Part. A.

SECRET

(Circu under cover and
notif f movement)

Begins: 11/3/87.
Ends : 11/3/88.

PO -CH /NL/0319

PART A

Chancellor's (Lawson) Papers:

PROFITABILITY OF INTERVENTION ON EUROPEAN CURRENCY UNITS

DD's: 25 Years

27/10/95

PO -CH /NL/0319
PART A

3888/011

SECRET

Mr Allan. I will make some [illegible] of this in briefing. In the context, a phrase would be better than para 8 calculations. Done. N.

FROM: C W KELLY

DATE: 11 March 1987

PRINCIPAL PRIVATE SECRETARY

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

PROFITABILITY OF INTERVENTION

You asked if we could do a crude calculation of the profitability of the intervention undertaken since last autumn.

2. There are a number of different ways of doing this, none of them perfect.

3. The simplest is probably to work out the sterling value of the dollar assets sold in the period August-October at then prevailing exchange rates and compare this with the sterling cost of buying back the same amount of dollars in the period November to early March.

4. On this basis, looking at market and off-market transactions combined, we had made good all our reserve losses by 9 March, and made a sterling profit of £95 million. The figures are shown in the attached table.

5. Two caveats should be made.

6. First, the calculation uses average monthly exchange rates. A quick examination of the daily figures suggest that this does not introduce any significant distortions.

7. Second, it takes no account the fact that the sale of (lower yielding) dollars assets last autumn in principle allowed us to reduce our sterling borrowing then and to refinance at lower rates

when we bought the dollars back in the early months of this year. In the meantime, dollar yields or the assets we would have hold have not moved significantly. In practice this is an over-simplification since we do not fund on a monthly basis. Even so, the overall effect of taking account of relative interest rates and interest rate movements would be to increase the apparent profitability of the intervention rather than the reverse.

8. We have not done a similar calculation on the previous episode of intervention post-Plaza and its subsequent reversal. But if we did that would also show us making a substantial profit.

C W KELLY

		Total Intervention $ million	Cumulative intervention $ million	Average monthly $/£ exchange rate	£m equivalent of monthly intervention	Cumulative £m capital
1986	August	- 286	- 286	1.487	+192.3	+ 192.3
	September	- 688	- 974	1.472	+467.4	+ 659.7
	October	-1,325	-2,299	1.428	+927.9	+1,587.6
	November	+ 147	-2,152	1.425	-103.2	+1,484.4
	December	+ 196	-1,956	1.438	-136.3	+1,348.1
1987	January	+ 141	-1,815	1.507	- 93.6	+1,254.5
	February	+ 380	-1,435	1.527	-248.9	+1,005.6
	March (to part way thru' 9th)	+1,435	0	1.575	-911.1	+ 94.5

Further intervention since all autumn losses were recouped has totalled $852 million (to 2.00 pm on 11 March).

ps2/5R

SECRET

Andrew

CHANCELLOR OF THE EXCHEQUER

FROM: CATHY RYDING
DATE: 12 March 1987

MR C W KELLY

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

PROFITABILITY OF INTERVENTION

The Chancellor was most grateful for your minute of 11 March.

2. The Chancellor will try to make something of this in his wind-up speech in the Budget Debate. In this context, he thinks it would be helpful to have the calculations mentioned in paragraph 8 of your minute - ie similar calculations on the previous episode of intervention post-Plaza and its subsequent reversal.

CR

CATHY RYDING

5

1 ~~Cotts~~
2 pup

SECRET

From: R B SAUNDERS
Date: 12 March 1987

PRINCIPAL PRIVATE SECRETARY

cc PS/Economic Secretary
Sir G Littler
Mr Cassell
Mr Peretz
Mr Grice
Mr C Kelly
Ms Goodman

PROFITABILITY OF INTERVENTION

Sir Peter Middleton has seen Mr Kelly's minute of 11 March. He has commented:

> "Given our policy for funding which means automatic sterilization, we must also have an interest rate gain to throw into the pot."

RBS

R B SAUNDERS
Private Secretary

3762/001

SECRET

1 ~~PLEX~~
2 PWP

FROM: P D P BARNES

DATE: 12 MARCH 1987

PRINCIPAL PRIVATE SECRETARY

cc Sir P Middleton
Sir G Littler
Mr Casseell
Mr Peretz
Mr Grice
Mr C W Kelly
Ms Goodman

PROFITABILITY OF INTERVENTION

The Economic Secretary has seen Mr Kelly's minute to you of 11 March.

2. The Economic Secretary has commented:-

> "Very good so far. However from now on it becomes less attractive to buy an appreciating currency."

PB

P D P BARNES
Private Secretary

3762/014

SECRET

Alex

You were right!

FROM: P D P BARNES

DATE: 13 MARCH 1987

PRINCIPAL PRIVATE SECRETARY

cc Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr Grice
Mr C W Kelly
Ms Goodman

PROFITABILITY OF INTERVENTION

The Economic Secretary's comments on Mr Kelly's minute of 11 March should have read:-

> "Very good so far. However, from now on it becomes less attractive to buy a depreciating currency."

2. My minute of 12 March should be withdrawn.

PB

P D P BARNES
Private Secretary

3888/041

SECRET

RP

FROM: C W KELLY

DATE: 19 March 1987

MS RYDING

Thanks

cc PS/Economic Secretary
Sir T Burns
Sir P Middleton
Sir G Littler o/r
Mr Cassell
Mr Peretz
Mr Grice
Ms Goodman
Mr Flitton

PROFITABILITY OF INTERVENTION

You asked us to do a calculation of the profitability of intervention post-Plaza and its subsequent reversal, along the lines of that done for the more recent eposide in my minute of 11 March.

2. The figures are shown in the first part of the attached table. The measure of intervention used in the published underlying reserve change rather than the true intervention figure.

3. On this basis the post-Plaza intervention in the Autumn of 1985 was reversed by the first few days of June 1986. The cumulative profit at that point was just over £16 million.

4. Taking account of both spot and forward transactions we had reversed the intervention loss by 16 April, making a broadly similar profit.

5. The second part of the table reworks the figures in my minute of 11 March for the more recent eposide, also using only the published figures. This has the effect of reducing apparent profitability to £48 million.

6. Needless to say, these figures are subject to considerable caveats. They are only one way of doing the calculation, and a very crude one at that. They are very sensitive to how the time periods are chopped up, and the point at which the valuation is made.

7. For this reason, I would strongly advise the Chancellor against using them next Monday. Having once given this form of calculation our implicit approval, we could not object if others also used it. But its application to other time periods could well produce results distinctly less favourable to the present government, or the present Chancellor.

8. This need not, of course, rule out using the figures more qualitatively, as the Chancellor has before. It was obviously profitable to sell dollars in the three months August to October 1986, when the average exchange rate was $1.46, and to buy them back in the first quarter of this year, with the exchange rate between $1.50 and $1.60.

cwk

C W KELLY

enc

		Total published underlying reserve change $m	Cumulative	Average monthly £/$ exchange rate	£ equivalent of monthly intervention	Cumulative £m
(i) Post-Plaza						
1985	October	-324	-324	1.422	+227.8	+227.8
	November	-201	-525	1.440	+139.6	+367.4
	December	-416	-941	1.446	+287.7	+655.1
1986	January	+132	-809	1.423	- 92.8	+562.3
	February	+112	-697	1.430	- 78.3	+484.0
	March	+278	-419	1.467	-189.5	+294.5
	April	+264	-155	1.499	-176.1	+118.4
	May	+138	- 17	1.521	- 90.7	+ 27.7
	June (part)	+ 17	0	1.510	- 11.3	+ 16.4
(ii) August 1986-March 1987						
1986	August	-141	-141	1.487	+ 94.8	+ 94.8
	September	-372	-513	1.472	+252.7	+347.5
	October	-668	-1181	1.428	+467.8	+815.3
	November	+ 35	-1146	1.425	- 24.6	+790.7
	December	+ 96	-1050	1.438	- 66.8	+723.9
1987	January	+ 72	- 978	1.507	- 47.8	+676.1
	February	+287	-691	1.527	-188.0	+488.1
	March (part)	+691	0	1.57*	-440.1	+ 48.0

* Average to 6 March

EB1/149

SECRET

BF
17/9

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 11 SEPTEMBER 1987

MR KELLY

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Cropper

PROFITABILITY OF INTERVENTION

The Chancellor would be grateful if you could let him have more up-to-date figures for the profitability of intervention, giving both the true figures, and what might be deduced from the published figures for reserve changes.

2. The earlier calculations you provided in the Spring were based on the increase in reserves then having matched the fall in reserves last autumn. The Chancellor would be grateful for advice on how the calculations should best be done now that we have a large net reserve increase.

ACSA

A C S ALLAN

4/2383

SECRET

FROM: **P N SEDGWICK**
DATE: 15 SEPTEMBER 1987

CHANCELLOR

cc
Chief Secretary
PCC
Mr Hawtin
Mr Moore
Mr Odling-Smee
Mr Peretz
Mr Turnbull
Mr Bottrill
Mr S Davies
Mr Mowl

POLICY ASSUMPTIONS FOR THE FORECAST

I attach a note, which reflects comments at a meeting of PCC this morning, on the policy assumptions that we propose to use for the current forecast. I would be grateful if you could let me know whether you are content with these.

P.N.S
P N SEDGWICK

Content. Re X, while the main forecast should be based on constant XR v both $ & DM, it would be helpful to have a note on the effect of varying this so that there is a constant XR v the ~~$~~ DM with the $ falling say 10%. Re Y.1 should be grateful to see TB with the turn consistent w. this (Relevant for TB, rather than FT's S). N.

Ch
OK (XR assumption is the main issue)
AA

POLICY ASSUMPTIONS FOR THE AUTUMN FORECAST

Note by EA and PSF

This note discusses the assumptions for the internal autumn forecast. Assumptions for the published Autumn Statement forecast will be considered nearer the time. The internal forecast will cover the next two full years, ie to end 1989 (to 1989-90 for public finances). The main forecast report will be circulated on Friday 9 October.

2. In general, the approach is to base policy assumptions as far as possible on the macro-economic policies set out in the 1987 MTFS.

Monetary Policy

NB against what?

3. The forecast will illustrate the implications for money GDP and interest rates of maintaining a more or less constant exchange rate to the end of 1988, and possibly for the whole forecast period if the rest of the forecast suggests that this is feasible. The forecast will assume no substantial intervention in the foreign exchange markets in the absence of significant pressure on the exchange rate. A partial and gradual rundown of the earlier rise in reserves could be assumed if pressures on the exchange rate are likely to be downwards and vice versa in the event of upward pressure. During the forecasting exercise the forecasters will consult Sir Terence Burns and Mr Cassell on the precise implementation of the exchange rate and intervention assumptions and on the implied forecast of interest rates. The path for interest rates will also take account of the paths for money GDP, the forecast of MO relative to its target ranges, and other indicators of monetary conditions.

4. It will be assumed that the PSBR is fully funded through debt sales outside the banking sector, including £2 billion a year from National Savings. The latter assumption may have to be reviewed during the forecasting round if the PSBR in individual years is further revised down compared with the FSBR. In the current financial year the present funding rule implies additional funding to offset that part of the rise in the foreign exchange reserves

in the first half of the financial year which is not assumed to be unwound during the rest of the year.

Fiscal Policy

5. The forecast will assess the likely outturn of the PSBR in 1987-88, taking into account both the information on borrowing in the first half of 1977-88, and fresh information on likely developments in the rest of the financial year.

6. The forecast will reassess the scope for fiscal adjustments in 1988-89 and 1989-90, after making provision for the forecasters' best view of the likely path for public expenditure.

7. The June forecast indicated that a PSBR set at 1 per cent of money GDP, as in the MTFS, would generate very large fiscal adjustments. If this remains the picture in the autumn forecast then, as in June, the forecast will assume that some of the fiscal adjustment goes to reduce the PSBR (below the 1987 MTFS ratios) and some to reduce personal taxes. The judgement on the allocation of the fiscal adjustment will be reviewed in consultation with Sir Terence Burns during the course of the forecast. The judgement will take account of the higher assumed path for privatisation proceeds (see para. 11(v) below).

Taxation and other government receipts

8. The forecast for pre-fiscal adjustment taxes will assume full revalorisation in 1988 and 1989 Budgets of all the income tax bands and allowances, and of specific duties. These assumptions together with the nature of the forecasts for the main determinants of taxes may well not produce a result consistent with the assumption in the 1987 MTFS that the share of non-North Sea revenues in non-North Sea money GDP would remain broadly constant.

9. As in the June exercise the corporation tax forecast will make an allowance for the effect of banks' provision for poorly performing sovereign debt.

Public expenditure

10. The forecast of public expenditure will take account of the existing plans, changes in economic assumptions implied by the rest of the forecast, and any other pressures on expenditure

considered likely to be conceded in the current Survey or subsequently.

11. As usual detailed public expenditure judgements and assumptions will be discussed during the forecast with the appropriate Treasury divisions.

(i) The forecasters will make their best forecast of public sector pay in consultation with Pay division and, in the case of local authorities, with LG.

(ii) The outturn percentage of local authorities' Aggregate Exchequer Grant to expenditure in 1988-89 will be forecast from details of the RSG settlements announced on 23-July, the forecast of LA relevant expenditure, and estimates of the associated grant underclaim. The outturn percentage is expected to fall by around one per cent between 1987-88 and 1988-89. It will be assumed to fall a little further (perhaps by ½ percentage point) in 1989-90.

(iii) The forecast of local authority rate income in 1988-89 will be consistent with the forecast of current expenditure, grant income implied by the recent RSG settlement, and assumptions to be discussed with LG about special funds, balances, and rate caps. LG will also be consulted on the likely effect in the run up period of the introduction of the Community Charge on local authorities' taxing decisions and income.

(iv) The forecast of nationalised industry prices, investment, etc. is being discussed with PE. The forecast of external finance will allow for the transfer to the private sector of newly privatised industries although this is unlikely to be of major significance in the period covered by the forecast (up to 1989-90); the forecast will assume no electricity and water privatisation before 1990-91.

(v) Privatisation proceeds for 1987-88 will be the best available estimate in the light of PE's current information. For 1988-89 and 1989-90 it is proposed to assume proceeds of £6 billion a year.

(vi) The forecast will assume an increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 with effect from 1 January 1988. It will also be assumed that a Community Budget is agreed before 31 March 1988. There is a risk however that a budget will not be adopted by then, in which case an emergency financing regime (provisional twelfths) would be implemented, pushing up the UK's net payments in 1987-88 by some £100 millions, and reducing them in 1988-89.

3888B/020

SECRET

Papers please.

[illegible]

FROM: C W KELLY
DATE: 16 September 1987

Ch

Can reasonably say that our experience demonstrates that over a period, intervention can be very profitable indeed. These calculations a bit artificial since we are v unlikely to want to support £ @ 1.65

AA

CHANCELLOR

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

PROFITABILITY OF INTERVENTION

You asked me to update the figures on the profitability of intervention which we provided in the spring.

2. There is, of course, no unique way of doing this over a period in which intervention has not summed to zero. But one possible methodology, which is consistent with that used in the earlier submission, was described in an article in the Bank of England's quarterly bulletin in September 1983. It involves calculating the sterling cost of the acquisition of dollars at the time they are acquired with the sterling value of those dollars at the end of the period. The procedure is to:

i. Estimate the sterling capital used to purchase dollars over the period by dividing intervention in each month by the average sterling/dollar rate during that month, and summing the resulting series.

ii. Calculate the end-period value of the dollars so bought by converting the cumulative total of intervention by the exchange rate ruling at the end of the period.

iii. Subtract (i) from (ii).

3. The calculation is subject to a considerable number of caveats. In particular it assumes:

i. That all intervention is in dollars.

ii. That intervention is evenly spread through the month.

iii. That there is no profit or loss from deals within the month.

iv. That net purchases over the period could be closed out at the exchange rate observed at the end of the period.

4. None of these, particularly the last, are likely to be true in practice. It also makes no allowance for interest rate effects, ie that we are paying a sterling interest rate on the sterling capital employed and receiving a (lower) dollar one on the dollar assets. Nor, though this is probably less important, does it allow for profits/losses arising within the reserve portfolio on assets bought and sold as a result of the demands made by intervention.

5. The three tables attached show the results of performing this calculation for the period since Louvre, the period since Plaza and the whole period since the beginning of 1979 respectively.

6. Table 1 shows that, calculated on this basis ignoring interest rate effects, we have made a small book "loss" since the Louvre agreement. Adding in interest rate effects would make this worse since US rates have remained below sterling rates.

7. The reason is not hard to find. Over a period when net intervention is not zero the calculation of profit is much influenced by the exchange rate which happens to rule at the end of the period covered. However profitable it is to buy dollars when sterling is strong and sell them when it is weak, any profit of this kind is soon wiped out if we continue to hold dollars when sterling is rising.

8. Table 2 shows that over the longer period since Plaza we have, on the same basis, made a small profit. But that also would be reduced if interest rate effects were taken into account. It could also very quickly be turned into a loss if sterling strengthened further against the dollar.

9. Table 3 shows that over the whole period since 1979 we have made a healthy profit, but one which is smaller than it was because of the effect of a weaker dollar on the sterling value of dollar assets acquired in previous periods.

10. I understand that you are thinking of using some of these figures at your IMF press conference tomorrow. I would advise strongly against. If we can do the calculations, so can anyone else. They would be able to show that since Louvre we have made a loss, which becomes a bigger loss if interest rate effects are taken into account, and that although we are still showing a book profit post-Plaza, that also ignores interest rates and could soon turn round if the exchange rate strengthened. Once you have given your imprimatur to calculations of this kind, they could be used against you.

11. You also asked what the "true" figures would look like, ie including changes to the unpublished forward book as well. You asked for a quick response and we have not had time to calculate this. But I am fairly certain that it would not improve the picture.

Urgent

Pse redo with different methodology. Use true reserve movements, & calculate profit/loss on basis of matching transactions only. (ie ~~[illegible]~~ taking into account only the $ bought to recoup ~~[illegible]~~ that SDR, & ignore any 'surplus' $ we have acquired.) NL.

C W KELLY

encs

SECRET

TABLE 1: ILLUSTRATIVE CALCULATIONS OF THE PROFITABILITY OF INTERVENTION SINCE LOUVRE (FEBRUARY (1987)

	(1) Spot intervention	(2) Monthly average exchange rate ($/£)	(3) End Monthly average exchange rate ($/£)	(4) Cumulative Sterling capital employed in intervention (Col(1)/ Col(2) then cumulated) £ million	(5) Sterling value of cumulative intervention (Col(1) cumulated/Col(3)) £ million	(6) Cumulative dealing "profits" (Col(5)-Col(4)) £ million
1987						
February	+ 287	1.527	1.546	+ 188	+ 186	- 2
March	+ 1785	1.592	1.604	+ 1309	+ 1292	- 17
April	+ 2912	1.630	1.660	+ 3096	+ 3002	- 94
May	+ 4760	1.666	1.628	+ 5953	+ 5985	+ 32
June	- 230	1.629	1.612	+ 5812	+ 5902	+ 90
July	+ 499	1.610	1.593	+ 6122	+ 6286	+ 164
August	- 457	1.598	1.630	+ 5836	+ 5863	+ 27
September (to 15.9.87)	+ 156	1.651	1.644	+ 5930	+ 5908	- 22

3888B/022

SECRET

TABLE 2: ILLUSTRATIVE CALCULATIONS OF THE PROFITABILITY OF INTERVENTION SINCE PLAZA (SEPTEMBER 1985)

	(1) Spot intervention £ million	(2) Monthly average exchange rate ($/£)	(3) End monthly average exchange rate ($/£)	(4) Cumulative sterling capital employed in intervention (Col(1)/ Col(2) then cumulated) £ million	(5) Sterling value of cumulative intervention (Col(1) cumulated/Col(3)) £ million	(6) Cumulative dealing "profits" (Col(5)-Col(4)) £ million
1985						
September	- 97	1.365	1.407	- 71	- 69	+ 2
October	- 324	1.422	1.445	- 299	- 291	+ 8
November	- 201	1.440	1.409	- 439	- 417	+ 22
December	- 416	1.446	1.446	- 727	- 718	+ 9
1986						
January	+ 132	1.423	1.409	- 634	- 643	- 9
February	+ 112	1.430	1.450	- 556	- 548	+ 8
March	+ 278	1.467	1.478	- 366	- 349	+ 17
April	+ 264	1.499	1.553	- 190	- 162	+ 28
May	+ 138	1.521	1.472	- 99	- 77	+ 22
June	+ 291	1.509	1.534	+ 94	+ 115	+ 21
July	- 4	1.508	1.492	+ 91	+ 116	+ 25
August	- 141	1.487	1.488	- 4	+ 22	+ 18
September	- 372	1.472	1.448	- 257	- 235	+ 22
October	- 668	1.428	1.408	- 725	- 716	+ 9
November	+ 35	1.425	1.437	- 700	- 677	+ 23
December	+ 96	1.438	1.484	- 633	- 591	+ 42

TABLE 2 (CONTD): ILLUSTRATIVE CALCUALTIONS OF THE PROFITABILITY OF INTERVENTION SINCE PLAZA (SEPTEMBER 1985)

	(1) Spot intervention ($/£)	(2) Monthly average exchange rate ($/£)	(3) End Monthly average exchange rate £ million	(4) Cumulative Sterling capital employed in intervention (Col(1)/ Col(2) then cumulated £ million	(5) Sterling value of cumulative intervention (Col(1) cumulated/Col(3)) £ million	(6) Cumulative dealing "profits" Col(5)-Col(4)) £ million
1987						
January	+ 72	1.507	1.514	- 585	- 532	+ 53
February	+ 287	1.527	1.546	- 397	- 335	+ 62
March	+ 1785	1.592	1.604	+ 724	+ 790	+ 66
April	+ 2912	1.630	1.660	+ 2511	+ 2517	+ 6
May	+ 4760	1.666	1.628	+ 5368	+ 5491	+ 123
June	- 230	1.629	1.612	+ 5227	+ 5403	+ 176
July	+ 499	1.610	1.593	+ 5537	+ 5780	+ 243
August	- 457	1.598	1.630	+ 5251	+ 5369	+ 118
September (to 15.9.87)	+ 156	1.651	1.644	+ 5345	+ 5418	+ 73

TABLE 3 - ILLUSTRATIVE CALCULATIONS OF THE PROFITABILITY OF INTERVENTION

		(1) Spot Intervention ($ million)	(2) Quarterly average exchange rate ($/£)	(3) End quarter exchange rate ($/£)	(4) Cumulative sterling capital employed in intervention, £ million (col (1)/col(2), then cumulated)	(5) Sterling value of cumulative intervention, £ million (col(1), cumulated, /col(3))	(6) Cumulative dealing "profits" £ million (col(5) - col(4))
1979	1	1244	2.016	2.067	617	602	-15
	2	1577	2.081	2.172	1375	1299	-76
	3	779	2.234	2.202	1724	1635	-89
	4	83	2.157	2.225	1762	1655	-107
1980	1	1126	2.254	2.164	2262	2222	-39
	2	537	2.286	2.357	2497	2268	-228
	3	605	2.382	2.388	2751	2492	-258
	4	450	2.387	2.392	2939	2676	-263
1981	1	355	2.309	2.242	3093	3013	-79
	2	-136	2.077	1.938	3027	3416	389
	3	-1124	1.839	1.811	2416	3035	619
	4	-67	1.883	1.911	2381	2841	460
1982	1	12	1.845	1.783	2387	3052	665
	2	-908	1.779	1.743	1877	2601	724
	3	490	1.725	1.695	2161	2963	803
	4	-1153	1.650	1.618	1462	2392	930
1983	1	-858	1.530	1.482	901	2032	1131
	2	221	1.555	1.535	1043	2106	1063
	3	22	1.509	1.495	1058	2177	1119
	4	-329	1.471	1.452	834	2015	1181
1984	1	-259	1.435	1.442	654	1850	1196
	2	-418	1.396	1.356	354	1659	1304
	3	-415	1.299	1.239	35	1480	1445
	4	16	1.216	1.158	48	1598	1550
1985	1	-241	1.115	1.230	-168	1308	1476
	2	538	1.258	1.312	259	1636	1377
	3	-142	1.376	1.407	156	1425	1269
	4	-941	1.436	1.446	-499	736	1235
1986	1	522	1.440	1.478	-137	1073	1210
	2	693	1.510	1.534	322	1486	1163
	3	-517	1.489	1.448	-25	1217	1242
	4	-537	1.430	1.484	-400	825	1226
1987	1	2144	1.543	1.604	989	2100	1111
	2	7442	1.641	1.613	5524	6702	1178

Note:

above figures are illustrative only and need to be interpreted with caution. The methodology, together with a discussion of its limitations is contained in the Bank of England Quarterly Bulletin article, "Intervention, Stabilisation and Profits", September 1983. The figures given above exclude interest.

psl/12A

SECRET

BF 22/9.

