GILT-EDGED

Inflationary fears appear misplaced

Before the last election, devaluation was inevitable, whoever won. Then, sterling's ERM parity was unsustainable. This time, a key issue is whether inflation is on the agenda, whoever wins.

Underlying worries about the inflation outlook have reappeared. Evidence of this came last week in a Reuters survey of 35 organisations, showing an expected year-end ten-year gilt of 7.73 per cent. By contrast, I expect yields to fall to 6.5 per cent by then. Even though the UK can enjoy modest growth, inflation should remain low. If it did not, Britain would be bucking the global trend of low inflation.

There are three market inflation fears. Firstly, there is concern that inflation pressures may already be in the pipeline. Similar concerns surfaced a few years ago when commodity prices rose. But then, strong global disinflationary pressures, which contributed to sluggish domestic demand, meant retailers and producers had to keep prices down.

These same competitive pressures are still with us. But now the concern is accelerating monetary growth. M4 is rising at an annual rate of 10.1 per cent. The fear is that if this remains strong, it will eventually be spent, triggering inflation. Although M4 needs to be monitored, it is premature to conclude this.

Nearly half — £22.9 billion — of the £55.8 billion rise in M4 last year was by "other financial institutions". Their holding of money is dictated mainly by rates of return, and so this amount is unlikely to be used for higher spending on goods and services.

Half — £28.1 billion — of last year's rise in M4 was in individuals' deposits. This compares with annual consumer spending in the economy of about £430 billion. Many factors explain this increase in deposits. Some households may have increased their precautionary savings in case of redundancy; others may need higher deposits to get a mortgage. There has also been a boost from building society mergers, although that money is as likely to be saved as spent.

As interest rates fall, one would expect some, but not all, of this extra liquidity to be spent. Along with rising incomes it should ensure a modest rise in consumer spending. But that is unlikely to be inflationary, given the competitive pressures and spare resources in the economy.

The second concern is that the Government, desperate to be re-elected, will cut interest rates to such a low level that it leaves the economy vulnerable to an inflation shock — although one would have expected a more expansionary Budget last November if there were a dash for growth.

In my view, recent rate cuts have been necessary and further easing is inevitable, as the economy still faces potential downside risks.

The third risk is if Labour wins, what is to stop them inflating? Although Tony Blair's Mais lecture last summer made low inflation his policy goal, the market will need to be convinced. For instance, could Labour prevent a surge in catch-up pay awards from the public sector, which could soon spill over into a deterioration in inflation expectations elsewhere?

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The UK's poor inflation track record means that these risks need to be monitored. But, in my view, we remain in a disinflationary international environment. Thus, the near-term risks for the global economy are on the downside, with the US and continental Europe slowing sharply. For the UK to experience the inflation some people in the gilt market are fearing requires such a boom in domestic demand that it is unlikely.

Bond markets in the US and on the Continent are benefiting from sluggish growth, low inflation and tight fiscal policies. This points to interest rates acting as the shock absorber, with US rates likely to fall from 5.25 per cent to 4.75 per cent, and the German discount rate set to hit an historic low of 2 per cent this year. As sterling has already fallen so far, it should remain relatively stable in this environment, allowing base rates to fall to 5.5 per cent in response to low UK inflation.

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