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Dear Paul.

EMCF SWAP

The Prime Minister asked why the revaluation of the European Monetary Co-operation Fund (EMCF) swap had contributed \$660 million to the fall in the reserves last month.

I enclose a note which sets out the details of the transaction. Briefly, the reserves fall reflects the different valuation practices of the Exchange Equalisation Account (EEA) and the EMCF and relates almost entirely to the EMCF's higher valuation for gold for the October-January swap. The transaction is a purely notional one. The EEA actually retains the 20 per cent of its gold and dollar holdings which forms the basis of the swap and the dollar income which accrues from it. Moreover, while the spot reserves were reduced by \$660 million on this account in January, there was a corresponding increase in the forward book of exactly the same amount.

Yours
Alex

A C S ALLAN
Principal Private Secretary

EMCF SWAP

The European Monetary Co-operation Fund (EMCF) provides short-term credit facilities for intervention for EMS members. The UK has participated since joining the EMS in 1979. Each member of the EMS swaps 20 per cent of its gold and dollar reserves with the EMCF in return for ecus. The swaps are for three months and revolve, so that after three months, EMS members receive back the same quantities of gold and dollars they previously swapped but provide as a new swap whatever quantities of gold and dollars then comprise 20 per cent of their total holdings.

The EEA accounts for the swap as follows. The UK surrenders 20 per cent of its gold and dollar reserves to the EMCF and so the spot reserves fall by that amount in the month the transaction takes place. Since the EMCF is committed to unwind the swap after three months, the forward book rises by the same amount. The EEA simultaneously receives ecus from the EMCF for the gold and dollars it has surrendered, so the spot reserves rise by that ecu amount and the forward book falls by the same ecu sum, reflecting the subsequent unwinding of the swap.

In principle, these transactions should cancel out completely, with no effect on either the spot or the forward book. However, this does not happen in practice because of the different way in which the EEA and the EMCF value their holdings. The operation can be broken down into three stages.

(i) When the EEA surrenders gold and dollars, the spot reserves fall and the forward book rises by the UK's valuation of its holding.

(ii) The ecus the EMCF gives the EEA in exchange reflect the EMCF's ecu valuation of gold and dollars.

(iii) Those ecus enter the UK's spot reserves, and are deducted from the forward book, at the UK's valuation of ecus.

This is, of course, only half the transaction. On each occasion the swap is unwound, the EEA enters a new swap with the EMCF, under which 20 per cent of the gold and dollar reserves held on that date are exchanged for ecus. It is the net valuation effect of both halves of the transaction which is separately identified as a reserve change in the reserves Press Notice.

In January, the bulk of the valuation effect was seen in the unwinding of the swap entered into in October. In that swap the EMCF had valued the EEA's gold at a much higher price than the UK does, although the EMCF and EEA had used similar valuations for the \$/ecu rate. As a result, the EMCF had credited the EEA with a much greater value of ecu than the EEA had given up (at its valuation) in gold and dollars. But this gain had to be surrendered when the swap was unwound in January. In the new swap, the EMCF had cut its gold price, thus reducing the overvaluation effect, but it also cut its \$/ecu rate so that

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it now undervalues the EEA's dollars. These two effects broadly cancelled, so there is little net valuation change in the January swap. The valuation change shown in the January reserves is, therefore, almost entirely the unwinding of the overvaluation of gold in the October swap. The Annex sets out the effect of the January transaction on the EEA's accounts in detail.

Valuation changes relating to the EMCF swap can be in either direction. In April 1987, the spot reserves fell by a net \$99 million as a result of the swap but in July they rose by \$57 million and in October rose again by \$129 million.

Not only is any valuation change in the spot reserves resulting from the swap offset by an exactly equivalent valuation change in the forward book but the whole swap transaction is in any case notional. The UK does not actually surrender gold and dollars for ecus; it continues to hold the underlying gold and dollar assets and manage them as part of the UK's reserves. It makes no loss on the swap as a result of the differing valuation practices and the dollar assets which form the basis for the swap continue to earn dollar income.

The EMCF difference reported in the reserves announcement reflects combined effect of the valuation differences in unwinding one swap and entering the next. The table below shows how the difference of \$660 million referred to in the January reserves announcement arises:

1. <u>Unwinding swap</u>	\$million	mecu
EMCF values gold at		1893
EMCF values dollars at		<u>3002</u>
		4895
EEA surrenders 4895 mecu which UK values at	5504	
EEA receives gold which UK values at	1448	
EEA receives dollars	<u>3385</u>	
	4833	
Effect on spot reserves	<u>-671</u>	
2. <u>Entering new swap</u>		
EEA surrenders gold which UK values at	1448	
EEA surrenders dollars	<u>4525</u>	
	5973	
EMCF values gold at		1786
EMCF values dollars at		<u>3536</u>
		5322
EEA receives 5322 mecu which UK values at	5984	
Effect on spot reserves	<u>+ 11</u>	
Overall effect of EMCF swap rollover on spot reserves	<u><u>-660</u></u>	