GILT-EDGED

UK may buck inflation trend

How long will it be before the economy overheats? The UK is inflation-prone — recent history shows this. The way journalists and the public crave for higher house prices reflects this and the way the government mishandled its membership of the exchange rate mechanism was symptomatic of this.

The key issue for gilts is whether this dismal experience will continue. The market thinks it will, judging from the large yield differential between conventional and index-linked gilt-edged stocks and the reaction to the past week's evidence of recovery. Most analysts predict a steeper yield curve by year-end.

If this is so, then the UK will be bucking an international trend. Elsewhere, the inflation outlook is encouraging. In March, annual inflation was 4.3 per cent in Germany, 2.2 in France, 1.2 in Japan and 3.1 in America. In those countries, inflation will fall this year and may remain low for some time. Even in Germany, recession will reduce headline inflation to 2.9 per cent and unit labour cost inflation to about zero by December.

The international environment is disinflationary. Oil and non-oil commodity prices remain low. World commodity prices fell 7.8 per cent in 1990 and 4.4 per cent in 1991. By last year, metal prices had stopped falling and world commodity prices rose 0.8 per cent. Even with recovery in America, our forecast points to only a 2 per cent rise in commodity prices this year and 2.9 per cent next. In sterling terms the rise in commodity prices over the last year has been unpleasant, but it will not get worse.

Why should Britain be the odd one out? After the suppression of inflation during the recession, and devaluation, inflationary risks are on the increase. This, and the unpleasantness of previous British inflation shocks, points to the need for caution.

Since sterling's ERM exit, the inflation picture has been mixed: rises in wages, earnings and retail prices have been low while input prices have risen sharply. Three inflation risks stand out: a wage explosion; retailers and producers taking advantage of recovery to rebuild margins; or another sterling fall.

The government's cash controls point to a draconian incomes policy for the public sector. While this could force industrial action, the wage risk lies in the private sector. The recent wage picture has been good but, even at the bottom of the recession, earnings growth still exceeded headline inflation.

Wage expectations are likely to be held in check over the next year by rising unemployment and low retail-price inflation. Settlements are still heavily influenced by headline inflation. In recent years, service-price inflation has been higher than other components within the index. But strong productivity gains in service industries and the fact that utilities' prices are based on past inflation should keep service inflation and retail prices growth low over the next year. However, it would be remarkable if wage inflation remained low for long. Britain did not stay in the ERM long enough to claim any benefit in terms of lower inflation expectations.

The danger then is that once recovery gathers pace, wage expectations will rise. Skill shortages, boardroom pay rises and even future VAT increases will add to wage pressure. Rising corporate profits should allow companies to grant higher wage settlements, even in excess of those justified by strong productivity gains. It would be premature to expect an early rise in margins. Excess capacity should allow a sufficient safety valve before inflationary bottlenecks reappear. Also, margins in the non-oil sector of the economy have held up better in this recession than in the early eighties. Higher costs can thus be contained in the battle for market share.

Sterling's current strength could be sustained for some months, easing immediate inflation risks. But sterling remains a "soft currency" and could be vulnerable to the release of complete trade data from this summer. All this suggests inflation will be stable over the next year but then will become a problem. The gilt market needs to remain cautious of this inflation risk.

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WORD-WATCHING

Answers from page *40*

EMPOLDER

(c) To make a polder of, to reclaim from the sea, from *em-* + *polder* Dutch for land reclaimed from sea: "By 1940 flood-fallowing experiments had been begun. An area of 100 acres was empoldered (i.e. surrounded by earth walls)."

PIKER

(b) US derogatory slang for a cautious gambler, someone who shies away from a risk, a shirker or lounger, 1889-, from *pike* noun, as in *turnpike*; H. L. Wilson, 1919: "I says to myself the other day, 'I bet a cookie he'd like to be like me!' Horner was a piker, even when he made bets with himself."

TARBAGAN

(b) A large- long-haired marmot, *Marmota bobak* or *Marmota sibirica*, from the Russian *tarbagdn*, found in the steppes of eastern and central Asia, also the pelt of this animal: "The giant marmot was being hunted for its fur, known as tarbagan skins." "The germ of plague is present in tarbagans in China."

PARACONE

(b) An external cusp on the front, outer corner of a mammalian upper molar tooth, from the Greek *para* beside + *cone*: "The first two upper molars of the hedgehog are provided with two well-developed external cones, the paracone and the metacone."

SOLUTION TO WINNING CHESS MOVE

The temporary sacrifice 1 Bxg6! wins, after 1 ...hxg6 2 Bxd8 and the h-pawn will run through to queen.