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 17 September 1987

MR C W KELLY

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

PROFITABILITY OF INTERVENTION

The Chancellor was grateful for your minute of 16 September. He would be grateful if you could rework the figures on a different methodology, using true reserve movements, and calculating the profit/loss on the basis of matching transactions only (ie taking into account only the dollars bought to recoup those sold, and ignoring any "surplus" dollars we have acquired).

2. I should be grateful if you could let us have these calculations by close of play on Tuesday, 22 September.

ACSA

A C S ALLAN

RA7.88

SECRET

pup

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 17 September 1987

SIR T BURNS

POLICY ASSUMPTIONS FOR THE FORECAST

The Chancellor would be grateful if you could consult him as necessary about the judgement on the allocation of the fiscal adjustment in the forecast.

ACSA

A C S ALLAN

POLICY ASSUMPTIONS

RA7.89

SECRET

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 17 September 1987

MR SEDGWICK

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Bottrill
Mr S Davies

POLICY ASSUMPTIONS FOR THE FORECAST

The Chancellor was grateful for your minute of 15 September, and is content with what you propose.

2. On the exchange rate assumption, he feels that while the main forecast should be based on a constant exchange rate against both the dollar and the deutschemark, it would be helpful to have a note on the effect of varying this so that there is a constant exchange rate against the deutschemark with the dollar falling by, say, 10 per cent.

not what you got

ACSA

A C S ALLAN

3888/041

SECRET

PMP

FROM: C W KELLY

DATE: 22 September 1987

CHANCELLOR

Thanks. Basic pt. is so. I suppose that intervention is profitable when it achieves its objective, & not if it fails. N.

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

PROFITABILITY OF INTERVENTION

You asked me to rework the figures in my minute of 16 September using true reserve movements (ie spot and forward combined) and calculating the profit/loss on the basis of matching transactions only, ignoring any "surplus" dollars.

2. In order to do this, we clearly need to have some rule about determining which purchases can be deemed to match which sales, otherwise we can produce almost any result we want by careful choice of periods.

3. One way round this problem is to calculate the figures only over periods during which intervention has summed to zero. The table attached does this for three such periods:

i. September 1985 (ie Plaza) to mid-April 1986.

ii. Mid-April 1986 to the end of the first week in March 1987.

iii. July, August and the first part of this month.

4. Using the same methodology as before produces a dealing profit of £57 million for the first of these periods and £42 million for the second, or a combined profit of £99 million for the whole period September 1985 to early March 1987.

5. In the most recent period we made a loss of £14 million.

6. The run of total intervention figures in the months missing from this table were as follows:

		Intervention $ million	Average exchange rate $/£
1987	March (last 3 weeks)	2890	1.59
	April	4465	1.63
	May	7381	1.66½
	June	- 3356	1.63

7. If the sales of dollars in June are notionally matched against purchases made in March and the first part of April we would have made a "profit" on those too. If, however, they are notionally matched against purchases in May, we would have made a "loss" of -£26 million.

CWK

C W KELLY

3888B/042

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(1)/Col(4)) then cumulated £ 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	+ 383		+ 3
December	- 588	- 1136	1.446	1.446	+ 787	+ 790		+ 3
1986								
January	+ 79	- 1057	1.423	1.409	+ 731	+ 733		+ 2
February	+ 332	- 725	1.430	1.450	+ 449	+ 504		+ 55
March	+ 398	- 327	1.467	1.478	+ 178	+ 235		+ 57
April(to 16th)	+ 327	0	1.471	1.553	- 44	+ 13		+ 57
							revised	
April(from 16th)	+ 231	+ 231	1.532	1.553	- 151	- 149		+ 2
May	+ 76	+ 307	1.521	1.472	- 201	- 201	- 199	-
June	+ 343	+ 650	1.509	1.534	- 428	- 425	- 429	+ 3
July	- 96	+ - 554	1.508	1.492	- 364	- 361	- 371	+ 3
August	- 286	+ 268	1.487	1.488	- 172	- 169	- 181	+ 3
September	- 688	- 420	1.472	1.488	+ 295	+ 293	+ 282	- 2
October	- 1325	- 1745	1.428	1.408	+ 1223	+ 1234	+ 1229	+ 11
November	+ 147	- 1598	1.425	1.437	+ 1100	+ 1132	+ 1115	+ 22
December	+ 196	- 1402	1.438	1.484	+ 974	+ 1000	+ 965	+ 36
1987								
January	+ 141	- 1261	1.507	1.514	+ 880	+ 907		+ 27
February	+ 380	- 881	1.527	1.546	+ 631	+ 661		+ 30
March(6th)	+ 881	0	1.571	1.604	+ 70	+ 112		+ 42
July	+ 810	+ 810	1.610	1.593	- 503	- 508		- 5
August	- 857	- 47	1.598	1.630	+ 33	+ 18		- 15
September(3rd)	+ 47	0	1.649	1.658	+ 4	- 10		- 14

3887B/008

SECRET

Nigel thanks

FROM: **C W KELLY**

DATE: **9 October 1987**

Many thanks for letting me know. N

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. They show that on this basis (ie ignoring interest rate effects and so on) the "profit" during the first post-Plaza period was £10 million and that made during the second period between 16 April 1986 and 6 March 1987 was £80 million, giving a cumulative profit over the two periods combined of £90 million.

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

cwk

C W KELLY

enc

3888B/042

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	- 239	+ 5
November	- 202	- 548	1.440	1.490	- 384	- 368	+ 16
December	- 588	- 1136	1.446	1.446	- 791	- 786	+ 5
1986							
January	+ 79	- 1057	1.423	1.409	- 735	- 750	- 15
February	+ 332	- 725	1.430	1.450	- 503	- 500	+ 3
March	+ 398	- 327	1.467	1.478	- 232	- 221	+ 11
April(to 16th)	+ 327	0	1.471	1.553	- 10	0	+ 10
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	+ 180	+ 8
September	- 688	- 420	1.472	1.448	- 295	- 290	+ 5
October	- 1325	- 1745	1.428	1.408	- 1223	- 1239	- 16
November	+ 147	- 1598	1.425	1.437	- 1120	- 1112	+ 8
December	+ 196	- 1402	1.438	1.484	- 984	- 945	+ 39
1987							
January	+ 141	- 1261	1.507	1.514	- 890	- 833	+ 57
February	+ 380	- 881	1.527	1.546	- 641	- 570	+ 71
March(6th)	+ 881	0	1.571	1.604	- 80	0	+ 80
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

RJ11.65 UNCLASSIFIED

CHANCELLOR OF THE EXCHEQUER

FROM: N G FRAY
DATE: 12 October 1987

MR C W KELLY

PROFITABILITY OF INTERVENTION

The Chancellor has seen and was most grateful for your minute of 9 October.

Nigel Fray
N G FRAY

FROM: HUW EVANS
DATE: 23 OCTOBER 1987

~~CHANCELLOR~~

cc
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Odling-Smee
Mrs Lomax
Mr Peretz
Mr Sedgwick
Mr Matthews
Mr R Allen
Miss O'Mara
Mr Dolphin
Mr Savage

Ch

Some interesting stuff here

AA

Yes. Pse [illegible] Mr B. (Relevant bits for the speech)

(German int rates

SOME RECENT INTERNATIONAL ECONOMIC DEVELOPMENTS

In the light of recent developments, we have put together some material on:

(a) a long term perspective on stock market prices;

(b) the German economy; and

(c) the US fiscal deficit.

Stock Markets

2. The seven charts attached, for each of the G7, show stock market indices (mainly industrials) in nominal terms and deflated by consumer prices. The latest observation in each case is close on Thursday. Some fairly obvious generalisations (which as usual do not apply so much to Japan):

(i) the fall in share prices in real terms after 1973 reflect the sharp fall in profitability and growth rates;

(ii) the big rise in share prices in real terms in more recent years takes us back to and in some cases a little beyond peaks in the 1960s and early 70s;

1987

Useful

(iii) the correction in the last week is not at all unusual by past standards: what is unusual is the speed, not the size of the correction.

3. The substantial rise in stock markets since the early 1980s has gone well beyond the rise in consumer prices or in profits. Table 1 on price/earnings ratios shows that even after the recent correction these ratios in most countries - though well down on the 1986 and 1987 peaks - remain well above the average of the early 1980s.

4. Table 2 on share price changes shows that, although the fall in the UK market in the last week has been second only to the US, ? by comparison with earlier this year or 1986 the level of prices in the UK is still relatively high.

Germany

5. The attached note by IF2 on the German economy summarises recent developments and prospects, especially on the inflation front. It is worth noting:

(i) how little the prospect for German inflation has changed;

(ii) the downward revision to German growth prospects in both short and medium terms;

(iii) the reappraisal of medium term German growth potential, now put at only 2¼ per cent - a little less than our estimate for the UK, even though the latter includes falling oil production;

(iv) lying behind the more pessimistic appraisals of German growth, an increasing awareness of the rigidities in the German economy.

The United States deficit

6. The President yesterday announced a lower figure, $148 billion, as the outcome for the fiscal year 1987 (ending on September 30); and a renewed determination to implement, if necessary by raising taxes, the $23 billion reduction - from an unspecified baseline - required to avoid automatic cuts under Gramm-Rudman.

7. Recent and prospective figures are as follows:

US BUDGET DEFICIT, FISCAL YEARS

$ billion

% of GNP

1983		208	6.3
1984		185	5.0
1985		212	5.4
1986		221 } -73 (1/3)	5.3
1987	latest Administration estimate	148	3.4
1988	HMT estimate	170	3.6**
	Outside average	175	3.7**
	US Administration	150-155*	3.3**

*at time of Annual Meetings

** based on WEP GNP forecast

8. Note that the big ($73 billion) reduction in the deficit in fiscal year 1987 was caused in part by one-off factors, including the effects of tax reform.

Conclusions

9. In order to provide some balance to the more pessimistic conclusions being drawn from recent movements in stock markets, and in particular the likelihood that growth in some countries, notably the United States, is likely to be slower for a time as a result of the fall in stock markets, it may be helpful to list positive factors emerging from the experience of the last week or so:

- further evidence, from fiscal year just finished, of substantial cut in US deficit;
- a greater willingness on the part of the United States Administration to implement if necessary by tax increases, the full $23 billion cuts in the budget deficit specified by the Gramm/Rudman legislation;
- some strengthening of the Louvre Accord following the Baker/Stoltenberg meeting;
- some reduction in short and long interest rates in recent days, which will help to offset the dampening effect on activity of lower stock market prices.

10. At the same time, it is as well to recognise that concerns about the German economy have some substance. A suggested line to take on Germany:

(i) inflation is low and expected to remain low;

(ii) inflation prospects in Germany have not changed, either for 1987 or for 1988: some modest rise in inflation from negative values always expected on account of oil prices.

(iii) little case for recent rises in German interest rates, still less for any further increases in German interest rates;

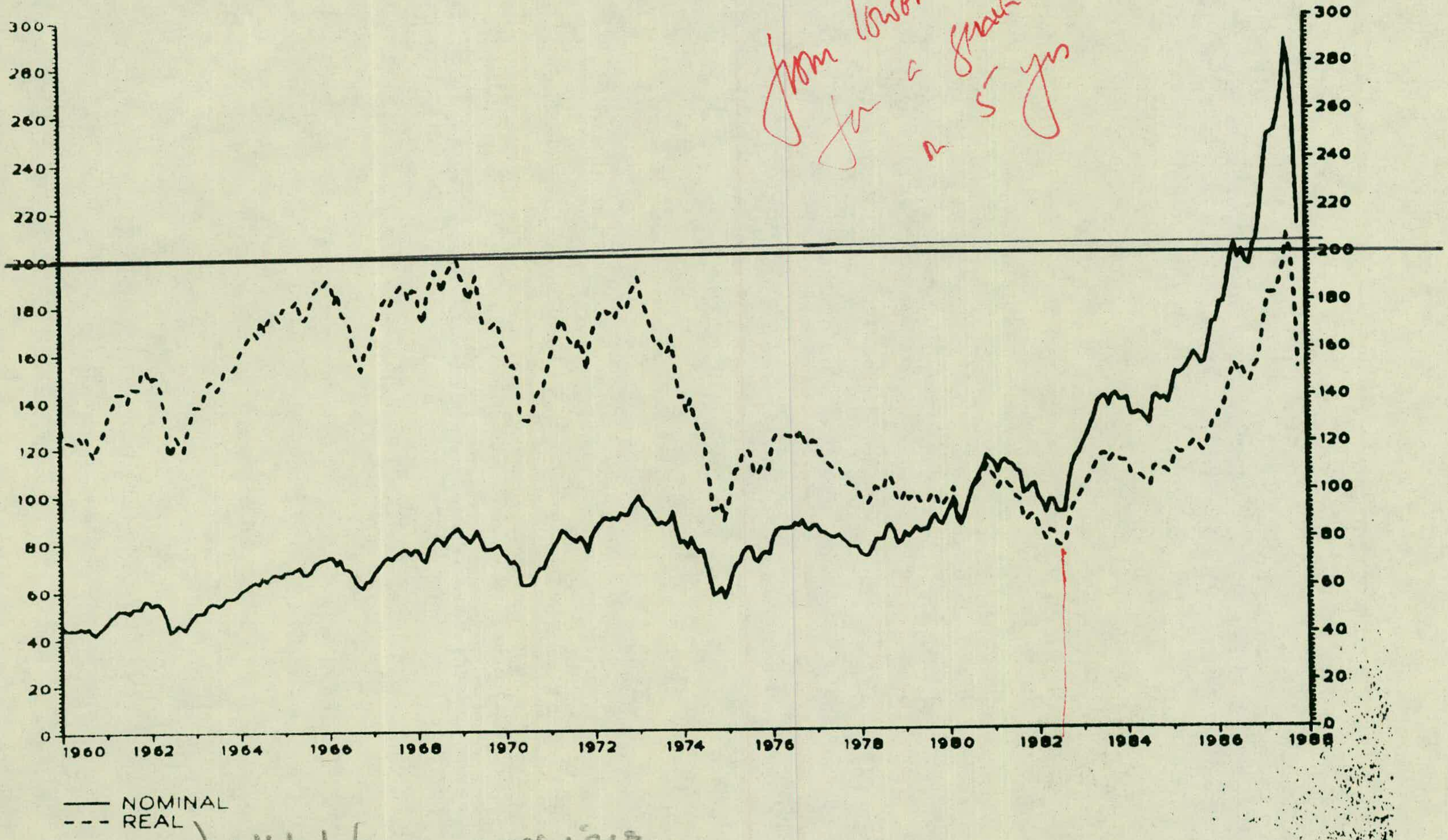
(iv) stock market corrections make the prospect of rising inflation <u>less</u> likely, in Germany as in other countries.

