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Neste, its biggest West European customer, with 5.2 million tonnes, far short of the 8 million to 9 million tonnes it was contracted to deliver. In the first eight months of this year, only about 2.5 million tonnes have been supplied, despite Neste paying the world market price.

Neste had to look for alternative supplies, and not just from the North Sea. But Mr Ihamuotila has not given up on the Soviet Union, or, perhaps, the Russian Federation. "We are their closest customer and they are our closest supplier. We are natural allies," he says.

He foresees the collapse of the Soviet market for Finnish exporters, forcing business to turn its back on the Soviet Union, if only temporarily. The Finns are well aware of having a market next door of more than 300 million people.

The Nordic countries' ever-mounting concern about the environment has also focused attention on the high sulphur content in Soviet crude. Strict air pollution controls favour cleaner North Sea oil.

More immediately, Mr Ihamuotila is looking for the benefits of having his main market of 14 million people in Finland and Sweden widened to about 20 million as the Baltic states and the heavily-populated Petersburg region come within its orbit.

Neste has the only modern coastal refineries in the Baltic, located in southern Finland, and specialises in cold weather products. Its bitumen is already being used to improve the Baltic states' roads.

The company has set up a 55 per cent owned joint venture in Estonia to build a £30 million oil terminal at Tallinn. Neste has also set up filling stations in the Baltic states and Petersburg region, supplying high grades from Finland and lower grades from Soviet refineries.

The masterplan at Neste is to expand geographically but narrow the field of its activities to concentrate on its core hydrocarbons business — hence the recent disposal of its battery interests. The company is now waiting for market conditions and Mr Lilley to allow it to carry the policy forward.

COLIN NARBROUGH

GILT-EDGED

With no poll, bonds may catch a cold this winter

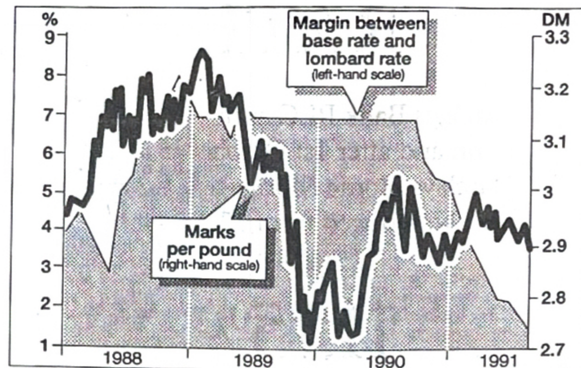
The gilt market is in for a difficult winter. This is despite the favourable international environment for bonds, where yields will be falling sharply in America and Japan. Europe's high real yields also look attractive, particularly ahead of monetary union. Gilts, however, have to face political and economic uncertainty.

Without a November election there is a risk of a sterling crisis this winter. The prime minister may delay calling an election until 1992 because he believes that the government's re-election chances will be higher then. However, the financial markets will interpret any failure to call an election this year as indicating that the government does not think it can win.

Although the opposition parties are committed to sterling stability, the gilt market is likely to factor in a sizeable political risk premium, anticipating higher short-term and long-term rates as the foreign exchange market would be expected to test any new government's exchange rate credibility.

Sterling's vulnerability is highlighted by the narrow interest rate differential between UK base rates and the German lombard rate. This spread has fallen from 7 percentage points last October to its present 1.25 points, and it could narrow to half a point in coming months.

Despite this narrowing spread, sterling has remained stable. One reason for this has been the uncertainty in Germany over the past year. Also, sterling's dependence on flows of "hot money" has fallen significantly this year. This is the result of a large, but temporary, reduction in the basic deficit of the UK's balance of payments. A significant reduction in the current account deficit and actual inflows of portfolio and direct investment have reduced the deficit on the basic balance from £29.2 billion in 1990 to only £965 million in the first half of this year. Despite this, there is still a sufficient stock of



hot money in the UK which, alongside portfolio investment, could soon be switched from sterling.

The economic environment could also pose problems for gilts. The outlook for the public sector's deficit is likely to be worse than the market expects, signalling large scale gilt issuance.

The movement of the public sector into a large deficit reflects the impact of the recession in reducing revenue growth and boosting government spending, as fiscal stabilisers such as unemployment benefits come into effect. With the economy set to grow at below its trend rate for some time, in an effort to contain inflation and trade problems, the upward pressure on the PSBR will be considerable. We expect a PSBR of £23 billion in 1992-3.

Judging from reaction to last week's £1.5 billion gilt auction, such issuance might not be easily placed, particularly as the market appears too optimistic about inflation prospects. The economy will probably have to be squeezed further if the recent reductions in headline and underlying inflation are to be sustained.

It is too early to suggest that people or companies in the United Kingdom have reduced their inflationary expectations on account of ERM entry. Although the reduction in inflation since last October has coincided with ERM membership, it is likely that the recession would have forced inflation down anyway — ERM or not. What we have seen over the past year is a recession suppressing inflation. Ironically, the loss in capacity from this recession could actually add to inflationary pressures as recovery could mean that supply bottlenecks will soon be reached. Furthermore, recovery is likely to see companies attempt to boost their profit margins.

Cyclical factors will ensure that the favourable inflation trend is sustained into the first half of next year. Productivity will improve as labour shedding continues after output has stopped falling. However, once the labour shedding process runs out of steam, it is difficult to see where the improvement in productivity is going to come from — particularly in an environment where investment is falling.

This means that wage pressures will feed through directly into underlying inflation. So far there has been a significant reduction in earnings growth as both wage drift (bonuses and overtime) and settlements have fallen.

I feel that it will not be until next year, when retail price inflation is creeping up and the labour market is tighter, that we will see that wage settlements have not yet adjusted to ERM entry. This could force interest rates higher next year, regardless of who wins the election.

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