Adding to the dollar crisis from the trade deficit is the growth of money supply and banking reserves in the U.S., particularly of short-term monetary fluff, which led several market participants to comment this week that the money supply "is out of the Fed's control." Since the dollar began dropping in mid-June, the Fed has raised the U.S. central bank "Fed funds" rate from below 5.5 percent to this week's level of 6.5 percent to attract money into dollars. However, with the total lack of long-term borrowing due to no plans whatsoever for capital spending in the U.S. economy, short-term rates are rising with the Fed funds rate up over 6 percent, while long-term rates have stayed flat at 7.5 percent for months.

As a result, both funds, already in the long-term portion of U.S. banking such as parts of M-2 time deposits and foreign funds such as oil dollars, have fled from long-term investments into short-term demand deposits, creating a self-feeding bulge in M-1 which feeds fear of inflation and thus further forces Federal Reserve Chairman Burns to hike interest rates indefinitely to protect the dollar from inflation fears. The incoming short-term deposits, particularly short-term Eurodollar deposits, have also been hastily acquired by the Euromarket banks to roll over non-paying Third World loans now coming due; as the banks borrow more reserves to meet the new deposits and loans on their balance sheets, M-1 rises.

North Sea Oil Bubble Hitting The Rocks

The City of London stock and government debt market bubbles, premised on "confidence in sterling" as North Sea oil is pawned abroad to give Britain a new balance of payments surplus, are fast heading for the rocks. The boom began last summer when Britain's payments went into the black, but with industrial production at 1970 levels, unemployment growing, and personal consumption expenditures dropping monthly, the payments picture is a purely cosmetic financial papering-over of an underlying mess. "Nothing's changed," editorialized the respected London *Investors Chronicle* this week to that effect.

To keep the initial inflows coming, the Bank of England since summer has promoted a regular North Sea bubble modelled on the disastrous 18th-century South Sea Bubble speculation of the stock of the South Sea Company to fantastic heights, and then fantastic depths. The Bank of England has been concerned to bring plenty of money in to finance Britain's huge government deficit through sales of government "gilts" (treasury bills), and is being pressed by Morgan Grenfell and other Lazard-influenced British banks to bring in enough foreign reserves so that sterling can rise from its current $1.74 level to $1.80 or higher.

This new, more solid sterling would then be used, according to a scenario circulated by Schroeders Bank, to force the BOE to loosen exchange controls so that an international boom in loans to European and Third World governments in sterling rather than dollars can begin, and bring back 19th century finance. Consortia to float sterling loans to the European Economic Community and World Bank are already being formed, Schroeders says, even though the exchange laws have not been modified. Since December 1976, over $12 billion has flowed into Britain this way.

The Bank's strategy has been nominally simple. Short-term rates have been lowered, with the British central bank rate now at 6 percent, below the U.S. Fed Funds rate of 6.5 percent, for the first time since N.Y. Federal Reserve chief Benjamin Strong and Bank of England head Montagu Norman agreed in 1920 to keep the geriatric pound alive as a handmaiden to the dollar by maintaining London rates above those in New York to discourage movement out of sterling into dollars. With these cheap short-term rates, U.S., European, Arab and British investors are furiously borrowing short-term at 6 percent and then buying stocks and government bonds at 8 to 12 percent rates of return — in the case of government gilts, doubling their money. In the past two weeks, the Bank has further encouraged these moves by removing tax exemptions on foreign funds brought in, encouraging foreigners to borrow more of the 6 percent sterling. The Bank has also issued a large amount of "part paid" government debt, i.e., margin paper bought for a fraction of its value and paid for on installment, which has further gunned the rise in the gilts market.

"Sobering Effects"

But the game is coming to a halt. First, the stock market, which rose from the mid-300's on the *Financial Times* Industrial Ordinary index this spring to an all-time high of 545 on Sept. 14, a 60 percent increase, did so only due to a total lack of corporate capital stock issued, which were chased by all the hot money. With no incentive for capital spending in the sagging world economy, British corporations plan to raise less than £600 million this year, of which £500 million has already been raised, compared to £1 billion raised in 1976 and £1.2 billion in 1975. Even so, last week, the *Financial Times* index plummeted to the 500 level in two days after Dunlop, Vickers, and GKN and other major corporations reported "dangerously low" profit figures for the first half of this year, reflecting poor "industrial performance," the *Financial Times* warned Sept. 24. At this writing the *Financial Times* index has recouped to the 514 level but is expected to fallthrough the 500 psychological "floor" next week.

