PO-CH/NL/0240

PART A

Part. A.

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 10/9/86.
Ends: 13/10/86.

PO -CH /NL/0240

PART A

Chancellor's (Lawson) Papers:

THE MANSION HOUSE SPEECH 1986

DD's: 25 Years

20/12/95.

PO -CH /NL/0240
PART A

CONFIDENTIAL

PWP

From: R B SAUNDERS

Date: 10 September 1986

MR PERETZ

cc Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell o/r
Mr Lavelle
Mr Evans
Mr Scholar
Mrs Lomax
Mr Culpin
Mr Kelly
Mr Grice
Mr Cropper
Mr Tyrie
Mr Ross Goobey
Mr Hudson

MANSION HOUSE SPEECH

Sir Peter Middleton has seen your minute of 8 September.

2. He thinks that the monetary section should be very short. There should be a review of the year so far and a comment on the satisfactory position on inflation and money GDP. He would emphasise M0 and the exchange rate as indicators and would like to ignore £M3 altogether if possible, leaving open the option of dropping it next year, although he thinks that might not commend itself to the Chancellor.

3. Any discussion about financial innovation should be set in the context of the Big Bang rather than monetary policy. He also thinks it would be useful to put the whole discussion in an international context if that could be done reasonably shortly. Another possible theme might be a look forward to gilt auctions.

4. He would not make much of the credit standing of the FRN, given possible echoes of the late 1970s.

RBS

R B SAUNDERS
Private Secretary

SM1/11

PUP

ACSA → RL 15/9

FROM: A C S ALLAN
DATE: 15 SEPTEMBER 1986

MRS LOMAX

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Ilett
Mr Hudson

MANSION HOUSE SPEECH

The Chancellor has seen the attached article in Forbes Magazine for September 22nd. He feels that the thought that much of the innovation in financial markets has been of a hedging/risk reducing nature (prompted by increasing market volatility) might be worth a mention in his Mansion House speech.

ACSA

A C S ALLAN

Are you confused by Dates and Darts and options and futures and program trading and zeros? Do you find all this frenetic trading alarming? Don't write Congress. Relax and enjoy it.

What's with the casino society?

By Susan Lee

FOUR TIMES A YEAR the stock market undergoes a nifty bit of high-speed action during what's known as the triple witching hour. Then, trading can send the market up or down 40 points in just 30 minutes, and an unwary investor can get his or her ears boxed: The simple purchase of IBM could turn into a nightmare if the buyer decides to place an order when the price is 144, only to find that it has spiked up to 150 a nanosecond later. Or, down that much. Either way, too hairy for a lot of people.

That's trading programs at work, big players arbitraging discrepancies between stock prices and the options and futures on stock indexes. If IBM has spiked up like that, it's because the stock had fallen behind the indexes and program traders have bid it up.

Critics—disgruntled small investors, drubbed money managers and even usually savvy observers—tend to regard these new trading strategies as the devil's work, degrading financial markets into crapshoots. Especially since scarcely a week passes without the debut of another arcane vehicle *(see chart, below)*. Have the new instruments become the means for speculation so raw that it frightens ordinary investors away?

It alarms some people that many of the new instruments, the so-called derivative securities, have become more important than the markets they shadow. The value of all NYSE-listed securities traded daily now averages $3.5 billion, while the underlying value of stock options is three times that—$11.2 billion. More options on IBM are traded than the number of shares traded. In fact, the price of IBM stock is now primarily set in the options market.

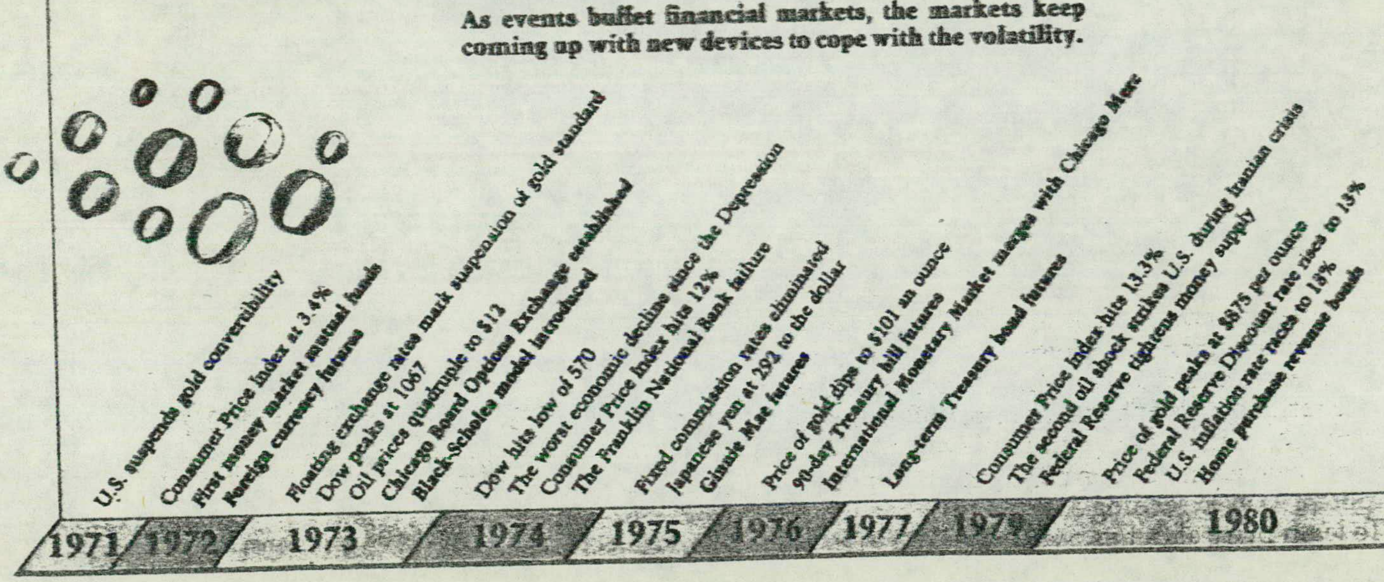
For doomsayers, all this becomes one more indication that the U.S. is degenerating into what a weekly business magazine called "The Casino Society." While such oversimplifications may spook the nervous—and sell magazines—they are so wide of the mark as to be almost funny.

The truth is that the new financial instruments represent a mostly healthy evolutionary response to a vastly changed economic world.

In the past 15 years the financial markets have undergone a remarkable transformation. Along with the changes wrought by the internationalization of the world's economy and improvements in communications technology, the markets have become unusually volatile, jumpy, wideswinging. Bonds move sharply, the foreign exchange market undergoes lightning-fast shifts in currency strengths and weaknesses, and commodities prices lurch from

Shock absorbers

As events buffet financial markets, the markets keep coming up with new devices to cope with the volatility.



highs to lows.

To say that this volatility has increased risk is a big understatement. Where bonds were something you bought and held until maturity, they are today just a tradable piece of paper like any other: Buy them at the wrong time and hold them too long, and you can lose 20% or 30% of your principal. The U.S. dollar bought 2.34 Swiss francs in 1984 and only 1.65 Swiss francs in 1986. Currency swings of that magnitude make foreign trade and investment extremely risky.

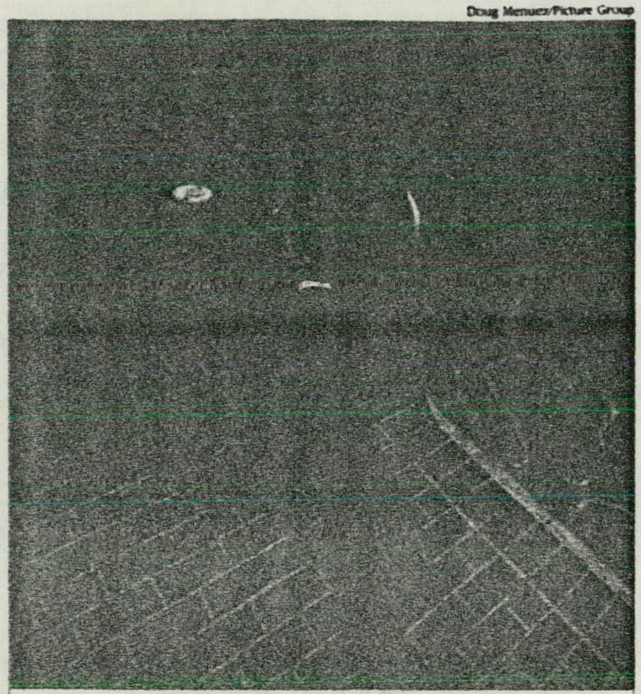
How can foreign trade go on in such an atmosphere? How can the long-term bond market function? How can any business person plan beyond a few days?

The answer is this: The burst of new instruments is nothing more than a response to these vastly increased risks. Indeed, most of the exotica are specifically designed to hedge against an uncertain financial environment. As Dean Richard West of New York University's Business School observes: "If the world were stable, I think a lot of this talk about hedging this, speculating that, swapping this, exchanging this and floating that would simply go away—it just wouldn't be necessary."

Even more pointedly, Steven Figlewski of New York University observes: "In the 1980s, if there hadn't been a Treasury bond futures market where dealers could hedge their positions, it's quite possible that the long-term bond market would have dried up."

Consider, for example, two responses to the erratic course of interest rates:

Doug Menuez/Picture Group

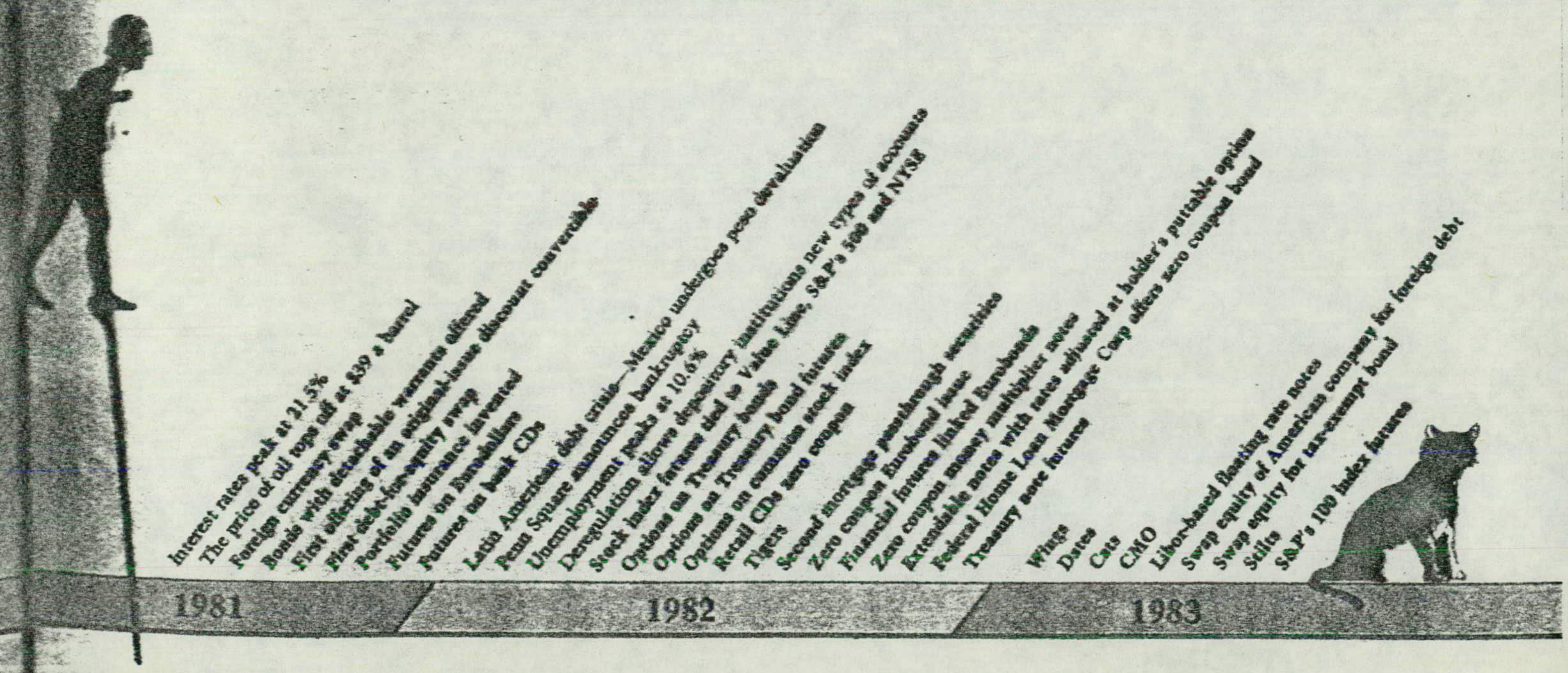


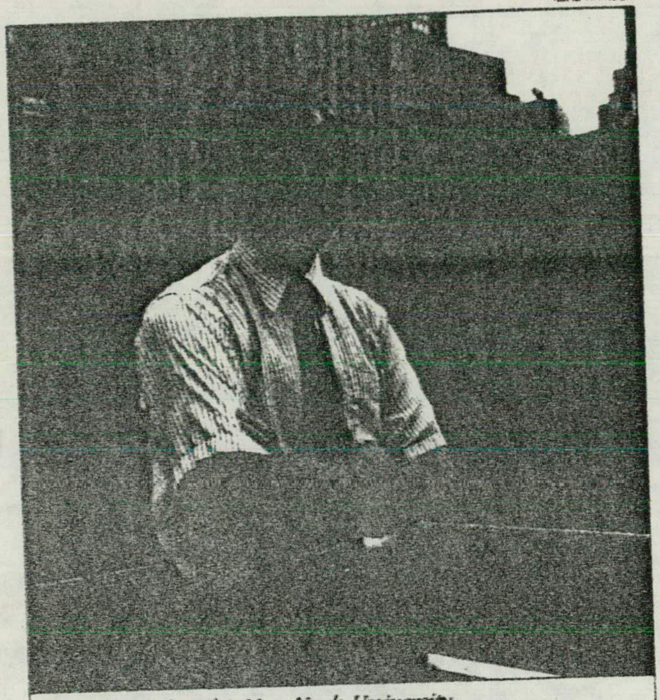
Myron Scholes, Stanford University
"Smart investors use hedges to reduce risk—they can take larger positions without small price fluctuations wiping them out and make bigger profits."