HPE

H P EVANS

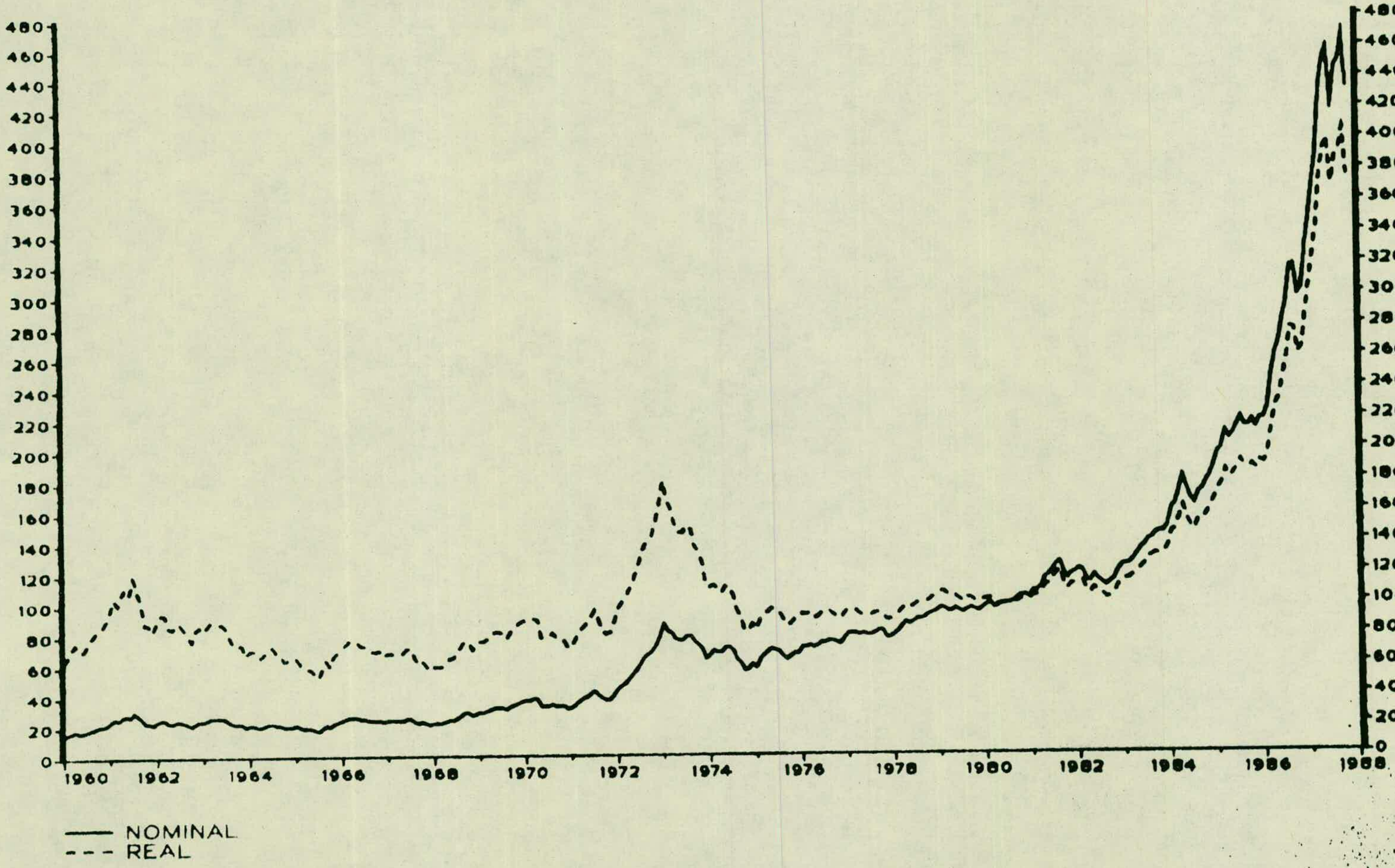
US SHARE PRICES

from lowest (real terms) to a greatest in history in 5 yrs

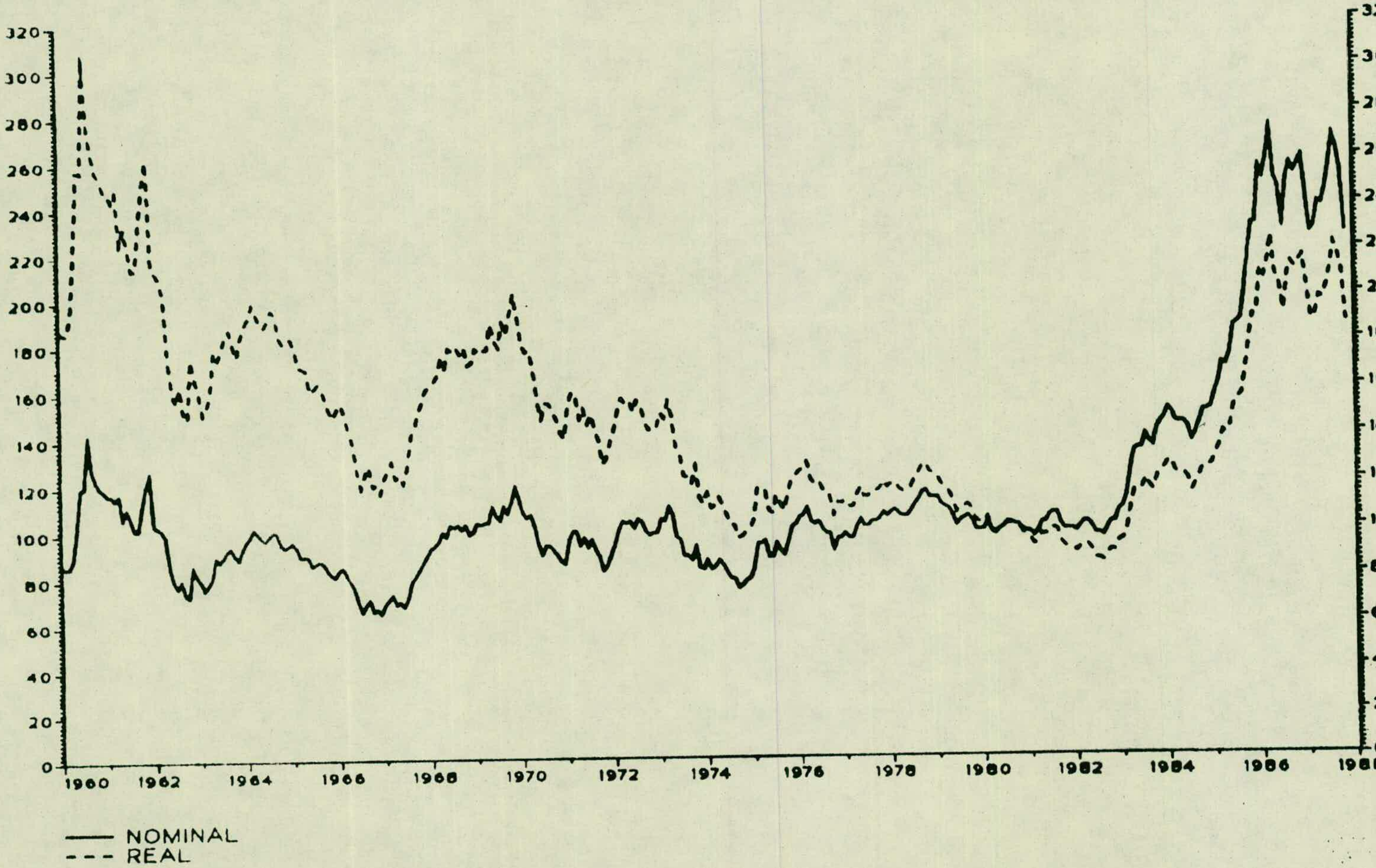


\ deflated by consumer price

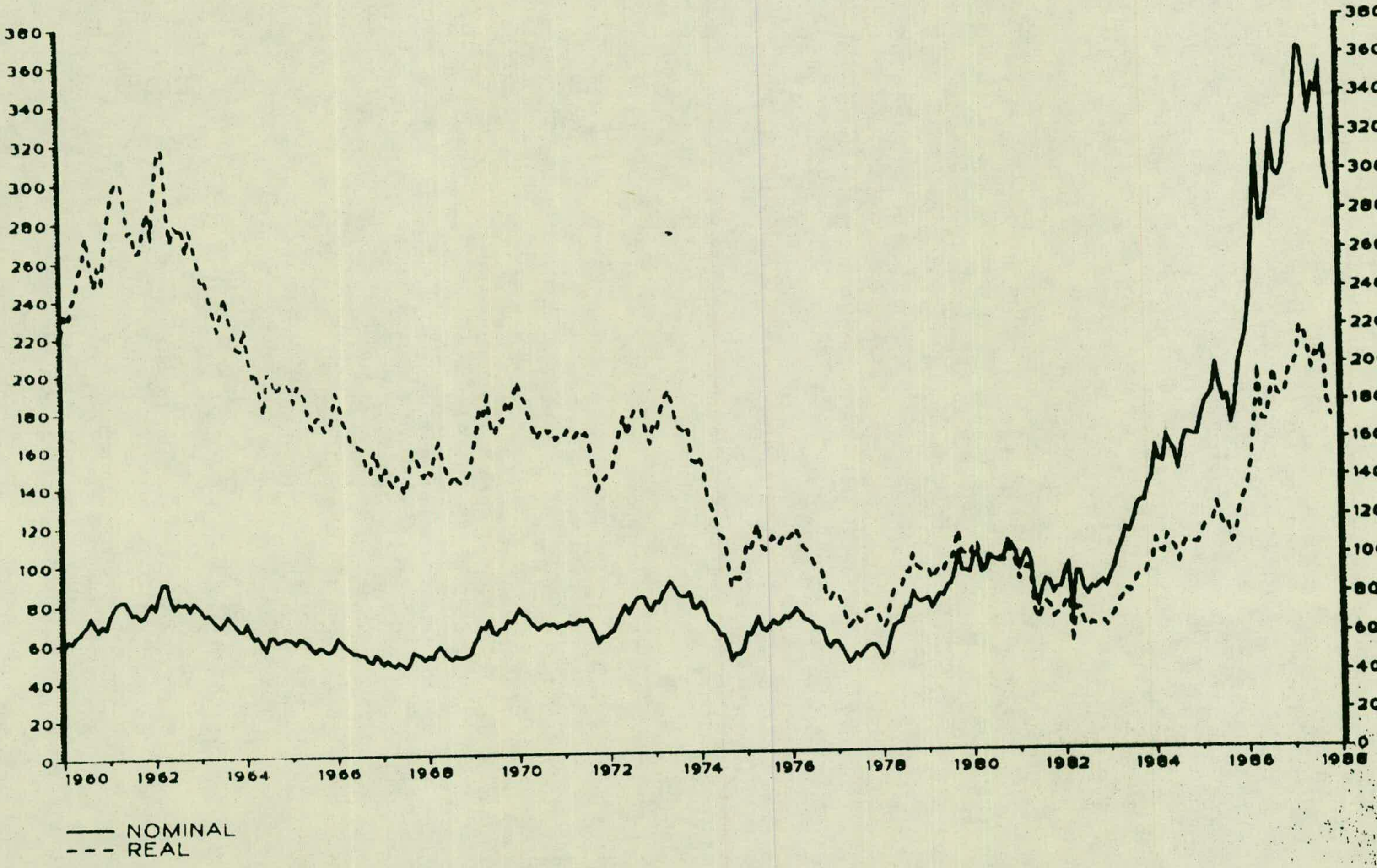
JAPANESE SHARE PRICES



GERMAN SHARE PRICES



FRENCH SHARE PRICES



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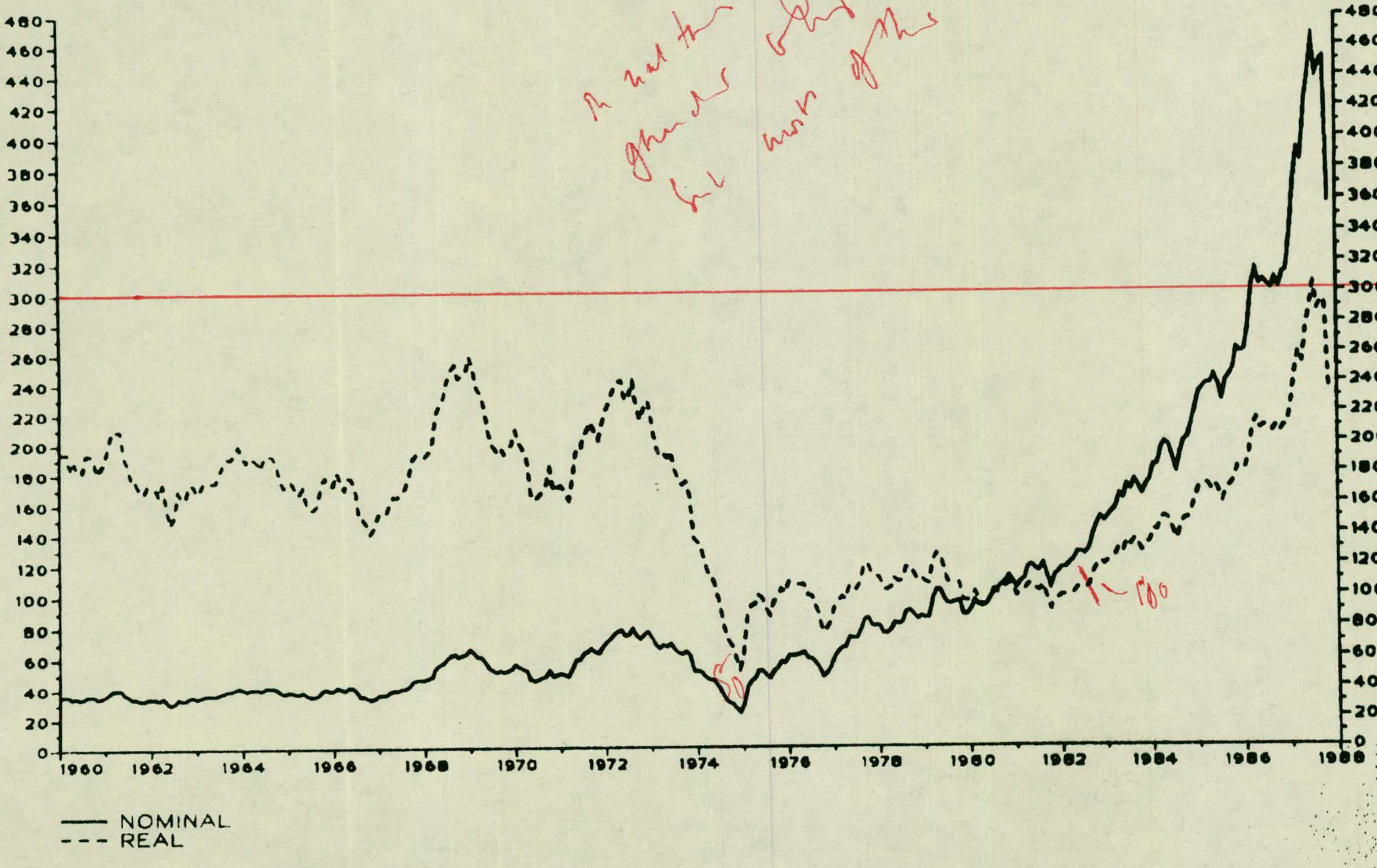
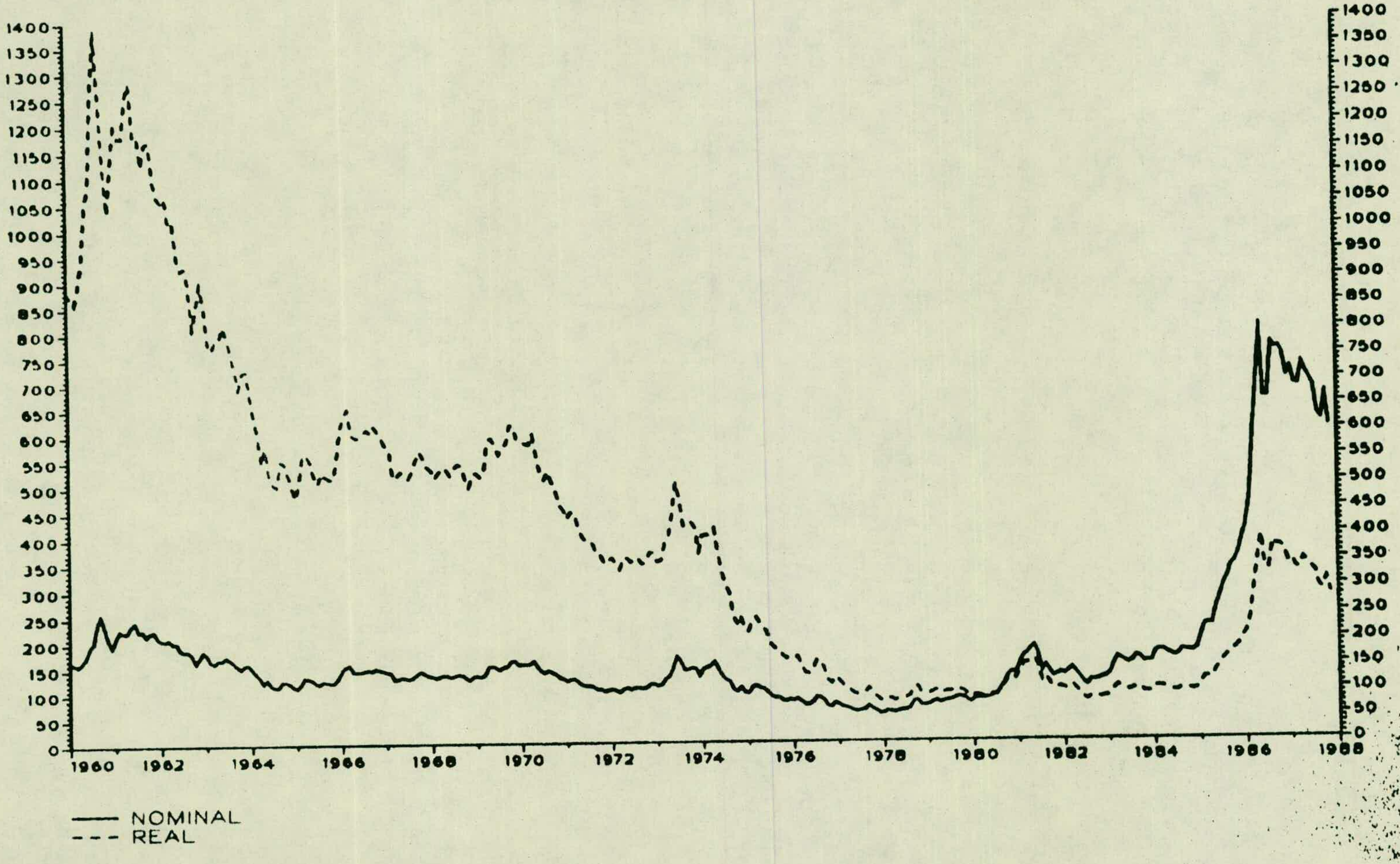
U.K. SHARE PRICES

In real terms [illegible] [illegible]
[illegible] [illegible] over 13 yrs –
but most of this in past 8.



ITALIAN SHARE PRICES



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CANADIAN SHARE PRICES

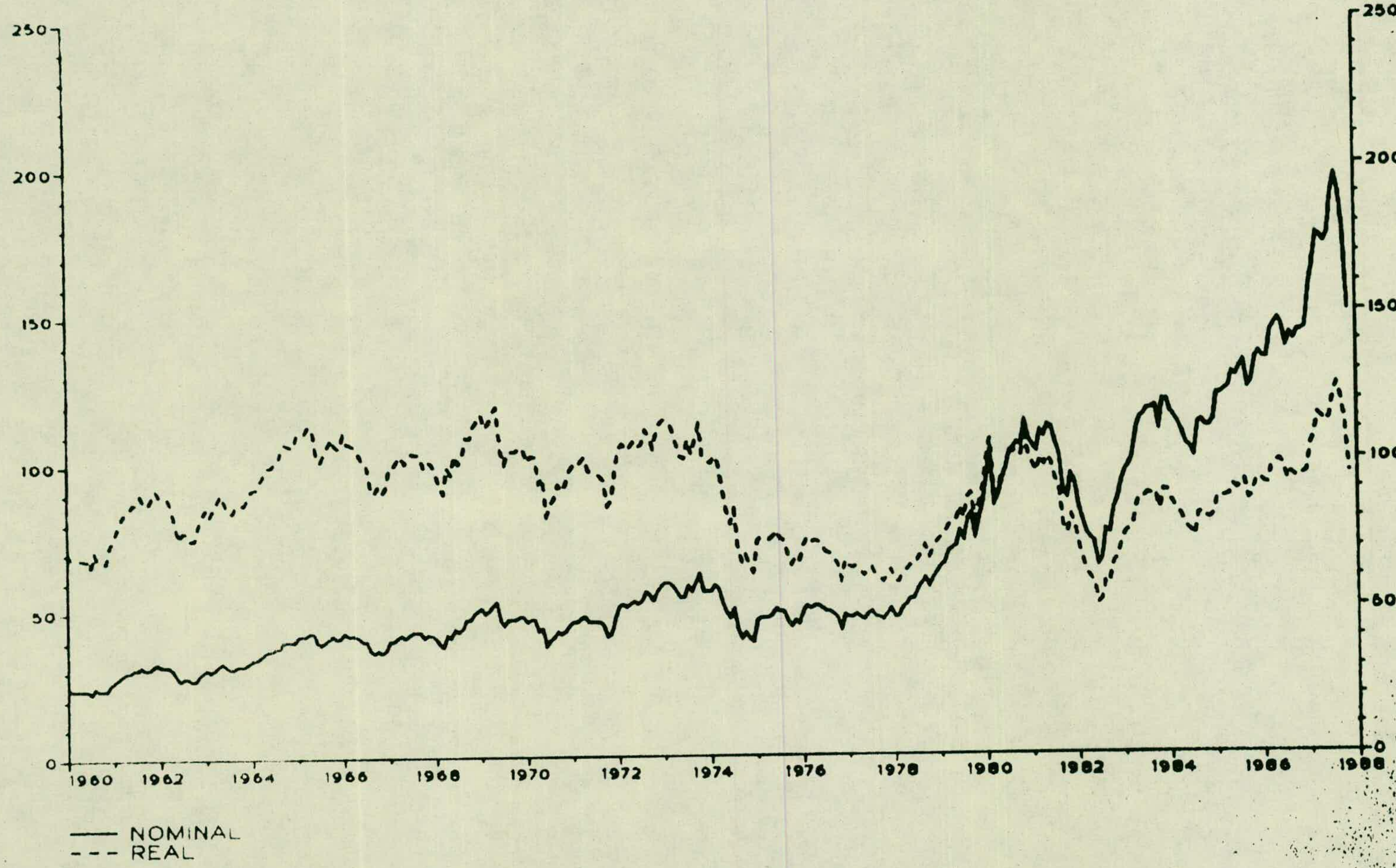


TABLE 1

PRICE-EARNINGS RATIOS

Interesting to see earlier periods

	1976-80	1981-85	1986	End August 1987	22 Oct 1987*
US	8.9	10.4	22.8	22.4	16.0
JAPAN	29.7	30.9	60.4	72.6	69.1
GERMANY	10.0	11.9	15.1	16.2	13.7
FRANCE	13.7	10.8	17.4	16.7	14.0
UK	8.3	11.8	19.1	18.4	14.9
ITALY	n/a	8.0	17.0	17.0	17.2
CANADA	8.4	15.8	22.7	21.4	16.5

Source: Phillips and Drew World Investment Review (to end August)

* Extrapolated assuming constant earnings

TABLE 2

SHARE PRICE CHANGES

	Percentage Changes Oct 15- Oct 22	Average 1987 Q1 to Q3- Oct 22	Average 1986- Oct 22
U S	-18	-18	8
Japan	- 8	- ½	49
Germany	-10	- 8	-11
France	- 5	-16	1
U K	-20	-12	21
Italy	-10	-12	-10
Canada	-15	-15	5
G7 average (using GDP weights)	-13	-13	11

THE GERMAN ECONOMY

Introduction

1. This note describes recent developments in the German economy by reference to a range of indicators and considers prospects for the economy over the next year or so. It concludes that real growth is unlikely to exceed the growth of productive potential and that inflation will probably remain around current, low levels. There does not, therefore, appear to be any justification for a tightening of policy.

Recent developments

2. Over the year to the second quarter of 1987 nominal GNP grew by just 3.4 per cent, with real growth totalling only 0.8 per cent. Indeed, real GNP in 1987Q2 was still slightly below its level in 1986Q3. Net exports continue to reduce growth as trade volumes adjust to the appreciation of the D-mark. Domestic demand growth, which was strong in 1986, has weakened considerably this year.

Table 1: GNP growth (percentage change on year earlier)

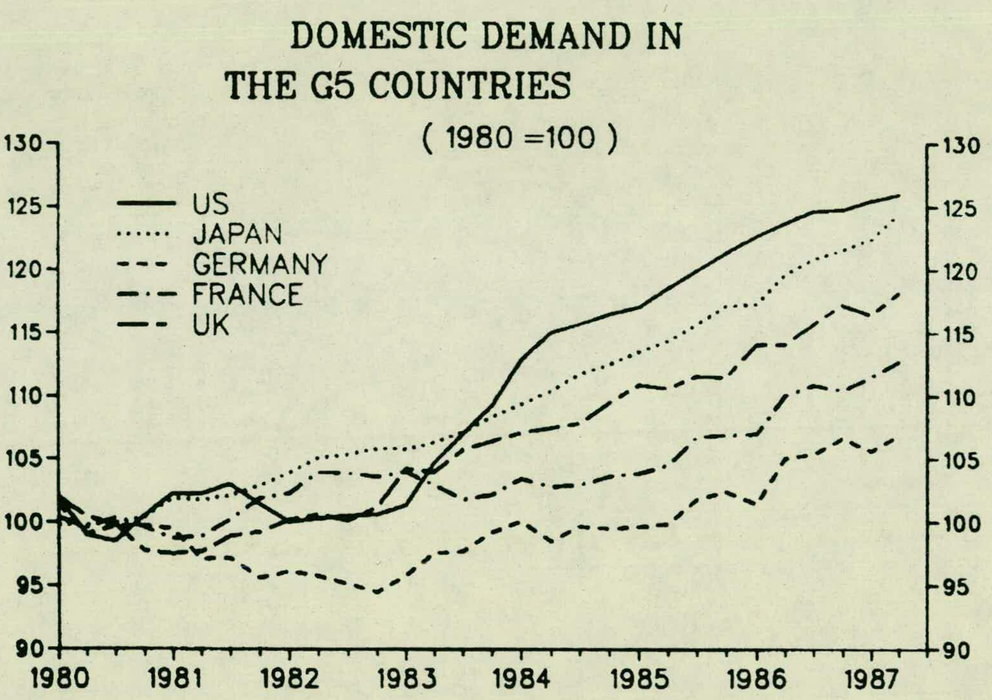
	Priv. Cons.	Priv. Invt.	Govnt.	Domestic demand	Net exports*	Real GNP	Nominal GNP
1986Q1	3.5	1.7	2.4	1.8	0.0	1.7	4.7
Q2	5.8	5.1	3.4	5.4	-1.7	3.4	6.7
Q3	4.0	2.6	3.5	3.7	-1.2	2.2	5.4
Q4	3.9	2.3	1.8	4.0	-1.4	2.4	5.6
1987Q1	2.6	1.5	2.1	4.4	-1.8	2.4	5.5
Q2	2.3	-0.4	0.9	1.7	-0.9	0.8	3.4
Q3**				(2)		(1)	(2½)

* contribution to growth

** forecast.

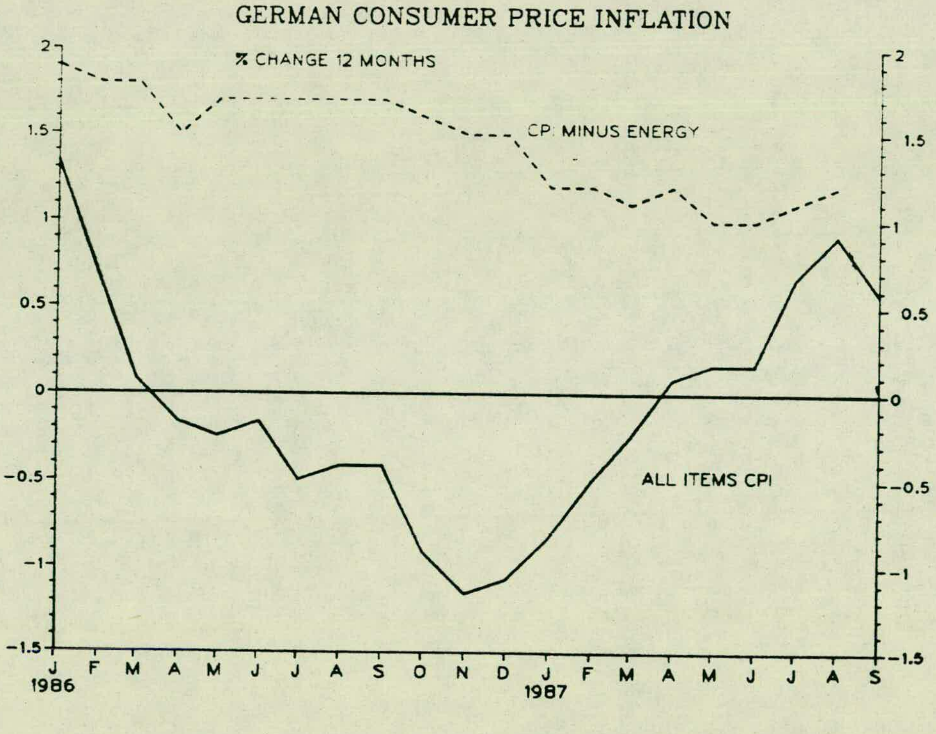
3. As Table 1 shows all components of domestic expenditure have slowed down. Private consumption was boosted in 1986 by tax cuts and very low, even negative, rates of inflation, so some slowdown was expected, though the scale of the actual slowdown has come as a surprise. The German Government, for example, expected growth of 3.5 per cent. Private investment surveys towards the end of 1986 pointed to a poor performance in 1987, largely attributed to uncertainty about exchange rates. There is little evidence that the relative stability of exchange rates since the Louvre Agreement is bringing about an early strengthening of investment.

4. Chart 1 shows developments in domestic demand in each of the G5 economies since 1980. Over this period German domestic demand has grown noticeably more slowly than demand in the other countries. This and the slow growth of output itself leads us to believe that the structural weaknesses in the German economy may be greater than we had previously thought and was part of the reason why in the summer we lowered our estimate of the annual growth rate of productive potential to 2¼ per cent (similar, or perhaps a little lower than the latest estimate for the UK). Nonetheless, present growth is well below this rate.



5. Other indicators of activity also show a weak real economy. Though industrial production in August was 2.3 per cent up on August 1986, this is a very erratic data series. Taking the latest three months together production was 0.9 per cent down on the same period in 1986. Retail sales in the second quarter were up only 2 per cent on 1986Q2, while construction orders fell by 5 per cent over the same period. Unemployment, which fell to 7.7 per cent of the labour force at the end of 1986 has now risen to 8 per cent.

6. Chart 2 shows developments since the beginning of 1986 in the annual inflation rate. The overall index of consumer prices fell by 0.2 per cent in 1986, and inflation was as low as - 1.2 per cent in November. During 1987 inflation has recovered to between ½ and 1 per cent as the effects of the fall in oil prices has dropped out. However, as Chart 2 also shows the rate of growth of the consumer price index excluding sources of energy has continued to slow down, albeit very slightly, in 1987, and the latest figures show this index is only 1.2 per cent up on a year earlier.



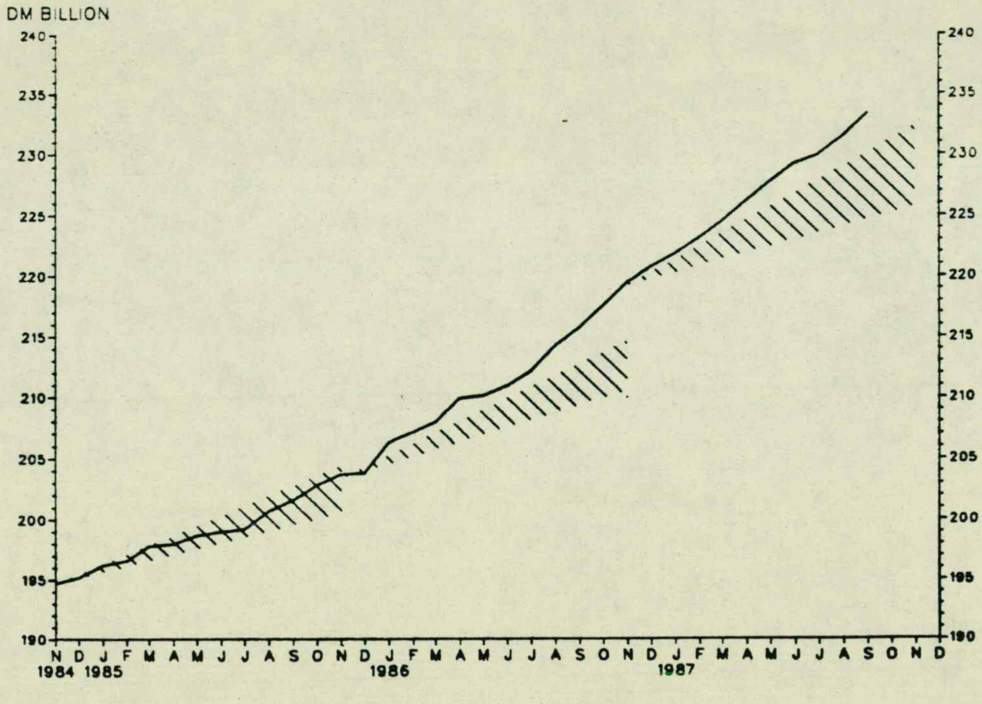
7. There are signs that Germany's trade surplus - expressed in US dollars - may now have stopped growing, but there are no unambiguous signs of any reduction.

Table 2: German visible trade balance ($ billion)

	Monthly	Latest twelve months at monthly rate
1987 January	4.8	4.5
February	6.1	4.7
March	4.8	4.9
April	5.3	5.0
May	6.0	5.2
June	4.6	5.1
July	5.6	5.1
August	4.9	5.1

8. Central bank money (CBM), the targeted monetary construct, grew well in excess of its target range in 1986, and has been above its target (of 3-6 per cent) throughout 1987, as Chart 3 shows. The latest figure, for September, shows growth of 7.8 per cent, at an annual rate, compared with the target base. CBM velocity is shown in Chart 4, at the back of this note.

CENTRAL BANK MONEY



3¾ Jun
5% Oct

9. The short term interest rate, as measured by the three-month interbank rate, which was around 4½ per cent at the beginning of 1987, fell to 4 per cent in February and to 3.7 per cent in June before rising again to 4 per cent in the second half of July. It remained at this level until the end of September, before rising to 5.1 per cent by Monday 19 October, led by the Bundesbank's decision to raise the rate it applies to repurchase agreements. In the last few days the Bundesbank has lowered very slightly the rate it applies to repurchase agreements and this has led to a small fall in money market rates to around 4^3/4 per cent.

