FE 2/2.4

3/2

SECRET

1982/8

CWP/cawyor

FOREIGN EXCHANGE AND GOLD MARKETS

Week ending 24th February 1982

The EMS realignment took the markets by surprise, but of more importance was the sharp drop in US money supply which permitted further reductions in interest rates. Prime rates in the US were cut by ½%, negating last week's increase and the dollar fell back from its recent peak levels. Weakening oil prices and the cut in base rates gave sterling a softer tone; the ERI fell 0.9 to 90.8.

Despite the ½% cut in the clearing banks' base rates, the uncovered differential between US and UK rates narrowed in sterling's favour during the week. It did so, however, against a background of further weakness in world oil prices, an improvement in the competitive position of two of the weaker European currencies and some concerns about the likely contents of the budget. These factors combined after the weekend to end sterling's recent period of stability. From a closing level in New York of 1.8368 on Wednesday night, sterling opened in London at 1.8485 on Thursday. After a quiet start, the pound began to move up on Friday against an easier dollar, following the good performance of the US bond market the previous day, touching 1.86 during the morning but falling back to 1.8518 by the close. The sharp drop in US money supply made for a weaker dollar again on Monday and sterling initially traded up to 1.8637 but soon encountered some selling stimulated by concerns about the effects of falling oil prices. With the Bank also edging its bill dealing rates lower, sterling developed an easier tone and this became more pronounced on Tuesday, when some aggressive selling in the Far East took the rate down to 1.8387 by the London opening. In then rather featureless trading, the rate moved narrowly around 1.84 until late in the day when, as the dollar firmed generally, it fell to 1.8270. Although the rate had recovered to 1.8350 by the opening on Wednesday, it fell half a cent on news of the first base rate cut and, with some sizeable commercial orders to sell sterling against marks in the market, it remained around 1.83 for the balance of the day, falling to 1.8225 at its weakest point, before closing at 1.8285. Sterling fell sharply on the Continent, losing 2½% in Switzerland (3.42¼) and 1½% in Germany (4.32¼) and France (11.01⅛). Against the ECU sterling closed at a discount of 13/16% on its new notional central rate. Euro-dollar rates fell sharply over the week, three-months' deposits closing down 1⅝% at 14 15/16% while sterling interbank rates were ⅝% lower at 14%. Sterling's forward premium narrowed to 1% and the covered differential was 1/16% in favour of London.

The long-awaited drop in M1 (-$3.1bn.) set off a rally in the US bond market and was followed by ½% cuts in prime rates to 16½%. While the dollar weakened in most centres it gave ground only reluctantly, as operators awaited confirmation that US interest rates were firmly set on a downward path. The large current account deficit announced in Germany for January did nothing to help the mark (2.3639) which moved to the bottom of the realigned EMS, 15/16% below the Danish crown (7.9265) which was devalued by 3%. The French franc closed at 6.0220. The Belgians spent $100mn. before their 8.5% devaluation at the weekend, the Italians sold $500mn. and the Irish $190mn. Elsewhere, the Swiss franc (1.8720) firmed to 0.79¼ against the mark and the yen improved 2% to 234.20. The Canadians spent $120mn. in support of their dollar.

Gold continued an active and nervous market. Further Russian selling and reports of some Middle East liquidations put further pressure on the price which failed to respond to the downturn in US interest rates. After setting a new two-year low of $360.50 on Monday, the final fixing at $362.75 made a fall of $11.25 over the week.

24th February 1982.

TRS