PO-CH/NL/0079

PART C

Part C.

SECRET

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Begins: 21/8/86
Ends: 27/2/87

PO -CH /NL/0079
PART C

Chancellor's (Lawson) Papers:

THE EXCHANGE MARKETS AND FOREIGN CURRENCY BORROWING

Disposal Directions: 25 Years

[signature]
26/7/95

PO -CH /NL/0079
PART C

SECRET

FROM: N J ILETT
DATE: 21 AUGUST 1986

SIR GEOFFREY LITTLER

cc: Mr Cassell
Mr Peretz o/r
Mr Kelly o/r
Ms Goodman
Mr McSharry

THE AUGUST RESERVES FIGURES

The Chancellor has asked for a note on the options on his return next Tuesday.

2. The table below shows market developments this month. The slight recovery over the past week or so is due to the weakness of the dollar (poor GNP figures) and the firmer oil price. Although the initial impact of the US interest rate cut was to weaken the dollar slightly, it is now more or less back where it was, in part on fear of G5 intervention. In cross-rate terms, sterling is still well down on the DM (though the DM has now climbed above the French franc on the EMS grid).

AUGUST	£ERI	$/£	DM/£	DM/$	YEN/$	Oil price
4	70.7	1.4680	3.0505	2.0780	153.82	$ 9.85 Aug
5	71.8	1.4840	3.1060	2.0930	155.12	$13.75
7	70.9	1.4755	3.0506	2.0675	153.72	$13.50
15	71.7	1.4943	3.0805	2.0615	153.93	$14.45 Sept
19	72.0	1.5036	3.0937	2.0575	153.46	$14.05
21 (opening)	71.7	1.4985	3.0742	2.0515	153.05	-

Memo items

i) Sterling touched record lows of DM 3.0316 on 11 August and Yen 225.12 on 4 August.

ii) The dollar touched a record low of Yen 152.55 and a 5 year low of DM 2.0425 on 20 August.

iii) ERM realignment 2/3 August (I£ devalued by 8%).

iv) US discount rate cut by ½% to 5½% on 20 August.

3. Last night's report estimated the underlying fall in the reserves at $358m (total $383m, reflecting $25m net repayments). The Bank may be able to get the

figure down a bit, but unless circumstances change (on which more below) not a lot. As things stand, we will take the largest fall in total reserves since December. Last month we published an underlying fall of £4m; the total fall was $105m.

4. The reasons this month are:

(a) the "ambuscade" on 4/5 August, when - on the Chancellor's instructions - the Bank spent over $120m in visible intervention to force the rate up;

(b) unusually low inflows from customers, ie. off-market transactions;

(c) thin August markets which have made it difficult to buy dollars on-market without being noticed, though this consideration has eased with the weakness of the dollar in the last few days ($15m bought on 19 August, $18m on 20 August).

5. (b) and (c) justify drawing on the forward book to smooth out erratic fluctuations in payments and receipts. But the main question is obviously what signal to give on the exchange rate.

6. My view is that we should confirm that we have been giving sterling some support without suggesting that sterling has been under heavy pressure, ie. show that we care. (As you know, last month's announcement gave rise to murmurs that the Government was indifferent to the fall in July.) This seems to point to a published underlying fall in the region of $150-200m. The total published fall would then be $175-225m, taking account of the net debt repayments; and on last night's figures we would take between $150m and $200m out of the forward book.

7. This course would mean that the positive reserves figures of the first six months of the year would be less useful as bull points; but the danger to the rate is surely the stronger argument.

8. The figures would of course be immediate background to the September operation, if that proceeds. This is again a matter of judgement, but I am inclined to the view that - particularly given the visible support early in August - an underlying

fall of $150-200m would not add significantly to the risk that the markets would decide that the September operation meant we were on the run.

9. Mr Gill (Bank) agrees with paras 6 and 7 above. I have not discussed para 8 with him.

N.J. Ilett

N J ILETT

PWP

FROM: F CASSELL
22 August 1986

CHANCELLOR

CAP

cc Sir P Middleton, or
Sir G Littler
Sir T Burns, or
Mr Peretz, or
Mr Ilett
Mr Richardson
Mr Ross Goobey

MARKETS

Over the past two weeks markets have been rather well behaved. After an initial further bout of weakness in sterling, associated with some substantial selling orders (including Boots financing of its US acquisition) the £ strengthened, helped by the growing belief that OPEC had put something together, and the ERI has remained fairly firm at around 71½. Interest rates have remained fairly steady. The attached note by HF gives details.

Last Tuesday, however, the downward revision to US growth in the second quarter sparked off expectations that the Fed would soon make another cut in its discount rate: US bond prices were marked up, the dollar moved down, and we had an afternoon of high activity in the gilts market that enabled us to sell £760 million of stock. This made total gilt sales of £1800 million for the banking month that ended on 20 August - a much better result than we had expected a week earlier.

On Wednesday evening the Fed duly cut its discount rate. However, this had virtually no immediate effect on markets, presumably because it had been so largely discounted. The centre of interest will now shift to the Germans. Their central banking council is, I understand, meeting next Thursday, amid expectations that they also will cut their discount rate; if they do, the Japanese may follow. The Bank has taken some relatively low key steps to discourage expectations that we would follow the Americans on their own: the markets seem to have got that message.

You will no doubt wish to consider our own position in the light of what the Germans and Japanese do. The conclusion at the August monetary meeting, which I took in Sir Peter Middleton's absence, was that on domestic grounds there was no case for reducing interest rates and that even if other countries reduced theirs, there could no longer be a presumption that we should follow.

This would still be my view. However, it is worth recording that the past week has brought one or two more reassuring signs. The good funding performance is one; the lower PSBR is another (though we must not jump to conclusions on this until we have seen the full effects of the PRT repayment on the half year's PSBR), so are the indications from the Halifax and the surveyors that the rise in house prices is levelling off.

Nonetheless, the key change since the last base rate cut, it seems to me, is that sterling has weakened at a time when the oil price has strengthened. This would incline me to be doubly cautious about an early reduction in interest rates - unless the exchange rate shows signs of moving up again.

F CASSELL

Background Note

	Interbank rates			Gilts					
	1 mth	3 mth	12 mth	Index	10 yr yield	FTSE 100	ERI	$	DM
8 Aug	10	9 15/16	9 7/8	88.9	9.57	1527	70.9	1.47	3.05
13 Aug	9 29/32	9 25/32	9 25/32	88.9	9.59	1581	71.5	1.49	3.07
15 Aug	9 15/16	9 25/32	9 21/32	89.2	9.55	1602	71.7	1.49	3.08
19 Aug	9 61/64	9 ¾	9 5/8	89.6	9.43	1604	72.0	1.50	3.09
22 Aug	10 1/32	9 27/32	9 5/8	89.7	9.38	1605	71.3	1.49	3.05

Money market rates have eased over the last fortnight on oil, sterling, and interest rates hopes. The softening had been gradual but steady, until hopes of an early rate cut in the wake of the US disappeared and caused a slight rise today.

The **gilts** market made some modest progress last week in quiet trading, and surged forward on Tuesday 19 August on the low July PSBR and the downward revision to the US GNP figures. The 2007 tap, which had been overhanging the market, was exhausted as gross gilt sales in banking August topped £1850m.

Equities have enjoyed a quiet but reasonably encouraging fortnight, helped by Wall Street and hopes of a reduction in interest rates.

Sterling touched an all time low of DM 3.03 on 8 August amid scepticism about the recent OPEC agreement. The pound gradually recovered as oil prices firmed, and rose briefly above $1.50, DM 3.09 on 19 August in quiet holiday markets. But some weakening in oil prices and the gloomy forecast from the NIESR caused some easing back. The failure of Germany and Japan to follow the ½% cut in the US discount rate on 20 August led to some further weakening of the **dollar**, although markets remained wary of the possibility of central bank intervention.

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SECRET

D of duplicate (I think treasure) CP ABOX

FROM: F CASSELL
22 August 1986

CHANCELLOR

cc Sir Peter Middleton, or
Sir Geoffrey Littler
Mr Peretz, or
Mr Ilett

HMG FOREIGN CURRENCY BORROWING

Following your meeting on 30 July the Bank have been having preliminary discussions with Credit Suisse/First Boston and Warburgs. These have gone encouragingly. The Bank's view is that there is a good prospect for raising $2½-3 billion on a straight ten-year FRN (with a penal put option at five years, and no call for the first five years). But the Bank advise pressing on with this urgently, since they believe that other governments are taking soundings in the market.

They therefore favour moving as early as possible, and have pencilled in a date of 8 September. This means that you will need to have a meeting next week (I understand your office is trying to fix one for Thursday morning) in which to take decisions on the key outstanding questions - eg the maturity and the offering technique.

The Bank will be sending over a technical paper* on the latter setting out a range of options, running from a straight syndication as last time to price-competitive mechanisms, such as auctioning among lead managers or final investors. The Bank themselves would not want to go to the latter end of that spectrum, and their paper will include examination of a possible intermediate position, in which, say, half the issue is placed and the other half left to be bid for among the management group.

The exact composition of that management group and how the British banks can be given more prominence in its public presentation is another subject you will wish to discuss at the meeting.

F CASSELL

*This has now arrived, copy attached.

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SECRET

IAN PLENDERLEITH
ASSISTANT DIRECTOR
HEAD OF GILT-EDGED DIVISION
01-601 4491

BANK OF ENGLAND
LONDON EC2R 8AH
22 August 1986

D L C Peretz Esq
HM Treasury
Parliament Street
London
SW1P 3AG

Dear David,

HMG $ BORROWING

I enclose, for your return on Tuesday, the paper we promised for the Chancellor setting out our proposals for the form and method of distribution of an HMG $ borrowing.

As you will see, we are proposing that we should be ready to bring the issue in the second week of September. To meet that timetable, we need to have decisions on the basic features covered in the attached paper as quickly as possible. It would therefore be very helpful if the meeting with the Chancellor could be organised as early as possible after the bank holiday break.

Yours ever,

Ian

HMG $ BORROWING

(Note by the Bank of England)

1 This note develops proposals for an HMG $ borrowing of $2 1/2-3 billion and seeks decisions on the form of the issue and on the method of distribution. Our aim is to be in a position to launch the operation - subject to market conditions - in the second week of September, post the holiday period and ahead of other borrowings of which we are aware.

The form of the borrowing

2 It is already agreed that for a one-shot operation of this size the only effective option is another FRN, and to avoid undue concentration of maturities we have concentrated on a basic 10-year term. Compared with a year ago the FRN market out to 10 years is a good deal broader, though still less so than at 5 years because many international institutions (eg IBRD) and central banks, as well as money market and bank traders, are restricted to 5-year instruments. For a straight 10-year issue we could now nevertheless hope to raise $2-2 1/2 billion on terms which would be only a few basis points more expensive than for a larger amount at 5 years.

3 There are two devices we could use to improve the chances of a successful issue of larger size, say, up to $3 billion without worsening the terms significantly -

(a) First, as with last year's FRN we could include a put option at the 5-year point, which would enable many of the otherwise excluded investors to participate. Since the aim would be to meet the formal requirement of these investors to be able to redeem their notes after 5 years, and not to offer a commercially attractive option, we would suggest that the put be on penal terms allowing redemption at a discount of say 100 bp to par. There are two circumstances in which such an option might be exercised - a severe deterioration in the UK credit, or a very major recovery in the credit standing of banks generally relative to that of sovereign borrowers. We judge that neither of these situations is sufficiently probable for a penal put option to be a serious risk. The consequences if the option were nevertheless exercised would be that we should not have succeeded in avoiding the bunching of maturities and would have that much more to do in refinancing or drawing on the reserves.

(b) Secondly, we could also offer a 5-year no-call provision. Given the existing FRN maturity it is unlikely that we would in fact want to call the new loan within a 5-year period, and the no-call provision in these circumstances would not give much away: the only situation in which it is likely to prove a constraint would be if sovereign credit <u>improved</u> dramatically relative to the credit standing of bank borrowers, eg if there were an <u>actual</u> world banking collapse, in which case we would be unable to take advantage of refinancing possibilities on finer terms for the no-call period. Against this, it would be an extremely attractive feature to investors who have recently suffered from early redemption by some other major borrowers, and it would greatly broaden demand by making new notes available as a basis for market-generated swap transactions for a definite 5-year period. Again, therefore, we would be strongly in favour of this feature.

4 It would be possible to raise smaller amounts - say, up to $1 billion in each case - in different forms alongside a 10-year FRN, which could then be for a lesser amount to reduce further the risks of overstraining the FRN market at that maturity. We have looked mainly at two such possibilities -

(i) A fixed rate bond which could be swapped into a floating rate liability at a lower all-in cost than a straight FRN (though this becomes more difficult for maturities beyond 5 years).

(ii) A perpetual FRN which would have attraction on maturity grounds but which would be more expensive than a 10-year FRN (say, over LIBOR rather than under LIBID, a difference of 1/8-3/16% a year).

These possibilities will not disappear if we do not take advantage of them at this particular juncture - they could be undertaken independently at a later date. We would advise against either being tacked on to the basic 10-year FRN because -

(a) they would be a substantial complication, making it difficult to get the market to focus its attention on what has to be the centrepiece of the overall funding, with the result that the market reception of the whole could be seriously adversely affected; and

(b) there would be a wider presentational risk that we would be seen to be scraping around in different parts of the market to put together a sufficient package and, in the case of the perpetual, which would be the first by a sovereign borrower, a risk of popular comment on the lines "first the family silver, now borrowing on the never, never, never". The counter-presentation that we were simply using different parts of the market for tactical advantage would risk, in our judgment, being seen as "too clever by half".

On this basis we think that a uni-tranche 10-year FRN issue, with the put option and call protection in paragraph 3, for $2 1/2-3 billion would give the best chance of a successful operation. It could be brought on the same record-low coupon (LIBID - 1/8%) as Denmark's recent $1 billion issue though at modestly higher all-in cost (after commissions and/or discount) of around LIBID -1/16%. This reflects the much larger amount into a market which already has our $2 1/2 billion issue from last year and the fact that the Denmark issue was in any case over-aggressively priced as is shown by its after-market performance (despite very substantial "stabilisation") and this experience will still be fresh in the market's mind.

Method of distribution

5 Last year's FRN was issued by the conventional syndication method, with the lead managers, CSFB and Warburg, controlling the distribution to ensure that the notes were placed with a wide range of investors from the outset, and standing ready to intervene to stabilise the market throughout the offering period,

so enabling further demand to build up on a firm foundation. It was by any standards a highly successful issue.

6 We are as confident as one reasonably can be that a straight repeat exercise, using the same lead managers and broadly the same management group, would again yield extremely fine terms with least risk of the operation being a visible failure. Last time's success itself (without which we could not realistically be planning the present exercise) would provide added confidence to the market if the same distribution formula was used.