• When interest rates started shooting for the stars in the 1970s, investors found they had enormous incentives to lock in those rates. The answer? In 1982 along came zero coupon bonds to protect against reinvestment risk. Says Stanford Professor William Sharpe: "Zeros provided a riskless instrument for investors who were looking out over 10, 20 or 30 years. Before zeros, they could buy Treasury bonds but would have to reinvest the stream of interest payments at uncertain interest rates. A zero will just pay you the lump sum 10, 20 or 30 years from now."

Zero coupon bonds, unheard of ten years ago, are one of the most popular of the new financial instruments. In essence they are bonds stripped of interest coupons and selling at the discounted present value of the principal at maturity. In an atmosphere of stable interest rates, no one would bother with zeros. But in today's volatile markets they serve a useful purpose—not for speculation but for investment.

• Without the new financial instruments, the U.S. market for home mortgages might well be in total collapse. How could a bank lend for 30 years at a fixed rate when it hasn't the foggiest notion what interest rates will be next month—let alone 30 years from now? Today, therefore, banks hedge against a steep rise in interest rates by making floating-rate loans. But borrowers want caps on how high those interest rates can float. Thus, in 1982, banks started hedging against the possibility that interest rates would rise above the caps by taking short positions in the bond





Maria Robledo

Steven Figlewski, New York University
"Portfolio diversification used to be the only way for investors to reduce risk. Now there are futures and options and other effective ways to manage risk."

futures market. Here, caps hedge risk for one party and create risk for another who, in turn, transfers the risk to yet another party.

Hedging like this makes sense. Consider the futures markets, which offer a classic way to hedge holding inventory in the present. Farmers, for instance, can use futures contracts in the commodities markets to protect against the risk of having farm prices move against them. Since farmers are long the commodity—they own it—they take a short position in the futures market. That way, if farm prices fall, they will lose money on their inventory but make money on their short position.

Robert Johnson of Johnson Farms in DeKalb, Ill. has been using the futures markets for seven years. And profitably. In 1983, for example, corn prices were high. Johnson wanted to lock in those prices, so he jumped into the futures market and sold short 1986 contracts at 1983 prices—and made a bushel when prices fell.

Ditto for business people who must make transactions in different currencies. They can take offsetting positions in the foreign exchange markets. Take Colgate-Palmolive, a firm doing lots of business abroad. This year, for instance, the company was nervous that the Australian dollar would fall and deck the value of its royalty payments in Australia. So Colgate-Palmolive sold short Australian dollars. (Good move: The Australian dollar has declined against the American dollar.)

Brokerage houses, of course, have been hedging their holdings of stocks and bonds against a price collapse for years. Says Professor Myron Scholes of Stanford, "Brokerage houses could be making money by turning over their inventories at the same time they are losing money on their holdings, so they go into the options or futures markets to offset inventory risk."

Even corporate treasurers have caught on. Say a firm receives a big lump of cash. Instead of going out and buying a bond, the corporate treasurer will now both buy a bond and sell short on the financial futures market, thus locking in the company's return against a sudden surge in interest rates.

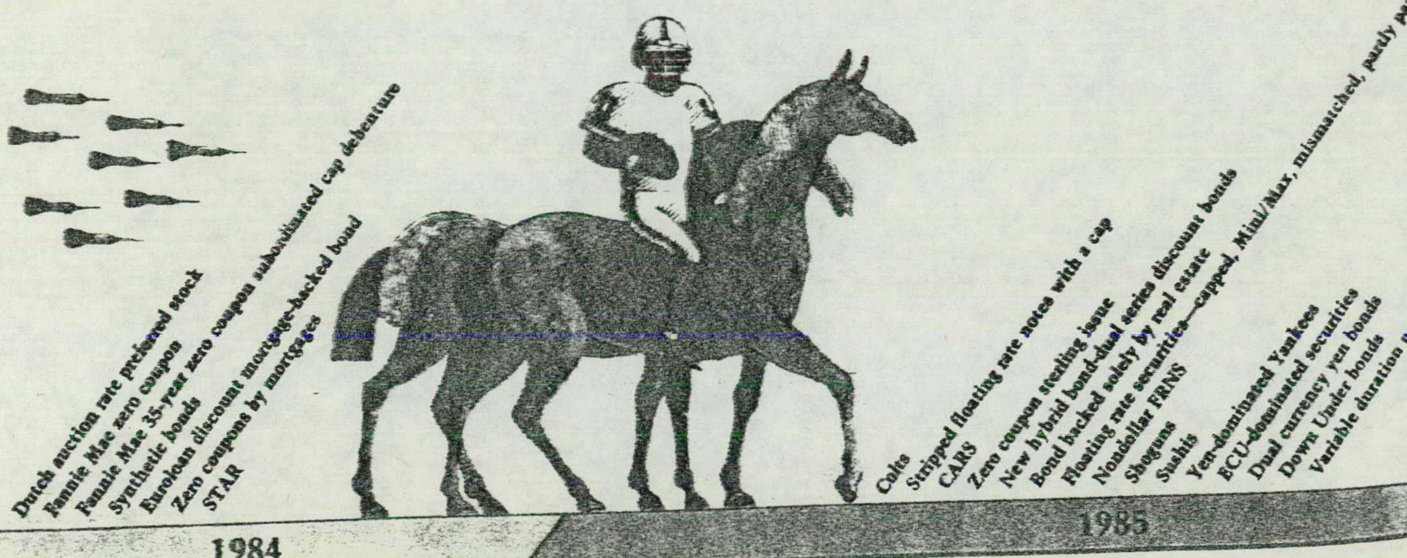
Possibilities for hedging encourage investment for the simple reason that without the ability to reduce risk, there would be less investment as people sought to avoid risk.

Do these instruments create opportunities for speculation as well? Of course they do. But they transfer risk from those who don't want to bear it to those who do.

Do the new instruments divert money from investment into speculation? Quite the opposite. They enhance liquidity in markets, and liquidity encourages investment: How many people would dare—in today's wild world—make a long-range fixed investment from which there was no reasonable escape?

Specifically, consider how two new instruments—mortgage-backed securities and junk bonds—create liquidity.

- By pooling small-denomination mortgages into securities that look like bonds, savings and loans can sell mortgages to a different class of investor. Thus, they permit



thrifts to divert funds from the bond to the mortgage market. And the ability to sell off their mortgages makes thrifts more willing to provide mortgages—even when interest rates are highly unstable—at a lower cost.

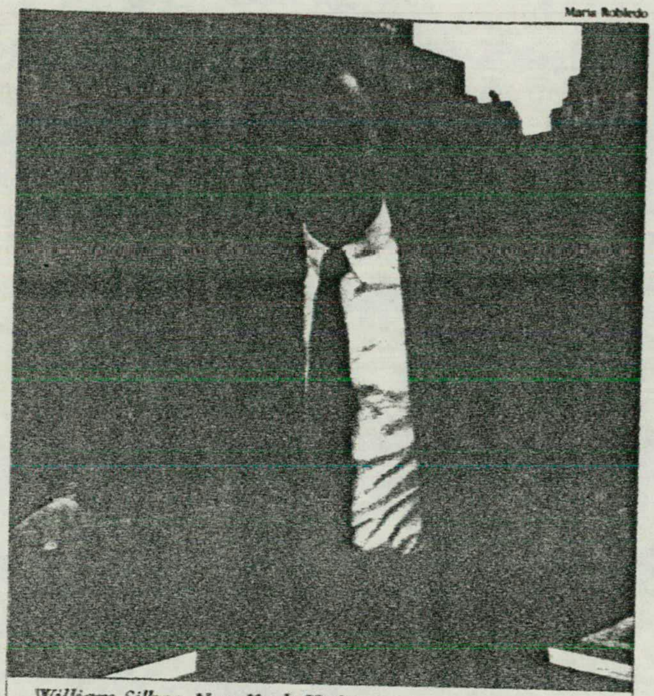
• Companies with questionable pasts, or no pasts, or overloaded balance sheets used to have trouble raising money. Now, however, junk bonds make it possible for these companies to offer a security that is somewhere between a bond and an equity as a source of funds. More speculative than ordinary bonds? Of course, but also more lucrative.

In both cases, something relatively illiquid has become liquid, and risk has been shared.

Is there such a thing as too much liquidity? A certain old-fogy attitude is outraged at the thought that everything can be turned into money quickly. The thought seems almost sacrilegious. Maybe so, but times change. Yesterday's sacrilege is today's orthodoxy. Says Hayne Leland of Leland O'Brien Rubinstein Associates, a Los Angeles investment management firm, "As long as everybody has confidence, liquidity is very useful. And it's unlikely that everybody will be irrational at once. There's always a price low enough to induce somebody to buy."

But what about the fear of too much speculation? The traditionalists forget that one person's speculation is another's hedge. That is, one side of a transaction might be a player who is taking on a lot of risk, or speculating, while the other side might be a player who is laying off risk, or hedging an existing position.

Maria Robledo



William Silber, New York University
"The markets have become more transactions oriented. Business is done on a transactions rather than an ol' boy basis."

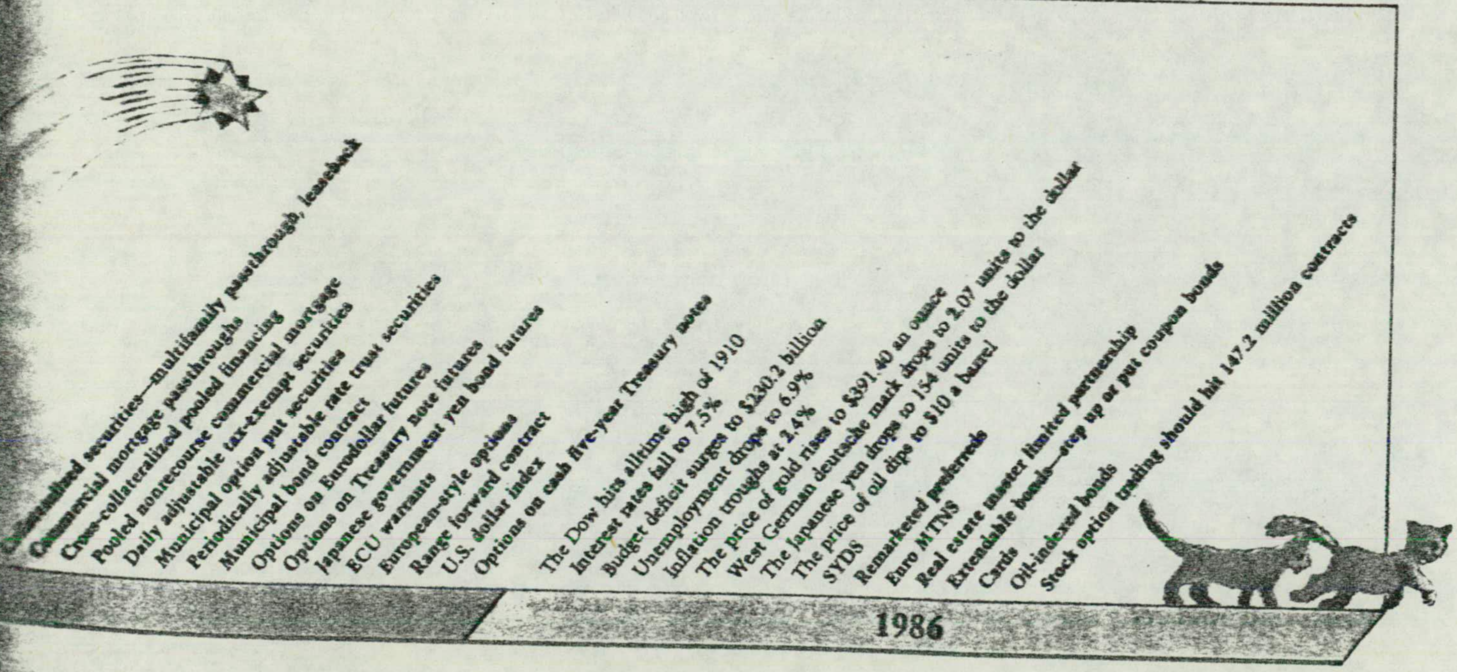
Take the options market for specific stocks. An option gives the holder the right, but not the obligation, to buy (a call option) or to sell (a put option) something at a specific price during a specific period. Options permit people to hedge positions in actual stocks.

If you're long IBM, you can lay off the risk of having IBM's price go down by either selling calls or buying puts—either strategy will limit how much money you would lose if the actual price of IBM goes down. (And limit how much money you'd make if the price goes up. That's nothing more than the familiar risk-reward tradeoff—nothing speculative about it.)

