintenance basis.

27. But we would want to be much more discriminating in our use of the scheme, considerably reducing its scale. In particular we propose:

i. Reducing the subsidy element below half per cent, possibly to 1/8th. We probably still need to maintain some incentive to borrowers to participate of this kind, though some of them might be prepared to do it for the experience alone.

ii. Introducing a minimum size of eligible loan, perhaps $25 million to eliminate the tail of very small loans.

28. We would also need to consider whether we should continue to allow exchange cover to water authorities, given their imminent privatisation.

29. Such an approach would have a number of implications. In particular, the volume of funds we would expect to take from the <u>European Investment Bank</u> would be much reduced, probably to no more than $100 or $200 million a year. The transition would have to be handled with tact, particularly since you are an EIB Governor. We are currently their second most important customer after Italy, taking about $1 billion equivalent from them in 1986.

30. We should also be likely to be cutting out the local authorities from the scheme almost entirely. At present we only allow them to borrow from the EIB, and few if any of them will have projects qualifying for EIB lending large enough to get over the suggested $25 million threshold.

31. We cannot make any change abruptly. It could take a few months to run off the commitments, or half commitments, we have already made to both borrowers and lenders.

<u>Own name borrowing</u>

32. On this strategy, the counterpart to reduced exchange cover scheme borrowing would be occasional but regular use of HMG's own name in borrowing on the major markets in the form of relatively infrequent set pieces, no more than one or two a year, designed to reinforce our prime market standing and timed to capitalise on advantageous market opportunities.

33. As it happens, none of the major long-term public markets look particularly attractive at present.

34. The fixed-rate dollar bond market in particular remains in poor shape, with yields drifting off considerably since February. The FRN market has also become significantly more expensive since

our two FRN issues, and it would not in any case look particularly clever to return to that market again so soon after last September's issue. Nor, even if there were time to organise anything before the market thins out for the summer break in August, would the Bank at present want to recommend to you going either to the DM or yen markets (though we could look at this again in the autumn).

35. The alternative would be to think again about some sort of sovereign note programme. In the past we have always fought rather shy of this idea, because of concern that the circumstances in which we might want to draw upon it substantially might be precisely those in which the terms we were offered turned against us. But that has not been the experience of other sovereign issuers, and may be of less importance anyway now that our reserves are more substantial. A note programme in the form of regular issues of short-dated paper (under one year maturity) could offer us considerable flexibility as well as attractive terms. The amounts involved could be fairly substantial, ultimately up to several billion dollars. Unless you wanted to make a further substantial increment to the reserves, this would in principle be sufficient to meet all our borrowing needs for at least the next year, may be longer (though it might make sense to use it more flexibly than this implies).

36. There are a number of possible forms a note programme could take, which we would want to explore further with the Bank of England if you were attracted by the idea.

Conclusion and points for decision

37. The strategy we have pursued in our foreign currency programmes since 1981, including the use of the exchange cover scheme to keep our own name off the markets, has served us well. But circumstances have changed, and for both practical and financial reasons, we now think that we should change the balance of the programme.

38. The specific points for decision are:

i. Do you agree that we should now plan to make more selective use of the exchange cover scheme?

ii. Specifically, do you agree that we should reduce the inducement paid to borrowers from ½ per cent to 1/8 per cent, introduce a minimum threshold for borrowing under the scheme of say $25 million, and in this and other ways be much more selective in the use we make of EIB and other sources. Should we cut out the water authorities as borrowers entirely?

iii. The counterpart to more selective use of the exchange cover scheme would be occasional set piece borrowings in our own name. Do you agree that as a first step we should explore the possibility of launching a substantial note programme?

C W KELLY

encs

cc: Mr George)
Mr Plenderleith) Bank of England
Mr Page)

SECRET

TABLE 1: MATURITY PROFILE OF SCHEDULED OFFICIAL DEBT REPAYMENTS

$ million

	HMG	Exchange cover scheme debt	Total
1987	240	1,160	1,400
1988	230	970	1,200
1989	230	700	930
1990	240	1,020	1,260
1991	240	830	1,070
1992	2,670	1,110	3,780
1993	140	780	920
1994	140	1,000	1,140
1995	140	820	960
1996	4,150	1,070	5,220

TABLE 2: STRUCTURE OF OFFICIAL DEBT AT END MARCH 1987

	$ million equivalent
HMG	
Bonds	6,650
Long-term North American loans	2,440
Bank credits	400
Sub-total	9,490
Exchange cover scheme	
Borrowing from European institutions	6,940
Bank credits	1,860
Commercial paper	500
Other	750
Sub-total	10,050
Grand Total	19,540

TABLE 3: ACTUAL AND PROSPECTIVE FOREIGN CURRENCY BORROWING AND REPAYMENTS IN 1987

$ million equivalent

	Q1	Q2	Q3	Q4	Total
British Nuclear Fuels	140	80	-	150	370
British Coal	320	30	370	200	920
South of Scotland Electricity Board	-	75	50	50	175
Northern Ireland Electricity Service	15	25	30	30	100
Water authorities	135	50	50	50	285
Local authorities	20	50	25	25	120
Other	30	10	10	10	60
Total new bororwing	660	320	535	515	2030
Total scheduled repayments	- 425	- 335	- 205	- 430	- 1395
Other repayments	-	- 20	- 120	- 380	- 520
	235	- 35	210	- 295	+ 115

TREASURY WORKING PAPERS

672/023

FROM: ROBERT CULPIN
DATE: 23 July 1987

CHANCELLOR

cc: Chief Secretary
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Odling-Smee
Miss O'Mara
Mr Pickford

TREASURY WORKING PAPERS

You asked me to let you know whether I saw any problems in publishing three working papers (Mrs Ryding's note of 29 June).

2. The short answer is that two of them could be embarrassing as they stand, but the risks can be reduced (though not eliminated) by judicious redrafting. Mr Odling-Smee is happy to negotiate revisions with the authors, on lines we have discussed. This will take a little time because of leave. But I don't think we need trouble you with the details unless we get stuck.

3. The <u>main</u> problems are these.

4. First, one of the papers finds (to be crude) that labour supply is largely unaffected by changes in taxation, even in the long run. That could look damaging, especially as it is the second Treasury-funded study to reach that sort of conclusion. But all it means is that reducing taxes will not cause many more people to look for jobs.

5. The solution is to say explicitly in the paper that it only tries to tell us what determines how many people look for jobs. It doesn't tell us how hard they work when they find them, what risks they are prepared to run, how flexible they are willing to be, what sort of jobs they go for, etc.

6. If this disclaimer makes you wonder why we have studies of things you don't want to know, and not of things you do, console yourself that this one comes a good deal cheaper than C V Brown.

7. More seriously, it leaves this question: "You have now financed two studies which tell you what changing taxes doesn't affect. If lower taxes are so important, where's your study of what they do affect?" There is always our standard repertoire of answers - "any fool can see that lower tax economies work better than higher tax ones," and so on. But are you content to go on resting on that?

X)

8. Second, the paper on inflation has (roughly) four conclusions. Only the third is that macro-economic policies make some difference - and even then they are relegated to a parenthesis. The first is all about commodity prices. Needless to say, this doesn't sound much like the Mais lecture.

9. The solution, again, is to insert more explicit disclaimers. The conclusions should include (approximately) the points that:

(a) the paper takes it as read that macro-economic policies determine the inflation rate;

(b) it does not try to measure the effects of those policies, because it is about the proximate causes of variations in inflation;

(c) one of the ways in which macro-economic policies have their effect is through their influence on those proximate causes - notably, of course, commodity prices.

Conclusion

10. Providing we can agree suitable amendments in broadly this spirit, I am content for the papers to be published in the usual

low-key way. You might like to consider the question at the end of paragraph 7.

ROBERT CULPIN

SECRET

From: Sir G.Littler
Date: 24 July 1986

ECONOMIC SECRETARY

Ch
This seems broadly sensible
AA 24/7

c.c. Chancellor
Sir P.Middleton
Mr Cassell
Mr Peretz
Mr Kelly
Mr Ilett

EEA HOLDINGS OF DM AND ECU

You recently suggested that we should consider switching more of our reserves into DM and perhaps taking up some ECU.

2. ECU holdings are a relatively new market development. We were advised some time ago that we do not have power to include them in the EEA and decided, in case of future need, to take the necessary power. We shall have it as soon as this year's Finance Bill receives Royal Assent. We are not at present itching to get into the ECU market: it is still not large in relation to our scale of operations; and they are not obviously apt or good value for our purposes. Some of the holdings of other Community central banks have a degree of political motivation which I see no need for us to share. Our judgment should be guided by considerations of financial value and return and ease of management: we have asked the Bank to make a study and report in the next few weeks.

3. DM are a different matter (and Yen, etc). We have kept the composition of the currency part of our reserves under constant review for some years and we at present hold an historically high proportion of non-dollar currencies. We added substantially to

our holdings last summer - quite good timing in retrospect, given the fall in dollar values since then. At our most recent review we decided to undertake further diversification: adding at least another $200 million to our DM holdings and switching $150 million from US to Canadian.

4. We have a range of criteria in managing the composition of currencies in the reserves, and some constraints.

5. First, we need to keep an eye on the asset/liability match. By far the major part of our liabilities is in dollars. Taking obvious groupings the present position is:

$ billion	**Assets**	**Liabilities**	**Difference**
US and Can $	7.8	12.5	-4.7
DM, Fl, SF	2.2	1.8	+0.4
Yen	0.9	0.3	+0.6

The extent of our long positions in DM, etc and Yen looks greater against the background of a net overall liability position. This is not too worrying because a part of the total liability is the very long-term (and low interest) post-war loans, and on other considerations the pattern is one which I feel very happy to defend - and even to extend somewhat.

6. Secondly, dollars are overwhelmingly the main currency of intervention. We need therefore to keep a fairly substantial part of the reserves directly or relatively liquid for use as dollars. It is a fact that - for very large transactions - the

dollar market offers enormously greater and easier entry and exit than any other, except sterling which we are not concerned with here! As an example: some time ago we decided to switch some Swiss Franc holdings into DM - equivalent currency value and better return; the Bank are finding it a slow process for lack of opportunities in secondary markets. You will not be surprised that the Yen market is usually not an easy one!

7. Thirdly, there is the question of return, where we have seen large differentials, usually of course in the opposite direction from value expectations. One reason for adding now to our DM holdings is that the loss of return by comparison with US instruments has much diminished: this is particularly relevant in deploying the proceeds of the dollar borrowing we made last September. A large part of that was quickly used in intervention to buy sterling which we have subsequently sold back at a dollar profit; we shall now be deliberately unmatching a part by taking DM and Canadian dollars, on an assessment of the overall interest and value returns.

presumably because market expectations have changed.

8. Fourthly, we have to respect the courtesies between national monetary authorities. This arises notably on holdings of DM. There is an understanding - much breached - that Community countries do not have large holdings of each other's currencies, as well as a broader disinclination to encourage speculative switches of currency holdings by central banks. Much breached, as I have said, and we do not in practice meet objections to what we do; and we have a special argument on DM that we need a large

and regular amount for BAOR costs. But the Bundesbank take a close interest in movements which may affect their money supply, and the Bank of England rightly feel that they should avoid huge and abrupt switches without some consultation.

9. Finally, for completeness, there are occasional strategic considerations, which can argue several ways. Larger holdings of Community currencies, especially DM, might seem appropriate if we were entering the exchange rate mechanism - even though contrary to past understandings and in practice not strictly necessary. Against this we do not want to act in ways which would encourage public speculation about our intentions.

10. In conclusion, we have built up a substantial non-dollar holding, and we propose to extend this. As Accounting Officer I am well content to defend this - in retrospect or prospect - against either criticisms of failure to maximise speculative gains or failure to respect dictates of cautious management. It seems to me right that we compromise between the different and usually conflicting objectives and constraints.

GEOFFREY LITTLER

(Geoffrey Littler)

3885B/018

CONFIDENTIAL

FROM: C W KELLY
DATE: 28 July 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr M Williams
Ms Goodman
Mrs Diggle

Ch
(Wasn't possible to fix slot for meeting before summer hols) AA

FOREIGN CURRENCY BORROWING PROGRAMME

My submission to the Chancellor of 14 July suggested that in future we should take a much more selective approach to the exchange cover scheme, reducing both its scale and the amount of subsidy paid to nationalised industry borrowers as an inducement to take part. We are to discuss with the Chancellor on 16 September.

2. Meanwhile, we have to continue to take operational decisions on the existing programme.

3. The next substantial tranche of borrowing tentatively pencilled in is for September. British Coal have a financing requirement of around £215 million then, which needs to be satisfied on or about 20 September.

4. We could pass this up. But it is the kind of substantial one-off requirement which we might well want to continue with even under the proposed new regime, and there are few others immediately on the horizon if we miss this opportunity.

5. If you are content, we therefore propose to make use of about two-thirds of it in a way consistent with the existing strategy. What we have in mind at present is:

i. To borrow about £90 million equivalent, probably in DM, through the intermediation of the European Coal and Steel Community (ECSC). This is the maximum amount for which British Coal currently have project approval to borrow in this way.

ii. To borrow about £50 million equivalent in DM through a repeat of the Schuldschein operation which we undertook last month (also for British Coal) and which proved to be entirely discreet.

6. As an alternative/complement to this, the Bank are exploring the possibility of a swap into US dollars from yen or Australian dollars.

7. The South of Scotland Electricity Board have a requirement in early September, for $50 million, which the EIB can provide in sub-LIBOR dollars.

8. Unless the Chancellor were prepared to agree now to a reduction in the subsidy paid under the scheme (which I am not sure that I would want to recommend unless and until there was a firm decision to rely more than in the past on own name borrowing), we will almost certainly have to pay the existing half per cent to British Coal and SSEB on their borrowings. I see no alternative to this.

C W KELLY

3760/021

CONFIDENTIAL

FROM: P D P BARNES
DATE: 2? July 1987

MR KELLY

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr M Williams
Ms Goodman
Mrs Diggle

FOREIGN CURRENCY BORROWING PROGRAMME

The Economic Secretary was grateful for your submission of 28 July.

2. The Economic Secretary is content that you should go ahead with the borrowing you propose, especially since nationalised industries will be net repayers of debt in the fourth quarter.

3. On the question of the ½ per cent incentive, the Economic Secretary calculates, on the assumption that this would be a one off payment rather than an annual subsidy, that the amount at stake is about £¾ million on this borrowing. He wonders why we cannot reduce this. In particular, he wonders whether it is the case that a reduction might mean that the industries would refuse to borrow foreign currency; if so, how it is that we can envisage a cut ultimately to 1/8th per cent; and whether a reduction this time to, say, ¼ per cent would rule out any further subsequent cut.

PS/EST
KELLY
28 July

PB

P D P BARNES
Private Secretary

3885B/031

CONFIDENTIAL

FROM: C W KELLY
DATE: 30 July 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr M Williams
Ms Goodman
Mrs Diggle

KELLY
↓
EST
30 JULY

FOREIGN CURRENCY BORROWING PROGRAMME

You asked whether a reduction in the half per cent incentive paid under the exchange cover scheme would mean that the industries lined up to borrow on our behalf in the autumn would refuse to participate.

2. It is difficult to be entirely certain about this.

3. On the one hand, participation in the scheme does provide them with some advantages over and above that of cost. In particular, some treasurers obviously get personal satisfaction out of the thought that they are tapping the international markets.

4. But they still have to persuade their boards, and there can also be costs to them of a kind which we do not reimburse. For example, although we are careful not to get in the position of asking the industries to do something which might be against their commercial interest, they do sometimes adjust the timing of their borrowing to fit in with what we want them to do, and that can be to their disadvantage if interest rates change adversely in the meantime. The South of Scotland Electricity Board was caught like this recently. In addition, foreign currency borrowing can sometimes involve them in a degree of complexity which they might rather be without.