7 Of course we recognise that there were complaints a year ago, particularly from intermediaries who would have liked to have had a more prominent role. These complaints were -

(i) We should have shown more favour to British houses. Our policy always is to "buy British" where we are satisfied that we are getting an equivalent service, but we could not responsibly advise HMG to buy an inferior service, especially for such a high profile operation. Our judgment remains that CSFB are outstandingly the best in this particular field, with Warburg (less certainly) the best British house. One of the loudest complainants (from one of the clearing bank groups) freely admitted privately that, had he been in our position, he too would in fact have used CSFB. Although league tables say very little, and nothing at all about the qualities which make one bank better than another, the tables for last year are nevertheless attached for what they are worth. We see no justification for changing a successful team for a virtually identical operation without positive reason for doing so, though we could, presentationally, give other British intermediaries greater prominence in the management group than we did a year ago.

(ii) The operation could have been done on finer terms. This of course is easily said after the event. At the time the unprecedently large issue was brought on extremely tight terms, and that was very much the theme of press comment at the time. Not one of our broad range of market contacts had suggested that the operation could be done on better terms before the event.

For these reasons we think the criticisms are ill-founded; and in any event we now have our existing issue to serve as something of a benchmark, so that we would have that much more confidence in the pricing of the new issue.

8 Although our view remains that HMG's interests would best be served by a conventional syndication, we accept both that any fixed-price offer - if it is very successful - is likely to produce criticism of this sort, and that it is not possible to demonstrate conclusively, to the complainant or other outside critics including the PAC, that there is no substance to the criticism. We have therefore reviewed possible alternative distribution techniques with some element of price competition.

9 There are a number of general points applying in greater or lesser degree to any technique of this kind in the context of a one-off offering of euro-notes and worth making at the outset -

(i) Any price competitive technique would involve setting the maximum size of the issue from the beginning - we could not, as last year, increase the size when we had established the success of the issue. This means there would be added risk in going for the somewhat larger amount.

(ii) Even if we went for the somewhat smaller amount, the obvious risk of embarrassment if we were seen to fail to raise the specified amount on terms appropriate to the UK's credit standing is such that we would certainly not advise going ahead with any issue using a price-competitive technique without underwriting.

(iii) Two factors would mean that the underwriting price would need to be set below the price that could be achieved on a conventional syndication:

- first, given the obvious purpose of price competition to demonstrate that we had achieved a market-clearing price at the time of the offer (ie that there was little or no demand at a higher price) many investors would be deterred from participating by the implied minimal scope for upwards price movement in the after-market.

- second, given that market intermediaries would not know in advance whether they would obtain any of the notes, they would not, to the same extent as in a conventional syndication, gear up their distribution capability actively to sell the notes to final investors.

(iv) We may nevertheless still benefit if the price "lifts off" from the underwriting price, but in these circumstances, for an FRN where the price can be determined more precisely than in the case say, of an equity or of a fixed-rate bond, this is most likely to happen as a result of "prestige" bidding by intermediaries without firm placing power aiming to buy league table position. In that case the issue is likely to perform poorly in the after-market, which would give a public impression of failure and damage the market reception of future HMG issues.

10 Two price-competitive techniques have been tried for issuing euro-FRNs hitherto -

(a) an invitation to bid confined to a handful of possible lead managers. This is the technique recently used by Denmark for its $1 billion LIBID - 1/8% FRN issue (of which half was to refinance an earlier issue), which was bought by Morgan Guaranty at a price of 99.77 1/2 but which has typically traded, in a very thin market, some 10-20 basis points lower than this. Although Denmark clearly obtained very fine terms on the issue, most of it has not yet been sold to investors, and this lack of success will certainly worsen the terms on which it trades, and on which Denmark can return to the market. With this example still so fresh in the mind intermediaries are likely to be more circumspect in the terms on which they might bid for a very much larger UK issue.

(b) a "retail" auction, with invitations to bid extended to a much wider range of intermediaries and final investors. This technique was tried by Sweden - with 80-150 invitations to bid - for two FRN issues (for $500 million and $700 million, respectively) in 1984, without conspicuous success, and subsequently discarded by Sweden itself in favour of conventional syndication. A particular disadvantage with this approach is that bidders would need to be given a few days to make up their minds during which there would be no form of price leadership or stabilisation, and during which market conditions generally could change adversely.

In the Bank's view either of these approaches would represent a considerable gamble: while it is possible that they could produce a successful issue, the odds for an issue of the intended size are against that outcome essentially for the reasons given in 9(iii) and (iv).

11 A variation on these approaches, which might improve those odds, would be on the following lines. The whole issue would be underwritten by a management group of about 30-35 intermediaries much as last year, consisting of lead managers and larger and smaller co-managers reflecting their known placing-power. Half of each managing intermediary's underwriting would be placed firm at the underwriting price, enabling the management group immediately to begin actively developing demand for the issue, as with a conventional syndication, and with the lead managers acting to stabilise the market in the normal way during this initial period. On this foundation the price-competitive element would be introduced by auctioning on a bid-price basis the other half of the issue, later on the same day, with each manager entitled to bid for the full amount he had underwritten. This would enable HMG to benefit from any price uplift resulting either from the managers' initial selling efforts or from "prestige" bidding by the managers themselves. If each tier of the management group were allocated half the underwriting of the tier above, it would enable a larger manager to end up with more notes than a lead manager, or a smaller manager to end up with more notes than a larger manager, if he were to bid more for them, so stemming any criticism of the way in which the bonds were allocated by the lead managers.

12 We think that with a structure on these lines the underwriting price, for the somewhat larger rather than smaller amount, would be very close to - and in practice indistinguishable from - the price for a conventional syndication, because it provides for a

greater degree of control and leaves scope for price uplift on the initially placed half of the issue. It goes some considerable way to provide a better defence against the criticisms of a successful conventional syndication. And it limits the risks of a poor after-market performance as a result of overaggressive bidding by a few very large intermediaries. If, therefore, there is to be a price competitive element in the distribution structure, we recommend that it should be in this form.

Questions for decision

13 This note invites the Chancellor -

(i) to agree that the form of the proposed $ borrowing should be $2 1/2 - 3 billion of a 10-year FRN, with a 5-year put option and a 5-year no-call provision, and that we should put ourselves in a position to launch the issue in the second week of September, subject to market conditions;

(ii) to decide whether the method of distribution should be by conventional syndication or incorporate some element of price competition; and if the latter, which of the alternatives.

Bank of England
22 August 1986

IFR

Issue 603 January 4, 1986

All Eurobonds 1985

Book runners only (full credit)

Rank	Managing Bank or Group	No of issues	Total US$m	Share %
1	CSFB	102	18.641.43	14.00
2	Merrill Lynch	49	8,199.73	6.16
3	Morgan Guaranty	62	7,843.66	5.89
4	Salomon Brothers	67	7,832.05	5.88
5	Morgan Stanley	65	6,835.57	5.13
6	Deutsche Bank	57	5,891.84	4.43
7	Goldman Sachs	41	5,409.42	4.06
8	Nomura	62	5,069.78	3.81
9	UBS (Securities)	26	3,732.73	2.80
10	Paribas	56	3,366.71	2.53
11	Orion Royal Bank	52	3,129.13	2.35
12	Daiwa	37	2,950.98	2.22
13	S G Warburg	35	2,559.73	1.92
14	SBCI	23	2,548.44	1.91
15	Bankers Trust	26	2,462.96	1.85
16	County Bank	8	2,339.24	1.76
17	Lloyds	9	2,322.52	1.74
18	Commerzbank	32	2,241.26	1.68
19	Yamaichi	32	2,228.64	1.67
20	Shearson Lehman	14	2,141.77	1.61
21	Societe Generale	23	2,087.35	1.57
22	CCF	23	1,917.07	1.44
23	Bank of America	8	1,869.51	1.40
24	Nikko	32	1,868.38	1.40
25	BNP	17	1,785.59	1.34
26	Samuel Montagu	7	1,782.45	1.34
27	Citicorp	13	1,442.80	1.08
28	Dresdner Bank	22	1,435.92	1.08
29	Barclays	7	1,379.27	1.04
30	Amro	25	1,283.78	0.96
31	Chase	12	1,116.42	0.84
32	Credit Lyonnais	11	1,080.82	0.81
33	Morgan Grenfell	13	986.58	0.74
34	ABN	19	967.21	0.73
35	Bank of Tokyo	13	863.74	0.65
36	Hambros	15	858.71	0.65
37	LTCB	11	819.28	0.62
38	IBJ	9	817.53	0.61
39	WestLB	14	767.45	0.58
40	Wood Gundy	12	662.00	0.50
41	Mitsubishi Finance	7	649.09	0.49
42	DG Bank	8	533.60	0.40
43	Sumitomo Finance	4	520.00	0.39
44	Manufacturers Hanover	7	501.09	0.38
45	Schroder Wagg	7	434.21	0.33
46	Kidder Peabody	5	432.84	0.33
47	Baring Brothers	6	407.64	0.31
48	BHF Bank	10	400.99	0.30
49	Kleinwort Benson	5	339.54	0.26
50	BBL	9	332.87	0.25
	Total of all Issues	**1,357**	**133,133.22**	**100.00**

Source: IFR International Bond Data Base

All Eurobonds 1984

Book runners only (full credit)

Rank	Managing Bank or Group	No of issues	Total US$m	Share %
1	CSFB	82	13.299.94	16.68
2	Morgan Guaranty	37	6,107.67	7.66
3	Deutsche Bank	56	5,251.61	6.58
4	Morgan Stanley	45	5,014.33	6.29
5	Salomon Brothers	31	4,624.45	5.80
6	Merrill Lynch	25	4,182.28	5.24
7	Nomura	34	2,513.20	3.15
8	Goldman Sachs	22	2.468.05	3.09
9	S G Warburg	24	1,946.90	2.44
10	Dresdner Bank	24	1,762.97	2.21
11	BNP	10	1,759.76	2.21
12	Paribas	17	1,725.34	2.16
13	SBCI	14	1,322.35	1.66
14	Daiwa	23	1,314.29	1.65
15	Amro	25	1,307.89	1.64
16	Societe Generale	12	1,275.04	1.60
17	Shearson Lehman	10	1,250.00	1.57
18	Orion Royal Bank	20	1,218.87	1.53
19	Commerzbank	19	1,162.36	1.46
20	Nikko	19	1,107.34	1.39
21	ABN	20	1,050.65	1.32
22	Barclays	2	950.00	1.19
23	Bank of America	5	910.00	1.14
24	Morgan Grenfell	12	862.93	1.08
25	Bankers Trust	7	840.00	1.05
26	County Bank	5	814.94	1.02
27	Yamaichi	17	810.00	1.02
28	Kidder Peabody	5	725.00	0.91
29	Wood Gundy	15	709.82	0.89
30	Samuel Montagu	8	694.02	0.87
31	Kredietbank	14	693.59	0.87
32	CCF	8	683.52	0.86
33	Manufacturers Hanover	7	681.67	0.85
34	Credit Lyonnais	8	607.14	0.76
35	Citicorp	8	578.74	0.73
36	WestLB	12	560.54	0.70
37	UBS (Securities)	6	490.70	0.62
38	Hambros	7	471.97	0.59
39	IBJ	5	464.54	0.58
40	Lloyds	2	445.00	0.56
41	Baring Brothers	5	419.99	0.53
42	Generale Bank	8	359.80	0.45
43	Smith Barney	3	300.00	0.38
44	J Henry Schroder	3	266.95	0.33
45	Hill Samuel	4	219.85	0.28
46	Mitsubishi Finance	3	204.21	0.26
47=	Chase Manhattan	2	200.00	0.25
47=	Svenska Handelsbanken	2	200.00	0.25
49	BHF- Bank	4	168.21	0.21
50	Bayerische Vereinsbank	5	161.26	0.20
	Total of all Issues	**821**	**79,753.09**	**100.00**

Criteria for League Management Tables:
International bonds with an international management group and which are listed or for which a genuine secondary market is maintained (for example Euroguilder issues which are privately placed but generally considered Euro-offerings). Among international issues not included are those for supranational entities in DM with domestic management group. Bonds are included as of launch date. Exchange rate as of launch date.

C/ content with
Sir G's recommendation
at X ?

SECRET

From: Sir G.Littler
Date: 22 August 1986

CR 22/8.

CHANCELLOR

Thanks. Content to show up to -150, but not more than that.
NL

c.c. Sir P.Middleton
Mr Peretz
Mr Kelly
Mr Ilett
Ms Goodman
Mr McSharry

THE AUGUST RESERVES FIGURES

enclosed unfolded behind

I attach a note by Mr Ilett. Mr Cassell has put separately to you notes on the markets and a note on possible borrowing.

2. Normal dealings for August will end on Weds 27 August. We can adjust on forwards over the following two days. Barring any unforeseen transactions we expect to end the month with an "underlying" figure of -350 (all figures in $ million). It has not been a dramatic month, but we were known to have intervened in support of sterling in the first week or so. I think we should show a minus, but not as much as - 200.

X

3. My recommendation is to go for about -150 (say +/-20 if we have net last-minute dealings), which on present form would mean taking 200 from our accumulation of forwards.

4. It would be helpful to know your reaction by Weds morning, but if you wanted to discuss further at our meeting on markets on Thursday, we would still have time to adjust forwards after that.

(Geoffrey Littler)

SECRET

B/F Thursday's meeting

FROM: F CASSELL
22 August 1986

CHANCELLOR

cc Sir Peter Middleton, or
Sir Geoffrey Littler
Mr Peretz, or
Mr Ilett

HMG FOREIGN CURRENCY BORROWING

Following your meeting on 30 July the Bank have been having preliminary discussions with Credit Suisse/First Boston and Warburgs. These have gone encouragingly. The Bank's view is that there is a good prospect for raising $2½-3 billion on a straight ten-year FRN (with a penal put option at five years, and no call for the first five years). But the Bank advise pressing on with this urgently, since they believe that other governments are taking soundings in the market.

CASSELL → CHEX 22/8

They therefore favour moving as early as possible, and have pencilled in a date of 8 September. This means that you will need to have a meeting next week (I understand your office is trying to fix one for Thursday morning) in which to take decisions on the key outstanding questions - eg the maturity and the offering technique.

Yes, 9.30am on Thursday

The Bank will be sending over a technical paper* on the latter setting out a range of options, running from a straight syndication as last time to price-competitive mechanisms, such as auctioning among lead managers or final investors. The Bank themselves would not want to go to the latter end of that spectrum, and their paper will include examination of a possible intermediate position, in which, say, half the issue is placed and the other half left to be bid for among the management group.

attached

The exact composition of that management group and how the British banks can be given more prominence in its public presentation is another subject you will wish to discuss at the meeting.

F CASSELL

*This has now arrived, copy attached.

SECRET

HMG FOREIGN CURRENCY BORROWING

22/3070D

SECRET

? NZ

FROM: N J ILETT
27 August 1986

A few marginalia.
[initials] 27/8

1. MR PERETZ
2. CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Culpin
Mr Kelly o/r
Ms Goodman o/a

ILETT → CH/EX 27/8

HMG FOREIGN CURRENCY BORROWING

You may find it helpful to have a note in advance of tomorrow's meeting. EF/MG have no fundamental difficulty with the Bank's proposals, as set out in the letter attached to Mr Cassell's submission of 22 August, but a number of points are worth further examination.

