SM1/60 SECRET until 8.45AM 2/9/86

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2 September 1986

David Norgrove Esq
10 Downing Street
LONDON

1. MEA to see

2 pa.

Dear David,

HMG FOREIGN CURRENCY BORROWING

Thank you for your letter of 1 September. This is to confirm that the syndication of the floating rate note will be going ahead tomorrow morning, subject to any last minute market developments. I attach a copy of our background briefing on all this.

Yours
Alex

A C S ALLAN

SECRET AND PERSONAL UNTIL 8.45AM ON 2 SEPTEMBER 1986

BACKGROUND BRIEF ON FRN

Factual

- HM Treasury will announce early on Wednesday morning (3 September) that it is issuing US $3 billion of floating rate notes (FRNs).

- The notes carry a coupon of $^1/_8$ per cent below three months LIBID and an all in cost of 8bp under LIBID. The final maturity is ten years (September 1986). But HMG has the option to call the notes at par on any interest payment date after the first 5 years; note-holders have a single put option after 5 years.

- The issue is being organised by the Bank of England on the Treasury's behalf and is jointly lead-managed by Warburgs and Credit Suisse First Boston.

- The notes are being sold in the international market in the normal manner for a eurobond operation.

- The $2.5 billion FRN issued in September 1985 had a maturity of 7 years and a coupon of LIBID.

Line to take

- The issue is essentially the second stage of the process begun with last year's FRN and has the same purpose ie taking a favourable opportunity to strengthen the UK's foreign currency reserves at a time of continued exchange market uncertainty.

- The issue increases the UK's stock of currency reserves by $3 billion and brings them more into line with those held by other countries (see annex).

- This operation, which is larger than last year's and on better terms extends the average maturity of foreign currency borrowings into the late 1990s. The terms are the finest available to any borrower for an issue of this type.

- There is no immediate intention to use these extra reserves. They will be invested in suitable financial assets. Like the UK's existing reserves, they will however be available for use if needed. Events in the foreign exchanges over the last 12 months have confirmed the importance of holding adequate reserves although in fact the proceeds of last year's FRN have not been required to be used; the reserves now stand at a slightly higher level than they did last autumn.

Defensive

ERM?

No change in our position.

Need to support sterling?

No. Decline in sterling in index and cross rate terms (ie against EMS currencies and the yen) is largely a consequence of the fall in the price of oil which has led to structural changes in the UK balance of payments. Given the size of the oil price movement, sterling has held up well.

Borrowing to intervene

(See line to take). No immediate intention to do so. Like the existing reserves, they will, however, be available for use if needed.

Already spent last year's issue!

On the contrary, even after allowing for valuation changes, our currency reserves are higher now than they were in October 1985, immediately after the 1985 FRN.

	October 1985	end-August 1986
currency reserves $b)	8.3	9.4

Reversal of policy on debt repayment

[Economic Secretary said in Written Answer on 24 November 1984 (col 448) that official debt had been reduced by $10 billion from figure reached by Labour government and that "a proper balance between the figures that we have now reached may well be where we should rest for the time being".]

Policy was to repay substantial part of expensive foreign debt inherited from Labour Government. This we did. Official debt at end of August 1986 was $7 billion lower than in May 1979 and $11 billion below peak at end 1977. Even after this issue it will still be $4 billion below inherited level and $8 billion below peak while level of gross reserves will be broadly the same as in 1979.

Moreover

(i) The new issue, like that in September 1985 is on very fine terms indeed. The repaid debt was much more expensive eg the $2.5 billion and $1.5 billion syndicated credits taken out by the Labour government in 1974 and 1977 were at LIBOR +$^3/_8$% rising to LIBOR +$^3/_4$% and LIBOR +$^7/_8$% rising to LIBOR +1% respectively.

(ii) This is a market operation. The Labour debt included a significant proportion of IMF debt (IMF debt accounted for 10 per cent of total official debt in March 1979, compared with zero now).

Reflects fact that this is a step taken from a position of strength, not weakness.

Running down of reserves to repay Labour debt

Of course a substantial part of the debt repayments were financed from the reserves. How else would it have been done? What the Government was doing, and taking credit for, was getting rid of large amount of undesirably expensive liabilities.

And NB: (i) Even so, net reserves are $4 billion higher than they were in April 1979.

(ii) The UK's total net external assets, private and public sector combined, have increased almost sevenfold since the end of 1979 (from £12.0 billion at end-1979 to £80.4 billion at end-1985) and are now second only to Japan.

Reasons for changes in reserves

Changes in reserves over time reflect number of factors - intervention, valuation changes and net borrowing. Over whole period since April 1979 there has been a substantial reduction in net borrowing, a number of valuation changes in different directions and a moderate plus from other transactions (including intervention).

Why take a different view from last year about the appropriate level of the reserves?

We did not rule out making a further increments last year. We now judge that a further increase would be appropriate and that an attractive market opportunity exists.

Does this mean we will be coming to the markets every year?

We have a regular programme of foreign currency borrowing through nationalised industries. This will continue. As last year, this particular issue is being made in the Government's own name to take advantage of particular market conditions. But there is no need for the Government to make regular own-name market issues, nor implication that that is what we intend to do. We will continue to take decisions in the light of all the circumstances at the time.