10. The Federal Government deficit in 1987 is now officially forecast to total DM26.3 billion (1.3 per cent of GNP), compared to an original estimate of DM24.3 billion (1.2 per cent) made at the end of last year. Expenditure is slightly above expectations and revenues have been hit by lower than expected growth. If growth remains weak in the second half of 1987, the deficit outturn could be even greater than the Government's latest forecast, and one Government spokesman has been reported as suggesting a DM29 billion (1.4 per cent) deficit was possible.

Growth prospects

11. Table 3 sets out recent forecasts for real GNP and domestic demand growth in Germany in 1987 and 1988.

Table 3: Growth forecasts (per cent)

	Real GNP		Domestic demand	
	1987	1988	1987	1988
Autumn WEP (October)	1.5	2.2	2.5	2.8
IMF WEO (October)	1.5	2.1	2.9	2.9
EC Commission (October)	1.3	1.8	2.5	2.1
OECD Economic Outlook (June)	1½	2	2^3/4	2^3/4
German Government (September)	1½-2	2.5**	3.2	3.5
Five institutes* (June)	1.7	2.2	n.a	n.a

* unweighted average of five forecasts

** current unpublished estimate 2 per cent.

A consensus, except for the German Government, has emerged that GNP growth will be about 1½ per cent in 1987 and 2-2¼ per cent in 1988, and that domestic demand growth will be between 2½-3 per cent in both years.

12. In the latest WEP forecast, which was finalised before the dramatic fall in world stockmarkets, a pick up in consumption and investment growth generates the rise in GNP growth between 1987 and 1988. Consumption will be boosted by the DM14 billion tax cuts planned for January 1988, while investment is assumed to recover as the company sector turns into investment some of the profits from its share of the terms of trade improvement and lower oil prices. The external contribution is expected to reduce growth by about ½ per cent.

Short term inflation prospects

13. Concern has been expressed in Germany at the resurgence of consumer price inflation since April after the negative inflation rates experienced last year. Chart 2 shows that this increase is almost entirely accounted for by the dropping out of the oil price fall from the twelve month inflation figures. German domestic inflation forecasts for 1987 have in fact been revised substantially downwards since October last year as is shown in Table 4. The same is true of the IMF forecast which may have been influenced by domestic forecasters. Our own forecast has been revised upwards a little since October 1986 reflecting higher oil prices and a lower than expected post-Louvre DM appreciation. The OECD forecast, made in December 1986, and incorporating their conventional assumption of no change in nominal exchange rates, looks likely to be proved most accurate.

Table 4: Revisions to consumer price inflation forecasts

	Forecasts made in:	
	October 1986	October 1987
WEP	0.3	0.8
German Government	1½	½
German Institutes	1.5	0.5
IMF	1.6	0.6
OECD	3/4 (Dec)	3/4 (June)

14. Indicators of short term inflation prospects are shown in the next table. Import prices have increased a little since the first quarter owing to the lower effective exchange rate and rises in commodity prices. Hourly earnings have also been buoyant following the negotiation of a shorter working week. Productivity however has also increased leading to relatively small increases in unit labour costs. None of these tendencies have yet fed into wholesale prices which have remained stable since the start of the year.

Table 5: Inflation indicators (per cent change on a year earlier)

	CPI	WPI	Earnings/hr	ULC	Production prices	Import prices
1985	2.2	0.5	4.1	-0.2	2.2	-2.5
1986	-0.2	-7.4	5.1	3.7	-2.9	-16.0
1987Q1	-0.5	-7.2	4.6	5.5	-4.2	-12.1
Q2	0.2	-4.7	5.3	2.7	-3.1	-6.6
Q3	0.7					

15. There has been little change in the prospects for inflation in 1988. Most forecasts of inflation for 1988 point to a return in inflation to an underlying rate of about 1½ per cent. The German Institutes and the IMF put the rate slightly higher. We, in common with the German government feel that the lower rate is more likely with continued competitive pressures on German industry from imports.

Table 6: Inflation forecasts for 1988 (per cent change)

	Forecasts in:	
	April 1987	October 1987
WEP	1.2	1.3
German Government	n.a	1.5
German Institutes	n.a	2.1
IMF	2.6	2.4
OECD	1½ (Dec 86)	1½ (June)

The stance of policy

16. The Federal Government has presented its budget for 1988 to the Bundestag. This includes DM14 billion tax cuts that have been planned for some time. Partly as a result of these cuts the Federal deficit is officially expected to rise to DM29.3 billion. In fact, if growth develops as we expect, rather than as the German Government now assumes (see Table 3), then the deficit could well be higher. No tax cuts are planned for 1989, but a further net DM20 billion tax cuts are planned for 1990.

17. The Bundesbank seems resigned to CBM growth through 1987 exceeding its target range of 3-6 per cent. In its latest report it admits that CBM may overstate the underlying trend in monetary expansion at a time of very low interest rates because of the large weight that currency has in the measure. The Bundesbank considers however that other monetary aggregates, especially the broad measure M3, are growing considerably faster than warranted by the medium term real growth potential of the economy with stable prices.

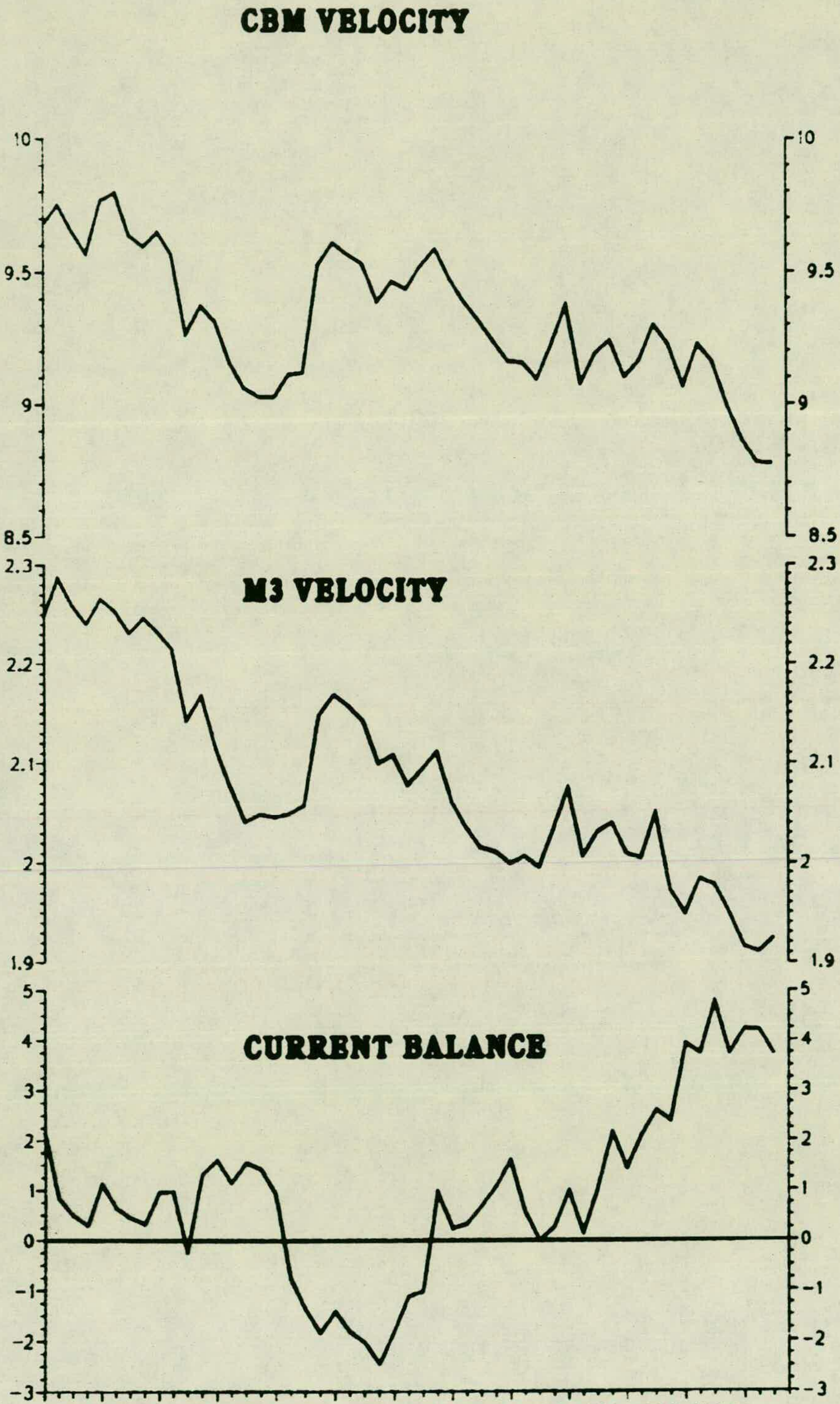
18. The Bundesbank assessment of the target range for CBM growth is determined by its estimate of potential growth and inflation assuming velocity is constant. For instance the mid-point of the CBM range for 1987 at 4½ per cent assumes real growth of 2½ per cent and inflation of 2 per cent. Chart 4 shows CBM velocity over a long period. There is perhaps some evidence of a long term

downward trend perhaps worth ½-1 per cent a year. If so, then the targets set by the Bundesbank may be somewhat too tight. It is possible that the downward trend in velocity has increased over the last two years - perhaps as a result of financial innovtation, though this has been limited in Germany - in which case it is difficult to assess the appropriate target growth rate for CBM.

19. Furthermore, there is a suggestion, see Chart 4 again, that CBM velocity tends to fall when the current account is in surplus, and vice versa. Thus, the recent rapid growth of CBM is not as exceptional as it at first appears.

20. In these circumstances, and given the short term inflation prospects set out in paragraphs 13 to 15, domestic circumstances do not on balance point to the need for tighter monetary conditions.

IF2 Division
23 October 1987


CBM VELOCITY
10
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CURRENT BALANCE
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CAMBRIDGE ECONOMETRICS AUTUMN REPORT

1. The publication of the Cambridge Econometrics (CE) Autumn Report is reported on page 10 of today's Financial Times. The Report assesses the outlook for the economy until the year 2000 and forecasts a growth rate of 2.4 per cent until the end of the decade, slowing to just under 2 per cent during the 1990s. This is expected to be accompanied by a small fall in unemployment and an average inflation rate of over five per cent. The Report also forecasts a deterioration in the balance of payments between now and 1990 and a steady improvement thereafter.

2. At 2.4 per cent, the forecast for output is similar to that set out in the FSBR. This showed output growth returning to its trend rate of 2½ per cent and staying at this rate until the end of the decade. The Autumn Statement forecast to the end of 1988 gives us no reason to alter our view of the medium term outlook for output growth. It is very difficult to predict the consequences of this rate of growth of output for the level of unemployment. But demographic trends and government policies to increase efficiency in the functioning of labour markets help to ensure that the trend is downwards.

3. CE projects a slight rise in inflation between now and the end of the decade. This is contrary to the projections set out in the FSBR and disregards the government's policy framework which makes clear that any threat to the medium term inflation objectives will be met by an appropriate tightening of monetary conditions.

4. CE are also rather pessimistic on the medium term outlook for the current account which they expect to deteriorate steadily until 1990. On the contrary, we would expect an improvement in the current account over the medium term. Likely favourable influences include a reduction in the growth of UK domestic demand and a return of the rate of growth of world trade to its medium term trend. The UK can also be expected to maintain its healthy competitive position against a background of steady growth and low inflation.

5. Forecasts of beyond 1990 are likely to be highly uncertain, and the Treasury does not do long term forecasts for this reasons.

Line to take

6. Cambridge Econometrics is one of many groups providing forecasts. They have a record of pessimism and appear not to have taken account of the striking improvement in the UK's economic performance in recent years.

7. Long term forecasts are too uncertain to be taken seriously.

PAGE 10 FINANCIAL TIMES 16·11·87

Slow growth forecast until end of century

BY PHILIP STEPHENS, ECONOMICS CORRESPONDENT

BRITAIN'S economy for the rest of this century is likely to be characterised by high unemployment and relatively sluggish growth. according to a review of long-term prospects published today by a group of leading economists

In its latest assessment of the outlook for the economy and industry up to the year 2000, Cambridge Econometrics forecasts an average annual growth rate of 2.4 per cent for the rest of this decade and a projected fall to just under 2 per cent during the 1990s

Living standards will therefore continue to rise. but at a slower pace than during the past few years Unemployment is forecast to fall only fractionally to 2.7m by the end of the century

The next 15 years will be dominated by shifts in the balance of the economy as North Sea oil output declines, the report says.

"In the short-term this means the replacement of consumer spending as the engine of (slowing) growth by investment and exports In the medium and long term,the fall in oil production means improved output prospects for those industries which can benefit from a lower value of sterling"

The group expects manufacturing output to continue to grow quickly. at least as fast as the services sector But faster productivity in manufacturing means that most of the jobs created will continue to be in the serices sector The share of services in national income is expected to reach 50 per cent by the end of the 1990s.

In spite of growth in manufacturing production averaging 3 per cent a year, the gap left by North Sea oil exports is likely to mean that Britain will face current account deficits at least until 1995. That in turn will put downward pressure on the pound and limit any further progress in reducing inflation.

The study's projections point a cumulative depreciation in sterling's value of 20 per cent by the year 2000 and to an average inflation rate of between 4 per cent and 6 per cent.

Cambridge Econometrics Autumn Report. 21 St Andrews Street, Cambridge CB2 3AX. Price £1.600

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CHAPTER III. THE BRITISH ECONOMY SINCE 1979

Introduction

Five years has been the average, and indeed the typical, duration of a full cycle in the British economy since the war. For that reason it has been taken as a convenient time span when considering medium-term developments such as the trend rate of growth of output or productive potential. If we now look back five years from 1987 the annual growth rate averages about 3½ per cent, suggesting a marked improvement in trend since the 1970s. This may be the correct conclusion to draw, but it cannot be accepted uncritically since the pattern of five-year cycles seems to have changed.

The last clear case of a cyclical peak came in 1979. In the first part of this chapter therefore we take that year as our reference point, so as to include the recession years of 1980 and 1981 as well as the subsequent years of recovery. We compare the eight years 1979 to 1987 with previous trends measured over periods of four to six years. But we do not mean to imply that 1987 is itself the end of a complete cycle: on the contrary, our short-term forecasts (see chapter I) point to a continuation of relatively buoyant activity for at least another year.

Taking 1979 as a starting point has the added advantage that this was a year in which there was a change of government and, in some respects at least, a change of economic strategy. If, therefore, one wants to ask how successful the new strategy has been, one must take the bad years as well as the good.

Nevertheless, it is now the years of recovery that most need interpretation, and the second part of this chapter focuses on the last five years. Over that period growth has been unexpectedly strong and we consider a number of possible explanations.

The economy since 1979 (table 1)

The prime objective of the strategy followed since 1979 has been the reduction of inflation. Judged by that yardstick the strategy was very successful in the early years, as inflation fell from 18 per cent year on year in 1980 to just 4½ per cent year on year in 1983. This was a more rapid deceleration than occurred in most other OECD countries at that time, thanks mainly to the strength of sterling. There was no explicit incomes policy except in the public sector, and real wages continued to rise despite the sharp recession and the massive increase in unemployment.

Since 1983 inflation has not fallen much further; indeed in some years it has risen. Real wages have increased strongly and the exchange rate has moved generally downwards, but the inflation rate has remained low because of the fall in oil and other commodity prices and because of the rapid growth of productivity, especially in manufacturing industry.

In the eight years from 1979 to 1987 growth averaged 1.8 per cent a year, or 1.5 per cent excluding North Sea oil and gas production. This compares well with the growth rate from 1973 to 1979 which was 1.3 per cent a year in total or 0.6 per cent excluding North Sea production. This may not, however, be a good period to take for comparison, since the 'pressure of demand' was probably higher in 1973 than in any other post-war year; in particular it was almost certainly higher than in 1979. Taking the period 1969 to 1979, covering two complete cycles, gives an annual growth rate of 2.0 per cent a year or 1.6 per cent excluding North Sea production. Thus the growth of production since 1979 is similar to the trend of the 1970s.

It is also of some interest to compare the growth rate since 1979 with estimates of productive potential made before the event. In the November *Review* of 1978 there is an extensive discussion of the sustainable growth rate of output, which may be representative of views as they were before the second oil shock, before the appreciation of sterling and before the onset of recession. At that time the growth rate of productive potential was put at about 2 to 2½ per cent a year, although it was hoped that faster growth than that would be possible for a few years so as to get unemployment down well below a million. In relation to that forecast therefore the subsequent growth of output can only be described, even today, as disappointing.

In the early years of the new 'monetarist' strategy there was a major loss of output and living standards hardly improved. Although the scale of the recession

Table 1. The UK and the world economy since 1978

	Inflation (% rate)		Unemployment (% level)		GDP at market prices (% growth rate)	
	UK	OECD	UK	OECD	UK	OECD
1978	8.3	7.9	5.9	5.1	3.6	4.2
1979	13.4	9.8	5.0	5.0	2.7	3.0
1980	18.0	12.9	6.4	5.7	−2.4	1.2
1981	11.9	10.5	9.8	6.6	−1.2	2.3
1982	8.6	7.8	11.3	8.0	1.5	−0.5
1983	4.6	5.2	12.5	8.5	3.4	2.9
1984	5.0	5.2	11.7	8.0	2.7	4.8
1985	6.1	4.5	11.3	7.9	3.6	3.1
1986	3.4	2.6	11.5	7.8	3.3	2.5
1987	*4.0*				*4.0*	

Sources: OECD, *Economic Outlook*, June 1987; UK GDP (average estimate) from CSO, *National Income and Expenditure*, 1987; forecasts for 1987 by NIESR.

2

was not expected or intended it can, in retrospect, be viewed as the cost of slowing down inflation and improving industrial performance. Now that output and total consumption (public and private combined) are both back to their pre-1979 trend lines, the cost has been paid in full. From now on, if growth remains strong, we shall begin for the first time to record net benefits.

Disappointment with economic performance since 1979, however, should be qualified by recognition that performance since about 1983 has been much better and unexpectedly good. Growth has been rapid compared with previous experience in this country and with the contemporary experience of the world economy. In the remainder of this chapter we ask how this has come about.

The evolution of economic strategy

The original 'monetarist' strategy was based on the supposed stability of the income velocity of £M3 and the supposed ability of the authorities to control that aggregate by appropriate adjustments in the PSBR and the level of interest rates. This was was set out clearly in the Financial Statement and Budget Reports (FSBR) 1980/81 and 1981/82.

The framework of policy in 1987 is very different. In the FSBR this year, pride of place is given to the medium-term path for money GDP. Both fiscal and monetary policy are set so as to reduce the growth of that magnitude, if only very gradually. In discussing monetary policy, exchange-rate stability is both assumed and advocated. The monetary aggregates are also mentioned but only the monetary base now merits a target range. The PSBR is now projected as a constant percentage of GDP. The reference to declining interest rates as an objective of policy has been dropped.

The presentation of policy has changed more than its real substance, but there has been some relaxation of the intended stringency of monetary and fiscal policy as well as a retreat from monetarist doctrine. Even in the second presentation of the medium-term financial strategy (MTFS) in March 1981 it was recognised that the exchange rate, real and nominal interest rates, and house prices are all useful indicators of the stringency of financial conditions. Since the second quarter of 1981 the effective exchange rate has been allowed to fall by more than 20 per cent and the relative price competitiveness of British exports has improved by about 10 per cent. We would regard this as a substantial relaxation relative to monetary policy at the beginning of the decade. The massive rise in house prices is another sign that the authorities are now prepared to tolerate developments they would once have regarded as signals of undue laxity.

The course of interest rates, however, tells a different story. In March 1981 short-term interest rates were just under 12 per cent. They are now 9 per cent but meanwhile the rate of inflation, measured over the preceding 12 months, has fallen from 12½ per cent to ~~under~~ about 4 per cent. There has, on any measure, been a major *rise* in real interest rates, at least at the short end of the market. This contrasts with the clear statement in the original MTFS that fiscal policy was being tightened so that interest rates could come down. This was understood to mean a fall in interest rates at least in line with the fall in inflation. That proved impossible to achieve because interest rates stayed high worldwide and our rates could not get far out of line without causing sterling to fall sharply. In these circumstances our judgement would be that the real exchange rate provides a better indicator of financial stringency than does the level of real interest rates.

The same edition of the MTFS showed the PSBR falling from 6 per cent of GDP in 1980/1 to 2 per cent by 1983/4. In the event progress was slower than intended and the PSBR in that year was in fact over 3 per cent. Since then (apart from the effects of the miners' strike) the reduction has run ahead of plan and the outturn for 1986/7 was below 1 per cent. But this does not mean that fiscal policy has been tighter than intended.

The budget of 1981 undoubtedly *was* contractionary in its effect on aggregate demand. Since then, however, we would characterise fiscal policy as mildly expansionary. The fall in the PSBR as a percentage of GDP is the result of growth in the economy above its long-run trend and of asset sales. The cyclically adjusted government deficit has increased as a proportion of GDP (see table 2). This is still true if the various components of revenue and expenditure

Table 2. Estimates of change in fiscal stance, 1980-6

Change in general government financial deficit as percentage of GDP

	Unadjusted	Cyclically adjusted	Weighted and Cyclically adjusted
1980	+0.2	−1.9	+0.2
1981	−0.9	−2.4	−0.9
1982	−0.1	−0.3	+0.4
1983	+1.0	+1.5	+0.8
1984	+0.4	+0.9	+0.3
1985	−1.0	−0.3	−0.5
1986	−0.2	+0.2	−0.2

Note: For method of calculation see Biswas, R., Johns, C. and Savage, D., 'The measurement of fiscal stance', *National Institute Economic Review*, no.113, August 1985. The estimates here differ from those calculated on earlier occasions in that they start from the net acquisition of financial assets by general government, not by the public sector, and they refer to calendar, not fiscal, years. The trend of GDP used in calculating the cyclically adjusted deficit is 2.0 per cent a year. The weights and yield elasticities are as in the reference above. Underlying data are taken from CSO, *National Income and Expenditure*, 1987.

are weighted to reflect their different estimated impact on aggregate demand. (If the figures were also adjusted for inflation, the increase in the deficit would be greater.)

Overall we conclude that macroeconomic policy since about 1983 has been rather more expansionary than intended at the beginning of the decade and that this has contributed to the buoyancy of output in the subsequent recovery. The scale of that contribution is discussed below.

Money GDP

As such emphasis is now being placed on money GDP as an intermediate target, it is of interest to compare the path set out for it in the MTFS each year since 1982 (see table 3). Initially there was a tendency to undershoot the path, but since 1983 all revisions have been upward. That said, the changes have been relatively small—of the order typically of about 1 per cent a year.

This rather good forecasting performance does not imply that money GDP has been, or easily could be, controlled from year to year by the government. The instruments available to the authorities—taxation, public spending and interest rates—are all slow acting in their effects. Some instruments work in a perverse way: increases in expenditure taxes and cuts in some kinds of public spending *raise* money GDP through higher prices, although they are deflationary. Most other instruments affect real output first and prices only indirectly and to an uncertain extent, if at all; this is true of changes in direct public spending on goods and services as well as personal taxation. The most direct effects on the price level (the GDP deflator) could be achieved by varying the exchange rate or public sector pay—but neither of these is at all easy for the authorities to manipulate.

As an intermediate target money GDP also suffers from the weakness that its relationship to the ultimate goal of policy, the rate of inflation, is not constant or predictable. Money GDP is not a variable that plays a significant role in our forecasting model nor, indeed, in that of the Treasury. Its economic significance is often greatly overplayed. To identify nominal GDP with demand, for example, and real GDP with supply would be inappropriate in almost any structural model of the economy.

Table 3. Money GDP projections from the FSBR

£ billion

	Year of publication					
	1982	1983	1984	1985	1986	1987
1980/1	231					
1981/2	255	254				
1982/3	280	275	281			
1983/4	307	296	304	306		
1984/5	336	322	328	327	327	
1985/6		346	350	354	358	360
1986/7			371	377	382	382
1987/8			392	399	407	411
1988/9			412	419	431	437
1989/90					455	464
1990/1						489

Sources: *Financial Statement and Budget Report* (FSBR) 1982/83, part 2, table 8; FSBR 1983/84, table 2.5; FSBR 1984/85, table 2.6; FSBR 1985/86, table 2.4; FSBR 1986/87, table 2.5; FSBR 1987/88, table 2.6.

Despite these limitations, money GDP is a less misleading 'totem' or focus of attention than was £M3. Its substitution is part of the shift to a more pragmatic framework of policy which has facilitated the renewed growth of output. Moreover, the authorities have shown in practice that they recognise perfectly well the fundamental difference between real growth in output and inflation, which their objective for money GDP seems to obscure.

