C14/32

SECRET

A

5

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

10 February 1988

Paul Gray Esq
10 Downing Street
London SW1

Dear Paul,

ACCOUNTING FOR THE RESERVES IN THE UK AND GERMANY

... You wrote to me on 9 January, at flap enclosing the attached article from the Financial Times on the profitability of German intervention. You asked what the results of a similar calculation for the UK reserves would show. I am sorry we have not been able to let you have a reply before now, but we have found it difficult to establish exactly what method the Germans use.

The short answer is that, on a comparable 'net dollar assets' basis, we think the Bundesbank probably scored a book loss equivalent to about £3 billion in 1987 and our Exchange Equalisation Account (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.)

Second, the Germans have very much larger net dollar assets than we do. Theirs total about $43 billion. Ours are currently $12 billion, since our dollar assets of about $26 billion are offset by dollar loans of about $14 billion.

Finally, the UK has actively shifted substantial amounts of dollars into other currencies and we have on occasions 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 in fact made a small overall profit transfer, taking into account its domestic operations. 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 declare 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 book profits as the dollar fell against sterling since the January 1985 peak. 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. On the other main currencies held by the EEA, we probably made a small book profit in 1987 on our yen holdings in sterling terms, but a small loss on our deutschemark holdings, with no significant profit or loss on Canadian dollars.

These calculations are inevitably dependent on the assumptions used and not too much weight should be put on the precise figures. It is also important to remember that the £0.4 billion figure for the EEA represents only a book loss: whether a loss or a profit is eventually realised depends on the exchange rate if and when intervention during 1987 comes to be reversed.

Yours

Alex

ALEX ALLAN

W Germany to raise taxes and cut spending

BY DAVID MARSH IN BONN AND ANDREW FISHER IN FRANKFURT

THE WEST GERMAN coalition yesterday decided to cut federal government borrowing by at least DM10bn (£3.36bn) next year through a mixture of increases in consumer taxes and cuts in budget spending

The move comes in reaction to a much sharper than planned increase in the federal deficit this year. It is now expected to be DM40bn compared with DM29.5bn set down in the 1988 budget approved by parliament at the end of last year

The tightening of fiscal policy now planned for 1989 runs completely counter to persistent calls from home and abroad for West Germany to cut taxes next year in order to bolster sluggish economic growth.

Mr Gerhard Stoltenberg, the Finance Minister, told the press after yesterday's cabinet meeting: "There is no room for further tax cuts (in 1989)."

At the same time the Bundesbank in Frankfurt announced action to reduce banking liquidity through a DM6bn cut in banks' rediscount quotas, effective February 1. The move, which will cut the amounts banks can borrow from the central bank at the 2.5 per cent discount rate, came in response to big increases in liquidity through currency inflows

The Bundesbank said the decision did not imply any change in its basic monetary stance. However, it underlines how the central bank is reacting cautiously to ward off possible inflationary dangers from currency inflows – DM25bn since October – accompanying the latest rise of the D-Mark

Yesterday's cabinet decision on the deficit underlines how West German fiscal policies have been severely blown off course by the fall of the dollar and the weakening economy

The admission by Mr Stoltenberg that the 1988 deficit will be much larger than expected is likely to expose him to a fresh wave of criticism at home from both Left and Right over the consequences of rising public borrowing

It casts a considerable question mark over whether the Government will be able to proceed with promised net tax cuts of DM20bn in 1990, conceived as a fundamental part of its economic strategy

The immediate causes of the jump in the 1988 deficit are higher West German contributions to the European Community and the near-disappearance of 1987 profits from the Bundesbank, due to be paid over to Bonn this year. The Bundesbank profit will fall to "near zero" from the DM6bn which had been written into the 1988 budget, the Finance Minister said

This is because the central bank will have to write off between DM6.5bn and DM7bn on the D-Mark value of its foreign exchange reserves. This is

Continued on Back Page
Details, Page 2

West Germany to raise taxes Continued from Page 1

because of the sharp fall in the dollar to DM1.5815 at the end of last year, the value the Bundesbank will use for its 1987 accounts

This year's federal deficit is also being driven up by DM14bn of tax cuts which came into effect at the beginning of the year. Additionally, tax revenues have fallen well below earlier, projected levels because of economic growth of only 1.5 per cent last year

Mr Stoltenberg said a supplementary budget would be introduced before the summer to take account of the extra 1988 deficit. Additionally, around May or June, detailed decisions would be taken on finding the budgetary savings of at least DM10bn planned for 1989, Mr Stoltenberg said

Mr Stoltenberg said the Government faced no substantial risks on the spending side for 1988, although this year's deficit could plainly be driven higher if the economic downturn eats further into tax revenues and drives up subsidies

At present, Mr Stoltenberg is projecting a growth of between 1.5 and 2 per cent in gross national product this year although some more gloomy private sector forecasters are predicting only around 1 per cent.

Econ Pol: Domestic Monetary Policy pt. 8

10. II.