10 DOWNING STREET

Prime Minister (2)

Treasury have looked into bear squeezes. While the note sets out the difficulties clearly enough, it is not very encouraging on the options available. The main risk from acting on short rates is that it might & repercuss too widely.

AT 25/1

What can we do?

Is there any possibility of securing the cooperation of the banks in not lending overnight for this purpose?

CONFIDENTIAL

A "bear squeeze" on speculators against Sterling

With Exchange Controls

The classic "bear squeeze" technique against currency speculators depended on the existence of exchange controls.

2. Under exchange controls residents were not allowed to hold dollar deposits; so opportunities for currency speculation by UK residents were limited, and important speculators were non-residents.

3. Nor were UK residents allowed to lend sterling to non-residents. So if non-resident speculators wished to borrow sterling to sell they had to borrow sterling from other non-residents in the offshore ("Eurosterling") market. Exchange controls, in effect, separated the eurosterling market from the domestic sterling market, and interest rates in the former could rise a long way without - in the short term at least - affecting domestic interest rates.

4. The eurosterling market was quite a narrow one. In those circumstances, the Bank could operate quite easily to push up rates in that confined market - that is the rates at which speculators had to borrow - to very high levels. The classic technique was for the Bank to sell dollars and buy sterling spot (hence taking money out of the short term eurosterling market, and pushing up rates) and sell sterling forward.

5. When the French - who still have exchange controls - used a similar technique before the last EMS realignment, they pushed overnight interest rates in the Euro French Franc market up to 1,000 per cent or more for a day or so, without affecting domestic interest rates.

Without Exchange Controls

6. Clearly, we cannot use this particular technnique nowadays.

The only equivalent would be to act to raise domestic short term rates to very high levels.

7. There is no need to operate in the foreign exchange market to push up overnight sterling interest rates. The Bank could achieve this relatively simply through their domestic money market operations. They would keep the market short through the day, causing a scramble for funds - which they could relieve late in the day by lending to the discount market at a rate of their choosing.

8. The difficulties are:-

(i) This of course would hit all who operate in the short term market - banks, discount houses, and so on - as well as currency speculators. There is no way to discriminate.

(ii) It would be hard to prevent this rise in overnight (and perhaps up to 7 day) rates feeding through to one month or three month rates - which would risk triggering a rise in clearing bank base rates.

(iii) Unless the purposes of the operation were clearly explained, it could easily be interpreted by the markets as a signal that the authorities wanted a rise in base rates.

(iv) It certainly could not be held for more than a day or so without bringing about a rise in base rates: so all would turn on there being an immediate impact on the exchange rate. If there were not we would be in a worse position than had it not been tried.

9. To give any reasonable chance of success:-

(a) We would probably have to explain clearly what we were doing and why. This would be the best way of reducing risks (ii) and (iii) above. But, of course, it would also increase the problems should we not quickly succeed

in raising the exchange rate. And we might be seen as coming very close to having a public exchange rate target, with all that would imply for the future operation of policy

(b) We would want to choose a period in which we could be reasonably confident that there would be no "bad news" (eg. on oil prices) weakening sterling - or better still in which we knew of some "good news" to come.

Intervention

10. The other way of seeking to "burn speculators' fingers" is straightforward intervention. Speculators can lose money without a rise in short term interest rates, simply by the exchange rate moving against them in an unexpected way. The purpose of the G-5 agreement on intervention was precisely to keep them guessing.

11. Of course speculators in that case can always maintain open positions, and hope that exchange rates move back their way: and if short term interest rates have not gone up, the cost of keeping an open position against sterling will not be increased. But they are unlikely to want to sit for too long on a unrealised exchange loss that looked as if it could get bigger.

12. It is, though, in this context important to distinguish between concerted G-5 intervention against the dollar, which we believe could have a useful impact, and large scale intervention on our own. Even the Germans have not had significant success intervening against the dollar by themselves. For us there would be an additional problem - of the kind that the Government of the day faced in the mid-1970s - that as intervention was seen to deplete the reserves, the figures for which are published monthly, confidence could turn further against sterling on that account.