

British Bubble To Burst, Pound Collapse Near

Despite the euphoria on London's stock and bond markets this week—bringing the stock market close to its all-time peak of five years ago and gilt-edged Treasury securities to their best level since November 1972—market insiders are privately counting the days until this bubble bursts and the ground is cut out from under the momentarily buoyant pound sterling. According to Sept. 8 commentary by *Guardian* columnist Hamish McRae, “some private calculations by a major New York bank indicate that sterling is already overvalued on grounds of industrial competitiveness.”

The obvious question, raised by McRae among others, is how long can British equities continue to rise when British industrial production is barely running above 1970 levels, having fallen almost 7 percent since the beginning of this year.

Moreover, the deflationary process presently underway in the world economy as a whole—as evidenced by the sharp production cutbacks in West Germany, France, Italy, and Japan during the second quarter—rules out any possibility of an “export-led” British industrial recovery.

Since April, the decline of industrial demand has triggered a 25 percent drop in world commodity prices, a certain harbinger of the depression to come. A burgeoning world oil “glut” has forced Kuwait to offer a ten cent discount to purchasers of its heavy crude oil. Last week, the OECD economics staff reported that the overall annual inflation rate of the 20 industrial nations had fallen to 4.8 percent, or about half the rise in the year from July 1976 to July 1977.

A Sept. 10 *Financial Times* feature “Depressing Times for the Commodity Markets” noted that copper has fallen from a high of 900 pounds per ton earlier this year to 680, zinc fell from 435 pounds to 295, coffee from 4,200 pounds to 2,300, to cite some of the most dramatic cases.

The Commodity market plunge, the *Financial Times* correctly concludes, will result in a huge jump in the current account payments deficit of Third World countries and a declining ability to service their massive debts. Britain and other already depressed industrial countries will be hit by cutbacks in capital goods orders from the Third World, leading into a self-reinforcing deflationary collapse.

Citibank's economics department expects the pound sterling to deteriorate sharply “within the next six months, unless the Fed goes berserk, which you can never rule out.” Should U.S. Federal Reserve chief Arthur Burns attempt to hyperinflate the U.S. economy out of the depression, then all bets are off since the U.S. dollar will fall faster than everything else!

Capital Inflows Reverses

The huge \$10 billion inflow of foreign capital into Britain this year has been almost entirely speculative and short-term in nature, based on the gradual slashing of the Minimum Lending Rate from a high of 15 percent to 6.5 percent as of Friday, Sept. 9. Investors rushed into British gilts to take advantage of their super-high yields before interest rates dropped further, and they bought British equities on the belief that continually falling rates would provide the basis for a rise in stock prices. But as McRae notes, this process cannot go on forever — at some point, British rates will fall so low that gilts will no longer offer an attractive investment when compared to Britain's relatively higher inflation rates; and shrinking corporate earnings due to the decline of industrial production will wipe out any momentary advantages to speculators playing the British stock market. At this crucial turning-point — and insiders expect it to come soon — a panicky capital flight will set in and the pound sterling's strength will evaporate as swiftly and as drastically as it came.

Indeed, according to a New York brokerage house study released in early August, the *real rate of return* on British equities and long-term gilts, when inflation and exchange risks are taken into account, was then already at -8.7 and -1.09 percent respectively. (This same study concluded that long-term German and Swiss bonds were the only investment left on international markets which still offered any certainty of a positive real rate of return.)

All such technical considerations aside, the central reason why the pound sterling is bound to collapse shortly is the crumbling of the real industrial base upon which all paper instruments ultimately draw their income. During the first quarter of 1977, fixed capital expenditures in Britain fell 7.2 percent below the previous year. According to Morgan Guaranty's World Financial Markets newsletter, the failure to maintain the technological level of British industry through fixed investment is crippling the ability of British capital goods producers to maintain their exports markets. Moreover, British industry, due to Commonwealth traditions, is particularly dependent on the Third World sector as a source of orders, and the commodity price collapse will force a drastic curtailment in Third World imports. According to Morgan, Britain's non-oil trade balance (not taking into account the benefits of North Sea oil) was already in deficit by \$300 million during the first half of 1977 — a sharp deterioration from the \$700 million surplus of last year.

Meanwhile the September 9 *Journal of Commerce* reports that Britain's “invisible” trade surplus is

eroding as well, since the rate-war between international banks has bitten heavily into the British banks' profit-margins on their eurodollar operations.

*Clearing Banks Push
for Overseas Sterling Lending*

Despite the pound's growing vulnerability, the "traditionalist" London clearing house banks, such as Lloyds and Standard and Chartered, are campaigning for the removal of capital controls to allow the expansion of overseas sterling lending for industrial projects, particularly in the Third World. According to Lloyd's Bank, the "talk on the street" is that the Bank of England will remove the controls on capital export, at least partially, by mid-September. Citibank, which is tied to Lloyd's through their joint ownership of the merchant bank Grindlay-Brandt's, is also enthusiastic about the idea of overseas sterling lending as a means to British recovery. One Citibank economist commented: "They should have free trade in capital as well as goods. It's good for long-

term real growth. Right now, their access to trade is shut-off... (Removal of capital controls) should have no major effect on sterling exchange rates."

Lloyd's Bank has recently participated in the largest loan syndication ever for Mexico, totaling \$1.2 billion, which was specifically designated for investments in steel, oil, and nuclear and hydroelectric projects—not for balance of payments deficit (i.e., debt service) financing. (Other banks participating included Deutsche Bank, Bank of America, and Morgan.) A similar loan to Argentina for "industrial expansion" will be signed by Lloyd's and Bank of America in London shortly. A Lloyd's spokesman at a Mexican press conference earlier this year made clear that the bank is eager to provide more funds for Latin America in sterling.

As it stands now, the sudden unraveling of the pound sterling is likely to throw all such well-intentioned—but decidedly inadequate schemes—to the winds.

— Alice Roth