PO-CH/NL/0079

PART E

Park. E.

SECRET

(Circulate under cover and
notify REGISTRY of movement)

Begins: 2/11/87.
Ends: 17/12/87.

PO -CH /NL/0079

PART E

Chancellor's (Lawson) Papers:

THE EXCHANGE MARKETS AND
FOREIGN CURRENCY
BORROWING

Disposal Directions: 25 Years

26/7/95

PO -CH /NL/0079
PART E

3883B/013

SECRET

PS. SGE X! I do not like any of the TS2 - leave it all to IBT - talk about the Bank's safety net. Refer as either 'the Chancellor's safety net' or at the v. least 'the BP safety net'.

FROM: C W KELLY

DATE: 2 November 1987

CHANCELLOR

Ch
OK? (A few points)

I have made a few changes. AA

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

RESERVES IN OCTOBER

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

2. We are publishing an underlying change of +$6699 million, by far the largest monthly increase ever. The previous record was last May, when the underlying change was +$4760 million.

3. The press notice explicitly draws attention to the fact that just over $1.5 billion of the increase was due to the foreign currency tranche of the BP sale. This is a departure from precedent. We have deliberately not drawn attention to the foreign currency receipts of previous privatisations, because that gave us a little more flexibility. But the greater danger now is that the market will think we have been doing even more direct intervention that we really have.

4. The true intervention figure was even higher. We also added $1.5 billion to the forward book, even after allowing for a further $1 billion of forward sales to the Ministry of Defence.

5. The range of market expectations is again very wide. Forecasts range from +$1 billion to +$6 billion.

6. In current circumstances, it is difficult to judge how a figure above the top of this range will be taken. The Bank's guess, which would also be my own, is that there will be some surprise, but not an enormous amount, and that the impact on the foreign exchange rate market will therefore be fairly limited. But this could be wrong. The danger is, of course, that this evidence of how hard we have been trying will make the markets think it more likely that we will have to give way on DM3 (though we are fortunate in being well below that by recent standards at present).

7. The impact on the gilts market could be more marked. It will help to put Friday's packet of tranchette into perspective.

8. New borrowing under the exchange cover scheme amounted to just over $50 million, made up of bits and pieces to which we were previously commited before the change in policy. Repayments amounted to just under $290 million.

9. Other countries' spot market intervention during the month is shown in table 2. The Japanese bought $2 billion and the Germans $¾ billion. There were also modest dollar purchases by a number of other countries. But the most substantial intervention was by the French, who sold $6¼ billion of DM as strains within the ERM became apparent at the end of the month. The Belgians and the Irish also sold (for them) substantial quantities of DM.

CWK

C W KELLY

enc

TABLE 1 - RESERVE TRANSACTIONS FOR OCTOBER 1987

		$ million	
		Spot	Forward
1.	End September levels	34808	4401
2.	Transactions in October		
(i)	Market	+ 8316	-4
(ii)	Swaps	-3741	+ 3741
(iii)	Maturities	+ 1106	-1106
(iv)	Other Bank customers	-81	-
(v)	Government		
+	(a) departments' expenditure	+ 1118	-1068
	(b) public sector debt interest	-76	-
	(c) HMG debt interest	-46	-
(vi)	Interest on the reserves	+ 103	-
TOTAL INTERVENTION		+ 6699	+ 1563
(vii)	Public sector borrowing under ECS		
	(a) borrowing	+ 51	
	(b) repayment	-284	
	net	-233	
(viii)	Repayments of HMG assigned debt	-3	
(ix)	EMCF valuation change	+ 128	-128
CHANGE IN THE RESERVES		+ 6591	+ 1435
3.	End October levels	41399	5836

+ includes +$1537 million BP receipts.

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

October 1987

	Dollars	EMS Currencies ($ million equivalent)
Ireland	+ 7	-382 DM
Belgium	+ 45 agst. DM	-515 DM
France	+ 338 + 60 agst. DM	-6284 DM
Italy	+ 890 + 10 agst. DM	+ 724 DM + 34 ECU
Netherlands	+ 337(Forward)	+ 255DM(Forward)
Germany	+ 760	-
Denmark	+ 93 + 25 agst. DM	-68 DM
Spain	-310 + 300 agst.DM + 140 agst other currencies	-213 DM
Sweden	+ 25	-281 DM
Norway	+ 127 + 76 agst.Yen	-158 DM
Switzerland	+ 250	-
Japan	+ 2012	-
Canada	+ 138 + 38 agst. Yen	-
US	+ 65 agst. Yen + 395 agst. DM	-
Greece	+ 45	-6 DM

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

4317.8

CONFIDENTIAL

ERMP C/8

FROM: I POLIN

DATE: 2 November 1987

1. MR KELLY wk 2.11

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 R Allen
Mr Botttrill
Mr Hibberd
Mr Grice
Miss O'Mara
Mr Pickford
Ms Goodman
Mr Call

THE RESERVES IN OCTOBER 1987

The reserves announcement for October will be made on Tuesday 3 November at 11.30 am. This month's announcement reports a rise in the reserves of $6591 million and an underlying rise of $6699 million. Foreign currency receipts from the US, Canadian and Japanese offers of BP shares amounted to $1537 million.

Ian Polin

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)

DRAFT PRESS NOTICE

THE RESERVES IN OCTOBER 1987

The UK official reserves rose by $6591 million in October. Foreign currency receipts from the US, Canadian and Japanese offers of BP shares amounted to $1537 million. Accruals of borrowing under the exchange cover scheme amounted to $51 million; repayments of such borrowing amounted to $284 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $3 million. The valuation change arising out if the quarterly rollover of the EMCF swap amounted to a rise of $128 million. At the end of October, the reserves stood at $41,399 million (£24,027 million*) compared with $34,808 million (£21,368 million+) at the end of September.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during October, including the BP receipts, was $6699 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).

