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Paper tigers

A new high in the prestige of modern central banks was recorded two Fridays ago when Britain waylaid the gold market. Without warning, Her Majesty's government announced the sale of more than half of the U.K. gold reserve, formerly called "treasure." Instead of selling the currency, however, Mr. Market chose to sell the collateral behind it. The Bank of England, protector and defender of the pound, should have blushed: The plunge in the bullion price was the most extravagantly undeserved compliment it has ever received.

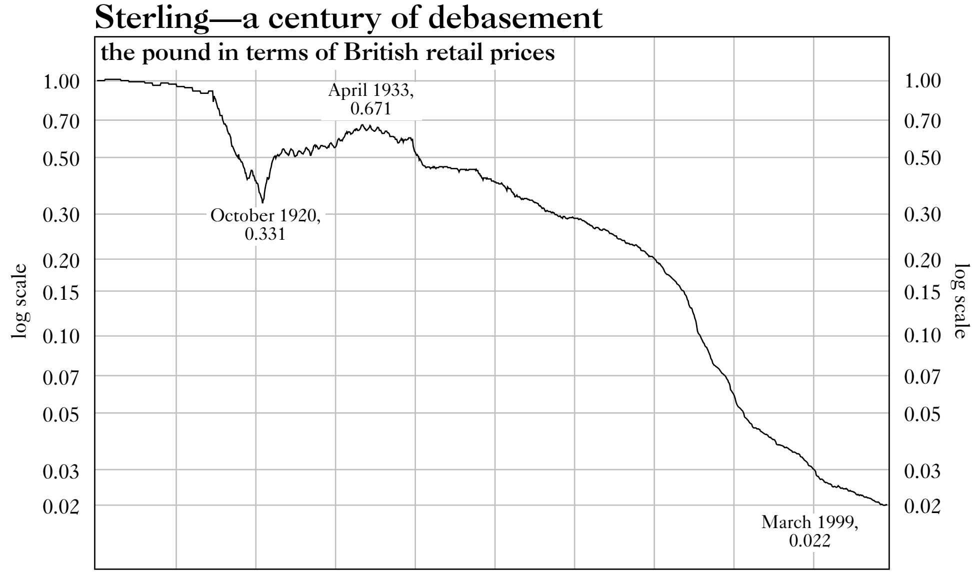
The world's oldest currency, sterling has, in this century, also been among the most perishable. It has depreciated in terms of both gold and British domestic prices, without let or hindrance, to borrow from Kipling. That the world should now be prepared to forgive the Bank of England is testament not only to the strength of the global bull bond market, but also to the blessed forgetfulness of the human species, even the monied portion of the species. It is testament, too, to deflation, or more exactly, we think, to the fear of it. In Japan, where the action in bank stocks suggests that a death-dealing financial collapse has been avoided, the two-year note today yields seven basis points (repeat: seven).

To accommodate those readers who have threatened to cancel their subscriptions over the continued unprofitable subtext of gold-bugism in these pages, we will not ourselves make the obvious and necessary point about the relative constancy of the value of bullion, or about the cycles of fashion in monetary assets, or about the tendency of managed currencies down through time to self-immolate. Rather, we will quote other noted authorities on these matters (any complaints, address to them). Thus, Christopher Fildes in the May 15 issue of *The Spectator*: "As late as 1931, a pound note was as good as a gold sovereign. Today's price for a sovereign is £41, so what was a dead heat is now a race won by a distance."

And Harry Bingham, of Van Eck Institutional Advisors in New York, in a recent concise history of the currency that is not called "sterling" for nothing: "Britain's Isaac Newton defined the British pound in terms of gold and silver almost 300 years ago. At the time, the pound was stated to be worth one-fourth of an ounce of gold and a pound of sterling silver. . . . Except for an interruption during the wars with Napoleon [and a century later, the war against the kaiser], the pound maintained its parity with gold and silver until 1931, when Britain formally refused to redeem pound notes for gold. Today, the pound is worth 1/170th of an ounce of gold and less than one-third of an ounce, not a pound, of silver, and this for the only paper currency that has survived for as long as 300 years."

