City of London by Stephen Lewis

Bank of England lights the touch-paper

The signs are that the October 1986 deregulation known as the Big Bang is only now set to detonate.

On 27 October 1986, London had its so-called Big Bang—the sweeping away of the rules and the institutional framework which had put the London securities markets among the more tightly regulated and protected in the world. The signs are, however, that the real "Big Bang" is only now set to detonate.

Open and lightly regulated markets in London have attracted most of the world's investment houses. Trading has reached a feverish pitch as prices in the London stock market have scaled successively higher peaks, and have lost contact with the underlying assets and profit streams which they are supposed to represent.

Stock market turnover has increased sevenfold as compared to its level one year ago.

Now, the United Kingdom authorities, having presided over this surge of speculative activity in the financial markets, are intent on collapsing these markets. This was the message of the shocking one-point rise in interest rates imposed by the Bank of England on Aug. 6.

The central bank explained its move as a response to "domestic monetary conditions." Domestic credit growth had been around 20% per annum in recent months, but this is hardly more rapid than the rate of credit growth in the previous two years.

What has changed is the composition of credit demand, with bank loans being extended primarily to support values in the financial markets and not to support real economic activity.

Some figures drawn from official Bank of England statistics for the November 1986-May 1987 period, roughly the first six months of the Big Bang era, illustrate the point. Over this period, bank lending to real estate operators rose at a 35% annual rate, while loans to insurance companies (mostly used to finance stock and real estate purchases) increased at a 49% annual rate.

The banks expanded their lending to securities dealers at no less than a 113% annual rate. Since May, these rates of growth have probably accelerated. There is little surprise that stock markets have been strong.

The sharp run-up in securities dealers' borrowing reflects an acute problem generated by the rise in market turnover. There has been a build-up of unsettled transactions. When a buyer or seller of stock does not, or will not, settle the transaction, the cost of completing the deal falls on the securities house through which the deal was processed.

Obviously, the securities houses try to minimize these costs by claiming stock or cash, as appropriate, from the sellers and buyers of securities. But when market turnover rises rapidly, as in the past few months, securities houses fall behind schedule in enforcing settlement and the backlog of unsettled stock exchange business balloons.

Since the securities houses do not carry enough capital of their own to finance this increase in unsettled buisness, they have recourse to bank loans. This category of bank lending is probably now standing at about £6 billion, a volume equivalent to 2% of the United Kingdom's total GNP.

It is the straightforward, legitimate stock exchange business which is the easiest to settle and which has presumably already been settled by the London securities houses. Some of what is left in the backlog of unsettled business may also be legitimate, and will cause no trouble for the financial system.

However, funds have been attracted to London since last October by its free-wheeling methods. Market values have been moving sharply.

There are serious grounds for concern that when the securities houses come to grips with their unsettled business, they will find that some of the deals have not been settled, because they were fraudulent or were entered into by investors who, if they were to give a full and fair account to their financial position, are now insolvent.

If only a small proportion of the unsettled business turns out to be troublesome, it would be enough to topple the pyramid of credit which is supporting the London financial markets.

Only 5 or 6 of the 50 or so securities houses making markets in stocks have access to capital to cover the potential losses arising from the settlements problems. Even these would hardly escape the consequences of a generalized crisis of confidence in the London securities market.

The United Kingdom authorities are aware of the explosive state of the market but seem intent on lighting the touch-paper.

Editors' Note: EIR *is pleased to welcome the first of what will be periodic contributions by Stephen Lewis, a senior economist in the City of London. Mr. Lewis will present an inside view of the situation as seen from that international financial center.*

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