---

* When converted at the closing market rate on Friday 30 October £1=$1.7230

\+ When converted at the closing market rate on Wednesday 30 September £1=1.6290

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

South of Scotland Electricity Board, $29 million; Manchester City Council, $16 million; Staffordshire County Council, $3 million, Powys County Council, $2 million; Cheshire County Council, $1 million.

Repayments of such borrowing were:

Electricity Council, $105 million; British Coal, $56 million; British Airways plc, $37 million; Yorkshire Water Authority, $25 million; North West Water Authority, $20 million; Northumbrian Water Authority, $19 million; British Nuclear Fuels plc, $5 million; Grampian Regional Council, $5 million; Lothian Regional Council, $3 million; North of Scotland Hydro Electricity Board, $3 million; British Rail, $2 million; British Telecommunications plc, $1 million; Humberside County Council, $1 million; Port of Tyne, $1 million; Others, $1 million.

4. The quarterly rollover of the EMCF swap, ie 20 per cent of the UK's gold and US dollar reserves, entailed a valuation increase of $128 million. This largely reflects the rise in the ECU value of gold, as valued by the EMCF. For the purposes of the swap, the EMCF values gold and dollars in terms of ecus at rates determined quarterly, whereas the UK values gold and ecus held in the reserves on an annual basis.

THE RESERVES IN OCTOBER 1987 : PRESS BRIEFING

Factual : main features of markets in October

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
1 October	72.8	1.61¾	2.98½	102.4	1.84½	147
8 October	73.3	1.64¼	2.99¼	101.3	1.82¼	145
14 October	73.3	1.65½	2.99½	100.5	1.81	142½
20 October	73.4	1.65½	2.99	100.8	1.80½	143¾
23 October	73.5	1.66	2.99½	100.7	1.80¼	143½
27 October	74.1	1.69¼	2.99½	99.6	1.77	142
30 October	74.6	1.72¼	2.98	98.5	1.73	138½

Sterling began the month around $1.62 and 73.0 in effective terms, but then it rose against the dollar with the markets continually testing the DM3 level. During the middle of the month it traded thinly and was mostly on the sidelines, as the markets focused their attention on the dollar and world equity markets. On publication of better-than-expected UK trade figures for September on 23 October it rose sharply to 73.5, $1.6615 and DM 2.99½. The Bank then signalled a ½% cut in their dealing rates. This signal had little immediate effect on the exchange rate, nor did the decision by most high street banks to lower their base rates. It reached a five-year high of $1.73 on 29 October but the deutschemark benefitted more than sterling from the dollar's decline, easing the cross rate to DM 2.97¾.

The dollar began the month trading around DM 1.84½ and Yen 147 showing a slightly firmer tendency evident since September's meeting of G7 ministers. Fears that US interest rates would have to rise in order to counter the rise in long-term rates in Japan and news of an improved US unemployment rate of 5.9% underpinned the currency. However failure to breach DM 1.85 and Yen 147½ and firming German and Japanese interest rates pushed the currency down to DM 1.8230 and Yen 145.30. News of a ½% rise in US prime rates on 7 October temporarily stabilised the currency. But publication of a worse-than-expected US trade deficit for August of $15.7Bn caused the dollar to fall sharply to DM 1.8090 and Yen 142.50. Following US Treasury Secretary Baker's criticism of other countries' interest rate levels the dollar fell to DM 1.77. However the Baker/Stoltenberg 19 October meeting and Stoltenberg's subsequent statement underscoring Louvre Accord brought a dollar rebound above DM 1.81. Initially falls in the equity markets had little impact on the foreign exchange markets. But they contributed to a very bearish nervous mood and rumours of a G7 meeting took the dollar to DM 1.8032 on 23 October and to a seven year low of DM 1.7210 on 29 October not helped by Delors' speech about the US being prepared to see a DM 1.60 level (subsequently denied by US Treasury). At the end of the month concerted intervention steadied it at DM 1.7285 and Yen 138.35.

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
	October	+ 6699	+ 6591
	Totals	+16707	+16586

(ii) This month's underlying change is the largest ever. The previous largest was in May this year ($4,760 million). Before that the largest underlying change was in October 1977 ($3,036 million).

(iii) Previous monthly underlying increases exceeding $1 billion were:

	$ million
October 1987	+ 6,699
May 1987	+ 4,760
October 1977	+ 3,036
April 1987	+ 2,912
January 1977	+ 1,915
July 1977	+ 1,794
March 1987	+ 1,785
September 1977	+ 1,768
March 1977	+ 1,075

(iv) Previous highest levels of spot reserves were;

	$ million
July 1987	34,915
September 1987	34,808
May 1987	34,679
August 1987	34,365
June 1987	34,364
April 1987	29,807
March 1981	28,469
February 1981	28,434
January 1981	28,394
August 1980	28,291
May 1980	28,284

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%
	26 October	9½	Down ½%

POSITIVE

1. Further substantial rise this month. Reserves now very strong after substantial underlying increase of $17 billion in year so far. Reserves now stand at record level of $41.4 billion.

2. Since the Budget sterling has remained broadly stable, particularly against the Deutschemark

3. Recent statements by Baker, Stoltenberg and Poehl have reaffirmed continued support for Louvre Accord.

DEFENSIVE

(A) **POLICY**

Calts
Point to remember: is can MG provide chapter & verse for X - Alex

1. **Is sterling pegged to the DM?** Under Louvre Accord agreed to seek a period of stability in major currencies (including yen and dollar). ~~[Bound to affect bilateral rates.]~~ Chancellor has made it clear that cross-rate against DM is of particular importance ~~to sterling~~.