People forget that using options to hedge is actually a more conservative, less risky way to play than just plain owning the security.

Just as the promise of vast gains keeps speculators in the market, the ability to hedge keeps investors in there, too. The stock index futures market, for example, allows investors to hedge movements in the overall stock market, and thus reduces concern that their cash positions will move against them. Meaning, they can hold on to stocks they like even when the overall market is heading down.

Of course, in these examples, there very well could be an investor on the other side—selling uncovered puts or calls, or going short in Treasury futures—taking enormous risk. Is that bad? Different people have different tolerances for, and abilities to withstand, risk. The sophisticated new instruments are risk-differentiated; just as more and more consumer markets are being fragmented today to cater to



Opportunity, thy name is discrepancy

It's 3:30 on the afternoon of Mar. 11, and the volume on the New York Stock Exchange is riding along at 166.1 million. Suddenly—frenzy. A billion-dollar trading binge convulses the stock market. Torrents of buy and sell orders rush in. And when the market closes, the Dow has jumped 43 points and volume has topped 187 million. Program trading *(see story)* has struck again.

What gives? Stanford professor of finance William Sharpe gives the following—very stripped down—explanation.

Imagine that three stocks form the S&P's 500, or the cash market. One trades every hour, and the other two trade every day or so. And then let's say that near the close of the day some information comes in indicating that the economy is set to fly.

This probably means all three stocks will look more valuable to investors. The more liquid stock trades immediately, and its price goes up to reflect the news. The prices of the two more illiquid stocks, however, stay the same. Thus, the S&P's goes up only slightly—less than the good news would seem to justify.

Meanwhile, traders are busy trading the S&P's Index futures, where transaction costs are cheaper than in the cash market. They are buying based on the expectation that the prices of the underlying stocks will shortly rise. This, of course, bids up the price of the futures.

Specifically, suppose our theoretical S&P's 500 was 100 before the good news. And let's say that after the news its value would be 108. But, because there are two illiquid stocks that haven't been bid up, the S&P's climbs only to 104. Busy buying in the futures, on the other hand, sends that index up to 110. Discrepancy! The Index sells a good deal higher than the value of its component stocks. Program traders thrive on discrepancies.

The computer spots this discrepancy and figures that it can buy the actual stocks cheap. Thus, the discrepancy triggers trading programs to short the futures and buy the stock simultaneously.

When the program is activated, attempts to buy the stocks at the old prices drive the prices higher in the cash market, while selling in the futures market causes those prices to droop. Theoretically, at least, the buying and selling of stocks and futures will cause the two markets to reach equilibrium. Thus has program trading made the market more efficient.

George Sebastian

William Sharpe, Stanford University
"Computer programs aren't screwing up the market. They are making it more efficient."

In a given week program trading accounts for perhaps 20% of the turnover in stocks. But it is really the triple witching days—which occur four times a year, toward the end of the quarter, when ordinary stock options, S&P's Index futures and S&P's Index options expire at the same time—that unsettle investors. On these days computer-driven sell programs can roil the markets, causing big swings and tremendous volume. But Hans Stoll, a Vanderbilt University professor of finance, recently conducted a study for the exchanges that found that the triple witching hour has no more effect on a particular stock than a large block trade, which could occur at any time.

If you are the queasy type, best thing is to stay away from the markets at triple witching time. Otherwise, relax. The whole process is making investing better, not worse. —Kerry Hannon

individual tastes, so are security markets.

And what about concerns that the new instruments permit too much leverage? "Combining leveraged assets with other assets, like Treasurys, could result in a portfolio with little net leverage," says Professor Scholes. He means that it is quite possible to put 10% of a portfolio into options and the other 90% into Treasury bills, thus creating a low-leverage strategy.

Vital to many of these new instruments is something called the Black-Scholes option valuation formula—the 1973 brainchild of Fischer Black and Myron Scholes. Mark Rubinstein, a professor at the University of California, Berkeley, speaks for most financially literate players when he calls Black-Scholes "the most important discovery ever made in financial economics." Why? "It showed how to generate different patterns of return over time," he says.

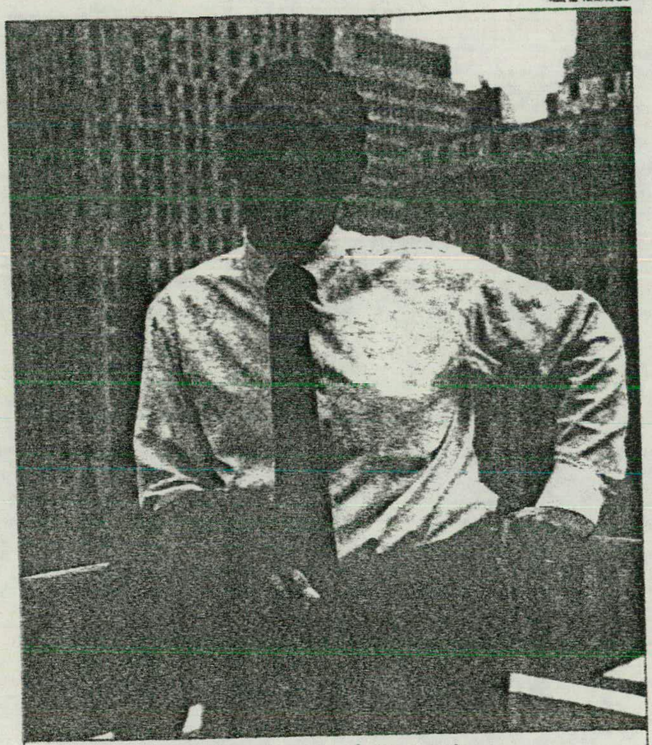
Consider, for example, a traditional pattern: buying and holding a stock. If you buy and hold, the stock might go up and you could make a profit, or it might go down and you could lose everything. A second pattern, one with options, changes your risk exposure and varies your returns as the price of the actual stock changes.

Say you bought IBM at 150 and bought a put option on IBM with the exercise price of 150. You will, of course, make money on the stock if the price of IBM goes above 150, although the value of your put option will fall. Conversely, if IBM falls below 150, the value of your put will go up. Clearly, using options creates a different pattern of return than just buying and holding. This particular option strategy allows investors to participate in most of the upside potential while insuring against most of the downside risk. It creates insurance—although the insurance costs money.

Says John Donaldson of Columbia University: "One cannot overestimate the importance of Black-Scholes. It's currently used to price everything in the world—from risky debt to mortgages—because they can all be viewed as options."

Consider Ginnie Maes, which are securities with implicit options. Because homeowners are able to refinance their mortgages, the investors who lend the mortgage money have, in effect, given homeowners an option to call the loan. Thus, when you invest in a Ginnie Mae, you have bought a security but you have also sold an option. And that presents a pricing problem. As William Silber of New York University asks: "How do you value that option in terms of the price of the security—what should I pay for the mortgage payments you will give me, and how much should you pay me for the option? It is very complicated to evaluate."

Maria Robledo



Dean Richard West, New York University
"The new instruments transfer risk, they don't create new risk."

That is where the complicated mathematics of the Black-Scholes formula comes in.

Not that Black-Scholes immediately provides the correct price. Investors modify the formula and obtain slightly different prices. Then they buy or sell, assuming their price is the true price and that until the market discovers that, they can arbitrage the mispricing.

All this furious trading has not gone unnoticed. Indeed, it has prompted some critics of the new scene to complain that the "volume of transactions has soared beyond economic purpose."

Granted that just about every new instrument is mispriced when it is introduced, and granted that a large return goes to the people who get in there first and work at taking advantage of the mispricing. But as they take advantage, the mispricing becomes less pronounced. This hardly constitutes mindless trading. Instead, exploiting price discrepancies will bring the price back into line, thus increasing the efficiency by which capital markets allocate capital.

There are, of course, reasons for the avalanche of new securities other than for hedging and for altering patterns of return. Two of the most important:

• Tax advantages. Or, as Mark Rubinstein observes, "Occasionally these strategies introduce a way of transferring money from the government to you." Take the Dutch Auction preferred stock, which allows corporate investors to claim the 85% tax exclusion on dividends but keeps its yield close to the market through an auction process held every 49 days.

Replacing common equity with junk bonds in a corporate financial structure also produces tax advantages—whether it is a self-imposed restructuring or a takeover: Interest on the debt is tax-deductible; dividends on the common stock are not.

• Cost advantages. Computer technology has lowered the cost of formulating the complicated strategies behind the new instruments, and the new instruments themselves have lowered the cost of transactions. And, as with anything, when it becomes cheaper to do, people do more of it.

Says Bill Sharpe: "There's a massive amount of computer power available today that just wasn't there ten years ago. The analytic engines are a lot cheaper."

As for transaction costs, one estimate is that 15 years ago futures indexes and other dynamic strategies might have been ten times more expensive. Today investors can economize on transaction costs by buying an index fund, which permits them to buy the whole market rather than hundreds of individual stocks; they can then trade this one instrument instead of hundreds. Indeed, most people sell or buy the futures because it's cheaper. (And more liquid—that's why news shows up first in the futures. *See box, p. 156.*)

Thomas Lea

Mark Rubinstein, University of California at Berkeley
"Society is better off because there are new opportunities for people to make different kinds of contracts with each other."

All this is complex and perhaps confusing. People instinctively—and out of mental laziness—distrust complexity and change. Many yearn for a simpler world where a stock was a stock and a bond was a bond and a mortgage was a mortgage. A world where your home was your castle, not just another financial asset. But those days are gone, and as the economic world has changed, new forms have emerged to deal with it. The best advice for the cautious and conservative is: Don't fight the new world; learn to live in it. ■

CHANCELLOR OF THE EXCHEQUER

AH

1. Andrew To see — Not yet seen AH

2. Ch

Some thoughts in cover story could carry across to Mansion House speech.

AA

10/9

Thanks.

The thought that much of the observation has been of a hedging/risk-reducing nature (prompted by recent market volatility) might well be worth a mention.

NL

[redacted]

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233 3415
Telex: 262405

PLEASE NOTE EMBARGO

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE 8 PM ON WEDNESDAY 16 APRIL 1986

16 April 1986

LOMBARD ASSOC SPEECH

CHANCELLOR'S SPEECH ON MONETARY POLICY

The Chancellor speaks to the Lombard Association tonight on monetary policy. The full text is attached.

2. Main points:

- "The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation"

- "Monetary targets are a means to an end"

- "Narrow money, in the shape of MO, has shown a predictable relationship with money GDP over a considerable number of years, and broad money, in the shape of £M3, has the advantage of familiarity"

- "Short term interest rates are the essential instrument of monetary policy"

- "The guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation"

- "Few would now dispute that the growth of £M3 in relation to its target ranges has proved a relatively poor guide to short term interest rate decisions for much of the 1980s ..... [But] I believe it would be quite wrong to conclude from recent experience that we can safely tolerate an unlimited build up of liquidity"

[redacted]

- "One reason why we have come to put increasing weight on the exchange rate and narrow measures of money is because we would expect these indicators to give early warning were the rapid growth of broad money to start to make its way into higher spending. What went wrong in the early 1970s was that the clear signals from these indicators were ignored"

- "MO is a useful advance indicator: it is influenced by many of the factors that influence money GDP, especially changes in interest rates and disposable incomes, but these influences show up in MO more immediately than they do in money GDP"

- "The exchange rate can still provide a very clear and tough discipline .... But I see no role for an exchange rate target outside a formal exchange rate system, shared by other countries, and supported by a co-ordinated approach to economic management and intervention"

- "The Budget deficit or PSBR should always be set low enough to ensure that it can absorb any likely shock and still be comfortably financed in a non-inflationary way"

- "Funding policy prevents the public sector from contributing to inflation, while the active use of short term interest rates controls inflationary pressure from the private sector"

- "Most well conducted countries operate policy in a very similar way"

- "In the presentation of monetary policy there is always a difficult tactical balance to be struck, which we may not always have got right, between conforming to the current preoccupations of the financial markets and seeking to shape the markets' perception of what really matters. Over time, we have gradually shifted the emphasis somewhat from the former to the latter, but the need to strike a balance is still there"

- "When we first took office, the UK had no consistent track record of prudent financial management - quite the reverse. The task ahead of us was massive..... Since then we have been pursuing this policy for the best part of seven years, and at last we are acquiring a track record and a reputation which is helpful rather than harmful to the economy"

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
SW1P 3AG
01-233 3415

52/86

LOMBARD ASSOCIATION SPEECH

MONETARY POLICY

April is the season of international meetings. My appearance here tonight is sandwiched between the Spring meetings of the IMF in Washington and the OECD in Paris.

Meeting other Finance Ministers, I am always struck by the extent to which we share a common approach to economic management.

The need for firm financial discipline: the importance of containing budget deficits: improving the working of markets and promoting greater competition. These priorities are taken for granted by all major countries today.

It is easy to forget how much has changed since we first took office 7 years ago.

An approach to economic policy, that is now the consensus among those throughout the world charged with responsibilities in these matters, was then radical, even revolutionary. Especially in Britain.

A few months before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

Putting that proposition into practice has been one of this Government's major achievements. That is an important reason why overseas opinion is in no doubt that Britain is indeed on the right track.

dangerous delusion to suppose that this implies a higher rate of growth of <u>real</u> output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher prices.

In essence, the mistakes of the past were based on ascribing magical properties to money: the belief that manipulating money, whether through printing or borrowing, could bring about higher real output and employment.

But important though money is, it isn't magic.

