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25 April 1990

Barry Potter Esq
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Dear Barry

ERM : SPAIN

... I attach a note addressing the questions in your letter of 23 April.

It is difficult to draw lessons for the UK from the Spanish experience after joining the ERM. Sterling is a much more widely traded international currency than the peseta; and Spanish financial markets are still underdeveloped, and subject to exchange controls and credit controls.

However, the attached note shows that it is not the case that interest rates, inflation and monetary growth have all risen since Spain joined the ERM in June last year. In fact Spanish interest rates have remained at approximately the same level since then, as has the Spanish rate of inflation. Money supply growth has fallen sharply, though this may partly be a result of credit controls driving borrowing and lending transactions into forms not included in the measure of broad money that the Spanish authorities target.

Yours

Jsg.

JOHN GIEVE
Principal Private Secretary

ERM Membership : Spain

There are some similarities between the UK's economic situation and that of Spain when the peseta joined the ERM in June 1989.

Notably :

- the Spanish economy had been growing exceptionally fast
- there was a rising rate of inflation : 6.9% in May 1989, compared with an average of 4.8%.
- high interest rates. A three month rate of around 15% just before joining the ERM.

There are also some differences, notably a government budget deficit in Spain equivalent to around 3% of GDP in 1989.

2. The main reason, however, for expecting experience with the £ to be different from that with the peseta is the much wider international use of the £ and much greater sophistication of our financial markets. The peseta is little used as an international investment currency, and Spanish financial markets are somewhat antiquated, with some exchange controls remaining in force. As a result the Spanish authorities are able to operate a variety of direct credit controls.

3. The attached charts show what has happened to the exchange rate, interest rates, monetary growth, and inflation since the peseta joined the ERM. The main points are as follows :-

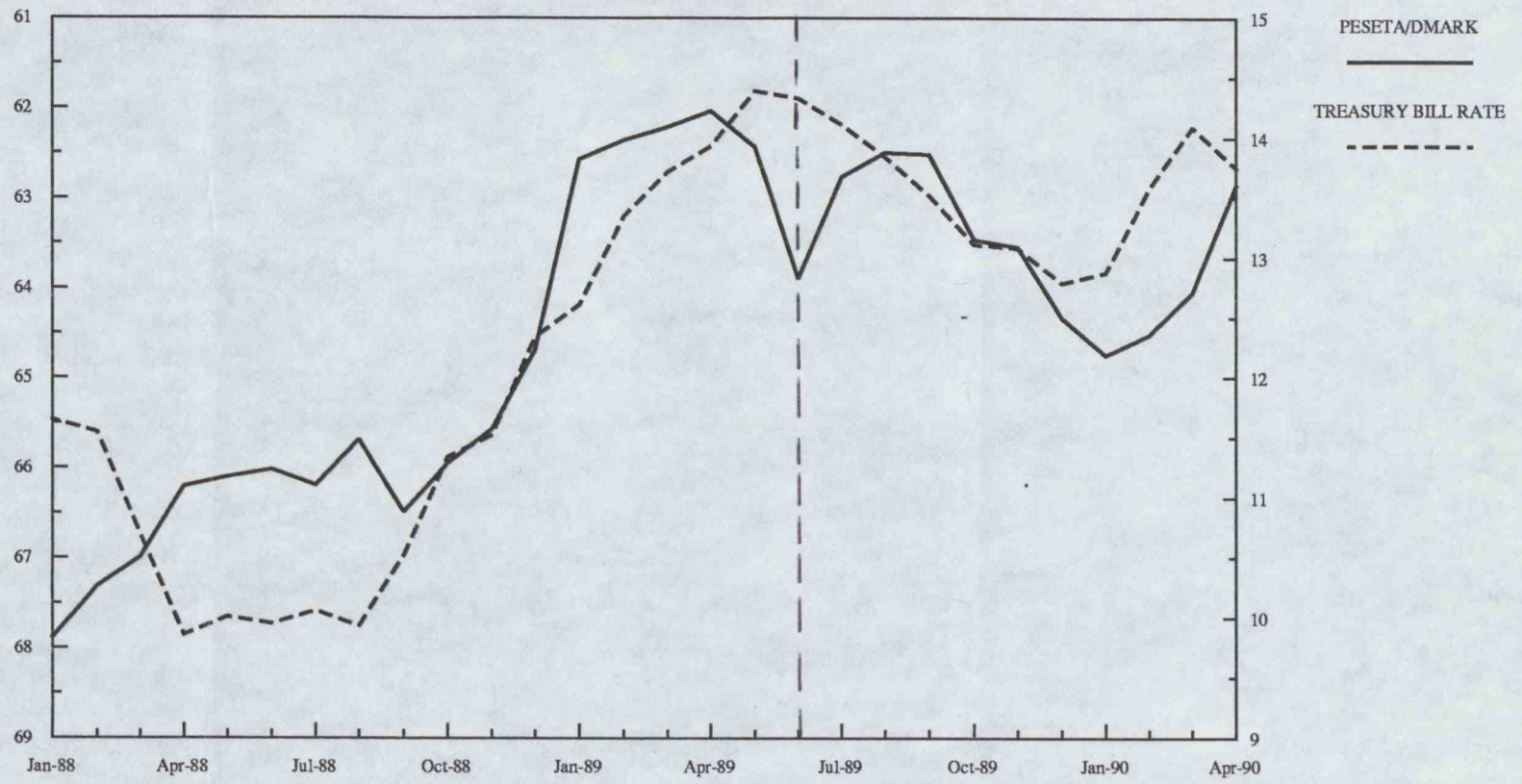
- a) Exchange rate. The peseta rose immediately after entry, from 64.33 per DM on 16 June 1989 (the day before entry) to 63.20 - an initial rise of around 2%. Over the period since then the peseta has fallen against the DM and then more recently risen again, but remained above its central rate of 65 per DM. Capital flows into the peseta that might have been expected, given the interest