(Chx spoke)

(B) **LOUVRE/G7/WASHINGTON**

2. **Louvre Accord coming unstuck?** No. Both US Treasury Secretary Baker and German Finance Minister Stoltenberg have reaffirmed commitment to cooperate on monetary and exchange rate policies.

3. **Recent dollar fall means Louvre Accord falling to pieces?** See above. Concept of managed floating does not rule out adjustments from time to time in response to significant events.

4. **Will there be another G7 meeting in the near future to discuss recent market events?** No present plans for a meeting. But Chancellor said on 30 October in radio interview that he was in favour of holding a G7 meeting to discuss falling stock exchanges and the weak US dollar if a "sensible package" was prepared beforehand. G7 countries have been in constant communication with each other about recent events.

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

6. **Have other countries been intervening over the last month/recently?** Ask them. Don't discuss details, but statements by other authorities do indicate this.

7. **Concerted intervention in foreign exchange markets pointless before underlying fundamentals have been resolved?** Intervention is one instrument in Louvre Accord. Chancellor said in House on 27 October "we did not intervene in order to stabilise markets until we had first intervened in a massive way following the Plaza agreement to drive the dollar down, and we only intervened to stabilise it after the deutschemark and yen had risen by as much as 50 per cent against the dollar in order to give that massive change in exchange rates time to work through."

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

8. **Prospects of further co-ordinated interest rate cuts?** Wait and see. Unhelpful to speculate.

9. **German monetary policy not helpful?** Chancellor said in speech to Stock Exchange on 26 October: "It would be helpful if German monetary authorities were to show more awareness of [The need to avoid] [~~unhelpful consequences of~~] undue monetary tightening."

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

11. **Interest rate cut made because sterling near DM 3 level?** No change in policy. ~~No explicit target;~~ Decision on interest rate taken in the light of monetary conditions as a whole, and to give a signal to the market.

12. **Why did Government act to lower interest rates on 23 October?** Sharp falls in share prices throughout world will tighten monetary conditions somewhat. Judged ½ per cent reduction in interest rates consistent with prudent policy, and an appropriate signal to the market at that time.

13. **Implication of recent heavy intervention for UK monetary conditions/funding?** Policy is full fund of PSBR over financial year as a whole. Intervention will be sterilised.

14. **Aren't you going to make a loss buying dollars on this scale in a falling market?** Much to early to tell. Smoothing intervention has been profitable in the past. [although that of course is not the reason it is undertaken].

15. **Is it true that the Bank have been switching dollars into deutschemarks and yen to limit the risk of losses on intervention?** [FT article 2 November 1987].
Never discuss detailed reserves transactions.

(D) **IMF SPEECH**

16. **What are current exchange rate bands for the dollar?** Not helpful to comment.

17. **Return to Bretton Woods?** 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 .... "to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way."

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

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

19. **Conditions required for UK participation?** Not possible to specify precisely. Number of factors and their interaction need to be taken into account. It would be wrong to commit Government in advance; circumstances change, nor would it help conditions in the foreign exchange market to be too specific.

(F) **RECENT MARKET EVENTS**

20. **Stock market collapse due to "volatility" shifting out of forex markets?** No reason to think so. Stability in all markets desirable.

(G) **SALE OF BP SHARES**

21. **Did all the underwriters from Japan, Canada and the US meet their obligations?** Yes.

22. **Why aren't sales to Europe included?** Paid in sterling and will be received in November.

23. **Have previous privatisation issues with an overseas element added to level of Reserves?** Yes, in those cases where share issues made overseas were paid for in foreign currency eg British Gas and British Telecommunications Plc.

(Authorities' safety net for

24. **What does the ~~Bank~~ BP [~~arrangement~~] mean for the Reserves?** Nothing, it is a sterling transaction.

X

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	- 0.9 (end September)	45
Japan	+ 1.4 "	72
Germany	+ 1.0 (w/e 23 October)	50
France	- 0.4 (end August)	69
Italy	- 3.3 "	46
Canada	+ 0.1 "	6
United Kingdom	+ 6.7 (end October)	41

Notes

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

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

SECRET

ps2/6R

FROM: CATHY RYDING
DATE: 3 November 1987

CD
pps

MR C W KELLY

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

RESERVES IN OCTOBER

The Chancellor was grateful for your note of 2 November.

2. The Chancellor suggests the following changes to the draft press briefing:

<u>Positive 2.</u> Redraft to read "Since the Budget sterling has remained broadly stable, particularly against the deutschemark."

<u>Defensive (A) 1.</u> Delete final sentence and replace by "Chancellor has made it clear that cross-rate against deutschemark is of particular importance." The Chancellor would be grateful if MG would provide chapter and verse of when he said this.

<u>Defensive (C) 9.</u> Redraft final line to read "[The need to avoid] undue monetary tightening."

<u>Defensive (C) 10 - final line.</u> Delete "increasingly".

<u>Defensive (C) 11.</u> Redraft answer to read "No change in policy. Decision on interest rate taken in the light of monetary conditions as a whole, and to give a signal to the market."

<u>Defensive (C) 12 - final line.</u> Redraft to read "rates consistent with prudent policy, and an appropriate signal to the market at that time."

<u>Defensive (G) 24.</u> Redraft to read "<u>What does the Authorities' safety net for BP mean for the Reserves?</u> Nothing, it is a sterling transaction."

