More worries for the gilt market

On 24th January this year I sent out a fax entitled "Shift of view: high UK monetary growth starts to cast its shadow over gilts", where I said that "[T]he inflation news will be good for the time being, but it is too late in the cycle to be chasing gilt yields lower". The central reason for my shift of view was that the acceleration in monetary growth since early 1995 - from an annual rate of 5% to 10% - had plainly become entrenched. I had previously hoped that it would be only temporary. Gilt yields have risen and fallen since January, but are now roughly where they were then and gilts have under-performed equities. ***The main purpose of this fax is to reiterate the cautious view on gilts and interest rates.***

1. Disappointing retail price index for September.

Factory-gate inflation so far in 1996 has been excellent, with the annual increase in the producer price index dropping to the lowest figure since 1967. But retail price performance has been disappointing. The September index - showing the RPIX figure up to 2.9% - was the latest setback. Of course, there are explanations in terms of higher oil prices (which will probably prove temporary), but favourable special factors (such as a sharp fall in seasonal food prices) were also at work. The correct verdict is simple and rather worrying. First, improving consumer demand is enabling retailers and service suppliers to widen margins. ***Secondly, the UK has passed the low point in inflation in the current cycle and the Government seems likely to miss its end-of- Parliament target of RPIX inflation of 2 1/2% or less.*** (But really bad inflation numbers are - of 4%, 5% or more - are still several quarters away.)

2. Euro-mania, the madness of committees and the euphoria about "peripheral" European bond markets

1996 has seen dramatic falls in Italian and Spanish bond yields, driven partly by hopes that the two countries would participate in European economic and monetary union on 1st January 1999 and partly by striking improvements in their monetary control (and, to a degree, in their fiscal policies). Progress has been particularly rapid in the last six weeks or so. Gilt yields have dipped in sympathy, on the view that they are cheap relative to the other members of the "peripheral" club (i.e., Italy, Spain, Scandinavia).

The declines in Spanish and Italian monetary growth are a valid reason for buying their government bonds. But Euro-mania is not. There is a growing body of evidence that the EMU is not going to happen on 1st January 1999. Indeed, a strong case can be made (see my argument in the research paper in the August *Gerrard & National Monthly Economic Review*) that EMU is never going to happen at all. (This is not to deny that the Maastricht convergence criteria have been a key influence on Italy's and Spain's improvements in monetary and fiscal management.) As far as gilt yields are concerned, they will ultimately depend on UK inflation (and UK monetary growth) and fluctuations in other European bond markets are of little relevance.

On the subject of Euro-mania, I would like to bring clients' attention to a front-page article in today's *The European*. (*The European* is just as Europhile as the *Financial Times*, but its stories are much closer to what is actually happening in continental Europe. The European stories in the *Financial Times*, and particularly its columns about EMU, should all carry the health warning 'The view from One Southwark Bridge'.) The story in *The European* refers to:

1. A Europe-wide publicity campaign costing Ecu 51m. to tell people about the Euro. (But the headline gives the "Ecu 51m." figure in dollars - $64m. - which rather gives the game away. Presumably the European Commission is to pay for the campaign, but European governments

might object to the budgetary costs if a really worthwhile campaign were mounted. Incidentally, how can a paltry $64m. - far less than British Airways spends in a year on marketing - go in converting hearts and minds? And, yes, this is not a spoof or 1st April. IT REALLY IS A $64M. QUESTION.)

2. A protest from the Association of German Consumer Groups at an earlier advertising campaign financed by the German government, on the grounds that it consisted of "long-winded brochures which amounted to little more than a mountain of barely intelligible theory". The association's finance expert, Manfred Westphal, said that German consumers resented the Bonn government's attempt to market the euro.

3. Worried about the general apathy/resentment/hostility, "the Commission has appointed 130 experts, called the euro groups, from banks and universities across the 15 EU member states. Their task is to fill in for over-stretched Commission officials as seminars and meetings on the single currency, due to be introduced on 1st January 1999." (What would Gilbert and Sullivan make of this, if they were alive today?)

4. Spain (and of course Italy and Portugal) are anxious about the formation of a two-tier Europe, as "a well-placed source in Madrid said 'For our country membership of Europe on equal terms with the rest is a matter of national pride'". (In most countries 'a well-placed source' is usually journalese for the prime minister's office.) ***Because the 1998 Inter-Governmental Conference will determine eligibility for EMU by qualified majority voting, Spain, Italy and Portugal - acting in concert - could block any country's membership, including Germany's and France's.***

What is the message from these various points? Surely, it is obvious. EMU is pure fantasy; it belongs in some sort of Euro- dreamworld. In this dreamworld there are thousands, even tens of thousands, of Euro-bureaucrats and hangers-on, and ***none of them says what they actually believe*** for two reasons. First, as Euro- dreamworld is a happy and idealistic place, it would be a great shame for anybody to wake up. Secondly, for the same reason, the first person to alert the dreamers (and remind them, awkwardly, that there is another place called "the real world") will be immensely unpopular. And so the fantasies and dreaming go on.

Psychologists have long been aware of "the madness of crowds", that people in large groups will do and say things that they would regard as crazy if they were acting as individuals. There seems to be a variant of this malady which might be termed "the madness of Euro-committees". In essence, groups of jet-lagged experts ("Euro-experts", no less) sit around tables in Brussels and Strasbourg, talk amongst themselves about Euro-subjects and reach conclusions which they somehow think are sensible and important, but which are utterly impractical to individual bankers, businessmen, retailers, economists and so on in the member states.

The key message is that there is not going to be a single European currency at any date in the relevant future. Bond trades which depend on the introduction of a single currency will - eventually - get nowhere. This is not to deny that the markets will buy and sell bonds on "convergence trades" and "divergence trades", and may keep on doing so for years to come. But we mustn't forget. IT IS THE FUNDAMENTALS - OF PUBLIC FINANCES, MONETARY GROWTH, CREDIT DEMAND AND SO ON IN THE VARIOUS COUNTRIES - THAT REALLY MATTER.

Of course, Euro-mania is not a valid reason for buying gilts.

Professor Tim Congdon 10th October 1996