The 'official line', recently reiterated by the Chancellor, is that inflation is controlled by appropriate macroeconomic policies whilst real growth of output and employment is encouraged by microeconomic policies. Here too there has been an evolution from doctrinaire statements to more practical action. In the government paper, 'Employment: the challenge for the nation' (*Cmnd* 9474, p.23), it was flatly stated that the government cannot 'create jobs'. But we have seen the development of special measures to reduce unemployment by several hundred thousand and to provide much-needed support for vocational training.

A more consistent line of microeconomic policy has been the emphasis on open and efficient markets and the encouragement of enterprise in the private sector. The effects of such policies are, of their nature, very difficult to quantify, but it would be wrong for that reason to dismiss them as negligible. The rapid recovery of output in recent years is at least *prima facie* evidence that they are being effective.

Economic growth since 1982

The growth of the economy may seem unremarkable looked at over the last eight years since 1979, but if we look only at the last five years since 1982 the picture is a different and more encouraging one: GDP has risen by 3½ per cent a year. The strength of the recovery was not widely foreseen. The experience of recession, both at home and abroad, led to a sharp reduction in estimates of the growth rates which might be achieved in the medium term. Thus the first edition of the MTFS in 1980 assumed a 'deliberately cautious' 1 per cent growth from 1980. Next year the Treasury was even more cautious and assumed only ½ per cent a year for the three years up to 1983; in the event the average was 1¼ per cent. By the year after that the forecast showed growth at 1¾ per cent rising to 2½ per cent; that also was an underprediction.

Table 4. 1982 projections and latest estimates

Average growth rates, 1982–7

	1982 projection	Latest estimate
GDP	1.4	3.4
Consumer spending	1.5	4.1
Public consumption	—	0.8
Fixed investment	2.6	4.2
Exports of goods and services	2.2	4.6
Imports of goods and services	2.6	6.2
Average earnings	6.9	7.3
Employment	−0.4	0.5
Personal disposable income	6.1	7.8
Consumer prices	5.2	4.3
World trade	4.2	4.4
Relative export prices	0.8	−0.9

Sources: Projections from *National Institute Economic Review*, no.102, November 1982 and NIESR printouts. Latest estimates from CSO, *National Income and Expenditure*, 1987; CSO, *Economic Trends*, 1987; and this *Review*, chapter I.

In order to understand why the recovery has been so strong it may be helpful to compare what has happened over the past five years with forecasts published beforehand. For this purpose we take the medium-term projections published in the *Review* of November 1982. Table 4 summarises those projections and compares them with our latest estimates. Our estimates for 1987 may still be significantly revised, but that should not affect the average growth rates calculated over five years to any great extent.

One reason for faster growth has already been touched on: policy turned out to be more expansionary than was assumed. In our projections we took the standard definition of fiscal policy used at that time—public spending plans as indicated in the latest expenditure White Paper, and tax rates constant. We also assumed that the effective exchange rate would be held constant at its end-1982 level, which implied a slight loss of relative price competitiveness. In the event the exchange rate has been allowed to fall significantly and competitiveness has improved. According to our model that accounts for much, but not all, of the extra growth which there has been in exports of goods and services. It will also have slowed down a little the growth rate of imports. This is another route by which the easing of policy has stimulated growth.

The single most important category of expenditure in explaining the growth of GDP in excess of the 1982 projection is consumer spending. The savings ratio, however, is a little higher in 1987 than expected. When the projections were made in 1982 that ratio was expected to fall, partly because real income growth was low. In the event real income growth was strong, but the savings ratio still fell for quite different reasons. Consumer credit and mortgage lending expanded rapidly and personal sector wealth was raised by the buoyancy of the stock market and of house prices. The ease of credit and the increases in asset prices are both at least partly the results of easier monetary policy.

In all we would estimate that the relaxation of fiscal and monetary policy, as compared with the assumption we made in 1982, increased the growth rate of GDP by nearly 1 per cent. This goes some way to explaining the excess of output growth over the projections, but it leaves about a further 1 per cent a year to be accounted for by other factors. In terms of expenditure growth the most important of these 'other factors' must be the growth in real personal incomes which accounts for the growth of consumption. To explain that we need to look mainly at the growth of real wages and their relation to productivity.

Productivity and real wages

Since the early 1980s productivity growth has been faster than the previous relationship with output would suggest. The initial response to the recession can be explained as a rapid 'shake-out' of labour as output expectations were revised down. But the continued strong growth of productivity during the recovery needs some further explanation. It is most pronounced in the manufacturing sector, but it is evident also in private non-manufacturing, which accounts for a much larger proportion of total employment.

Fixed investment does not provide an explanation. It has been low relative to the path of output for several years, as has been identified spending on training. It seems therefore that the improvements in productivity have resulted rather from better use of existing plant and the existing skills of the labour force. The pressures on management to improve the efficiency of industry have been severe and continuing. The experience of the recession remains as a warning of the consequences of inefficiency to those managers who have retained their jobs. The abolition of exchange controls, and the consequent move by pension funds and other major financial institutions to invest overseas, makes it necessary for UK firms to compete in an international market for capital. The reform of corporate taxation encourages firms to aim at profitability above all else, rather than growth of output or employment.

The experience of the recession and the rise in unemployment have also changed the behaviour of trade union members. The end of incomes policies, the much reduced political influence of the TUC, and the failure of strike action in a few well-publicised cases will all have contributed to the change. Trade union legislation may also have played a part, although its practical importance is difficult to judge.

The effect of these changes has *not* been to reduce the pressure for real wage increases, as the government and many independent commentators hoped. On the contrary, it has been to forge a new alliance between management and workers in individual firms based on a common interest in survival. In effect productivity gains and industrial peace are being exchanged for real wage increases. Real wages since the recession have risen much faster than would have been expected from the previously-estimated relationships with unemployment and inflation. This is the main reason why consumer spending has been so strong. This process has been helped in the last year or two by the fall in the price of oil and (in real terms) of other commodity prices. Partly for that reason firms have been able to raise wages relative to consumer prices whilst reducing the share of wages in domestic value added.

The growth of consumption, and hence of output, has also been helped by the 'underpinning' of living standards by social security benefits. If productivity and real wages increase to the same extent, the wage bill of the company sector is unchanged at a constant level of output. Consumer spending, however, will increase because the living standards of those who remain in work rise more than the living standards fall of those who lose their jobs. Thus total demand is *not* constant, output rises and the fall in employment is reduced.

Trade performance (table 5)

The visible trade balance crossed over into deficit in 1983 and the deficit has widened substantially in the past two years (partly because the oil price has fallen). The volume share of UK exports in world trade, which fell sharply in 1981 following the appreciation of sterling, has since recovered a little, thanks in part to the more recent exchange-rate depreciation. In addition it may be possible to detect some improvement in underlying performance in recent years, although this is not certain.

The volume of UK exports of manufactures grew faster than world trade in 1985 and 1986, and probably in 1987 as well. The increase in share was modest but it contrasts with a long-established downward trend. This can be interpreted in a variety of ways. The UK share always has been better maintained when world trade is growing slowly. There may be a delayed response to the gain in relative price competitiveness from 1980 to 1984, but the lag is probably too long for that explanation to be sufficient. Gains in competitiveness in European markets probably matter more than the simultaneous loss of competitiveness in America since the dollar has been depreciating. Firms are using their better profit margins to open up new markets and to develop new products for export. Improved labour relations and lower unit costs are encouraging international firms to produce in the UK for export to Europe.

Against this must be set the continuing rapid growth of imports of manufactured goods. The marginal import content of exports of manufactures is now very high, so the balance of payments has not benefited to the full extent of our improved performance in world markets. Moreover, the strong growth in consumer spending has resulted in several dramatic 'surges' in imports, most recently in the summer of this year.

So far during the recovery, trade performance has *not* been the main engine of growth. As growth in the UK has outstripped growth in most other advanced economies (and because oil prices fell last year) we have crossed over from current account surplus to deficit. If the pace of expansion is to be maintained, growth will have to be more export-led so that the trend to deeper deficit is arrested. That is one way in which improved supply performance can create its own demand; in the long run it may be the *only* sustainable basis for faster growth of output.

Table 5. UK trade and the balance of payments

	Volume of UK exports of manufactures	Volume of world trade in manufactures	UK share	Relative export prices	Balance of trade in manufactures	Current balance without oil as % of GDP[a]
1978	100	90	111	85	3.0	−0.7
1979	99	95	104	90	1.4	−2.3
1980	100	100	100	100	2.4	−1.3
1981	94	103	91	98	1.8	−1.2
1982	96	100	96	92	0.9	−2.6
1983	96	104	92	89	−0.8	−3.3
1984	104	114	91	88	−1.2	−4.6
1985	111	119	93	90	−0.9	−3.4
1986	114	119	96	88	−1.5	−2.1

Sources: CSO, *United Kingdom Balance of Payments*, 1987; Statistical Appendix in this *Review*.
(a) Balance of payments on current account *minus* the value of oil and gas production *plus* earnings in the UK of overseas oil companies.

Conclusions

The strength of the recovery in output owes little to the success of the macroeconomic strategy as originally conceived. It owes more to its failures and subsequent modification. It was helped by the retreat from monetarism and it was helped by the failure of employers and unions to heed the exhortations in favour of a 'low wage' and 'low technology' solution.

That said, we, amongst others, were unduly pessimistic about the effect of the strategy on output. The private sector, with no substantial fiscal stimulus to demand, proved more resilient than we expected. The profound shock to the economy of the 1979–80 recession may have served to awaken dormant entrepreneurship. This was probably helped by the government's efforts to encourage enterprise and reduce reliance on state intervention. Many of the least efficient firms went out of business altogether. Others, in order to survive and in co-operation with the labour force they *did* retain, adopted new technologies or working methods which previously they had neglected, or been unable, to introduce. In return, they paid high real wages which strengthened consumer demand. Whether such innovations and such co-operation could have been better fostered by a less hostile macroeconomic environment in the early days of the strategy remains an open question.

161/3

PWP

FROM: **PETER CURWEN**
DATE: 30 November 1987

MR R I G ALLEN

cc
PS/Chancellor
Sir T Burns
Mr Sedgwick
Mr Hibberd
Mr Bottrill
Mr Pickford
HA/004

EFFECT OF STOCK MARKET FALLS ON INDEPENDENT FORECASTS OF GROWTH

You asked how independent and city forecasts of growth in 1988 had been affected by the recent stock market falls.

2. The attached table shows (for the 12 organisations who have produced a forecast in the last month) how expectations have altered. On average these 12 are now forecasting 2.21 per cent growth in 1988 compared with 2.34 per cent prior to 19 October.

3. In interpreting the figures it should be noted that not all of the change may be due to the effects of the falls in world equity markets. Other factors, such as the Autumn Statement, may have had contributory or offsetting effects. For example, two forecasters (NIESR and Phillips and Drew) have actually raised their 1988 growth forecasts.

Both among the most pessimistic originally. Biggest fall is LBS, down from 2.8 to 2.2%

Peter. S. Curwen

PETER CURWEN

GDP FORECASTS FOR 1988

FORECASTING ORGANISATION				LAST FORECAST PRIOR TO STOCK MARKET FALL					POST-STOCK MARKET FALL; FORECAST			
	GDP MEASURE	APRIL	MAY/JUNE	JULY	AUGUST	SEPTEMBER	OCTOBER		NOVEMBER		DIFFERENCE Ⓐ BETWEEN PRE- AND POST-FALL FORECASTS	
National Institute	O				2.2 →				2.4 *		+0.2	
London Business School	O						2.8		2.2 *		-0.6	
Phillips and Drew	A						2.0		2.2		+0.2	
Goldman Sachs	A						2.5		2.1		-0.4	
Henley	A						2.4		2.6		+0.2	
Cambridge Econometrics	O	2.2 →							1.9		-0.3	
CBI	O					2.2 →			2.0 *		-0.2	
Oxford	A			2.2 →					2.2		0.0	
Wood Mackenzie	A						2.3		2.1		-0.2	
James Capel	A					2.6 →			2.6		0.0	
Alex. Laing & Cr.	A						2.2		1.9 *		-0.3	
Capel Cure	A						2.5		2.3		-0.2	
AVERAGE OF ABOVE FORECASTS							2.34		2.21			

* Forecast received after publication of November's Forecast Comparison

Ⓐ NB: All of this change may not be due to stock market fall. Autumn Statement and any number of other factors may have contributed.

SECRET

From : D L C Peretz
Date : 23 December 1987

PPS P!

Thanks. This note fails to cover one other dimension: viz how usable Ecu reserves are (eg if a need to be turned to support the £). I was also v grateful for Sir G Littler's observation on the ~~[illegible]~~ original proposition. My hunch is that the market would respond to a continuing demand for Ecus far better than Mr P predicts, & that this would be the solution for the 1979 EMS agreement problem. NL

CHANCELLOR

cc
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Scholar
Miss O'Mara
Ms Goodman
Mr Cropper

INTERVENTION IN ECUS

I have as you asked (Mr Allan's minute of 18 December) considered the scope for switching more of any intervention we do in future in European currencies into intervention in ecus. I have discussed this with the Bank of England.

2. The attractions, if we can do this, are obvious. It ought to some degree to help mollify the Bundesbank : or at least it would be harder for them to object, since it is not contrary to the letter of the 1979 EMS agreement.

3. The relevant technical factors are as follows :-

i) it is more or less impossible to deal in ecus outside Europe.

ii) even in Europe, there are problems about dealing in size. The Bank had to approach nine different banks before getting a quote for the $90 million worth of ecu they bought on 4 December (though admittedly that was on a Friday afternoon).

iii) ecu intervention is probably less effective psychologically than intervention in DM when we are trying to defend a rate against the DM.

iv) in theory at least it would be less effective also because of sterling's weight of around 12% in the ecu basket.

v) if banks sell ecus they do not possess, and need to cover their positions they tend to do so initially at least by buying just the main three currencies (DM, French francs and sterling) rather than the complete basket, tending to give sterling a higher weight still.

vi) the main market is in ecu/DM and ecu/dollars. So if we are selling £s for ecu the banks will normally themselves go through an additional £/dollar or £/DM leg. In practice this means we find it easier to get quotes if we are selling dollars or DM for ecu, rather than £s.

vii) ecus are not that easy to invest. The only real option is to leave them on (interest earning) bank deposit. There is no short-term government paper market as there is for other currencies; and the ecu bond market is difficult to use.

4. All of this means that it would be difficult to rely on doing all or even most of our European currency intervention in ecu. But we could certainly try to do as much as we can. In practice the simplest approach may be to buy DM (or dollars) first, and then switch them quickly into ecu - with the Bank of England subsequently reporting the transaction on the concertation as an ecu purchase. Even then, the quantity we can buy (and invest) is likely to be limited.

D L C PERETZ

CONFIDENTIAL

COMITE pour l'UNION MONETAIRE
de l'EUROPE

Secrétariat Exécutif
PM/CA

Décembre 1987

Compte rendu de la réunion du 9 Novembre 1987
(Rome - Association des Banques Italiennes)

Membres du Comité présents : MM. Valéry GISCARD d'ESTAING - Helmut SCHMIDT, co-présidents
MM. Pierre BEREGOVOY - Wilfried GUTH - David HOWELL - Manfred LAHNSTEIN - Rinaldo OSSOLA - Mario SCHIMBERNI - Gaston THORN - Niels THYGESEN - Jelle ZIJLSTRA - Xénophon ZOLOTAS
MM. Paul MENTRE et Uwe PLACHETKA, Secrétaires Exécutifs

Membres du Comité excusés : MM. Miguel BOYER SALVADOR - James CALLAGHAN - Etienne DAVIGNON - Renaud de LA GENIERE - Anthony O'REILLY J.A. SANCHEZ ASIAIN - Jose da SILVA LOPES

Assistaient également à la séance :

MM. François-Xavier ORTOLI, Président de TOTAL-COMPAGN FRANCAÏSE des PETROLES, trésorier de la Fondation de soutïen - Bertrand de MAIGRET - John KIRSCHEN, FIAT.

M. MINGASSON, Directeur Général Adjoint à la Direction Générale des Affaires Economiques et Financières, COMMISSION des COMMUNAUTES EUROPEENNES - M. Tommaso PADOA-SCHIOPPA, Directeur Général de la BANQUE d'ITALIE et M. JOZZO, Directeur, ISTITUTO SAN PAOLO di TORINO, membre du Conseil d'Administration de l'ASSOCIATION BANCAIRE pour l'ECU, ont participé à l'ensemble de la réunion.

1 - M. Valéry GISCARD d'ESTAING remercie les membres italiens du Comité et l'Association des Banques Italiennes pour l'organisation de cette journée. Il propose de discuter le matin des problèmes du développement de l'Ecu et l'après-midi des problèmes relatifs à la Banque Centrale Européenne et aux travaux futurs du Comité.

M. Helmut SCHMIDT indique qu'il serait inconcevable que le Comité n'évoque pas la situation internationale actuelle. Il est convenu d'avoir un échange d vues sur ce problème lors du déjeuner et d'en reprendre les conclusions dans le communiqué de presse.

2 - A l'invitation des coprésidents, M. SCHIMBERNI présente le document qu'il a établi sur le développement de l'Ecu privé (document n° 1 joint en annexe).

Il souligne notamment les points suivants ;

- utilisation de l'Ecu dans les opérations communautaires;
- utilisation de l'Ecu dans les règlements multilatéraux;
- renforcement du système de clearing interbancaire;
- développement des opérations financières émises en Ecu;
- émission d'actions libellées en Ecu.

M. JOZZO complète l'intervention de M. SCHIMBERNI en rappelant le développement des opérations de clearing interbancaire sous l'égide de la B.R.I. et les aménagements techniques actuellement en cours de discussion.

M. OSSOLA conclut ces exposés introductifs en rappelant que développement de l'Ecu privé et développement de l'Ecu officiel sont intimement liés dans la mesure où les opérateurs privés ont besoin de sentir une volonté et un calendrier politiques pour lancer des initiatives nouvelles.

3 - D'une discussion à laquelle participent notamment M. GISCARD d'ESTAING, M. ORTOLI, M. LAHNSTEIN, M. GUTH et M. PADOA SCHIOPPA, il ressort qu'un accent particulier devra être mis dans le rapport du Comité sur les opérations interbancaires. M. GISCARD d'ESTAING note que c'est dans la

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mesure où les économies de coût de transaction réalisées par les banques à travers le clearing interbancaire seront répercutées sur les entreprises, qu'il y aura pour elles une incitation concrète à développer leurs opérations en Ecu. Il est par ailleurs convenu de prendre certains contacts complémentaires à l'extérieur du Comité pour approfondir les questions relatives aux règlements multilatéraux, à l'utilisation de l'Ecu dans les politiques communautaires, et notamment la politique agricole commune, et à la dénomination totale ou partielle en Ecu du capital des grandes sociétés européennes.

4 - M. PADOA SCHIOPPA présente les vues italiennes sur le développement du système monétaire européen. Il entend notamment réfuter trois idées fausses :

a -"le passage d'un panier de monnaies à une monnaie abstraite est une nécessité." En réalité, le marché procède directement à des arbitrages d'actifs libellés en Ecu et se détache donc progressivement de toute référence à une définition.

b -"Il faut créer un lien entre le circuit de l'Ecu privé et le circuit de l'Ecu officiel." Il note que déjà certaines banques centrales, telle la Banque d'Italie, détiennent des Ecus privés et les utilisent dans des interventions. Des Ecus privés pourraient être utilisés par les banques centrales pour leurs interventions en dollars. Un saut quantitatif est nécessaire mais les éléments qualitatifs sont déjà là.

c -"Un prêteur de dernier ressort est indispensable pour le développement des opérations interbancaires." En fait ce n'est qu'en 1913 que cette fonction a été créée aux Etats-Unis et les banques centrales nationales européennes ont déjà des responsabilités à l'égard de leur propre système bancaire. Les éléments techniques existants (clearing interbancaire, Banque des Règlements Internationaux, Comité des Gouverneurs de banques centrales) permettent d'aller suffisamment loin s'il y a une volonté politique.

En réponse à une question de M. GISCARD d'ESTAING, M. PADOA SCHIOPPA précise que dans le cadre d'une négociation d'ensemble sur l'avenir du S.M.E., les Autorités italiennes seraient sans doute prêtes à accepter un rétrécissement de la marge de 6 % conférée à la lire italienne, marge qui a été peu utilisée en pratique et que la convergence des taux d'inflation rend moins nécessaire.

5 - M. MINGASSON retrace les conclusions des Gouverneurs des banques centrales, reprises par les Ministres des Finances dans leur communiqué de Nyborg en Septembre. Pour l'essentiel, les améliorations intervenues portent sur l'extension de la durée des concours à très court terme, sur la possibilité mutuellement agréée de conduire des interventions intramarginales (dans la limite

...

des quotas de positions débitrices et créditrices au titre des concours à court terme) et de la possibilité d'accepter un règlement intégral en Ecu des créances nées des interventions.

M. MINGASSON souligne combien ces dispositions, combinées avec le maniement coordonné des taux d'intérêt, ont été utiles dans la période récente de turbulences monétaires.

M. MINGASSON considère que l'accord de Nyborg épuise pratiquement les possibilités de progrès à l'intérieur des textes existants et estime donc qu'une impulsion politique est aujourd'hui nécessaire.

6 - La discussion relative à la situation internationale, marquée notamment pas les interventions de M. SCHMIDT, de M. GISCARD d'ESTAING, de M. GUTH, de M. THORN, de M. BEREGOVOY et de M. LAHNSTEIN, conduit le Comité à mettre l'accent sur les points suivants :

- il n'y a pas à s'attendre à de nouvelles initiatives américaines et c'est donc aux Européens de définir leur stratégie;
- il existe des possibilités de soutien de l'activité en Europe, notamment par l'avancement dans le temps de certains programmes d'allègements fiscaux;
- le renforcement du S.M.E. irait dans le sens d'un meilleur équilibre du système monétaire international.

7 - M. GISCARD d'ESTAING ouvre la discussion sur la Banque centrale européenne en demandant à M. MENTRE de présenter le document : "un calendrier pour l'action" (P.J. n° 2). M. MENTRE met notamment l'accent sur les points suivants :

- nécessité d'une décision rapide, idéalement en 1988, de création d'une Banque centrale européenne pour que, compte tenu des délais de toute nature, elle puisse être opérationnelle suffisamment avant 1992;
- utilisation de cet intervalle de temps pour traiter les problèmes de la livre sterling, de la lire italienne et de la peseta et pour procéder à l'élimination des contrôles des changes résiduels, notamment en France, en Italie et en Belgique;
- définition d'une structure de relations entre banques centrales nationales et banque centrale européenne qui, notamment par le jeu de réserves assises sur les agrégats monétaires (ou la base monétaire) assurerait une cohérence d'ensemble aux politiques monétaires.

...

8 - D'une discussion à laquelle participent M. SCHMIDT, M. GUTH, M. ZIJLSTRA, M. OSSOLA, M. HOWELL, M. BEREGOVOY, M. PADOA SCHIOPPA, M. MINGASSON et M. ZOLOTAS, ressortent les éléments suivants :

- il faut viser une structure du type du système fédéral de réserve américain avec un Open market committee prenant les décisions de gestion et reflétant un équilibre entre les gouverneurs de banques centrales nationales et des personnalités indépendantes nommées au niveau européen;
- la convergence des politiques économiques et le rééquilibrage des balances de base doivent accompagner le mouvement d'intégration monétaire;
- des instruments d'intervention spécifiques en Ecu devront être utilisés mais en parallèle avec les interventions menées par les banques centrales nationales.

D'un débat sur le gradualisme, auquel participent notamment M. GUTH, M. OSSOLA, M. THORN et M. LAHNSTEIN, il ressort que la décision rapide de création d'une banque centrale européenne a pour objet de lancer un mouvement dans lequel s'inscriront un ensemble de mesures selon un calendrier par définition graduel.

M. HOWELL précise sur ce point que les déclarations récentes de Mme THATCHER ne permettent pas d'envisager l'entrée de la livre sterling dans le dispositif de change, ce qui n'exclut pas que les Autorités britanniques acceptent cependant des progrès dans le dispositif portant sur d'autres aspects. Tout en notant que la livre respecte en fait actuellement les marges de fluctuation étroites, les autres membres du Comité considèrent que l'appartenance au système forme un tout et qu'il y a bien un choix à opérer entre une action étendue à l'ensemble de la Communauté et une action limitée à un plus petit nombre de pays.

