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GILT-EDGED

Global trends to pose problems for sterling

International developments over the next two months are likely to test the Chancellor's anti-inflationary resolve. The possibility is that Mr Lawson will not rise to the challenge.

Against the background of an underlying UK inflation problem and a sizeable current account deficit, higher interest rates overseas will lead to downward pressure on sterling. Such potential currency risks are now again the biggest concern for Japanese investors.

The firmness of oil and non-oil commodity prices has boosted inflationary pressures in the major nations. For Japan and Germany, these pressures have been exacerbated by the strength of the dollar. This has contributed to a rise in inflationary expectations and a sharp upward movement in short-term money market rates. German three-month interest rates have risen 1.25 points so far this year, to 6.8 per cent, while three-month interest rates in Japan have picked up 0.25 points in the last month. Bond markets in these economies have seen yields rise across the curve.

The corresponding rates in the US and Britain have declined 0.25 points over the last month, despite higher underlying inflationary problems. These interest rate trends reflect the importance of exchange rate movements in overall economic policy, and the fact that the dollar and sterling have sustained their effective rates recently.

Such currency levels cannot be maintained while the global economic imbalances persist. Britain and the US have sizeable deficits of more than 3 per cent of GDP. Meanwhile, the surpluses of fundamentally sound economies such as Japan and West Germany have grown.

For the imbalances to be corrected, three things are needed. Sterling and the dollar must weaken to enhance competitiveness. US and British demand must slow, thereby reducing import growth, while overseas demand for British and US goods needs to strengthen. The strength of the dollar and sterling is harming competitiveness while the prospect of tighter stances in Japan and Germany has poor implications for the deficit countries.

Tightening is also likely to occur alongside intervention against the dollar by major central banks. This could provoke higher US interest rates, causing undesirable upward pressure on the dollar and having damaging knock-on implications for global policy.

It is important that monetary authorities do not overreact to signs of rising inflation. Global activity is expected to slow this year, which should ease inflationary pressures by year-end. Yet the lag between the peak in growth and rising inflationary pressures could contribute to further monetary tightening.

Last week, figures pointed to German annual wholesale price inflation reaching 6.5 per cent in April. This was the highest rate for seven years and the latest in a series of rising inflationary indicators.

In Japan, import price inflation has picked up from an annual rate of minus 8.5 per cent last November to plus 2.3 per cent in March. Set against a background of strong domestic demand growth and tight labour market conditions, rising inflationary pressures have already fed into wholesale prices and eventually will push up retail prices in Japan.

Consequently, we believe that international interest rates are trending higher. The Japanese authorities are likely to increase the discount rate from 2.5 per cent to 3 per cent. This would represent the first rise in the discount rate for nine years. German money market rates are also set to trend up, and another increase in the discount rate cannot be ruled out.

The consequences for Britain are twofold. Over the next three months the interest rate differential in favour of sterling will decline. This would result in sterling weakness. As Britain is not in the EMS, there is no perceived floor to sterling if it comes under downward pressure. The dilemma for the Chancellor is that with domestic demand already slowing he will not want to increase interest rates but may be forced to, in order to protect sterling.

Second, current global monetary tightening could cause very slow world growth in the latter half of the year, curbing demand for British exports. This would exacerbate the current account deficit, unless British policy curbs import growth by more than recent trends suggest it has.

The implication is that the Chancellor will have to tighten policy further if he wants to regain his credibility as an anti-inflation fighter.

Against this background the short end of the gilts market does not offer a favourable alternative to cash. However, the long end of the yield curve should also suffer through such a monetary tightening. This is because the current policy stance does not solve Britain's underlying problems.

For the problems to be controlled and for long gilt yields to react positively, the Chancellor needs to set out some sensible medium-term policy for the exchange rate. Sterling needs to be allowed to depreciate to a more sustainable level, which is consistent with an improvement in the current account deficit. As last week's Bank of England *Quarterly Bulletin* pointed out, adjusting relative unit labour costs for exchange rate movements, Britain suffered a loss of competitiveness of 9 per cent in 1988 and of 3 per cent in the fourth quarter of last year alone.

Further, the Chancellor needs to control domestic demand and credit growth in such a way that inflationary pressures do not recur with a vengeance when the economy grows strongly again.

There is growing concern for international investors about the potential currency risk from investing in high yielding currency markets. In 1988-89, only £0.03 billion of the Bank of England's net gilt purchases of £13.3 billion was from the overseas sector. This year, the proportion will be higher as the attraction of gilts for overseas investors declines.

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