5. My guess is that if we did lower the incentive (which incidentally is a continuing one throughout the life of the loan rather than one-off) some of the borrowers would decide that they would continue to co-operate, and others would decide they would prefer not to.

6. Such an outcome would not concern us at all if we were to follow the strategy suggested in the submission, particularly since those most likely to remain are those capable of borrowing reasonably large amounts at one go. But it could lead us feeling uncomfortable if we were to continue to rely upon nationalised industries for <u>all</u> our borrowing needs, because we would then need all the borrowers we could get.

7. It seems to me unwise therefore to make the reduction until we are certain that we are following the strategy proposed, rather than sticking with the old one.

8. It would incidentally be difficult to make the change only for the borrowers mentioned in my submission of 28 July, and not for the continuing dribble of borrowing by eg local authorities. If we are to make a change, we would have to announce it and promulgate it generally.

CWK

C W KELLY

3885B/030

CONFIDENTIAL

FROM: C W KELLY

DATE: 30 July 1987

Ch/

To see. You will also want to see Mr Kelly's minute of 30/7 to EST, below.

I am attracted in X: psr [illegible]...

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman
Mr Cropper

KELLY
CH/EX
30 July

FOREIGN CURRENCY BORROWING : A SOVEREIGN NOTE PROGRAMME

You asked us to expand on the idea of a sovereign note programme proposed in my minute of 14 July.

2. I attach a note about this prepared by the Bank of England.

3. The note is written in fairly general terms. It is difficult to be more specific until we have spoken in detail to potential operators. The Bank are, quite rightly, reluctant to do this until they know you are attracted by the idea in principle. We do not want the markets to get wind of what we are about prematurely.

4. The main features are, however, fairly clear:

i. The programme could amount ultimately to several billion dollars, built up over a period.

ii. We would sell the notes both in the US domestic market and in the Euromarket, though we would probably start in one or the other first.

iii. We would try to market them in a way which would distinguish them from conventional commercial paper, following the (successful) lead set by Canada with their Canada Bills.

iv. We would aim to operate the programme fairly flexibly, changing the amount outstanding according to market conditions and our own needs. But we ought to aim for a minimum programme of at least $1 billion to ensure liquidity.

v. The selling mechanism would probably be to post prices each day on the basis of which a small group of competiting selling agents would solicit orders from their clients.

vi. The posting would be done by the Bank, probably by the unit which deals with the investment of the reserves and which will be able to draw on experience in managing asset of around $2 billion in the form of other short-term sovereign dollar paper. They would, however, operate within the context of a general strategy agreed with us.

vii. The Bank's current judgement is that we ought to be able to aim at pricing of around Libid -25 basis points. The selling cost would probably be fairly small, perhaps several basis points only (though this is one of the areas we would have to explore). There would also be some start-up costs.

viii. If the target pricing were achieved, we ought to be able to make a small turn in investing the proceeds, rather a larger one if they were used instead to repay eg some of the existing relatively expensive bank debt rather than treated as an increment to the reserves.

X

ix. The price advantage would, however, be reduced to the extent that it was thought necessary to supplement the programme with some kind of back-up facility.

5. The key question is perhaps whether we could feel comfortable with a large part of our reserves backed by a short-term programme. My own view is that we can now afford to be rather more relaxed about this than when we last looked at the idea,

partly because our reserves are now at a much higher level (so that the note programme would account for a much smaller proportion), and partly because the experience of Canada has shown both that it is possible to run the programme up and down in a fairly discreet fashion and that circumstances which might affect yields on long-term debt have had no noticeable impact on the demand for, or cost of, issues of short-term paper.

CWK

C W KELLY

enc

cc: Mr Plenderleith) Bank of England
Mr Page)

SOVEREIGN NOTE PROGRAMME FOR THE UK

(Note by the Bank of England)

1. One of the main recommendations of the recent paper on Foreign Currency Borrowing was that consideration should be given to launching a sovereign note programme in HMG's name.

2. This possibility was first put forward in a Bank paper in 1985 during the discussions which led to the issue in October 1985 of the $2½bn FRN. At that time it was not the preferred option as the low level of the foreign currency reserves made assured longer-term finance the prime need. In present circumstances a note programme warrants serious consideration. Such a programme could offer considerable flexibility as well as attractive terms. It would take the form of regular issues of short dated dollar paper (although were we to join the ERM, some thought should also be given to the possibility of an ECU programme). The paper would be sold internationally and rolled over continually. If desired, such a progamme could over time raise fairly substantial sums, ultimately up to several billion dollars. Alternatively, or additionally, it could be used to bridge shortfalls in the borrowing programme as they emerged, with the aim of refinancing funds raised on a longer term basis when the capital markets became more receptive.

3. We already have a small, but well-established presence in one of the domestic US short term note markets - commercial paper - through a $500mn programme on behalf of SSEB (in the past there have also been similar programmes for British Gas and Rolls Royce, but these were run down prior to privatisation). The US commercial paper market now totals around $350bn. Parallel US domestic markets are US Treasury Bills ($400bn), bankers acceptances ($70bn) and CDs ($50bn). In addition the US Federal Agencies, the IBRD, and the Government of Canada run short term note programmes totalling around $30bn. In recent years a Euro commercial paper (ECP) market has also developed strongly - the total outstanding of ECP is currently probably around $35bn.

BANK OF ENG. NOTE

4. Until recently, sovereigns were not able to enter the US commercial paper market in their own name, lacking the necessary "current transactions" (ie commercial receipts and payments) to obtain the SEC's waiver from registration which is necessary for all commercial paper issues. But the SEC is nowadays willing to accept that the "current transactions" of state enterprises meet the case. As a result a number of sovereign issuers - Canada, Denmark, New Zealand, Spain and Sweden - have entered the market. HMG should be able to obtain the same exemption.

5. While we could launch an HMG commercial paper programme a more attractive way to capitalise on the strength of our name would be to aim to differentiate the programme from other sovereign commercial paper and rather try to position ourselves alongside Federal Agency discount notes. IBRD adopted this approach in 1982 with their own discount note programme, and more recently the Government of Canada launched "Canada Bills" in October 1986. A critical factor would be the pricing of the paper. The levels at which the different instruments trade varies from day to day. As a guide, however, the level at which sovereigns (eg Sweden) and supranational borrowers (eg EIB) trade is roughly the same in the ECP and US domestic CP markets at around Libid - 15bp. Generally, IBRD discount rates and Canada Bills are issued at levels around 10bp or so lower and the Federal Agencies (FNMA and FHLB) issue at roughly the same margin lower again. At the moment, in fact, the spreads between issuers are slightly narrower.

6. Realistically we could not hope to price HMG notes on a level with those issued by the Federal Agencies, since they enjoy a wide range of investment approvals (eg eligibility for investment by various regulated institutions) which our notes would not be able to obtain. And to some extent such advantages also exist for IBRD and Canada. However against this, there is substantial interest for paper issued by sovereign names of the quality of HMG - as demonstrated by the success of the two FRN's - and provided we took care to build the programme up slowly, waiting for the best rates, we might be able to issue at terms close to, and even possibly better than, those achieved by IBRD and Canada.

7. If we achieved the target of pricing at around Libid - 25bp, we should have little difficulty in reinvesting the proceeds from the programme profitably.

8. The most important element of the strategy to achieve this target pricing will be the marketing of the programme. Subject to further discussion with some of the leading players in the market, which we can undertake if the idea is felt worth pursuing further, our current thinking on how to handle this programme is as follows. We would need to be ready to offer paper each day so that the widest possible range of investors would have the assurance of being able to buy paper from us on a regular basis. The selling mechanism should be aimed to mimic that of the Federal Agencies with prices posted each day on the basis of which a small group of competing selling agents would solicit orders from their clients. The pricing of paper would also take into account the knowledge we gain from the investment of over $2bn of the reserves in other short term sovereign dollar paper. These same agents would be required to ensure the liquidity of the paper in the secondary market: good liquidity would require the maintenance of a minimum programme of probably at least $1bn. Other elements of the strategy would be designed to distinguish the notes in investors eyes from existing commercial paper. These would include not seeking a commercial paper rating for the programme but relying instead on the UK's AAA long term debt rating; the name of the notes - possibly UK $ Treasury Bills; and the settlement arrangements, where we should try to follow the same mechanism as applying to Federal Agency paper.

9. The above discussion has focussed on the US domestic short term paper market. It should however be possible to sell the same or very similar short term HMG notes in the euro commercial paper market with a similar method of distribution. An obvious way of maximising our use of these two short term note markets would be to treat the two as complements rather than substitutes, by mounting a programme to tap both. We would need to consider whether we should launch into the two markets simultaneously, or follow a two-step approach, beginning say in the US and then extending into ECP if and when we have established a firm base in the US (or vice versa). We might have a better chance of

getting the rates we want if we start in the US, at the heart of the dollar note market where liquidity is greatest and quality differentials, which ought to work in our favour, are most accurately reflected in rates obtained. The risk of our suffering from a drying-up of interest if markets weaken is also much less in the US than in the euromarket.

10. A subsidiary question in running a note programme is whether it needs to be backed by an underwriting commitment or a back-up credit through which the borrower can refinance notes if for any reason he cannot sell them in the market. If it were felt necessary, we could arrange such a facility to cover some or all of the programme. This would however add to the cost. For the present, with the reserves, and their liquidity, at relatively high levels, we would be inclined to forego this protection. Were circumstances to change in the future, a facility in this form might become more necessary, even though in those circumstances it would be likely to be somewhat more expensive.

11. The main disadvantage that was seen in 1985 for a note programme was that the borrowing would be on a short-term rollover basis. For reserve management purposes, given the low level of the reserves at the time, the prime need was to fund debt repayment by assured longer-term finance. It was thought that there could be circumstances where there was a loss of confidence abroad in the UK which would make it difficult to maintain a note programme without accepting yields which would themselves reflect adversely on the UK's standing; but where the only alternative would be to cease issuing fresh paper, with a consequent drain on the reserves, which might be under pressure for other reasons in the circumstances envisaged. However in our present position this is perhaps less of a concern now, and the markets have in the meantime become more resilient for the better names. Canada, for example, has been subject to considerable strains both domestically and internationally over the last few years. While these lead to rumours that the ratings for its foreign currency bonds might be downgraded - with consequent increases in the yields at which existing

euro-Canadian issues traded - they had no noticeable impact on the demand and cost of issues of Canadian short term dollar paper.

Conclusion

12. The idea of a note programme seems to us to have merit, and to fit well with the way in which it is proposed external debt management policy should be conducted in the immediate future. If there is interest in pursuing this idea further, we suggest that the next step should be for us to explore how such a programme might best be organised in more concrete detail by talking to a few of the major market participants. We would do this on a purely exploratory basis and we are reasonably sure that confidentiality could be maintained.

Bank of England
28 July 1987

MR 1/36

CONFIDENTIAL

BF 9/9.

FROM: A C S ALLAN
DATE: 3 August 1987

MR KELLY

ACSA
KELLY
3 Aug

cc: PS/EST
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman
Mr Cropper

FOREIGN CURRENCY BORROWING: A SOVEREIGN NOTE PROGRAMME

The Chancellor was grateful for your minute of 30 July, which he will want to discuss with you at the meeting on 16 September.

2. There is one point on which he would be grateful for further elaboration before the meeting: this was your comment in paragraph 4(viii) that we might make a larger turn if we used the proceeds of a note issue to repay some of the existing relatively expensive bank debt.

ACSA

A C S ALLAN

3885B/039

CONFIDENTIAL

FROM: C W KELLY
DATE: 5 August 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman o/r
Mr Cropper

FOREIGN CURRENCY BORROWING : A SOVEREIGN NOTE PROGRAMME

You ask me to expand on my comment that we might make a larger turn if we used the proceeds of the note issue to repay some of the existing relatively expensive bank debt.

2. The Bank think that if we were to have note programme we might reasonably aim at a target price of around LIBID -25 basis points. Selling agent fees and start-up costs would knock a bit off this, but probably not an enormous amount.

3. If we were to treat the proceeds as an increment to the reserves, part could be switched into other currencies and part into short-dated fixed rate securities, depending upon investment strategy at the time. But a large part would almost certainly be held in floating rate form in the usual mixture of current accounts, the short-term paper of other sovereigns and market deposits with the BIS and other banks. The lowest yield on these type of instruments is probably LIBID -25 basis points, the highest around LIBOR. We are unlikely to want to add much, if anything to our portfolio of US Treasury Bills, which yield well below this.

4. On this basis, we ought therefore to be able on average to make a small turn, but not a very large one.

5. The alternative is to make use of some or all of the proceeds to substitute for existing debt. The most obvious candidate in this context is the $2.2 billion or so we have of bank credits. The Bank have made considerable progress over the last year or so in renegotiating the terms on this. But we are still paying an average of something like LIBOR +¼. Refinancing part of this at sub-LIBID rate would bring significant financial advantage.

6. There are, however, a number of other considerations:

i. To the extent that we use the proceeds of the note issue to refinance existing debt we would be passing up the opportunity of increasing the level of the reserves - which might be important, if for example, a decision were to be taken to join the ERM.

ii. There is a potential relationship issue. It would not be conducive to good relations with the banks to call in the credits within a relatively short time of going to the trouble of renegotiating them, even though we have the right to do so.

iii. Apart from the effect on our general reputation, this could become important if we thought there was a possibility of wanting to turn to the banks again in the near future for a substantial part of our borrowing requirement.

7. The Bank attach considerable importance to (ii) and (iii). I have some sympathy with this point of view. But it seems to me to have become less compelling now that the reserves are so much more substantial than they were, particularly since a note issue would itself provide some of the flexibility which we might previously have expected to obtain by financing through the banking system.

8. In any event, not all the bank debt has been renegotiated this year. There is a large slug which was either renegotiated earlier, did not need to be renegotiated because it was initally taken out on comparable terms, or has not yet been touched for some other reason. The note programme will also take some while to build up to its full extent, by which time a more decent interval will have passed even on that part of the debt which has been recently renegotiated.

9. My conclusion is that if you were attracted by the idea of a note programme, and if you did not regard building up the reserves as an overwhelming objective, a sensible strategy might be to use part of the proceeds to retire part of the bank debt over a period of time, but for the moment at least stopping short of going the whole hog and retiring the lot. We could perhaps aim to have reduced it by, say, up to $1 billion by the end of the first 12 months of the note programme, depending upon how that developed and on other circumstances.

C W KELLY

cc:- Mr Plenderleith o/r) Bank of England
Mr Page)

PH1/85

CONFIDENTIAL

FROM: CATHY RYDING

DATE: 10 AUGUST 1987

MR C W KELLY

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman
Mr Cropper

FOREIGN CURRENT BORROWING: A SOVEREIGN NOTE PROGRAMME

The Chancellor was grateful for your minute of 5 August.

2. The Chancellor has commented that a sovereign note programme would be a new departure. The Chancellor would rather, therefore, contemplate embarking on it in two stages. The first stage would be simply to replace as much existing more expensive debt as the Bank can be persuaded is wearable. Then, when the time seems right, we could continue the sovereign note programme (which by then would have become a familiar event) in order to augment the reserves. He would be grateful if you would work out a plan for stage 1, keeping stage 2 up our sleeves for the time being.

