International financial developments

Among the main developments:

- *In the second half of 1981 the oil exporters' current account surplus was running at barely one third of its peak in the first half of 1980. The main beneficiaries were the industrial economies, whose combined current account deficit had been largely eliminated by the second quarter of 1981.*
- *Efforts by other developing countries to reduce their current account deficit through import restraint were largely nullified by adverse movements in their terms of trade and increased interest payments.*
- *The underlying rate of growth of international bank lending revived in the third quarter of 1981. Oil exporting countries became net borrowers for the first time since the fourth quarter of 1978.*
- *Exchange rates fluctuated markedly in the New Year with interest rates once again the preponderant factor.*

This review covers recent developments in world payments balances and their financing, the deployment of the surpluses of the oil exporters, international banking, and the foreign exchange markets. A comprehensive review of international banking markets in 1980–81 can be found on page 42.

Balance of payments developments

In 1981, the main influence on the distribution of current balances among the major country groupings was the sharp decline in the demand for oil in the industrial countries, with the consequent weakness of oil prices. Between the final quarters of 1980 and 1981, the revenues of the oil exporters fell by one fifth in dollar terms as a result of a fall in export volume of about 25% and a rise in oil prices of 4%. Influenced also by a rapid rise in the volume of their imports, the oil exporters' current account surplus fell markedly during the year, and in the second half it was running at an annual rate of around $40 billion, barely one third of its peak in the first half of 1980. A number of oil exporting countries are now in substantial deficit.

The OECD countries provided the main counterpart to the falling surplus of the oil exporters. In particular, the combined deficit of the major six overseas economies was almost eliminated after the first quarter of 1981 (but there were some important shifts in the distribution of surpluses and deficits within this group—see below). There was a more modest improvement in the external position of the smaller OECD countries during 1981, but this was achieved at the expense of severe domestic restraint, especially in Europe, and the improvement appears to have been concentrated in a small number of countries, notably the Netherlands, Norway and Switzerland. By contrast, the developing countries experienced only a minor reduction in their current account deficit during 1981. Their efforts at import restraint have been largely nullified by a worsening in their terms of trade and mounting interest payments.

Current account summary(a)

$ billions; *seasonally adjusted*

	1980 Year	1981 Year	Q1	Q2	Q3(b)	Q4(b)
Major overseas countries(c)	- 43	-19	-11	- 3	- 3	- 3
Other OECD(d)	- 38	-31	-10	- 9	- 7	- 5
Total OECD(d)	- 81	-50	-21	-12	-10	- 8
Oil exporting countries	110	65	24	19	12	10
Other developing countries	- 66	-74	-19	-20	-18	-16

(a) The columns do not sum to zero because of incomplete country coverage (eg the United Kingdom is excluded because of the lack of statistics for 1981), timing differences, and other statistical deficiencies.

(b) Bank estimates.

(c) United States, Canada, France, Italy, Japan, and West Germany.

(d) Excluding United Kingdom.

Major OECD current balances

The decline in 1981 in the current account deficit of the major OECD countries taken together was reflected, within the group, in a particularly marked improvement for a number of the countries which had been hardest hit by the 1979–80 oil price rise. Much of this can be attributed to substantial changes in competitive positions resulting from a combination of the rapid appreciation of the US dollar until August last year and the wide inflation differentials among the major countries. The most significant current account improvement has been that of Japan, with a surplus

Major overseas countries: current balances

$ billions; *seasonally adjusted*

	1980 Year	1981 Year	Q1	Q2	Q3	Q4(a)
United States	3.7	6.3	3.3	1.1	2.1	-0.2
Canada	- 1.4	- 6.6	- 1.7	-1.8	-2.3	-0.8
France	- 7.8	- 7.8	- 2.2	-0.4	-2.0	-3.2
Italy(a)	- 9.9	- 8.0	- 4.5	-2.0	-0.6	-0.9
Japan	-10.8	4.7	- 0.8	1.9	2.5	1.1
West Germany	-16.4	- 8.0	- 4.7	-2.3	-2.3	1.3
Six major overseas countries	-42.6	-19.4	-10.6	-3.5	-2.6	-2.7

(a) Includes Bank estimates.

of nearly $5 billion last year, due largely to its highly competitive position. In West Germany, the improvement on current account did not begin until the second quarter of 1981, but in the final quarter there was a surplus for the first time in nearly three years. This shift can be attributed largely to buoyant exports. By contrast, the United States' current account probably moved into small deficit in the final quarter of 1981, in spite of the weakness of domestic demand.

External financing and reserve movements

Exchange rate pressures associated with high US interest rates altered the pattern of capital flows between OECD countries in 1981 as the authorities in many countries responded to downward pressures on their exchange rates against the dollar by running down their reserves. But the extent of such intervention was not great; current US policy is not to intervene, apart from in exceptional circumstances, and exchange rate pressures were also offset in 1981 by authorities outside the United States being willing to align domestic short-term interest rates more closely with those in the United States.