rate premium over the DM, have been limited by rigidities in Spanish peseta markets, and also by official restrictions.

- b) Interest rates. The initial rise in the peseta no doubt reflected the extra attraction of high peseta interest rates, once the perceived risk of devaluation was reduced by joining the ERM. This led immediately after joining to a significant fall in euro-peseta interest rates, but only a very slight fall in domestic interest rates, which was quickly reversed. (The difference between the two is the result of exchange controls). In July 1989 the official peseta interest rate was raised by $\frac{3}{4}\%$, alongside some tightening of credit controls to try to reduce domestic monetary growth. Market interest rates now at much the same level as when Spain joined the ERM.
- c) Monetary growth. The Spanish target a broad measure of money, rather like M4, called ALP. The target range for 1990 is $6\frac{1}{2}\%$ - $9\frac{1}{2}\%$. Just before ERM entry, in Q2 1989, ALP was growing at an annual rate of $13\frac{1}{4}\%$. The annualised rate of growth over the most recent three months (to February 1990) was $3\frac{1}{2}\%$. The Spanish authorities believe however that much of this very sharp slowing in monetary growth may be the result of credit controls acting to divert borrowing and lending into transactions that do not affect the measured money supply. Very recently these controls have been relaxed: in particular the compulsory reserve asset requirement has been reduced from 17% to 5%.
- d) Inflation. The rate of inflation in Spain has changed little since joining the ERM. The annual rate remains around 7% - averaging 6.7% in the first three months of 1990, compared with 6.9% just before Spain joined the ERM.