The government debt market is headed for "the same

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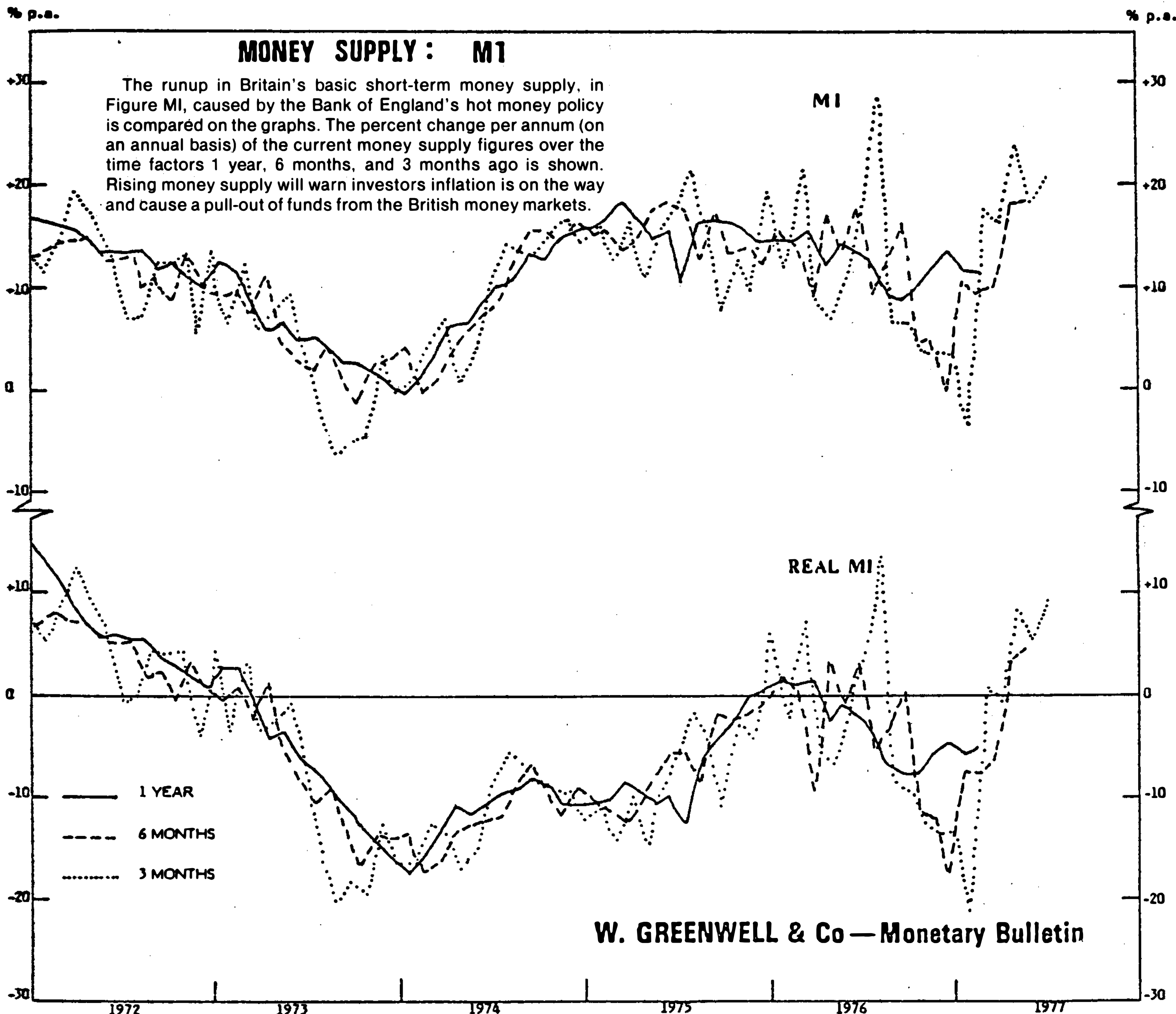

sobering effect which has already been seen in equities," the *Financial Times* warned editorially Sept. 24; it is here that the margin of sales and Bank of England's direct excitation of speculative activity has "made some brokers very nervous," the *Financial Times* added yesterday. The Bank has been encouraging investors into the long-term gilt by maintaining a *moving trend* of falling long-term interest rates, from 20 percent in January to 12 percent now. As long as rates fall, investors will buy gilts "now," before the rate of return to them gets lower.

However, the tremendous kick to the money supply built up by the short-term lending in sterling will soon hit the papers and cries of "inflation!" will bring down all London markets unless the Bank can control money growth. To control money growth, the Bank must *raise* long-term interest rates by selling more Treasury bills to sop up the money sloshing around. In such a case more government debt is chasing the same amount of cash and long-term rates the government must pay will rise. The minute even an end to the downward long-term rates, let alone a shift to upward, is perceived, most of the $6 billion which has flown into the gilt market from abroad will start to flow right out again "in a wave of forced selling," the *Financial Times* states.

When will all this happen? Market observers say that it could be soon, if the U.S. is forced to raise the Fed Funds short-term rate to 7 percent or above to keep funds in the dollar.

An *Executive Intelligence Review* preliminary survey of the U.S. banking reserves and shifts from long- to short-term funds trends indicates that the Fed rate could move up faster than most analysts believe, especially if Japan and Germany keep announcing trade surpluses which bang on the dollar.