Developing countries balance of payments[a]

$ billions; *not seasonally adjusted*

	1980	1981		
	Year	Q1	Q2(b)	Q3(b)
Current balance	-66	-18	-18	-19
Capital balance, excluding official financing	64	14	16	19
of which:				
Direct investment(b)	*8*	*2*	*2*	*2*
Capital market finance(c)	*42*	*5*	*10*	*11*
Other(d)	*14*	*7*	*4*	*6*
Official financing balance	- 2	- 4	- 2	—
of which:				
Borrowing from IMF	*3*	—	*2*	*1*
SDR allocations	*1*	*1*	—	—
Reserves (increase -)(c)	*- 1*	*3*	—	*- 1*

(a) Excluding oil exporting countries. Figures may not add exactly because of rounding.
(b) Bank estimates.
(c) Adjusted to exclude valuation changes.
(d) Includes official flows, trade credits, errors and omissions.

In 1981 as a whole, the combined current account deficit of OECD countries (apart from the United States) continued to be financed in part by reserve depletion, and, with the aggregate current account deficit narrowing significantly, *ex post* capital inflows were sharply reduced. Nevertheless, during the fourth quarter of 1981, the easing of upward pressure on the dollar enabled most OECD countries to rebuild some of the reserves lost earlier in the year.

Despite continuing high current account deficits in the developing countries, the rate of their borrowing from the international banking system slackened markedly early in the year—partly, it seems, for seasonal reasons. Thereafter their bank borrowing picked up again. Inflows of other capital are estimated to have been higher than in 1980; official and other concessionary capital inflows continued to rise, while a significant increase in payments arrears has been reported. In addition, reserves were run down in the early part of the year, and there was increased borrowing from the IMF.

Deployment of oil money

The cash surplus available for investment by the oil exporters remained at around $20 billion in each of the first three quarters of 1981, the effect of their falling current account surplus being offset by external borrowing. Identified investments in the second and third quarters were smaller than the cash surplus, and in the latter period totalled only $8 billion. Bank deposits, which have usually reflected fluctuations in the total cash available, fell in the third quarter for the first time since the middle of 1978 (although within the total there was a rise in eurocurrency bank deposits in the United Kingdom).

Oil exporters' current account balance and cash surplus available for investment

$ billions

	1980	1981				
	Year	Year	Q1	Q2	Q3	Q4
Exports	304	281	75	72	67	66
Imports	133	159	36	39	41	42
Merchandise trade	171	122	39	33	26	24
Net invisibles	- 61	- 57	-15	-14	-14	-14
of which, official transfers	*- 4*	*- 5*	*- 1*	*- 1*	*- 2*	*- 2*
Current balance	**110**	**65**	**24**	**19**	**12**	**10**
Net external borrowing etc(a)	9	..	- 8	2	7	..
Surplus available for investment	**119**	..	**16**	**21**	**19**	..

.. not available.
(a) For definitions, see footnote (a) to following table.

Identified deployment of oil exporters' surpluses[a][b]

$ billions

	1980	1981			
	Year	Q1	Q2	Q3	Q4(c)
United Kingdom:					
Sterling bank deposits	1.4	0.3	0.3	- 0.1	—
Eurocurrency bank deposits	14.8	4.6	0.3	3.4	—
British government stocks	1.9	0.1	0.3	0.2	0.1
Treasury bills	- 0.1	0.2	—	—	- 0.2
Other sterling placements	0.1	—	—	—	—
Other foreign currency placements	- 0.5	- 0.1	- 0.4	- 0.1	—
	17.6	5.1	0.5	3.4	- 0.1
United States:					
Bank deposits	- 1.1	0.3	- 0.8	- 1.9	0.5
Treasury bonds and notes	8.2	3.0	2.5	3.2	2.2
Treasury bills	1.4	0.3	- 0.1	- 0.6	- 0.2
Other portfolio investment	4.7	1.5	1.2	1.8	0.1
Other	0.9	- 0.2	- 0.2	0.2	..
	14.1	4.9	2.6	2.7	2.6
Bank deposits in other industrialised countries	26.2	- 0.1	1.9	- 2.1	..
Other investment in other industrialised countries(d)	17.0	7.1	4.0	2.5	2.2
IMF and IBRD(e)	4.9	0.7	0.6	0.5	..
Loans to developing countries	6.7	1.2	1.7	1.4	1.0
Total identified deployed net cash surplus	**86.5**	**18.9**	**11.3**	**8.4**	..
Residual of unidentified items(f)	32.5	- 2.9	9.7	10.6	..
Total net cash surplus derived from current account (as shown in the previous table)	**119**	**16**	**21**	**19**	..