Market conditions

2. You will be considering immediate market questions at the meeting, and the German decision will have been announced by 1pm our time. The question for the borrowing operation is whether, given sterling's relative fragility over the past few weeks, an own-name operation would actually worsen confidence because we would be thought to be on the run. This decision can of course be left to the last minute (though if the operation was cancelled at the last minute for foreign exchange market reasons, and that became known, the effect could be damaging). As things stand there is no reason not to go ahead.

seems implausible

3. The Deputy Governor will no doubt bring you up-to-date on conditions in the euromarkets. EF has seen nothing to suggest that markets are moving against us, though there are press rumours of further sovereign interest at least in the fixed interest rate sector.

The FRN

4. The Bank has asked for decisions on the form of the issue and on the method of distribution. On the main points:-

(a) Maturity

The Bank's ten year maturity would put repayment well beyond the present "hump" in 1990-1994 (see Annex 1). This is clearly satisfactory. There are, however, arguments for taking advantage of the trend towards perpetuals. First, we would be the first sovereign to issue a perpetual, which would help quite a lot in presenting the issue as breaking new ground, borrowing from a position of strength etc. Second, there is the obvious advantage on maturity. Arguments against, as the Bank says, are costs of up to 3/16% a year, ie $5½m on a $3bn issue. The implication of the Bank's paper is that we could not raise $3bn on a perpetual; if so, that does not square with what some of our own market contacts have been saying. The Bank has also argued that a perpetual could be harder to defend politically, though some of us have difficulty in following that argument. The basic question is whether a perpetual is worth the cost.

In fact the Bank would not recommend going for more than £1½bn ← $? for a perpetual, so if we accept their advice and want to go for £3bn in a single operation, this option is not on.

DCL

(b) Call/put features

Last year's experience confirms the wisdom of the proposed 5 year put as a technique for encouraging central bank demand; and the penal terms suggested for this year (redemption at a discount of 100bp to par) seem unlikely to prejudice the operation. The Bank's suggestion that we should offer a five year no-call provision is perhaps rather more awkward. Under normal circumstances we are of course unlikely to wish to call the issue within 5 years, given our existing repayment obligations. Last year, however, the Bank pointed out that a call option provided protection against market changes such as LIBOR becoming unrepresentative. This argument still applies, unlikely as such developments may seem over the next five years. (You may remember the French Treasury issuing a domestic bond linked to the gold price and living to regret it!) On the other hand, the Bank argues that the no-call provision would greatly broaden demand and so help sell a $3bn issue — which may not otherwise be easy, with a 10 year maturity.

?

Quite difficult ✓

(c) Pricing

The Bank points out that although we could achieve LIBID -1/8, ie the same record low as the recent Denmark $1bn

-1/16 for us according to Bank.

issue, the all-in-cost would be slightly higher than Denmark at around LIBID -1/8. It is true that the Denmark issue was over-aggressively priced and that its trading performance will not help Denmark borrow next time. On the other hand, the Danish Government has got its currency cheaper and there may be a choice between preserving the best possible market reputation, obtaining good marks in the specialist press etc, and getting the cheapest possible funds. The Bank has a tendency to go for the former whatever the circumstances; so you might press them to be a little more aggressive, though something turns on whether we think we are likely to want to go back to the market again before long, or not. (Paragraph 9 below is relevant).

Method of sale

5. The Bank would clearly prefer a straightforward syndication, as last time; and their arguments against the two price-competitive techniques so far used (paragraph 10 of their paper) are convincing. (These techniques were essentially invitations to bid at the wholesale level (Denmark recently) and at the retail level (Sweden 1984).) If you judge some element of price competition essential, the Bank proposes a new technique, with half the issue placed conventionally at a firm price and the other half auctioned among the members of the management group which unwrite the first half. This would give considerable help presentationally against criticism that we had not done enough to get the best possible deal, and would also be more consistent with the Government's general stance on competition. As with other competitive procedures, the Bank's compromise would mean that we would have to fix the size of the issue in advance, and so take a bit more of a risk in going for $3bn from scratch. Also, it could at least in theory bring the return to HMG below what a conventional syndication would have achieved just as well as above. But given the Bank's advice that it should not be more expensive, on balance EF/MG are inclined to go for the Bank's compromise rather than conventional syndication given the presentational advantages, and despite the disadvantages of having to fix the amount from the outset.

Choice of lead managers

6. The Bank would like to use CSFB and Warburgs again.

Unfortunately we are scarcely in a position to organise a "beauty contest", given the need for secrecy and the time constraints. As last year, the choice of CSFB is just about inevitable unless the success of the issue is to be brought into question for the dubious benefit of employing some alternative non-UK organisation. Warburgs is a less obvious choice and could, for example, be replaced by one of the UK clearers. However, we have very little time indeed if we are to launch the issue on 8 September, so for practical reasons there is a good deal to be said for using the same people as last time.

Presentation

7. If there is time, you might like to give some initial consideration to presentation at the meeting. The objective is presumably, as last time, to handle the operation in as low-key a manner as possible. We are working on the briefing. Subject to further reflection, notably by Mr Kelly when he returns from leave on Monday, we are inclined to suggest that the issue should be presented as building on the success of last year's FRN and having the same purpose, ie reflecting the judgement of the appropriate level of foreign currency reserves for the UK to hold at a time of continued exchange market uncertainty; prudential financial management eg in relation to the official debt repayment profile; no immediate intention of using the proceeds, but available for use if needed; events of the past 12 months have confirmed the importance of holding adequate reserves; no change on the ERM etc.

Potential for UK tax evasion

8. The Inland Revenue have asked me to draw to your attention that an HMG issue on the same UK tax terms as last year, namely in bearer form and with interest paid gross, will provide an additional route for UK residents to avoid tax. The Revenue accepts that the euromarkets already provide ample opportunity for UK residents to do just that, but suggest that Ministers should consider whether it is appropriate for the Government to issue such instruments itself. Lesser Revenue difficulties are that there would also be a loss through delayed payment of

tax as investors account for the tax themselves rather than pay through deduction at source, and extra administrative costs in assessment and collection. The view taken last year was that these consequences are an inevitable result of going to the euromarkets and therefore a necessary cost of the operation. I do not think the Revenue would be surprised to learn that you take the same view this time round, but I have undertaken to pass the point on.

Exchange cover scheme borrowing

9. The table at annex 2 shows how the routine foreign currency borrowing programme is going. The objective is to refinance all maturing debt, including own-name HMG borrowing, through new ECS borrowing. We more than met this objective in 1985, after a difficult year in 1984, and if all goes as planned (including a $300m operation with the European Investment Bank and Salomons for BNFL in October) we shall again meet this year's objective. Prospects for 1987 are, however, uncertain; we shall have to find $1.5bn, rather more than in recent years, and we now rely very heavily upon the South of Scotland Electricity Board and BNFL, both on nuclear projects. It is too early to assess the prospects for 1987, because industries' borrowing plans are uncertain. A lot will depend on whether the National Coal Board can be used. My advice, subject to these uncertainties, is that there must be serious doubt whether we can use the routine borrowing programme to finance all of next year's repayments.

This is probably best left for EST to consider on his return.

10. There is, however, some difficulty in using doubts about the future of the exchange cover scheme as a justification for borrowing in the Government's own name. You may recall that the Prime Minister thought last year that the argument that privatisation was so successful that there were no industries left to use as exchange cover scheme borrowers might provoke the response that the Government had sold off the family silver and was now running up more debts.

We wouldn't need to use this justification.

N.J. Ilett.

N J ILETT

ANNEX 1

Maturity profile of scheduled official debt repayments:

	$M
1987	1411
1988	1158
1989	883
1990	1191
1991	1012
1992	3414
1993	866
1994	1059
1995	923
1996	678
1997	304
1998	281
1999	285
2000	218
2001 onwards	484

Note 1 figures include all official debt, including HMG own-name, assigned British Airways loans, and exchange cover scheme loans.

Note 2 non-dollar debt translated into $s at end-June 1986 rates.

S E C R E T

ANNEX 2

Exchange Cover Scheme borrowing/repayments

$m

	new borrowing	repayments (all official debt)	net
1984	1306	1400	- 94
1985	1592	1063	+529
1986 H1	750	640	+110
(estimate) H2	810	625	+185

For a more detailed account, see paras 15-20 of Mr Kelly's submission to the Chancellor of 24 July 1985 on HMG Foreign Currency Borrowing.

1/3065

Thanks. What were (a) spot reserves and (b) official foreign currency indebtedness @ end-April 1979? N

SECRET

FROM: D McSHARRY
29 August 1986

1. MR ILETT ~~ILETT~~ N J Ilett 29/viii
2. PRINCIPAL PRIVATE SECRETARY

cc Sir P Middleton
Sir G Littler
Mr Peretz
Mr Kelly o/r
Ms Goodman o/r

CHANGES IN THE RESERVES SINCE LAST YEAR'S $2.5bn FRN ISSUE

The Chancellor has asked for a table showing changes in the reserves since the issue of the $2.5 billion floating rate notes in September last year. The attached table shows that after allowing for the FRN issue, there has been a small increase in the spot reserves since last October (excluding valuation changes) of $303 million. This comprises $135 million of net intervention and $168 million of net borrowing (under the exchange cover scheme).

2. On the Chancellor's second question, if we were to add $3 billion to the reserves, the new level of spot reserves of around $22 billion would be the highest since March 1982 when the reserves stood at $23,187 million (prior to the revaluation); after the 1982 revaluation the reserves moved down to $18,969 million. The lowest the reserves have been under the present administration is $14 million in May last year. (The highest under Labour was $21.9 million in March 1979. The peak of Labour's official debt was $25.5 million in December 1977; a $3 billion FRN would increase present official debt to around $18 billion. Even so, net reserves are still $5 billion higher than they were in April 1979.)

Peak was over $28bn in 1981

Ch
You were right in thinking that we have not "spent" any of last year's $2.5bn.
AA
29/8

D. McSharry

D McSHARRY

3/3065

SECRET

CHANGES IN THE LEVEL OF THE RESERVES (SPOT AND FORWARD) SINCE SEPTEMBER 1985

$ MILLION

	Underlying change (ie total spot intervention	Net borrowing	Change in reserves (excl. valuation changes)	Valuation changes	Total change in spot reserves	Level of spot reserves at end-period	Change in forward book (excl. revaluation)
1985 Sept (pre-FRN)	- 97	+ 17	- 80	-	- 80	14,176	+ 75
Oct (post FRN)	-324	+2650	+2326	- 192	+2134	16,310	-
Nov	-201	- 133	- 334	-	- 334	15,976	- 1
Dec	-416	- 17	- 433	-	- 433	15,543	- 172
1986 Jan	+132	+ 63	+ 195	- 178	+ 17	15,560	- 53
Feb	+112	+ 138	+ 250	-	+ 250	15,810	+ 220
Mar	+278	+ 157	+ 435	+2505	+2940	18,750+	+ 120
Apr	+264	- 19	+ 245	- 8	+ 237	18,987	+ 294
May	+138	+ 41	+ 179	-	+ 179	19,166	- 62
June	+291	- 269	+ 22	-	+ 22	19,188	+ 52
July	- 4	+ 82	+ 78	- 183	- 105	19,083	- 92
Aug*	-135	- 25	- 160	-	- 160	18,923	- 148
Total change (since ~~Oct~~ Sep 85)	+135	+2668	+2803	+1944	+4747		+ 158

* Estimate

\+ after the annual revaluation

PUP

SECRET

FROM: DAVID PERETZ
1 September 1986

MR ALLAN

cc PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Kelly
Mr Ilett
Ms Goodman

1986 FRN

I attach as we agreed a short note that the Chancellor could have with him when he speaks to the Prime Minister about this this afternoon. It is written in the form of a note that the Chancellor could leave with the Prime Minister if he thought it would be helpful to do so.

DLCP

D L C PERETZ

Ch

As requested – and I've now found record (such as it is) of when you last discussed it with PM. – attached

AA
1/9.

17/3070E

SECRET

FOREIGN CURRENCY BORROWING: PROPOSED 1986 FRN

The Prime Minister agreed in May that a further foreign currency borrowing could be mounted if a suitable opportunity arose, preferably during a recess.

Timing

2. It looks as though market conditions are now right for an issue even larger and on better terms than last year. Work is therefore in hand to make an issue of eurodollar floating rate notes as soon as possible, either on 3rd or 8th September. A final decision on the date will need to be made on 2 September.

Size

3. The issue is planned to total $3bn, and would be increased if demand permits.

Terms

4. Terms should be equal to the finest currently available in the market. The Bank of England will be aiming for the finest possible terms consistent with a successful operation. On present estimates, the all-in cost may be 6 or 7 basis points below LIBID. This is better than New Zealand recently achieved on a much smaller issue; and Denmark's attempt to do still better last month was very poorly received. It will again be the largest operation of its kind ever in the euromarkets.

Maturity

5. The issue will carry a 10 year maturity (1985 issue had a 7 year maturity). It is sound financial management to spread and lengthen the repayment profile for official debt. There is currently a negligible difference in cost for this somewhat longer term money. But in order to boost demand for 10 year

notes, two technical devices are being incorporated; a 5 year no-call provision and a 5 year put option (the latter on penal terms). The slight risk of additional cost attached to these devices is worth taking to get the extra demand, particularly from central banks many of which are debarred from formally committing themselves for more than 5 years.

Management

6. There will be a repeat of last year's conventional syndication. We have considered the alternative of a competitive tender, but syndication avoids the risk there would be in a competitive tender of obtaining worse terms, and leaves the way open to increase the amount beyond $3bn if the demand is there.

7. The lead managers will be the same as last year: Credit Suisse, First Boston, who are world leaders by a considerable margin, and Warburgs, the largest British house in the market. CSFB could not be replaced with a British house on an operation of this size without an unacceptable risk of failing to meet our objectives. The Bank of England have however been instructed to give as much prominence as possible to the contribution of British banks to the wider management group. Nevertheless, no doubt there will be complaints.

Presentation

8. It is proposed to present the issue in as low key a manner as possible: essentially as a repeat of last year's operation, and with the same purpose, namely to borrow from a position of strength so as to ensure that we hold adequate reserves in a time of unsettled currency markets. Using the same team and the same method of sale should help this presentation. Also, it enables us to move faster.

PWP

19/3070E

Note
Passed drafting comments on to Mr Kelly
AA 2/9

S E C R E T AND PERSONAL

FROM: C W KELLY
1 September 1986

CHANCELLOR

Ch
A few comments at passim.

cc EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Peretz
Mr Illett
Ms Goodman
Mr Hosker T.Sol
Mr Woodall IDT

1986 FRN

We will be submitting final advice to you on pricing tomorrow morning with a view to taking a final decision about whether or not to proceed tomorrow night. At present the omens still look fairly good.

2. The exact timing of the announcement is still being discussed with the lead managers. But it seems likely that we will be following much the same pattern as last time. This would involve:-

(i) A one sentence announcement read over the phone by Press Office to Reuters at about 8.30am, immediately before the lead managers begin to ring the selling group.

(ii) A slightly more detailed but still very low key factual press notice to be issued a short while afterwards. We will let you have a draft of this tomorrow.