The only sustainable way to boost the rate of growth of real output is to improve the <u>supply</u> performance of the economy. That means removing restrictions, improving incentives and generally developing a more dynamic and enterprising economy. That is why the MTFS has been accompanied, from the very beginning, by a constellation of policies designed to let free markets work better.

<u>Ultimate objectives</u>

In terms of ultimate objectives, therefore:

- The purpose of the MTFS is to reduce the growth of total money demand - total spending power - in the economy, which can conveniently be measured by money GDP, at a rate which will gradually squeeze inflation out of the system while allowing the economy to expand in real terms;

- the purpose of our supply side policies is to increase the rate at which the real economy is capable of growing over the longer term.

In principle, there is a strong case for setting targets in terms of non-interest-bearing money on the one hand and interest-bearing money on the other. But in practice this is not realistic, since the boundaries are constantly shifting. So throughout my time as Chancellor I have chosen instead to set targets for narrow money, in the shape of MO, which has shown a predictable relationship with money GDP over a considerable number of years, and broad money, in the shape of £M3, which has the advantage of familiarity.

But we must never forget that monetary targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS.

There is, of course, no scientific formula for determining the "right" size of the PSBR. Nor is there any precise relationship between the PSBR and any given rate of monetary growth. But in practice there are very real constraints on how much it is prudent to borrow.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Short term interest rates

To recapitulate. While fiscal policy has an important supporting role, and Budget deficits need to be low, it is monetary policy that lies at the heart of the MTFS. The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation.

In practice this involves a combination of economic analysis and market judgement. Policy must be continuously informed by a careful assessment of what monetary conditions are - and need to be - to meet the Government's objective. But implementing interest rate decisions in today's fast moving financial markets also requires a degree of tactical skill.

Short term interest rates are the essential instrument of monetary policy. The Government has to ensure that they are at whatever level is necessary, in prevailing conditions, to ensure downward pressure on inflation. That is not to say that the market does not exercise an influence, which from time to time can be powerful. But we have never suggested that the market could, entirely independently, be left to set the level of interest rates.

The relationship between official influence and market factors was clearly set out in the March 1980 Green Paper on Monetary Control.

> "The level of short term interest rates at any time is determined by the interaction of the markets and

<u>Assessing monetary conditions</u>

I have said enough to show that the <u>timing</u> of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for making this key judgement. Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

That is not to deny the special status of the monetary targets. Movements in the aggregates outside their target ranges always establish a <u>presumption</u> in favour of changing short term interest rates.

But that presumption is not overriding. For two reasons:-

- First, we can never be completely confident that the target ranges have been set correctly: that is, that they have been based on a correct assessment of the relationship between the aggregate in question and money GDP.

- Second, in differing degrees all the monetary aggregates respond to changes in short term interest rates with a lag: so it takes time for policy action to bring them back within their target range.

<u>Broad money</u>

The business of setting targets for £M3 has become particularly hazardous, given the cumulative evidence of

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

Few would now dispute that the growth of £M3 in relation to its target ranges has proved a relatively poor guide to short term interest rate decisions for much of the 1980s. Indeed some would argue that the real question is why we have persisted with £M3 for so long, and in particular why I did not drop it altogether at the time of the last Budget.

I believe it would be quite wrong to conclude from recent experience that we can safely tolerate an unlimited build up of liquidity. The risk in dropping £M3 was that markets might have taken it as a signal we were indeed prepared to do just that.

I am satisfied that the growth of £M3 in recent years reflects a genuine desire on the part of the private sector to increase its liquidity on a lasting basis. So it does not presage higher inflation. But that judgement must be continuously tested against other evidence. A similar judgement proved disastrously wrong in the early 1970s.

One reason why we have come to put increasing weight on the exchange rate and narrow measures of money is because we would expect these indicators to give early warning were the rapid growth of broad money to start to make its way into higher spending. What went wrong in the early 1970s was that the clear signals from these indicators were ignored.

the same developments have distorted its non-interest bearing component.

The truth is that it has become increasingly difficult to draw a line between money balances held for transactions and those held for savings. MO is only a proxy for transactions balances: but for as long as it continues to bear a reliable relationship with money GDP, we shall continue to give it a significant weight in our assessment of monetary conditions.

But messages coming from both monetary aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. And here the exchange rate is of particular importance.

<u>**The exchange rate**</u>

In an economy as open as the UK's there is a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions. And, as I have frequently observed, significant movements in the exchange rate, whatever their cause, can have a short term impact on the general price level and on inflationary expectations which make sound internal policies harder to implement.

I accept that in the right circumstances membership of a formal fixed exchange rate system can itself provide a very effective framework for monetary policy. Indeed, the gold standard was the earliest and most durable form of financial discipline. Modern fixed exchange rate systems are more flexible. But the exchange rate can still provide a very clear and tough discipline, obliging the authorities to take timely action when domestic policies are out of line with other low-inflation countries.

Those who recall the economic history of Britain in the 'fifties may recall some resemblance to the thinking behind the abortive "Robot" plan - the idea that the key to the conduct of ~~such~~ sound economic policy lay in the interplay of interest rates and the exchange rate.

Almost all my fellow Finance Ministers - and the Governors of their respective Central Banks - would recognise this description of how monetary policy is conducted in practice. Most well conducted countries operate policy in a very similar way. Those who are members of a fixed exchange rate system typically have domestic montary targets; and those outside such systems still recognise the need to take account of the exchange rate.

And as a result, inflation is coming down worldwide.

Those who attribute this to the worldwide fall in commodity prices, of which the recent collapse in the oil price is merely the most spectacular example, put the cart before the horse.

Just as the excessive global monetary expansion of the early 1970s was responsible for the explosion of commodity prices that occurred at that time, so the return to prudent monetary policy in the 1980s - a return in which this Government was in the vanguard - has been directly responsible for the subsequent fall in commodity prices.

It is not at all the fortuitous gift of some global fairy godmother.

Conclusion

I have described how, over the years, the MTFS has evolved, and where policy stands now.

We have not hesitated - and will not hesitate - to raise interest rates as and when necessary; and we have moved to a position where credit is determined by price rather than bureaucratic controls.

This, of course, is all part of our wider move to let markets work more freely, and to restore the role of the price mechanism.

But the most important change is perhaps this.

At the time of the first MTFS, almost everything remained to be done. Inflation, monetary growth and public sector borrowing were all high. Financial discipline had to be restored. The long process of containing public expenditure and dismantling the controls that were stifling the economy's natural growth potential was only just beginning. We had embarked on a policy far from the accepted wisdom of the 1960s and the 1970s. Those who understood what we were about - and not everyone did - doubted our resolve.

So it was essential to keep it simple. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

It had been blessed by the IMF; it had been targeted by the previous Government; and it had a clear link with fiscal policy. So, in the words of the March 1980 Green Paper, targeting of £M3 was widely understood to give "a general assurance that macroeconomic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation".

But even as far back as that Green Paper, we also made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances.

Since then we have been pursuing this policy for the best part of seven years, and at last we are acquiring a track record and a reputation which is helpful rather than harmful to the economy.

No doubt it will take a further period of time before it can be as beneficial as is the case in a country like Germany, which has had a good track record for very much longer.

But we are on the way, and the evidence is there to show that we mean what we say.

POLICY CHALLENGE

WHITHER MONETARISM?

The Chancellor's Mansion House Speech

- with comments by three wise men

Jock Bruce-Gardyne Tim Congdon Patrick Minford

CENTRE FOR POLICY STUDIES

8 Wilfred Street, London, SW1E 6PL

1985

1985
MANSION
HOUSE
SPEECH

POLICY CHALLENGE

WHITHER MONETARISM?

The Chancellor's Mansion House Speech

- with comments by three wise men

Jock Bruce-Gardyne Tim Congdon Patrick Minford

CENTRE FOR POLICY STUDIES

8 Wilfred Street, London, SW1E 6PL

1985

CONTENTS

THE CHANCELLOR'S SPEECH

Financial markets, both in London and throughout the world, are in the throes of fundamental and far-reaching changes. Barriers between previously separate markets are coming down. The old institutional distinctions no longer apply. The financial map is being redrawn.

I am not one of those who view these changes with trepidation. I believe that the changes we are seeing are good for Britain, and good for London as a financial centre. For what we are seeing is a radical shift towards the liberalisation of financial markets. One which has brought in its train a new wave of experimentation and innovation.

Free markets have always benefited this country. They will continue to do so. We are an open, trading economy. And one which, despite the strictures of the House of Lords Select Committee on Overseas Trade, makes a good part of its living from the export of financial services.

And while I am on the subject of the House of Lords Report, let me say this. The Government's policy is to create the conditions in which business can thrive and prosper - manufacturers and non-manufacturers alike. And anyone who fails to recognise that British industry as a whole, for all its problems, is in a healthier state today than it was six years ago is simply not living in the real world.

And let me take this opportunity of congratulating all those in British industry who have brought about this improvement.

The Government therefore wholly rejects the mixture of special pleading dressed up as analysis and assertion masquerading as evidence which leads the Committee to its doom-laden conclusion.

We equally reject its principal remedy - that British manufacturing industry should be protected by a cocoon of subsidies - particularly at a time when the rising threat of protectionism of one kind or another throughout the globe represents the gravest single threat to world prosperity and employment.

Meanwhile, the changes we are seeing in the financial markets bring with them the need for institutions, individuals, and financial authorities to adapt their own practices. To acquire new skills; to adopt new methods of working.

We in Britain - and this is as true of the Government as it is of the financial markets themselves - have been in the vanguard of that process of evolution. We have moved further and faster than many of our competitors. But there is much more to do. My theme tonight is the way in which liberalisation and innovation are affecting markets, and the Government's policy towards them.

I shall talk first about the world economy. Then about the institutional changes in London, and how they affect the way in which the authorities view their

ISBN: 0-905880-76-5

The Centre for Policy Studies emphasises that it never expresses a corporate view in any of its publications.

essential task of supervision. I shall then say a few words about the impact of liberalisation on domestic financial policy. And finally, I will discuss the economic outlook for our country over the next two years or so.

The World

A month ago I was in New York for a meeting of G5, the Finance Ministers and Central Bank Governors of the five major industrial countries.

At that meeting we concluded, first and foremost, that protectionist pressure must be resisted at all costs. The US Administration is as firmly convinced of this as we are, and determined to fight against proposals in Congress for protectionist legislation.

But we recognised that words were not enough. We acknowledged that while there is a limit to what can be achieved by concerted intervention on the foreign exchange markets, we were not impotent; and that we should therefore, acting together, lose no time in helping to bring about an orderly depreciation of the dollar against the other major currencies. In the last four weeks a useful start has been made on this essential process of adjustment. And let me emphasise that the agreement is still firmly in place.

Of course there is more to do.

- First, in correcting domestic imbalances. The US has begun to tackle the fundamental problem of its fiscal deficit, but further progress is clearly needed.

- And second, in maintaining open markets. Japan in particular needs to do more, especially in financial markets. The measures the Japanese authorities have already announced are greatly to be welcomed. But they need to be implemented and made effective without delay.

As you know, I was not able this year to attend the annual Bank and Fund meetings. My presence was required at the seaside. Those who did go to Korea will confirm that the central themes of the Plaza meeting were reaffirmed and underlined at Seoul. In addition, I was glad to see the widespread recognition that the international debt problem is now entering a phase in which the tried and tested case-by-case approach of the IMF needs to be reinforced by a complementary role on the part of the World Bank.

At the centre of discussion at both meetings was recognition of the need to halt the protectionist tide. I come back to this point. Our overriding aim is to maintain a free trading and financial system at home and abroad. A free market system brings benefits for all. The more regulations we can remove, the more barriers we can lower, the more liberal we can make our trading practices, the better off we shall all be.

Supervision

The same considerations apply to our domestic markets, and not least to financial markets. London's market position can never be taken for granted. The City has remained pre-eminent in international banking precisely because it has always struggled for dominance.

All of you here tonight are familiar with the rapid pace of change in London over the last two or three years. I wonder how many of you are in the same organisations, with the same mix of business, as you were three years ago. Whereas two years ago I addressed an audience of stockbrokers, merchant bankers and clearing bankers, tonight I am probably talking to directors of conglomerates and managers of financial supermarkets.

Certainly, this upheaval has posed problems for the authorities. But I believe we have acted promptly to solve them. The Financial Services Bill will provide the necessary legislative framework for the regulation of the securities markets. We have prepared a modern framework for the building societies. The Building Societies Bill will come before the House of Commons very shortly. And we have now begun the process of consultation leading in due course to a replacement for the 1979 Banking Act which has proved to be deficient in some important respects.

Our guiding principles are clear.

Effective and well-operated supervision is an essential element of London's competitive advantage. It must offer reasonable protection for individual depositors and investors. And it must also preserve the stability and integrity of the system as a whole. At the same time we have to devise a system which is flexible enough to allow the markets and the institutions within them to develop.

We must also take notice of the traditions and practices of existing regulation. And build on the City's proven ability to devise and run its own self-regulating mechanisms.

But we cannot ignore the overlap between markets. The possibilities of too much, or too little, supervision for institutions which straddle market boundaries. And the resulting need for adequate co-operation between different sets of supervisors.

The way in which we have chosen to balance these sometimes conflicting constraints and requirements is now clear in the case of building societies and the securities markets.

The way forward for banks is still under active consideration - with the help of advice, both solicited and unsolicited, from many here tonight.

