Equity peak does not signal recovery

The pound is not yet out of trouble, despite its sharp fall since Black Wednesday. The economy remains weak, interest rates will have to fall further and the budget and current account deficits are rising to unsustainable levels.

Although the stock market hit a record peak on Friday, this does not signal recovery. As Wall Street has shown over the past few years, in the midst of a deep recession, rising stock prices do not guarantee recovery. They are a symptom of falling rates.

Economic prospects remain poor. Although there have been signs of life, such as retail sales data, it is still premature to talk of recovery. Britain remains mired in recession; there is too much debt and too little confidence. Real interest rates are still too high for people and companies to service debt.

Meanwhile, those people with the ability to spend still lack the confidence to do so, largely because of poor employment prospects. Any increase in spending before Christmas may thus prove temporary, particularly as the corporate sector continues to retrench. Expect stocks to fall, investment to decline and unemployment to rise to 3.4 million by the end of next year.

Falling house prices will also reduce the personal sector's wealth-income ratio, resulting in a higher savings ratio and limiting spending.

This suggests still lower base rates are required to guarantee recovery. Naturally, the authorities will be cautious, waiting to assess the impact of monetary easing on spending. The futures market is pointing to 6 per cent rates by the summer; but rates could reach that sooner and decline further. The dollar fell in the past year because of lower rates and weak growth, despite appearing favourable on purchasing power parity. The same is likely to happen to sterling, even against European currencies and certainly against the dollar.

The danger for sterling, though, is not just that recovery may be delayed but that even if demand picks up next year, the economy will still be in difficulty. It will not enter a period of sustained growth but will experience weak, imbalanced growth, with either the current account or Budget deficit undermining sterling. The sizeable current account deficit is not just a legacy of sterling's uncompetitive ERM parity. It largely reflects structural problems. In particular, Britain does not produce enough high-quality goods any more. Hence there will be a further increase in import penetration, which will limit growth.

'There is too much debt and too little confidence'

The benefit to trade from sterling's fall may not be fully evident. Exporters may try to rebuild margins squeezed during sterling's ERM days. This factor, and recession on the Continent, will limit export growth. Also, the inflationary impact of sterling's fall may be limited next year as importers' margins are squeezed.

The budget deficit, meanwhile, needs to be financed through higher savings from the private sector, or the overseas sector. This points to downward pressure on sterling, higher yields, or both.

International investors remain wary of gilts. Either sterling needs to fall to such an attractive level that international investors want to buy gilts, or gilt yields must rise to offer a sizeable premium over harder-currency European markets, offsetting supply and exchange-rate risk.

Even if the deficit is financed through domestic sources, long yields have to remain high. Rates will have to remain attractive to increase insurance and pension fund holdings of gilts. Even if the funding rule is changed, allowing banks and building societies to fund the deficit, this will either ration the amount banks lend to the private sector, or force banks' deposit rates to become more competitive as they raise funds to lend to the government. Higher rates will clearly crowd out other lending, limiting recovery.

While it may appear more desirable to allow sterling to fall, further declines could add to longer-term inflation worries, and this could push up yields anyway. This points to a much steeper yield curve, as seen in the US this year. Short-dated gilts will remain attractive, as the economy's weakness will contain inflationary pressures in 1993, allowing scope for interest rates to fall. But longer-dated yields will have to rise, as the Budget deficit will be difficult to finance.

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