This shd closely resemble last year's

(iii) The Bank of England will be calling in the market correspondents of the heavies to make certain that they understand the technical details of the issue and present the terms in the most favourable light. It would be out of keeping with the low key approach we are adopting for us to do the same with the economic/political correspondents. But, as they did last time, Press Office will contact the four

I have doubts / Comments on this

majors on the phone to steer them in the right direction. They will also be indicating that Mr Peretz and/or myself will be available to answer any questions. In the absence on leave of both Mr Culpin and Mr Pickford, Mr Woodall will be handling this end of things.

hmm!

3. We have also been working on a background briefing note. I attach the current version, which still requires further work.

attached

4. In particular, we have not yet fully taken onboard the points recorded in Mr Allan's note of 1 September. We will do this in the next version.

5. There is no difficulty in demonstrating that the new debt is on better terms than the Labour debt repaid earlier. The most obvious comparisons are with the syndicated credits of $2.5bn taken out initially in March 1974 and $1.5bn taken out in February 1977. The first was at LIBOR plus $^3/_8$ rising to LIBOR +$^3/_4$ for the last three years. The second was at LIBOR +$^7/_8$ rising to LIBOR +1%. By comparison we are hoping to get an all in cost of something like LIBOR -20 basis points.

good stuff

6. It is also true, as you suggest, that a significant part of the Labour debt was from the IMF rather than from the markets.

Not quite so telling

	$ billion		
	Total official debt	IMF	IMF debt as % of total
End 1977	25.5	4.1	16
End March 1979	23.3	2.3	10
End August 1986	15.2	-	-

7. We can certainly make something of this, not forgetting:-

(i) That as the table shows the Labour Government themselves repaid a fairly substantial part of the IMF debt and

(ii) that part of it (the oil facility) was on very favourable terms, which was why as Financial Secretary you took a deliberate decision not to repay it earlier.

8. We are keeping knowledge of this operation to as restricted a circle as possible. The secrecy of the last one was one of the factors behind its success. The speed with which we are now proceeding should help.

9. But for the record I should perhaps say that if there should be any sort of leak between now and next Wednesday our proposed line would be something like:-

(i) Of course we continue to keep borrowing opportunities under review. We do this all the time as part of prudent reserves management.

(ii) But for obvious market reasons we are not prepared to confirm nor deny any rumours about particular options.

10. In principle the least said the better.

CWK

C W KELLY

2/3065-1 **SECRET** AND PERSONAL

DRAFT BRIEFING: 1986 FRN

Factual

- [Details of issue; size, timing, managers etc.]

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

Line to take

- The issue ~~builds on the success of~~ is essentially the 2nd stage of the process begun with last year's FRN ~~[even larger, and better terms.]~~ and has the same purpose, ie, taking a favourable opportunity to strengthen the ~~[it reflects judgement of the appropriate level of]~~ the UK's foreign currency reserves ~~[for UK to hold]~~ at a time of continued exchange market uncertainty.

- ~~The objective is to place the UK's external finances on an even sounder footing.~~ The issue increases the UK's stock of currency reserves by X and brings them more into line with those held by other countries.

- This operation, (which is ~~slightly~~ larger than last year's, and on better terms,) extends the maturity of foreign currency borrowings into the late 1990s.

- 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 ~~[volatility of dollar, G5 coordinated intervention]~~ have confirmed the importance of holding adequate reserves, although in fact ~~[illegible]~~ the proceeds of last year's FRN have not so far req? been used at all.

Defensive

ERM?

No change in our position.

SECRET

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.

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, ie immediately after the 1985 FRN.

Table

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

Increase accounted for by exchange cover scheme borrowing (net of debt repayments) ($ 0.1 b), valuation changes ($ 0.9 b) and other transactions (broadly net intervention) ($ 0.1 b).

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.

Good

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 ~~(While gross reserves will be slightly higher than~~ below peak, without any reduction in gross reserves. Moreover the new issue is on very fine terms indeed. 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 expensive liabilities we did not need.

And NB: (i) Even so, net reserves are $4 billion higher than they were in April 1979 (as a result of valuation factors, SDR allocations and moderate amount of intervention).

(ii) The UK's total net external assets, private and public sector combined, have increased almost seven-fold ~~by over £68 billion~~ since the end of 1979 (from £12.0 billion at end-1979 to £80.4 billion at end-1985 — 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 intervention.

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.

UK now regular market participant

We have a regular programme of foreign currency borrowing through nationalised industries. This will continue. As last year, this particular issue is so large that it is being made in the Government's own name; and it takes advantage of favourable market conditions. But there is no plan for the Government to make regular own-name market issues, nor is there any need for the Government to do so.

Comparisons with other sovereign borrowers

[Will be covered in Bank's factual brief.]

OFFICIAL DEBT AND RESERVES FACTSHEET

Level of official reserves

$ billion

End-period	Total	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.

Peaks and troughs **$ billion**

		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

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.

SECRET

CHANGES IN SPOT RESERVES, 1979-86

$ million

		Underlying change (ie total spot intervention)	Net Borrowing	SDR Allocations	Total change in reserves (excluding valuation changes)	Valuation changes			Total change in reserves	Level of gross reserves at end of period
						EMCF	Annual revaluation	T		
1979	1	+1,244	+149	+367	+1,760	-	+4,493	+4,493	+6,253	21,947
	2	+1,577	-1,454		+123	-	-	-	+123	22,070
	3	+779	-447		+332	+349	-	+349	+681	22,751
	4	+83	-322		-239	+207	-	+207	-32	22,719
1980	1	+1,126	-519	+392	+999	+341	+2,904*	+3,245	+4,244	26,963
	2	+537	-259		+278	+931	-	+931	+1,209	28,172
	3	+605	-1,198		-593	+58	-	+58	-535	27,637
	4	+450	-693		-243	+82	-	+82	-161	27,476
1981	1	+355	-1	+373	+727	+266	-257	+9	+736	28,212
	2	-136	-2,674		-2,810	+229	-	+229	-2,581	25,631
	3	-1,124	-872		-1,996	+61	-	+61	-1,935	23,696
	4	-67	-108		-175	-174	-	-174	-349	23,347
1982	1	+12	+29	-	+41	-201	-4,218	-4,419	-4,378	18,969
	2	-908	-281		-1,189	-77	-	-77	-1,266	17,703
	3	+490	+72		+562	+34	-	+34	+596	18,299
	4	-1,153	-397		-1,550	+248	-	+248	-1,302	16,997
1983	1	-858	-59	-	-917	+211	+1,046	+1,257	+340	17,337
	2	+221	+11		+232	+145	-	+145	+377	17,714
	3	+22	+64		+86	+102	-	+102	+188	17,902
	4	-329	+173		-156	+71	-	+71	-85	17,817
1984	1	-259	+174	-	-85	-4	-979	-983	-1,068	16,749
	2	-418	-744		-1,162	-82	-	-82	-1,244	15,505
	3	-415	+83		-332	+87	-	+87	-245	15,260
	4	+16	+391		+407	+27	-	+27	+434	15,694
1985	1	-241	+204	-	-37	-18	-2,111	-2,129	-2,166	13,528
	2	+538	+215	-	+753	+37	-	+37	+790	14,318
	3	-142	+104	-	-38	-104	-	-104	-142	14,176
	4	-941	+2,500ø	-	+1,559	-192	-	-192	+1,367	15,543
1986	1	+522	+358	-	+702	-178	+2,505	+2,327	+3,029	18,750
	2	+693	-247	-	+438	-8	-	-8	+430	19,188
July		-4	+82	-	+78	-183	-	-183	-105	19,083
August		-141	-18		-159	-	-	-	-159	18,924

* includes $80 million IMF gold restitution.

ø includes $2,500 FRN issue

Note: The information above is published in the monthly reserves press notice.

SECRET

CHANGES IN THE LEVEL OF THE RESERVES (SPOT AND FORWARD) 1979-1986)

$ million

		Market	Off-Market	Total intervention	Net borrowing	*Total change in reserves	UK official spot reserves (at end period)	Sterling exchange rate index (1975=100)
1979	Q1	+2375	- 163	+2212	+ 495	+7200	21,947	82.4
	Q2	+1747	+ 146	+1890	-1454	+ 436	22,070	87.0
	Q3	+1224	- 397	+ 827	- 447	+ 380	22,751	91.3
	Q4	- 166	- 332	- 498	- 322	- 820	22,719	88.5
1980	Q1	+ 417	+1626	+2043	- 47	+4900	26,963	93.0
	Q2	+ 805	+ 2	+ 807	- 259	+ 548	28,172	94.5
	Q3	+ 378	+ 224	+ 602	-1198	- 596	27,637	96.7
	Q4	+ 420	- 191	+ 229	- 693	- 464	27,476	100.2
1981	Q1	+ 428	+ 352	+ 780	+ 372	+ 895	28,212	101.8
	Q2	- 313	- 452	- 765	-2674	-3439	25,631	97.8
	Q3	-1316	+ 145	-1171	- 872	-2043	23,696	90.6
	Q4	- 246	+ 9	- 237	- 108	- 345	23,347	89.7
1982	Q1	+ 122	- 21	+ 101	+ 29	-4088	18,969	91.2
	Q2	- 404	-1104	-1508	- 281	-1789	17,703	90.3
	Q3	+ 569	- 23	+ 546	+ 72	+ 618	18,299	91.5
	Q4	-1413	- 208	-1621	- 397	-2018	16,997	89.1
1983	Q1	- 183	- 691	- 874	- 59	+ 113	17,337	80.5
	Q2	+1094	- 728	+ 367	+ 11	+ 377	17,714	84.3
	Q3	+ 709	- 550	+ 159	+ 64	+ 223	17,902	84.9
	Q4	+ 250	- 632	- 382	+ 173	- 209	17,817	83.2
1984	Q1	+ 764	- 998	- 234	+ 174	- 856	16,749	81.7
	Q2	+ 321	- 783	- 462	- 744	-1206	15,505	79.8
	Q3	+ 201	- 739	- 538	+ 83	- 455	15,260	78.0
	Q4	+ 764	- 635	+ 129	+ 391	+ 520	15,694	75.1
1985	Q1	+ 409	- 682	- 273	+ 204	-2180	13,528	72.1
	Q2	+ 987	- 212	+ 775	+ 215	+ 990	14,318	78.9
	Q3	+ 351	- 423	- 72	+ 104	+ 32	14,176	82.1
	Q4	- 473	- 641	-1114	+2500	+1386	15,543	79.8
1986	Q1	+ 428	+ 381	+ 809	+ 358	+3672	18,750	75.1
	Q2	+1439	- 462	+ 977	- 247	+ 730	19,188	76.0
	July	+ 159	- 255	- 96	+ 82	- 14	19,083	74.0
	Aug	- 102	- 184	- 286	- 18	- 304	18,924	71.4

* including end-March valuation changes (Q1)

SECRET

pwp

10 DOWNING STREET

From the Private Secretary

1 September 1986

Dear Alex,

FOREIGN CURRENCY BORROWING

The Chancellor this afternoon described to the Prime Minister the present plans for mounting a foreign currency borrowing through a floating rate note. The amount would be $3 billion, over 10 years, and the terms might well be finer than the issue mounted last year. The intention would be to syndicate the issue on Wednesday this week, market conditions permitting.

The Prime Minister was content with this proposal. She was however concerned that the greatest possible care should be taken with the presentation. The issue might attract headlines in view of the dearth of other news at present.

Yours

David.

(DAVID NORGROVE)

Alex Allan, Esq.,
H.M. Treasury.

CH/EXCHEQUER

REC.	2-SEP 1986
ACTION	MR PERETZ
COPIES TO	SIR P MIDDLETON SIR T BURNS SIR G LITTLER MR CASSELL MR C KELLY MS GOODMAN

✓ 2/9

SECRET

SECRET

cc CST
PMP

FROM: C W KELLY
2 September 1986

PRINCIPAL PRIVATE SECRETARY

cc PS/EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Peretz
Mr Illett
Ms Goodman
Mr Woodall
Mr Hosker T.Sol
Mr Plenderleith B/E

THE FRN

I attach a revised version of the background briefing which takes account of the Chancellor's comments on the previous version. You may want to send a copy to Mr Norgrove.

done AA

CWK
C W KELLY

Ch Ch
This takes on board your comments
AA
2/9.

SECRET

2/3065-1

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 seven-fold 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

$ billion

End-period	Total	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
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May 1978	$350 mn	$ bond issue in New York: $200 mn with a 7 yr maturity and $150 mn with a 15 yr maturity.	Fixed rate 7 yr : 8½% 15 yr : 8 7/8%	7 yr bonds repaid in May 1985. 15 yr bond due 1993
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$ billion

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6/5

INTERNATIONAL COMPARISON OF RESERVES

June 1986, $ billion

	Total*	of which convertible currencies
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France+	35.1	29.5
Italy	22.6	18.3

* gold valued at SDR 35 per oz

\+ May data.

25/3070E

SECRET AND PERSONAL

OK.

* Content with existing press notice 2, tho' there sh[oul]d be a new note 2 which sh[oul]d cover last year's issue. Pse could we see a draft of this ASAP. (The old note 2 was of course heavy with background briefing). N.

FROM: C W KELLY
2 September 1986

CHANCELLOR

Ch
OK to go on terms negotiated? And OK for press notice?
AA 2/9

cc EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Peretz
Mr Illett
Mr Woodall IDT
Mr Hosker T.Sol

THE FRN

We now have final advice from the Bank and the lead managers about pricing.

2. The proposal is that we should go for an all-in cost of LIBOR -20 basis points (equivalent to LIBID -8 basis points). This would be made up of a coupon of LIBID -$^1/_8$ and commissions of 33 basis points.

3. This would be very tight pricing indeed, slightly better than was envisaged at your meeting last week. It represents a discount of only 4½ basis points on the level at which the existing FRN is currently trading. I share the Bank's view that it represents the extreme limit of what in current circumstances we can reasonably expect to achieve.

4. It would not, unfortunately, be the tightest issue ever bought to the market. That distinction falls to a 10-year $1bn issue by Denmark last month. But the Danish issue came a cropper. Much is still with the underwriters and it is currently trading at LIBOR -18.

5. Presentationally, it helps that both the coupon and the front end commissions are lower than on the last occasion (LIBID -$^1/_8$ against LIBID and 33 basis points against 60). In practice, the latter of course simply fall out arithmetically once the all in cost and the coupon are determined. Perhaps of more significance is that the Bank have negotiated downward the praecipium - the part of the fees which the lead underwriters

take off the top to compensate for their additional risk - from 8 basis points to 3 points.

Other features

6. On reflection the advice is now to fix the price at which the five year put option can be put against us at 99¼ rather than the 99 at one stage envisaged. This still, in most circumstances, would imply a considerable disincentive against the option being exercised.

7. You may like to note that the lead managers have asked us to refrain from referring to this feature in public as a "penalty".

Position of British banks

8. The composition of the Management Group will be the same as last year - 31 banks (plus the two lead managers) of which 13 are British. All the British banks with any interest in the area have been included.

9. We have reviewed with the Bank the possibility of increasing the underwriting proportion taken by the British firms. But the Bank's advice, with which we concur, is that with one exception there is very little room for adjustment without genuine risk to the success of the issue. Because of the increase in size on last year, the British firms will in any case be taking a larger amount of notes in absolute terms. The exception is that Morgan Grenfell will be promoted from the lower tier (receiving 1¼% of the total) to the upper tier (receiving 2½% each) because of the sizeable increase in their capital this year and their increased activity in managing bond issues.