CATHY RYDING

3885/054

SECRET

a
Case also for small plus: if it's minus, how do we answer questions:
(1) Why were you supporting sterling @ rates which never went below 2·97DM (or whatever)?
(2) last month you bought $ @ [1·70]; now you're supporting @ [1·75]: very unprofitable?
AA

FROM: C W KELLY

DATE: 20 November 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Miss O'Mara
Mr R I G Allen
Ms Goodman

NOVEMBER RESERVES

We need to take a preliminary view about the end-month reserve figure, so the Bank have some guidance about the extent to which they should be swapping forward maturing forward contracts. The last dealing day for value this month is in principle next Thursday, 26 November.

2. At close last night, on the assumption of no further intervention in the remaining five days, we appeared to be heading towards a underlying reserve fall of around $80 million.

3. I can see no reason to seek to adjust this figure. A small minus, after the very substantial plus last month, would be mildly reassuring to the gilts market and would reflect the reality that sterling has not been under any significant upward pressure so far during the month.

4. The Bank take the same view. Indeed, they would be mildly in favour of publishing a small minus this month, even if it became necessary to achieve this by some small-scale swapping into the forward book.

Strongly disagree. ~~We should~~ publish a relatively small plus - preferably the true figure for mkt intervention, [illegible] any non-market transactions (e.g. Arab) [illegible] forward book. This will still reassure the gilt [illegible] while (so [illegible] change [illegible]

C W KELLY

[illegible] subjects [illegible] the [illegible] buys $ [illegible] (last month's massive [illegible]) & [illegible] the [illegible] to [illegible] & the [illegible] of Paris - all [illegible]

CONFIDENTIAL

From : D L C Peretz
Date : 27 November 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Miss O'Mara
Mr R I G Allen
Mr Cropper
Mr Tyrie

LETTER FROM MR SMITH

I imagine you will want to reply to Mr Smith fairly promptly, so that he has your reply before Prime Minister's Questions on Tuesday 1 December. I understand that Mr Kinnock raised the same issue at Business Questions yesterday.

2. There is of course a real difficulty here, and the attached draft letter papers over the cracks using the agreed briefing line.

3. I assume that you did not in fact mention the 3 DM rate in the way referred to by Philip Stephens on 10 November (unfortunately we have no transcript of the interview). Even so there is a question whether to lead with a denial of that - the course suggested to me by Mr Tyrie - or to reverse the order of the two sentences in the second paragraph.

4. The final paragraph very slightly glosses the words you used at the Mansion House : "continuing exchange rate stability", rather than "maintaining a stable exchange rate" (which in other circumstances I would much prefer).

5. I assume it would be sensible for Mr Allan to clear the reply with No. 10, before it goes.

DLCP

D L C PERETZ

DRAFT LETTER

FROM : Chancellor of the Exchequer

TO : The Rt Hon John Smith QC MP

Thank you for your letter of 26 November. This is not, of course, the first occasion on which newspaper reports of the Government's exchange rate policy have been misleading.

I did not mention any specific figure for the exchange rate in my interview with the Financial Times which formed the basis of the article published on 10 November. In her interview reported in the Financial Times on 23 November, the Prime Minister confirmed that we are not tied to any specific range for sterling, in the way we would be were we members of the EMS exchange rate mechanism.

I have however made clear, most recently in my speech at the Mansion House on 4 November, the Government's firm commitment to maintaining exchange rate stability, with the rate against the deutschemark being of particular importance.

No. Neither draft is right. Reply as in margin.

Ch
I thought David Peretz's draft was too defensive. This is my suggested redraft.
AA

C5/PAS/45

DRAFT LETTER TO: John Smith Esq

Thank you for your letter of 26 November.

There is no difference between the Prime Minister and me on exchange rate policy. Our policy is to maintain a stable exchange rate. But we are not tied to any specific, fixed range for sterling, in the way we would be if we were members of the exchange rate mechanism of the EMS. I am sorry you find this simple point difficult to grasp.

[Having made the Government's exchange rate policy clear, I should be very interested to know what the Labour Party's is. Do you support the policy of massive devaluation, advocated by Bryan Gould, with the inflationary consequences that would inevitably follow?]

or (if you don't want to provoke further correspondence):

[It is a sign of the desperation of the Labour Party's economic policy that you are reduced to scavenging among newspaper stories in an attempt to find something to say.]

I have made the Government's policy on the exchange rate clear on a number of occasions, ~~[illegible]~~ for example at the Mansion House on [date] and [2nd example]. I enclose copies of these speeches: see [page references]. As this is, of course, well understood both in the financial markets and by business and industry.

(NIGEL LAWSON)

224.47

FROM: H C GOODMAN
DATE: 1 December 1987

1. MR PERETZ /approved - draft. HC Goodman 1/xii
2. ECONOMIC SECRETARY

cc: Chancellor
Sir Peter Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr R I G Allen
Miss O'Mara
Mr Polin

Ch/ Content with attached briefing? MPW 1/12

/ not I have extensively changed it.

RESERVES IN NOVEMBER

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

We are publishing an underlying change of +$31 million. The market are expecting an underlying increase of around $1 billion. So, this smaller than expected increase should be generally reassuring, both in the gilts market and foreign exchange markets.

The true intervention figure was a little higher at +$49 million, so $18 million was swapped into the forward book.

New borrowing under the exchange cover scheme amounted to $100 million, accounted for entirely by one loan to BNFL. Repayments totalled $249 million, comprising $187 million under the exchange cover scheme and $62 million, which is decribed as assigned debt, this is debt novated to the Government from British Airways.

