## Foreign Exchange by David Goldman

# Separating wheat from chaff

*Sterling becomes "the investment currency" par excellence despite short-term softness.*

The British pound sterling rose above its 1967 pre-devaluation peg of $2.42 this week from last week's levels of $2.40. Although it may jump around near the $2.40 level for the rest of September in a market heavy with rumors of international banking crises and interest rate shifts, sterling should be basically strong through 1980. A rise into the $2.50 range is expected by several leading Anglo-American portfolio managers.

The British economy continues its endless slide with unemployment topping 2 million (7 percent) and industrial production falling at 10 percent annual rates, but the Bank of England knows it has a quiet insurance policy for sterling. U.S. Federal Reserve Chairman Paul Volcker's sure intent of slowly raising U.S. interest rates over the rest of the year so as to ensure a further cooling of the U.S. economy means a worsening world recession in which sterling will continue to look relatively good as a "pure" investment vehicle.

The rumors flooding the markets during the first two weeks of September helped sterling up considerably, no surprise since the British Foreign Office was largely responsible for the rumors.

On Sept. 4, Foreign Secretary Lord Carrington told the *Financial Times* of London that Saudi Arabian Oil Minister Sheikh Zaki Yamani plans to cut Saudi oil production this fall by 12 percent and raise oil prices from $28 to $32 per barrel. Foreign Office sources told Reuters that OPEC at its November Baghdad summit will further index the price of oil to Western inflation, growth, and currency rates.

Sterling quickly shot up above $2.42 on the news, since Britain, with increasing North Sea oil production, would benefit from rising oil prices.

Traders cited reports from Riyadh that the Saudis, angry at the Mideast peace impasse, plan to halve their investment in government bonds of the United States, Germany and Japan, and buy sterling and gold instead.

There is no question that foreign money, much of it Arab, has been increasingly flowing into Britain. Official figures just released show foreigners bought £1 billion in sterling bank deposits during the second quarter compared to only £259 million in the first quarter.

Foreigners also purchased some £900 million in British government gilt-edged bills or "gilts" during the second quarter compared to only £17 million in the first. Foreign funds have been flowing in if anything at an even faster clip during August and September.

The gilts market has recovered from the year's worst slump this July as a result, shooting up from 67.5 to almost 70 on the *Financial Times* gilt-edged index.

It is the gilt markets which have given rise to most of the recent downside rumors for the pound. Bond traders say the Bank of England will soon be forced to lower its Minimum Lending Rate (discount rate equivalent) which would be good for bond prices. The MLR has been held to 16 percent since July, near its spring peak of 17 percent, while U.S. prime rates fell by half from 20 percent to 10 percent during the same period.

With plant closings increasing and the economy characterized by even conservative London brokers as "out of control," the City is telling the Bank that it can well afford to drop the rate. Rumors of lower rates on Sept. 10 led to some sales of sterling, which fell temporarily below $2.40.

These fluctuations in sterling, however, are short-term. World interest rates are headed up, led by the renewed Volcker tightening in the United States that has moved the U.S. prime back to 12 percent and may take it to some 14 percent by November. As Volcker's monetary policy adviser, the Bank of England knows this, and is not likely to make any really significant cuts in its own rates. And as the United States and Western Europe are brought deeper into recession, the British economy will look better on a relative scale.

Even the most recent scare that U.K. money supply is burgeoning out of control, which some analysts have said could threaten the pound, is not clear-cut. The higher comparative interest rates, a rising oil price, and a world trade recession which could weaken the dollar all mean that sterling should on balance reclaim its title as the "investment currency" par excellence which has no visible connection to its own economy.