CR

CATHY RYDING

4323.4

SECRET

FROM: H C GOODMAN
DATE: 1 September 1987

1. MR KELLY
2. CHANCELLOR OF THE EXCHEQUER

cc: PS/Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Peretz
Mr Culpin
Mr Nelson
Mr Polin

RESERVES IN AUGUST

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

2. The figure we are publishing for the underlying change in the reserves, which is usually taken as the measure of intervention during the month is -$457 million. I understand you discussed the figure to be published with Mr Cassell before going on holiday and suggested a negative figure slightly below last month's +$499 million. In fact the situation changed very little in the last fortnight and with the agreement of the Economic and Financial Secretaries we asked the Bank to go for a figure in the $450-460 million range.

3. The true figure was about -$860 million, thus it was necessary to reduce the forward book by $400 million. This now stands at $3¾ billion, which gives ample scope to provide the Ministry of Defence with their foreign currency requirements for the remainder of the year of $1½ billion in September. Following your meeting on 24 July we told the Ministry of Defence they could take up this option and they have now responded positively.

SECRET

4. The market's expectation is for the figures to be flat, so the foreign exchanges may be somewhat disappointed. The markets were clearly not aware of the intervention carried out in the week of the base rate rise to support sterling, so we can expect to see some downward pressure on sterling as a result but understanding of the 7 August move, which took them by surprise may, improve. The reception in the gilts market may, however, by more influenced by the positive implication for funding.

5. The total change in the spot reserves which takes account also of transactions on the capital account was larger at -$550 million, because of net repayments of foreign currency borrowing of $90 million.

6. The second table, which is not published, gives details of other countries' market intervention during the month. The French and the Italians have done substantial intervention and the Italians in particular have been under pressure, necessitating an interest rate rise, but renewed political stability has eased their situation. For much of the month, the Danes have been at the bottom of the ERM, amid rumours that they will devalue after their election. In general though the mechanism has been quiet. Elsewhere the Japanese did a substantial amount in an attempt to keep the dollar above Y141 and at the end of the month the Fed also took some action.

7. Table 3 gives a comparison of published changes in the UK Reserves and other countries', but the figures are subject to different valuation and other conventions so they give only a broad order of magnitude and should be treated with caution.

8. The press notice is published at 11.30am tomorrow. We would be grateful for your approval of the press briefing as early as possible in the morning.

H C Goodman

H C GOODMAN

SECRET

TABLE 1 - RESERVE TRANSACTIONS FOR AUGUST 1987

		$ million	
		Spot	Forward
1.	End July levels	34915	4151
2.	Transactions in August		
(i)	Market	-515	-9
(ii)	Swaps	-234	+ 234
(iii)	Maturities	+ 625	-625
(iv)	Other Bank customers	-107	-
(v)	Government		
	(a) departments' expenditure	-269	-
	(b) public sector debt interest	-47	-
	(c) HMG debt interest	-1	-
	(d) IMF interest	-1	-
(vi)	Interest on the reserves	+ 92	-
TOTAL INTERVENTION		**-457**	**-400**
(vii)	Public sector borrowing under ECS		
	(a) borrowing	+ 30	
	(b) repayment	-121	
	net	-91	
(viii)	Repayments of HMG assigned debt	-2	
CHANGE IN THE RESERVES		**-550**	**-400**
3.	End August levels	34365	3751

SECRET

SECRET

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

August 1987

	Dollars	EMS Currencies ($ million equivalent)
Ireland	-64	-47 DM
Belgium	-242 -50 agst. DM	-160 DM -44 ECU
France	-714 -267 agst. DM	-40 DM
Italy	-2102	-870 DM
Netherlands	+ 20(Forward)	+ 16 DM(Forward)
Germany	-133	-
Denmark	+ 46	-
Spain	+ 823	-
Sweden	+ 70	-
Norway	+ 251	-
Switzerland	+ 40	-
Japan	+ 959	-
Canada	+ 712 -50 agst. DM	-
US	-681 agst. DM + 105 agst. Yen	-
Greece	+ 31	-

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

SECRET

4317.8

CONFIDENTIAL

ERMP C/8

FROM: B NELSON
DATE: 2 September 1987

1. MS GOODMAN ✓ M Goodman 1/ix.
2. CHANCELLOR OF THE EXCHEQUER

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 Call

THE RESERVES IN AUGUST 1987

The reserves announcement for August will be made on Wednesday 2 September at 11.30 am. This month's announcement reports a fall in the reserves of $550 million and an underlying fall of $457 million.

B NELSON

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

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

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until 11.30 Wednesday 2 September 1987
thereafter UNCLASSIFIED

DRAFT PRESS NOTICE

THE RESERVES IN AUGUST 1987

The UK official reserves fell by $550 million in August. Accruals of borrowing under the exchange cover scheme amounted to $30 million; repayments of such borrowing amounted to $121 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 August, the reserves stood at $34,365 million (£21,076 million*) compared with $34,915 million (£21,915 million+) at the end of July.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying fall in the reserves during August was $457 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).

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

South of Scotland Electricity Board, $30 million.

---

* When converted at the closing market rate on Friday 28 August £1=$1.6305

\+ When converted at the closing market rate on Friday 31 July £1=1.5932

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until 11.30 Wednesday 2 September 1987
thereafter UNCLASSIFIED

Repayments of such borrowing were:

British Coal, $108 million; Electricity Council, $5 million; British Airways plc, $2 million; British Railways Board, $2 million; South of Scotland Electricity Board, $2 million; West Midlands County Council, $1 million; Others, $1 million.

THE RESERVES IN AUGUST 1987 : PRESS BRIEFING

Factual : main features of markets in August

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
3 August	72.1	1.58½	2.95½	103.8	1.86½	150½
6 August	72.1	1.57½	2.96½	104.5	1.88	151
11 August	72.2	1.57	2.98	105.1	1.89½	151½
17 August	72.6	1.59	2.98	104.2	1.87½	150
24 August	72.7	1.63½	2.97	101.1	1.81½	142
28 August	72.5	1.63	2.95½	101.1	1.81½	142

Attention last month focussed on the dollar. Sterling was largely on the sidelines and a series of indicators had little or no impact. At the beginning of the month (and in the last two days of July, which count for value in August) sentiment was rather negative. The base rate rise on 7 August produced little immediate reaction but led to some downward pressure on fears of bad trade figures to be published on 11 August. In the event there was little reaction. This pattern was repeated with the publication of the provisional money numbers on 20 August. During the month large overseas investments (by Nat West, Kidde, WPT and Blue Arrow) also had an impact in pushing sterling down. Towards the end of the month weaker oil prices, fears of a miners' strike, and anticipation of the July trade figures produced some more downward pressure. Sterling rates fluctuated against the dollar and other currencies, usually in opposite directions, with the effective rate moving over the month from 72.1 to 72.5.

At the beginning of the month the dollar rose to DM 1.89¾ and Yen 152 on continuing concern about the Middle East. Central Bank intervention during the first week steadied the dollar at DM 1.89, but the publication of disappointing US trade figures for June at the end of the second week led to a sharp decline

against DM and Yen which carried through into the second half of the month, following the downward revision of US second quarter's GNP figure. The dollar slide was not helped by statements from US officials, but further substantial Central Bank intervention steadied it to close the month at DM1.81½ and Yen 142.

Previous reserve changes

(i) Reserve changes ~~in recent months~~ this year have been:

$ million

		Underlying Change	**Total Change**
1987	January	+ 72	+ 29
	February	+ 287	+ 305
	March	+ 1785	+ 1892
	April	+ 2912	+ 2768
	May	+ 4760	+ 4872
	June	- 230	- 315
	July	+ 499	+ 551
	August	- 457	- 550
	Jan-Aug total	+9628	+9552

Bank Base Rates

Base rate changes ~~in recent months~~ this year have been:

		Base Rate	**Change**
1987	10 March	10½	Down ½%
	19 March	10	Down ½%
	29 April	9½	Down ½%
	11 May	9	Down ½%
	7 August	10	Up 1%

POSITIVE

1. Reserves strong after substantial underlying increases in first half of the year. Fall this month broadly same size as increase last month.

Since the Budget

2. Sterling has remained broadly stable, in line with February agreement at the Louvre, ~~which is holding well.~~

~~3. Sterling held up well on publication of the June and July trade figures and July money numbers.~~

DEFENSIVE

1. **Exchange rate policy.** Chancellor made clear that period of stability for sterling and other currencies highly desirable. Actions in recent months bear this out.

[Chancellor said in speech to CBI annual dinner on 19 May:

> "I allowed, last year, a proper adjustment in the exchange rate as we lost, in short order, half the value of our oil. I made clear in the autumn that the adjustment had gone far enough. I have made equally clear this Spring that I do not want to see it reversed. And I have shown, as plainly as possible, that I share the overwhelming view of British industry that a period of exchange rate stability is now highly desirable".]

2. **Louvre accord?** Reaffirmed at Venice Summit. Has now successfully produced six months of exchange rate stability. Recorded intervention of G7 countries shows commitment translated into action.

3. **June and July trade deficits show fall in exchange rate needed to maintain competitiveness?** ~~Non-oil visible trade responding to 1986 exchange rate adjustment.~~ Vital to keep pay ~~settlements~~ costs under control if ~~existing gains in~~ competitiveness to be maintained.

4. **Details of intervention?** Policy never to discuss. Not for us to disclose other countries' actions, but see Q2.

No. Total deficit this year ~~smaller than~~ running slower than envisaged at Budget time. No reason to change earlier judgement that present level of sterling is appropriate.

acceptable

5. **Implications for funding?** Policy is full fund of PSBR over financial year as a whole. Other things being equal a fall in reserves means lower sales of debt to achieve a given quantity of funding. Funding programme well on course.

6. **Risk of 7 August base rate rise pushing sterling up too far?** Balance struck between exchange rate and domestic monetary growth consistent with aims for money GDP and inflation.

7. **UK membership of ERM.** No change in Government position. Matter kept under continual review. Will join when satisfied that balance clearly favours doing so.

8. **Will UK join ERM at 12 September Ecofin when EMS on agenda?** UK member of EMS, therefore takes full part in discussions - this is just a regular meeting. Question of ERM membership separate. See above. Nothing to add to what Chancellor said on 15 June:

> "It would have been too complicated membership [of the ERM] before the election. Clearly now that [the General Election] is out of the way, it becomes something we can consider on its merits. That was the only change in the [Government's] position."

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	- 0.9	46
Japan	+ 0.5	70
Germany	- 0.9	50
France	+ 0.1	66
Italy	- 0.6	50
Canada	+ 0.1	6
United Kingdom	- 0.6	34

Notes

1. The figures for Germany, France and Italy were originally published in ECUs.
2. Figures converted to dollars at end July exchange rates except for USA figures, which are for end-May and UK which are for the end-August.
3. Figures not strictly comparable because of different valuation conventions for eg gold.

3886B/015

SECRET

Ch/ Content to write as drafted - and for the text to be handed over with the verbal reinforcements in para. 13? 25 8/9

FROM: C W KELLY
DATE: 8 September 1987

OK. on Dr 2 drafting [illegible]

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir G Littler o/r
Mr H P Evans
Mr Peretz

LETTER FROM SECRETARY BAKER : HONG KONG

You sent an interim reply on 1 September to the attached letter from Secretary Baker seeking your support for US pressure for a revaluation of the Hong Kong dollar. I now attach a substantive reply, which has been agreed with the Bank and FCO and has also benefitted from comments from Hong Kong and from Tim Lankester. Sir G Littler saw it in draft.

2. You went over some of this ground with Mr Baker in April. The arguments have not changed much since then.

3. The US want to see a Hong Kong dollar appreciation because:

i. It would strengthen their hand in further negotiations with the Koreans and Taiwanese. They have not so far achieved as much as they had hoped with these countries on the exchange rate front, finding the discussions very heavy going.

ii. It would help to reduce the pressures in Congress for tough trade legislation.

4. There are grounds for believing that they may be exaggerating the significance of both factors.

5. The Koreans and Taiwanese have no doubt mentioned the stability of the Hong Kong dollar viz a viz the US dollar as a reason for not wanting to move any faster themselves. But

whether in reality it would make any significant difference to them is another question. It seems unlikely to be the real sticking point.

6. Similarly, Mr Lankester's advice is that while a successful negotiation with Hong Kong might improve sentiment in Congress a little, it is unlikely to make that much difference. Both Houses seem a good deal less concerned about Hong Kong than about Taiwan and Korea and some other countries, perhaps recognising the modest size of its overall visible trade surplus (rather larger if invisibles are taken into account) and the open nature of its economy.

7. Just as they are probably exaggerating the potential advantages to them, the US show no sign of grasping the quite considerable difficulties which could be caused for Hong Kong by any change in the dollar link. The permanence of the link at its present level has become something of an article of faith there - and one for which the authorities have been prepared to pay a price. They stuck with the dollar while it was appreciating, despite the effect that had on their domestic economy, and they are staying with it now it is depreciating, despite the effect on the price level.

8. Given the feverish atmosphere in Hong Kong, it simply is not worth doing anything which might risk undermining fragile confidence there, particularly when the US case is such a feeble one.

9. The attached draft attempts to make the case against doing what the US want mainly on political/confidence grounds. But it also points out how Hong Kong can be distinguished from the other Asian NICs by the open nature of its economy. If there is any protectionism, it is arguably operated against Hong Kong by the US, through the multi-fibres agreement.

10. It must be unlikely that the Americans will find any of this convincing. They will have heard too much before in other contexts about immutable exchange rates and the consequences of changing them. But we ought to at least try; and it might be helpful if you were to follow up the letter with a bilateral discussion with Mr Baker in the margins of the annual meetings.

11. Schultz and Mulford have both written to the Governor of Hong Kong along similar lines. He is preparing a reply along lines consistent with the attached. The FCO are considering whether to ask the Foreign Secretary to send a message of his own to Schultz.

Handling

12. The draft letter is classified Secret, to rub in the delicate nature of the exchange as far as Hong Kong is concerned.

13. Baker's letter to you appears to have been delayed in transit. It seems advisable that your reply should now be got to him as quickly as possible, particularly since the US Trade Bill is about to go into conference. If you are content with the text, we will therefore telegraph it to Washington in advance of sending the signed version in the bag. In handing it over, the Embassy could:

i. Emphasise the sensitivity of this question as far as Hong Kong is concerned.

ii. Reiterate the importance we attach to maintenance of the link at its present rate.

iii. Wonder politely whether the US may not be exaggerating the significance a change in it would have either for Congressional sentiment or for the course of further negotiations with Korean and Taiwan.

iv. Suggest that you will want to reinforce the letter by speaking personally about it to Baker in the margins of the annual meetings.

C W KELLY

Encs

cc: Mr McLaren) FCO
Mr Hum)

Mr Loehnis) Bank of England
Mr Kent)

3886B/014

SECRET

DRAFT LETTER FROM CHANCELLOR OF THE EXCHEQUER TO:

The Hon James A Baker III
Secretary of the Treasury
Room 3330
Main Treasury Building
15th and Pennsylvania Avenue NW
WASHINGTON DC 20220
USA

HONG KONG

I am now able to respond more fully to your letter of 7 August, to which I sent you an interim reply on 1 September. As you know, there seems to be some delay in your letter reaching me.

I have reflected carefully on what you say. I fully share your view about the importance of doing all we can to forestall further protectionist measures. I support your efforts over Korea and Taiwan. I respect your judgement about the extent to which your hand would be strengthened with Congress and in future discussions with these countries about their exchange rates if there were now to be some modest appreciation in the Hong Kong dollar, although I wonder if such a change can really be a significant sticking point for either.

But I have not changed the view which I expressed in April that a change in the link would be both inappropriate and dangerous. I simply do not share the view contained in your letter that a modest revaluation in the Hong Kong dollar is unlikely to involve serious adverse consequences for Hong Kong. On the contrary, I believe that the consequences could potentially be very serious indeed.

