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GILT-EDGED

A high risk policy for current account deficit

Recent developments suggest that Britain has not sufficiently overcome the problem of strong domestic demand growth being transmitted into growing import and higher prices. While present economic policy will be successful at tackling inflation, the cost will be a deterioration in the current account deficit.

With the Chancellor successfully maintaining the confidence in his policy, the gilts market appears to be reasonably optimistic about longer-term prospects. Notwithstanding the limited supply of gilts, this misplaced optimism is explained by the market focusing solely on two of the encouraging themes in present economic developments.

First, the immediate outlook of a marked pick-up in inflation is likely to be a short-term phenomenon. Demand pressures point to inflation peaking at around 6 per cent in the first quarter of next year. A positive outlook for inflation is then supported by a number of features. The Government is clearly committed to keeping inflation under control. This points to a tight monetary policy being sustained for the rest of the year. Even if higher interest rates push sterling to unsustainable levels, this is likely to be accepted by the Chancellor as necessary to counter the inflationary threat.

The combination of a tighter policy, which should dampen down pay settlements, and continued strong growth in productivity points to a favourable outlook for unit labour costs. This suggests that British inflation can be kept under 4 per cent for a sustainable period.

A second important positive feature in the economy is the improvement that has been witnessed in the supply-side. Industry is in a healthier state than for some time, as is evidenced by productivity, output and profit figures. For instance, as a proportion of gross domestic product, non-oil profits are at their highest level since 1964. As a result, industrial confidence remains high. This should indicate that industry will be better able to cope with a tight monetary policy. More importantly, it implies that there exists scope for industry's revival to continue.

These features are supportive of the long-end of the gilt market. However, it is clear that the current account deficit is not being viewed as a major problem. This is where we believe the market is wrong. Even allowing for a possible upward revision to invisible earnings, the current account deficit is set to reach £12 billion this year. And the outlook is for the deficit to deteriorate to £12.8 billion in 1989 and remain high for some time to come.

A deficit of this size will not only restrain longer-term growth prospects but, if it results in sterling coming under downward pressure, will also pose the biggest threat to the inflationary outlook.

While the deficit has been exacerbated by the strength of the economy this year, underlying structural problems account for the deterioration over the longer-term. The poor manufacturing trade performance is one of the main reasons why the deficit has reached alarming proportions. Evidence of the poor trend is seen by figures showing increased import penetration across all sectors of manufacturing industry. In 1974, imports accounted for 23.3 per cent of home demand in manufacturing; this figure rose to 27.8 per cent in 1981 and by last year was 35.2 per cent.

Both price and non-price factors are important in explaining this movement towards increased import penetration.

Britain does not appear able to produce goods of the right mix or product type that can satisfy strong consumer-led growth. For instance, from 1980 to 1987 consumer spending grew by 24.3 per cent in volume terms, while the volume of consumer-related imports increased by 63.6 per cent.

The inability to produce high quality goods appears to be related to insufficient investment in the British economy. As investment is clearly the key to the whole problem, it is strange that policy has not been more conducive to industry's needs. If investment does not continue on a sustained basis, then the movement towards increased import penetration of the British economy is likely to continue.

In the long-run, Britain will have to have a growth rate consistent with a balance of payments equilibrium. This implies that the long-term outlook is not encouraging for British growth prospects. If policy continues to react to a deficit by attempting to cut domestic demand, then the structural problems that account for the deficit are unlikely to be improved.

The current account deficit points to Britain running down its ownership of overseas assets, or to increased borrowing from aboard. As Britain has accumulated such a large stock of overseas assets, this points to a deficit being sustainable for a number of years. However, the sustained deterioration of the deficit points to Britain having, inevitably, to borrow from overseas. This may then force sterling and interest rates to levels necessary to improve the external constraint, but which are inconsistent with the requirements of the domestic economy.

The risk is that, by not creating an environment in which the current account deficit can improve, sterling is likely to come under downward pressure, raising fears of higher inflation. In fact, the possibility of a run on sterling represents the biggest risk for the outlook for inflation.

And the biggest risk for the outlook for industry is if the authorities then seek to defend such a weakening currency by pushing interest rates to even higher levels. This would clearly have a deflationary influence on economic activity and hence on profit growth, and would hit investment intentions.

These risks inherent in current policy suggest that yields may have to rise further in the short-term. What is clearly needed is a policy to curb consumption while allowing the underlying structural improvement to occur. However, the Chancellor has ruled out measures that would appear necessary, such as credit controls or a tighter fiscal stance. In the absence of these, we would suggest that the large budget surplus should prepare the way for a Budget to aid industry through tax changes that boost investment and not further personal consumption. Until such measures are forthcoming, the structural problems will remain and the market will eventually have to come to terms with them. The longer-term risks are high and we see little scope for yields to fall.

Gerard Lyons
Chief UK Economist
SBCI Savory Milln