GILT-EDGED

In economics, for lean and fit read skinny and weak

The recession is likely to be deeper and more prolonged than the gilt market is expecting and will highlight the inadequacies of government policy, which is not capable of tackling the economy's deep-rooted problems. In part this is because the economy is not lean and fit, but skinny and weak.

The immediate outlook points to a large reduction in inflation and a sizeable improvement in the current account deficit. This could improve sentiment for sterling, allowing interest rates to fall and prompting a bounce-back in activity.

The trouble is that the market appears to be regarding this as a shallow recession and has thus focused on the cyclical aspects of the downturn while ignoring the structural factors. These will mean that any bounce-back in activity is likely to be small and temporary.

First, the level of indebtedness, particularly within the corporate sector, suggests that the normal transmission mechanism from lower interest rates to higher activity will not work fully in this downturn. The financial deficit is contributing to investment cutbacks, rising unemployment and bankruptcies in all sectors.

As interest rates fall in response to the deepening recession, people and companies are more likely to repay debts and rebuild savings, limiting consumption and output growth.

Second, the balance of payments constraint points to either a sterling depreciation or a tight fiscal policy to depress domestic demand. Although falling imports could lower the current account deficit to £8 billion in 1991, this cyclical improvement will still leave the deficit at an unsustainable high level. Furthermore, the structural problems associated with the deficit will remain, including Britain's high propensity to import and its inability to produce sufficient quality goods for export. Thus any increase in demand will lead once more to a deterioration in the current account deficit.

Third, the ERM constraint will limit export growth potential, particularly given the government's commitment to sterling's uncompetitive exchange rate. This is being exacerbated by the growing American recession and sluggish world growth.

Sterling's overvaluation will be seen either when interest rates fall this year, and the short-term support for sterling evaporates, or when economic activity revives and inflation and import problems re-emerge. Although the authorities do not want a devaluation, this may be forced on them by the market, particularly once it is clear that underlying problems remain.

Although there will be a sharp, recession-induced fall in inflation this year, the policy stance should be viewed as a short-sighted response to reducing inflation. Underlying problems on inflation are not being addressed.

The problem of high wage growth is set to persist, particularly in view of skill shortages. As with the experiment with monetary aggregates in the early Nineties, inflationary expectations are unlikely to be reduced by ERM entry. A wage bargaining process based on forward-looking wage contracts needs to be instigated by the government.

At present, wage cuts are likely to depend on the economy being squeezed further. However, this would reduce the manufacturing base. It is clear that the deterioration in competitiveness and the decline in investment will lead to future capacity constraints and limits on productivity growth. Both will be inflationary. Furthermore, the reduction in capacity will limit Britain's capacity for import substitution.

What is needed is a credible and consistent policy framework. This necessitates sharp cuts in interest rates, allowing sterling to depreciate to a sustainable level, consistent with an improvement in the trade balance.

To neutralise any inflationary implications of lower interest rates, fiscal policy should be tightened, and redirected towards boosting savings and investment, thus improving the supply side.

Against this background we expect the shape of the yield curve to change dramatically. Yields at the short end will fall this year as inflation and interest rates fall.

Meanwhile, yields on long-dated government debt will experience two moves. First they will decline, as the disinflationary global environment improves the outlook for world bonds. Then, however, domestic factors will cause longer-dated yields to rise sharply, as the poor outlook for inflation and the current account increase the risk premium attached to sterling assets.

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