Evans in search for buyer

Evans Healthcare, which was bought out from Glaxo for £27 million in October 1986, has asked First Boston, its merchant bank, to seek buyers for the business rather than press ahead with a flotation on the Stock Exchange. Evans is Britain's leading supplier of generic pharmaceuticals to retail chemists and one of only two producers of vaccines in the country.

Unbranded medicines no longer protected by patents are one of the fastest growing sectors of the pharmaceuticals industry. Two thirds of Evans' £44 million sales last year came from generic drugs, with the majority of the remainder accounted for by vaccines. Operating profits have grown from £1.1 million in 1986-87 to £5.2 million in the year to June.

Banks dispute

Taipei (Reuter) — Mrs Shirley Kuo, Taiwan's finance minister, said the government cannot begin to sell off shares in three state-run commercial banks until it decides which of its branches actually owns the stock. She said the First Commercial Bank, Hua Nan Commercial Bank and Chang Hwa Commercial Banks would be privatized, but that officials first had to thrash out who had the right to initiate the sale.

Number two of a series.

GILT-EDGED

Underlying trends point to high-risk policy for sterling

The United Kingdom economy is set to experience a hard landing over the next year. Economic growth will slow substantially. The trend for underlying inflation will be upwards and the current account will remain in sizeable deficit. This economic scenario is unlikely to allow sterling to remain stable and a sharp fall in the currency is likely.

Financial markets have tended to focus on the positive aspects of the policy stance. In particular, high interest rates have slowed consumer spending and have led to a stagnation of the housing market. Now, mainly on account of the mortgage rate effect, retail price inflation has started to fall.

However, there are potential problems in the outlook for consumer spending and inflation. First, overall consumer spending has not slowed as quickly as wished, and the growth of earnings and the impact of National Insurance reductions could mean that spending rebounds in the run-up to Christmas. Second, underlying inflation has continued to pick up and with earnings growth rising, fears of a wage-price spiral remain.

Negative effects of policy are already being seen in other areas of the economy. High interest rates are adversely affecting UK output and investment intentions.

In the second quarter, for instance, manufacturing output growth was flat, while industrial production fell 1 per cent. Over this quarter, it was noticeable that there was a 2 per cent fall in the output of chemicals, textiles and clothing.

The latter industries are clearly being hit by a loss of cost competitiveness, associated with sterling's strength. A slowdown in manufacturing is not good for the economy. As domestic demand slows, what is needed is for output-growth to be maintained, through production being switched to meet overseas demand.

Another major problem is that investment intentions have been reduced. For instance, according to the latest CBI survey in July, the balance of firms expecting to authorize more capital spending on plant and machinery over the next year fell to 3 per cent from 18 per cent in April. In the survey before the tightening in monetary policy took place last year, the corresponding figure was 32 per cent.

As in the early 1980s, it is more likely to be smaller companies that are adversely affected by a tight monetary policy stance. Unlike the larger companies, they tend not to be so well diversified internationally and are thus more exposed to a domestic slowdown. Also, they are more likely to borrow funds at the high level of domestic interest rates. Larger firms tend to be more cash-rich and borrow at lower rates in the international capital markets.

If investment is curtailed and smaller firms cut back on expansion plans, then this could emerge as a longer-term problem for the economy. The balance of growth in future years will not be as desirable as one would wish. Furthermore, it makes it more difficult to envisage a significant improvement in the current account outlook.

The current deficit was exacerbated by the strength of domestic demand last year, but the poor underlying trend was clearly in evidence long before 1988. The underlying picture of a worsening deficit appears to be explained by structural problems in the economy, in particular the low level of past investment in the UK. As shown in the table, the latest comparable figures from the OECD show that over the period 1960-87, Britain had the lowest level of capital formation as a proportion of GDP amongst the G7 countries.

As Britain does not produce goods of the right mix of product type to solve the current account deficit, increased investment is required in order to produce better quality goods. While importing investment goods is preferable to importing consumer goods, it begs the question why we cannot produce them ourselves.

At present, exchange rate movements are being increasingly determined by capital flows seeking out high-yielding currencies. However, currencies do eventually move in response to underlying fundamentals. On this basis, the fundamentals for sterling are not favourable. Eventually, sentiment towards sterling is likely to change.

GROSS FIXED CAPITAL FORMATION (% of GDP)

	'60-87	'80-87
USA	18.2	17.9
Japan	31.4	29.0
Germany	22.8	20.5
France	22.8	20.5
UK	18.1	15.8
[illegible]	23.6	21.6
Canada	22.3	[illegible]

Source: OECD

It is difficult to envisage the Chancellor wanting to allow sterling to fall. A depreciation would add to inflationary pressures and may be damaging at this stage of the electoral cycle. Instead, it is more likely that interest rates would be kept high to support the currency. However, sterling has been supported solely by short-term capital funds. With a current account deficit of £14.6 billion last year, there was no evidence of net inflows of long-te[illegible]capital. Last year, for instance, longer-term capital flows were leaving Britain.

Identified flows of direct and portfolio investment overseas exceeded inflows into Britain by £13. billion, and after taking into account valuation changes the net effect was an outflow of £20.5 billion. Thus short-funds attracted to the UK had to offset the current account deficit and the outflow of longer-term capital.

Even allowing for the balancing item this meant there was a substantial flow of short-term funds that was financing the current account deficit.

As European interest rates rise over the next few months these speculative funds are likely to be increasingly attracted overseas. Financial markets are likely to demand ever-higher British interest rates to support sterling. The problem though is that high domestic interest rates are not improving the underlying fundamentals in the economy. Eventually, sterling will come under downward pressure, with a negative impact for the economy and the gilt market.

Gerard Lyons
DKB International

Restart 'soon' of CSD

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