GILT-EDGED

Deficit set to stay the Achilles' heel despite ERM step

Entry into the exchange-rate mechanism of the European Monetary System will not improve the underlying fundamentals for Britain without a significant sacrifice of economic growth. The government is unlikely to want these consequences to appear before the election. The decision to enter the ERM now should be viewed as blatantly political, signalling an early general election.

The immediate outlook for the gilts market is attractive. Short-term rates will decline as sterling remains underpinned and expectations of further rate cuts grow. Longer-term gilts will also benefit. After such a long period of *ad hoc* monetary policy, international investors will be attracted to sterling. This will be reflected in arbitrage flows from other European bond markets, such as Bunds. The yield spread of gilts over Bunds will become a determinant of the market's performance, just as it has in France.

As political factors seem to have dictated the timing of entry, further rate cuts are possible. ERM entry and the consequent base rate cut are unlikely to prevent a recession. With consumer confidence low, the housing market in the doldrums and unemployment set to rise, a sharp rebound in consumer spending is unlikely.

While the gearing of smaller firms will be helped by lower rates, the corporate sector is still suffering from debts, which reached £18.4 billion in the first half of this year. In view of sluggish domestic demand and the uncertain international environment, we would still expect to see a further reduction in inventories, improved but subdued investment intentions and labour shedding.

One encouraging short-term prospect is that this could result in subdued wage pressures in this autumn's pay round.

But, despite the improved winter outlook, the political risks have not been significantly reduced by ERM entry. As the underlying fundamentals remain poor, Britain is a hostage to fortune of international events. There remains the possibility of a sterling devaluation, an aggressive use of reserves, or indeed, an interest rate rise, before a possible election. Furthermore, the downward movement of British rates could be halted by events in Germany. Despite the possibility of an American recession and lower rates, the correlation between gilts and Treasuries will be reduced. Gilts will now trade more closely with their European allies. With Germany at a different stage of the economic cycle, enjoying strong growth, there is a possibility of a further German rate increase.

While the present level of sterling does signal an anti-inflationary commitment by the government, there are problems. In particular, sterling has entered at too high a level. The competitiveness of the tradeable goods sector is likely to be hit, particularly in the short term.

For ERM entry to prove successful, inflationary expectations will need to be reduced. However, these are unlikely to fall unless the credibility attached to sterling's membership is established. In view of the perceived political decision behind joining and the present inflation rate, this may take time.

A good example is France. It has taken a long time for French yields to converge with those of Germany. This has required not only a commitment by the French government to reduce inflation but also a severe demand-deflationary policy.

In fact, for Britain to attain the same degree of credibility, fiscal policy has to be tightened. It is difficult to envisage the chancellor doing so at this stage of the electoral cycle. Indeed, the fiscal position is deteriorating, with revenue growth slowing and lax controls over government spending.

Sterling's credibility, especially in terms of its dependence on hot money, could be hit by the persistence of the current account deficit. Its overvaluation and the deteriorating British competitiveness mean the current account deficit will not be reduced by higher exports.

Furthermore, while the recession will contribute to a cyclical improvement in the current account deficit, Britain's inability to produce high quality goods means the structural components of the deficit will persist. With investment falling, Britain's lack of capcity means the longer-term outlook for the deficit remains poor. The current account deficit is set to remain the Achilles' heel of the British economy.

GERARD LYONS
DKB International