There are now less than ten years to run before Hong Kong becomes a Special Administrative Region (SAR) of the Peoples Republic of China. We are effectively in a transitional period. We and the Chinese are engaged in intensive discussions, through a Joint Liaison Group, to ensure that the transfer of government in 1997 takes place as smoothly as possible; while the Chinese are busy drafting the Basic Law which will provide the legal framework for the future SAR. In general our co-operation with the Chinese is good. But we have some very difficult issues to deal with, and there are plenty of pitfalls ahead.

Against this background, political and financial confidence in Hong Kong is holding up well. But it is fragile and easily damaged. It is vital that we do nothing which might undermine it. The Joint Declaration signed in 1984 has been accepted as providing the best possible basis for the territory's continuing prosperity and the maintenance of its present freedoms. But there are naturally apprehensions, and confidence needs constantly to be reinforced. Loss of confidence would lead not only to damaging financial volatility and capital flight, but very likely also to the flight of those who provide so much of Hong Kong's entrepreneurial flair. There are already some signs of this happening. The British Government has a responsibility to the people of Hong Kong to do everything we can to preserve and buttress their present life style and economic system both before and after 1997. We take that responsibility very seriously. The price to be won if we succeed is considerable - the maintenance of a free market enclave in communist China.

You will know doubt recall the effect that a loss of confidence had in September 1983, when the Hong Kong dollar fell briefly to HK$9.50 to the US dollar. That crisis was averted by the establishment of the fixed rate system. Ever since, the link has been an important element in the preservation of confidence. It has become the fulcrum of the entire financial system. The Hong Kong government has repeatedly emphasised its permanence <u>at its present rate</u>, and has now mananged to get this widely accepted.

I appreciate that what you are proposing is a change in the rate and not abolition of the link. But my judgement is that in the peculiar circumstances of Hong Kong the two could be tantamount to the same thing. The link is maintained largely by market mechanisms, confidence in which could easily be shaken. The resources of the Exchange Fund, which hold the reserves of the Hong Kong government, are small in relation to volume of market transactions. Moreover, because Hong Kong is in the unusual position of not having a central monetary authority, some of those normal functions being undertaken by commercial banks, the monetary authorities cannot act entirely autonomously. A change - in either direction - in the rate of which the Hong Kong dollar is linked to the US dollar could easily set in train a chain of events which the Hong Kong authorities could not control. Once it was seen that the link could be moved upwards, it would become immediately apparent that it could equally be moved downwards, undermining confidence and introducing a new degree of instability.

I feel strongly that any such change must be avoided except in the most drastic circumstances. Premature fears of the partial loss of their competitive edge on the part of Korea and Taiwan clearly do not fall into this category.

It is because the Hong Kong authorities take the same view as strongly as I do that they stuck with the dollar link when the US dollar was appreciating, even though that contributed to a considerable slow-down in domestic economic activity, and continue to stick with it now, even at the risk of some overheating. Any competitive benefit that Hong Kong is currently enjoying from a weaker US dollar is by no means permanent.

These considerations are in my view paramount. But, even if they were not, there are a number of factors which distinguish Hong Kong's position from those of the other Asian NICs.

First, the Hong Kong economy is exceptionally open. It employs no restrictions on either trade or capital. By contrast, despite their recent or prospective removal of a number of trade barriers and capital controls, the domestic markets of Korea and Taiwan remain relatively protected. In this respect Hong Kong has already done more than any of its competitiors in recognising its responsibility, as you put it, for the preservation of an open trading system.

Second, Hong Kong is not only an open economy. It is also, partly as a result, very flexible. One consequence is that wage and price levels react relatively quickly to changes in the nominal exchange rate. There are already signs that inflation is picking up as a result of the effective depreciation in the Hong Kong dollar. The competitive adjustment you are seeking in the real exchange rate (which is, of course, what matters for these purposes) is already happening through this mechanism rather than through an adjustment in the nominal exchange rate.

Third, while I understand why you focus in your letter on bilateral trade balances, Congress ought to understand that these are irrelevant to an assessment of the need for adjustment in a wider context. I note, for example, that Section 1304(C) of the Senate Trade Bill would oblige the President to begin negotiations with other countries about their exchange rate only if they both have significant bilateral trade surpluses with the US and have material global surpluses. I do not accept, and I am sure that you do not either, that any country should seek to balance its trade flows with each trading partner individually.

But overall Hong Kong's trade surpluses have been small and of recent origin (see table attached). Indeed in 1987 the prospects are for the trade account to be an overall balance. Domestic exports continue to rise rapidly (though by much less to the US than to other countries. The US share of Hong Kong's domestic exports fell to 38 per cent in the first half of 1987 compared to 44 per cent in 1985). But there has been an equally rapid rise in imports, including particularly large increases from

Korea (71 per cent) and Taiwan (47 per cent). There is no evidence here of any gain in competitive edge against these countries. Indeed Hong Kong runs substantial trade deficits with both.

Full current figures for Hong Kong would be unlikely to alter the picture materially. Invisible trade is in surplus. But, partly offsetting this, the best guess the Hong Kong authorities can make is that taken together net flows arising from interest, profits and dividends and from transfers are in deficit. It is probable that the US, as the largest single investor in Hong Kong, is a significant recipient of such net outflows.

By contrast, Taiwan has long been in chronic current account surplus and Korea is moving into a very substantial one.

One final point. Even if I were to accept that it made sense to look at bilateral surpluses and deficits - which as I have said I believe can be seriously misleading - the position of Hong Kong is complicated by the growing proportion of its trade which is of an entrepot nature, particularly involving the US and China. Adjusting the bilateral trade figures for re-exports would significantly reduce Hong Kong's bilateral trade surplus with the US. If you have complaints about the balance of US trade with China, they should of course be directed towards the Chinese rather than to the Hong Kong authorities. As you know, the Hong Kong government has always been co-operative in responding to complaints about excessive Chinese content in Hong Kong textile exports to the US covered by the MFA - which is of course a form of trade restriction which adversely affects Hong Kong.

I hope that I have said enough to convince you that the politial and other sensitivities surrounding Hong Kong at the present time far outweigh any possible economic justification for a change in Hong Kong's link with the US dollar. In case I have not, I must emphasise that I regard this as a very delicate and important matter. I hope you will defer any further action until we have had a chance to discuss it together bilaterally at the annual meeting.

Although your own letter bears no security classification, I have marked this letter Secret. I would regard knowledge of the terms of these exchanges as potentially very damaging to confidence in Hong Kong and to the stability and prosperity of the territory.

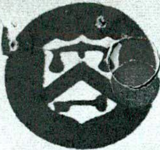
SECRET

ANNEX: TRADE BALANCE OF HONG KONG : 1978-1987 H1 HK$ billion

	Domestic exports	Re-exports	Total exports	Total imports	Of which "retained imports"	Visible trade balance
1978	40.7	13.2	53.9	63.1	49.9	- 9.1
1979	55.9	20.0	75.9	85.8	65.8	- 9.9
1980	68.2	30.1	98.2	111.7	81.6	- 13.4
1981	80.4	41.7	122.2	138.4	96.7	- 16.2
1982	83.0	44.4	127.4	142.9	98.5	- 15.5
1983	104.4	56.3	160.7	175.4	119.1	- 14.7
1984	137.9	83.5	221.4	223.4	139.9	- 1.9
1985	129.9	105.3	235.2	231.4	126.1	3.7
1986	154.0	122.5	276.5	276.0	153.5	0.6
1987 H1	85.8	80.1	165.9	172.2	92.1	- 6.2

Note: Components may not add to total because of rounding.

Source: Hong Kong Review of Overseas Trade in 1986.



THE SECRETARY OF THE TREASURY
WASHINGTON

CH/EXCHEQUER
REC. 25 AUG 1987
ACTION SIR G. LITTLER
COPIES TO CST EST
SIR P MIDDLETON
MR CASSELL
MR LAVELLE
MR M.P. EVANS
MR PERETZ
MR MOUNTFIELD

Mr Kelly

August 7, 1987

Dear Nigel:

I am writing to you to share our concern about Hong Kong's exchange rate policy. Assistant Secretary Mulford raised this issue with Geoff Littler in the spring, who agreed with our intention to contact senior Hong Kong officials regarding their exchange rate policies; in late April, in fact, we met with Monetary Affairs Secretary Nendick in Osaka.

In view of recent events -- including consideration of trade legislation by the U.S. Congress and the recent reduced movement in the appreciation of the new Taiwan (NT) dollar and Korean won -- we have decided to resume talks with the Hong Kong authorities as soon as possible. We recognize that Hong Kong has a completely fair and open trading system and, moreover, that it has special reasons for maintaining its link to the U.S. dollar. Nonetheless, we believe that a modest revaluation of its currency vis-a-vis the U.S. dollar is warranted.

Korea and Taiwan have allowed their currencies to appreciate after we initiated discussions with them last year on their exchange rate policies. Since the beginning of this year, the new Taiwan dollar has appreciated by more than 16 percent against the U.S. dollar and the Korean won by nearly 7 percent. Even so, further appreciation of the new Taiwan dollar and of the won is still required, as both have lagged far behind the appreciation of other key currencies against the dollar. The prospects for achieving additional movements by Korea and Taiwan will be jeopardized without similar, albeit more modest, action by Hong Kong, since both have expressed considerable concern during our discussions about the competitiveness that Hong Kong has been gaining against them due to its exchange rate policy.

Reflecting these competitive gains, our trade deficit with Hong Kong grew by 17 percent in 1986 to $7.6 billion. This bilateral trade surplus was equal to 21 percent of Hong Kong's GNP (compared with 1.5 percent for Germany, 2.8 percent for Japan, 6.7 percent for Korea, and 18.3 percent for Taiwan) and clearly illustrates the undue competitive edge that Hong Kong's exchange rate policy has given it in the U.S. market.

Although Hong Kong remains in balance in its overall trade account, a modest revaluation of its exchange rate would facilitate our efforts to obtain further appreciation of the Korean won and the NT dollar, as well as our efforts to resist protectionist legislation. Furthermore, we believe that a modest

revaluation of the HK dollar is unlikely to involve serious adverse consequences for Hong Kong, and would be accepted by the markets. In fact, such a revaluation could help to ease mounting inflationary pressure.

Both the Senate and House trade bills have now passed and will go to a joint conference in September, where the fate of provisions mandating negotiations and, potentially, retaliation against surplus countries is unclear. Without Hong Kong's cooperation, the Administration's prospects for forestalling such provisions will be diminished. Passage of such provisions could prove very injurious, not only to Hong Kong, but also to other countries and to the world's trading system. Thus, it is most important that Hong Kong understands its responsibility for the preservation of an open trading system, and act accordingly in the exchange rate area. We firmly believe that such action would be fully consistent with Hong Kong's long-term economic interests in an open, growing world economy, on which it is so critically dependent.

As you are well aware, our concern about the exchange rate policies of Hong Kong and the other Asian NICs is not just a bilateral matter. At the Louvre, we joined with our other G-7 colleagues in calling upon the NICs to allow their currencies to reflect more fully underlying fundamentals. At the Venice Summit, our Heads of States reiterated the importance of this, and urged the NICs to make a greater contribution in achieving a better global balance.

Consistent with these collaborative efforts, I hope that I will be able to count on your support on this issue as we continue our efforts to reduce global imbalances and prevent protectionist legislation.

Sincerely,

James A. Baker, III

The Right Honorable Nigel Lawson
Chancellor of the Exchequer of the United Kingdom
London

3763/037

SECRET

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 9 September 1987

PS/CHANCELLOR

CL – Text as approved by you typed up in enclosed folder.

cc Sir P Middleton
Sir G Littler
Mr H P Evans
Mr Peretz
Mr C W Kelly

LETTER FROM SECRETARY BAKER : HONG KONG

The Economic Secretary has seen Mr Kelly's submission to the Chancellor of 8 September.

2. The Economic Secretary thinks that the draft letter attached to Mr Kelly's submission considerably overstates the case for a fixed HK dollar/US dollar exchange rate. This may be harmless normal diplomatic hyperbole. But the Economic Secretary thinks that if Korea and Taiwan do eventually revalue, Hong Kong may wish to follow suit at some stage.

3. Nonetheless, the Economic Secretary thinks that, provided that we do not actually believe our own rhetoric, there is no harm in sending the letter as drafted.

Guy Westhead

P D P BARNES
Private Secretary

SECRET

3888B/013

CONFIDENTIAL

Timing/gain/objectives/stage 2 (flexibility)

KELLY
↓
CH/EX
15SEPT

FROM: C W KELLY

DATE: 15 September 1987

CHANCELLOR

Ch
All this is silent about timing
AA

cc: Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Peretz
Mr Culpin
Ms Goodman
Mr Cropper

FOREIGN CURRENCY BORROWING : A NOTE PROGRAMME

You suggested embarking on a sovereign note programme in two stages. The first stage would be intended only to refinance existing debt. Only when the programme was established would we contemplate increasing it so as to augment the reserves, if circumstances so allowed.

2. Neither we nor the Bank see any difficulty with this approach.

3. On launching the programme we would say something like:

i. Like the 1985/1986 FRNs it represents sensible use of an attractive market opportunity, taking advantage of the very high standing of the UK name in the international capital markets.

ii. Unlike the FRNs, however, the prime objective on this occasion is not to bring about a step increase in the reserves. It is to increase the flexibility of our management of external assets and liabilities and to ensure that we continue to minimise the cost of foreign currency borrowing. The proceeds would be used to refinance existing debt rather than add to the total outstanding.

4. We would want to try to avoid being too explicit about what it was precisely we were refinancing, since that would reduce the very flexibility we are seeking. The details would come out, for anyone who was interested, in the monthly reserves press notices.

5. Nor, obviously, would we want to be tied to trying to match precisely receipts from the programme with repayments of debt in any one month.

6. The amount of bank debt we could expect to prepay during this initial period would depend upon the size the programme assumes (which would partly depend upon demand) and on the extent to which we continued with other borrowing under the new arrangements proposed for the exchange cover scheme. A large part of the programme will be required simply to meet scheduled maturities and prepayments of other expensive debt which is already in hand or planned.

7. The arithmetic is as follows:

i. Scheduled repayments and prepayments already agreed for the last quarter of this year and for 1988 amount to around $2,100 million.

		$ million	
	1987 Q4	**1988**	**Total**
Scheduled repayments	450	1,110	1,560
Early repayments	375	170	545
Total	825	1,280	2,105

ii. Against this, new borrowing in the first three-quarters of this year is expected to exceed repayments by $230 million. So we have that much in hand already if the intention is broadly to keep the level of official debt as it was at the beginning of 1987.

iii. We have also pencilled in between $300 and $400 million new borrowings in the fourth quarter of the year under the (amended) exchange cover scheme.

iv. There is also likely to be some exchange cover scheme borrowing in 1988. It is very difficult to put a figure to this. It will depend upon a number of factors as well as market conditions. But it might be reasonable to think in terms of doing perhaps $400 to $500 million, with British Coal being the main borrower.

8. On this basis we would need to find between $1 billion and $1.2 billion out of the note programme over the next 15 months simply to refinance what we already have in hand before we begin to tackle the bank debt.

9. There is obviously a lot of uncertainty in these figures. We do not yet know how quickly we will be able to build up the note programme. Nor do we know how our few remaining borrowers will react to the revised terms for the exchange cover scheme. But on the assumption that we could, if necessary, live with a small reduction in the gross reserves, a reasonable ambition might be to aim to pay down over the next six to nine months all of the $600 million or so of bank debt which has not already been renegotiated in the recent past. This could imply building up the note programme to something of the order of $1.5 to $1.75 billion by, say, mid-1988. If the programme went well, we could then make a start on prepaying some of the remaining bank debt.