9 - M. GISCARD d'ESTAING et M. SCHMIDT tirent les conclusions de cet échange de vues en indiquant que l'on ne peut envisager une succession de traités et qu'il faut donc bien, dès le début, se mettre d'accord sur les étapes finales, étant entendu que des actions d'accompagnement, du type de celles déjà évoquées (statuts individuels des monnaies, contrôle des changes, opérations privées, rôle de la B.R.I. et du FECOM), devront être mises simultanément en place. Les deux coprésidents prendront contact avec la présidence du Conseil Européen (Danemark pour le deuxième semestre 1987 - Allemagne Fédérale pour le premier semestre 1988) pour voir comment une décision sur l'avenir du S.M.E. pourrait s'insérer dans les prochains travaux du Conseil

10 - M. ORTOLI présente aux membres du Comité l'Association pour l'Union Monétaire de l'Europe, présidée par M. Van der KLUGT, et vice-présidée par M. AGNELI. Des coordonateurs nationaux sont en cours de désignation : M. ORTOLI, Président de TOTAL-C.F.P. pour la France, également trésorier de l'Association ; M. LUCCHINI, Président, COFINDUSTRIA, pour l'Italie, M. SICKINGHE,

...

Président, STORK, pour les Pays-Bas, M. SOLVAY, Président, SOLVAY, pour la Belgique, M. MERCKLE, Président, BOSCH, pour l'Allemagne Fédérale, M. SOLANA, Président, TELEFONICA, pour l'Espagne.

L'assemblée constitutive de l'Association se tiendra à Paris le 9 Décembre, à l'occasion des rencontres EURO 92. Un lien étroit sera maintenu avec le Comité, notamment par une participation au conseil d'administration de l'Association des deux secrétaires exécutifs du Comité.

11 - M. GISCARD d'ESTAING propose aux membres du Comité de tenir leur prochaine réunion à Paris, la date du 22 Février étant finalement retenue. Cette réunion aura pour but d'approuver les propositions du Comité à soumettre au Conseil Européen. A cet effet, le groupe de travail mettra au point un document d'ensemble sur la base des décisions prises par le Comité lors de sa dernière réunion à Bruxelles et lors de la présente réunion. Ce groupe de travail sera composé de MM. DAVIGNON, Directeur, Société Générale de Belgique, SCHIMBERNI, Président, MONTEDISON, de LA GENIERE, Président, Compagnie Financière de Suez, LAHNSTEIN, Président, Groupe Bertelsmar GUTH, Président, Deutsche Bank, HOWELL, Membre du Parlement Britannique, SANCHEZ ASIAIN, Président, Banco de Bilbao, THYGESEN, Université de Copenhague, PLACHETKA, économiste, Bonn, et MENTRE, Président, Crédit National, Paris.

Le Comité a été suivi d'une conférence de presse des deux coprésidents, dans laquelle a été commenté le communiqué de presse (P.J. n° 3). Les questions ont porté, pour l'essentiel, sur l'évolution présente du système monétaire international.

Ch/ David Peretz has pointed out that there may well be an invitation to join a concertation first thing tomorrow. Might be a good opportunity to do our bit if you were willing to authorise without discussion with officials.

SECRET

From: Sir G.Littler
Date: 5 January 1988

c.c. Sir P.Middleton
Sir T.Burns
Mr Scholar
Mr Peretz
Ms Goodman

CHANCELLOR

*

MPW 5/1

OK: prepared to do a further $25m (DM for $) today if there is concerted action including the US. NL

INTERVENTION

No immediate problem - we have enjoyed a respite on sterling and have not been pressed to join in concertation - but there is a question which we should address.

2. So far, since the G7 agreement of 23 December, there has been massive intervention by U.S., Japan, and Europe, in broad concertation. In Europe, the Bundesbank have done over $1bn and other central banks have done much the same in total. We have done only $25mn (DM/$) - which looks well below a normal 'share'. (Strictly, we have not been accorded a share - but when you and I discussed over the Christmas break how to respond to a demand on us to join a major operation, we thought we ought not to be forced above 10-15% of the non-German half of the European contribution).

3. I see no need for us to 'catch up' - our argument that we did more than our share in the past is still worth something. But I would be a little uneasy if it came to be thought that we were refusing to cooperate and 'standing out of the G7 agreement'. In practical terms I suggest we authorize the Bank to make another one or two token participations of $25mn - if during the next few days there are further rounds of substantial concerted action by other Europeans. Perhaps we could have a word tomorrow?

(Geoffrey Littler)

bf 8/1

SECRET

Thanks: I think we will stop ~~to~~ [illegible] [illegible] 8 [illegible] [illegible] Bank [illegible] N.

From : D L C Peretz
Date : 6 January 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Scholar
Miss O'Mara
Ms Goodman
Mr Cropper

Wait & [illegible]

INTERVENTION IN ECUS

You asked (Miss Wallace's minute of 4 January) a supplementary question about the useability of ecu reserves.

2. In part, the difficulties here are the mirror image of those in <u>acquiring</u> ecus described in my minute of 23 December.

- the market is not large, so there might be difficulties finding banks willing to buy significant quantities of ecus for sterling.

- since normally ecu transactions are into dollars or deutschemarks, the banks would probably want to go through a separate sterling/DM or sterling/dollar leg - adding to the complications of the operation.

3. There is a further complication. There may be some difficulty in investing ecus in a way that enables us to get our hands on them quickly in case of need. There is no equivalent to the US Treasury bill market. Of the $\$\frac{1}{4}$ billion of ecus we have at present, around \$50 million worth are invested in ecu bonds (but the market is not large or liquid); \$160 million worth in one month bank deposits and \$40 million worth in two month bank deposits. We could no doubt place them on overnight deposit, but the Bank think we would not get very good terms. If we had very large amounts of ecus, of course, we could arrange our affairs so that a significant value of deposits matured every day and were available for intervention. But while we have only

Will do note tonight

[illegible] summit [illegible]

modest amounts in total there will, I think, continue to be a problem about investing them in a way that ensures both a decent return and that significant amounts are available for use in intervention at short notice.

4. Of course, you are quite right to suggest that all such points amount to much the same message : the more we (and others, including other central banks) use the ecu market, and the more ecus we hold, the more the market will develop, and the easier we will find it to use ecus as an intervention currency (in both directions).

D L C PERETZ

SECRET

From: Sir G.Littler
Date: 8 January 1988

MISS M.P.WALLACE

Sir GL
Thanks. Do by all means pursue this with market ASAP. N

c.c. Economic Secretary
Sir P.Middleton
Sir T.Burns
Mr Scholar
Miss O'Mara
Ms Goodman
Mr Cropper

INTERVENTION IN ECUS

Your minute of 4 January and earlier exchanges.

2. On the market for ECUs, I would share the Chancellor's hunch that it might respond better if there were a substantial and continuing demand - and this could make it easier for us to deal in larger amounts. Primarily I would expect more professional intermediation (i.e. mobilising/demobilising between ECU and all or the main ECU components); whether there would be a significant further build-up of private holdings of ECU assets/liabilities is more doubtful.

3. I can see nothing in the 1979 EMS Agreement to constrain us in dealing in ECU/£ either way - indeed communautaire symbolism would be entirely on our side. So I could see such a development as being useful in two ways, although very much within limits:

- as a way of dealing to some extent in DM/£ in spite of the Bundesbank;
- as a way of opening up possibilities of amending the EMS Agreement, in the direction of widening technical choice of tactics and, more importantly, trying to undermine the intransigeance of the Bundesbank.

4. I would like to pursue the second point with Trichet, in the context of attempting to develop a joint Anglo-French position in favour of more freedom of manoeuvre, although I shall also want to explore with him more direct arguments against the Bundesbank. Trichet will be quick to see and eager to help elaborate ideas that dealings against ECU could be a communautaire approach to equilibrating ERM currencies and a way to build up the ECU in both official and private hands in parallel!

5. On the first point, ECU/£ operations are likely to be a second-best tactic compared with DM/£ operations - in terms of the impact on the DM/£ exchange rate. Crudely:

- if we buy DM for £100mn: we weaken sterling by supplying £100mn extra and strengthen the DM by siphoning out of the market, say, DM298mn - the general impact on both currencies is most marked where it applies twice, i.e. on the DM/£ cross-rate;
- if we buy ECU for £100mn: the net extra sterling supplied is, say, £86mn, while the contraction of DM (only its part of the ECU) is, say, DM100mn only.

On this basis we get only 60% of the impact on the DM/£ rate, or would have to buy ECU for £167mn to achieve the same effect as in buying DM for £100mn. Obviously this is schematic: in practice the response of market rates may vary - even arbitrarily - but I can see no reason for hoping they would be less unfavourable to ECU/£ than these sums suggest, indeed I suspect the contrary.

(Geoffrey Littler)

~~BF next PM Walters~~

AA / WR spoke ~

CHANCELLOR OF THE EXCHEQUER

Ch

This follows PM's discussion with Sir A Walters – lots of anti-intervention, nonsense of tying ourselves to DM stuff etc.

But, more helpfully, he has been enthused by a visit to Kiwiland & is a great advocate of cutting the top rate of tax. And he would go for a PSBR surplus of £2-3bn (thinking this is extremely restrictive).

AA

108/G/GBH/151/01

SECRET

FROM: MISS M O'MARA
DATE: 12 JANUARY 1988

pp.

CHANCELLOR OF THE EXCHEQUER

cc Sir G Littler
Mr Peretz
Ms Goodman

59.84
54.62
-8.72

INTERVENTION

You asked for information on a number of points as background to your bilateral with the Prime Minister tomorrow.

Average rates at which foreign currency has been purchased in 1987

For calendar 1987:	$1.6393	DM2.9413
1 April-31 December 1987:	$1.6712	DM 2.9759

Average exchange rates over financial years

	1982-83	1983-84	1984-85	1985-86	1986-87	April 1987 to close 11 January 1988
$	1.6719	1.4923	1.2565	1.3775	1.4926	1.6868
DM	4.0818	3.9158	3.7286	3.7201	3.0487	2.9759

83-84 - 86-87 : 1.40
82-83 - 86-87 : 1.46

Intervention over financial years

We thought you might also be interested to know what the net underlying intervention was in both dollars and deutschemarks over this period. However, the Bank cannot break their figures down in that way. In principle, they could give us total intervention in both currencies for each of these years but in practice, they have not been able to do so in the time available. Figures on that basis would not, of course, mean a great deal.

Total intervention by each of the G7 countries from 24 December 1987 to 12 January 1988

Dollar transactions		%	Non-dollar transactions	$million equivalent
US	1,944	30	-	
Japan	2,206	33	-	
Germany	1,139	17	-	
UK	50 (against DM)	1	23 (DM)	
France	424	6	151 (DM)	
Italy	214	3	370 (DM)	
Canada	648	10	-	
	6625	100		

Defence procurement

You asked what proportion of the defence procurement budget was denominated in dollars.

The MOD's dollar requirements are likely to amount to around $1,165 million in 1988-89 and $1,335 million in 1989-90 The rise reflects Trident expenditure in the US. Other things being equal, dollar expenditure will fall away again through the 1990s. Roughly 8-9 per cent of MOD's defence procurement budget is denominated in dollars but around 90 per cent is being purchased in the forward market in a rolling programme. Dollars for 1988-89 have already been bought at an average rate of $1.62 and some forward purchases have been made for 1989-90 too. (A similar arrangement applies for overseas expenditure in DM, relating mainly to spending by the British forces in Germany. This is projected at around DM3,780 million in both 1988-89 and 1989-90. Again 90 per cent has already been bought forward for 1988-89, at an average rate of DM2.76, and some forward purchases have been made for 1989-90.)

German accounting treatment of reserves

As you will have seen (Mr Gray's letter of 9 January), the Prime Minister has noted that projected Bundesbank profits from its reserve holdings are likely to be much reduced in 1987 because of the fall in the dollar between end 1986 and end 1987. She has asked what the effect would be if we were to value our own reserves in the same way. We shall, of course, provide a calculation and explanation for the Prime Minister as soon as possible but you may like to have an initial response before the bilateral.

In fact, the calculation No 10 have actually asked us to perform (comparing the valuation of the UK's reserves at the end of 1987 with the rates at which foreign currencies were acquired since 1 April 1987) is not relevant to a comparison between German and UK accounting methods.

In order to produce their accounts, the Germans revalue their stock of foreign currency reserves (held in dollars, other than Germany's position in the IMF and SDRs) at the end of each calendar year. (The stock, of course, will include interest receipts on foreign currency assets which have accrued over the year.) | * To do this, they have the choice of using either the historic low for the DM/$ rate or the rate prevailing on 31 December each year. In practice, presumably for reasons of prudence, they have chosen the historic low. For 1986, that rate was DM1.7275; for 1987, DM1.5740.

In the UK, the EEA presents its accounts in sterling at the end of each financial year. The holdings of individual currencies are converted at the average of the daily closing rate for the 3 months ending 31 March. Thus, dollar holdings at the end of 1986-87 are valued in the EEA accounts at $1.5431. We cannot, of course, at this stage indicate what the figure for 1987-88 will be but the average rate for the first 11 days of January is $1.8243. If, like the Germans, we were to use the historic low for last decade say and apply it to the calendar year, the figure would be ~~$1.0350~~ $2.4650. This would apply to both 1986 and 1987, since it was reached on ~~26 February 1985~~ 24 October 1980.

(* MOM subsequently said this was not so Bundesbank convert all $ interest receipts into DM & these score directly towards BB's profit)

In Germany, the Bundesbank owns the nation's foreign currency reserves but is obliged to transfer profits to the Federal Government after provisions and additions to reserves. Profits comprise interest receipts on foreign currency assets, as well as profits from the revaluation of holdings and, we presume, purchase and sale of foreign currency. (I attach an extract from the 1957 Bundesbank Act which sets out the basis on which profit is distributed.)

Thus a fall in the dollar to a figure below that at which it was previously valued in the reserves will reduce the profits which the Bundesbank passes to the Federal Government on both interest receipts, valued in DM, and because of the valuation loss on its stock of reserves. It will therefore, ceteris paribus, increase the German General Government Financial Deficit. In the UK, a dollar fall will affect the sterling equivalent of the interest we earn on our dollar assets. In turn, this will, ceteris paribus, reduce central government receipts and increase the PSBR. However, unlike Germany, valuation changes in the UK reserves do not score until a cash transaction occurs and then they are classified as financing the PSBR.

This is the best description we can provide of the German accounting system at short notice. As you can see, it is quite complex and, in particular, we are not clear about the Bundesbank's treatment of in-year changes in dollar holdings. We have asked the Bank to provide us with a more detailed description which we will reflect in the response to No 10's request. Meanwhile, if the Prime Minister raises the issue tomorrow, you might like to point out briefly:

(i) the description of the German accounting system implied in Mr Gray's letter does not seem to be correct;

(ii) Germany holds its reserves almost exclusively in dollars; the UK holds a variety of currencies;

(iii) the UK, unlike Germany, has substantial foreign currency liabilities as well as assets. We became long in dollars only at the end of April 1987.

MOM

MISS M O'MARA

Extract from the Bundesbank Act (1957)
Part VI

which the Federal Court of Audit is to carry out. The audit report of the auditor, together with the comments of the Federal Court of Audit thereon, shall be communicated to the Federal Minister of Finance.[1]

27. Distribution of profit

The net profit shall be distributed in the following order:

1. twenty per cent of the profit or twenty million Deutsche Mark, whichever is the higher, shall be transferred to the legal reserves until they reach five per cent of the total amount of banknotes in circulation; the legal reserves may be used only to offset falls in value and to cover other losses; the fact that other reserves are available for this purpose shall not preclude their use;
2. up to ten per cent of the remaining net profit may be used to form other reserves; the total amount of these reserves may not exceed the Bank's capital;
3. forty million Deutsche Mark, and from the accounting year 1980 onwards thirty million Deutsche Mark, shall be transferred to the Fund for the Purchase of Equalisation Claims set up under the Act on the Redemption of Equalisation Claims until its dissolution;
4. the balance shall be transferred to the Federal Government.

28. Return

The Deutsche Bundesbank shall publish, as at the 7th, 15th, 23rd and last day of each month, a Return which must include the following particulars:

I. Assets
Gold
Balances with foreign banks and money market investments abroad
Foreign notes and coins, foreign bills of exchange and cheques
Domestic bills of exchange
Lombard loans
Cash advances to
(a) the Federal Government and its Special Funds
(b) the Länder Governments
Treasury bills and Treasury discount paper of
(a) the Federal Government and its Special Funds
(b) the Länder Governments
Securities

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[1] Amended by article 9 of the Act of March 18, 1975 (Federal Law Gazette I, p. 705).

108/G/GBH/151/06

pp

Avges 1987 1.64
now 1.82
Avge 1983-87 1.45
(5 yrs)

FROM: MISS M O'MARA
DATE: 13 JANUARY 1988

MR HUDSON

cc Sir G Littler
Mr Peretz
Ms Goodman

1982-1986 1.47
1983-1987 1.45
1978-1987 1.74

INTERVENTION: AUTUMN STATEMENT DEBATE

You explained that the Chancellor had decided to omit the passage on intervention from his speech for the Autumn Statement debate tomorrow but asked for some material on sterilisation and on profitability which he might use if these points were raised by others. These I attach.

2. The passage on sterilisation is more technical than we would normally offer for a speech in the House. This is quite deliberate. I assume the question would only be raised by someone who had a reasonable knowledge of these issues and, with luck, this kind of response should ensure the House chokes off any further debate. You said that the Chancellor wanted to refer only to liquidity, not money, so this is all we have mentioned. I suppose it is just possible that someone might refer to the Bundesbank's sterilisation operation last week. This seems pretty unlikely and if they do, the suggested response will cover that too. I certainly do not think we want to draw attention to it ourselves.

3. You told me that the Chancellor wanted to refer to the average $/£ rate over, say, the last 5 years, implying, you thought, that we had bought most of our dollars at rates significantly lower than those now prevailing. I suspect we have misunderstood the point the Chancellor wanted to make but we have not been able to reformulate it more convincingly. Those Members who have an interest in these matters will be concerned that we are making a loss on the dollars we have taken in over the last year; they will not see it as relevant that the average $/£ rate has been much lower since, say, 1983-84 ($1.45). Indeed, this might

miss point

simply provoke them to ask the average rate at which we actually bought dollars over this period - information we are not prepared to reveal on market grounds. It is probably better to suggest, as we did in the spring, that intervention is the weapon we use in response to short-term fluctuations around a trend.

MOM

MISS M O'MARA

Sterilisation

We are determined to maintain a stable exchange rate for sterling, particularly against the deutschemark, and have made plain our willingness to cooperate with the other major industrialised countries in avoiding excessive exchange rate fluctuations. So it is not surprising that in the months following the Louvre agreement, the scale of our intervention in the foreign exchange markets has increased. The doubling of our reserves over the last year is ample evidence of that. It is true that to some extent intervention injects additional liquidity into the financial system. This is why, over time, we aim to sterilise any net intervention by funding it fully, but only as and when appropriate. In particular, the events of Black Monday and its aftermath in themselves tightened monetary conditions, and in those circumstances, I judged that to offset the intervention we had undertaken by extracting liquidity on a major scale would be quite the wrong policy response. I have therefore made it clear on a number of occasions that while we shall continue to fund our intervention fully, we shall not necessarily aim to do so entirely within the financial year in which the intervention takes place.

Profitability

A number of scare stories have been circulating about the losses the UK is claimed to be incurring on its holdings of dollars, as a result of the recent sharp movements in the $/£ rate. Let me say first that the authorities do not hold dollars with the aim of making speculative profits. We hold them as one of the currencies with which we intervene in the markets - and it is certainly worth remembering that UK intervention is not confined to dollars. As it happens, intervention to stabilise exchange rate fluctuations has turned out to be profitable in the past, since the authorities tend to buy dollars, for example, when the dollar rate is low and sell them when the dollar rate is high. But we do this in support of our exchange rate objectives, not in search of profit. We cannot tell today at what rate we shall sell the dollars we bought earlier this year and unless and until those dollars are sold, we simply cannot assess whether that intervention has been profitable. ~~Meanwhile, the dollar assets we hold are earning us interest.~~ What is more, we have substantial foreign currency liabilities as well as assets - as the House knows the UK has borrowed heavily in dollars in the past - and here the dollar fall will work to our advantage. We must not forget that it is our net position which matters in judging the impact of any currency movements on the value of our reserves.

But it is worth noting that the average dollar rate over the five years 1982-83 to 1986-87 was $1·46, so the current rate of over $1·80 is historically high.

SECRET

Markets folder

From : D L C Peretz
Date : 13 January 1988

MR A ALLAN

cc PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Ms Goodman

Thanks: The fact that Italians are being drawn by the G3, while in principle offensive, is in practice convenient for us. It gives us a good reason for minimal co-operation. N.

WEEKEND BASLE MEETING : INTERVENTION

I have a report from the Bank of some of the points that came up at Basle this weekend, and Monday and yesterday, on intervention. These may be of some interest to the Chancellor.

2. The $50 million of $/DM intervention we have done since Christmas seems to have been enough to avoid any criticism about our failure to give wholehearted support to concerted intervention since Christmas.

3. The Germans, however, took the opportunity to complain again about our purchases of DM in December, some of which took place after the December Basle meeting. They got some support from the Italians, who were unhappy that we have not bought lira, but not, apparently, from anyone else. The main German concern, however, seemed to be to get some sort of commitment from the Bank of England that we would not do the same again (apparently they even had the cheek to suggest that they ought to be consulted before we buy ecu, because of the DM weight in the ecu, though everyone agreed this did not come within the ambit of Article 15 of the Inter-Central Bank Agreement). The Bank declined to give any such commitment (I say the Bank, because the issue apparently came up in various different committees in Basle, and the discussion took much the same course in each committee). They said that we would of course try not to be unco-operative, but what we did had to depend on the circumstances.

4. The Italians drew attention to an article that appeared a few days ago in Il Mondo, reporting the gist of this dispute. This

SECRET

was in fact reported in very abbreviated form in the Guardian, a couple of days ago.

5. The other point of interest to emerge was the unprecedented degree of German/Japanese/US co-operation on intervention, beginning on 4 January. The three central banks had, apparently, decided on tactics the previous Friday. They decided to carry out overlapping operations in each other's markets, with the Fed making its presence known in Tokyo (by telephoning banks, rather than actually dealing); the Bundesbank starting its operations in the Far East while the Bank of Japan was still operating in Tokyo; and the Fed starting its operations for the day while European markets were still open. The Bundesbank said that what was striking was that the Fed had on this occasion shown themselves able to respond very quickly, without the usual delay of an hour or so while they consulted the US Treasury.

DLP

D L C PERETZ

SECRET

Rup

0.524
0.565

Ch
V bad, but luckily not the different DM you quote to PM?

FROM: MISS M O'MARA
DATE: 18 JANUARY 1988

— Fortunately, no.

CHANCELLOR OF THE EXCHEQUER

cc Sir G Littler
Mr Scholar
Mr Peretz
Ms Goodman

PB. Pls produce a little table for use if it comes up @ [illegible] mtg.

INTERVENTION

You will recall that the Bank had considerable difficulty in supplying us with the average rates at which they had purchased dollars and deutschemarks over the last year. They eventually gave us some figures over the telephone on Tuesday which I incorporated in a note to you that evening. We asked the Bank if they could explain how they had done their calculations and a letter setting this out reached us on Friday.

2. However, now that we have the details, it is clear that the Bank misread the figures they gave us over the telephone. V. bad Instead of telling us the average rates at which they had bought dollars and deutschemarks, they in fact gave us the average exchange rates for the two currencies over the periods in question. For the record, the correct figures (which the Bank have confirmed) are:

Average rate at which intervention carried out

1987-88 to date (cf 1982/3-1986/7 avge of 1.46)

	$/£	£/DM
Since 1 January 1987	1.6640	2.98¼
Since 1 April 1987	1.6840	2.99
Since 1 May 1987	1.7050	2.99½

Average exchange rates over period

	$/£	£/DM
Since 1 January 1987	1.64	2.94
Since 1 April 1987	1.67	2.97½
Since 1 May 1987	1.6750	2.98

The significance of the 1 May date (for which I did not provide figures in my earlier note) is that it is only since then that the EEA has moved to a net long position in dollars. The beginning of May was also around the time by which we had recouped the reserve losses of the previous autumn.

3. The Bank have stressed that these figures are very rough and ready. They were compiled by taking the average daily rate at which the Bank dealt when purchasing dollars and deutschemarks from the market in intervention operations, after making appropriate allowance for those days on which they sold those currencies in market intervention. They make no allowance for dollars used for other purposes but as you know, a large number of dollars bought in the market have been sold to customers, especially Government Departments, and used for servicing and repaying official debt. No allowance has been made for the impact of these purchases and sales on the average rates given above. Similar points apply, to a lesser extent, to our deutschemark holdings. Furthermore, no allowance has been made for diversifying our dollar holdings into other currencies. (The bulk of this switch was undertaken before the dollar's fall in the last 6 months and before October's massive inflows, so it will have generated a respectable profit.)