SPAIN

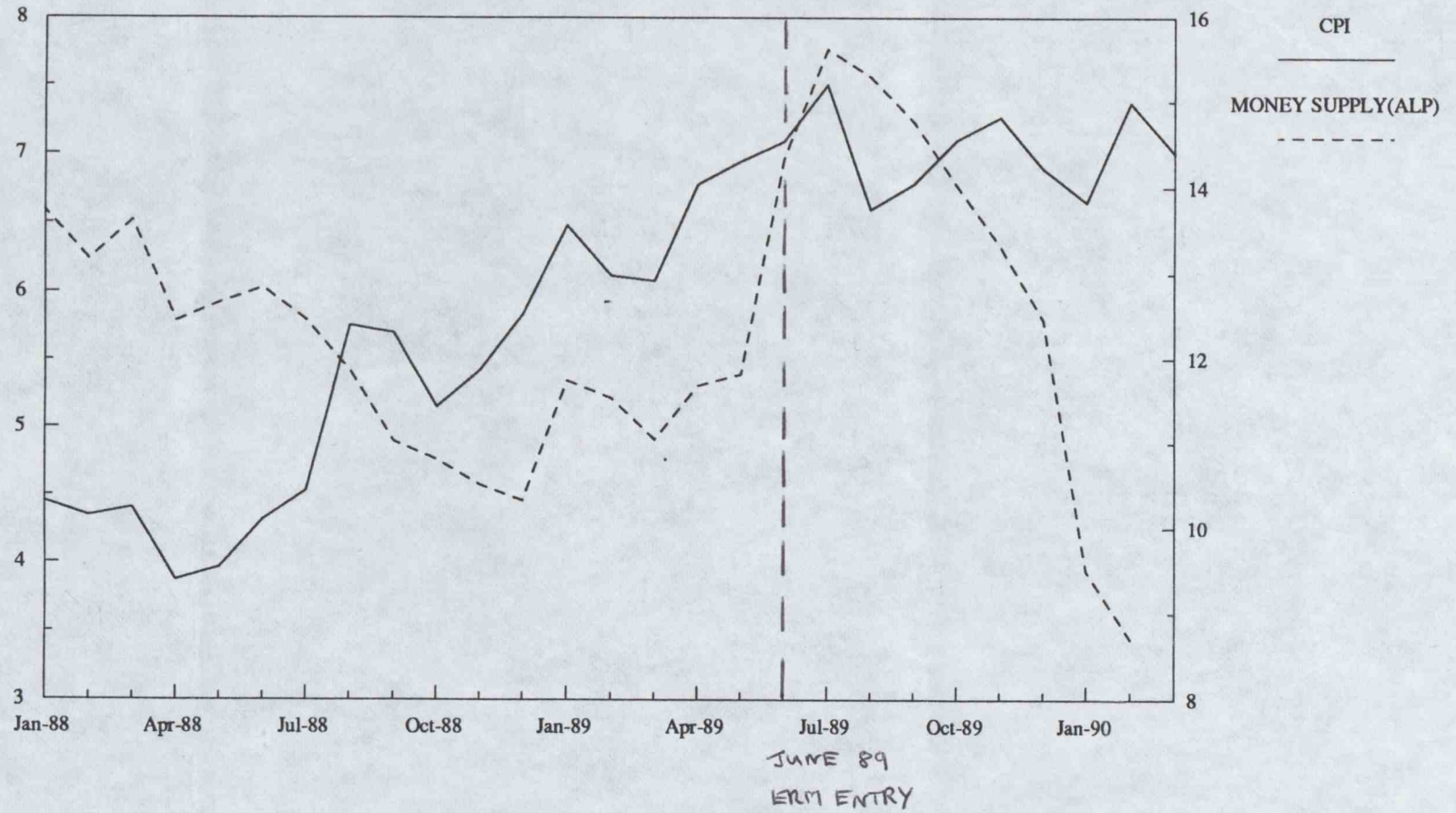
PESETA/DMARK EXCHANGE RATE AND TSY BILL RATE



JUNE 89
ERM ENTRY

SPAIN CPI AND MONEY SUPPLY(ALP)

% CHANGE ON A YEAR EARLIER



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