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LONDON SW1A 2AA

From the Private Secretary

1 December 1986

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Dear Frank,

Prime Minister 2

You may be interested.
I don't know whether the
suggestion is worth anything.

OFF MARKET TRANSACTIONS

DRW

2/12

I wonder whether I could put to you a suggestion (which may well have been considered several times in the past).

A substantial part of the drop in the reserves in recent months, and no doubt before, has been caused by the Bank's understandable reluctance to off-set in the market the reserves used in meeting the Government's own foreign exchange commitments. It is obviously very difficult for the Bank to be seen to sell sterling when the rate is under pressure and the Bank may even be intervening to support it.

The problem here is the signal which may be given by the Bank's actions, rather than the extent of the transactions themselves, which are almost always tiny in the terms of today's markets.

A solution might be found if we could institute an arrangement to distinguish sterling sold or bought by the Bank to finance off market transactions and sterling sold or bought for market intervention reasons. The aim would be that transactions in the markets to finance the Government's own foreign exchange needs should carry no implication about the Government's intentions for the exchange rate.

One possibility would be to hold an auction at a particular time each day, with the Government's currency needs specified in advance. I do not know enough about the daily fixing carried out by the Bundesbank to be able to say whether an arrangement of that kind could be developed for our purposes. But my guess would be that off market transactions are too small for an elaborate arrangement to be justified.

An alternative possibility would be for the Bank to announce each day its expected foreign currency needs and

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to buy in the market that amount of currency at the same time each day. (If the Bank's estimate of its needs that day turned out to be wrong, an adjustment would be made to the figure for the following day.) At say, 1100, it would telephone two or three banks and ask them to make a price. Calls from the Bank at any other time of day would then unambiguously represent market intervention for exchange rate management purposes.

Clearly such an arrangement would reduce the Bank's flexibility. However, loss of flexibility is precisely what it is intended to achieve, because the exercise of discretion has tended over time to mean a continuing drain on the reserves - and their handling has become ever more difficult as the imbalance in the Government's own foreign exchange transactions has grown. The main loss would be that market participants would know clearly which of the two kinds of transactions the Bank was performing when they were asked for a price. But to my mind that would not be a high cost, since intervention these days is valuable far more for the signal it gives than for the direct effect of the money which is actually spent.

Forgive me for burdening you with this, but off market transactions clearly are a problem.

I am copying this letter to Alex Allan for his interest.

Yours ever,
David.

DAVID NORGROVE

Frank Cassell, Esq.,
H. M. Treasury