GILT-EDGED

UK interest rates face a premium for political risk

How vulnerable is sterling? This question is likely to be the dominant factor affecting gilts in the run-up to the election. Sterling's performance will dictate the timing of interest rate cuts and will determine whether foreign investors buy gilts.

Political pressures will weigh heavily on sterling in coming months. The pound is already vulnerable to politically motivated interest rate cuts and the possibility of a Labour government may lead to increased fears of a devaluation.

Despite Labour's commitment to the exchange-rate mechanism, the foreign exchange markets will be wary until they have been given a chance to test its economic credibility if elected. Clearly sterling could weaken before the election or a political risk premium may need to be reflected in interest rates.

Even allowing for this political risk, I believe it is more likely that economic factors will allow interest rates to fall in the next six months, without undermining sterling. There are two reasons for this.

First, the world economy is weaker than the markets realise. Present misplaced views about economic recovery in America will soon be replaced by expectations of deep recession there, as weak consumer confidence and rising unemployment delay recovery. Weaker domestic demand is leading to slower growth in Germany and Japan albeit from high rates. This points to lower American and Japanese rates and no rises in Germany. This international environment should give an opportunity for British rates to fall.

Second, Britain's recession will be deep and prolonged. Recent interest rate cuts have not boosted output or spending, but have allowed people and companies to increase savings and repay debt.

The combination of rising unemployment and a wage squeeze will lead to a dramatic cut in unit labour costs. This measure of underlying inflation could decline from its present rate of about 11 per cent to as low as 4.2 per cent by the fourth quarter; a far sharper fall than is realised. This fall in unit costs will occur as German unit labour costs rise, and should benefit sterling. This international and domestic economic climate should allow base rates to fall to 10 per cent by autumn. This may seem low, but, allowing for inflation, real interest rates will be 5.5 per cent, higher than now, indicating monetary policy will stay tight. This outlook should lead domestic investors to favour short-dated gilts to equities or cash.

Although sterling can remain stable this year it will become more vulnerable next year. This year, sterling is benefiting from a cyclical improvement in inflation and current account deficit. However, Britain's deep problems of low investment and savings imply any economic recovery will reignite inflation and trade problems.

The trade deficit is likely to deteriorate next year. Britain already fails to produce sufficient quality goods for an export-led recovery. This problem is likely to be exacerbated by a further loss of productive capacity in this recession and by sterling's high ERM rate.

A large deterioration in trade, or inflation next year, could threaten sterling's ERM parity. The clear risk is that base rates may need to rise. Ironically, this would further depress domestic demand and productive investment and make it inevitable that sterling will eventually weaken. Indeed, the problem next year is the need for sterling to adjust fully to ERM membership. Hitherto, the weakness of the mark has meant no clash between domestic factors and the ERM constraint. This is unlikely to continue.

This will pose problems for foreigners. The latest Bank of England *Quarterly Bulletin* says in the first quarter of this year foreigners were net gilt buyers for the first time since the third quarter of 1989.

There will be more need to attract foreign investors as the government's funding requirement grows. Talking to the Japanese, it is clear they are wary of Labour and cautious of sterling. This factor, and the global capital shortage, may point to yields rising steadily from the year-end, particularly long dates.

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