The Johnson Matthey Bankers affair has drawn attention to certain inadequacies in the system of banking supervision. In the wake of that debacle I set up a Review Committee chaired by the Governor of the Bank of England, and the recommendations of that Committee form the basis for the consultation now under way.

We propose to end the two-tier system of regulation, which unwisely assumed that those institutions able to call themselves banks required a less rigorous sytem of supervision. And to strengthen the mechanisms of co-operation between the supervisors and banks auditors.

I attach the highest importance to this latter change. As part of their duties, auditors have to form an independent view of a bank's assets. And of the systems used to manage them. It is vital that the supervisors should be able to draw freely on this information when necessary, and that the auditors should be kept informed by the supervisors of matters of concern which arise at their end. To match these changes in methods of supervision there must, of course, be institutional changes. The Governor has already indicated how he proposes to begin the process of strengthening the supervisory arm of the Bank.

I hope and believe that the new systems of supervision we are now putting in place will reduce risks substantially. But it is impossible to eradicate risk entirely. Nor would it be right to seek to do so. Nor of course does supervision in any way derogate from the overriding responsibility of management for the proper conduct of its business.

Equally, no system of supervision can be proof against deliberate fraud. So we must ensure that where there is fraud it is uncovered in a timely fashion. And that the evidence is acted on expeditiously. This is, of course, absolutely essential if the reputation of the City, both domestically and internationally, is to be protected.

Let me make it quite clear. Financial supervision is a matter the Government takes very seriously indeed.

While others are charged with the day-to-day duty of supervision in particular fields, it is the Government's responsibility to ensure that the statutory framework is right, and that overall it is being effectively implemented. We cannot escape from that responsibility - nor would we wish to do so.

Many of the changes I have described have been forced upon us by the liberalisation of markets. But I welcome them wholeheartedly. We are engaged in building a stronger, more competitive set of markets, and a more robust, but no less flexible, set of supervisory bodies to match.

Monetary Policy

It would have been surprising if these changes to market structures, which were accelerated by the action we took in 1979 and 1980 to sweep away a range of outdated controls, had not affected the operation of domestic financial policy - the third area I said I would cover.

Liberalisation and structural change affect financial indicators in a variety of ways. The boundaries of the banking system become blurred as banks and securities houses merge. Longstanding distinctions between different financial assets have become less precise.

Companies can choose between a large number of instruments, currencies and financial centres. For instance ten years ago a British company wishing to borrow sterling would have done so directly, and almost certainly in London. Today the same company might issue dollar commercial paper in New York, and swap the proceeds into sterling.

We have recognised the need to take account of these changes in the way that financial policy is operated. Inevitably, the growth rates and significance of the various measures of money supply have been affected. This has, rightly, been reflected in changes in the way in which we interpret signals from the different financial indicators.

Liberalisation and innovation have made that process more complicated.

What has not changed, however, is the essence of policy. The Government continues to attach the highest priority to the maintenance of sound financial conditions. The aim of monetary policy is to ensure sustained and steady downward pressure on inflation. This can be secured only by delivering an appropriate growth of money GDP over the medium term. And looking back at the implementation of policy it is important always to check whether the outcome for money GDP has been in line with our objectives.

But to achieve this, it remains operationally necessary to conduct monetary policy through the use of intermediate targets - taking account of relevant information such as the behaviour of the exchange rate - rather than by attempting to target money GDP directly.

As I explained in my Budget speech we have found it helpful to target measures of both broad and narrow money.

Broad money measures the liquidity of the economy. An excessive build-up of liquidity supplies a store of purchasing power that can be translated into spending, thus providing an undesired boost to the growth of money GDP and hence to inflation.

The question, however, is what is excessive? In monitoring the growth of broad money it is important to gauge the extent to which the private sector genuinely wants to build up its liquidity on a permanent basis. That inevitably involves an element of judgement.

During the 1970's, with controls in operation and negative real interest rates, the demand for liquidity grew less rapidly than money GDP.

In the 1980's, following the abolition of controls and a return to positive real interest rates, liquidity has grown faster than money GDP. Over the past five financial years, for example, while £M3 has grown by 82 per cent and PSDL 2 by 84 per cent, money GDP has grown by only 54 per cent - and prices by 43 per cent. It has become increasingly evident that both individuals and companies wish to hold an increased proportion of savings in liquid form.

In retrospect it is now clear that we have persistently underestimated the strength of this demand. We can maintain, and are maintaining, progress towards our inflation objective while £M3 is growing at a rate well above the top of the range set in this year's Budget

Statement. To try to bring it back within the range - which, with the benefit of hindsight, was clearly set too low - would imply a tightening of policy which the evidence of other indicators of financial conditions tells us is not warranted.

I shall as usual be considering what target to set for £M3 for 1986-87 at the time of the next Budget. In the meantime, we shall continue to monitor £M3, and indeed other measures of broad money, as part of the task of forming an overall judgement about monetary conditions. That judgement has to take into account the level of short-term interest rates, where a cautious approach continues to be indicated. It must also be influenced by the behaviour of MO, which, as a relatively undistorted narrow aggregate, is more clearly related to spending patterns. If, contrary to our expectations, the rapid growth of broad money were to show up as higher spending one would expect to see early warning signals in the growth of MO. So far this year, it has stayed very comfortably within its target range.

I realise that MO has not yet acquired many friends in the square mile, despite the evidence of its relatively stable relationship with transctions in the economy and the steady trend in its velocity of circulation. It may not be widely known by those who argue that MO is an excessively narrow aggregate that the German target aggregate, the composite known as Central Bank Money, is in fact slightly over 50 per cent notes and coin.

The other good and early guide to changing financial conditions is the exchange rate. When, as now, signals from the various measures of money become difficult to interpret, the exchange rate inevitably assumes an increased weight in monetary policy decisions. It has a direct impact on the price level and on inflationary expectations. Sharp movements tend to coincide with changes in the market's perception of monetary ease or stringency. Large swings in any case cannot be ignored. The present level of the exchange rate is close to the average level of the past two and a half years.

We will continue to judge monetary conditions in relation to the indicators I have just described. At present I believe that these are consistent with continued lower inflation, which I firmly expect to see. But we will continue to monitor all the evidence. If the performance of one indicator were to deteriorate we would need convincing evidence from the other indicators before concluding that this was acceptable.

There is, essentially, nothing new in this approach to the conduct of monetary policy.

Let me quote, if I may, from a speech I made getting on for four years ago, when I was Secretary of State for Energy. (It was subsequently published as a pamphlet.)

> 'It has always been a grotesque caricature of the present Government's economic policy to pretend that it consisted of leaving everything to an automatic

pilot known as sterling M3. As far back as March 1980 we published our Green Paper on Monetary Control, in which we explicitly stated that to assess underlying monetary conditions properly it is necessary to take account of the evidence of <u>all</u> the various monetary indicators ...

'In a world in which the monetary system is in a constant state of evolution, the exercise of judgement and discretion is inescapable. The important question is: who is exercising that judgement and that discretion?

'If it is being exercised by those who do not really believe in the policy in the first place ... then any departure from predetermined rules and guidelines will understandably be regarded with the gravest misgivings, since it will as likely as not represent a backsliding from financial discipline as such.

'If, on the other hand, the discretion is being exercised by those whose commitment to the policy, and to the overriding need to maintain financial discipline, is beyond doubt, then there is no cause for such misgivings. On the contrary, the judgement that is being applied, fallible though it may be, is one calculated to minimise the risk of error in carrying through the complex task of sensible monetary control in a financially advanced and sophisticated modern economy'.

That was nearly four years ago. <u>Plus ca change</u>.

It is, I recognise, all frightfully annoying for the young Turks who write the brokers' circulars. I imagine that anyone who reads them must feel rather like the American lady many years ago who, confused about the complexities of foreign policy, was introduced to John Foster Dulles, who courteously took her round the course.

When she emerged she was asked whether all was now clear to her. 'Oh no,' she replied 'I'm just as confused as before. But at a much higher level.'

<u>Funding</u>

The approach I have just outlined to the assessment of monetary conditions also has implications for the conduct of funding policy.

The purpose of funding is, quite simply, to ensure that the Budget deficit is financed in a non-inflationary way.

As I said on this very occasion, two years ago:

> 'The broad aim of funding policy will continue to be to fund the PSBR, by raising finance outside the banking system, from the UK private sector and from external flows ... Over the medium term there should be no systematic tendency either to overfund, or to underfund, the borrowing requirement.'

That was the intention.

But in practice, short-term considerations came to make overfunding almost a way of life. And that cannot make sense.

It introduces distortions into the financial markets - not least a rapidly growing bill mountain - which are undesirable in themselves and can make policy harder to operate.

Accordingly, we are no longer seeking to control the recorded growth of £M3 by systematic overfunding. As I have said, we do not believe the recent behaviour of £M3 gives cause for alarm. But should it at any time become desirable to tighten monetary conditions, that would be achieved - and let there be no doubt about this - by bringing about a rise in short-term interest rates. The objective of funding policy is to fund the PSBR over the year as a whole: no more, no less. And that we are doing.

The experience of the last year has also demonstrated once again the value of a clear strategy within which the interpretation of financial conditions can evolve. The Government's firm commitment to the Medium-term Financial Strategy, with its clear route to still lower inflation, has been a source of strength in a changing and sometimes confusing world, in which innovation and liberalisation in financial markets proceed apace.

The UK Economy

I thought it right, on this important City occasion, to discuss the operation of monetary policy in some detail. But the acid test of monetary policy is its record in reducing inflation. Those who wish to join in the debate about the intricacies of different measures of money and the implications they may have for the future are welcome to do so. But at the end of the day the position is clear and unambiguous. The inflation rate is judge and jury.

In short, I take comfort from the fact that we have, over the years, brought about monetary conditions that have delivered lower inflation, despite all the distortions to monetary aggregates.

This year we have seen a temporary 'blip' in the RPI, as I warned in my Budget Speech. This was largely attributable to movements in the mortgage rate and to the temporary fall in the exchange rate earlier this year. Inflation peaked in May at 7 per cent. It is now back down to 5.9 per cent. By the end of this year I expect if to be close to the Budget forecast of 5 per cent, and below 4 per cent by the middle of next year.

Maintaining and improving on that rate through and beyond 1986 depends on continued control of monetary conditions. I am confident that the policies now in place and the techniques of monetary management we are using can ensure that control.

Lower inflation points the way to continuing growth of output.

You may remember that a few years ago a common cry was 'Where is the growth coming from?' We can now see the answer. It came in a balanced way from several sources, with investment and exports growing twice as fast as consumer spending. Over the next year exports and investment may not grow as fast as in the past year, but other components of demand - notably private sector consumption - may contribute more.

So far unemployment has been less affected than might have been expected by the healthy growth rate. This reflects two developments, both of which will be beneficial to the economy in the long run, even though their short-run impact on unemployment is adverse.

The first development has been the rapid growth of productivity, particularly in manufacturing industry - up 30 per cent over the past 5 years.

The second has been the large rise in the number of people entering the labour force, including a growing number of married women not previously registered for work. So that though the number of people in work has risen by some 600,000 over the past two years, that has not brought about a fall in the total of registered unemployed.

Both these developments, however, are generally to be welcomed. They increase the strength, competitiveness and flexibility of the economy. In the years ahead both will add to our productive potential.

But so long as unemployment remains at its present high level we cannot be complacent. There is much still to be done to improve the flexibility and adaptiveness of the labour market. And, meanwhile, employers who concede unnecessarily high pay rises are doing no-one a favour: neither their own firms, nor the competitiveness of the British economy, and certainly not the unemployed.

Given common sense on this front, the omens are good.

At this time of the year it has become customary for the pundits to revise upwards their expectations of growth for the current year. At the same time they invariably conclude that the next year will see a marked slowdown. They have been promising this for the past three years. I suppose if they go on long enough, they are bound to be right eventually. But I see no sign of it yet.

Over the past four years, the economy has been growing at an average rate of 3 per cent a year, with this year the best so far.

That encouraging performance has been achieved, not by so-called reflation. It has been acheved through the pursuit of a prudent fiscal policy and an anit-inflationary monetary policy, againt the background of a more competitive, deregulated and productive economy. And that, my Lord Mayor, is the policy I intend to maintain.

CHANCELLOR REAGAN?

Jock Bruce-Gardyne

> 'Monetarism': discreetly, at the Mansion House, London, after a long and often painful illness, borne with much bombast, on October 17, 1985'

Such is the obituary pronounced, with glee by some and gloom by others, since Nigel Lawson's address to the Bankers and Merchants of the City of London. Chancellor and Prime Minister have worked overtime to persuade the watching world that 'monetarism' is alive and well and living in Downing Street. They have not found many takers.

The kernel of the Mansion House message - or so it seems to me - was contained in the passage where the Chancellor repeated himself.

> 'In a world in which the monetary system is in a constant state of evolution, the exercise of judgement and discretion is indispensible. The important question is: who is exercising that judgement and that discretion'.

'If it is being exercised by those who do not really believe in the policy ... then any departure from pre-determined rules and guidelines will understandably be regarded with the gravest misgivings ...

'If, on the other hand, the discretion is being exercised by those whose commitment ... to the overriding need to maintain financial discipline is beyond doubt, then there is no cause for such misgivings'.

That, as he reminded the City and the listening world, was what he had told the gnomes of Zurich back in 1981: that the medium is the message. When hardened old sinners like Tony Barber or Denis Healey dump £M3 unceremoniously in the trash-can then we had best fasten our lap-straps. But when the stern unbending team of Thatcher and Lawson execute a similar manoeuvre it only goes to prove their sophistication.

