

ANDREW TURNBULL

17 July 1989

INTERVENTION AND STERILISATION -  
1987 - 1988

On your comments dated 16 July:

(i) As I said, there are many definitions of sterilisation. I was concerned to define it so that we knew the principles which lay behind it. The normal definition among economists (eg the IMF) is one that leaves the quantity of high-powered money constant. I would contend that, since we target M0, this is a sensible definition for the UK. The Treasury quantity definition, however, is one which, through funding levels, holds a much broader aggregate constant - so that the private sector acquires gilts equal in market value to the intervention. This is a relevant definition if you are targetting a broad aggregate, but, since we simultaneously contend that the broad aggregates are misleading, it is clearly inconsistent to hinge the definition of sterilisation on such a disavowed indicator of monetary conditions. The "funding" definition of sterilisation is a hangover from the old days of credit control and targetting. We should, therefore, use M0 as our sterilisation standard and concentrate on the monetary, not the credit, conditions being held constant.

Alternatively, using the short interest rate criterion, instead of the M0 constant condition, we do have sterilisation in the sense that we sell bills to maintain the short interest rate. In fact, since short interest rates remain the same, Eddie George properly regards all intervention as immediately sterilised.

In my view, this interest rate definition is not as reliable or as useful as the M0-fixed definition. Many of the reasons for this view are obvious, but one is worth noting - we should be fixing the real rate of interest, not the nominal value.

(ii) Here you are implicitly postulating that there is always an infinitely elastic demand for gilts whatever the quantity in the portfolio of the private sector. You "suppose there is an increase in the demand for sterling" - but what you really mean is that there is an increased demand for highly transitory transactions sterling which is immediately sunk in buying gilts at the constant interest rate and exchange rates. The Government simply supplies the gilts and pockets the foreign exchange. You are then quite right. To simplify, if foreigners are willing to absorb unlimited quantities of gilts, the expansion of sterling is sterilised without affecting interest rates or exchange rates. This applies only if the additional (net) demand for sterling is a net movement in the demand curve for gilts. But is it not far more likely that the net demand increase would not be entirely for gilts? In which case, in order to sell gilts equal to the intervention, one would have to increase the interest rates.

But, *cet par*, that would attract a larger demand for sterling and so would drive up the exchange rate. This, in turn, would induce more intervention, more gilts sales to sterilise and higher interest rates, upward pressure on sterling, etc.

So far, this ignores the dynamics and expectations effect. I believe that these considerations will exacerbate the effects and render the system probably unstable. But that is a long story.



(iii) As I indicated on page 2, I do not think that the effect on the yield curve would be anything but very small. I doubt very much whether one would ever be able to discriminate between the Treasury (more gilts) result and the money market (more bills) result. The yield curve slope is determined primarily by expectations and is affected only to the extent that different policies on sterilisation generate different expectations.

(iv) I remain convinced that unsterilised intervention did contribute to monetary growth in 1987-88. In order to maintain the exchange rate, interest rates were reduced dramatically (on a first definition) and M0 grew faster (on a second definition) than it would have expanded without this intervention. ~~If it stood up to critical examination it would certainly be an important result.~~

(v) The ephemerality of sterilised intervention has been argued above. I would add, however, that all the studies I have ever seen confirm this empirically (using the M0 constant definition). If you know of a counter-example, I would very much like to review it. If it stood up to critical examination, it would certainly be an important result.

the Clack

P.P. ALAN WALTERS

cc Paul Gray

Professor Brian Griffiths

ce Patrick Walker to ~~George~~ Professor Griffiths This Page  
How do you reconcile your view (para 11) that there  
was some unsterilised intervention and that it added to  
growth of M0 with Treasury's (Bank view) that it was  
sterilised? Either you are saying that they did not  
succeed in sterilising (1) or that sterilisation was only a matter  
of broad funding / broad money but that at least of M0  
sterilisation was incomplete? 17 July 1989

AT  
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AT 18/7

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