.. not available.
(a) This table excludes liabilities arising from net borrowings and inward direct investment and also, on the assets side, changes in credit given for oil exports. These items are shown as net external borrowing etc in the previous table.
(b) See the additional notes to Table 16.1 in the statistical annex for list of oil exporting countries.
(c) Provisional.
(d) Mainly loans and holdings of equities.
(e) Includes holdings of gold.
(f) The residual may reflect errors in either the current or capital account.

In the fourth quarter, there was a small outflow from the United Kingdom, while in the United States there was a continued inflow into Treasury bonds and notes and bank deposits rose after falling in the two previous quarters.

International banking and eurocurrency markets[1]

International developments (third quarter of 1981)

There was a return to more rapid growth of international banking activity in the third quarter of 1981 following the slowdown in the first half of the year. Gross external claims of banks in the BIS reporting area[2] grew by $71 billion in the September quarter compared with $53 billion and $40 billion in the first and second quarters respectively. The underlying rate of growth of lending, which excludes the redepositing of funds between the banks, also increased during the third quarter, but not as rapidly as that of total lending. Net new lending to final borrowers during the first nine months of 1981 was $110 billion, $5 billion less than in the corresponding period of 1980.

The position of the reporting banks *vis-à-vis* countries outside the area showed two distinct changes during the third quarter—oil exporting countries as a group became net takers of funds for the first time since end-1978, and other countries began to rebuild their deposits.

The oil exporting countries increased their outstanding borrowing by $2 billion while running down their deposits by $1 billion. The reversal of the position of the oil exporters reflects the movement of several of their number into substantial deficit and also the larger proportion of their surplus placed in longer-term investments and non-bank assets (see above).

Other countries outside the reporting area increased their borrowing by $15 billion (slightly more than in the previous quarter), while their deposits increased by $6 billion after falling in the two previous quarters. Thus their net new borrowing declined from $16 billion to $9 billion. This shift was shared by developed countries and those in Eastern Europe. The non-oil developing countries, while adding $2 billion to their deposits, increased their borrowing by $11 billion, after two quarters of slower increase. Within this group, net new borrowing by Latin American countries rose from $5 billion to $7 billion, with Mexico the largest borrower.

Within the reporting area, banks in the United States—large suppliers of funds throughout the previous five quarters—ceased to be a source of net new credit as the continuing fast growth of their external claims was matched by that of their external liabilities.

Eurosterling

In the third quarter of 1981, the growth of the reporting banks' eurosterling assets (£1.2 billion) again exceeded that of liabilities (£0.4 billion). Since December 1980, the extent to which the banks are switched out of sterling has narrowed from £4.0 billion to £1.7 billion.

The moderate increase in liabilities in the latest quarter was fairly evenly spread through the market, though UK non-banks' deposits remained unchanged for the second consecutive quarter at £1 billion. The growth in lending was mainly to Western European countries other than the United Kingdom.

Eurosterling market[a]

£ billions

	1980		1981		
	30 Sept.	31 Dec.	31 Mar.	30 June	30 Sept.
Deposits by:					
UK banks	2.1	2.6	3.0	3.2	3.3
UK non-banks	0.8	1.1	1.0	1.0	1.0
Other Western Europe	5.6	5.1	4.9	4.5	4.7
Oil exporting countries	1.0	1.0	1.0	1.0	1.0
Other	1.5	1.5	1.5	1.4	1.5
Total	**11.0**	**11.3**	**11.4**	**11.1**	**11.5**
Of which, central monetary institutions	*0.8*	*0.9*	*0.8*	*0.7*	*0.7*
Claims on:					
UK banks	2.2	2.3	2.6	3.0	3.2
UK non-banks	0.6	0.7	0.7	0.6	0.7
Other Western Europe	4.0	3.7	3.7	3.9	4.7
Other	0.7	0.6	0.7	1.1	1.2
Total	**7.5**	**7.3**	**7.7**	**8.6**	**9.8**

Source: Bank for International Settlements.

(a) The table shows sterling liabilities and claims of banks in the Group of Ten countries (except the United States and—by definition—the United Kingdom), Austria, Denmark, the Republic of Ireland and Switzerland. Apart from this geographical limitation, full data on business with residents of the countries in which the reporting banks are situated are not available for all countries. The table therefore understates the size of the market.

BIS half-yearly maturity analysis of lending to individual countries (first half of 1981)[3]

The analysis for end-June 1981 revealed that international bank lending to countries outside the BIS reporting area grew by some $32 billion in the previous half year (rather more than shown by the BIS quarterly series, which has a narrower statistical coverage than the half-yearly series). There was little change overall in the maturity profile of lending, but there were some shifts *vis-à-vis* certain groups of countries. One of the most marked was for the Middle Eastern countries; in the first half of 1981 there was a noticeable shortening in the maturity of their outstanding debt, although the total outstanding fell slightly. By contrast, there was a sizable lengthening in the profile of borrowing by the Asian developing countries. Although there was very little change in the structure of aggregate lending to Eastern Europe, there were marked dissimilarities between individual countries, with a significant shortening in lending to the USSR.

