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Treasury Chambers, Parliament Street, SW1P 3AG
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Michael Scholar, Esq.,
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Dear Michael,

THE EXCHANGE RATE

The foreign exchange markets have been reacting to the Falklands/Argentine situation since the weekend, and as you know sterling came under quite strong selling pressure at times today.

The general uncertainty has been reflected in a rise in the gold price, from \$328 an ounce on 2 April to \$346 an ounce at the London close today; and a general strengthening of the dollar against other currencies. Both the Japanese and German authorities have intervened today to support their currencies (spending \$240 million and \$30 million respectively); Japanese intervention was particularly heavy as they sought to prevent the yen rate approaching 250 to the \$. The French have also spent around \$60 million supporting the franc, although in the main the effect of recent events has been to divert attention from their currency.

Not surprisingly, sterling has suffered more than other currencies. The following table shows movements since Friday.

	London close 2 April	London close 6 April	% fall
£ effective index	<u>91.00</u>	<u>89.36</u>	- 1.8
£/\$	1.7877	<u>1.7490</u>	- <u>2.2</u>
£/Deutschemark	4.29	<u>4.22</u>	- <u>1.6</u>

The fall in the effective exchange rate has thus been limited to under 2 per cent. The effective rate is of course the best measure we have of the possible impact of changes in the exchange rate on inflation and competitiveness. There have been similar movements in recent months. For example, over a few days in the first half of December the effective rate fell from around 92 to 89.6 on interest rate and oil price

/expectations.

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expectations. Yesterday and today the Bank have had to intervene to steady the market, spending around \$60 million and \$152 million respectively.

There must be a risk that this pressure will continue. After discussion between officials and the Bank, the Chancellor has therefore authorised the Bank to continue to intervene in a similar manner, within a figure of about \$200 million a day up to and if necessary just over the Easter weekend. We would expect the daily figure to be no more than about half that on the two days, Good Friday and Easter Monday, when the New York and Far East markets are open but London, Frankfurt and Paris are closed. There is as usual no question of allowing ourselves to become pinned to support any particular effective rate or dollar rate.

At the same time pressures in the domestic markets have brought a rise in sterling interest rates. Three month sterling rates have risen $\frac{1}{2}$ per cent since 2 April. We have thus been following a policy of allowing both interest rates and the exchange rate to take some of the strain; and have not sought to block all movement on either front. The movement does not so far constitute a threat to base rates.

It may be that market pressures will ease over the next few days. If, on the other hand, they do not, and they bring a further sharp fall - carrying the effective exchange rate, say, 2 per cent or more lower - then the Chancellor thinks that it may become necessary to consider policy action on interest rates, to see us through the period of uncertainty. If this were to happen, we would expect to reverse the action as soon as the uncertainty ended.

Yours ever,

J. O. Kerr.

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