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Devaluation on the agenda whoever wins

By the end of this year the British economy will have to cope with an unsustainable exchange rate and a continuing balance of payments constraint. It will be almost like the Sixties. Regardless of who wins the election, devaluation will be back on the agenda.

Gilts are now benefiting from the continued recession, falling inflation and sterling's stability. Talk of recovery still seems premature, despite the recent increase in personal sector savings. The overhang of debt, the stagnant housing market, an uncertain election outcome and poor employment prospects all suggest continued weakness. If demand remains weak, the corporate sector will continue to retrench with destocking, labour shedding and cutbacks in investment.

These factors point to a further improvement in both the headline and underlying rate of inflation. This will become more evident by the summer, when lower wage settlements, now being agreed, will be reflected in the average earnings data. Although the service sector may be isolated from the anti-inflationary discipline of the ERM, the weakness of the economy should prevent a resurgence of service sector inflation this year.

The key factor for gilts, though, is sterling. As last week's reserve figures showed, the currency has not needed sizeable intervention to maintain ERM stability. Despite the imminent election, the commitment of all three main parties to the ERM appears to have reduced sterling's risk premium. This has led international investors to view gilts favourably. Indeed, the spread of ten-year gilts over Bunds appears attractive, at 144 basis points; the comparable spread for French and Dutch bonds is 88 and 105 basis points respectively.

The international environment is attractive for bonds. The continuing recession in America and the sharp downturn in Japan will lead the American and Japanese authorities to lower rates again, allowing bond markets there to rally. Although the Bundesbank will keep policy tight, this will highlight the attraction of high real yields on European bond markets. The irony is that while it is sterling's commitment to the ERM that will allow gilts to benefit from any European bond market rally, and thus overcome supply and political worries, it is the very same commitment that could store up problems later in 1992. By then, German rates should be falling but the scope for lower British base rates will be limited. Lower rates could prompt a recovery in consumption, leading to a surge in imports and a deterioration in the current account.

The gilt market would be foolish to ignore the implications of Britain's trade problem. It implies either a sizeable devaluation of sterling or — if devaluation is prevented by ERM — policy will have to be tightened to curb domestic demand growth. This suggests that British real interest rates will have to remain at high levels if the economy is to adjust to ERM membership.

This points to extremely weak British growth for some time, leading to rising unemployment, continued bankruptcies and a further squeeze on the manufactured trade sector. Despite the talk of the need to establish credibility in the ERM, the implications of the domestic economy of this high and overvalued exchange rate may lead the gilt market to talk openly of devaluation.

A re-elected Conservative government will probably decide to accept this trade-off for squeezing inflation. It would also allow the government to get the economic and political cycles back into synchronisation. Many of the government's present problems stem from Nigel Lawson's expansion after the last election and it will be keen to avoid a similar mistake. Although a Labour government might raise interest rates temporarily to gain market credibility, devaluation might become necessary unless its supply-side policies work very quickly. A hung parliament, meanwhile, would inevitably lead to sterling weakness as political uncertainty persisted.

A sizeable devaluation will be a key ingredient if Britain is to achieve sustainable growth. The benefits to capacity and competitiveness are clear but the inflation worries associated with devaluation are overdone, particularly in the present international deflationary environment.

In fact, it can be argued that the loss of capacity as a result of sterling's overvaluation will lead to supply bottlenecks and reignite inflation once demand recovers. While gilts are now very attractive, by year-end things could be dramatically different. Then, sentiment may again be driven by the monthly trade figures and the potential currency risk.

GERARD LYONS