Gold has borne its share of abuse during the almost 20-year bear market, but few indignities can match the market's demonstrated preference today for currencies of no particular pedigree, which includes nearly all of them. Either British social democracy has turned over a new leaf, or Mr. Market—having for so long pushed paper assets in one direction and gold in the opposite direction—is preparing to change his mind. We cling to the latter hypothesis,

Sterling—a century of debasement

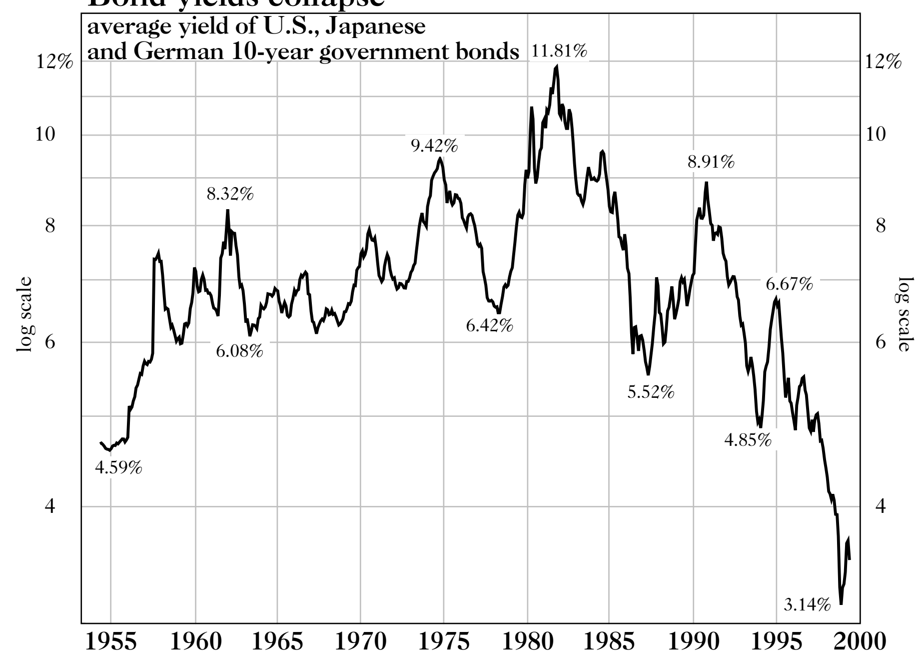


Prepared for *Grant's Interest Rate Observer* by Topline Investment Graphics although we have taken to heart the observation of a reader who said that gold will move when it is good and ready to, not when we tell it to.

Still, we can't help but comment on the poor quality of the competition for gold that the central banks are fielding. As for the pound, nobody who has read its history will be able to take it seriously in 1999, a year that happens to mark the 50th anniversary of its epic devaluation in 1949 and the 35th anniversary of the British payments crisis of 1964. The latter episode, which anticipated the sterling devaluation of 1967 (which is not to be confused with the float-cum-devaluation of 1972 or the float-cum-devaluation of 1992), was the one that inspired an economics minister in the first government of Harold Wilson to fasten the blame for Britain's currency troubles on the "gnomes of Zurich." Putting the nation's gold where their mouth was, the Laborites in 1966 proceeded to sell gold at the then-prevailing \$35-per-ounce price. By 1972, Britain had ditched 1,356 tons, more than half of its stash.

Now, not only do the Laborites, or rather the New Laborites, hate gold, but so do the gnomes and, indeed, the non-gnomes (these days, we do not exclude most gold bulls from the gold-hating majority—even we have our limits). The outer darkness into which the ancient monetary metal has been cast is illuminating, nevertheless. New lows in bullion are as much a sign of the times as are new highs in Japanese government debt instruments (last week's one-year bill auction was more than 13 times oversubscribed; priced at 0.049%, the securities rallied all the way to 0.035%, thereby demonstrating momentum if not what is known as "value"). Bullion and bonds, we think, together constitute a grade-A historical anomaly. The juxtaposition should force people in markets to confront the cyclically recurring question: "Is it really different this time?" This much, at least, is different: With the marginalization of the euro (not predicted here) and the weakness of the yen, the dollar has become the world's only universally acceptable monetary asset. It's Coke without Pepsi, a position never before obtained by a currency that can be duplicated at next to no cost on a high-speed printing press. (Arguably, sterling was just as important in its heyday as gold is today. Then, again, look what happened to sterling.)

Bond yields collapse



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It is hardly out of character for the Bank of England to show gold the gate. Our older readers may remember when, late in the Napoleonic era, the bank dragged its feet on the resumption of a gold-backed pound (was it really only 190 years ago?!). Down through the centuries, central banks have struggled with the dual mission of running a sound monetary policy and earning their keep. In formal gold-based monetary systems, of which none survive, gold not only collateralized the currency but also tempered the growth in bank credit. Both functions have been sorely missed on occasion in the post-gold era, although the lack of a regulator on bank-credit expansion has proven an excellent facilitator of bull markets. Still, the ingots yielded no income (by definition, they couldn't, any more than a \$10 bill can; they were money, i.e., "cash"). Even central bankers who believed in the gold standard sometimes wished their vaults held fewer ingots and more interest-bearing securities.