The unseemly mirth which followed was, I suppose, predictable. Yet the Chancellor has a point. When Lord Barber ditched the monetary pilot inherited from Roy Jenkins in the winter of 1979-80 he was all too plainly targetting for 'growth', and to hell with the inflationary implications. Similarly when Denis Healey passed what he elegantly described as 'sod off day' - the day the supervisors from the IMF packed their bags and said goodbye in 1978 - he was all too plainly setting off down the primrose path to inflation once again. Now on this occasion that is not the message that the City has absorbed. If it had been the pound and gilts would surely have been skitterring. I think one can see why.

Paradoxically it could be the dropping of the £M3 pilot which has served to reassure the City. For one of the particularities of sterling M3 is that you have to get it right domestically. When bank lending to the personal sector is growing exponentially, as it has been these three years past, the only way in which the Government can strive to bring £M3 into line is by 'over-funding' - i.e. selling more gilts than it needs to sell just to cover its Budget deficit. But those gilts must be sold to the non-bank British public: i.e. to UK institutions and individuals. Sales to foreigners do not count.

At the Mansion House the Chancellor confirmed what had seemed to be the case for some months previously: that in his view £M3 had become too wayward to mope over, and hence that he had given up the forlorn chase after it with over-funding. In future sales of gilts would roughly match the deficit, and no more. That is not the crucial point. The crucial point is that when he lets £M3 go hang then selling gilts to foreigners is just as good as selling gilts to Brits.

In fact better. For foreigners who buy his gilts must first buy sterling. And if they first buy sterling, that buoys up the exchange rate. Which in turn keeps up the pressure on UK domestic costs, cools inflation expectations, and teaches manners to the members of the CBI if they go on paying themselves and those who work for them way over the odds. Hence - in the short run at any rate - ditching £M3, far from being an inflationary signal, may logically be interpreted as a pointer to mroe stable UK prices.

The Chancellor is predicting inflation down below 4 percent again by the end of 1986. This forecast has been greeted sceptically. But as he has fairly pointed out, Treasury forecasts - particularly of inflation - have frequently confounded the sceptical in recent years. Given strong sterling and weak commodity prices this one could turn the trick again.

So far, so good. The distant scene is a rather different matter. In the first place while it is true that high real rates of interest have evidently transformed bank deposits from pin-money into stores of value, it would not take much - by way of faster inflation or lower interest rates - to transform them back again. So while £M3 may be misbehaving, it still seems cavalier to despatch it to the salt mines. Then according to the Chancellor there is 'convincing evidence from the other indicators' that monetary conditions are quite as strigent as they should be. Which, pray? MO, certainly; but alas, MO has few suitors far outside Great George Street. Most of the other dials - £M2, PSL2, asset prices - are almost out of sight. Now the Chancellor <u>used</u> to say that, over time, the monetary indiators - subject, agreed to 'judgement and discretion' - were the best guide we had to the future course of prices in the High Street. Some of us still cling to these funny old delusions, and wonder occasionally what we may be stoking up for ourselves in 1987 or 1988.

The Chancellor, for his part (and whatever the Treasury may say to the contrary), is now banking on the exchange rate. As the international punters watch Mr Volcker and Mr Baker squatting on US interest rates almost as if they were a pat of butter, they get the hint and want to take their money and run. 'Run to London', says our Chancellor. And they seem inclined to do so.

Here we come to problems 2 and 3. Problem 2 is that international sentiment, as we know, is ever more volatile with the passing years. If OPEC were to fail to 'get its act together' come the spring, the long-promised slump in world oil prices could yet be upon us. Under these circumstances it must be doubtful whether Mr Lawson could still get sufficient punters at his stall to keep a firm grip on the exchange rate without a substantial jump in domestic interest rates.

Problem 3 is that if he is successful in tempting in the foreign money the CBI, which is already restive, will begin to get rebellious once agian. Now Sir James Cleminson and Sir Terence Beckett may make good hors d'oeuvres for breakfast at No.11. But the CBI has learnt a thing or two in recent years. It does not just complain on television as it used to do. It does the rounds of the Government backbenchers. And it is one thing to stare down the great industrialists: but something else again to stare down the Tory backbench 1922 Committee.

So there is a missing ingredient. The missing ingredient is participation in the European exchange rate mechanism. And I would hazard a guess that it is missing in a literal sense. It was intended to be there. But the Prime Minister is yet to be converted.

A great deal of rubbish is talked about the e.r.m. Collective wisdom in the City, at the Bank of England, in the CBI, and across much of the spectrum of the House of Commons, would have us believe that by linking up the pound to the deutschmark system (which is what it is) we should enjoy lower interest rates, more stable currency, and probably faster growth and more employment thrown in for good measure. It is almost uncannily similar to the magic qualities attributed to precisely the opposite nostrum - floating exchange rates - fifteen years ago (and by many of l the same peope). In reality there is no earthly reason, from its past performance, to expect greater exchange rate stability vis-a-vis the dollar through linkage with the deutschmark. Rather the contrary, in fact. Equally participation in the e.r.m. could logically be expected at a the present time to lead to our interest rtes being higher, not lower, than they would otherwise be. As for growth and employment, Joanna Southcott's box would be about as useful.

But the e.r.m. does have one unique ingredient. It involves a set of rules. The participants are committed to keeping their currencies in station (unless they take a conscious - and very high profile - decision to do otherwise). So whereas the CBI is at liberty at present to demand four points off base rates, and sterling down to DM3.50 or whatever figure takes its fancy, while the Treasury, having jettisoned its monetary target, has no logical refutation apart from barrack-room abuse, if we signed on with the e.r.m. it could cheerfully advise the CBI to read the rule-book. All the more so since the CBI leads the chorus of demands for us to join the club.

For the moment (but for how long?) all this is academic. The Prime Minister will not tolerate such continental entanglements and so, as Dr Johnson used to say, 'there's an end on't'.

Even without this magic ingredient, however, the strategy on which the Chancellor is now embarked could work better than the critics are willing to concede for the next eighteen months if he can stick to it that long. It is likely to involve some real increase in the PSBR for 1985/6, however disguised by asset sales, whether that increase results from a slump in oil revenues, a cut in tax rates, or some additional increase in public spending programmes, or - most likely - a combination of the three. That, coupled with lower inflation rates resulting from strong sterling and weak commodities, should mean that the purchasing power of those in work will be rising steeply. Prospects for those without a job may not be so rosy: with margins squeezed, rising labour costs and unaccomodating sterling, it is hard to envisage many employers embarking on recruitment drives. But we still have one of the highest 'activity rates' in the world: more than five out of every six of us are poised to share in the take-home pay bonanza, and that is an awful lot of voters.

Looking more than eighteen months ahead the prospects do become more murky. Experience must lead one to expect that by then some of the impressive volume of domestic credit building up will come through in prices; and also that the pressures of relatively high interest rates and a relatively strong currency will be feeding through into unacceptable strains on the corporate sector, and also - very possibly - the banking sector. Meanwhile the debt service element in the total public spending bill will, as Tim Congdon regularly reminds us, be assuming formidable proportions, while on the other side of the ledger the Chancellor's revenues from oil will presumably be shrinking substantially; and the balance of payments on current account is likely to be well into the red.

If all this sounds strangely familiar, it is. For what we are really embarked upon may not be monetarism updated; nor is it 'supply side' economics; but it has all the hallmarks of Reaganomics. Now we all know where Reaganomics have landed the United States: a huge and unsustainable budget deficit; a huge and unsustainable payments deficit; an uncomfortably expensive currency; and an almost irresistible surge of protectionism. But we should not overlook where they have taken President Reagan to: a landslide re-election, and the highest popularity

Only a long dose,

rating of any second-term President in living memory.

One's instinct is that, for Britain, Reaganomics are likely to prove a shorter tether than they have been for Reagan. Which is why I ventured to suggest in the House of Lords the other day that Nigel Lawson should be having words with the Prime Minister about a date with the electorate not later than the spring of 1987. And let's hope there will be time enough to switch tracks again back to fiscal discipline when the votes are safely garnered in.

START OF A SOMERSAULT?

Tim Congden

Mr Lawson started as a radical Chancellor of the Exchequer. In his Mansion House speech in November 1983 he said that the Government's key financial objective was price stability. Although he qualified this by describing it a an "eventual" goal, the speech undoubtedly came as a surprise both for its boldness and its ambition.

Unhappily, a large gap hs emerged between rhetoric and performance, and the gap is widening with every speech which Mr Lawson makes. The Mansion House speech in 1985 was much plainer and more circumspect than its predecessor two years earlier, but even then most City analysts did ot believe its forecasts for government borrowing 1985/86 or 1986/87. The loss of trust is symptomatic of a more general problem. The Thatcher government is widely admired for reducing inflation from the 15 per cent level it averaged in the late 1970s to the 5 per cent figure nowregarded as a norm. But this is regarded as an achievement of the first term. There is a widespread perception that not much progress has been made on the financial front in the second term.

Are the doubts ad the criticisms justified? If they are, Mr Lawson must feel doubly disappointed. Financial policy would have failed to meet the expectations of many government supporters; it would also have failed to fulfil his own stated aspirations. Mr Lawson has a reputation for tough and whole-hearted commitment to the Government's medium-term financial strategy. In June 1981 while Financial Secretary to the Treasury, Mr Lawson put the strategy into perspective for the benefit of regional City editors. In his briefing to them he remarked that "in order to reduce the inflation rate on anything more than an ephemeral basis it is necessary to reduce the rate of monetary growth". It followeed that "the centrepiece of the strategy is a medium-tern monetary target, to which we rae committed". In a sharp rebuttal of a report from the Treasury and Civil Service Committee which has just appeared, Mr Lawson observed that nowhere in the report was "it suggested that that target cannot or will not be met; indeed, our record since taking office is evidence that we do meet our monetary targets, however unpopular the short term measures needed to do so are".

Moreover, the monetary target was not to be seen in isolation. It could only work in harmony with "a consistent fiscal policy" which therefore implied "a reduction in the public sector borrowing requirement as a proportion of national output". Mr Lawson continued, "it is in this sense that our policy is fiscalist as well as monetarist. And it is for this reason that we have included in the strategy an illustrative fiscal framework." (In fairness, it should be added that he denied that the Government had a PSBR target because "inevitably there is much that is uncertain").

The June 1980 briefing gives us criteria for assessing the Government's financial behaviour in its second term, criteria with which Mr Lawson cannot disagree. Has inflation been reduced? Has fiscal policy supproted the aim of monetary control?

ii

The first disappointment is that inflation has not fallen. On the contrary, it has risen from the low point of 3.7 per cent touched in May 1983. Uncertainty about the Government's determination to stick to its financial targets contributed to a run on sterling in December 1984 and January 1985. To check this slide the Bank of England endorsed a big jump in interest rates which increased the cost of mortgages. This, combined with the usual effect of sterling depreciation on import prices and on pay settlements in export-orientated manufacturing, led to an acceleration in inflation. The twelve-month increase in the retail price index reached 7.0 per cent in May 1985, virtually double the figure on ~~w~~ich the Conservatives fought the 1983 election.

Much better news on inflation is in prospect in early 1986. But very favourable world commodity prices, not government policies, are largely responsible for the improvement. The setback on inflation in 1985 can legitimately be interpreted s the consequence of slippage on financial control. This slippage hs several dimensions, with an apparent inability to hold public expenditure to target as perhaps the most fundamental.

In the 1984 Budget the Government had a planning total for public expenditure in 1984/5 of £126.5b after asset sales of £2b; the effective planning total was therefore £128.5b; the outturn was £131.9b, an overrun of £3.4b. At the same time its planning totals for 1985/6 and 1986/7, again after adding asset sales, were £134b and £138.5b; the outturns are now expected to be £136.7b and £143.9b respectively. In practice there is almost certain to be some above-estimate spending in a pre-election year. So 1986/7 could see a planning total of £145b, £6.5b - or 4 per cent - more than the first official projection of Mr Lawson's Chancellorship.

That may not sound too bad. Most Chancellors are unable to resist the innumerable pressures on the public purse and have to accept some defeats in their battles with the spending departments. But the difficulties with expenditure have not prevented Mr Lawson from cutting taxes, with the result that the PSBR has also exceeded the figures envisaged in the 1984 Budget.

The crude PSBR totals do not bring out the underlying deterioration and are open to misinterpretation. On their basis, Mr Lawson was able to claim in this year's Autumn Statement that in 1985/86 "the PSBR would be the smallest it has been as a percentage of GDP since 1971/72. He said that this would be the case even without £2.5b proceeds from special asset sales.

The fault here is to take no account of North Sea oil taxes. It is obviously incorrect for any government to take credit for the fiscal advantages given by these taxes. They are an accidental gift of nature. As they are also finite, they should not be regarded in the same way as permanent sources of revenue such as income tax. A reasonable procedure is t\calculate what the PSBR wuld be in the absence of asset sales and North Sea taxes. Sooner or later they will both come to an end. The results of the exercise are presented in the acompanying table.