10. It is too early to speculate about how soon we might expect to go on to the stage of using the programme to increase the level

of the reserves. I should, however, perhaps put down on a marker that we will be constrained in future years, as well as in 1988, by the need to refinance scheduled maturities without being able to rely too much on indirect borrowing through the exchange cover scheme. And the first call on the 1985 FRN is as early as this time next year.

CWK

C W KELLY

cc:- Mr Plenderleith) Bank of England
Mr Page)

PMP

Clearly the ST Times pushes up Stephens. But ST.?? v. bad. X is for him: Bank must bring that to Times. N.

<u>Ch</u>

I'll get Robert onto this. It looks as if it's one story by Stephens out of Washington yesterday, followed up by him today & picked up by Telegraph leader writer.

I have told John Footman (PS/Gov) that this must stop. He assures me it is not official Bank briefing & will try to find out source (if it is from Washington, field is v narrow). I'm pretty sure it's not Eddie, who wouldn't do this sort of thing even given his worries about intervention/funding/inflation. But worth explaining your thoughts to him more fully & I shall fix up private drink after Party Conference. AA

Thursday, October 1, 1987

FINANCIAL TIMES

1/10/87.

Lawson urges break with free-floating exchange rate system

BY PHILIP STEPHENS IN WASHINGTON

MR NIGEL LAWSON, the Chancellor, yesterday called for a decisive break with the system of free-floating exchange rates established in 1973 in favour of a move to a permanent regime of managed rates.

His call, at the annual meeting of the International Monetary Fund in Washington, came as Mr James Baker, the US Treasury Secretary, suggested a more prominent role should be given to the gold price in international economic policy and exchange rate management.

The US Treasury Secretary said he was proposing consideration by the Group of Seven nations of the use of a new commodity price indicator, including gold. The indicator, he said, could be helpful as an early-warning signal of potential price trends.

He declined to elaborate, but it prompted speculation among officials in other delegations over whether the US Federal Reserve, the US central bank, might be considering mobilising its gold reserves.

Mr Lawson's speech emphasised his long-term commitment to the system of "managed floating" which the majorindustrial countries have been operating since February's Louvre Accord.

The informal target ranges which governments had been working with since then should be the basis for a more permanent system of exchange rate bands for the major currencies, he said.

The Chancellor added that he was not advocating a return to the Bretton Woods fixed exchange rate system. Governments should retain a degree of flexibility in terms of the width of the bands established around agreed central rates for their currencies.

He said, however, once the system had been established for some time details of the bands could be published. If the time came to adjust one currency's value, the movement in its central rate would be confined to within the existing band. This would prevent the markets from being given a one-way bet and would allow central banks to retain tactical flexibility.

Mr Lawson said he had discussed his ideas with other finance ministers in the Group of Seven leading industrial nations - the US, Japan, West Germany, France, Britain, Canada and Italy.

They were all agreed on the need for stable exchange rates, he said.

Senior monetary officials here said the thrust of the proposal was in line with the thinking of Mr Baker and that of Mr Eduard Balladur, the French Finance Minister. Earlier this week, Mr Balladur described the experience of floating rate as "disastrous."

It was far less certain, however, whether the British ideas would win support from Japan and West Germany. The central banks in those countries, which are independent from their governments, are extremely wary of too firm a commitment to fixed or semi-fixed exchange rates.

The Bank of England is also thought not to share Mr Lawson's enthusiasm for too precise a system which might limit the freedom of manouevre of national authorities in setting monetary policy.

Mr Karl Otto Poehl, president of the West German Bundesbank, re-affirmed his stance yesterday that the key objective of monetary policy must remain the defeat of inflation rather than management of exchange rates.

The Chancellor, however, said the recent experience should not be seen as a temporary phase. "Our objectives should be clear: to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way."

Managed floating, he said,

Continued on Back Page

IMF report, Page 4; Editorial comment, Page 26; Money makers, Page 39; Third World debt plan, Back Page

Exchange rate call

Continued from Page 1

could be underpinned by a broad policy framework for the Group of Seven.

This policy framework would involve the development of economic performance indicators for the group as a whole to ensure that there was no persistent inflationary or deflationary bias in their overall policy stance. The indicators would be mainly financial, but special attention would be paid to the trend of world comodity prices.

Goverments could agree a nominal framework for policy, in terms of either a path for the growth of output or for the average inflation rate.

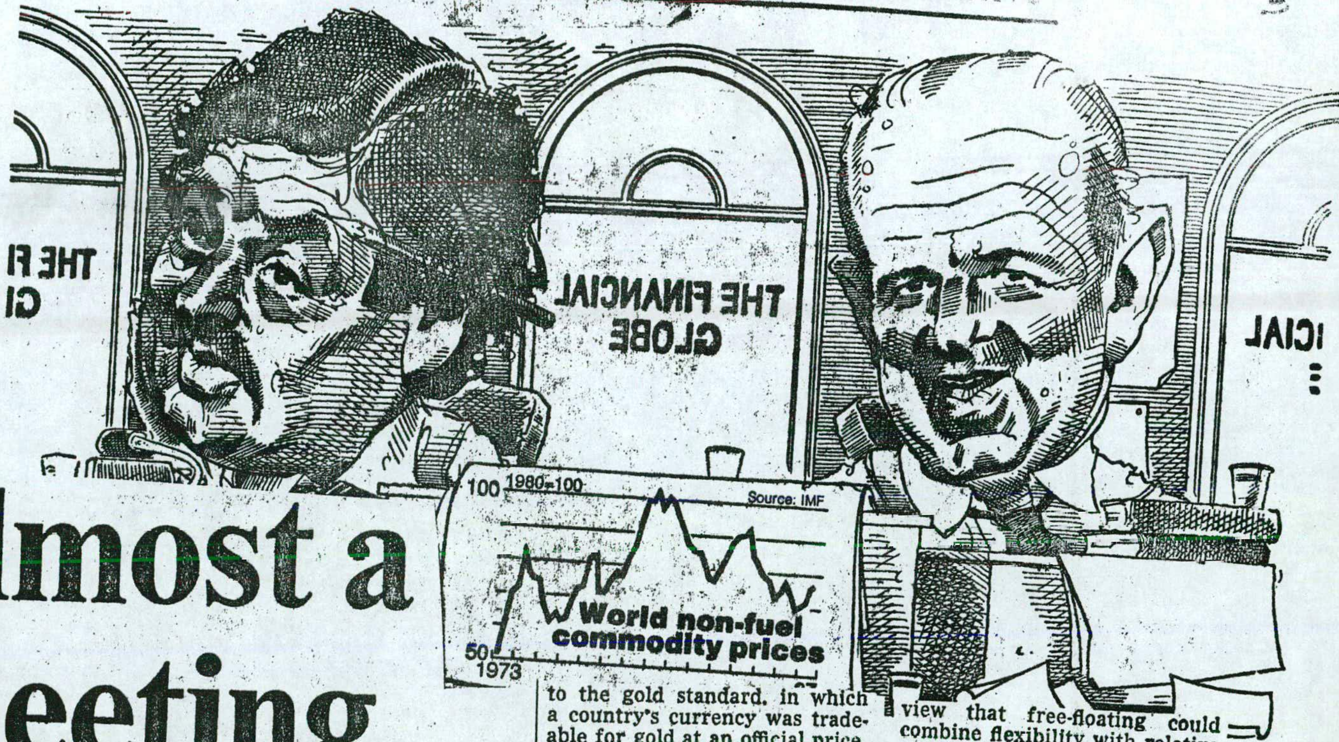
Mr Lawson said it would not be essential for Britain to become a full member of the European Monetary System for the regime of managed rates to operate. He added, however, that the Government's position was that at some point sterling would be taken into the exchange rate mechanism.

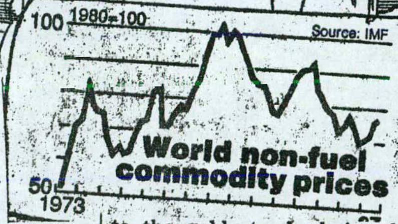
Mr Baker said the commodity price indicator he was suggesting would operate as "an analytical tool." It could be used along with other measures of economic performance - such as growth, external imbalances, and exchange rates - in reaching judgments about policies and performance.

He gave no indication, as to the weight that gold might be given in the proposed basket of commodities, nor whether he foresaw re-instating any direct link between the gold price and the dollar.

Officials with other delegations here said they were uncertain as to the extent that Mr Baker wanted to give a new role for the gold price, although the Treasury Secretary said he had discussed the idea with some other governments.

The Baker-Lawson currency initiative





Almost a meeting of minds

MR NIGEL LAWSON, Britain's Chancellor advocates a permanent shift to a system of managed exchange rates. Mr James Baker, the US Treasury Secretary, suggests that the gold price should be included in a new indicator of inflationary pressures in the world economy.

There is clearly something happening in international economic policymaking.

If nothing else, their two speeches at the International Monetary Fund this week underlined a decisive break with the regime of free-floating exchange rates which replaced the fixed-rate Bretton Woods system in the early 1970s.

Both seem determined that the Plaza accord of September 1985 and the subsequent Louvre agreement earlier this year should be more than brief episodes in economic history.

Instead, the concerted move first to devalue and then to stabilise the dollar should provide the basis for a new international monetary system. The actual shape of that system is much hazier.

Mr Baker's decision to single out gold for inclusion in a basket of commodities which might be used by policymakers as a guide to future price trends appeared deliberately ambiguous. Only in a subsequent background briefing for American journalists was he prepared to rule out a return to the gold standard.

Mr Lawson's detailed blueprint for a new world order, meanwhile, has yet to convince the Bank of England, let alone the more independently minded Japanese and West Germans.

The joint commitment by the Group of Seven industrial nations to the ad hoc system of exchange rate management now in place is not in question.

For now the two latest proposals are only ideas on the table. They will be considered alongside France's longstanding call for a system of currency "reference zones," based on national economic performance indicators, and alongside West Germany's preference for continued pragmatism in managing the present regime.

There was also the whiff of political opportunism. Mr Baker can justly claim to have been the driving force behind closer international exchange rate co-operation. The Plaza accord came at his initiative, and he set the subsequent pace towards a more formal framework for policy co-ordination.

The consensus in Washington, however, is that Mr Baker's priority now is the election of Vice-President Bush in the November 1988 presidential elections. Economic stability, and more specifically avoiding a sharp rise in US interest rates, is seen as one of the key

AFTER THE First World War, there was a widespread return to the gold standard, in which a country's currency was tradeable for gold at an official price. By the mid-1920s, the US, Germany, Britain and 39 other countries had returned to the standard at its pre-war parity, in spite of arguments from economists like Keynes that gold was overvalued. The system was designed to promote stability and curb inflation.

1931. International financial panic led to serious runs on currencies. The Bank of England suspended its obligation to sell gold on Sptember 21. A further 32 countries then aband-

prerequisites of a Bush victory.

And, in a country where daily television news reports still flash the gold price on the screen, a favourable reference to gold is hardly bad politics.

Mr Lawson has hung his own policy of stabilising sterling at a relatively competitive rate on the coat-tails of the Louvre accord. Clearly, the Chancellor has not abandoned his two-year campaign to persuade the Prime Minister to take sterling into the European Monetary System's exchange rate mechanism. As Britain takes a lead in international exchange rate management, Mrs Thatcher's objections to the EMS look increasingly eccentric.

If Mr Baker was the architect of enhanced exchange rate co-operation, Mr Lawson is displaying all the fervour of a religious convert. Only two years ago the British Treasury openly ridiculed US suggestions that free-floating should be permanently abandoned.

But this week it was Mr Lawson who provided the most detailed critique of the old system, and the clearest outline of how a permanent regime of "managed floating" might work.

The changing nature of financial markets, with speculative capital flows driving 24-hour trading had confounded the view that free-floating could combine flexibility with relative stability, he said.

To replace this system the Chancellor suggested a regime based on what governments and central banks have been doing since the Louvre accord.

The flexible—and secret—exchange rate bands established in February would be the foundation for a new system of "managed floating." Each currency would have a central rate within the bands, which could be moved to establish a new range if governments agreed an adjustment was needed. But, to limit speculative gains in the markets, the new band would be based on a central rate set within the limits of the previous range.

The bands, Mr Lawson said, would be underpinned by a broad policy framework aimed at ensuring that the overall policy stance of the Group of Seven had neither a persistent inflationary nor a deflationary bias.

The focus of the economic performance indicators which finance ministers have been using as the basis for co-ordination would switch from national to aggregate targets for the group.

These targets in turn would represent a framework for policy in terms of either a path for output growth in the group as a whole or one for the average inflation rate.

Performance against the targets would be monitored using a range of economic indicators, including the trend of world commodity prices. It is on this latter point that the British ideas chime with those of Mr Baker.

The shared view is that governments need to establish an overall anchor for inflationary expectations following the breakdown of credible policies

The Daily Telegraph

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Mr Lawson's apple holds its fascination

FORBIDDEN fruits are fairest. Chancellor Lawson's enthusiasm for the management of exchange rates grows apace the longer the Prime Minister's veto denies him his wish to participate in the European currency grouping. For months he has kept the pound in close alignment with the German Mark. Not content with that, he used his address to the International Monetary Fund on Wednesday to call for what amounts in all but name to a return to the Bretton Woods system of linked currencies worldwide which prevailed from the end of the war until the early 1970s.

Mr Lawson, to be fair, has more substantial reasons than pique to favour managed parities. For so long as the financial markets expect exchange rates to be stable, the relatively high level of British interest rates makes the pound look attractive. But there is a price to be paid. Holding exchange rates in rough alignment involves heavy intervention by central banks in the foreign exchange market. Buying foreign currencies to keep the national one from rising, as the Bank of England has been doing intermittently for many months, leads to a consequential growth in the availability of credit at home. Mr Lawson has convinced himself that this does not involve risks with future inflation. It is doubtful whether he has entirely convinced the Bank of England and he has certainly not convinced the German central bank. Nor does the US Treasury Secretary sound persuaded: "It would be unfortunate if our efforts . . . led to a stable currency relationship . . . but in the context of inflationary economic policies that reduced the real value of all currencies." It would indeed.

In any case Mr Lawson is surely baying for the moon. Currency packs need scoutmasters. Bretton Woods had the dollar: the Continental pack has the Deutschmark. There is no obviously acceptable currency leader nowadays for a global system. So we shall no doubt continue as we have been doing, with some governments, including our own, intervening to try to achieve desired currency levels, while others refrain from doing so.

We must hope that Chancellor Lawson is right to dismiss the potentially inflationary consequences of such intervention, and that in this instance the Germans are wrong.

3881B/029

SECRET

FROM: C W KELLY

DATE: 1 October 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Peretz
Mr Culpin
Ms Goodman
Mr Polin

RESERVES IN SEPTEMBER

I attach for your approval the draft press notice and accompanying briefing on the September reserves. The briefing draws heavily on your IMF press conference.

2. We are publishing an underlying change of +$380 million.

3. I am sorry that, despite your instructions, this is such a round number. The Bank were caught out by an unexpected transaction at the last moment.

4. The true intervention figure was +$1030 million. $650 million was added to the forward book. We expect to take most of that out again within the next few days in the form of further forward sales to the Ministry of Defence.

5. The range of market expectations is very wide. Most of the published forecasts are for a modest +$100 million or +$200 million. But these tend to date from before the intervention of earlier this week, and not everyone will fully appreciate that the bulk of that will count for value next month. Salomons have suggested a figure of +$2.5 billion.