The sterling value of the Reserves which we are publishing has fallen from £24,027 million at end October to £22,533m. This is entirely a valuation effect due to the dollar's fall from $1.7230 on 30 October to $1.832 on 30 November. Moreover the increase in the dollar value of the non-dollar foreign currency reserves will not yet be reflected in the figures since the exchange rates at which these are valued are set by convention only once a year (end March). However, commentators normally concentrate on the dollar value of the reserves.

Other countries' spot market intervention during the month has shown in table 2. The Japanese bought £3 billion, the Germans $¾ billion and the US $1 billion, mainly in the first ten days of the month, when uncertainty about the outcome of the US budget deficit talks and conflicting statements from the US administration were at their height. In addition, before the co-ordinated interest rate changes of 5 November, the ERM was very stretched with the French at the bottom. This accounts for the $2.3 billion equivalent intervention by the French and the $1.4 billion equivalent by the Italians. By the end of month this pressure had eased off and with it the levels of intervention.

HC Goodman

H C GOODMAN

TABLE 1 - RESERVE TRANSACTIONS FOR NOVEMBER 1987

		$ million Spot	Forward
1.	End October levels	41399	5836
2.	Transactions in November		
(i)	Market	+ 115	+ 63
(ii)	Swaps	-1980	+ 1980
(iii)	Maturities	+ 1962	-1962
(iv)	Other Bank customers	-47	-
(v)	Government		
	(a) departments' expenditure	-90	-63
	(b) public sector debt interest	-85	-
	(c) HMG debt interest	-6	-
	(d) IMF interest	-1	
(vi)	Interest on the reserves	+ 163	-
TOTAL INTERVENTION		**+ 31**	**+ 18**
(vii)	Public sector borrowing under ECS		
	(a) borrowing	+ 100	
	(b) repayment	-187	
	net	-87	
(viii)	Repayments of HMG assigned debt	-62	
CHANGE IN THE RESERVES		**-118**	**+ 18**
3.	End November levels	41281	5854

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

November 1987

	Dollars	EMS Currencies ($ million equivalent)
Ireland	+ 80 + 5 agst. DM	-152 DM
Belgium	+ 22 agst. DM	-317 DM +4 Swfr
France	-	-2270 DM
Italy	+ 992	-374 DM
Netherlands	+ 40 + 75(Forward)	
Germany	+ 812	-
Denmark	+ 35	
Spain	+ 414 + 115 agst. Yen/Swfr/DFL	-726 DM
Sweden	-100 + 125 agst. Yen	-119 DM
Norway	-439 + 360 agst. DM	-425 DM
Switzerland	+ 120	-
Japan	+ 3074	-
Canada	-21 + 17 agst. Yen	-
US	+ 428 agst. Yen + 788 agst. DM	-
Greece	-22	
Portugal	+ 29 + 20 agst. DM	

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

CONFIDENTIAL

ERMP C/8

FROM: I POLIN

DATE: 1 December 1987

1. MISS O'MARA approved in draft. M Goodman 1/xii
2. ECONOMIC SECRETARY

Distribution

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THE RESERVES IN NOVEMBER 1987

The reserves announcement for November will be made on Wednesday 2 December at 11.30 am. This month's announcement reports a fall in the reserves of $118 million and an underlying rise of $31 million.

Ian Polin

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)

DRAFT PRESS NOTICE

THE RESERVES IN NOVEMBER 1987

The UK official reserves fell by $118 million in November. Accruals of borrowing under the exchange cover scheme amounted to $100 million; repayments of such borrowing amounted to $187 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $62 million. At the end of November, the reserves stood at $41,281 million (£22,533 million*) compared with $41,399 million (£24,027 million+) at the end of October.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during November, was $31 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 Nuclear Fuels plc, $100 million.

---

* When converted at the closing market rate on Monday 30 November £1=$1.8320

\+ When converted at the closing market rate on Friday 30 October £1=$1.7230

Repayments of such borrowing were:

British Airways plc, $105 million; North West Water Authority, $22 million; British Telecommunications plc, $10 million; North of Scotland Hydro Electricity Board, $10 million; Lothian Regional Council, $9 million; Electricity Council, $8 million; Northumbrian Water Authority, $4 million; Civil Aviation Authority, $3 million; South of Scotland Electricity Board, $3 million; Welsh Water Authority, $3 million; British Steel Corporation, $2 million; British Nuclear Fuels plc, $1 million; Lancashire County Council, $1 million; Severn Trent Water Authority, $1 million; Strathclyde Regional Council, $1 million; Yorkshire Water Authority, $1 million; Others, $3 million.

THE RESERVES IN NOVEMBER 1987 : PRESS BRIEFING

Factual : main features of markets in November

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
2 November	74.6	1.73	2.97½	98.0	1.72	137½
4 November	75.0	1.74½	2.98½	97.8	1.71	137
9 November	75.6	1.79	2.98	95.9	1.66¼	134½
16 November	74.8	1.74	2.98½	97.7	1.71½	137
23 November	75.7	1.79	2.98½	95.9	1.66½	134½
30 November	76.4	1.83	2.99½	94.4	1.63½	132

With the market's attention focused on the outcome of the US budget talks, sterling for the most part was on the sidelines. It benefited from the dollar's weakness moving up from $1.7270 and ERI 74.6 at the beginning of the month to $1.8320 (its highest level since May 1982) and ERI 76.4 on 30 November.

New para

Against the continental currencies, movements were restricted to a narrow range and were generally influenced by fluctuations in interest rates. Upward pressure on sterling was eased by a ½% cut in UK base rates (to 9%) on 4 November and, when further falls in equity markets raised expectations of another cut, a low of DM 2.97 was noted on 10 November. However, ~~as share prices recovered a little and the downward pressure on interest rates abated, sterling was in good professional and commercial demand. News of a rise in the inflation rate (to 4.5% in October) temporarily subdued activity, but sterling was pulled higher with the firmer dollar immediately after the US budget package announcement and,~~ when the ~~market realised that the~~ cuts in West German, French and Dutch interest rates ~~would not be~~ matched here, ~~it~~ moved up to a high of DM2.99½ on 25 November and ended the month on a firm note.