10. The Bank have also negotiated a special and private arrangement with the lead managers which will give the British firms (and they alone) an option to increase their allocation by up to 50% at any time up to 11am Friday at the expense of the lead-managers' share if they find they can generate sufficient demand.

11. This should be of some minor benefit in reducing complaints about the way we are handling the issue. But it is unlikely to stop them, not least because what the British banks really want is the lead management slot and the kudos that goes with it. To the extent that the arrangement becomes public knowledge, there could also be some possibility of come-back from non-British banks who will not benefit from the arrangement.

12. You should, perhaps, be aware that the Bank are proposing to exclude three of the British firms, (Barclays, Standard Chartered and Kleinwort Benson) from this special arrangement as a minor slap on the wrist for their failure to respond to Bank guidance about participating in the recent Chinese bond issue before agreement has been reached about old Chinese debts. We have not objected to this (and of course have an interest in maintaining discipline of this kind). The Deputy Governor has spoken to Sir Peter Middleton about it.

Gov mentioned this?

Press Notice

14. The timing of the initial announcement is now set for 8.45am tomorrow. I attach a draft of the Press Notice which, following last year's precedent, we would propose to issue shortly thereafter. It is based closely on that issued last year and is deliberately very low-key. The second Note for Editors is included because you wanted it there on the last occasion. But you may feel that this time it looks slightly otiose.

15. I will be circulating a revised background briefing shortly.

Timing

16. The Bank would like a decision in principle before close today. I recommend that they should be given this on the terms proposed.

17. That would still leave it open to us to abort the operation at any time until 8am tomorrow.

CWK

C W KELLY

3 September 1986

HMG ISSUE OF DOLLAR FLOATING RATE NOTES

HM Treasury today announced a US $3 billion floating rate note issue in the international capital markets. The notes have a 10 year maturity and a coupon of 1/8% below 3 months' LIBID (London interbank bid rate) refixed and payable quarterly. The issue has been organised by the Bank of England on the Treasury's behalf and is jointly lead-managed by S G Warburg & Co Ltd and Credit Suisse First Boston Limited.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01-233-3415

Notes for Editors

1. Official foreign currency borrowing is undertaken from time to time to supplement the official reserves. At the end of August, before this note issue, the official reserves totalled the equivalent of $18.9 billion.

[2. At the end of 1985 (the latest date for which figures are available) the UK's net external assets, private and public sector combined, totalled the equivalent of £80.4 billion. This compares with a total of £12.4 billion at the end of 1979.]

3. Enquiries on the details of the issue should be addressed to the Press Office of the Bank of England (tel. 01-601-4411).

30/3070E

Thanks. A successful operation. My congratulations to those involved. We shall have a good dinner. X.
M.

FROM: C W KELLY
3 September 1986

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Peretz
Ms Goodman
Mr Woodall IDT

Ch
Looks good. Geoff tells me he thinks the French had been planning an issue but will now have to re-think since they would have trouble matching this
AA

THE FRN

With trading now winding down in London the FRN currently (at 5.30pm) stands at 99.81/82. There may be a bit more activity in New York before the close there.

2. This is very satisfactory. The increase to $4bn has been absorbed with a rising price, but not to the extent that it looks, or can be made to look, as if we had underpriced the deal. On the other hand the selling group, who will get their stock at 99.70, still have a decent incentive to get on with the selling.

3. Only one repackaged swap - $250m by Morgan Guaranty - has so far got off the ground. But others are being looked at. If they materialise there could be another bout of demand tomorrow.

4. Press interest has so far been very subdued. There has not yet been any comment on television. IDT are not aware of any particularly silly stories as yet, although I imagine we are unlikely to escape entirely scot-free.

X

5. As expected, complaints from UK (and some US) banks about not being given the lead-management slot have already begun to come in. So far, as far as I am aware, they have been fairly muted. But that may be simply because the chairmen of the banks concerned have not yet been wound up.

CWK

C W KELLY

CONFIDENTIAL

9/ You asked for Sir T's views.

FROM: T BURNS
DATE: 3 September 1986

CR 3/9

CHANCELLOR

Mr Rawlins. 2. I have drafted a reply for Mr Allan (below).

cc Sir P Middleton

DR GOLDBERGER AND DEVALUATION

You asked me for a brief comment on Dr. Goldberger's suggestion (attached) that we need a devaluation if we are to avoid a growth recession in 1987.

2. I would make the following points;

- it is always very dangerous to get into the position of validating excessive increases in pay with accommodating exchange rate movements. That is simply a recipe for higher inflation. Attempts to buy improved "competitiveness" with exchange rate depreciation have usually ended in tears;

- having said that it is likely that the real exchange rate will have to fall as we go through the adjustment to lower oil revenues. You have argued that this can be achieved through lower domestic costs but on present form it is more likely to come about through a lower nominal exchange rate;

- one reason for higher real interest rates in the UK than elsewhere is the market expectation of a lower exchange rate;

- inevitably there will be increasing pressure on the exchange rate as we move towards the election unless there is a dramatic turn-round in the polls. The higher the exchange rate today the greater that pressure is likely to be;

- the United States real exchange rate has fallen sharply over the past 18 months and is now not so far out of line with its historical average. There is likely to be some significant undershooting of this level before the US trade position has turned round to an acceptable degree. But once that has taken place the attention of the foreign exchange market could turn to Sterling in a noticeable way;

- world commodity prices are very weak and inflation is running at a lower rate than we expected. From that point of view exchange rate depreciation today would be less of a problem that it might be on other occasions. I would not overstate this as we have probably passed the low point of the inflation cycle.

- Goldberger overstates the role of competitiveness in the determination of output. The main role of competitiveness is in affecting the balance between internal and external demand. A lower exchange rate will probably improve the prospect for external demand and lead to lower domestic demand. I would not expect the movement of the exchange rate, over the range he is discussing to be the arbiter ot whether we have a growth recession next year or not.

3. The implications of these observations might be as follows;

- we have to be prepared for a lower exchange rate at some stage over the next 2 years;

- it would be a mistake to try to defend or achieve any particular exchange rate level. Obviously the exchange rate is one factor to take into account in judging monetary conditions but there is no particular target that can be set sensibly;

- if monetary conditions at home and overseas permitted lower interest rates we should not resist solely because this might mean a lower exchange rate;

- all things being equal there is a case for getting some exchange rate depreciation behind us now when inflation is low, the balance of payments in surplus and the election some way off;

- but I would not want to operate interest rate policy directly to bring this about. It would be dangerous behaviour that could easily rebound.

T BURNS

FROM: THE Rt. Hon. JULIAN AMERY, M.P.

112, EATON SQUARE.
SWIW 9AA
TEL: 01-235 1543
01-235 7409

X

Personal

11th July, 1986

Dear Nigel,

I think perhaps you ought to see the enclosed paper from my friend, Dr. Goldberger, who advises me from time to time on economic matters.

His main theme is fairly simple. He thinks that the disproportion between our unit production costs and those of our competitors could drive us into a recession before the autumn of next year.

He argues therefore that in the broader interests of securing a Conservative election victory, we ought to take steps by the reduction of interest rates to bring the value of sterling down and so make us more competitive.

As he sees it, this is the quickest way, though not in strictly economic terms the right one, of fending off a recession while there is still time.

I am not sufficiently expert in these matters to judge whether he is right. It is obviously a measure of timing but I think you ought to have his paper studied. Neither our Party nor the country can afford to lose.

Love

Julian

Julian Amery

The Rt. Hon. Nigel Lawson, MP

X

30-40% $ fall in 1985/6 US domestic prices actually moderated.

In boom and sellers' market conditions devaluation does increase prices. But we still have world-wide disinflation with monetary policies and willingness to apply them,falling commodity prices and strong competition.Moreover,we are not devaluing to correct a temporary deterioration. We are in"fundamental disequilibrium".We have to rectify accumulated adverse factors such as greater inflation,higher earnings AND LABOUR UNIT costs than our competitors.We cannot wait for attitudes to change.We have to use the adjustmental process of devaluation.

The man-made disadvantages have to be man-unmade by devaluation.

REQUIRED ACTION.

Growth is central to improve living standards and to reduce unemployment. Stationary material well-being is not enough.There has to be a momentum towards better expectations to raise political prospects.

1).The Chancellor,CBI and statistical indicators(forecasting the future from the past) are now warning that the economy ~~is slowing~~ has slowed.Yet,we may well see a near-term improvement as the delayed positive oil price impact on growth shows up beneficially supported by high consumer spending from the earnings bonanza.This should not falsely overshadow the underlying real economic factors which will re-assert themselves.

In the absence of competitive strength (undermined by too high labour cost) a growth recession is a very real possibility.The only question is when-in 1987.

Interest rates should fall to at least 8-8½% so as to devalue the £ to an objective of DM3.00/3.10 and $1.30/1.35.

2).To achieve a desirable impact for 1987/8 action has to be taken now to be gradually completed around the end of 1986.If this is not done market forces may anyway-and unbeneficially-threaten devaluation during 1987 as the balance of trade deteriorates and earnings rises will be seen to fuel inflation while allround confidence fades.

X

3).With a pre-emptive,self-initiated active programme it becomes possible to see 3½-4% growth in 1987/8 and 3-3½% inflation after the devaluation effect.

?

4).Following pay rises lower by some 2% and greater growth unemployment could fall to under 3 million and strongly indicating a continuing downward trend.

5).A direct effect on growth of tax cuts in the 1987 budget,while a psychological-and may be political-boost,willtake too long,at least 12-15 months.

To Julian Amery.

Forgive me for not replying sooner to your letter of 11 Feb.

I have read the Gallagher's paper with much interest.

I ~~agree~~ ~~will~~ fully share his concern over size of the discrepancy between the ~~past~~ trends of unit costs in this country and our major overseas competitors; although I do not, ~~for~~ the ~~reasons~~ 1987 ~~recession~~ as he does, expect 1987 to be a year of recession.

As for the exchange rate, the £ has already come down to the DM 3.00/3.10 range favoured by Goldbergers, albeit without any further reductions in UK interest rates.

32/3070E

Thanks. [AA: Can you monitor for me for Monday?] NL.

Yes AA

FROM: DAVID PERETZ
4 September 1986

CHANCELLOR

Ch
Chris Kelly says no new developments today. AA 5/9.

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Kelly
Ms Goodman
Mr Woodall IDT

THE FRN

You might like a further situation report.

2. No significant further demand emerged in New York last night. The FRN is still trading roughly where it was last night, at 99.80/81. The Bank report modest two-way business at this price.

3. There has been a certain amount of run of the mill swapping activity. But the one formal repackaged swap, by Morgan Guaranty, has not gone well. Morgans seems to have priced it too tightly: perhaps they were a little bit too greedy in terms of their own profit margin. This seems likely to discourage other banks who were contemplating producing similar vehicles.

4. Last year's FRN which had initially fallen four or five basis points, after the new issue, to 100.35, has now recovered to 100.37.

5. At the current price for the new FRN, the Bank of England do not expect British banks to want to exercise their option to increase their allocations from the private "pot" arranged for them. The arrangement requires them to pay 99.85. Of course if any bank was really determined to demonstrate its placing power, for future reference, it should be prepared to take and sell some extra notes at a small loss: but the Bank think it unlikely that any British bank will want to do this.

CONFIDENTIAL

6. So the circumstances the Bank and lead managers were envisaging yesterday, a sharp rise in price in the absence of a further rise in the quantity, have not arisen - and are perhaps now not particularly likely to do so.

7. The press comment this morning, which you will have seen, is all pretty low-key. Just what we wanted.

8. Altogether the operation seems to have gone very well so far. We will let you know if there are any significant further developments.

DLCP

D L C PERETZ

Thanks. A good note, with some good points in it. The main value of Drucker's piece is not so much any new insights or themes, but the arrangement of a number of well known recent trends and developments into a coherent overall picture. This has value for exposing purposes, even if it may not add more than a little for analysts or cause us to reappraise policy. N

FROM: T BURNS
DATE: 8 September 1986

CHANCELLOR

Ch
Could discuss @ [illegible]
AA

cc Sir Peter Middleton
Sir G Littler
Mr Evans
Mr Culpin

THE CHANGED WORLD ECONOMY: PETER DRUCKER

Mr Evans has sent you some comments on the Drucker article (4 August) and a note by Mr Carpinter. I agree with his general observations. In particular Drucker greatly exaggerates the extent of "uncoupling" of both primary products from industrial activity and of output from employment. I found the piece enjoyable to read but I don't think it changed my views. On the other hand it did raise some interesting questions.

Primary products and the industrial economy

2. Drucker reminds us that conventional wisdom used to assert that "a sharp and prolonged drop in raw material prices inevitably, and within 18 to 30 months, brings on a worldwide depression in the industrial economy". Implicit in this approach was the view that lower commodity prices would reduce the purchasing power of commodity producers leading to inadequate demand.

3. More recently - since the early 70's - the opposite view has tended to dominate; that upward price shocks to commodities were disruptive. Two factors were mentioned;

- higher commodity prices increased inflation and effectively tightened monetary conditions if policies were non-accommodating;

- to the extent that employees attempted to resist the loss of income implied by the adverse terms of trade real wages would become excessive and adversely affect supply conditions.

4. In recent months we have seen falling prices for oil and other commodities. The initial reaction of most commentators was that this would improve the prospect for the industrial countries. But exports to the commodity producers have slumped and the beneficial effects to domestic demand have been hesitant. Do we have to re-appraise our views about the role of commodity prices?

5. It is still too early to say. But;

- it is likely that the outcome will be affected by the extent to which policies are non-accommodating. Governments refused to accommodate the effect of higher commodity prices. Now it is important that they pursue policies that will take advantage of lower inflation and maintain the growth of domestic demand if the gains from lower commodity prices are to be felt in higher output;

- what we have seen so far is only the short-term effects and later the beneficial impact on domestic demand will dominate. This remains my central view;

- the relative importance of the various factors may be influenced by the rate of inflation. At low rates of inflation (or negative rates as they were during much of the inter-war years) lower commodity prices may have less of a beneficial effect because of downward price rigidity;

6. A gloomy interpretation of the present position is that we are afflicted by asymmetries and that all sharp changes are for the worst. When commodity prices rise;

- policy is non-accommodating;

- the demand effects on commodity producers are slow to take effect;

- pay settlements attempt to offset the terms of trade loss;

But when commodity prices fall policy is accommodating, commodity producers react quickly to lower earnings and pay settlements are little affected. I would not want to go that far but there may be something in it. Even so, this does not necessarily mean that output does not improve when commodity prices fall, only that the improvement is delayed.

7. However where I disagree with Drucker is in the extent to which the importance of commodity prices has declined. As long as oil is included it is difficult to accept the idea that commodity prices have become "uncoupled" from industrial activity.

8. Drucker emphasises the declining weight of commodities in the industrial economies. But in part they have been substituted by semi-finished manufactures. One possibility is that these semi-finished manufactures will take on more of the characteristics of commodities - relatively homogeneous, falling relative prices, and dominated by countries with lower average incomes. One crucial difference is that their supply is not so inelastic but even so prices could become more volatile and become a greater influence in the international inflation transmission mechanism.