6. In these circumstances it is difficult to judge how the actual figures will be taken. But it would surprise me if they had much impact at all.

7. There was only one piece of new foreign currency borrowing during the month, just over $100 million equivalent in DM by British Coal at the beginning of the month.

8. Other countries spot market intervention during the same period is shown in table 2. The ERM was relatively quiet. The Italians managed to reverse most of the support they had provided for the lire in August. The Germans, the Japanese, the Canadians and the US all bought modest amounts of dollars. The most substantial dollar purchases were by Spain ($1640 million) and Norway ($632 million). But this reflected their own particular circumstances rather than a contribution to Louvre - the seasonal pattern of tourist earnings in the case of Spain and returning political confidence in Norway.

CWK

C W KELLY

SECRET

TABLE 1 - RESERVE TRANSACTIONS FOR SEPTEMBER 1987

		$ million	
		Spot	**Forward**
1.	End August levels	34365	3751
2.	Transactions in ~~August~~ september		
(i)	Market	+ 1560	-2
(ii)	Swaps	-1381	+ 1381
(iii)	Maturities	+ 725	-725
(iv)	Other Bank customers	-78	-3
(v)	Government		
	(a) departments' expenditure	-361	-
	(b) public sector debt interest	-69	-
	(c) HMG debt interest	-76	-
(vi)	Interest on the reserves	+ 60	-1
TOTAL INTERVENTION		**+ 380**	**+ 650**
(vii)	Public sector borrowing under ECS		
	(a) borrowing	+ 109	
	(b) repayment	-32	
	net	+ 77	
(viii)	Repayments of HMG assigned debt	-14	
CHANGE IN THE RESERVES		**+ 443**	**+ 650**
3.	End September levels	34808	4401

SECRET

SECRET

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

September 1987

	Dollars	EMS Currencies ($ million equivalent)
Ireland	+ 171 + 10 agst. DM	-111 DM + 113 ECU
Belgium	+ 34 + 10 agst. DM	-20 DM
France	+ 20 agst. DM	-1138 DM
Italy	+ 233	+1844 DM
Netherlands	+ 15 + 35(Forward)	+ 87 DM(Forward)
Germany	+ 216	-
Denmark	+ 9	-
Spain	+ 1640	-
Sweden	-	-42 DM
Norway	+ 632	-
Switzerland	+ 75	-
Japan	+ 670	-
Canada	+ 353 + 20 agst. Yen	-
US	+ 235 agst. Yen	-
Greece	+ 26	-

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

SECRET

4317.8

CONFIDENTIAL

ERMP C/8

FROM: I POLIN
DATE: 1 October 1987

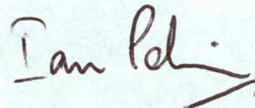
1. MR KELLY *seen in draft*
2. CHANCELLOR OF THE EXCHEQUER

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 Call

THE RESERVES IN SEPTEMBER 1987

The reserves announcement for September will be made on Friday 2 October at 11.30 am. This month's announcement reports a rise in the reserves of $443 million and an underlying rise of $380 million.



I POLIN

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

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

CONFIDENTIAL

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until 11.30 Friday 2 October 1987
thereafter UNCLASSIFIED

DRAFT PRESS NOTICE

THE RESERVES IN SEPTEMBER 1987

The UK official reserves rose by $443 million in September. Accruals of borrowing under the exchange cover scheme amounted to $109 million; repayments of such borrowing amounted to $32 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 September, the reserves stood at $34,808 million (£21,368 million*) compared with $34,365 million (£21,076 million+) at the end of August.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying ~~fall~~ rise in the reserves during September was $380 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).

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

British Coal, $109 million.

---

* When converted at the closing market rate on Wednesday 30 September £1=$1.6290

\+ When converted at the closing market rate on Friday 28 August £1=1.6305

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until 11.30 Friday 2 October 1987
thereafter UNCLASSIFIED

Repayments of such borrowing were:

British Airways plc, $17 million; British Railways Board, $3 million; Welsh Water Authority, $3 million; British Coal, $2 million; Shetlands Islands Council, $2 million; Yorkshire Water Authority, $2 million; Northumbrian Water Authority, $1 million; Others, $2 million.

4317.2

THE RESERVES IN SEPTEMBER 1987 : PRESS BRIEFING

Factual : main features of markets in September

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
1 September	72.8	1.64	2.97	100.8	1.81	142
7 September	73.3	1.66	2.97½	100.2	1.79	142
11 September	73.1	1.65½	2.97	100.4	1.79½	142
14 September	72.9	1.63½	2.97½	101.4	1.82	144½
21 September	73.3	1.65	2.99	100.9	1.81½	143½
24 September	72.9	1.64	2.98	101.2	1.82	143½
30 September	73.1	1.63	2.99½	102.1	1.84	146

Sterling remained firm during the early part of the month rising to 73.3 in effective terms and $1.66 as optimism grew about the state of the UK economy. However, publication on 24 September of a record UK trade deficit of £1.6 billion took the markets by surprise and the immediate reaction was to mark sterling down sharply. It touched lows of $1.63 and DM 2.97. But on further reflection the markets decided that the figures were not as bad as had first appeared. Sterling rallied as a consequence and closed that day off it's lows around $1.64 and DM 2.98. It ended the month on a firm rate carried up with the firmer dollar to around DM 2.99½.

The dollar traded below DM 1.80 at the beginning of the month as fears grew about the size of the US trade deficit. The markets were reluctant to push the dollar below DM 1.79 for fear of central bank intervention. On release of US trade figures on 11 September showing a deficit of $16.47bn in July the markets pushed the dollar down to DM 1.7875 and Yen 141. On reflection the markets considered that they had seen the worst of the US trade figures and the dollar made a techncial rally to above DM 1.81. It was also helped by news that the US had taken firm military action in the Gulf. It then traded quietly in a narrow

[…]nge awaiting the outcome of the annual series of IMF meetings in Washington. The market reaction to the G7 Washington meeting, which agreed to reaffirm the Louvre accord, was favourable and the dollar closed the month at DM 1.84 and above Yen 146.

Previous reserve changes

(i) Reserve changes this year have been:

$ million

		Underlying Change	Total Change
1987	January	+ 72	+ 29
	February	+ 287	+ 305
	March	+ 1785	+ 1892
	April	+ 2912	+ 2768
	May	+ 4760	+ 4872
	June	- 230	- 315
	July	+ 499	+ 551
	August	- 457	- 550
	September	+ 380	+ 443
	Totals	+10008	+ 9995

Bank Base Rates

Base rate changes this year have been:

		Base Rate	Change
1987	10 March	10½	Down ½%
	19 March	10	Down ½%
	29 April	9½	Down ½%
	11 May	9	Down ½%
	7 August	10	Up 1%

POSITIVE

1. Further rise this month. Reserves strong after substantial underlying increases in first half of the year.

2. Since the Budget sterling has remained broadly stable, in line with February agreement at the Louvre.

3. G7 in Washington this week confirmed that currencies within ranges consistent with fundamentals and recommitted themselves to continue to co-operate to foster stability around current levels.

DEFENSIVE

1. **Does Chancellor's IMF speech signify change in policy?** ~~Chancellor's speech was about way in which he saw Louvre agreement developing in the longer term. No change in policy towards sterling.~~ Not at all. It describes the policy as it has already evolved, since Plaza & Louvre and suggests how it can usefully be taken forward.

2. **Do others in G7 agree with new approach?** ~~Have to ask them. All signed up to continue with Louvre agreement.~~ US Treasury Sec? Baker spoke along similar lines, and of course all G7 have reaffirmed Louvre.

3. **Why not publish bands?** Not helpful at present. May well be sensible at some time in future, but Chancellor make clear such a move "some way off".

4. **Is exchange rate now only thing driving interest rates?** Not at all. Interest rates continue to be set in the light of a range of factors affecting financial conditions. But for all G7 countries exchange rate stability is an increasingly important objective.

5. **Return to Bretton Woods?** ~~Chancellor arguing for continuation of bands and adjustments within these, not fixed parities. Not advocating new institutional arrangements. Chancellor said in IMF speech objectives should be~~ No: in his speech Chancellor explicitly spelled out why he was not advocating return to Bretton Woods. Good idea if you were to read the speech. In it, he defined objective as "to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way".

6. **Exchange rate policy for sterling?** Chancellor made clear that period of stability for sterling and other currencies highly desirable. Actions in recent months bear this out. Renewal of Louvre shows other G7 countries also hold this view.

No.

7. **Three months of trade deficits show fall in exchange rate needed to maintain competitiveness?** August figures erratic. UK economy growing faster than other majors, which are currently underperforming. No reason to change earlier judgement that present level of sterling is appropriate.

8. **Details of intervention?** Policy never to discuss. Remember book for September closes 2 days before end of month.

9. **Implications for funding?** Policy is full (fund) of PSBR over financial year as a whole. Chancellor said intervention would be sterilised . Funding programme well on course.

10. **UK membership of ERM?** No change in Government position. Matter kept under continual review. Will join when satisfied that balance clearly favours doing so.

11. **Do changes to EMS agreed on 12 September bring UK membership nearer?** Changes welcome, but ~~[hardly decisive to the question of ERM membership.]~~ position on UK membership remains as above.

12. **Does Chancellor's IMF speech make ERM membership irrelevant?** ~~ERM and Louvre are different. [Different membership; and ERM has firm published bands backed up by formal financing links for intervention.] ERM is a formalised system : Louvre is a more flexible regime.~~

While there is clearly some overlap, ERM has characteristics that Louvre does not.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	- 0.8	44
Japan	+ 1.0	71
Germany	N/A	49
France	- 0.4	69
Italy	- 3.3	46
Canada	+ 0.1	6
United Kingdom	+ 0.4	35

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 for USA are at end July; figures for Germany as at 23 September; other countries are as at end August, except for UK which are at end September.

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

SECRET

FROM: J M G TAYLOR
DATE: 2 October 1987

C W KELLY

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

RESERVES IN SEPTEMBER

The Chancellor has seen your minute and enclosures of 1 October.

2. He has substantially altered some of the briefing. The amendments are as follows:

Defensive Question 1: Does Chancellor's IMF Speech signify change in policy? Delete suggested reply. Replace with: "Not at all. It describes the policy as it has already evolved, since Plaza and Louvre, and suggests how it can usefully be taken forward."

Defensive Question 2: Do others in G7 agree with new approach? Delete suggested reply. Replace with: "US Treasury Secretary Baker spoke along similar lines, and of course all G7 have reaffirmed Louvre".

Defensive Question 5: Return to Bretton Woods? Delete first two sentences, and all up to quotes in third sentence. Replace with: "No: in his speech Chancellor explicitly spelt out why he was not advocating return to Bretton Woods. Good idea if you were to read the speech. In it he defined objective as ...".

Defensive Question 7: Three months of trade deficits show fall in exchange rate needed to maintain competitiveness? Add "No." before first sentence of reply.

SECRET

<u>Defensive Question 11: Do changes to EMS agreed on 12 September bring UK membership nearer</u>? Recast to read: "Changes welcome, but position on UK membership remains as above.

<u>Defensive Question 12: Does Chancellor's IMF Speech make ERM membership irrelevant</u>? Delete suggested reply. Replace with: "While there is clearly some overlap, ERM has characteristics that Louvre does not."

3. The Chancellor would also be grateful for a note on the forward book - its past, present, and likely future - given MOD requirements (paragraph 4 of your cover note refers).

J M G TAYLOR

3887B/008

SECRET

ap (do not destroy)

FROM: C W KELLY

DATE: 5 October 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Grice
Ms Goodman
Mr Nelson
Mr Cropper

PROFITABILITY OF INTERVENTION

I very much regret that I have uncovered an error in the figures attached to my minute of 22 September.

2. The correct figures are attached.

3. Unfortunately they show a rather different picture.

4. The first post-Plaza period of intervention remains profitable (+$44 million). But during the second period between 16 April 1986 and 6 March 1987 it now appears that we made a loss, of $70 million, which more than offset the profit during the first period.

5. I apologise for having mislead you. The error does not affect the earlier figures in my minute of 16 September.

Withdrawn after I pointed out signs wrong plus other errors!!

C W KELLY

enc

SECRET

PROFITABILITY OF INTERVENTION

Date	(1) True change in reserves (spot and forward) $ million	(2) Cumulative totals $ million	(3) Monthly average exchange rates ($/£)	(4) End month exchange rate ($/£)	(5) Cumulative sterling capital employed in intervention (Col(1)/Col(3)) then cumulated £ million	(6) Sterling value of cumulative intervention (Col(2)/Col(4)) £ million	(7) Cumulative dealing "profits" (Col(6)-Col(5)) £ million
1985							
September	- 22	- 22	1.365	1.407	+ 16	+ 16	-
October	- 324	- 346	1.422	1.445	+ 244	+ 240	- 4
November	- 202	- 548	1.440	1.409	+ 380	+ 389	+ 9
December	- 588	- 1136	1.446	1.446	+ 787	+ 786	- 1
1986							
January	+ 79	- 1057	1.423	1.409	+ 731	+ 750	+ 19
February	+ 332	- 725	1.430	1.450	+ 449	+ 500	+ 51
March	+ 398	- 327	1.467	1.478	+ 178	+ 221	+ 43
April(to 16th)	+ 327	0	1.471	1.553	- 44	0	+ 44
April(from 16th)	+ 231	+ 231	1.532	1.553	- 151	- 149	+ 2
May	+ 76	+ 307	1.521	1.472	- 201	- 209	- 8
June	+ 343	+ 650	1.509	1.534	- 428	- 424	+ 4
July	- 96	+ - 554	1.508	1.492	- 364	- 371	- 7
August	- 286	+ 268	1.487	1.488	- 172	- 191	- 19
September	- 688	- 420	1.472	1.488	+ 295	+ 282	- 13
October	- 1325	- 1745	1.428	1.408	+ 1223	+ 1239	+ 16
November	+ 147	- 1598	1.425	1.437	+ 1100	+ 1112	+ 12
December	+ 196	- 1402	1.438	1.484	+ 974	+ 945	- 29
1987							
January	+ 141	- 1261	1.507	1.514	+ 880	+ 833	- 47
February	+ 380	- 881	1.527	1.546	+ 631	+ 570	- 61
March(6th)	+ 881	0	1.571	1.604	+ 70	0	- 70
July	+ 810	+ 810	1.610	1.593	- 503	- 508	- 5
August	- 857	- 47	1.598	1.630	+ 33	+ 29	- 4
September(3rd)	+ 47	0	1.649	1.658	+ 4	0	- 4

PW

Ch

Revised version attached

(1) Who does what on intervention (& when) is crucial: post-Louvre intervention has been rather haphazard, & hence earned much less conviction. Need both obligations plus burden sharing. Interest rates, as you say, v much harder.

(2) Will inevitably be a lot of judgement about what represents "right" level of XR – no science in saying that XR is consistent with current a/c balance. And in principle should be self –

equilibrating, except goods prices & (particularly) wages are slow to adjust.

③ Need to consider carefully how much to reveal @ Washington.

AA

RA7.57

21/10/87

MANAGED FLOATING

<u>**Propositions**</u> (to be refined and reordered as coherent argument)

1. Exchange rates should not be volatile: they should broadly reflect economic fundamentals, which are slow-moving.

2. This means (?) that they should be such as to be compatible with medium term current account equilibrium on the basis of existing performance and policies (nb current and long term capital account; analysis in 2 stages).

3. Although international agreement to an exchange rate regime will influence policy decisions, it is futile to seek some more overt policy change/harmonisation mechanism.