MOM

MISS M O'MARA

108/G/GBH/151/36

SECRET

Let SLS Certainly [illegible] include a £ est. re DM profit/loss on our DM holdings. 2. I have no objn to the changes [illegible]

FROM: MISS M O'MARA

DATE: 29 JANUARY 1988

1. SIR G LITTLER
2. CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Grice
Ms Goodman
Mr Cropper

Ch
This seems to give UK figures for net dollars only, instead of for all convertible 'currencies' (i.e. DM & Yen but not gold, SDRs). We must have made a small further 'loss' on these during 1987, so not presentationally helpful to include them. But doesn't it look odd not to?
AA

ACCOUNTING FOR THE RESERVES IN THE UK AND GERMANY

Mr Gray wrote on 9 January, drawing attention to a recent 'Financial Times' article about the implications of the dollar's fall for the profits the Bundesbank are obliged to pass to the German Federal Government. He said the Prime Minister would be interested to see a valuation of the UK's reserves at the end of 1987, calculated on the same basis.

2. Unravelling the Bundesbank's accounts must vie for complexity with explaining the agri-monetary consequences of the EMS or solving the Schleswig-Holstein question but the Bank (on whose expertise we have drawn heavily) believe they have now got to the bottom of the matter. I attach a draft reply.

3. The short answer to the Prime Minister's question is that, on the Bank's best guess, the Bundesbank's losses totalled around £3 billion in 1987; on the same basis, the EEA would have "lost" around £0.4 billion on its net dollar position. But as the draft letter explains, it is by no means clear what profit or loss the Bundesbank will actually transfer to the Federal Government in 1988.

4. The Prime Minister enquired only about calendar 1987 but the Bank have also calculated what has happened since we first established a net asset position in US dollars in April 1987.

5. Since then, the EEA has bought about $20 billion of US dollars in gross terms, at an average exchange rate of $1.68. The net addition was rather smaller, at $15 billion, since it was possible to achieve sales of about $5 billion in the period June-August. This will have improved the average rate at which dollars were bought to about $1.70. If the end-year position were closed at yesterday's exchange rate of $1.78, the result would be a loss of around £0.5 billion, after allowing for interest income and for the sterling financing cost of the foreign exchange acquisition. (There will have been a small offsetting sterling profit from a switch in July of $1¼ billion into deutschemarks and Yen, both of which have appreciated against the pound.)

6. This estimate exceeds the £0.4 billion figure for calendar 1987 given in the draft letter, even though it uses a more favourable closing dollar exchange rate, because it ignores the substantial profits the EEA made by running a dollar short position until April.

MOM

MISS M O'MARA

SECRET

DRAFT LETTER TO:

Please re-do, still as draft

[Do tomorrow dupe from Margaret O'Mara]

Paul Gray Esq
10 Downing Street

ACCOUNTING FOR THE RESERVES IN THE UK AND GERMANY

You wrote to me on 9 January, enclosing the attached article from the Financial Times

~~You drew attention to a 'Financial Times' article~~ on the profitability of German intervention. ~~in your letter of 9 January and said the Prime Minister would be interested to see the valuation of the UK's reserves at the end of 1987, calculated on the same basis.~~ I

You asked what the results of a similar calculation for the UK reserves would show.

I am sorry we have not ~~replied to you sooner~~ been able to let you have a reply before now, but we have found it ~~quite~~ difficult to establish exactly what method the Germans use.

2. The short answer is that, on a comparable 'net dollar assets' basis, we think the Bundesbank probably scored a book loss of about £3 billion equivalent in 1987 and the EEA a book loss of £0.4 billion.

There are, of course, several important differences between the position in Germany and in the UK, as the Prime Minister recognised.

First, the German reserves are owned by the Bundesbank, whereas the British reserves are a Treasury account. This difference in ownership is reflected in a difference of treatment of the reserves in relation to the borrowing requirement.

The Bundesbank's profit transfer (generally heavily influenced by changes in the deutschemark valuation of their foreign exchange reserves) is scored along with tax receipts as an item reducing the German Government's Borrowing Requirement.

In the UK, the EEA's purchases and sales of foreign currency do not affect the size of the PSBR but, like other changes in the mix of the Government's assets and liabilities, are treated as financing it. Valuation changes to the UK reserves affect the financing of the PSBR only when the gain or loss is realised and is reflected in a flow of sterling into or out of the reserves. Receipts of interest on the UK's foreign currency reserve assets do reduce the PSBR as they are treated as central government current income. Similarly, payments of interest on foreign currency borrowing form part of gross debt interest and so increase the PSBR. (In both these cases, the sterling sums involved will, of course, be affected by exchange rate movements.)

have very much larger net dollar assets than we do. Theirs total about $43bn.

Second, the Germans' ~~reserves include very substantial (about $43 billion) quantities of US dollars with no offset in the form of dollar liabilities; the UK's dollar reserves~~ Ours are currently ~~a much more modest~~ $12 billion, since our ~~in net terms (about half the gross asset position is offset by dollar liabilities).~~ ~~— we have~~ dollar assets of about [$24 billion] offset by dollar loans of about [$12 billion].

(check).

Finally, ~~Lastly,~~ the UK has actively shifted substantial amounts of dollars into other ~~strong~~ currencies ~~when international considerations have allowed it to do so~~ and we have on occasion bought deutschemarks against sterling in intervention operations on a considerable scale. As a result, the non-dollar proportion of our net foreign currency reserves has increased from 35 per cent in mid-year to 48 per cent at the end of 1987.

It is by no means straightforward to assess the effect of the dollar's fall on the Bundesbank's profit transfer and hence on the German Government's Borrowing Requirement. The Bundesbank's accounting principles are complex and contain a large element of discretion. Currency gains and losses are generally treated as contributing to profit, but there is considerable use of provisions to smooth the payment made to central government.

For example, the Bundesbank absorbed the losses on its substantial stocks of foreign exchange during the long period of deutschemark appreciation from 1968 to 1979 and made almost no overall ~~profit~~ transfer of losses. When the dollar started to appreciate in the 1980s, much of the profit was initially 'used' to offset earlier losses, but from 1982 there were annual transfers of profits of DM 10 - 13 billion (transfers relate to results a year earlier). At the same time, a substantial reserve (peaking at DM 7 billion at end 1984) was created.

??

The present phase of dollar weakness started in 1985. Even so, the Bundesbank managed to achieve sizeable - though diminishing - overall profits in 1985 and 1986, despite dollar holdings averaging around $22 billion. This will have been possible principally because of the use of profits carried over from earlier years (but also because interest earnings on the reserves are credited to profit, whereas there is no interest charge for the corresponding deutschemarks used to acquire the reserves). The transfer to central government was sharply reduced to DM7 billion in 1987 (reflecting 1986's lower overall profits, but after a transfer from the "provisions" reserve). Nevertheless, this was still enough to reduce the borrowing requirement by 20 per cent below the level it would otherwise have been.

The prospects for transfers in 1988 and 1989 are hard to judge, given the Bundesbank's discretion over how declared profit is struck and the existence of a further DM2.7 billion of "provisions" reserve. But with net dollar holdings of about $29 billion at end-1986 and $43 billion at end-1987, the Bundesbank must have suffered substantial deutschemark valuation losses, not fully offset by interest income. The Bank of England guess their losses, as calculated on their standard basis but before allowing for transfers from reserves, might have totalled some DM 9 billion (£3 billion) for calendar 1987. The press therefore seems correct in judging that any profit transfer in 1988 is likely to be small.

By contrast, the UK reserves have been much less exposed to dollar depreciation. Our dollar liabilities substantially exceeded our dollar assets for most of the recent period of dollar weakness, leading to substantial exchange rate book gains overall in sterling terms, as the dollar has fallen against sterling since 1985. Only in April 1987 did we move into a position where dollar assets exceeded liabilities. Using the same method as the Bundesbank, the Bank of England calculate there would have been a book loss on the EEA's net dollar position in 1987 of about £0.4 billion, before allowing for any transfer from reserves.

These calculations are inevitably dependent on a number of assumptions and the Prime Minister will not want to put any weight on the precise figures. It is also important to remember that the £0.4 billion figure for the EEA only represents a valuation loss: whether a loss or a profit is eventually realised depends on the exchange rate~~s,~~ if and when intervention during 1987 comes to be reversed.

HAMBROS

41 Bishopsgate London EC2P 2AA Telephone: 01-588 2851 S.W.I.F.T.: HAMB GB2L Telex: 883851

HAMBROS BANK LIMITED

PERSONAL

2nd February, 1988

The Rt. Hon. Nigel Lawson, M.P.,
House of Commons,
London, SW1A 0PW.

This is what I would like to discuss with Sir G Littler. He would like to set the process on a strictly [illegible] basis. –

Dear Nigel,

I have acquired in confidence the enclosed papers about the Giscard/Schmidt Committee which is preparing proposals for a European Central Bank (which you may not have seen). The Committee plans to complete its work on 22nd Februry and publish its proposals soon thereafter.

2. My informant tells me that Schmidt and Giscard have got the bit between their teeth and are determined to get a new Treaty agreed, with the British if possible but without us if not. Giscard claims to have fixed the French Government and the Germans are said to be on the move. (I know Lahnstein who is a member of the Committee and could, if you wished, try to find out more from him).

3. To my only partially tutored eye the proposals, as they stand at present, seem to leave a great many key questions unanswered, especially those relating to the division of responsibility between the European and national Central Banks over the control of the money supply, interest rates and exchange rates. They make it all sound so easy! But this letter is not about the substance, passionately interested though I am in that. I am at this stage only making a procedural point.

4. I recall only too vividly our failure to stay on the inside track at the formative stage of the talks on the E.M.S. in the summer of 1978 when Clappier and Schulman, rightly or wrongly, took the view that Ken Couzens was not making a constructive contribution to the 3-Power secret group set up at Copenhagen and went ahead without us with a Franco-German paper for the Bremen Summit. As a result we were hopelessly on the defensive at Bremen, lost a lot of ground and, later on, only with difficulty made the "soft landing" of joining the E.M.S. but not the E.R.M. "Les absents ont toujours tort"! Even if the February 22nd proposals are neither particulary welcome nor practical, we ought to get in on the discussion of them at an early stage.

BUTLER
(HAMBROS)
→ CH/EX
2/2

/5.

5. I do not for a moment think that you would allow yourself to be wrong-footed as Healey and Callaghan were. But I thought you might welcome a sight of the enclosed papers so that you can prepare a procedural ploy for the post-February 22nd situation. It might be better to take the initiative immediately to promote a thorough and unbiassed, probably inter-governmental, discussion than to stand defensively by while the band waggon rolls.

6. Needless to say, if I can be of any help, I am at your disposal.

Yours ever

Michael

Sir Michael Butler.

MDB/MML
Encs.

Copy:- The Rt. Hon. Sir Geoffrey Howe, Q.C., M.P.
The Rt. Hon. R. Leigh-Pemberton,
Sir David Hannay, KCMG.

91/G.LCLD.4501.034

Ch

I sat on this while arguing about 1978 & 79 figures — see Geoff's note AA

SECRET

Thanks!

FROM: B NELSON

DATE: 11 February 1988

1. MS GOODMAN ✓ MS Goodman 11/ii
2. APS/CHANCELLOR

cc Mr Peretz
Ms O'Mara
Mr Polin

LEVEL OF THE FORWARD BOOK SINCE 1980

Not quite: they have cut off 78 and 79 which you wanted.

You asked for an update of the tables attached to Mr Peretz's minute of 13 October to the Chancellor on Funding Policy and the Forward Book setting out details of the level of our forward book.

3. The 'raw' figures are given in table 1. These are the figures that appear in Table 1 of the monthly reserves submission to the Chancellor. The figures are complicated by valuation differences arising out of the EMCF swap. So to simplify these have been stripped out in Table 2 and Table 3 which details changes in 1987.

3. Between 1980 and 1986 the size of the net forward book fluctuated (as measured at the end of the calender years) between around $900 million and $2,300 million, the largest change being a drop in 1982 as the Bank intervened to break sterling's fall. During 1987 there was an increase in forward transactions with the market of $10 billion following the heavy intervention in the early summer and in the autumn of that year. This was offset by forward contracts of $3,090 million with MOD for their foreign currency requirements in 1988-89.

PS. Pls could we see again the reply to my last query on this year's over/underfunding. N

B Nelson

BARRY NELSON

91/G.LCLD.4501.038

SECRET

TABLE 1

LEVEL OF THE FORWARD BOOK: 1980-88
(Including EMCF swap valuation difference)

	Beginning of the year $ million (ie 1 January)
1980	756
1981	1,592
1982	1,216
1983	224
1984	452
1985	577
1986	1,097
1987	714
1988	5,854
end of January 1988	6,017

TABLE 2

FORWARD BOOK: 1980-88
(EXCLUDING EMCF SWAP VALUATION DIFFERENCE)

	Level of the Forward Book at the Beginning of the year (ie 1st January)	$m Change during the Year
1980	1131	+ 1140
1981	2271	- 419
1982	1852	- 940
1983	912	+ 213
1984	1125	- 37
1985	1088	+ 63
1986	1151	- 284
1987	867	+ 5658
1988	6525	
at 31 January 1988	6028	

SECRET

TABLE 3

FORWARD BOOK: END MONTH LEVELS IN 1987
(Excluding EMCF swap valuation difference)

	$m
January	936
February	1029
March	3334*
April	4887
May	7502
June	4382
July	4693
August	4293
September	4943
October	6507
November	6525
December	6525

* after revaluation

SECRET AND PERSONAL

From : D L C Peretz
Date : 22 February 1988

Ch
Discuss with PEM @ 5.30?
AA

Discuss

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara

INTERVENTION

We thought you might like a note marshalling some of the arguments that can be used for buying different foreign currencies to defend DM3, should that be necessary.

Arguments for intervening (any currency)

2. i) The January trade figures (to be published on 24 February) may not be good - to judge from the export figures. There is a strong "smoothing" case for preventing any rise in the £ before then, and for acquiring some ammunition.

ii) Since the end of December we have had an underlying fall of around $700m in the combined spot and forward reserves - representing net foreign currency payments for MOD and other departments financed by running down the forward book. There is a case for making good this reserve loss when we have an opportunity.

Arguments for buying dollars

iii) Since we stopped market intervention in mid-December we have successfully switched $200m of our $ portfolio into DM (the Bundesbank know about $175m of this); and $450m into yen.

iv) Over the past 2 months we should have been buying $s in the market to cover MOD's forward $ needs (for Trident etc), but have not done so. To make up this backlog and other dollar payments for Government departments financed from the Reserves we should now buy around $100m in the market. Dollar payments for Trident will tend to rise in future (at present MOD buy only 18 months forward) and this would be an argument for buying further dollars in advance.

Arguments for buying DM (for use with the Germans)

v) We have an agreement with the Bundesbank that we will buy DM forward, for the BAOR, regularly, in small amounts. In fact we have not done this over the last two months, and have a backlog of perhaps $600m worth of DM purchases to make up. However the understanding is that we will only do this with the Bundesbank's consent. The Bank think it unlikely that with the $ weaker the Bundesbank would actually agree to purchases in current circumstances of more than, say, $20m a day. If we did larger amounts it would, however, be a point to make after the event.

vi) It would presumably help with the Germans vis-a-vis the DM/$ rate if we bought equal quantities of DM and $s.

vii) It would also help in relation to ERM concerns if we bought French francs as well - and this would be justified by the extra return we get on French francs, even if there is to be a small devaluation after the Presidential election. To be really helpful in the ERM, however, we would need to buy Belgian francs : the BFr is currently at the bottom of the narrow band ($1^3/_4$% below the Guilder) and the Belgians intervened themselves last Thursday, selling $100m of DM.

Buying ecu

viii) Buying ecu would be harder for the Germans to object to. Mechanically, we might have to buy DM or $s first and then quickly switch into ecu. The main difficulty is that of acquiring ecu in sufficient volume. Obviously the more central bank intervention there is in ecu the easier this will become, and we are exploring with the French possible longer-term proposals in this area. But this will not help with the immediate problem.

Conclusion

3. The question is : if we have to intervene, what mixture of currencies should we go for. One possibility, which would fit reasonably well with a combination of the arguments above, would be :-

a) As many ecu as we can acquire (recognising that this may be a limited amount) and ? some Swiss francs and Yen.

b) The remainder divided roughly

- no more than 50% dollars
- at least 25% DM
- up to 25% Ffr or other currencies

4. Our net dollar portfolio is now some $\$^3/_4$bn less than before Christmas, because of payments made (iv) above) and the switch into DM and Yen (iii) above). So on this mix we could buy a total of at least $1½bn of currencies before we had built our net $ portfolio up again to where it stood in mid-December.

5. There could of course be an operational need to intervene to prevent the £ going through DM3 at very short notice. We were lucky this morning, but another piece of "good" news could easily trigger a speculative attack - particularly so as there is not much action elsewhere in the currency markets. So it would be helpful to be able to give the Bank guidance as soon as possible.

DLP

D L C PERETZ

SECRET

From : D L C Peretz
Date : 25 February 1988

Thanks.
2 comments.
1st, I don't object to work – @ [illegible] – @ this stage – to stir things up by various the issue of the EMS agreement (para 3), although I have no objection to do w. it if the French do w.
2nd, I still believe the banks will do more if they are told there is in effect a minimum demand for ecus (from the authorities). Have they been told this?

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara

INTERVENTION : ECUS

The Bank are now clear - at all levels - about the marching orders on intervention, as set out in Mr Allan's minute of 24 February.

2. We have also been considering with them what might be done to make it easier to intervene in ecus, and there are a few immediate points to report, going beyond those mentioned in my minutes of 23 December and 6 January, and Sir G Littler's minute of 8 January.

Medium-term

3. There is of course the question of what might be done over the medium-term, as well as more immediately. I am, as you agreed with Sir G Littler, running a small Treasury/Bank group to look at this, and also more generally at our attitude to the Balladur proposals. On the ecu there are several ideas we are looking at that might help develop the ecu market, for example :

- getting together with others, the French in particular, to encourage them to intervene in ecus also (we are considering whether any change to the EMS agreement is needed, or might help).

- setting up an HMG ecu denominated note programme in London.

We also have to look forward to the next reweighting of the ecu basket, due in 1989 and when the Spanish and Portuguese currencies come in.

Short-term

4. More immediately, I can add the following to the points in my earlier notes :-

a) The Bank's best estimate (which of course is very uncertain) is that the maximum amount of ecu they could buy would be $100m worth a day for 5 days. Earlier in the morning they would expect dealing to be easier than the Friday afternoon episode on 4 December when the dealers had to approach nine banks before getting a quote for $90m worth. But they will try and see : it may be possible to do more.

b) The bulk of the transactions will have to be done by buying dollars first and then switching them into ecu. Because the second transaction takes longer we would normally be holding dollars for a short period (perhaps ! five minutes or so) before the switch is done. I do not see that that matters. — It doesn't

c) Investing the ecu is in one respect easier (though at a cost) than indicated in my minute of 6 January. They can I now understand be placed on deposit with the BIS : we lose the BIS turn, of around ¼%, on market rates, but gain a degree of liquidity.

X 5. The basic problem of course is that the market in ecus as such is still pretty thin; and it takes banks time - and costs money - to put together the necessary bundle of currencies and assets. The problem is less with the larger currencies (DM, Ffr, £s, etc). But buying, for example, the Drachma assets necessary to match an ecu deposit takes time (during which the bank has an exchange risk exposure), and has relatively high transaction costs.

[illegible]. We are continuing to think about this, and I will report further if we have any further ideas. Meanwhile, if intervention is triggered the Bank will try to buy as many ecu as they can.

DLP

D L C PERETZ

108/G/GBH/150/38

FROM: MISS M O'MARA
DATE: 1 MARCH 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr R I G Allen
Ms Goodman
Mr Polin

A few changes,
otherwise OK.

a

OK?

RESERVES IN FEBRUARY

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

2. The Chancellor asked us to aim for a small net change over the month and we shall be publishing an underlying fall of $25 million. This month's forward purchases for MOD have been financed out of the forward book. Market expectations range widely from an underlying fall of $150 million to an underlying rise of $400 million, although some analysts are predicting little change. Tomorrow's figure should therefore cause no surprises. Some in the market evidently thought the authorities were supporting sterling at the beginning of the month but in fact, we did very little market intervention in either direction in February.

3. The total reserves fell this month by $166 million. Aside from the $18 million repaid from BA debt novated to HMG, 90 per cent of this month's repayments were made ahead of schedule, as part of our continuing policy to prepay our more expensive debt while the reserves remain high. The market will not, however, realise this, since the reserves press notice does not distinguish between prepayment and repayment on schedule and we would not want to highlight the point. As suggested last month, the volume of new loans under the official exchange

cover scheme is now much reduced, as the changes announced last December begin to bite.

4. Table 2 shows other countries' market intervention. Markets generally were fairly quiet in February. Neither the US nor Germany engaged in any spot market intervention during the month and Spain once again intervened more heavily than any other country, both in dollars and deutschemarks. The EMS was not under pressure in February.

MOM

MISS M O'MARA

TABLE 1 - RESERVE TRANSACTIONS FOR FEBRUARY 1988

		$ million Spot	Forward
1.	End January levels	43093	6017
2.	Transactions in February		
(i)	Market	+ 49	-2
(ii)	Swaps	-1429	+ 1429
(iii)	Maturities	+ 1233	-1233
(iv)	Other Bank customers	-49	-
(v)	Government		
	(a) departments' expenditure	-48	-234
	(b) public sector debt interest	-34	-
	(c) IMF interest	-7	-
(vi)	Interest on the reserves	+ 260	+ 1
TOTAL INTERVENTION		**-25**	**-39**
(vii)	Public sector borrowing under ECS		
	(a) borrowing	+ 29	
	(b) repayment	-152	
	net	-123	
(viii)	Repayments of HMG assigned debt	-18	
CHANGE IN THE RESERVES		**-166**	**-39**
3.	End February levels	42927	5978

SECRET

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

February 1988

($ million equivalent)

	Dollars	OTHER CURRENCIES (including EMS)
Ireland	-	-67 DM
Belgium	+ 8	+ 386 DM + 41 Dfls + 98 ECU
France	-	+ 356 DM
Italy	-93	-61 DM -23 Ffr
Netherlands	-	+ 162 DM
Germany	-	-
Denmark	+ 18	+ 114 DM + 84 Yen
Spain	+ 767	+ 469 DM
Sweden	+ 385	+ 170 DM
Norway	-5	-
Switzerland	-	-
Japan	-	-
Canada	+ 840	+ 116 Yen + 72 DM
US	-	-
Greece	-64	-
Austria	-	-
Portugal	+ 36	-

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

SECRET

91G.SCB.4317.8

CONFIDENTIAL

ERMP C/11

FROM: I POLIN

DATE: 1 March 1988

mar 1/3

1. MISS O'MARA
2. ECONOMIC SECRETARY

Distribution

PPS
PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mr Culpin
Mr H Evans
Mr Peretz
Mr Sedgwick
Mr R Allen
Mr Bottrill
Mr Bush
Mr Grice
Mr Hibberd
Mr Pickford
Ms Goodman
Mr Segal
Mr Cropper
Mr Call

THE RESERVES IN FEBRUARY 1988

The reserves announcement for February will be made on Wednesday 2 March at 11.30 am. This month's announcement reports a fall in the reserves of $166 million and an underlying fall of $25 million.

Ian Polin

I POLIN

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

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

CONFIDENTIAL

91G.SCB.4317.3

DRAFT PRESS NOTICE

THE RESERVES IN FEBRUARY 1988

The UK official reserves fell by $166 million in February. Accruals of borrowing under the exchange cover scheme amounted to $29 million; repayments of such borrowing amounted to $152 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $18 million. At the end of February, the reserves stood at $42,927 million (£24,212 million*) compared with $43,093 million (£24,346 million+) at the end of January.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during February, was a fall of $25 million. This underlying change is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

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* When converted at the closing market rate on Monday 29 February £1=$1.7730

\+ When converted at the closing market rate on Friday 29 January £1=$1.7700

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

Civil Aviation Authority, $29 million.

Repayments of such borrowing were:

South of Scotland Electricity Board, $142 million; Electricity Council, $5 million; British Rail, $2 million; West Midlands County Council, $1 million; Others, $2 million.

91G.SCB.4317.2

THE RESERVES IN FEBRUARY 1988 : PRESS BRIEFING

Factual : Main features of markets in February

	1 Feb (cob)*	Month's High	Month's Low	29 Feb (cob)*
£ ERI	74.2	74.7 (26th)	73.9 (9th)	74.7
£/$	1.75½	1.77½ (29th)	1.72¾ (12th)	1.77¼
£/DM	2.97¼	2.99¼ (29th)	2.96½ (1st)	2.99¼
$ ERI	95.1	95.7 (12th)	94.5 (26th)	94.5
$/DM	1.69½	1.72½ (12th)	1.68 (3rd)	1.68¾
$/Yen	129½	132 (12th)	127¾ (3rd)	128¼

*cob = close of business.

February saw return to relative stability in the foreign exchange markets with most currencies restricted to trading in narrow ranges.