What's new about the present day, therefore, is not that the official stewards of the golden ingots would like to sell, but that their plans for doing so elicit so little opposition. Essentially, the preference for currencies over bullion in 1999 is unconditional; interest rates no longer seem to figure into the monetary-asset demand calculation very much. It is, of course, the mirror image of 1980, when the panicked demand for gold was itself unconditional. Then, as you may remember, no interest rate was deemed high enough to turn back the tide of inflation. (Is any Japanese interest rate deemed low enough to check deflation? Not to judge by the yen-denominated yield curve.)

If central bankers were scorned 20 years ago, they are lionized today, even when a particular government makes no secret of its determination to cause its currency to depreciate (as the British and the Swiss have done) or when the modern history of a particular currency is really the history of debasement (as is the post-1931 history of sterling). It's true that the Bank of Japan has come in for concerted criticism, and perhaps the reason for the collapse of Japanese interest rates is not so much trust in the BoJ as it is doubt that the bank will ever be able to effect an economic recovery. Still, someone must have faith in the integrity of the currency—enough, at least, to accept a $1\frac{1}{4}$% yield over the next 10 years.

The first of what is promised to be a series of British gold auctions is set for July. Barring a U.S.-led collapse in bond prices, the interest rates at which the Bank of England will reinvest the proceeds of the sale will be among the lowest of the past half-century (yields in the accompanying graph are calculated as a blended 10-year government yield on the yen, the mark and the U.S. dollar). The Japanese two-year note, as mentioned, yields all of seven one-hundredths of one percentage point, before tax. For ourselves, bearing in mind that the doubling time of money invested at seven basis points is only slightly less than a millennium (990.5 years), we can't see the appeal. Safety? Not very likely in the event the Bank of Japan ever considers a rise in the overnight call rate. As a point of perspective, a gold ingot lent for three months yields just under 1.25%; indeed, as of Monday every gold lease rate out to 12 months was greater than every Japanese government bond yield out to 10 years.

By comparison, it's true, the German 10-year bond yield is almost full-bodied, at 4.11%, and the U.S. rate is positively towering, at 5.66%. Yet, over the sweep of the past quarter century, these yields, too, must be reckoned low. As for gold, the only thing one can say is that there is really nothing to say. Having made new lows, it's been written down and written off. (An investor friend relates that he recently bought 250,000 gold calls struck at $500 for five years at a cost of $2 each. Given that the forward gold price is approximately $370, he observed, the calls are essentially free. Oil can go up 80% or so in less than a year, he reflects, but to take the options market at face value, no way can gold go up 30% in five years.)

Following a debasement of the pound by Edward VI in 1549, there was a peasant revolt in Norfolk, Devon and Cornwall. After years of inflationary war finance, in 1810 there were parliamentary hearings into the cause of the alarming loss of the paper pound's purchasing power. And when, at the turn of the 20th century, cheap silver was offered up in competition to the gold-based pound, there was a Gold Standard Defence Association to stand up for the British creditor class.

No such resistance to the course of action announced by the British Treasury is evident today when, to many observers, the clear and present monetary danger is deflation rather than the opposite. Even a little currency appreciation is deemed to be too much (from the time last fall that the Bank of England began to cut its base rate, the trade-weighted sterling index has appreciated by 4.6%). Or, perhaps, the market is looking through immediate events to future British membership in the European Monetary Union, at which point the pound would cease to exist and Britain would share in the European Central Bank's monetary reserves. Certainly, to judge by the shape of the British government yield curve, some such story is making the rounds. Every market rate on the sterling curve is lower than the 5¼% short-term lending rate. The global bond markets are beginning to meld the British curve into Europe's.

But, for now, Britain is still Britain, and sterling is still sterling, and the pound's strength against the puny euro has set off alarm bells within the British commercial and monetary establishments. These concerns came to light in a remarkable report on the day of the gold sale bombshell. "The Bank of England, the U.K. central bank," the *Financial Times* story led off, "yesterday signalled growing concern over the pound's continued resilience, saying it would cut interest rates again if the currency remained strong."

The fourth paragraph got to the essential monetary issue: "The Bank said that if the pound did not fall, inflation could undershoot the targeted annual rate of 2.5%. 'Depending on other developments in the economy, there might, therefore, need to be further easing of interest rates in order to keep inflation on track,' it said."

Certainly, this is not the one and only official view of British monetary policy. The deputy governor of the Bank of England, Mervyn King, made hawkish sounds on Monday. However, the main fact, we think, is that sterling's depreciation is predestined; the only issue is the rate of decay.

In the wake of the British gold sale announcement, Haruko Fukuda, chief executive of the World Gold Council, a not disinterested party in the transaction, charged, "We at the World Gold Council have been told by HM Treasury that it was emphatically a political decision." Then, again, most monetary policy decisions are. In the circumstances, the choice of holding low-yielding currencies and selling $275 gold is more than trust. It is an act of faith.

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Sell gold? Buy pounds? Good luck

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GRANT'S

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EDITOR

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Sincerely yours,

James Grant