Manufacturing products and employment

9. Drucker emphasises the declining share of employment in manufacturing. I agree with Mr Evans that it is wrong to characterise this as an uncoupling of products and employment. Rather it reflects the relative growth of productivity in manufacturing compared to services.

10. But there is no intrinsic reason why rapid productivity growth should be limited to manufacturing. Several commentators now stress the immense scope for increased productivity in services, largely through the application of computers. But also consider the growth of productivity in other areas; for example the home. Domestic service must have been one of the most rapidly

declining activities over the past 80 years, largely because of the application of machines. But productivity growth in services may not be as obvious; the great measurement difficulties mean that output may be seriously under-estimated.

11. I enjoyed his remarks on the difficulties of distinguishing products from services and the role of invisible earnings. Manufacturing is often treated as a homogeneous group whereas there is a huge difference in the service content of different types of manufactures. And it is possible to unbundle the service content so that it is bought in from specialists rather than produced by the company doing the assembly. Such specialisation is bound to exaggerate the apparent decline of manufacturing relative to services.

Capital movements and trade

12. Like Mr Evans I was less impressed by the section on capital movements not because I disagreed with it but because we have been over this ground many times and his conclusions are unexceptional. His discussion of the US deficit added little and although he had some interesting remarks about the position of Japan I felt he ignored the domestic pressures (largely demographic) for a high rate of domestic saving.

Conclusions

13. I agree with his emphasis on the world economy in discussing "the world of tomorrow". Many of the difficult policy questions of the future need to be looked at in the context of the world as a whole. One index of this is the interest these days in the US about international economic questions. It is not so long ago that there was almost no reference in US macro-economics to questions of international trade and payments. Now the position has changed; partly because of the US deficit but also because of more general considerations. Hopefully this article will remind a wider American audience that they are inescapably a part of the world economy.

14. Although the share of trade in world activity is no longer rising at the rapid pace it was the general perception is of increased inter-dependence. Much of this is probably down to the role of international companies. It is now commonplace to work for international companies and to buy their products. Increasingly it is possible to buy their shares. The notion of what is a British, Japanese or American company becomes vague.

15. This is bound to lead to tensions between governments and companies. But it also means that in matters such as tax systems, employment legislation and controls of one kind or another governments are forced to examine their arrangements in terms of the relative position with other countries.

TB

T BURNS

BF 18/9

CONFIDENTIAL

FROM:T BURNS
DATE:8 September 1986

Discuss. [This is most interesting & v important: a good deal more work clearly needed with the Davies ASAP: BofB is aware.] N.L.

CHANCELLOR

cc Sir Peter Middleton
Mr Sedgwick
Mr Odling-Smee
Mr S Davies
Mr Allum
Mr Mills

CONSUMER SPENDING AND IMPORTS

Last week we had a brief discussion about the current growth of imports. I mentioned that import growth was currently relatively modest compared with other periods of rapid consumption growth - possibly because durable spending growth is currently lower than usual.

2. I attach a minute from Mr Davies setting out some of the relevant background information.

T BURNS

Burns → CH/EX 8/9

FROM: S J DAVIES

DATE: 4 SEPTEMBER 1986

SIR TERENCE BURNS

cc : Mr Sedgwick
Mr Barrell
Mr Allum
Mr Mills

CONSUMER SPENDING AND IMPORTS

I attach a note by Mr Mills, prompted by the request for figures that you made on Tuesday. The comparison with the fourth quarter and second half of 1984 are possibly a little distorted by the introduction of "VAT on imports" - but that was generally believed to have mainly involved switches between months within the half year.

2. **A propos,** I could mention a conversation I had with Ford economists who came to see me in August. I had noticed that thus far in 1986 total car registrations had risen on a year earlier, UK produced car registrations had risen, but registrations of imported cars had fallen (SMMT figures), inspite of a loss of market share by British Leyland. Obviously the reason was changes in sourcing by multinationals (Ford, GM and Peugeot).

3. The Ford economists said that their sourcing had changed basically for two reasons. Firstly a rise in productivity, and hence output in their UK factories; secondly they had been selling cars out of stock. The stock correction was now over and if the UK market strengthened further they might not be able to meet the additional demand from UK production. Sure enough, I have since noted that in the first 20 days of August there was a <u>rise</u> over a year earlier in the market share of imported cars, the first month this year this has happened.

And Rover Group in trouble

note
tb-conspnd

4. But I would not necessarily conclude that we will revert to a pattern of a rising share of imports in car sales. Peugeot look likely to build up UK production further, there is the famous Nissan plant about to start up, and the new Honda/BL car coming on stream as well.

SJD

S J DAVIES

FROM: CHRISTOPHER MILLS

DATE: 4 SEPTEMBER 1986

MR S J DAVIES

cc : Mr Allum
Mr Barrell

THE COMPOSITION OF CONSUMER'S SPENDING AND ITS EFFECTS ON IMPORTS

A preliminary analysis over four periods of increasing consumer's spending, 72Q2 to 73Q1, 79Q1 to 80Q1, 82Q3 to 83Q3, 84Q4 to 86Q2* indicates significant differences between the last of these periods and the others. The last period is also presented using half-yearly data to remove any erratic effects due to VAT changes on imports.

2. The rise in consumption of durables, relative to the rise in total consumption, is lower than usual.

3. Adding consumption of clothing and footwear to durables does not change this result. However removing cars removes the anomaly. The overall lower growth in durables spending is entirely accounted for by low spending on cars.

4. This appears to be reflected in the import statistics - car imports have increased by far less than in previous consumer booms.

5. Imports of other consumables are also low. Hence the rise in consumer imports is much less than has occurred in previous consumer booms.

The tables below show the main points.

---

* All data are in real terms, and seasonally adjusted.

docs
millsconsp

Table 1:

	% Increase in:				Imports:		
	Total Consumption	Spending on Durables	Spending on Cars	Spending on Non-car Durables	Total* Consumables	Cars	Non Cars
72Q2-73Q1	6.6	18.4	16.5	21.1	25.3	14.0	29.0
79Q1-80Q1	3.9	14.1	25.2	4.3	14.7	12.9	16.6
82Q3-83Q3	4.6	13.9	22.1	6.8	15.5	35.0	8.0
84Q4-86Q2	6.4	11.3	8.5	13.6	5.8	4.1	6.9
84H2-86H1	6.3	10.9	8.6	12.8	3.6	1.6	4.9

Table 2: Ratio of increases to increase in total consumption

				Imports:		
	Spending on Durables	Spending on Cars	Spending on Non-car Durables	Total Consumables	Cars	Non Cars
72Q2-73Q1	2.8	2.5	3.2	3.8	2.1	4.4
79Q1-80Q1	3.6	6.5	1.1	3.8	3.3	4.3
82Q3-83Q3	3.0	4.8	1.5	3.4	7.6	1.7
84Q4-86Q2	1.8	1.3	2.1	0.9	0.6	1.1
84H2-86H1	1.7	1.4	2.0	0.6	0.3	0.8

C Mills,

C MILLS

Ch
I got the additional column from Mr Mills – certainly not all cars.

---

* Weighted average of indices of imports of passenger cars and "other consumer" goods.

3058/1

FROM: C W KELLY
DATE: 10 SEPTEMBER 1986

MISS RYDING

cc Mr Peretz
Miss Goodman

KELLY → RYDING 10/9

THE FRN

As on the last occasion, participants at the signing ceremony for the FRN yesterday were presented with a commemorative pen.

2. Jack Hennessey of CSFB has apparently told the Bank that he would like to present one of these personally to the Chancellor.

3. I see no reason to advise the Chancellor to make time available to Mr Hennessey for him to do this.

4. This is particularly so since if he saw Mr Hennessey (a representative of a US/Swiss house) he ought really also to make time available to exchange mutual congratulations with David Scholey of Warburgs, the other lead-manager and a British house.

5. If the Chancellor were to bump into Jack Hennessey at some other occasion at which they were both present, that would, of course, be another question. But I imagine that that is unlikely.

Ch
But I presume you'd like a pen anyway!?

AA

CWK

C W KELLY

Is he being invited to the Ambassador's reception in Washington on the IMF week? If so, I shall doubtless bump into him there — or rather he will make a point of bumping into me. Otherwise, I shall be grateful if he would forego the mtg & let me have the pen! N.

3058/36

SECRET

FROM: C W KELLY
DATE: 16 SEPTEMBER 1986

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Scholar
Mr Culpin
Miss Goodman
Mr McSharry o.r.
Mr Ross Goobey

Thanks. Helpful. Re para 6, (we will of course want to make use of the forecasts) look to whether we publish a figure for this month – September. N.

RESERVES IN OCTOBER

You asked whether we could make a guess about the likely underlying change in the reserves in October (Miss Ryding's minute of 9 September).

2. Obviously, we have no way of knowing what market conditions will be like in October. But we do know that:

(i) Net interest payments are likely to be fairly small, possible the order of -$15 million. It is difficult to be more precise than this. Although we know about the incidence of payments and receipts a large proportion of both assets and liabilities are at floating rates.

(ii) Expenditure by government departments is likely to be fairly average, possibly of the order of -$300 million. This judgement is based upon the seasonal pattern in previous years and some knowledge of any special requirements of the main departments concerned. But departments' ability to forecast the timing of their requirements this far in advance is, unfortunately, not very good. The figure is therefore subject to a substantial margin of error.

3. We also know that off-market inflows from the Bank's other customers (ie other central banks) have averaged around +$100 million a month so far this year.

4. The implication is that if October turns out to be an average month for off-market inflows, the Bank will have to purchase something like $215 in the market to end up with a zero underlying change in the reserves. Anything more would leave us publishing a plus figure; anything less a minus.

5. This ought not to be an impossible task in normal circumstances. It is considerably less than the corresponding figure at the beginning of September. But it is obviously subject to a large measure of uncertainty. In particular off-market inflows can vary quite considerably. They also tend to turn to outflows at precisely the times when we are having difficulty in buying dollars in the market. Nor can we assume that market circumstances will be normal.

6. We do, of course, have an additional degree of freedom in that we can increase or reduce the published figure by charging the (unpublished) forward position. The forward book still remains reasonably substantial, even after the use we made of it in August.

7. The total change in reserves will also be affected by net borrowing. At present this looks like being healthly positive, of the order of +$300 million.

CWK

C W KELLY

3058/56

PWP

FROM: C W KELLY
DATE: 18 SEPTEMBER 1986

PRINCIPAL PRIVATE SECRETARY —

12/12.

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Miss Goodman
Mr Ross Goobey

Thanks: & it is a reassuring statement to have on record!

MR HATTERSLEY, THE EXCHANGE RATE AND EXCHANGE CONTROLS

You may like to see, in case you have not done so already, the attached extract from Mr Hattersley's speech of last week in New York.

Ch

Relevant for Delors and repeal of Exch Control Act.
(I don't think you've previously seen full text)

AA

CWK

C W KELLY

EXCHANGE RATE POLICY

For Labour's plans to succeed we have to work in proper partnership with the world outside Great Britain - a world which I know will in general will not be governed by socialist parties nor committed, as we will be committed, to a policy of economic expansion. Because of Britain's special position as a world financial centre, that requires us to take a specific and realistic view on the future of sterling.

X

The Labour Party has no intention of reintroducing statutory exchange controls. There will be no legal prohibition on the export of capital from the United Kingdom economy. We have taken that decision for four reasons. First, the reintroduction of old style exchange controls is literally impossible - indeed either to attempt it or to predict it would have quite the opposite effect from that which its supporters claim. Money would leave the United Kingdom not simply during the early weeks of a Labour Government but during the campaign in which the election of a Labour Government became more certain. Since old style exchange control is impossible it is hardly worthwhile discussing its disadvantages. But there were two subsidiary reasons for deciding not even to consider such a policy which I mention in passing. There would be formidable technical problems involved in reintroducing statutory controls and reintroduction might severely damage the status of the City as a world financial centre - with a consequent reduction in our invisible earnings. The fourth reason is worth a more detailed explanation. We have thought of something better.

Our intention is to deter - rather than to prohibit - the investment overseas of the monies held in the portfolios of UK collective investment schemes - unit trusts, insurance companies and pension funds. All those institutions at present receive considerable tax concessions on their investments. Those fiscal privileges will be withdrawn from United Kingdom institutions if they do not repatriate a specified proportion of their foreign investment. Before the aboliton of statutory exchange control, on average, about 5% of institutional funds were invested abroad. This now amounts to over 16%. Our general objective will be to reduce the percentage to something like the 1979 figure, though there would clearly be a transitional period and we would not intend to treat every institution according to the same rigid formula. Our proposals neither affect direct overseas investment by British companies, nor holiday makers and businessmen wanting to take small sums out of the country. Nor do they affect inward investment flows whether direct or portfolio. You may be able best to understand our proposals if you think of them as similar to those which were introduced by President Kennedy in 1963 and to schemes which operate today in some Canadian provinces.

Exchange control was removed in 1979, partly for ideological reasons, but partly to allow an outflow of capital and thus ensure that sterling did not become even more overvalued. Our proposals are the mirror image of that intention. The repatriation of a percentage of institutional overseas portfolios will exert some upward pressure on sterling values. And it will help to avert any over-depreciation which would undermine our efforts to rebuild British industry. A recent assessment by Greenwell Montagu made the point exactly "This plan would undoubtedly be a significant inducement to bring back funds into the country, particularly for the institutions. The prospect of a Labour election victory might even induce some repatriation to start before the election, on the following calculation. If Labour were to win and repatriation were to start on a large scale, the exchange rate would, on that ground alone, be expected to rise. In these circumstances, it might be better to anticipate that rise than be forced to buy sterling later at a higher price. No doubt there would be a lot of money going the other way, foreigners' money for example, so the net effect is by no means guaranteed. But the possibility of large scale repatriation could, for a period, hold sterling up a lot higher than might otherwise be expected." That upward pressure will assist us in our endeavours to hold down interest rates without risking an unacceptable sterling depreciation. Its effects will be intensified in that they will influence exchange rate expectations - even in advance of the General Election. We

V odd stuff

are, I think, the first Labour Opposition which has ever been accused of first, risking the overvaluation of sterling and second, producing a rush of sterling into the United Kingdom.

Of course I am not suggesting for a moment that this one device will, in itself, be enough to secure our desired exchange rate level. Whichever way sterling moves in the short term a new Labour Government will respond with the available mechanisms and techniques open to us including, if necessary, intervention policy backed by adjustments in interest rates. And, of course, in some circumstances it would be right for the currency itself to take some of the strain. The new tax based incentive for the repatriation of overseas portfolio investments would be an added weapon in our armoury. It also has one other crucial advantage. It is a demonstration that we accept the realities of the world in which we shall become the government of Britain and that we are already preparing to overcome some of the difficulties which previous Labour Governments did not always anticipate.