4. The above can be achieved provided there are not massive net capital movements of a undesirable kind (<u>define</u>).

5. A hands-off policy will <u>not</u> prevent such capital movements: why should it, given the short-term nature of the market? yet the short-term nature of the market can produce prolonged movements in one direction.

6. Equally, stability <u>can</u> be brought about by concerted intervention, backed by appropriate interest rate differentials whenever necessary, provided

(i) the market is convinced that the agreement is for real

(ii) the margins are tactically adequate (eg ± 5 per cent).

7. The arrangement should be periods of stability, periodically adjusted by movements of the central point <u>within</u> the existing margins.

8. With a system of this kind in place, the individuals who comprise the market will have no incentive to challenge it: indeed the reverse.

[9. The purpose of all this is, of course, essentially to stabilize the $ exchange rate.]

10. Note the two-way process: capital movements generate fluctuations in exchange rates, but equally fluctuations in exchange rates generate capital movements.

[11. NB Consider how to reinforce credibility by (a) strong currency intervention and (b) extensive swap arrangements.]

[12. Consider the thesis of banking versus portfolio funds. Once rate is stabilized, banking funds may tend to move it; but this will generate equal and opposite movements of portfolio funds which believe in the system].

[13. Consider: do we need net capital movements between developed countries? NB List reasons why capital movements might arise.]

1. Chart $ exchange rate in the 80s (1980-85, 1985-87). Clearly not justified by underlying economic circumstances (eg inflation over period - while current account driven by exchange rate, not vice versa) (real exchange rate), and clearly damaging - both to USA and world.

2. Policy co-ordination may be desirable - and towards low inflation essential. But no substitute for direct action on exchange rates for reasons in 1. above - and for obvious reasons harder to achieve. (Seen as a purely internal matter; whereas other countries clearly have a locus in exchange rate matters: logical point).

3. Exchange rate agreement needs to be buttressed by:

   (a) agreement to give high weight to exchange rates in monetary policy (interest rates);

   (b) agreement on anti-inflationary stance.

4. Should intervention be sterilised (albeit later) or unsterilised?

5. Reference ranges initially unpublished, but ultimately published (discuss).

6. Need to establish anti-inflationary anchor? Non-oil commodity prices?

7. Need to agree on who does what and when, re (a) intervention and (b) - more difficult - interest rate changes. G7 meetings.

8. Why good time to start/consolidate exchange rate stability now (cf a few years ago). Inflation convergent and low, and no great exchange rate mis-alignments.

9. "Indicators" exercise would be chiefly concerned with aggregate G7 growth and inflation (discuss) - preferably nominal GDP but could look separately.

10. The anti-inflationary club - and expulsion from it.

11. Need to give time for post-1985 exchange rate changes to take full effect.

12. Other measures: eg Japan open markets (alternative: protection).

13. Important that agreement is in terms of nominal, not real exchange rates.

14. Need to take head-on "loss of independence" argument: no independence now, Bretton Woods, NATO, etc. Can leave at any time.

15. Is the equilibrium rate one which will balance current account? Or current account plus "normal" long-term capital flows? If so, how are latter determined.

(Floating exchange rates necessary in times of high and divergent inflation - NB).

16. Consider the nature of the foreign exchange market - cf the Stock Market and the fundamentals of the companies concerned: in fact Stock Markets likely to be closer to fundamentals, since some investors do take a long view. Nature of the foreign exchange markets should be accepted even by those who believe we can do nothing about it.

17. Free floating v. managed floating? Even in free floating seldom complete indifference. Certainly not in the UK. The one obvious example of free floating is the US 1980-85 disaster.

18. Intervention: this should be profitable - if authorities make money, private operators lose it. This will give latter incentive to support authorities. (Give examples of UK profits over past year in foreign exchange market). [Get true figures].

RA7.57

(copy to Robert)

Please re-do

MANAGED FLOATING

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10. Note the two-way process: capital movements generate fluctuations in exchange rates, but equally fluctuations in exchange rates generate capital movements.

[11. NB Consider how to reinforce credibility by (a) strong currency intervention and (b) extensive swap arrangements.]

[12. Consider the thesis of banking versus portfolio funds. Once rate is stabilized, banking funds may tend to move it; but this will generate equal and opposite movements of portfolio funds which ~~stabilize~~ believe in the system].

[13. Consider: do we need net capital movements between developed countries? NB List reasons why capital movements might ~~assist.~~ arise.]

psl/8A

1. Chart $ exchange rate in the 80s (1980-85, 1985-87). <u>Clearly</u> not justified by underlying economic circumstances (eg inflated over period - while current account driven down by exchange rate, not vice versa) (<u>real</u> exchange rate), and <u>clearly</u> damaging - both to USA and world.

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   (a) agreement to give high weight to exchange rate in monetary policy (interest rates);

   (b) agreement on anti-inflationary stance.

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(Floating exchange rates necessary in times of high and divergent inflation - NB).

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18. Intervention: this should be profitable - if authorities make money, private operators lose it. This will give latter incentive to support authorities. (Give examples of UK profits over past year in foreign exchange market). [Get true figures].

Managed floating

Propositions (to be refined & reordered in coherent argument)

1. XRs shd not be volatile: they shd broadly reflect economic fundamentals, wh are slow-moving.

2. This means (?) that they shd be such as to be compatible with medium term current a/c equilibrium on the basis of existing performance & policies.

[nb ct & long term cap a/c]

3. Altho' national agreement to an XR regime will influence policy decisions, it is futile to seek some more overt policy change / harmonisation mechanism.

[analyse in 2 stages]

4. The above can be achieved provided there are not massive net capital movements of an undesirable kind (define)

5. A hands-off policy will not prevent such capital movements: why shd it, given the short-term nature of the market? Yet the short-term nature of the market can produce prolonged movements in one direction.

6. Equally, stability can be brought about by concerted intervention, backed by appropriate interest rate differentials whenever necessary provided
   (i) the market is convinced that the agreement is for real
   (ii) the margins are tactically adequate (eg ± 5 %)

7. The arrangement allows periods of stability, periodically adjusted by movements of the central point within the existing margins.

8 With a system of this kind in place, the individuals who [indeed] comprise the market will have no incentive to challenge it: the reverse

[9. The purpose of all this is, of course, essentially to stabilize the $ XR]

10. Note the 2-way process: cap movements generate fluctuations in XRs, but equally fluctuations in XRs generate cap movements.

[11. NB Consider how to reinforce credibility by (a) strong currency intervention & (b) extensive swap arrangements.]

[12. Consider the flows of banking v portfolio funds]. Once rate is stabilized, banking funds may tend to move in; but this will generate equal & opposite movement of portfolio funds [illegible] in scheme or system]

[13. Consider: do we need net cap movement to the developing countries?]

NB list reasons why cap movements might arise

1. Change $ XR in 80s (1980-85, 1985-87) change not justified by underlying economic circs (eg inflation over period — while Ct a/c driven by XR, not vice versa) (real XR), & change damaging — some these & G and.

2. Policy co-ordination may be desirable — & towards low inflation essential. But no substitute for direct action on XR for reason in (1) above — & for other reasons hard to achieve. (Not a purely national matter; other countries closely tied to XRs on XR matters: logical pt)

3. XR agreement needs to be twofold
(a) agreement to give high weight to XR in monetary policy (int rates)
(b) agreement on anti-inflation stance.

4. Shd intervals be stabilisation (adjust later) or restriction?

5. Reference range initially unpublished, but ultimately published (discuss)

6. Need to establish anti-inflation anchor. ?Non-oil commodity prices?

7. Need to agree on who does what when re (a) intervention & (b) — how different — interest rate changes. G7 ...

8. Why good time to start/consider on XR stabilisation now (cf a few yrs ago). Infl convergence & low, & no gt XR misalignments.

9. ~~[illegible]~~ 'Indicators' exercise and be closely combined with aggregate G7 growth & inflation (discuss) — preferably nominal GDP, but could look separately

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12. (Other measures: eg Japan open ...)(alt: protection)

13. Important that agreement is in terms of nominal, not real XRs

14. Need to take head on 'loss of independence' argument: no independence now, Bretton Woods, NATO, etc. Can leave @ any time.

15. Is the equilibrium rate one which will balance Ct a/c? Or Ct a/c + 'normal' long-term cap flows? If so, how are latter determined?

16. (over page) // (Floating XRs unhelpful in times of high & diverging inflation — ...)

16. Consider the nature of the forex mkt — cf the stock mkt & the fundamentals of the companies concerned: a good stock mkt is likely to be closer to fundamentals, since some investors do take a long view.) Nature of forex mkt should be accepted even by those who believe we can do nothing about it.

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18. Intervention: this should be profitable — if authorities make money, private operators lose it. This will give latter incentive to support authorities. (Give examples of UK profits over past year in forex mkt). [GET THESE FIGS]

SA5.016.SS

FROM: CLARE PELHAM
DATE: 21 October 1987

MR TAYLOR

cc Mr Moore
Mrs Brown
Mr Bent

CURRENT PRICES OF PRIVATISATION SHARES

You asked for a note of the current prices of some major privatisation shares compared with their offer prices. This is below:

Company	Fully Paid Offer Price (Date of Offer)	Current Price (3:30 pm today)	Wed Close	Change at Thurs 9.30
Jaguar	165p (August 1984)	454	448	(-12)
British Telecom	130p (November 1984)	234	237	(-8)
British Gas	135p (December 1986)	152	149	(0)
British Airways	125p (February 1987)	177	175	(-4)
Rolls Royce	170p (May 1987)	167	166	(-1)
BAA	100p (partly-paid price in fixed price offer) (July 1987)	125 (partly-paid)	125	(0)
BP			297	(-4)

Clare Pelham

CLARE PELHAM

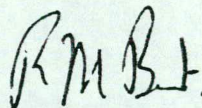
GOVERNMENT EYES ONLY

BP SHARE SALE

The briefing material below has been cleared with all parties to the sale, as is required by the terms of the Underwriting Agreement. But our lawyers have rightly advised us to stress the importance of the Health Warning given the BP share price and the uncertain state of world stock markets. This note, which is not being given a wide circulation, amplifies the Health Warning as follows:-

PRESS OR PUBLIC ANNOUNCEMENTS (SAVE IN PARLIAMENTARY PROCEEDINGS IN ANSWER TO ANY QUESTION OF WHICH PRIOR NOTICE HAS NOT BEEN GIVEN) SHOULD RECEIVE THE PRIOR CLEARANCE OF ROTHSCHILDS (ON BEHALF OF THE UNDERWRITERS) AND BP.

ANY PRESS OR PUBLIC ANNOUNCEMENT OR COMMENT MADE BY A MINISTER OF THE CROWN WHICH IS NOT SO CLEARED AND WHICH IS MATERIAL IN THE CONTEXT OF THE OFFER CAN LEAD TO THE UNDERWRITERS SEEKING TO TERMINATE THE UNDERWRITING AGREEMENT.



R M BENT
H M Treasury

PRIME MINISTER'S QUESTIONS

BP SHARE SALE

HEALTH WARNING: ANYTHING SAID ABOUT THE OFFER, BP OR BP'S TRADING ENVIRONMENT MUST BE FACTUAL, ACCURATE AND FAIR, AND SHOULD BE CONSISTENT WITH THE PROSPECTUS. NO OPINION SHOULD BE EXPRESSED AND NO PREDICTION MADE ABOUT THE PROSPECTS FOR THE SHARES OR FOR BP'S BUSINESS OR ABOUT BP'S COMPETITORS OR THE OIL INDUSTRY GENERALLY. NO STATEMENTS SHOULD BE MADE WHICH COULD BE INTERPRETED AS AN INDUCEMENT OR RECOMMENDATION TO BUY, OR NOT TO BUY, BP SHARES.

Line to take

I can confirm that the Government is not considering terminating the offer. It is fully underwritten.

The [Rt] Hon Member will understand that there are limits to what more I can say while a public offer is underway.

Details of the offer are set out in the Prospectus, a copy of which has been placed in the Library. Copies of the Prospectus are being sent to all those who have registered their names with the BP Share Information Office, and are now publicly available.

Investors must decide for themselves whether or not to apply. They have until 10 am on 28 October to make up their minds and to deliver a completed application form to whichever primary receiving centre is appropriate for their particular surname.

Supplementaries

Should small investor apply?

The offer is priced at £3.30, payable in three instalments. Investors must decide for themselves whether to apply, taking account of the offer terms set out in the Prospectus and current market prices.

Position of those who have applied already?

Once applications have been made they cannot be withdrawn.

Government prepared to modify terms of offer?

Terms of offer are as set out in the Prospectus. No change is contemplated.

Wider share ownership in tatters?

Not so. Hon Member must wait and see what happens on BP share sale. Implementation of Government's wider share ownership

policies has been highly successful.

Shareholders buying into earlier Government sales always knew that share prices could go down and well as up. They have a continuing stake in the success of British enterprise.

Will the offer be left with the Underwriters?

That depends on the number of applications received when the offer closes at 10 am on 28 October.

Collapse of City institutions under weight of underwriting?

Hon Member is presuming outcome of the BP share sale, and casting doubt on strength of City institutions. Do not share his concerns.

Advertising and marketing costs wasted?

Right and proper to advertise share sales. Can give no estimate of costs of BP sale at this stage.

Cutback in offer advertising?

Some readjustment is being made to the offer advertising. Advertisements setting out the terms of the Prospectus and/or supplying an Application Form are being published according to plan.

Limit on foreign ownership of partly paid shares?

Not appropriate. The issued ordinary share capital of the company is already listed on the stock exchanges in London, Tokyo, Paris, Geneva, Basle, Zurich, Dusseldorf, Frankfurt and Hamburg and is traded in the form of depositary receipts on the stock exchanges in New York and Amsterdam. Foreign share ownership is welcomed by the company.

How many foreign shareholders expected?

That depends on the outcome of the offer.

1531/029

FROM: M J NEILSON
DATE: 21 October 1987

CR

Content?

CR 21/10

MS RYDING

STOCK MARKET : BRIEFING FOR No 10

As agreed I attach a short line to take and background on stock market developments for No.10. We also agreed that we could fill in the closing market information after the Chancellor had cleared the line to take. (This has been cleared with NG),

M J NEILSON

CL

See separate BP note below.

I am also inclined to add (updated) version of table giving price of various privatisation issues - see bottom of this bundle.

AA

I agree

I have [illegible] suggested [illegible]

1531/027

LINE TO TAKE

Stock Market

[Stock market falls are massive over-reaction. Will not affect UK economy, which remains strong. Falls led by Wall Street, following uncertainty about US economy. US authorities now acted to restore confidence. Market still volatile, but signs of settling. Even at lowest point London market was higher than at the beginning of this year.]

Interest rates

Maintained at levels necessary to keep downward pressure on inflation. [~~Very comfortable with position at present.~~]

BP ~~see separate brief~~

BP offer will go ahead as planned. Offer underwritten precisely to guard against ~~this sort of circumstance.~~ fall in share price. (See also separate brief.)

Following the initial collapse on Wall Street, There have been enormous gyrations in stock markets all around the world. The UK has been swept up in that, and share prices are now back to the levels of some six months ago.* But what matters is that the British economy, and British industry, remain sound and strong.

(* check)

Exchange market

Exchange rates have remained stable in spite of turmoil in the equity markets. All Summit countries are committed to that.

Brief should also cover (a) steadiness of gilts market

(b) Labour's BP share sale in 1977

(c) Labour's inability to decide whether it is in favour of ordinary people owning shares or not

Even at the close on Tuesday it was still above its level at the start of the year.

BACKGROUND

At close on 21 October London stood at [1944], [15½]% down on close Thursday 15 October, ~~and~~ but [8]% up on the day. ~~This compares with a [ ]% fall in New York and an 9.4% fall in Tokyo~~ (full details in table attached).

