

PROFESSOR WALTERS

cc Paul Gray

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INTERVENTION AND STERILISATION

Could I offer a few comments and questions on your minute to Mr Gray of 11 July.

I agree with your main conclusion that the dominant influence in 1987-88 (and in my view even before that) was that interest rates were too low, given the demand and inflation rate pressures, so any differences are second order ones.

i. The discussion in the first half of your note defines sterilisation in relation to the money markets, whereas the Treasury defines it in terms of funding, ie sales of gilts to the non-bank, non-building society private sector sufficient to cover the PSBR/PSDR plus any changes in foreign exchange holdings. Thus, in their framework, the counterpart to higher reserves held by the public sector is not lower holdings of bills but higher gilt-edged liabilities. In their system, intervention of £X million leaves the banks' assets and liabilities unchanged; the public sector's holdings of foreign exchange up by £X million and its debt up by £X million; and the private sector's holdings of gilts up by £X million and its holdings of foreign exchange down by £X million.

ii. In the first full paragraph on page 2, you say that sterilised intervention does not keep the exchange rate from rising. It is not clear why this should be so. Suppose we start from a position of equilibrium where the interest rates are keeping monetary growth close to the authorities' targets, and the exchange rate is showing no tendency to move one way or the other. Suppose there is then an increase in demand for sterling. The Government could attempt to hold the exchange rate by intervention, sterilising this by selling more gilts. The position is

then that the supply of sterling assets has been increased to match the increase in demand for sterling assets. The Government could short-circuit this process by selling gilts for foreign exchange. Why should this not prevent the exchange rate from rising? Why should it not be possible to sustain this indefinitely? I agree that it is difficult for the authorities to assess whether an increase in demand for sterling is transitory or permanent, but as a matter of theory I do not see why it should not be possible to hold the exchange rate indefinitely. This is of course possible only when sterling is rising as the opposite process comes to an end when reserves have been exhausted.

iii. At the bottom of page 2, you say that sterilised intervention is likely to increase the downward slope of the yield curve. In the Treasury's view of the world, it steepens the yield curve because the supply of gilts is being increased relative to short-term assets.

iv. At the top of page 3, you said that unsterilised intervention contributed to the monetary growth in 1987-88. The Treasury maintain that intervention was, other than over very short periods, sterilised throughout this period. How then was it contributing to monetary growth?

v. At the top of page 4, you state that if sterilised intervention has a positive effect it is only ephemeral. As indicated in ii above, I do not understand why this should be so.



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16 July 1989