(1) All transactions data in this passage exclude the estimated effects of exchange rate fluctuations and hence may not correspond with the differences between amounts outstanding.

(2) As defined in Table 13 in the statistical annex.

(3) The major part of the UK contribution to the half-yearly analysis, which sets out by maturity the claims of banks in the Group of Ten countries, Austria, Denmark, the Republic of Ireland and Switzerland and a number of their affiliates domiciled in other countries, is contained in Table 14.3 in the statistical annex.

There was little overall change over the period in the amount of unused credit, but unused credits for the developed countries outside the BIS reporting area, the Middle Eastern countries, and the African and Asian developing countries all increased as a percentage of outstanding borrowing, whereas those for Eastern Europe continued to fall.

London market (fourth quarter of 1981)

The London eurocurrency market, as measured by the gross foreign currency liabilities of UK banks, grew by $18 billion in the fourth quarter of 1981 compared with $11 billion and $32 billion in the second and third quarters respectively. The Japanese banks now account for over 23% of the market, slightly more than the American and British groups.

Other countries in the BIS reporting area were again the main external sources of funds. Those within the European reporting area increased their deposits by over $10 billion, and the United States, which continued to be a source of net new credit to the London market, placed nearly $6 billion.

Non-oil developing countries increased their borrowing by almost $3 billion, but also built up deposits in London so that their net indebtedness rose by only $1 billion. The other groups of countries outside the BIS reporting area were all net users of funds during the fourth quarter.

The maturity analysis of UK banks' foreign currency claims and liabilities at mid-November 1981 is published in Table 14.2 in the statistical annex. The degree of maturity mismatching was relatively stable between the mid-August and mid-November reporting dates, although the net short-term liabilities of the consortium banks, and to a lesser degree, the British banks, increased. At mid-November, the net liability positions of these two groups of banks for maturities of up to six months expressed as a percentage of their total claims stood at 46.8% and 27.2% respectively, compared with 43.8% and 26.5% at mid-August. By contrast, the American banks slightly lessened their short-term net liability positions.

UK banks' liabilities and assets by customer(a)

$ billions

	1980	1981			
	31 Dec.	31 Mar.	30 June	30 Sept.	31 Dec.
Foreign currency liabilities of UK banks to:					
Other UK banks	118.5	130.2	129.0	139.4	141.3
Other UK residents	13.9	17.0	16.6	19.8	18.4
Overseas central monetary institutions	58.6	58.1	54.3	53.0	53.1
Other banks overseas	222.8	233.3	238.6	249.8	266.6
Other non-residents	67.8	74.7	75.9	86.2	94.8
Other liabilities(b)	3.8	3.9	3.6	3.9	3.4
Total liabilities	**485.4**	**517.2**	**518.0**	**552.1**	**577.6**
Foreign currency assets of UK banks with:					
Other UK banks	116.4	129.0	127.1	137.5	135.2
Other UK residents	22.9	23.5	21.2	22.8	27.0
Banks overseas	249.1	263.0	264.1	277.4	291.3
Other non-residents	88.2	92.3	96.2	105.3	113.0
Other assets(b)	8.4	8.6	8.8	9.6	11.4
Total assets	**485.0**	**516.4**	**517.4**	**552.6**	**577.9**

(a) Figures differ from those in Table 6 in the statistical annex (see additional notes to Table 14.1).

(b) Mainly capital and other internal funds denominated in foreign currency.

UK banks' net liabilities and claims by country or area(a)

$ billions

Net source of funds to London – /net use of London funds +

	1980	1981			
	31 Dec.	31 Mar.	30 June	30 Sept.	31 Dec.
BIS reporting area:					
European area	− 3.3	+ 1.4	—	+ 3.2	+ 2.7
Canada	+ 0.5	+ 1.8	+ 2.9	+ 3.0	+ 1.5
Japan	+17.9	+15.8	+14.7	+15.2	+16.7
United States	−20.4	−22.2	−26.2	−32.9	−34.5
Offshore banking centres	+ 7.6	+ 8.2	+12.2	+12.2	+ 9.7
Other Western Europe	+ 6.7	+ 8.3	+ 9.8	+10.1	+11.1
Australia, New Zealand and South Africa	+ 3.3	+ 3.6	+ 4.4	+ 5.6	+ 6.5
Eastern Europe	+10.5	+11.3	+11.6	+11.2	+11.5
Oil exporting countries	−38.5	−43.9	−42.1	−44.2	−43.0
Non-oil developing countries	+13.5	+16.5	+18.5	+21.5	+22.8
Others(b)	−10.9	−12.4	−14.1	−12.6	−17.3
Total	**−13.1**	**−11.6**	**− 8.3**	**− 7.7**	**−12.3**

(a) The breakdown corresponds to that in Table 14.1 in the statistical annex.