Exchange rate policy is, of course, important, because of its potential effect on the rate of inflation. I do not hold the view that the inflation rate can be sacrificed for other objectives. Indeed, I do not believe that the other objectives can be achieved if inflation is allowed to get out of hand. There is agreement in the British Labour movement - the trade unions no less than the Party - that a sudden increase in money wages, which was produced as a misguided response to our decisions to stimulate the economy, would be bound to result in the slowing down of our employment and investment programmes. It is our clear and unequivocal view that to pursue expansion as if consequent increases in inflation were of no importance, is just as foolish as to follow the policy which has damaged the British economy over the last seven years. That policy is the apparent belief that if inflation is held down, everything else will automatically and inevitably fall into place. Experience proves that to be wrong. The control of inflation is essential. But it is only one campaign in the battle for an expanding economy.

PUBLIC OWNERSHIP

The last seven years have been unique in recent British history in one, perhaps surprising, way. We have been governed by the most ideologically committed Cabinet which has ever presided over British fortunes. Because of the ideological obsessions of the present administration, decisions have been taken that no practical businessman would contemplate - amongst them selling off capital assets at knock-down prices and the consequent long term loss of government revenue. The All-Party Public Accounts Committee severely reprimanded the government for under-pricing the sale of British Telecom assets. Some estimates suggest that undervaluation was as much as £1.3 bn. The most recent

3058/54

SECRET

PWP

FROM: C W KELLY
DATE: 23 SEPTEMBER 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Culpin
Miss Goodman
Mr Brook

Ch
Effective is probably about 69.5 @ 8.15 PM. Discuss first thing AM & see whether meeting/further action necessary?
AA

Yes

Thanks. We may need to give the figures to all concerned prior 11.30. (Govr will I think aware of this)

FOREIGN EXCHANGE MARKETS

Sterling finished the day in a much healthier position than it began. After trading within a fairly narrow range for most of the day we moved up above $1.45 in mid-afternoon. We closed at 69.7 in effective terms, $1.45 and DM2.98, 4 pfennigs up on the day.

2. The Bank intervened in deutschemark as the US markets opened, selling the equivalent of $25 million which they partly recouped later (they had earlier spent $7 million in the Far East this morning and $14 in New York last night giving a total of $33 for the day as a whole). The intervention was, as intended, noisy and was widely reported. It undoubtedly helped provide a more favourable background. But we were also helped by the fact that there were already one or two substantial buying orders for sterling around from an unknown source and by the fact that the dollar itself was also moving up against the deutschemark, taking us with it. Oil prices have remained fairly steady throughout the day.

3. The result is a much better background for the reception of tomorrow's trade figures than we might have anticipated, for the market can still only be described as fairly fragile.

4. The Bank's tactics for tomorrow can only really be

determined at the time. The intention will, of course, be to keep the rate where it is or even moving up a little just before 11.30am. To that end they will continue to be ready to offer support in New York tonight, in the Far East tomorrow morning and in London when the markets open here. But their present intention, which could well change depending upon circumstances, is that it would be best to hold back the bulk of our fire until after 11.30am.

5. The present understanding is that they have the authority to spend up to $200 million over today and tomorrow combined. They still have a large part of that left and are content to live within it tomorrow. They are not pressing for any larger amounts.

6. Intervention would be in either deutschemark or dollars, or both, depending upon the circumstances. At one point the Bank were concerned that selling dollars might be misinterpreted as reneging on the Gleneagles agreement. But, not surprisingly, the Bundesbank have confirmed that for their part they see no difficulty with this at present exchange rates. A difficulty would only arise if the dollar were to sink so low against the deutschemark that the Germans would be in the position of buying dollars at the same time as we were selling them.

7. Since the close we have fallen back a bit against both the dollar and the deutschemark but not, as yet, to an extent to cause great concern.

C W KELLY

SECRET

Thanks. So far, so good - no crisis.

FROM: DAVID PERETZ
24 September 1986

Ch
Seems sensible. Need to watch carefully tomorrow
AA

CHANCELLOR

cc Sir P Middleton
Mr Cassell
Mr Kelly
Miss Goodman
Mr Brook

FOREIGN EXCHANGE MARKETS

We got through the trade figures today quite as well as we could have hoped - in fact ending the day with a small upward movement in the ERI to 69.4. The gilts market had another rotten day; and money market rates hardened slightly.

2. The Bank intervened quite strongly, as you know, shortly after the figures came out - spending $43m ($18 and 25 dollars worth of DM). They also acted to take off the market a $60m selling order for sterling from another central bank. This will count as a customer transaction (off market) rather than market intervention, though of course it has the same effect on the reserves.

hope this wasn't Bundesbank!

3. After their pre-lunch bout of intervention the Bank have in fact been dealing in both directions, and at the time of writing the day's net score is down to $33m.

4. They will have to play tomorrow a bit by ear. The market is very fragile. It may be of course that tomorrow will be quiet, if uneasy, with the market looking forward to the weekend meetings. But we thought we should lay contingency plans. There must be a risk of a sharp mark down in sterling if press comment is alarmist.

5. If that happens the Bank will stand ready to intervene early tomorrow in London (they will need to judge their moment: but if the mark down happens before the London opening there might be a chance to catch a rebound). In those circumstances they would also stand ready to activate the extra trick of getting the Bundesbank also to act on our behalf. In the current pre-G5 meeting climate - with market talk of concerted action - it

is just possible that this would have some extra impact.

6. I have agreed that the balance of the $200m "ration" we agreed for yesterday and today (currently standing at about $140m) should be available for use if necessary tomorrow. The Bank would of course tell us if they felt there were circumstances in which they could spend more to useful effect.

DLCP

D L C PERETZ

3058/23

SECRET

FROM: C W KELLY
DATE: 25 September 1986

CHANCELLOR C/content with X?

CR 25/9

Content XL.

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Miss Goodman

END-MONTH RESERVE FIGURE

We need to decide fairly soon what figure we want to disclose for the September reserve change, to be published on 2 October.

2. The true underlying position as of last night was -$556 million. It is a consequence not so much of recent market intervention as of the large requirement for foreign currency this month from government departments and other off-market transactions. The Bank have found it difficult to cover these in the market, for obvious reasons.

3. Clearly we have to show a substantial figure. The market would expect nothing less after the events of the last few weeks.

4. On the other hand, there is the usual dilemma that too large a figure may create worries that things were actually worse than the markets had realised.

5. This is inevitably very subjective. My own view, which is also that of the Bank, is that we ought to think in terms of X something like -$300 million. This imply drawing upon the forward book to the extent of $250 million.

6. $300 million would be the largest underlying fall we have published since the last three months of last year when the run of figures was -$320 million in October, -$200 million in November and -$416 million in December.

C W K

C W KELLY

SECRET

30/9/86.

MR. ALLAN

Alex.
Pse do a draft
minute, on these lines,
& let me see it. N..

cc: Sir P. Middleton
Sir T. Burns
Mr. Cassell
Mr. Peretz
Mr. Kelly
PS/Governor
Mr. Loehnis

SWAP

This is for the record and to inform certain others of points which came up in discussions with the Chancellor yesterday.

2. The swap was arranged in principle yesterday, and subject to minor technical drafting is being settled now between London and Frankfurt. It is for £1 billion and the equivalent in DM. It follows customary form for swaps arranged by the Bundesbank and other European central banks. It can be drawn upon, in consultation, by the initiative of either party, and the party doing so accepts any exchange risk.

3. As you know, I would very much have preferred to try to negotiate an arrangement to operate between sterling and DM but with the liability expressed in dollar value. My reason was and is simply that I consider it a reasonable assumption that, over the coming months, the dollar is more likely than not to decline in value against the DM. In these circumstances, as a matter of proper management of the reserves, we have been switching some of our holdings from dollars to DM; my strong preference would be to undertake any necessary intervention in dollars rather than DM (thus preserving the potentially more valuable currency); and by extension, if a swap in DM was to be arranged, I wanted the liability to be in dollars. It seemed to me that there might be a basis on which to attempt to negotiate this, given that the Bundesbank, albeit unwilling for its own good reasons to acquire sterling, is ready to acquire dollars, and should therefore be persuadable into an arrangement giving them a potential dollar value - given that one element in the arrangement of the swap was to meet their wish for us to avoid intervention in dollars.

4. All that is over the dam. We are left with a swap in straight DM. My recommendation, which I have already conveyed orally to Sir P. Middleton and Mr. Kelly, both of whom agree, is that we should be very reluctant to use the swap. I understand that the agreement with the Bundesbank does not deny us freedom to intervene in the currency of our own choice, and in general I think our choice should be to sell dollars, on the present constellation of exchange rates.

5. As I see it, the advantage of the swap is a contingent one. If a situation should arise in which we needed heavy intervention and did not want to draw for this entirely on our own reserves and perhaps in consequence have to show a large reserves loss at the end of the month, we could draw on the swap, on the basis that the operation would not affect our reserves, would not be public immediately, and might be cleared up gradually before the maturity of the swap and thus enable us to mask forever the extent of our intervention. I do not see this as a very likely contingency.

6. Meanwhile, and again this is valid only as long as something like the present constellation of exchange rates lasts, I should like to keep up our DM holdings in the reserves as we have planned.

Sir G. Littler
30 September, 1986

3058/53

SECRET

FROM: C W KELLY
DATE: 3 OCTOBER 1986

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Scholar
Mr Culpin
Miss Goodman
Mr Ross-Goobey

Ch
Silly to be worrying about the too much until we get through next week.
AA

Thanks: let's [illegible] to discuss later in the month.

RESERVES IN OCTOBER

At the risk of stating the obvious, I ought perhaps specifically to draw your attention to the extent to which we are already heading towards a very large underlying reserves fall in October, to be upblished on 11 November.

2. At close last night total market intervention in the month was already $441 million. The $282 million we did on the last two days of September were for value this month and therefore come on top of yesterday's $116 million and the previous days $43 million.

3. In addition, we now have more accurate forecasts of expenditure by Government departments and of net interest payments. These are expected together to total $414 million (rather more unfortunately than had been anticipated at the time of my submission of 16 September).

4. This makes a total of -$855 million.

5. In current circumstances it is probably unrealistic to expect to be able to make much of a dent in this by intervention in the other direction during the month. Indeed the probability must

be that we add to it still further. Nor can we reasonably expect much if anything by way of off-market inflows from the Bank's other customers. Outflows may be more likely.

6. We can, of course, modify the figure to some extent by use of the forward book. But the Bank's capability for doing so, or doing so without being detected, is not unlimited. Forward maturities, which can simply be allowed to stand where they fall without being rolled forward, total about $270 million. A larger adjustment than this would mean asking the Bank to swap into the month. This is technically feasible, but may attract attention if done on any scale, particularly when/as now,/attention is focussed on them.

7. It is little consolation that net borrowing during the month is expected to be fairly heavily positive, to the extent of around +$300 million.

C W KELLY

Thanks. I don't think this will do. PGM bilateral mtg.

CONFIDENTIAL

FROM: SIR T BURNS
DATE: 10 October 1986

& after PO forum (have for discussion)

In any case [illegible] have a [illegible] surplus!

Big change: XR's were driven by capital flows & not by cr a/c

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr H Evans
Mr Odling-Smee
Mr Sedgwick
Mr Culpin
Mr S Davies
Mr Riley
Mr Owen

BALANCE OF PAYMENTS CURRENT ACCOUNT

I attach a note on the balance of payments current account. I hope this will form the basis for a reply to the Prime Minister's questions set out in David Norgrove's letter of 30 July 1986 (copy attached).

2. We have tried to make it consistent with the October Forecast which you are also receiving today but we will need to check it again after the weekend.

Ch
This is hopeless (and v unhelpful it is so late in spite of much urging). Paras 1 to 28 are more suitable for the academic panel than the PM. Paras 29 to 34 contain most of the good points. Para 36 to 39 are a plea for a tighter fiscal policy which I doubt are what you had in mind for this paper! Para 40 (only) is v condensed arguments against foreign exchange premia, discriminatory public purchasing etc. I would suggest structure on the lines of attached outline. Need redraft by Tuesday night to can discuss @ forecast meeting on Wednesday.
AA

TB

T BURNS

ENCS

pwp

PERSONAL

FROM: C W KELLY
DATE: 14 October 1986

MR ALLAN

cc. Ms Goodman

THE FED SWAP

I have been meaning to have a word with you for some time about (iii) of your letter on the markets of 3 October to David Norgrove. I am sorry that I have not done so before.

Unfortunately, the statement in (iii) that we have never revealed the existence of the swap with the US Federal Reserve is not true.

(a) The current size of the swap facility is displayed for all to see on page RTAZ on the Reuters screen.

(b) When we last made drawings upon it (in 1976) there were consequent fairly self-evident entries in at least one table in the BEQB. We also appear to have been fairly willing to talk about it at the time.

I doubt that you need to issue a correction to your letter, especially after all this time. But I thought you would like to know the position.

C W KELLY

SECRET AND PERSONAL

WG has a single ~~table~~ tabular memo for the PM @ this afternoon's mtg.

CH/EXCHEQUER
REC. 21 OCT 1986 √21/10
ACTION SIR P. MIDDLETON
COPIES TO SIR T. BURNS
PWP

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 October, 1986.

Re X, this was not agreed: it is a pure Wicks initiative. I do not believe any action is called for unless & until there is a specific request from the PM. But for my own satisfaction, pse let me have a graph showing the correlation betw. PSFD as a % GDP & UK short term interest rates. Re Y (2nd letter) the PM has a wholly exaggerated idea of the RPI effect of elec. prices. So far as I can recall, 1% on elec prices is about 0.03% on the RPI.

Dear Alex,

THE ECONOMIC PROSPECTS

The Prime Minister yesterday held a seminar at Chequers to discuss the economic prospects and economic policy. Present were the Chancellor of the Exchequer, the Chief Secretary, Sir Peter Middleton, Sir Terence Burns, and Professor Brian Griffiths. The meeting was discursive, and this record picks up the main threads.

The Prime Minister expressed strong concern about the underlying economic position. The markets were themselves signalling great disquiet, and they might be right. The savings ratio was falling; consumer and retail sales were growing very strongly; the current account had moved into deficit; it was perhaps significant that the effective exchange rate had fallen from 76 after the Budget to 67 now, even though the oil price had risen during that time. There was a whiff of a Barber boom about the economy, and the markets seemed to believe that the Government wanted to cut taxes in the 1987 Budget, come what may.

In discussion, it was pointed out that real interest rates had been negative in 1972. They were now enormously positive. Moreover, during the next few months inflation would be rising, and there were some signs of falling pay settlements. The effect would be to reduce the growth in real incomes which was fuelling consumer spending. It was acknowledged that the forecast of the current balance given in the FSBR had been wrong. But exports had been badly affected this year by the slow-down in UK export markets.

The Prime Minister suggested that fiscal policy could well be contributing to the overheating. The PSBR out-turn in 1985-86 had been only £$5^1/_2$ billion, with asset sales of around £$2^1/_2$ billion. The out-turn this year was expected to be at least £$7^1/_2$ billion, with asset sales of £$4^3/_4$ billion. The Public Sector Financial Deficit was in some ways a better measure than the PSBR, and that showed a very large increase between the two years. A looser fiscal policy and a deteriorating current balance were two very worrying

Since the aftn. letter the CST & P Walker cannot now do better than 3% on elec prices, this implies a diff of only 0.1% on RPI. ~~[illegible]~~

SECRET AND PERSONAL

developments. Against this, it was argued that the PSBR, even allowing for asset sales, was a lower percentage of GDP than it had been in 1981 after the very tough Budget of that year. The fall in oil revenues might also be a reason for allowing higher borrowing. It was agreed that further study would need to be made in the coming months of the links between public borrowing and interest rates.