Exchange rate/monetary effects

The issue will not have any significant effects on either the exchange rate or the monetary aggregates.

Effect on the dollar

Proceeds will be added to the reserves. So we will be adding the same amount to the demand for dollar assets (to hold in our reserves portfolio) as to the supply (in terms of the new HMG liabilities). There will therefore be no significant effect on the dollar exchange rate.

Comparisons with other sovereign borrowers

The terms are the finest available to any borrower for an issue of this type.

Choice of lead managers

We are repeating a successful formula.

OFFICIAL DEBT AND RESERVES FACTSHEET

Level of official reserves

End-period	Total	$ billion o/w convertible currencies
1979	22.5	18.0
1980	27.5	18.6
1981	23.3	13.5
1982	17.0	9.6
1983	17.8	9.0
1984	15.7	7.6
1985	15.5	8.5
1986 Q1	18.8	8.8
1986 (August)	18.9	9.4*

Level of official debt

	Total	o/w HMG borrowing
1979	20.7	9.7
1980	17.4	7.7
1981	13.3	4.6
1982	12.1	3.9
1983	12.0	3.7
1984	11.3	3.4
1985	14.6	5.7
1986 Q1	15.1	5.7
1986 (August)	15.2*	5.6

*__NB__ There is a 3 month lag on the publication of these figures. August levels will not therefore be released until December 1986.

$ billion

Peaks and troughs

		Reserves		Official debt	
		Total	Convertible currencies	Total	HMG
Under Labour (Mar '74-Apr 79)	high	21.9 (Mar '79)	19.3 (Jan '78)	25.5 (Dec '77)	12.9 (Sept '77)
	low	4.1 (Dec '76)	2.5 (Dec '76)	8.7 (Mar '74)	4.5 (Sept '74)
Under Conservative (May '79 to date)	high	28.5 (Mar '81)	19.7 (May '80)	22 (May '79)	10.1 (May '79)
	low	14.0 (May '85)	6.8 (Mar '85)	11.0 (Sept '84)	3.2 (Apr (84)

Major HMG borrowings since 1974

Date	Amount	Description	Terms	Repayment/amount outstanding
March 1974	$2.5 bn	Eurodollar bank credit 10 years on a rollover basis with a 3, 6 or 12 month option	Floating rate yrs 1 & 2: LIBOR + 3/8% 3, 4 & 5: LIBOR +½% 6 & 7: LIBOR +5/8% 8, 9, 10: LIBOR +¾%	Repaid in monthly instalments from May-July 1981
Jan 1976	SDR 1 bn	1975 oil/facility	Floating rate	Equal quarterly repayments from Apr '79 to Jan '83

Date	Amount	Description	Terms	Repayment/amount outstanding
May 1976	SDR 700 mn	1975 stand by arrangement	Floating rate	Repaid by Apr '79.
Jan-Aug 1977	SDR 3.36 bn (Note only SDR 1.64 bn drawn down)	1977 stand-by arrangement. To be drawn down over 2 years	Floating rate	Repaid by Apr '79
April 1977	$677 mn (equivalent)	Foreign currency bonds denominated in $ issued with 5, 7 and 10 yr maturities for $202 mn, $82 mn and $18 million respectively. Others: DM 365 mn, Swfr 360 mn and Yen 21,500 mn issued with single maturity of 7 yrs	5 yr $ bonds at 8 3/8% 7 yr $ bonds at 8 5/8% 10 yr $ bonds at 8 7/8% 7 yr DM bonds at 7½% 7 yr Swfr bonds at 5 7/8% 7yr Yen bonds at 8%	Bulk of repayments made in Apr 1984. Remaining $18 million due for repayment in '87
February 1977	$1.5 bn	Eurodollar bank credit. 7 yrs on a rollover basis with a 3, 6 or 12 month option. Loan drawn down in 2 tranches: $1 bn and $0.5 bn	Floating rate yrs 1 & 2: LIBOR +7/8% yrs 3 to 7: LIBOR +1%	Repaid in monthly instalments from July to Dec 1980
May 1978	$350 mn	$ bond issue in New York: $200 mn with a 7 yr maturity and $150 mn with a 15 yr maturity.	Fixed rate 7 yr : 8½% 15 yr : 8 7/8%	7 yr bonds repaid in May 1985. 15 yr bond due 1993
September 1985	$2.5 bn	Floating rate notes with a 7 year maturity	Floating rate 7 year LIBID with no margin reset and repayable quarterly.	

Reserves movements since before 1985 FRN

$ billion

	End-period	Convertible currencies	Total spot reserves (published)
1985	March (post revaluation)	5.4	14.2
	September	6.0	15.2
	October	8.3	17.6
1986	March (pre-revaluation)	8.1	17.8
	March (Post-revaluation)	8.8	19.9
	August	9.4	18.9

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INTERNATIONAL COMPARISON OF RESERVES

June 1986, $ billion

	Total*	of which convertible currencies
UK	15.6	11.5
Germany	48.6	38.9
US	46.3	15.2
Japan	35.0	29.5
France+	35.1	29.5
Italy	22.6	18.3

* gold valued at SDR 35 per oz

+ May data.

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