~~sterling~~ the pound

were not

Do we really need this?
At the very least it should be 'boiled up'.

The difficulties encountered in resolving America's fiscal problems tended to dominate proceedings on the foreign exchanges, causing the dollar to fall rapidly. Following remarks from Baker and Mulford which were taken to imply that the US were prepared to acquiesce in a lower dollar and reports that the budget negotiations were unlikely to agree on any cuts over and above the Gramm-Rudman-Hollings requirement, the dollar's decline gathered pace and, when no new initiatives on currency stability emerged from the regular meeting of central bankers in Basle, the US unit fell to post-war lows of DM 1.6485 and Y 133.20 on 10 November. Speculation that a budget package was imminent subsequently provided the dollar with some respite and it received further boosts from the publication of a slightly better-than-expected trade deficit for September of $14.08bn and from strong indicators for retail sales and wholesale prices. Nevertheless, underlying sentiment remained bearish and, although the dollar moved up in the immediate aftermath of the budget announcement on 23 November, the rally was short-lived as the markets were disappointed with the package and worries persisted over ratification of the agreement and about prospects for a new international currency understanding. Despite co-ordinated interest rate cuts in West Germany, France and Holland and statements from Stoltenberg and Kohl that they were considering ways of stimulating the German economy, the dollar ended the month on an easier note. Following speculation during weekend of 28/29 November that Baker was prepared to see the dollar continue to fall, the dollar closed the month at post-war record lows of DM 1.6350 and Yen 132.17.

Previous reserve changes

(i) Reserve changes this year have been:

$ million

		Underlying Change	Total Change	Level of Spot Reserves At the end period
1987	January	+ 72	+ 29	21,952
	February	+ 287	+ 305	22,257
	March	+ 1785	+ 1892	27,039+
	April	+ 2912	+ 2768	29,807
	May	+ 4760	+ 4872	34,679
	June	- 230	- 315	34,364
	July	+ 499	+ 551	34,915
	August	- 457	- 550	34,365
	September	+ 380	+ 443	34,808
	October	+ 6699	+ 6591	41,399
	November	+ 31	- 118	41,281
	Totals	+ 16738	+16468	

+after revaluation

(ii) Last month's underlying change was the largest ever.

(iii) **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%
	26 October	9½	Down ½%
	5 November	9	Down ½%

POSITIVE

1. Little change in reserves this month. Reserves remain very strong after substantial underlying increase of $17 billion in year so far. Reserves now stand at $41.3 billion.

Apart from recent weakness of dollar,

2. Sterling remained comparatively stable since Budget, especially against the deutschemark, despite recent stock market fluctuations.

DEFENSIVE

(A) **POLICY**

1. **Exchange rate policy for sterling?** Under Louvre Accord G7 agreed to seek period of stability in major currencies. Chancellor made clear in Mansion House speech governments' ~~commitment~~ policy of to maintain a stable exchange rate with cross-rate against deutschemark of particular importance. This is consistent with Governments' aim for money GDP and hence inflation. Policy has been made clear not merely by Chancellor's statements, but by what has actually happened.

~~2. **Specific range for sterling?** See 1. But as Prime Minister said in interview reported in 'Financial Times' on 23 November - sterling is not tied to a specific range against the deutschemark and as it would be were we members of the EMS exchange rate mechanism.~~

(B). **LOUVRE/G7/WASHINGTON**

3. **What are current exchange rate bands for dollar?** Not helpful to comment.

at present

2. Prime Minister's FT interview? PM was pointing out that we were not members of the ERM, and thus not formally bound to stay within a published range.

4. **Return to Bretton Woods?** No: in his speech Chancellor explicitly spelt out why he was not advocating return to Bretton Woods. In it, 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."

5. **Louvre Accord coming unstuck?** [~~No.~~] Both US Treasury Secretary Baker and German Finance Minister Stoltenberg have reaffirmed commitment to cooperate on monetary and exchange rate policies. At ECOFIN Council on 16 November EC Finance Ministers reaffirmed importance of Louvre Accord, and agreed to cooperate with other countries in decisions to ensure more stable development of world financial and foreign exchange markets.

6. **Is it US policy to drive the dollar down?** Recent statements by Secretary Baker indicate US does not want to see further dollar fall.

7. **Will there be another G7 meeting in the near future to discuss recent market events?** Chancellor said in House on 26 November that he hopes a G7 meeting will be held before Christmas. ~~But necessary pre-conditions are: US Congress needs to ratify budget deficit package; the largest surplus countries, Germany and Japan should commit themselves to further action to improve their economic momentum; and parties should agree that conditions are right for stabilisation of the dollar which is an essential element to avoid recessionary dangers.~~ G7 ~~countries~~ finance ministers are, of course, in constant telephone communication with each other about recent events.

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

9. **Is it true that Bank have been switching dollars into deutschemarks and yen to limit risk of losses on intervention?** [FT article 2 November 1987.]
Never discuss detailed reserves transactions.

10. **Aren't you going to make a loss buying dollars in a falling market?** Much too early to tell. Depends on exchange rate at which intervention is unwound (if and when it is). ~~(Smoothing~~ (Stabilising intervention has been profitable in past, although that of course is not reason it is undertaken).

11. **Have other countries been intervening over last month/recently?** Ask them. Don't discuss details of other countries' intervention.

