

Sir M. Butler

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 May 1990

EMU

I enclose yet another letter from Sir Michael Butler. You may wish to take account of it in any reply to his letter of 23 April.

C. D. POWELL

John Gieve, Esq.
H.M. Treasury

A handwritten signature, likely of John Gieve, written in dark ink.



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Tim Austin

1st May 1990

*CAF
4/5.*

Mr Charles Powell
10 Downing Street
London SW1

*MS
1/5.*

Dear Charles,

In paragraph 5 of my letter to the Prime Minister of 23rd April I promised a short paper on the effects of the proposals in the European Committee's Stage 2 paper in the field of resisting speculative attacks. It has taken a few days to iron out the bugs. But I now enclose a paper which ought, I hope, to pass muster with the experts. I should be most grateful if you would show it to the Prime Minister.

Yours ever

Michael

Maintaining parities against speculative attack
under the European Committee's Stage 2 proposal

Example I

Scenario.

Sterling interest rates need to be raised to deal with U.K. inflation. Dollars and yen as well as marks and francs are moved into pounds and there is upward pressure on the £/ecu parity. The rules of the EMF forbid revaluation of any currency against the ecu. The EMF has therefore to work with the Bank of England to counter the speculative flows.

Counter-action.

Initially, the Bank of England sells pounds for ecus in the market and adds the ecus to reserves to the extent necessary to hold the pound/ecu rate. But this process must not be allowed to go on too long or the U.K. money supply will increase to an undesirable extent. The EMF should see the force of this argument because of their commitment to price stability. So at this stage the EMF would raise ECU interest rates in order that the ecu can remain as strong as sterling. If the flows into the ecu from outside the E.C. were considerable, the ecu would rise against the dollar and the yen, and the pound with it, for as long as the speculative flows continued. There is no reason why action so far should cause problems for the pound or the ecu. It might in time cause some problems, say, for the mark or the franc where either higher interest rates could be required to prop up the currency or the German or French Central Banks might have to sell ecus (or pounds or dollars) from their reserves. If essential, they could borrow ecus for the purpose from the EMF.

*affecting
all
others*

Example

Example II

Scenario.

The pound is weak despite relatively high interest rates. The economy is going into recession. Lowering U.K. interest rates provokes a run on the pound. It is agreed in the EMF that there is no case for devaluation on balance of payments/macro-economic grounds.

Counter-action.

The Bank of England uses some of its ecu and foreign exchange reserves to buy pounds for ecus in the market, if necessary also borrowing ecus from the E.M.F. for this purpose. The E.M.F. also buys pounds for ecus in the market, if necessary in large quantities, holding the pounds in its reserves. If necessary and provided all continue to be agreed that devaluation should be avoided, some of the other major central banks will also buy pounds.

*Presumably
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Defence against downward pressure is naturally less strong than against upward pressure (where under the rules the EMF cannot allow it to succeed in forcing a revaluation). But the EMF and other central bankers should bear some of the strain in the interests of maintaining stability.

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This scenario assumes that the speculative flows against the pound do not arise from irresponsible behaviour by the British authorities contrary to the rules of EMF, either creating additional sterling to replace pounds changed into ecus or monetary financing of budget deficits. But let us assume that Greece finds itself under speculative attack because of irresponsible behaviour and yet the EMF consensus is that devaluation is not the appropriate response. For such a case, under our proposals as now refined, action to protect the drachma against speculative attack would be accompanied by:-

- (a) a warning to Greece from the EMF and ECOFIN to rectify its irresponsible behaviour;
- (b) if this warning is not heeded, enforcement of an obligation by Greece (applicable to all member states) to reconvert some or all of the drachma added to the EMF's reserves into ecus;
- (c) in the last resort, suspension of convertibility of drachma into ecus.

Conclusion.

These defences for the pound would be considerably stronger than the existing ERM defences, which have in practice so far proved more effective than expected, and would probably be sufficient in most normal circumstances. Once the new Stage 2 system had achieved credibility in the markets, such speculative attacks would be rare. In the last resort, devaluation of sterling might become unavoidable but, judging by experience with the ERM, a far smaller devaluation would do the trick than would be needed if the pound was floating.

More generally, the proposed hard ecu system would also provide more effective sanctions against irresponsible behaviour by other member states than now exist.

0011L MDB/MML

23rd April, 1990