<u>The Impact of North Sea Oil Revenue and Asset Sales of the PSBR (all figures in £m)</u>

(1)	(2)	(3)
Actual PSBR	North Sea revenues	Receipts from asset sales

1978/79	9,222	500	-300
1979/80	10,020	2,200	1,467
1980/81	12,680	3,840	944
1981/82	8,629	5,880	959
1982/83	8,865	7,810	2,103
1983/84	9,735	8,900	2,592
1984/85	10,255	12,000	3,200+
1985/86	8,000	11,500	3,700+
1986/87	7,500	8,500	6,000+

	(4) PSBR, without North Sea oil and asset receipts	(5) Actual PSBR as % of GDP	(6) Adjusted PSBR as % of GDP
1978/79	9,422	5.4	5.5
1979/80	13,687	4.9	6.7
1980/81	17,464	5.4	7.5
1981/82	15,468	3.3	6.1
1982/83	18,778	3.2	6.7
1983/84	21,227	3.2	7.0
1984/85	25,455	3.1	7.8
1985/86	23,200	2.2	6.5
1986/87	22,000	2.0	5.8

+The figure for asset sales in this column does not correspond to that for 'Special asset sales' in official documents, but also includes council house sales, land sales, etc. These are assume to have been £1.2 b in 1984/85, 1985/86 and 1986/87.

Figures are actual until 1984/85; thereafter they are projections based on official documents.

Sources: several issues of 'Financial Statement and Budget Report' and 'Autumn Statement'.

The disturbing message is that the PSBR as a proportion of gross domestic product, adjusted for the special influences, was 7.8 per cent in 1984/85, the highest figure under the present Conservative Government. True enough, the estimates for 1985/86 and 1986/87 are more reassuring, with the adjusted PSBR falling in both years. But the Chancellor has told us that this would happen before and, time after time, his forecasts have not been reached.

The conclusion must be that so far in its second term the Conservative Government has done nothing to reduce inflation beneath the level established in its first term and that there has been some weakening in the Treasury's resolve to restrict the budget deficit. Fiscal policy may not have been self-evidently incompatible with monetary restraint, but neither has it been convincingly supportive.

ii

What, then, of the money numbers? How firm has Mr Lawson been in defending the so-called 'centrepiece of the strategy'?

When Mr Lawson spoke about monetary control at the beginning of his period of Chancellor it would have been inconceivable that the growth of sterling M3 could ever again run at 20 per cent on an annual basis. If the Barber boom taught theConservative Party anything, it taught the dangers of irresponsibly rapid credit and money growth. But there are many signs that a 20 per cent rise in sterling M3 will be recorded in early 1986. At present sterling M3 is about 14 per cent higher than twelve months ago and in the last four months the rate of increase has accelerated further. Between now and April next year companies will be borrowing heavily from their banks to finance capital expenditure ahead of the change in capital allowances. In addition, both building societies and banks are enjoying strong demand for mortgages, and intend to meet this demand as fully as possible.

The outcome will be even higher rates of bank lending growth and, hence, of monetary expansion. It is not quite certain that sterling M3 will register a 20 per cent increase, but it is very likely Mr Lawson recognises the possibility and wants to anticipate the potential embarrassment. In the 1985 Mansion House speech he therefore suspended sterling M3 from target status.

Patrick Minford

CONSULTING THE ORACLE

The Chancellor's Mansion House Speech and November Statement have much to recommend them. There is a new and welcome flexibility in fiscal policy which we have been advocating for some time; using asset sales for tax cuts against a background of long-term public expenditure reform is a good way to proceed. It brings forward supply-side improvements and sugars the bitter pills of reform and restructuring which this government is everywhere handing out. Furthermore, 1985/86 will be the first year under this Government in which real public spending has actually fallen: all the major ministries now, even including Defence, Health and Social Security, are finally moving seriously on public expenditure control and reform. All this make it very hard to understand the cries of 'insufficient stringency' being heard from economists in the Square Mile; can it be that they have not understood the elementary algebra of the Government's planning of debt, taxes, and spending over a long period in a consistent way, or is it that they are extrapolating past failures in expenditure control? If the latter, of course they may have a case: but it is my judgement that there has been a turning point. The government's critics have been handed some modest extra infra-structure spending where a good new case could be made; and existing capital spending, which has always been substantial and has risen steadily in the past few years, has been better highlighted. However, privatisation, the better performance - partly under the threat of privatisation - of remaining public sector industries, the fall in the number of civil servants, the levelling-off of unemployment, and the relentless search for efficiency (under the Rayner and Heseltine managerial approaches), all these, with new attitudes among spending Ministers, are now at last taking visible effect. When turning-points appear, it is important to hail them and not to go on fighting the last war.

The Delphic riddles of monetary policy

Mores the pity that the Chancellor has retreated into muddle and discretion in monetary policy. He announced that £M3 would be downgraded as an indicator; this was right because, as I have long argued it has become highly unreliable in the new competitive savings environment. He also announced that MO, the unfamiliar Monetary Base (consisting of currency in circulation plus bankers' balances of currency and reserves with the Bank of England) which is as its name implies the base of the whole money and credit pyramid, would be upgraded to a principle indicator role. Again, good. MO has been an extremely reliable monetary indicator since the inauguration of a new financial environment in 1979; its sharp tightening in 1979-81 preceeded the sharp fall in the growth of Nominal GDP by an average of 2-3 quarters. During this critical episode, interest rates and the exchange rate were forced up and through these channels nominal GDP was reined back.

M0 turns out to have just the right degree of interest elasticity to be a good and reliable indicator; its response to a 1% p.a. rise in short-term interest rates is about half percent in the short run rising to about 2% in the long run. Not too high (with a lot of close substitutes) so that its reduction does not much affect interest rates and spending. But not so very low that when it is reduced, spending has to fall immediately to reduce the demand for it; in other words, interest rates do act as something of a shock absorber for changes in its supply.

But the Chancellor spoilt all this by wrapping it up in ambiguity and references to the exchange rate as another (principal) target. His remarks - liberally interpreted through the mouths of friendly commentators - have been taken to mean that interest rates are now aimed at stabilising the trade-weighted exchange rate at around 80.

Rumour also has it that parts of the Treasury, in combination with great and good policy-makers throughout Whitehall and in the Bank of England, are pushing hard, in the same spirit, for the UK to join the European monetary system. The current target of 80, it is suggested, is a sort of trial run for joining the EMS at around current exchange rates.

This is a dangerous game, in two ways.

First, discretion, ambiguities, half truths, deception - these things are the stock-in-trade of old-fashioned Keynesian central banking and the direct antithesis of what the Medium Term Financial Strategy was designed to put in place, namely a clear set of targets around which expectations could be reliably formed about the monetary environment.

[illegible] MTFS

Second, suppose we take all this rumour-mongering at face value and assume we were to join the EMS at 80, what would this do to monetary policy and the economy? In the short run, we now - because of this muddled and ridiculous state of affairs - have the tightest monetary policy we have ever had. M0 is <u>declining</u> at one and a half per cent p.a. on the past three months; over the past six, it has grown a miserable one and a half per cent p.a., and on the past twelve, three and a half per cent. These figures are flashing red on the dashboard of monetary control; a collapse in the growth rate, unless immediate action is taken to reduce interest rates, is now increasingly likely. Already, the latest production figures are showing the first decline: is this surprising when the real interest rate to <u>prime</u> borrowers is no less that eight per cent p.a.?

In the long run, joining the EMS would push us back into the 'fixed-but-adjustable' parity world of the last year of Bretton Woods; in this world, when policies diverge, as they systematically do, periodic devaluations and revaluations are necessary and their timing relatively predictable, with the result that when a parity change is in the offing, capital moves violently across the exchanges to take advantage of what is effectively a one-way option. When this happens, central banks are forced to make very sharp changes in interest rates to dam up the flow. They are also forced to adopt exchange controls, because monetary policy alone cannot cope. Both these things are highly damaging to an economy; interest rate swings of this size cause big swings in the economy too and exchange controls foster inefficient, because protected, investment projects.

These rumours - and any policy reality behind them - must stop before more damage is done. What is required is a series of clear demonstrations, by actions on interest rates, of the primacy of the M0 target range, currently being seriously undershot. The exchange rate should cease to be a criterion of action - and visibly so - except when it moves violently and so threatens [illegible] stability; in other words it [illegible] never [illegible] 'override' mechanism' [illegible] target. A[illegible] M3 [illegible] bank credit, and any other [illegible] 'the [illegible] sight.

In [illegible] I would [illegible] sense will prev[illegible] monetary policy [illegible] lines. But if money [illegible] - e.g., say up [illegible] target - the [illegible] fall and [illegible], [illegible] inflation will [illegible]. [illegible] provoke panic [illegible], [illegible] late to rever[illegible].

end of 1987. It is to avoid such confidence-depressing and volatile movements that monetary rules are advocated.

<u>Tax threshold or standard rate?</u>

I have argued repeatedly for rises in tax thresholds on the grounds that these cut the proportion ~~the~~ of income paid in tax most for the low paid who are in, or close to, the unemployment trap. For the same reason I was in favour of the Chancellor's Budget changes to National Insurance which lowered the contributions of the low paid.

Unfortunately, though a step forward in a number of areas, especially on SERPS and the poverty trap, Mr Norman Fowler's Green Paper on Social Security made a very small impression on the unemployment trap; essentially it changed only the position of young workers. Even with previous changes in tax thresholds and National Insurance, 25 per cent of the labour force still have ratios of income out of work to income in work of over [illegible] per cent, and another 17 per cent [illegible] ratios between [illegible] and [illegible] per cent: i.e. are in the unemployment trap. <u>[illegible] means that thresholds of income tax and national insurance are still the highest priority for tax reduction, on grounds of economic efficiency and less abstractly of the effect on unemployment. This point is well known to the Chancellor.</u>

But against it a political point is made: that the voters in lower and upper-middle class expect, on the basis of previous Tory [illegible] - and will appreciate - cuts in the standard rate which give them a greater proportionate benefit than rises in the thresholds. This point seems to me to be less weighty than the economic point above: cuts in the standard rate are only about half as effective on our estimates in reducing unemployment as rises in tax thresholds for the same fiscal costs. Politically, however, it also has the following flaw in it: at this time of high unemployment voters are sensitive to the charge that they are getting rewards <u>instead of</u> the money going to 'create jobs'. This charge does stick to some extent if the tax cuts are standard rate cuts; but if they are rises in tax thresholds, it can be answered that these are the most effective ways of creating jobs as well as giving some tax relief to the harder pressed voters. Remember that since the war taxes have risen not because of a rising standard rate (which has in fact fallen by 20p in the £) but because of falling real tax thresholds (down for example, no less than 34 per cent since 1949 for a couple with two children). On the effectiveness of ~~raising~~ in tax

11583 thresholds, the Liverpool [illegible]; [illegible] tax thresholds [illegible] same money [illegible] cuts in the [illegible].

Conclusion: [illegible]

Mrs Thatcher and her Chancellor are now well placed to preside over at least two more years of reasonable growth, with a prospect of slowly falling unemployment and modestly declining inflation. A key element in this is a post-Mansion House renewal of monetary policy - no more words please, but a series of actions clearly signalling that a proper M0-targeting system is truly in being - and no backsliding on privatisation and public sector reform generally. But there is a good chance that this will happen and that the British economy could be, for the first time in a long period, giving out good vibrations on all major fronts.

There may be reasons for this drastic step, but the Government - for long so dogmatic about monetary control - should spell them out. The usual mutterings about 'distortions' and 'behavioural changes' have been heard, but why were these distortions and behavioural changes not present before the middle of 1985 (when the monetary overshoot began) and why were they present afterwards? Was there an obvious change in the institutional framework of monetary control three or four months ago? Perhaps Mr Lawson could enlighten us on the details.

Monetary mismanagement has been accompanied by government criticism of both sides of industry for excessive pay increases. The exhortations to keep wage settlements down are curiously reminiscent of the 1960s and hint at a return to incomes policy of some kind. If that were to happen, the Government would have accomplished a remarkable somersault in economic policy. A key theme of the 1979 election was that inflation could and should be curbed by monetary means, not direct government interference in pay. But now that the Government has breached its own fiscal and monetary guidelines, it feels emboldened to berate private employers for paying workers 'too much'. Like so many Chancellors before him, Mr Lawson cannot treat the British people as adults, as the best judges of their own incomes and rewards.

Fiscal overruns, 20 per cent monetary growth, warnings about excessive pay increases... It all sounds so depressingly familiar, so depressingly like the muddle of the 1970s. One has to wonder whether the Mr Lawson who spoke so intelligently to the regional City editors in June 1980 is the same Mr Lawson who is now our Chancellor of the Exchequer. What has happened to monetarism, fiscalism and price stability? What is left of the medium-term financial strategy? Does Mr Lawson, who was supposed to have been its ' intellectual architect' still really believe in it?

CHANCELLOR OF THE EXCHEQUER

One world
Short-termism
Bullish on UK economy
LSSO & PEPs
[TSB figs]

C.

MANSION HOUSE

1. At tomorrow's meeting, it would be helpful to identify the <u>themes</u> for the speech, and the main message we want to put to the audiences and the press

2. This will influence the <u>order</u> of the speech. At present we end on domestic economy, which may not be a high note.

3. On Big Bang, there is clearly a balance to be struck between welcoming the <u>opportunities</u>, and noting the <u>dangers</u> & stressing the need for prudence on all sides. My personal view is that we could stress the former more, ~~and that this could be a good~~

(cf London v other mkts

AH
17.9.