BP share price [299] at close on 21 October, (BP offer price fixed at 330p).

4148/006 NH

EQUITY INDICES

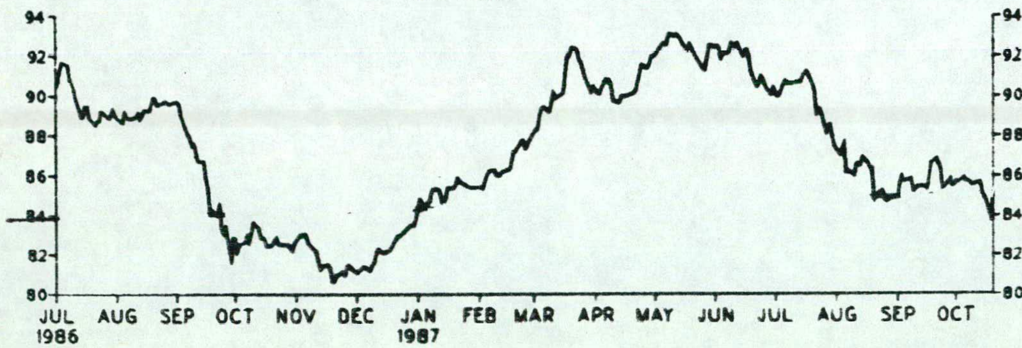
(closing, except where indicated)

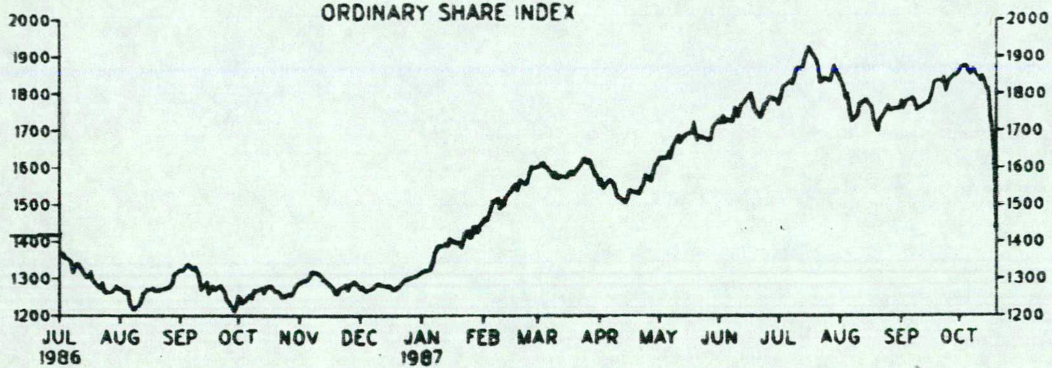
	Closing Index level	Change on previous close points	%	Change on Thursday close points	%	Change on 1987 peak points	%	Change on 1987 previous low points	%
NEW YORK									
(Dow Jones Industrial)						(2722 on 25/8)		(1927 on 2/1)	
Thursday 15	2355								
Friday 16	2247	-108	- 4.6						
Monday 19	1739	-508	-22.6	-616	-26.2	-983	-36%	-188	-10%
Tuesday 20	1841	+102	+ 5.9	-514	-21.8	-881	-32%	- 86	- 4%
Wednesday 21									
Thursday 22									
Friday 23									
LONDON									
(FSTE 100)						(2449 on 16/6)		(1798 on 29/1)	
Thursday 15	2302								
Friday 16	-								
Monday 19	2052	-250	-10.9						
Tuesday 20	1802	-251	-12.2	-501	-21.7	-647	-26%	+ 4	-
Wednesday 21 ~~(11.15)~~ Update to close	[~~1956~~ 1944	~~+154~~ +142	~~+ 8.5~~ + 7.9	~~-346~~ -358	-15.6	~~-493~~ -505	~~-18%~~ -20½%	~~+158~~ +146	~~+ 9%~~ + 8%]
Thursday 22									
Friday 23									

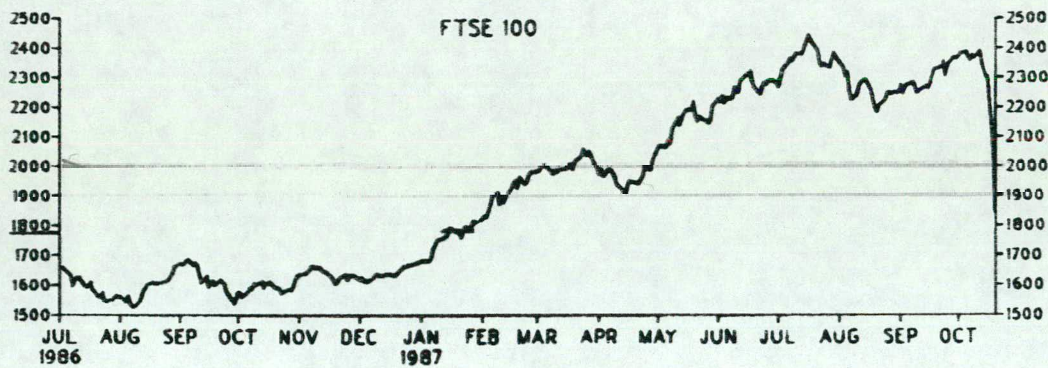
4148/007 NH

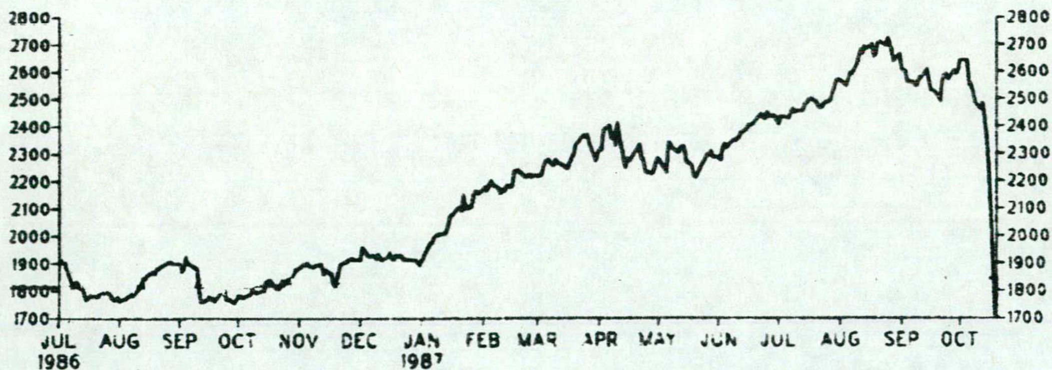
	Index level	Change on previous close		Change on Thursday close		Change on 1987 peak		Change on 1987 previous low	
		points	%	points	%	points	%	points	%
TOKYO									
(Nikkei Dow)						(26626 on 14/10)		(18544 on 13/1)	
Thursday 15	26428								
Friday 16	26367	- 61	- 0.2						
Monday 19	25746	- 621	- 2.3	- 682	- 2.6				
Tuesday 20	21910	-3836	-14.9	-4518	-17.1	-4736	-18%	+3366	-18%
Wednesday 21	23947	+2037	+ 9.3	-2481	- 9.4	-2699	-10%	+5403	+29%

CAPITAL MARKET INDICES









Daily Mail

An up-to-the-minute guide for the anxious investor

What you can do when shares are tumbling

by MARGARET STONE

BP's firecraker could be a damp squib. City whizz-kids cancelled their champagne orders. And cash suddenly looks very attractive.

But as the market regains its colour, the shareholders who kept their head when all around were losing theirs — held and then bought more shares — could be the ones sipping champagne.

All along the line, old hands have been telling new investors that prices can go down as well as up. Well, the inevitable has happened — prices have gone down, with a vengeance.

Investors have three options:

- Stick with the shares and units — in the expectations that this is a market shakeout rather than a market collapse of some duration.
- Switch into fixed-interest investments both to protect capital and secure a positive return on your money.
- Look for alternative investments to provide capital growth.

The message coming loud and clear from the unit trust industry is that unitholders are not panicking. On the other hand, the industry is not making it easy for them to sell.

Expense

The crisis is forcing many unit trust groups to do what the SIB (Securities and Investments Board) wants and 'forward price' — in other words they are not buying back (and selling) units at a known price fixed in advance, but at a price obtained after the order has been placed.

With prices tumbling so sharply, in the absence of a quoted price, unitholders are not risking selling but, having failed to get out at the top, are now riding out the storm.

An alternative for unitholders is to switch into the 'parking funds', designed by the unit trust groups for just such a market shakeout.

Investors sell their units at the normal bid price, leave it earning around 6.75 per cent in a group deposit account, and then move back into units on preferential terms.

The rate is comparable to the lower range of rates offered by building societies, but investors could, at the expense of just a little flexibility, earn themselves a substantially higher return.

A rate of 9.25 per cent with only three months' notice is available from the Mercantile Building Society for anyone needing a short-term home for £25,000 or more. Give notice immediately the deposit is made for earliest access to funds.

Other societies (Chelsea, Greenwich and Mornington) pay 9.25 per cent but your money will be locked away for 1-2 years in a term share which could be inconvenient if the market, when it does recover, races ahead as it did in 1975.

Building societies flesh out the saying about 'it is an ill wind ...' The BP share offer was expected to drain the coffers of societies this month.

It would be wrong to accuse societies of gloating, but some of the burnt fingers in the current market will return to and probably stick with old favourites like building societies long after the wounds have healed. And even more so, if interest rates harden, as seems likely.

Healed

Another old favourite, of course, is gold, traditionally a lifebelt for all seasons, particularly dangerous ones. The current crises could boost gold and there are predictions of $580 an ounce by the year end — compared with $348 15 months ago and $478 now. But don't expect gold to reach the peaks it did in 1980.

For the small investor the cheap way to buy gold today is the Krugerrand, on sale at virtually no premium. Another good buy is the new 1987 Britannia because first year of issue coins usually command a good premium

Wednesday October 21 1987

Daily Telegraph

Rolls-Royce drops by 53p

THE Stock Market's crash during the past two days has left many small investors in newly privatised companies nursing big losses.

People who finished paying for Rolls-Royce shares with the second 85p instalment only last month have seen their investment lose 53p in three days. Their total investment of 170p is now only worth 153p.

PRIVATISATION STOCKS (Where companies have been privatised by more than one share issue the price and date quoted are those of the most recent offer).

Company	Issue Striking price (p)	Highest level	Thursday's price	Closing price
Amersham International (1982)	142	647½	625	535
Associated British Ports(1984)	270	673	636	550
BAA (1987)	245(100pd)	151	151	118
Aerospace (1985)	375	685	531	445
British Airways (1987)	125	235	219	160
British Gas (1986)	135	200	168	138
British Petroleum (1987)	330	410	352	285
British Telecom (1984)	130	335½	261	217½
Britoil (1985)	185	357	315½	246
Cable & Wireless (1985)	293½*	507	496	380
Enterprise Oil (1984)	185	348	314	256
Jaguar (1984)	165	628	578	405
Rolls-Royce (1987)	170	240	206	153

* adjusted for scrip issue

3767/043

A very good note. Highly relevant to mtg / which f[...] ASAP.

FROM: ECONOMIC SECRETARY
DATE: 23 October 1987

CHANCELLOR

CRASH OF 87 AND THE 1929 ANALOGY

For what they are worth, I elaborate below the ideas I mentioned at the markets meeting this morning.

2. History does tend to repeat itself, albeit neither exactly nor deterministically. We have the power to prevent events unfurling as they did after the crash of 1929 if we learn from that (and subsequent) experience.

3. One lesson has been learnt - and that is the crucial importance of preventing bank failures. Friedman concluded that the banking collapse and consequent reduction of the money supply by one third turned what would have been a severe recession into an unprecedented depression. Deposit insurance in the USA, coupled with the willingness of central banks to act as lenders of last resort, should prevent a repetition. (Nonetheless, we need to consider whether the high level of securitisation means a security market collapse can have a direct impact without bank failures. Also, banks can contract the global money supply without failures by calling in loans. Given their existing exposure to sovereign debt they may be very tough on a new set of creditors, rendered dubious risks by the collapse of the securities market).

4. However, even if we know how to prevent a recession becoming a depression, I am less certain that we know how to prevent a major market collapse initiating a severe recession.

5. There is no doubt that a fall in securities markets will have a severe effect on demand and growth in the real economy via several channels:-

(i) the wealth effect on consumer spending/borrowing,
(ii) the equivalent effect on company investment intentions,

(iii) contraction of bank lending/recalling loans to dubious risks

(iv) ripple effects to housing market.

6. If anything these effects are likely to be greater now than in 1929 since financial wealth is proportionately greater.

7. Unfortunately we face the same dilemma as in 1929:

- expansionary measures have little effect because confidence has been punctured (Keynes rightly said monetary relaxation was like pushing on a string),

- the measures necessary to restore confidence are themselves contractionary - e.g. reducing the US budget and trade deficits.

8. Even with the benefit of nearly 60 years of hindsight, I have never seen a convincing analysis of how this dilemma could have been resolved in 1929 to avoid a severe recession. So I am not optimistic that there is a ready means of avoiding a repetition now.

9. But we can avoid what commonsense suggests were three failings in governments' response then which aggravated the problem:

(i) Lack of vigour. Governments then were so bemused they seemed to react with too little too late and not to press home such initiatives as they did take. In part this clearly sprang from their recognition of the dilemma outlined above. Maybe monetary relaxation did feel as ineffectual as pushing on a string. But if that is the main anti-deflationary measure available maybe we just have to push harder.

Likewise they probably recognised that cutting deficits was both necessary to restore confidence and deflationary. As a result they went about trying to restore balance in a half-hearted way. This got the worst of both worlds. It reduced nominal spending without restoring confidence. The lesson for Reagan should be clear. Apparently half-hearted attempts to cut the deficit will not restore confidence,

but will reduce spending power. Cuts must either be credible or not at all. Best of all they should be credible but offset by relaxation overseas.

(ii) Lack of Unity. Because governments did not coordinate their actions effectively they were less effective than they could have been. Uncoordinated steps - particularly in easing monetary conditions - will have little effect since markets will assume they will be undermined by contrary action (e.g. higher interest rates) elsewhere. What is needed now is obviously a reduction in both short term interest rates and long term funding in Germany, Japan and UK which is seen to be coordinated. Maybe a G7 meeting, properly prepared and with concrete decisions to announce, would be helpful.

(iii) Loss of Initiative. Because governments reacted like rabbits before a stoat in 1929 and were seen to be 'doing nothing' the intiative moved elsewhere. So politically they lost the initiative to protectionist pressures and the markets sensed a lack of leadership which further weakened confidence.

(iv) Failure to recognise that the collapse eclipses its original cause. There is a danger now as then that governments will remain mesmerised by the problems which initiated the collapse and fail to recognise that the main problem progressively becomes the financial collapse itself. It may have been inflationary fears which unsettled Humpty Dumpty (ie confidence) but it is the fall itself which finally shatters him.

Indeed it is only a slight exageration to say that, though inflationary fears caused the collapse, the collapse has cured inflation. Increasingly, if it continues, the problem is likely to be the financial collapse itself.

To be more precise a 10% interest rate may have been barely adequate to contain inflationary pressures last week. Today 9½% is at least adequate. And I can readily foresee further cuts (preferably coordinated with Japan and Germany) without

reigniting inflationary flames.

Unfortunately there are fewer lessons for this for the UK than for the other major countries since were are not really part of the imbalance which has sparked it off.

Peter Barnes

PETER LILLEY

(composed by the Economic Secretary and signed in his absence).