(b) Includes international organisations and certain unallocated items.

Medium-term eurocurrency credits

In the fourth quarter of 1981, credits totalling over $24 billion were announced. This brought the total for 1981 to almost $123 billion, an increase of nearly 70% on 1980, but about one third of the total relates to borrowing to finance takeover activity in the United States during the third quarter and it is not clear to what extent, or when, these credits will be drawn. OECD countries increased their borrowing sharply in the fourth quarter, and accounted for over half the total of new credits announced. Borrowing by those countries usually classified as oil exporters as well as by other developing countries that export oil was also higher.

Average spreads for public sector borrowers from the major OECD countries remained close to $\frac{1}{2}$% in the fourth quarter, while average spreads for minor OECD public sector borrowers fell to slightly less than $\frac{1}{2}$%, the lowest in 1981. However, these average spreads are heavily influenced by the particular borrowers active at the time, and it is generally unusual for minor OECD borrowers to obtain lower spreads than major OECD countries.

Spreads on credits to developing countries rose during the year, reaching their peak in the third quarter when a number of loans to Brazil carried spreads of over 2%. The general rise in spreads for this group of borrowers disguised

Announced new medium-term eurocurrency credits(a)

$ billions

	1980	1981			1982
	Year	Year	Q3	Q4	Jan.
Major OECD countries	19.4	67.6(b)	49.8(b)	8.3	1.4
Minor OECD countries	18.6	13.8	1.6	4.7	2.2
Oil exporting countries	7.4	6.4	1.4	2.8	0.3
Eastern Europe	2.6	1.2	0.1	0.1	—
Developing countries	24.6	33.5	6.6	8.4	1.8
of which:					
Net oil exporters(c)	*6.6*	*9.7*	*1.5*	*2.2*	*0.5*
Newly industrialised countries	*10.2*	*13.6*	*3.4*	*3.5*	*0.6*
Other	0.6	0.3	0.1	—	0.3
Total(d)	73.3	122.8(b)	59.5(b)	24.3	6.0

(a) Maturities of three years and over.

(b) Including $41 billion related to takeover activity in the United States.

(c) Chiefly Mexico and Malaysia.

(d) Totals may not add because of rounding.

a distinct tiering: in particular, terms for Asian countries improved, whereas those for Latin American borrowers worsened.

International bonds and notes

During 1981, completed bond issues totalled a record $43.4 billion, an increase of 22% over 1980. The fourth quarter, with $16.4 billion, was the busiest of the year, with completions more than $7 billion higher than in the previous quarter. Dollar issues continued to dominate the market with their share rising to just over 60%. In January, both total new issues and the share of dollar issues slipped back a little from those in the fourth quarter.

Floating-rate note issues increased to account for 20% of the market in the fourth quarter, with almost all such issues denominated in dollars. In January, the number of zero-coupon bond issues rose sharply, to thirteen (compared with four in the whole of 1981); their face value was $3.3 billion, but only $0.9 billion was raised since zero-coupon bonds sell at a considerable discount, with the return to investors coming from capital gain rather than from interest payments. During 1981, bonds issued by borrowers from OECD countries continued to account for approximately three quarters of the market; borrowing by the developing countries made up only 6%, with Mexico responsible for over two thirds of this. The Eastern European countries were absent from the market throughout the year.

Deutschemark issues totalled only $2.6 billion in 1981 compared with $7.8 billion in 1980; this was partly due to the decision of the West German Capital Markets Sub-Committee to restrict new issues in the first half of 1981.

Completed international bond issues[(a)]

$ billions

	1980	1981			1982
	Year	Year	Q3	Q4	Jan.
Total(b)	**35.6**	**43.4**	**8.9**	**16.4**	**4.0**
By currency:					
Dollars	14.8	24.3	5.2	9.9	1.8
Deutschemarks	7.8	2.6	0.5	1.4	0.3
Swiss francs	7.4	8.5	1.9	2.8	1.1
Sterling	1.2	1.4	0.3	0.2	—
Yen	1.6	3.1	0.7	0.8	0.3
Other	2.8	3.5	0.5	1.3	0.4
By borrower:					
OECD countries	26.5	32.2	6.7	12.2	3.1
International institutions	6.9	8.0	1.6	3.3	0.6
Developing countries	1.6	2.8	0.7	0.9	0.3
Other	0.6	0.4	—	0.1	0.1

(a) Euromarket and foreign issues, both fixed and floating rate, with original maturities of three years and over. Includes private placements, if publicised, but excluding Canadian borrowing in New York.