12. **Concerted intervention in foreign exchange markets pointless before underlying fundamentals have been resolved?** Intervention is only one instrument in Louvre Accord. Chancellor said in House on 27 October "we did not intervene in order to stabilise markets until we had first intervened in a massive way following the Plaza agreement to drive the dollar down, and we only intervened to stabilise it after the deutschemark and yen had risen by as much as 50 per cent against the dollar in order to give that massive change in exchange rates time to work through." Another instrument is interest rates. The Chancellor said on 24 November in speech to American Chamber of Commerce, "interest rates in the US need to be set at level that can support dollar and finance the deficit" ..... "Surplus countries should give more attention to world interest rate differentials and monetary conditions in industrialised world ... when setting their interest rates".

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

13. **Prospects of further co-ordinated interest rate cuts?** Wait and see.

14. **Recent moves by Germans/French/Dutch in cutting interest rates helpful?** Yes. But only a step in preparing right conditions for necessary stabilisation of dollar. Actions also had calming effect on exchange rate mechanism (ERM) of European Monetary System. Other steps to stabilise dollar are; largest surplus countries, Germany and Japan take further action to improve internal economic momentum and Japan should open its markets more fully to imports.

15. **Why not cut interest rates like Germans to support dollar?** UK has already brought its interest rates down by full 1% since stock markets fall. [Chancellor said in the House on 26 November that, rates having come down by a full point, he did not think any further reduction was called for at the present time. Though concerned by the recessionary influences that may come from the stock market collapse, still inflationary forces to be kept under control.]

16. **Is exchange rate now only factor driving UK interest rates?** Not at all. Interest rates continue to be set in light of range of factors affecting financial conditions. But period of stability for sterling of benefit both to industry and as firm counter-inflationary anchor.

need to maintain adequate downward pressure on inflation.

17. **26 October/5 November interest rate cuts made because sterling near DM 3 level?** No change in policy. Decision on interest rate taken in light of ~~monetary conditions as a whole.~~ But ~~Clearly~~ right in disturbed financial ~~market~~ ~~circumstances~~ conditions of late October/early November to reduce interest rates in order to allow some expansion in liquidity.

18. **Why did Government act to lower interest rates on 5 November?** Sharp falls in share prices throughout world will tighten monetary conditions somewhat. Judged ½ per cent reduction in interest rates consistent with prudent policy after consultation with international partners. In market circumstances, clearly right to reduce interest rates.

19. **Implication of recent heavy intervention for UK monetary conditions/funding?** Policy to ensure, over time, any net intervention funded so that effect on liquidity sterilised. Will be done as and when appropriate, though not necessarily within same financial year.

20. **German monetary policy not helpful?** Chancellor said in speech to Stock Exchange on 26 October: "It would be helpful if German monetary authorities were to show more awareness of [the need to avoid] undue monetary tightening." Germans have since cut their interest rates

(D) **EXCHANGE RATE MECHANISM (ERM)**

21. **UK membership of ERM?** No change in Government position. Matter kept under continual review. Will join when time is right.

22. **Conditions required for UK participation?** Not possible to specify precisely what conditions would have to be fulfilled before UK joined ERM (as Prime Minister reaffirmed in FT interview reported 23 November). Number of factors and their interaction need to be taken into account. Would be wrong to commit Government in advance; circumstances change, nor would it help conditions in foreign exchange market to be too specific.

23. **Role of European Monetary System (EMS) in preserving stable exchange rates?** ECOFIN Council on 16 November agreed that EMS has played important role in coordination of policies between member countries and in preserving stable relationships between European countries including in foreign exchange markets. Basle/Nyborg decisions prove EMS has been strengthened.

(E) **RECENT MARKET EVENTS**

24. **Stock market collapse due to "volatility" shifting out of forex markets?** No ~~reason to think so~~. As Chancellor said in his Mansion House speech this idea is "manifest poppycock" ~~. Stability in all markets desirable.~~ as recent events have demonstrated.

(F) **US BUDGET DEFICIT PACKAGE**

25. **UK view on US budget deficit package?** Welcome budget deficit agreement ~~as first step~~. Await ~~agreement of~~ ratification by Congress. Further action by ~~other~~ surplus countries still necessary.

26. **Reduction too little too late.** ~~No. Welcome agreement which has been reached. Now await Congress approval. But other countries need to play their part too.~~ Substantial reductions (by $73 billion already achieved in fiscal 1987.

LAST SENTENCE

NB: THIS STILL NEEDS TO BE WATCHED, GIVEN PLANNED GERMAN FISCAL MOVES ON WED.

27. **Cuts in US budget deficit could cause recession?** No. Package of cuts necessary to restore market confidence and is necessary step towards reduction of trade imbalances. ~~Gives lead to other countries to take action.~~

28. **World situation will send UK into recession?** No. Government's sound economic and financial policies have enabled UK to weather recent gyrations in stock markets and fall of dollar. Chancellor said in Weekend World interview on 8 November; "I will take whatever steps are necessary to make sure British economy is secure ... and is affected as little as possible by any difficulties outside."

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	+ 1.1 (end October)	46
Japan	+ 0.9 "	73
Germany	+ 13.0 (w/e 23 November)	63
France	- 2.0 (end September)	67
Italy	+ 0.5 "	46
Canada	+ 0.1 (end August)	6
United Kingdom	- 0.1 (end November)	41

Notes

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

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

SECRET

Ch
We will get Geoff over after you've done your speech.
AA

From: Sir G.Littler
Date: 16 December 1987

CHANCELLOR

c.c. Sir P. Middleton
Sir T. Burns

INTERVENTION

Bruss.

