GILT-EDGED

Debt is the worry, not inflation

This economic cycle is different. The British economy has been recovering for more than three years, but inflation is still low. Even the normally cautious Bank of England expects it to stay low. In spite of this, there are misplaced fears that recovery will trigger inflation. Some people are even making comparisons with the credit boom of the 1980s. The 1890s might be more appropriate. Then, the world economy was undergoing structural change, with commodity prices and inflation falling, triggering severe economic dislocation, as newly industrialised economies caught up.

Now it is the turn of South-East Asia to catch up. Western companies have to restructure. This has brought low inflation in the 1990s, and this will continue. British firms are working existing employees and capacity more efficiently. Productivity has risen. Unit labour costs remain subdued. Even though skilled workers' pay may rise, global disinflationary pressures and corporate downsizing will cap wage pressure.

There are some risks. The biggest is the lack of previous investment, because it could trigger inflation bottlenecks. Higher productivity should lessen this risk. Also, rising imports and a deteriorating trade deficit may act as a safety valve for inflation pressures. Firms' past reluctance to invest means that even an improving rate of return on capital in business may not trigger the investment it should.

Low inflation contributed to a strong rise in real personal disposable income last year. Along with subsequent policy easing, this should allow steady consumer spending. However, sluggish wages and job insecurity will ensure that the rebound in spending is at a moderate, not unsustainable pace. Consumers still expect value for money, and this will cap inflation pressure.

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Falling inflation can accompany steady economic growth. The retail price equation in the Treasury's economic model shows significantly less inflation pressure in the last four years than the model would have expected. I expect this trend to continue, with underlying retail price inflation falling from 2.9 per cent last year to 2.4 per cent this year and only 2 per cent in 1997.

This should hardly worry gilt investors. Low inflation should let the Chancellor cut rates again, particularly if rates on the Continent fall. I expect base rates to fall to 5.5 per cent by late summer, although the Chancellor may take a neutral stance in the next two months, as he assesses the pace of recovery.

Although sterling may weaken in the immediate approach to an election, its downside against the mark should be limited, partly because the recent devaluation has been followed by competitive gains, and not inflation. This calls into question the pessimism being built into the gilt market, where ten-year yields are 1.8 per cent above those on comparable German bonds.

This risk premium is too high. It reflects concerns that British inflation is about to soar, either by the Chancellor easing policy too much before the election or by Labour reflating when they win. Will policy lead the UK to buck the international trend of low inflation? I do not think the risks in the UK are higher than elsewhere.

If investors are to worry, it should be about debt. In the new fiscal year, the Government plans to issue £32.6 billion in gilts, taking into account £11.4 billion maturing gilts as well as new issuance. This is sizeable, but, judging from recent years, the outcome could be higher.

For international bond markets, inflation is not the problem. Debt is. Debt-to-GDP ratios have continued to rise in the industrialised world, as pension and health costs have increased. High structural unemployment has added to the problem on the Continent, and the Government's inability to control general expenditure has worsened matters here. Fortunately the UK's medium-term debt outlook does not look so bad, but investors may need to be convinced that an incoming Labour government could control spending. In view of these debt worries, the yield curve may remain steep, even though inflation will stay low.

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