X

The meeting agreed that the prospect for inflation was worrying. But some increase next year was inevitable in view of the sharp fall in mortgage rates and oil prices earlier this year. It was noted that the election in 1983 had been fought with inflation at 4%. It would be a test of the Government's stewardship whether the next election was fought with inflation lower than that. But this could well be difficult to achieve.

On the exchange rate it was noted that depreciation added to inflation and tended to release the pressure on employers to control their costs. It was agreed that the exchange rate could not be allowed to fall much further. Equally, substantial intervention could not be allowed to continue. Some small further movement in the exchange rate might be allowed (a move on the index from 67.3 to 67 was mentioned), but it would then be necessary to raise interest rates quickly. If this proved necessary, the increase would need to be large enough so as to avoid, if possible, a need for a further increase at around the time of the Autumn Statement.

X

There was a brief discussion of the National Insurance Fund and National Insurance contributions. It was agreed that an increase of 1/4% in both employer and employee contributions would be worth considering as a means to boost market confidence when the Autumn Statement was announced. However, the markets might see this simply as a means of making room for tax cuts in the next Budget. It was further agreed that an increase in the NHS element of NIC should be considered, to bring home to people the ever increasing cost of the National Health Service, and to help the PSBR.

Note
It doesn't help the PSBR unless NIC rates are increased correspondingly.
ACSA

I am recording other points separately.

I am copying this letter to Jill Rutter (Chief Secretary's Office).

Yours,
David.

David Norgrove

A.C.S. Allan, Esq.,
HM Treasury.

CONFIDENTIAL

FROM: S J DAVIES
DATE: 31 OCTOBER 1986

[illegible]

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Butler
Mr Kemp
Mr Monck
Miss Peirson
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Gilhooly
Miss Noble
Miss O'Mara
Mr Allum
Mr Brooks
Mr Stock

C/ Content with form of words?

CEP 31/10

I am surprised [illegible] has agreed to this: [illegible] GAD [illegible] report [illegible] (6½?) [illegible] for 1987/88 [illegible] The effect of the 1987/88 settlements that have already taken place, [illegible] settlements in future [illegible].

FORM OF WORDS FOR GAD REPORT

I would be grateful if you could approve the attached form of words for inclusion in the Government Actuary's report that is due to come out after the Autumn Statement. The assumptions on earnings and unemployment will also be given by DHSS in a PQ answer on the day of the oral statement. The draft form of words is the same as in last year's report, apart from changes as appropriate to numbers and dates (the relevant page from last year's report is also attached). The numbers are those you agreed earlier in the month.

2. No RPI assumption is needed for this report as the September 1986 RPI figure, which is what determines 1987-88 expenditure, has already been published. RPI assumptions for later years will be published in Part 3 of the Autumn Statement.

3. In my submission of 3 October on Economic ~~Submissions~~ Assumptions for Public Expenditure I raised the possibility of asking the Government Actuary to spell out a figure for settlements as well as earnings - to make clear that 6½ per cent on earnings implied a much lower number for settlements.

note
ch-gadrpt

4. Pay now advise against inclusion of a reference to settlements. When commentators pick it up (as they will), it will look as if the Government is promulgating a pay norm, and it will immediately be asked, "if that is the Government's intention, why is such a major step being done in such a low-key way?" At a more technical level, a figure of (say) 4 per cent in the GAD report would tend to highlight how ambitious the assumption of even a one percentage point fall in earnings next year really is (given the likelihood that overtime will start to rise again etc). Subject to your views, therefore, a settlement figure is not included in the attached draft.

SJD

S J DAVIES

DRAFT FORM OF WORDS

The income from contributions and the expenditure on benefits in the remainder of 1986-87 and in 1987-88 will depend inter alia [upon] the level of unemployment and on the rate of increase [of] in earnings. In accordance with the normal practice, working assumptions have been given to me by the Government [in regard to] for these factors. The assumptions I have been instructed to use for the purpose of the above estimates can be summarised as follows:

(i) that the number of claimant unemployed in Great Britain, excluding school-leavers, adult students and persons whose employment has temporarily stopped averages 3,100,000 in 1986-87 and 3,050,000 in 1987-88;

(ii) that average earnings in the tax year 1986-87 are assumed to be 7½ per cent higher than in 1985-86 and average earnings in the tax year 1987-88 are assumed to be 6½ per cent higher than in 1986-87.

ltrs
bb-assmpt

EXTRACT FROM CMND 9672

9. The income from contributions and the expenditure on benefits in the remainder of 1985–86 and in 1986–87 will depend *inter alia* upon the level of unemployment and the rates of increase of earnings and prices. In accordance with the normal practice, working assumptions have been given to me by the Government in regard to these factors. The assumptions I have been instructed to use for the purpose of the above estimates can be summarised as follows:

(i) that the number of claimant unemployed in Great Britain, excluding school-leavers, adult students and persons whose employment has temporarily stopped averages 3,050,000 in 1985–86 and 3,000,000 in 1986–87;

(ii) that average earnings in the tax year 1985–86 are assumed to be 8% higher than in 1984–85 and average earnings in the tax year 1986–87 are assumed to be 7% higher than in 1985–86.

1779.21

SECRET

Pres PPS

FROM: H C GOODMAN

DATE: 4 February 1987

1. MR KELLY 5.2.
2. CHANCELLOR OF THE EXCHEQUER

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Peretz - o/r
Mr Scholar
Mr Culpin
Mr Romanski

Mr Jefferson-Smith - C + E

Mr C W Corlett - IR

This is outrageous. I authorised no such consultations. I regard this as a breach of Budget security. I would like an investigation. NL

REPEAL OF EXCHANGE CONTROL ACT

I regret to report a possible leak about your intention to repeal the Exchange Control Act.

2. Customs and Excise told us today that at a meeting on 22 January with the British Bankers Association, some of those present appeared to have picked up a rumour that the Act was likely to be repealed shortly. Customs officials did not, of course, confirm this.

3. Repeal of the Act has consequential implications for a large number of other Acts. We thought it prudent to consult with the Revenue departments about some of this.

4. In the case of Customs, the VAT Act 1973 (schedule 6, group 5) refers to the definitions for securities used in the 1947 Exchange Control Act. This will need to be replaced by another definition. Customs have been undertaking a review of the classification of securities and intend to update these in this year's Finance Bill. So FP asked them to sweep up this point in the context of that review. They were specifically asked to keep numbers in the know as low as possible.

5. The consultative meeting with the BBA was part of the review. It was then that the BBA hinted that they suspected your intention to repeal the 1947 Act.

13/56

6. If the point arises again we will of course continue to deny any knowledge of it.

H C Goodman

H C GOODMAN

17

SECRET

From: SIR PETER MIDDLETON
Date: 13 February 1987

CHANCELLOR

Thanks. CX spoke. (I am sceptical, but NFA). N

REPEAL OF THE EXCHANGE CONTROL ACT

... I have as you asked conducted some enquiries into this apparent leak. The results are reflected in the attached notes from Mr Kelly and from Customs and Excise.

2. I think it is clear that Ms Goodman's minute of 4 February gave an unduly alarmist account of what went on. It was clearly only a passing reference, which might have been fishing, or even - as Mr Jefferson-Smith suggests - a misunderstanding of the present position. I doubt whether there is anything here that we need to pursue further.

3. As to your other questions, the meeting with the BBA seems to have been entirely in order. There was no question of consulting them about the repeal. As Mr Kelly acknowledges MG should have informed you before consulting the revenue departments in confidence. But, that apart, the question seems to have been handled entirely properly.

PEM

P E MIDDLETON

2252/037

COVERING SECRET

FROM: J E FLITTON

DATE: 27 February 1987

1. MR KELLY ✓ 27.2

2. MR ALLAN

cc: Mr Peretz
Ms Goodman

FLITTON TO ACSA 27/2

INTERVENTION 1979-1987

I attach tables and a chart showing changes in total intervention (spot and forward) and a breakdown of the annual reserves revaluation between gold and foreign currencies.

2. They are as follows:

(i) annually since 1979 (by financial year);

(ii) monthly since April 1985, showing also totals for financial years 1985-86 and 1986-87 (to date);

(iii) a bar chart, prepared by Miss Kirk, of the total change in (ii); and

(iv) the annual revaluation showing separately the gold and foreign currency components.

Keep 1 & 2 tables (as below), with footnotes

J E FLITTON
MG1

Ch

(1) want Feb figures in all tables

(2) revaluation table should be on financial years (if others are).

(3) revaluate 82/83 of foreign currency reserves only

(4) two new cols e.g.: revaluation & total res revaln (no separate reval. table)

(5) No bar chart

2252.35

SECRET

~~TOTAL INTERVENTION (SPOT AND FORWARD)~~ 1979-1987

Doesn't include borrowing

CHANGE IN FOR'N CURRENCY RESERVES, 1979/80 - 1986/7

$ million

Financial Year	Market Intervention	Off-Market transactions	Total ~~Intervention~~
1979-80	+3,222	(1038) +1,040	(6260) +4,262
1980-81	+2,031	+387	+2,418
1981-82	-1,753	-319	-2,072
1982-83	-1,431	-2,026	-3,457
1983-84	+2,817	-2,908	-91
1984-85	+1,695	-2,839	-1,144
1985-86	+1,293	-895	+398
1986-87 (to date) January	+2,069	-3,003	-934

Footnote 1 [illegible] spot & forward
2 (Revaluation - explain)
3 Gross reserves also affected by net borrowing, not shown here

Wants! to EHS-FA

SECRET

2252/34

(≈ OFF MKT TRANSACTIONS)

MONTHLY

~~TOTAL~~ INTERVENTION (SPOT AND FORWARD) APRIL 1985-~~JANUARY~~ FEB 1987

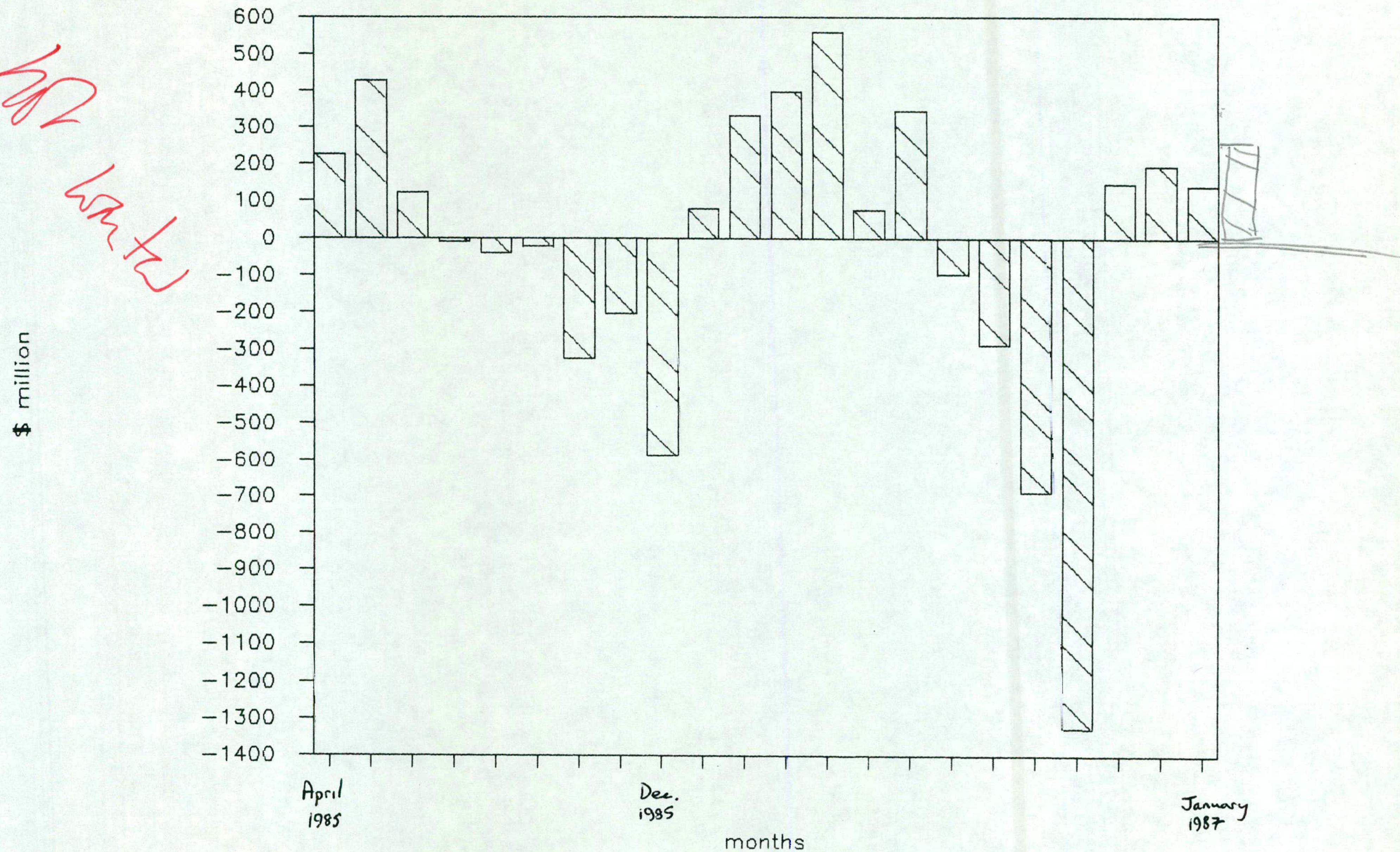
$ million

		Market	Off-market	Total
		Mkt	transactions	
1985	April	+442	-217	+225
	May	+447	-19	+428
	June	+98	+24	+122
	July	+95	-105	-10
	August	+102	-142	-40
	September	+154	-176	-22
	October	-306	-18	-324
	November	+72	-274	-202
	December	-239	-349	-588
	Total	+865	-1276	-411
1986	January	-187	+266	+79
	February	+204	+128	+332
	March	+411	-13	+398
	April	+755	-197	+558
	May	+197	-121	+76
	June	+487	-144	+343
	July	+159	-255	-96
	August	-102	-184	-286
	September	-92	-596	-688
	October	-785	-540	-1325
	November	+448	-301	+147
	December	+466	-270	+196
	Total	+1961	-2227	-266
1987	January	+536	-395	+141
	FEB			

Financial year totals

	Market	Off-market	Total
1985-86	+1293	-895	+398
1986-87 (to date)	+2069	-3003	-934

total intervention Apr 85–Jan 87



2252/36

BREAKDOWN OF ANNUAL (MARCH) RESERVES REVALUATION

$ million

	Gold	Foreign Currencies	Total
1979	+3,116	+1,377	+4,493
1980	+3,628	-804	+2,824
1981	+272	-529	-257
1982	-2,754	-1,464	-4,218
1983	+1,351	-305	-1,046
1984	-443	-536	-979
1985	-1,166	-945	-2,111
1986	+592	+1,913	+2,505

Wants on Financial Yrs,
For'n currencies only,
1986-87 to end of Feb
(also, explain)