(b) Totals may not add because of rounding.

Foreign exchange and gold markets

(Four months to end-February)

Exchange markets were quiet in November and December, but became increasingly volatile in the New Year: interest rates continued to be the dominant factor, but political problems in some European countries and the declaration of martial law in Poland were also influential.

US interest rates fell sharply in November, and the dollar weakened. At the beginning of December, official interest rates were reduced in the United States, Japan and Europe, and some European countries cut their rates further in January. US interest rates began to rise again early in December as the markets became concerned about the prospective size of the US budget deficit, and the rapid growth of the monetary aggregates reinforced this trend. The dollar strengthened markedly, and reached its highest level for five months in mid-February.

Relatively high interest rates and a continuing current account surplus helped sterling to strengthen considerably in November. The gains against the dollar were subsequently lost, but sterling continued to appreciate against other currencies, particularly after the miners' ballot. But concern about a further weakening in oil prices and reductions in interest rates depressed the pound somewhat at the end of February.

The European Monetary System (EMS) came under pressure in mid-December when the Belgian franc retreated on expectations of an imminent devaluation. It recovered after substantial increases in short-term interest rates but remained weak and was devalued by 8½% in February. The Danish krone was devalued by 3% at the same time. The Swiss franc, which was less affected by the crisis in Poland than other European currencies, was very firm despite cuts in interest rates, while the yen, after a very firm beginning, fell sharply as interest rate differentials widened significantly. Gold was an active market, and the price fell well below $400.

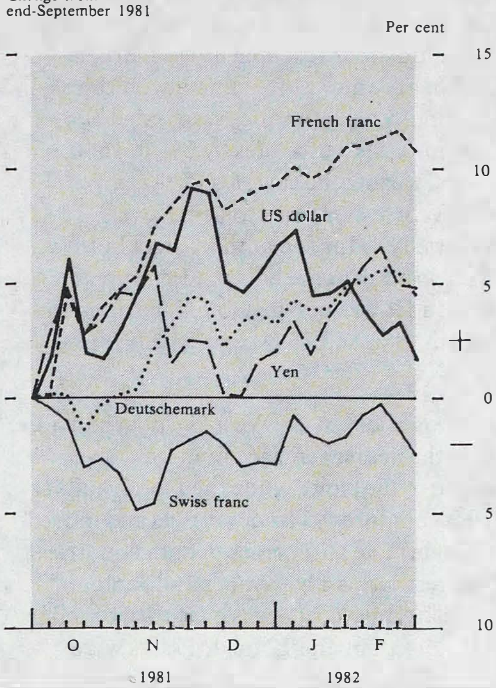
Sterling

Sterling opened November at $1.8855, DM 4.15¾ and 89.3 in effective terms. The increase in North Sea oil prices, settlement of the industrial dispute at BL and the decline in US interest rates all helped sterling to remain firm. The cut in clearing banks' base rates to 15% on 9 November had little effect, but the pound suffered a temporary set-back on 11 November, falling to $1.8660, as the dollar strengthened briefly on interest rate considerations following renewed concern over the projected size of the US budget deficit. Sterling quickly recovered, however, as US interest rates resumed their fall, and the widening differentials in favour of sterling gave rise to considerable portfolio investment demand. The pound rose to $1.9234 on 16 November, before easing back on profit-taking, particularly against continental currencies. It quickly resumed its upward trend as interest rate differentials widened further and the October trade figures gave an additional boost. Sterling closed at $1.9600, DM 4.32¼ and 91.8 in effective terms.

In early December, the pound eased against a firmer US dollar, which was supported by rising eurodollar interest rates, but strengthened further against European currencies, reaching DM 4.35 on 8 December. The cut in banks' base rates to 14½% on 3 December was largely matched by similar reductions in official interest rates in Europe and the United States and had little effect on the pound. Eurodollar interest rates continued to rise, however, and growing concern over prospects of industrial action by

Sterling against selected foreign currencies

Change from end-September 1981



the miners and Ford workers, along with an OPEC agreement to reduce oil prices, put pressure on sterling which fell sharply to $1.8740, DM 4.23 and 89.8 in effective terms on 11 December. It weakened further, to $1.8535, on 14 December when all European currencies fell against the dollar, following the military take-over in Poland, but thereafter recovered as tax payments delayed by the Civil Service dispute gave rise to substantial shortages in the money markets and sterling inter-bank rates firmed. The pound ended 1981 at $1.9110, DM 4.29, with the effective exchange rate index (ERI) at 90.9—a fall over the year of 20% against the dollar, $8\frac{1}{2}$% against the deutschemark, and $10\frac{1}{2}$% in effective terms.