At the Monetary Committee meeting in Brussels yesterday I was able by prior arrangement to keep the question of intervention by the U.K. out of the discussion in the full Committee - although there was some very interested reference to the "U.K. dilemma" during the customary review of markets.

2. However I had to agree to a private talk with Tietmeyer and Gleske, Trichet and Dini, at which I was attacked strongly on both the substance of what we had done and the lack of consultation and 'breach of EMS undertakings'.

, Bank.

3. I suggested we focus on substance - acknowledging that we had not handled the consultation very well. I explained how we saw our problem - wanting to keep the exchange rate, worried over reducing interest rates, willing to intervene within reason but finding that huge dollar intervention was not as effective as we wanted and believing with reason that more 'direct' intervention in DM would serve us better. But we fully shared the anxiety of others not to disrupt the ERM, or drive the dollar down. In our view our interests could be met without doing damage, preferably with some cooperation. I emphasised two particular points:

- our actions had not, I insisted, damaged the ERM - and the others could not really challenge this;

- I did not believe we had undermined the dollar, although I was distressed that the Bundesbank seemed to be using our action as an alibi for contracting out themselves: it was unreasonable for them and others to rely on the U.K. continuing indefinite financing of the U.S. deficit.

The latter point gave rise to a lot of argument, with Trichet and Dini showing some sympathy and Gleske some embarrassment, but it did not win the day.

4. The worries about the ERM were not pressed very hard. The first set of main arguments pressed was:

- any buyer of DM in the market at the present time was disruptive (all);
- for the U.K. to be seen to be a buyer of DM would do great damage (all);
- the U.K. action, if it became known, could encourage such large holders as Taiwan and Korea to diversify into DM, which would have horrific effects (Gleske, with some support from others).

I argued that these points were over-stated and, while I joined others in agreeing that publicity of the wrong kind could be damaging, I reverted again to the possibility of cooperation to keep the right overall balance.

5. Tietmeyer, Trichet and Dini then urged me to recognise the shock - political as well as technical - our action had caused. Apart from emphasising the depth of feeling behind the various high-level approaches (to you and the Prime Minister), they made

(Tietmeyer, but with nervous support from the others) three pionts in the nature of threats:

- that the Bundesbank might go into the market to buy sterling to offset any deals we did - this thought was introduced by some heavy remarks about our failure to respect the EMS agreement on cross-holdings;
- that Baker and Stoltenberg had discussed our action together, that Baker had been dismayed and could not reconcile it with your pressure for cooperation, and that both Stoltenberg and Baker doubted whether there could be any point in a G7 statement this weekend (the Congressional process may well end successfully by Friday) if the U.K. is 'not cooperating (I said I found this extreme and was surprised that Baker had not, as far as I knew, contacted you - that in turn seemed to surprise Tietmeyer);
- that Stoltenberg was still contemplating calling a meeting of Ministers this weekend (I suggested that such a meeting could precipitate a realignment: Trichet was horrified by the idea and Tietmeyer said he had himself tried to discourage it).

6. I brought our talk to a close, on the basis that we must grab a quick lunch and resume the full Monetary Committee, by saying:

- I was not convinced by all the arguments, and felt that some of the difficulties could be overcome by cooperation which would be our wish;

- but I recognised the worries which had been expressed and would report them - although I repeated that in my view the ERM worries were not justified;
- and of course our policies and tactics in this area were a matter for continuous review in the light of a pretty fluid and unpredictable situation.

7. Tietmeyer begged me to consult you as soon as possible, because he wants to talk with Stoltenberg this afternoon - with a view to considering both German action vis-a-vis us and what line to take with Baker on the G7 statement.

(Geoffrey Littler)

SECRET

Thanks

From: Sir G.Littler
Date: 17 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

PROSPECTIVE CALL FROM STOLTENBERG

Tietmeyer telephoned me last night: a 10-minute conversation which was interesting both for what was and what was not said! He said that Stoltenberg would want to call you some time this morning, for the following purposes:

- to check that you are content with the latest draft of the G7 statement he has agreed with Baker: the text was sent over last night and is attached;
- to tell you of the private arrangements he has made with Baker and Miyazawa about intervention (Tietmeyer would not or could not give me the details in advance);
- to seek your agreement to the form of announcement - the proposal is that, assuming the U.S. confirm success with Congress by Friday night (the process probably not to be completed until Saturday), there should be simultaneous announcement in all G7 capitals, probably at 11 a.m. our time on Sunday 20 December;
- to seek your response to his message to you about U.K. intervention in DM.

2. The last point was presented very much more as an extra than as anything like a climax. It seems clear that the message to you was drafted <u>before</u> I spoke with Tietmeyer following my talk with you yesterday - and sent as drafted. Tietmeyer's first

reaction to what I said at lunch-time was strong disappointment that I refused to give a categorical assurance that "we would not in any circumstances buy DM without Bundesbank consent". But he did not revert to this in last night's conversation. My guess is that Stoltenberg does not want a row with you - quite possibly sent his message as a sop to the Bundesbank - and will be willing to be persuaded to 'hope for the best' without pressing you now for a more explicit assurance of the kind his message sought.

3. The draft statement contains no surprises. I have only two comments at this stage:

- first, simply to draw your attention to the last sentence of the first paragraph, which is a clever way of meeting the U.S. wish for a reference to the 'indicators' work!
- secondly, the language is American in parts: e.g. in para 1 "in light of".

The only change I would like to press is another of Mulford's split infinitives - "to fully reflect" at the end of para 7.

4. It will be interesting to hear the details of the private intervention agreement - I guess one of cross-rate upper and lower limits. We can cope with the proposed publication arrangements and I suggest should not try for anything different.

GL

(Geoffrey Littler)