Sterling began the month on a firm note following the 1 February ½% increase in UK base rates to 9%. It also benefited more than continental currencies from the flow of funds out of the dollar following the reduction in US prime rates on 2 February. However, a spate of industrial unrest, concern the economy might be overheating and fears for balance of payments prospects subsequently gave sterling a softer tone and, it dipped to a low of 73.9 in effective terms on 9 February. As the dollar strengthened, sterling fell further to the month's low on 12 February. However, it was later boosted by a better-than-expected PSBR figure for January. News of worse-than-expected UK bank lending figures tended to be offset by renewed expectations of higher interest rates and, with the CBI's monthly survey indicating continued growth and a strong export performance, sentiment towards sterling became more bullish, rising to the month's highs of $1.7755, DM 2.99¼ and ERI 74.7 on 29 February. Although easing slightly on publication of the trade figures for January, sterling quickly rebounded.

The dollar strengthened during February on a further contraction in the US trade deficit but it failed to consolidate its gains. Concern that the US economy was heading for a period of recession resurfaced; and with the subsequent ¼% cut (to 8½%) in US prime rates, the dollar dipped to the month's lows on 3 February. The bond market then rallied and the dollar recovered its losses rising to highs of DM 1.7250 and Yen 132 on publication of an improved US trade deficit on 12 February. Thereafter, trading became subdued until Swiss National Bank Chairman reportedly claimed on 19 February that the dollar might come under renewed pressure because of trade imbalances, causing a sharp fall through DM 1.70, triggering chart-based sales. The dollar then drifted lower, touching DM 1.6855 and Y 128.10 on 29 February.

Previous reserve changes

(i) In 1987 the underlying rise in the spot reserves totalled $20,475 million and the total rise in the spot reserves totalled $19,513 million (not including March revaluation changes).

(ii) At the beginning of January 1987, the spot reserves stood at $21,923 million; at the end of December 1987, they stood at $44,326 million.

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

		$ million		
		Underlying change	**Total change**	**Level of spot reserves at the end period**
1987	October	+ 6,699	+ 6,591	41,399
	November	+ 31	- 118	41,281
	December	+ 3,737	+ 3,045	44,326
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927

(iv) October 1987 underlying change was largest ever.

Bank base rates

(i) Base rate changes since beginning of 1987 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%
	4 December	8½	Down ½%
1988	1 February	9	Up ½%

Level of official debt

Now stands at $19.5 billion at end October* (latest published figure, BEQB, February 1988, Table 17.2). (In May 1979 was $22 billion).

*at end October market rates.

POSITIVE

1. Reserves remain very strong after substantial underlying increase of $20 billion in 1987. Now stand at $43 billion.

2. Sterling has been broadly stable, especially against deutschemark since last Budget.

DEFENSIVE

(A) POLICY

1. **Exchange rate policy for sterling:** Chancellor repeatedly made clear that sensible to continue to pursue policy of seeking stability for sterling, with exchange rate against deutschemark being of particular importance. This is what British industry wants and at same time provides anchor against inflation which markets can readily understand. Aim has been achieved over past year. [See Chancellor's 1987 Mansion House speech; 'Financial Times' interview, 4 January, and speech in Autumn Statement debate, 14 January, OR vol 125 no 72 cols 465-474.]

2. **Why is exchange rate stability so important?** Gyrations in exchange rates create ~~grave~~ damaging ✓ uncertainty and ~~damage~~ undermine business confidence throughout world. ~~Need to ensure that exchange rate risk does not distract companies from seeking improvements in performance as plan for future.~~ Gibberish Commitment to some form of exchange rate stability is only feasible way of securing wider international cooperation on economic policy.

3. **Why stability against deutschemark?** It provides necessary financial discipline as guarantee against resurgence of inflation. ~~Industry has asked for this.~~ (In 1987, nearly 50% of UK exports went to EC: under 15% to US.)

Gives industry most of what it wants. ✓

4. **Is aim still wider exchange rate stability as well as stable £/DM rate?** Following Louvre Accord, amounted to same thing for several months. Dollar fell towards end of last year. Very much hope dollar stability will be re-established and some signs this has indeed occurred; but meanwhile, keeping £/DM rate stable.

5. **Why is present DM/£ level right?** Matter of judgement. After Louvre Accord, Chancellor noted sizeable fall in exchange rate against non-dollar currencies which followed oil price collapse had gone far enough. Said that, by same token, no wish to see substantial rise. DM/£ rate was then 2.79. Now 2.99.

6. **Is Government capping sterling/deutschemark rate at 3 DM?** Government commitment to exchange rate stability, espcially against deutschemark, well understood.

7. **Let sterling fall to keep UK industry competitive?** Responsibility for competitiveness lies primarily with industry. Authorities will not allow sterling to fall to offset failure of British firms to keep costs under control. Competitiveness still better than 1984/5 before fall in oil price.

8. **Record current account deficit in January suggests exchange rate against deutschemark too high?** No. Monthly trade figures highly volatile - fall in exports inconsistent with other evidence eg February CBI survey. In any case, Government made clear that not pursuing policy of sterling depreciation to improve competitiveness.

(B) G7

9. **G7 statement issued on 23 December** "Reaffirmed basic objectives and economic policy directions of Louvre. Stressed need to strengthen underlying economic fundamentals and to continue policy cooperation. Agreed; either excessive fluctuation of exchange rates, further decline of dollar or rise in dollar to extent that becomes destablising to adjustment process, could be counterproductive to growth prospects for world economy. Re-emphasised common interest in more stable exchange rates and agreed to continue close cooperation."

(C) INTERVENTION

10. **Value of intervention as instrument?** As Chancellor told House on 14 January (OR vol 125 no 72 col 470), ".... it is idle to suppose that official intervention on its own .... amounts to a coherent policy. But intervention is an important tactical weapon and it would be foolish not to use it as appropriate".

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

12. **Have other countries been intervening over last month/recently?** Must ask them. UK does not discuss details of other countries' intervention.

13. **Is there a secret clause on intervention in G7 agreement [as claimed by M Balladur]?** No comment.

14. **Is intervention profitable?** Profitability is not main reason for intervention. Primarily undertaken to support exchange rate policy. However, for intervention to be profitable, authorities would need to sell sterling when it is firm and buy it back when it is soft. This is, of course, what authorities aim to do when smoothing undue fluctuations and such operations have generally proved profitable over time.
[N.B. See also BEQB, September 1983 pgs 384-391.]

15. **What is effect of dollar's depreciation over this financial year on value of reserves?** Because reserves published in dollars and holdings of gold and non-dollar currencies valued at 'parity rates' fixed at end of previous financial year, depreciation of dollar will make no difference to published value of reserves at this stage of year. But likely to mean that, when parity rates fixed at beginning of April for 1988-89 reserves will need to be revalued upwards - non-dollar elements of reserves will be worth more in dollar terms on basis of new parity rates.

16. **Will there be capital loss on dollar element of reserves on revaluation?** No. Sterling loss would only occur when dollar element of reserves actually sold and then only if sold at lower sterling value than that at which purchased. In practice, may take some time for intervention to be unwound, if at all.

17. **Do capital losses or gains on reserves affect size of PSBR (as in Germany)?** No. Like other changes in mix of Government's assets and liabilities, finance PSBR - and then only when gain or loss is realised and reflected in flow of sterling into or out of Exchange Equalisation Account.

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

(D) INTEREST RATES/MONETARY POLICY

19. **What was effect of 1 February interest rate rise on exchange rates?** Still committed to exchange rate stability.

20. **Implication of recent intervention for UK monetary conditions/funding?** Policy to ensure, over time, any net intervention funded so that effect on liquidity sterilised.

(E) EXCHANGE RATE MECHANISM (ERM)

21. **UK membership of ERM?** [Chancellor reported widely in press saying after 9 February ECOFIN in Brussels that UK had not changed view on joining ERM, but Government was pursuing deliberate aim of keeping sterling in line with EMS. Inaccurate Reuters report. Chancellor said as "matter of fact" sterling had ~~been held~~ stayed close to currencies participating in ERM].
No change in Government position. Matter kept under continual review. Will join when time is right.

22. **½ per cent rise in interest rates would not have been necessary if UK had been in ERM?** Nonsense. Joining ERM would not be soft option. Countries within ERM frequently change their interest rates.

23. **<u>Genscher's support for French proposals for Central Bank of Europe</u>?** M Balladur simply calling for consideration of connected issues and looking to time after completion of internal market (1992). Genscher's proposals made in party not Government context.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month	Level at end of month
USA	- 2.8 (end January)	43
Japan	+ 1.9 (end January)	83
Germany	- 4.0 (w/e 12 February)	59
France	+ 3.0 (end December)	71
Italy	+ 5.2 (end December)	65
Canada	+ 1.4 (end January)	10
United Kingdom	- 0.2 (end February)	43

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.

1323/3/pk

SECRET

FROM: D PERETZ
DATE: 1 March 1988

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr G Littler
Mr Scholar
Miss O'Mara

* *

Thanks. This is now a serious option: Note, any further intervention to hold down the £ should henceforth, & until further notice, be in ecus.

N.

INTERVENTION: ECUS

Following my minute of 25 February the Bank have been taking further discreet soundings in the market about the possibility of buying ecus. (In practice I think this means talking to Lloyds Bank, who are the only clearer operating on any scale in ecus).

2. As a result the Bank have revised upwards their estimate of maximum possible ecu purchases - to something in the range $¼-½ billion worth of ecus in one day, to be followed by $100 million worth a day for a further four days.

DLCP

D L C PERETZ

1323/11/pk

SECRET

(passed to DP)

Prop

FROM: D L C PERETZ
DATE: 2 March 1988

PRINCIPAL PRIVATE SECRETARY

cc: PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara

Ch
(A rather silly note)
AA

(a) Yes. The answer to the question that emerges in (b) & (c) is that if & when we exhaust the capacity of the Eur market, then the previously promulgated rules should be followed – but with consultation with me ~~[illegible]~~ if & when contactable

INTERVENTION: ECUS

I should record what I have agreed with the Bank of England (Michael Foot) following your minute of this morning.

(a) I have assumed, I hope rightly, that the new instruction is <u>not</u> intended to mean that the Bank should be prepared to let the pound rise above DM3 if they cannot buy sufficient ecus to hold it down. ✓ (!)

(b) In London, the Bank will do any significant intervention (other than any currency purchases to cover specific customer needs) in ecu. They will normally do this by buying dollars and simultaneously selling the dollars for ecu. In practice, because the second transaction is harder to do, there will frequently be a gap of a few minutes while we hold the dollars. ✓ !

(c) In New York and the Far East, although it may prove possible to buy some ecu, and the Bank will do so if they can, they are more likely to buy dollars, and then switch them into ecu once the European market opens the following morning. ✓

(d) In normal working hours the Bank will, of course, keep us closely in touch with what is going on; and we will keep you in touch similarly. If it looks as if more intervention will be required to hold the rate than can be made in ecu alone, we will need to be ready to make a rapid decision about what the Bank should do next.

2. The only remaining operational question is what we should do if in the early hours of the morning the Bank of England find themselves buying more dollars than they think they are likely to be able to swap easily into ecu once the European market opens. The occasions on which the Bank have had to buy more than $300-400 million worth of foreign currency overnight to protect the cap have, however, been very rare (about three times this year) and have not come without warning. So I have left it that except in really exceptional circumstances the Bank will not wake us all up in the middle of the night, but will report the situation first thing in the morning.

DLCP

D L C PERETZ

INTERVENTION

ECUS

1987-1988,

SECRET

FROM: D L C PERETZ
DATE: 3 MARCH 1988
cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara

CHANCELLOR

Re para 3, (Agreed.

INTERVENTION

The Bank of England have now swapped into ecus all the dollars bought last night in New York. It took three hours to complete the operation this morning.

2. The Bundesbank and Banque de France have been told about the ecu purchases, I think at Governor as well as working level. I understand that the reaction from the Bundesbank was "not quite as bad as it might have been": no doubt it makes it easier that the operation took place at a time of relative dollar strength. Even so the Bank are expecting a sticky time at Basle this weekend.

3. On a separate but related point I should record that the Bank are <u>not</u> going to propose any immediate funding move to sterilise this intervention. To announce new gilts tomorrow would simply encourage further foreign inflows, requiring additional intervention. This judgement seems to me to be absolutely correct. It is precisely why we have left ourselves the freedom to carry over funding of intervention from one financial year to the next, if necessary. Moreover, there is the additional point that the latest CGBR figures suggest there may be an offsetting change within the funding arithmetic for the year.

DLCP

D L C PERETZ

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332

From
Mr David Nickson CBE DL
President

CBI

9/3/88

Confederation of British Industry
Centre Point
103 New Oxford Street
London
WC1A 1DU
Telephone: 01-379 7400

P.39.88

NEWS
RELEASE

CBI

EMBARGOED - NOT FOR
PUBLICATION BEFORE
1400 HOURS WEDNESDAY
9 MARCH 1988

STRONG POUND A SERIOUS THREAT TO INDUSTRY - CBI PRESIDENT

COMBINATION OF HIGH EXCHANGE RATES AND HIGH INTEREST RATES WILL HIT COMPETITIVENESS

The strengthening of sterling against the deutschmark and other currencies has added to uncertainty and presents a serious threat to British industry, Sir David Nickson, President of the Confederation of British Industry, said today (Wednesday). "It is bound to make us less competitive, both in our home market and in overseas markets. The Government's willingness to hold sterling below 3 deutschmarks has been a major factor in our recent economic resurgence. Business can no longer have confidence about where the exchange rate is going.

"The breach of the 3 deutschmark level against the pound is not good news for industry. CBI members have stressed repeatedly that exchange rate stability within a competitive band against currencies in Europe is vital. This is where sixty per cent of our exports go, and where our future lies. Stability is even more important than the level of interest rates - high though these are in real terms. High exchange rates and high interest rates at the same time are bad bedfellows.

"The Budget is only a week away. Let us hope that the Chancellor can conjure yet another surprise from his despatch box by returning the pound to around the 3 deutschmark level by lowering interest rates, while avoiding the danger of rising inflation through his fiscal policies. Otherwise he will be selling British industry short."

MF

Sir David, who was speaking to members of the CBI's Eastern region in Cambridge, continued, "But we must not leave it all to the Chancellor. It is to our own resources that we must look to overcome these problems. It is just one more challenge to be faced. We shall only outsell our competitors if we can produce attractively designed goods of high quality and deliver them at the time the customer wants them and provide a reliable after sales service. Price is important but not always crucial: experience has shown that customers are always prepared to pay for quality and service.

"The key to success lies in our own hands. It is productivity which is vital in our attempt to improve our competitiveness, and in terms of our overall costs it is unit labour costs, rather than pay settlements, which determine our ability to compete. I have been greatly encouraged by the fact that productivity throughout British industry has increased over the past year by about 7 per cent so that the increase in our unit labour costs has been of the order of 1½ per cent.

"In an increasingly international world, there is no way that major industrial companies can avoid paying the real rate for the job. The problems we have with skill shortages show that the experts we need can easily sell their skills elsewhere. We have no alternative but to pay the rate they would get from other employers. But there are many things that businesses can do to improve their own competitiveness and there are many things also that Government can do to help.

MF

"Only yesterday, I led a delegation of CBI member companies to meet the Secretary of State for Energy, Mr Cecil Parkinson, to convey to him the great concern among both heavy and significant industrial users of electricity about the impact of the planned rise in electricty prices on business costs. We asked him to give serious consideration to how the impact of any price increases this year and next can be minimised.

"We also face significant increases in the cost to businesses of local authority rates. Here, again, we have suggested to Government ways in which it could help industry reduce the impact on competitiveness.

"The CBI has made known to the Chancellor that in order to improve the long-term competitiveness of British industry it is vital that we should move away from consumer-led growth to investment-led growth. It is important therefore that the Chancellor in his Budget next week leaves industry as much money as he can to invest in its future, in research and development and particularly in training people in the skills of which industry is short at present.

"It is, after all, on the wealth created by industry and commerce that the Government depends for its income through taxation and that the nation as a whole depends for its standard of living. If the tax and cost burdens prove too great, British industry will only be less competitive, with the result that Britain's balance of payments deficit will be larger. And in the long run that will mean sterling will be weaker and that the inflation that the Government has had such success in squeezing out of the system will return. None of us wants to see that. We must all work together for a more competitive and prosperous future."

9 March 1988

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From
Sir David Nickson KBE DL
President

CBI

for Nickson folder tomorrow

10th March 1988

I will see Sir D Nickson ~~[illegible]~~ on the day after the Budget. L

Dear Nigel

I sent you a copy of the Press Release on my speech in Cambridge yesterday on the subject of Exchange Rates and James Cleminson has also copied to me the letter he wrote to you yesterday. You won't be at all surprised at the CBI's concern which was fully covered in this morning's Press - and for once I see Sam Brittan is in agreement with CBI's views."

As you know so well we have been extremely pleased with the management of the Economy and have particularly welcomed the degree of confidence imported by the stability of the £ against the DM over the past year.

I would, therefore, only just like to confirm again, what you know so well, that our members' number one priority for economic policy is exchange stability within a competitive band against the European currencies. This we clearly set out in "Maintaining the Momentum of the Economic Recovery".

The benefits have been substantial. Investment in European export markets has been encouraged - just what the UK needs in the run up to 1992. However, they are being put in jeopardy by the developments of the past few days. For one manufacturer, to whom we spoke yesterday, the rise through the DM 3.00 ceiling was the last straw for his troubled export department. It is now being closed and that part of the business will be transferred to a subsidiary in Europe.

Companies are once again unclear about the Government's monetary policy and, in particular, its policy towards the exchange rate. Of course a higher exchange rate makes it more difficult to sell goods and services abroad, everyone knows that, but it is the uncertainty about underlying policy that is more significant.

We understand only too well the Government's concern about inflationary pressures and the CBI shares your commitment to low inflation. However, we believe that the danger of a rise in inflation is being significantly overstated. Output is growing rapidly, but British business as a whole is not experiencing capacity constraints. Cost increases remain moderate and wage settlements, particularly in manufacturing, are being matched by improvements in performance. In addition, the rate of increase in the RPI is currently at its lowest level, year on year, since October 1986.

/ ...

Even if the Government do believe that inflationary pressures in the UK are building up, then we doubt that allowing the exchange rate to appreciate is the appropriate way to tackle this. The exchange rate is a blunt instrument and there is little direct link between the exchange rate and wage settlements. The most likely effect of sterling appreciation is to reduce exports, eat into profits and hence investment. Yet further increases in investment and exports are crucial to our future economic prospects.

As I said in my speech our view is that fiscal policy should be tightened if the Government believe that demand is growing at an unsustainable rate.

We look forward to your Budget Statement on Tuesday and I am confident that, sharing our concerns as I know you do, we shall hear a message that can lead to certainty on a competitive level for sterling which we think should still be back at around the DM 3.00 level and, at the appropriate moment, to lower interest rates.

All best wishes for Tuesday

Yours ever

David

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
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ay Mail

oice from the past

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YESTERDAY'S heresy is today's orthodoxy, and vice-versa. Mr Mick Budgen (Con, Wolverhampton SW), rose yesterday like the spectre of Lawson past.

He spoke of the present rate of economic growth as not sustainable. He recommended the re-introduction of monetary controls.

Such controls were, unless I err, all the rage with Mr Lawson a few years ago. Now he sniffed suspiciously at them, as if Mr Budgen had offered him an awful outmoded kipper tie or a pair of velvet flares. They smacked to him of socialistic intervention. As such, he rejected them. Surely, when younger he'd have accepted them gratefully and commended them to Mr Budgen?

Let none suppose that Mr Lawson has knowingly abandoned the battle against inflation. It continues, but presumably by other means.

Mr Forman (Con, Carshalton), I think it was, averred that keeping inflation down was far more important than a three per cent rise in the pound. Mr Lawson agreed.

Mr Winterton (Con, Macclesfield), was worried about high interest and exchange rates. They could undermine British industry's competitiveness abroad.

Mr Lawson rebuked him. Our salvation does not lie in devaluation or higher inflation.

Maggie's rebuke

Even more emphatic later was Mrs Thatcher in exchanges with Mr Kinnock. He was quoting (perhaps selectively) his newfound friends at the CBI. They, too, think high interest and exchange rates bad for industry.

Mrs T rebuked him, too. It was vital, indeed paramount, to keep inflation down. Inflation had broken down the old Bretton Woods system of fixed exchange rates. The very last thing industry wanted was a high rate of inflation. Mr Kinnock wheedled on. He suggested that even Mr Lawson had thought that keeping the pound in line with the Deutschmark would be a pretty good anti-inflationary discipline.

The pound has actually risen against the Deutschmark. Perhaps Mrs Thatcher regards this as an even better anti-inflationary discipline. She remained adamant any way. 'You can't buck the market,' she said.

If the pound were low and sinking, Labour MPs would be bellyaching, and quite rightly, too. As it is, high and rising, they bellyache at that, too.

There is no pleasing them. In their impartial rage, they resemble the early Nazis, who roared at an election: 'We don't want higher bread prices. We don't want lower bread prices. We want National Socialist bread prices.'

The trouble about this rising pound, as various Tories pointed out, and Mr Lawson agreed, is that it in part reflects a growing confidence in Britain's economy under Mr Lawson's 'excellent economic stewardship', as Mrs Thatcher called it.

Binges are out

How, then, could Mr Lawson bring the pound down except by resigning or going spectacularly mad? It is his birthday today, incidentally. Perhaps a disgraceful and widely-reported binge, preferably ending in the cells, might shake the confidence which Labour finds so distasteful.

But he is heavily pregnant at the moment with Tuesday's Budget, which imposed on him and his lieutenants yesterday an unusual reticence. Doctors advise against binges in such an interesting condition.

Friday March 11 1988

MPs from all sides were in harmony against Brussels threats to harmonise VAT and to clap it on to children's clothes and food. Mr Beaumont-Dark (Con, Selly Oak) issued some splendidly insular noises. He bade the Brussels bureaucrats to mind their own business. 'We run our own affairs here,' he cried, 'thank God.'

Mr Beith (Lib, Berwick) mentioned, as others have mentioned before, that harmonisation of taxes is not necessary for the coming single European internal market. Nor it is, to be sure. But to have taxes wildly out of step would produce all sorts of damaging distortions.

Labour MPs seem understandably unwilling to grasp that lower tax rates on the very rich can actually produce more revenue. To accept this would expose their motives for taxing, which a Tory yesterday expressed as 'spite'.

PMP

Nigel F. tells me that this was in fact Tim Smith, not him (though T Smith may have been acting on briefing supplied by Nigel!)

Thanks. I was, of course. Thx @ N Time :-) 25 11/3

The Guardian

Market will rule, says Thatcher

(!) 6

The pound

By Alan Travis

THE **Prime Minister** yesterday appeared to rule out intervention over the rising value of the pound against the deutschmark, saying: "There is no way we can buck the market."

However, earlier the Chancellor, **Mr Nigel Lawson,** told MPs that any further significant rise in the exchange rate, particularly against the DM, "would in my opinion be unlikely to be sustainable."

When he was challenged by Labour MPs to recall an interview with the Financial Times on November 10 in which he had indicated the pound should not be allowed to rise above 3 DM, Mr Lawson replied: "I never quoted one figure."

The FT had reported the Chancellor as saying that maintenance of a 3 DM level was a useful anti-inflation discipline and industry was interested more in exchange rate stability than interest rates.

Yesterday, **Mr Neil Kinnock** quoted Sir David Nickson, the president of the Confederation of British Industry, as saying that high interest and high exchange rates at the same time were bad for British industry. "Do you agree?" the Labour leader asked the Prime Minister.

Mrs Thatcher replied that it was vital to try to keep inflation down. "You will recall we used to have the Bretton Woods exchange rate system and it was inflation that brought the end of that system.

"The last thing the CBI needs is a high rate of inflation because they could not keep on selling their goods abroad."

Mr Kinnock retorted that both the CBI and the Association of British Chambers of Commerce took a different view of inflation. In the interests of guarding against price and cost inflation it was necessary to get the pound down to 3 DM and to cut interest rates.

"When faced with that particular advice why do you prefer primitive monetarism?"

Mrs Thatcher replied that she had never known industrialists want higher inflation rates than their industrial rivals on the world market.

When Mr Kinnock referred again to the Chancellor, Mrs Thatcher said that Mr Lawson had never said that stability meant immobility: "Adjustments were needed, as we learned when we had a Bretton Woods system and as those in the European Monetary System have learned that they have to have a revaluation and devaluation from time to time. There is no way in which you can buck the market."

During Treasury questions **Mr Patrick Duffy** (Lab Sheffield Attercliffe) said the surge in the pound would aggravate the trade balance and external payments situation. "How does the Chancellor explain last month's hike in interest rates, or was he overruled?"

Mr Lawson said he was not sure what he meant by a predictable surge: "I was not aware you yourself had predicted it." The Government remained committed to maintaining a policy of exchange rate stability and that had been agreed at the Group of Seven meeting in December.

"Of course, while stability does not mean immobility, any further signficant rise in exchange rates, particulary against the DM, is unlikely to be sustainable."

He added that the strength of the pound reflected the confidence around the world in the British economy.

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