Sterling began January very firm, touching $1.9370 on 4 January as eurodollar interest rates fell briefly. But disappointing US money supply figures soon led to a sharp upturn in eurodollar rates and the uncovered differential in favour of sterling narrowed. Although weakening against the dollar to $1.9115 on 7 January, sterling maintained its strength against European currencies and in effective terms, and reached DM $4.33\frac{1}{2}$ and an ERI of 91.8 on 8 January. Subsequently, industrial action on the railways and the threat of a miners' strike affected confidence in the pound and by 14 January it had fallen sharply to $1.8550 and DM $4.27\frac{1}{2}$. Once it was evident that the miners had rejected strike action, sterling began to recover; and it was then sustained by investment demand which continued as the gradual reduction in the Bank of England's bill dealing rates helped to generate a rally in the gilt-edged market. The reduction in banks' base rates to 14% on 22 January caused only a brief set-back, and sterling quickly recovered following the publication of a current account surplus of £0.5 billion for December, to close the month at $1.8835, DM $4.35\frac{3}{4}$, and with the ERI at 91.7.

Sterling held up well against the strengthening dollar at the beginning of February and made gains against continental currencies to reach DM 4.39 and 92.0 in effective terms on 4 February. But it fell on the announcement of a cut in BNOC's price for North Sea oil. By 8 February, the rate had fallen to DM 4.35 and 91.3 in effective terms. It rebounded sharply to touch DM $4.40\frac{5}{8}$ on 9 February, but quickly fell back on profit-taking and settled down to trade in the range $\$1.83\frac{1}{4}$–$\$1.85\frac{1}{4}$ and DM $4.37\frac{1}{2}$–DM $4.39\frac{1}{4}$. Towards the end of the month concern about a further weakening in the oil markets, along with an easing in short-term interest rates and the subsequent cut in banks' base rates to $13\frac{1}{2}$% on 24 February, led to downward pressure on the pound which fell to DM $4.32\frac{1}{4}$ on 24 February. Demand for sterling in advance of petroleum revenue tax payments helped it recover somewhat despite a further easing in interest rates, and it closed at $1.8225 (against a stronger dollar), DM $4.34\frac{1}{4}$ and 91.1 in effective terms.

Official reserves

The UK reserves rose by $57 million, to $23,373 million, in the four months to end-February (see table). After allowing for net borrowing under the exchange cover scheme, a further repayment to the IMF under the oil facility, end-year repayments under the North American loans, and a valuation loss arising from the quarterly renewal of the EMCF swap, the reserves showed an underlying rise of $316 million.

UK official reserves

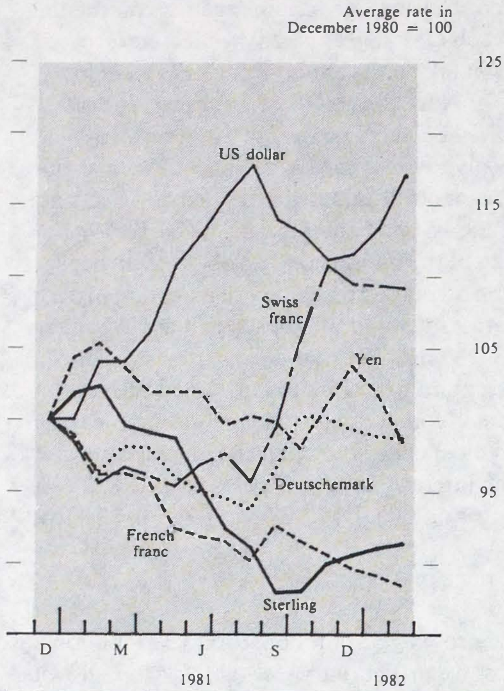
$ millions

	1981		1982	
	November	December	January	February
Change in reserves	**+147**	**−116**	**−122**	**+148**
IMF oil facility repayment	—	—	− 77	—
Other HMG capital repayments	—	−126	—	—
EMCF swap valuation change	—	—	−201	—
Exchange cover scheme:				
Borrowing	—	+121	+100	+ 71
Repayments	−107	− 15	− 6	− 19
Underlying change in reserves	**+254**	**− 96**	**+ 62**	**+ 96**
Level of reserves (end of period)	**23,463**	**23,347**	**23,225**	**23,373**

US dollar

In November, short and longer-term US interest rates fell by around 3% and $1\frac{1}{2}$% respectively. Economic indicators for October, notably those for unemployment, industrial production and durable goods orders, tended to confirm that a significant downturn in the US economy was underway; against this background, the continued low growth of the principal monetary aggregate (MI B) led to expectations of an easing in monetary policy. The reduction in discount rate to 13% on 2 November added support to these expectations, as did the subsequent removal of the 2% surcharge for large borrowers on 16 November, although the latter was largely a technical adjustment which followed rather than led the downward movement. The dollar fell sharply against sterling and the yen, but showed a much smaller fall against European currencies, losing only $2\frac{1}{4}$% over the month against the deutschemark, to DM 2.2052, on 30 November, and $3\frac{1}{2}$%, to 104.9, in effective terms. By the end of November most prime rates had fallen to $15\frac{3}{4}$%, and on 4 December discount rate was cut from

Indices of effective exchange rates



13% to 12%. However, renewed concern about the prospective size of the US budget deficit, along with indications of a possible increase in the Treasury's refunding operations around the end of the year when a sizable number of corporate bond issues remained outstanding, helped reverse the trend in interest rates.The monetary aggregates also showed a sharp increase, and the dollar strengthened, particularly after the introduction of martial law in Poland, to reach DM 2.2940 and 108.5 in effective terms on 14 December.

Despite continuing signs of weakness in the US economy, the market remained preoccupied with the rate of growth of the monetary aggregates, which rose very sharply in early January. Suggestions that this rise might be due to technical factors were treated with scepticism, and interest rates rose further, with some market participants expecting the recession to end sooner than forecast. Prime rates were increased to 16½% on 2 February and the dollar continued to strengthen. Disappointment with the US budget proposals and the absence of any significant falls in the monetary aggregates caused interest rates to rise further and the dollar reached DM 2.4067 and 113.4 in effective terms on 15 February, its highest for five months. Prime rates were increased to 17% on 17 February, but a substantial fall in the monetary aggregates, and indicators suggesting a further slowdown in economic activity, brought short-term interest rates down by around 2%. The dollar fell to DM 2.3525 on 22 February and prime rates were reduced to 16½%. However, markets remained unsure of the future trend of US interest rates, and the dollar subsequently rose to close at DM 2.3830 and 113.3 in effective terms.

Other currencies

EMS currencies appreciated against the dollar in November and, although there were no tensions in the system, the Belgian franc weakened significantly, falling from the middle to the bottom of the 2¼% band amid political uncertainties following the inconclusive November elections. By mid-December it was under severe pressure (with the divergence indicator reaching 89) as markets became convinced that the new Government would seek an immediate devaluation. The authorities responded by increasing discount and Lombard rates by 2% to 15% and 17% respectively and raising the cost of short-term borrowing to foreign correspondents to penal levels. The Belgian franc rose briefly to the top of the system but quickly resumed its position at the bottom. Pressures subsequently eased and it was possible to reduce discount and Lombard rates to 14% and 15% respectively on 6 January.

A considerable improvement in the West German balance of payments helped the deutschemark climb from the bottom to the middle of the band, while the Dutch guilder also benefitted from an improved trade surplus and moved to the top of the system. The authorities in both countries reduced official interest rates in December and January. The German Special Lombard rate was cut to 10%, and in the Netherlands the discount and Lombard rates were reduced to 8½% and 9½% respectively. Official interest rates also eased in France, but this had little effect on the French franc which remained near the top of the system. The Irish pound weakened somewhat after the fall of the Government and the inconclusive election result.

On 21 February, following a period of relative calm in the EMS, the Belgian franc was devalued by 8½% and the Danish krone by 3%. At the same time, the Belgian authorities introduced a supporting package of economic measures which included a wages and prices freeze. After the realignment the Danish krone rose to the top of the system.

The Swiss franc strengthened markedly in November, breaking through the Sw. Fcs 0.80 level against the deutschemark; the authorities reduced Lombard rate to 7% on 4 December and progressively lowered money market rates. The franc eased back at first but soon breached Sw. Fcs 0.80 once more and closed at Sw Fcs 0.79½. The Norwegian krone remained stable against the dollar and strengthened by over 2½% in effective terms, while the Swedish krona eased back against the dollar but showed gains against EMS currencies.

The narrowing of interest rate differentials against the Japanese yen and a strong current account position caused the yen to rise sharply during November, reaching ¥213.72 against the dollar on 30 November. Discount rate was cut to 5½% on 11 December in an effort to boost domestic demand, but US interest rates were moving upwards once more and the yen fell back sharply to close at ¥236.57. The Canadian dollar strengthened to US$0.85 at the end of November as Canadian interest rates fell more slowly than those in the United States and the November budget was well received. The interest rate premium gradually disappeared, however, and the Canadian dollar fell back to close at US$0.81, but it remained stable in effective terms.

Gold

The price of gold did not rise in response to the fall in US interest rates in November. Instead, heavy selling developed, and by 17 November the price had fallen below $400 to fix at $395.75. Demand reappeared at these lower levels and gold recovered to $419.25 following the declaration of martial law in Poland. Producer selling and the upturn in US interest rates forced the price down to a two-year low of $369.75 on 10 January. It recovered briefly in February, but then fell back again in nervous and active markets on further producer selling to fix at $360.50 on 23 February. It closed the month at $362.60, a fall of $64.40 over the four months.

London gold price

Fridays