Plans & worries (pay)

11/3070F

RESTRICTED

FROM: DAVID PERETZ
17 September 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Lavelle
Mr Evans
Mrs Lomax
Mr Scholar
Mr Culpin
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Ch

One thought for a theme: you could compare the way increased volatility affects Governments and the financial sector. This could provide a link between the parts A the speech dealing with world & UK economy* & parts dealing with big bang. (* including monetary policy)

AA

MANSION HOUSE SPEECH

Mr Hudson asked us to make a start on this, by producing a broad outline and some thoughts for possible topics and themes. You are having a discussion tomorrow.

2. Parts of the speech will have to be written - as usual - more or less at the last minute. In particular, what is said in the monetary policy section usually has to be tailored to what is going on in the markets at the time. And other sections will be easier to write after the Washington meetings, and after we begin to see how the autumn forecast is turning out. What we need to identify now is anything by way of drafting we can be getting on with immediately, and whether there are other topics or themes you think would be attractive.

3. The attached outline is an amalgam of words and ideas from Rachel Lomax, Huw Evans and myself - and one or two others. There is a good deal more material than needed: you can use it as a menu to select from. You will see we are suggesting an international, integrated world economy, linking theme; and a substantial section on the city, Big Bang, etc (which will I imagine be preoccupying most of the audience).

4. On monetary policy, as things looks now I would have thought

we want to say very little indeed. The news is that there is no change in the way policy is conducted. But just at present I do not get the impression that anyone is expecting a change.

5. It is difficult to get very far into any discussion of the individual aggregates, or the exchange rate, without beginning to raise questions about what we are going to target next year; and I do not see any point in setting that particular hare running. However we will be getting shortly some of the material the Bank are beginning to put together reporting the results - rather meagre I believe - of the work they have been doing on broad money, in preparation for the Governor's Loughborough speech on 22 October. We can look at that when it arrives to see if it suggests any particular line you could use at the Mansion House.

After all this time!

6. Beyond that, my only other thought is that you might include some fairly light reference to the end of the banking month. The last ever set of full banking month figures will be published on 16 October, the day of the speech.

DLCP

D L C PERETZ

MANSION HOUSE SPEECH

Possible outline and themes

Introduction

Speak X days after return from annual international financial meetings in Washington. And 11 days before start of a new era in London's securities markets, the big bang, which has been largely a response to developments in world financial markets. A good moment to take stock of the growing integration of the world economy, and financial markets in particular. And to consider what this means for policy.

World Economy

Have been struck over years of meetings with fellow Finance Ministers by our shared recognition of Government's responsibility to maintain stable and consistent macro-economic policies. And recognition that this responsibility is heightened in a world of closely integrated and fast moving financial markets.

2. Heartened by acceptance at Washington this year that Governments' responsibilities go further. That in a global financial village we also need to recognise interdependencies in approach to financial markets and to tax policies, because national differences [example?] can lead to damaging distortions in markets.

3. [Section on world economy and Washington themes:

- State of world economy: disappointing first half year, latest evidence, prospects for sustained medium term growth.

- Look at major economies, imbalances on current account, fiscal policies. Thus far, little sign of much correction.

- [Agreed that] sustained and steady growth requires different adjustment by different countries, especially US, Japan. Developing countries].

4. [Consensus in Washington also on main areas of micro-economic

policy, applicable to industrial and developing countries

- market orientated policies
- privatisation
- need for tax and subsidy reductions]

Ch
I think these early passages (paras 1 - 6) could be kept short (they say little that is new). It is paras 7 & 8 that contain the meaty & interesting stuff. AA

Big Bang

The last three years a time of unprecedented change in the City. Intensive legislative activity. More change in prospect. But big bang important milestone - ending of fixed commissions and dual capacity after 74 years. Proposed Stock Exchange/ISRO merger historic step in integrating domestic and international security markets.

2. Upheaval no less than needed to maintain London's position as major international financial centre. Deregulation and new technology transformed financial markets worldwide. Major centres form part of global market in which innovation has become a way of life and traditional distinctions - between national and international markets, and between different kinds of financial intermediation - increasingly blurred.

3. Major effort has been needed to equip Stock Exchange to compete in world markets. Clear that sustained effort will be needed to retain London's pre-eminence. Major challenges lie ahead for everyone concerned - new self-regulating bodies and authorites as well as market participants.

4. Maintaining London's pre-eminence more than a matter of national pride. Financial services already one of Britain's most successful and fastest growing industries - as well as a major employer. Spin-off for rest of f.s. industry from having major international centre here in London. Development of more efficient capital market should bring benefit for borrowers and lenders as well as practitioners. More liquid gilts market will help

! a drink ?

reduce cost of funding. Industry will benefit from access to cheaper and more flexible financing; development of new markets and new instruments offers greater scope for managing risks of variable interest rates and exchange rates. Obvious benefit for major companies - but, in time, benefit should extend to middle and smaller size companies whose access to international capital markets and the innovations they have spawned now limited.

5. But industry should be alert to potential risks as well as opportunities presented by big bang. Noted before how emphasis on short-term performance by institutional investors, fear of hostile take-overs, reinforces tendency of British industry to take short-term view - in wage disputes as well as investment and R&D decisions. [Companies can help themselves by taking more initiative in building long-term relationships with investors, explaining and taking public credit for strategic decisions eg publishing more information about R&D expenditure. And] behaviour of institutional investors sometimes reflects the pressures that companies, as trustees of pension funds, themselves exert.

6. Can do much more to build up body of loyal individual shareholders - Government has shown the way, with the privatisation programme (British Telecom, reference to TSB, but probably not BGC) and provided new opportunities eg through PEPs. Heartening response to PEPs; more generally, no reason why private investor should lose out from big bang, as sometimes suggested. Indeed new technology and search for new markets should provide opportunity for major extension of individual share ownership.

7. Exciting times in City, but thoughtful people naturally feel some trepidation too. Hear a number of concerns:-

- the new climate will be too bracing. Well capitalised international firms with experience of operating under the new rules will go all out for market share, even if that means under-pricing risk. Danger of damage to the stability of the financial system, as well as viability of British owned firms.

- Conflicts of interest will prove difficult to resolve, particularly given pressure to exploit economies of scale. Intensely competitive and integrated financial markets will offer increased temptations and opportunities for fraud.

- At a global level, increasing integration of financial markets will be inimical to effective supervision and investor protection: those centres who insist on higher standards will be put at a disadvantage relative to those with laxer regimes. Risk of competitive "bidding down" of regulatory standards.

WS-

8. Responsibility for ensuring that these fears prove unfounded is shared.

- The first line of defence against financial failures must be good management. It is management's job to see that business is conducted prudently, on the basis of a clear sighted appraisal of market opportunities and realistic pricing of risk, and to enforce high standards of integrity at every level. Not only banks who would do well to study lessons of 1970's (Sovereign debt).

Cd develop this: new instruments help to hedge/spread/reduce risk. This was your point on the Forbes article, and it's made by Lamfalussy (see highlight).

- One of those lessons is need to strengthen capital base of financial system. Considerable progress in increasing capital ratios of banking system since 1982. Similar considerations may apply to non-bank financial intermedaries too. Those who profit from opportunities created by freer markets should be prepared to increase their capital, [to enable them to take over the inevitable casualities of rapid change, and in the interests of the stability of the system as a whole].

Again, see Lamfalussy

C. May be worth discussing how to make this point. AHH

- Bound to be casualities. But British firms are taking advantage of opportunities opening up elsewhere. Still some way to go - especially in Japan. Government is committed to obtaining reciprocal treatment in other financial centres. "We have opened our doors without prejudice to nationality - but only on the understanding that British institutions will be allowed to operate in overseas markets on equal terms with domestic institutions."

- Effective supervision and the energetic prosection of fraud essential not just to London's reputation, but to stability of financial system. Adequate investor protection pre-requisite for wider share ownership. Government responded to challenge of financial change. Financial Services Bill, now reaching the statute book, provides comprehensive statutory framework, with tough powers against insider trading. Up to those who argued strongly for practitioner based approach to get the new system up and running without delay. Banking Bill to come soon. Full response to Roskill - reference to SFO etc.

- Both Government and regulators need to be fully aware of the wider horizons opening out for financial institutions and markets. Lead regulator arrangements recognise importance of effective co-operation between different regulatory bodies, spanning institutions performing similar functions. Also pressing need for effective co-operation at international level between various regulatory bodies. Valuable work by Basle Committee of Banking Supervisors. In securities field useful progress in reaching agreement on exchange of regulatory information for prosecution of financial fraud, on bilateral basis. Next job is to consider ways of harmonising key regulatory requirements eg on capital adequacy. Don't under-estimate difficulties, but can't be dodged. [?Best way forward may be on bilateral basis - as suggested by Governor.]

May depend on developments at G10 or elsewhere in Washington ?

C.
May be worth considering reordering this ~~para~~ section on Responsibility so that it splits up between
- management
- banks
- supervisors + regulators (we ~~don't~~ barely mention SROs at present)
- Govt.

I'm not sure the point on "Bound to be casualties" belongs here. If it does, it ~~must~~ could be the last point, ~~then~~ perhaps rounded off more positively.

AJH

Monetary Policy

No Mansion House speech is complete without a word about monetary policy. Given the nature of modern financial markets - the speed with which they react, sometimes overreact, to news and to changes in expectations - the extent of agreement among my fellow Finance Ministers about the aims of monetary policy is perhaps not surprising. Nor is it surprising that most of us actually conduct policy, in practice, in a very similar way, taking account of similar indicators and evidence. Most of the major countries are also facing similar difficulties in the interpretation of monetary conditions, as financial innovation clouds the statistics.

Develop this thought a bit, to maintain global theme?

2. In the UK, policy will continue to be conducted precisely as I set out fully earlier this year, after the Budget, in a speech to the Lombard Association. Setting short term interest rates requires constant exercise of judgement, taking account of all the evidence. But the essence of policy remains, as it has been since 1979, to maintain the sound financial conditions needed to ensure sustained and steady downward pressure on inflation.

? [illegible]

3. [<u>If anything needs to be said about individual aggregates/indicators</u>. Clear that demand for **liquidity** continues to rise faster than money GDP. **MO** has continued to provide a useful guide to policy, and is now growing around the middle of its target range. **Real interest rates** high. **Money GDP** if anything a little below the path foreseen at time of Budget.

?

4. **Exchange rate** has also proved an increasingly useful guide. Certainly cannot ignore movements. While intervention performs a helpful smoothing role, wrong to react to every market fluctuation. And need to interpret more firmly based movements with care. Right for example for there to have been <u>some</u> fall in the rate when oil prices fell: that is how the economy adjusts to lower oil prices. But too large or fast a fall would have had unacceptable inflationary consequences.]

5. [<u>If any need to reassure market about PSBR/funding position</u>. A year ago, said the aim of funding policy was to fund PSBR: no more, no less. That was what we did in 1985-86. We will

do the same this year. The Government's funding needs over the remainder of the year are modest, and well within the capacity of the new gilt edged market.]

Domestic economy

[To be written later, in light of IMF speech, preliminary indications from forecast, etc.]

Ph/P

FROM: A P HUDSON
DATE: 19 September 1986

NOTE FOR THE RECORD

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Lavelle
Mr Evans
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Ross Goobey

MANSION HOUSE SPEECH

The Chancellor held a meeting yesterday to discuss the outline of the Mansion House speech (Mr Peretz's 17 September minute).

Themes

2. The Chancellor identified three themes for the speech.

a. Globalisation could be the framework for the section on financial markets. This should include the possibility of an international approach to supervision.

b. Short-termism in industry had been a useful theme in the speech to the Scottish CBI, and could be developed further.

c. Wider share ownership would be topical, and would have a broader appeal. Figures would be available by then for the number of new shareholders resulting from the TSB flotation. It should also be possible to say more about Personal Equity Plans, though the regulations would not be published by then.

Structure

3. The Chancellor hoped that this year's speech could be shorter than last year's. He suggested that the structure should be:

- Big Bang, financial markets, and wider share ownership;
- Monetary policy and the exchange rate;
- World and domestic economy.

Big Bang

4. The points in the early paragraphs of the outline on Big Bang should be kept very short, because they were by now very familiar.

5. On the opportunities presented by Big Bang, he would make the point that London had competed successfully in financial markets where there had not been restrictions, eg. foreign exchange and Eurobonds. This suggested that London could also compete successfully in equities.

6. On the likelihood of casualties, a reference should be made to the very high salaries, pointing out that with high rewards went high risks.

7. The Chancellor suggested two further points about the risks of Big Bang: first, many of the innovations had been risk-reducing instruments, and that it was wrong to suggest that innovation only added to risk; and second, there was a need to strengthen the capital base of the banks.

8. There was no need to say explicitly that Big Bang was good for the small investor. The way to approach the point was that in the final sentence of paragraph 6 on page 3 of the outline.

Monetary policy

9. The Chancellor saw nothing to say about monetary policy, beyond that it was proceeding satisfactorily. He did not want to say anything about the exchange rate unless he had to. But this section could not be drafted until much nearer the time.

The economy

10. The section on the economy would follow closely what was said in Washington. The Chancellor hoped he would be able to end on an upbeat note.

Next steps

11. The Chancellor asked Mrs Lomax to draft the section on Big Bang, Mr Cassell and Mr Peretz to draft the section on monetary policy, and Sir T Burns to draft the section on the economy.

APH

A P HUDSON

PUP

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Ch

I have alerted PS/Gov at home & told him our comments will be passed over @ 8 AM tomorrow.

Attached draft reflects comments from Peter & Robert.

AA

Alex

Do you want this?

RA8.100

DRAFT LETTER TO PS/GOVERNOR

6/10/86.

GOVERNOR'S MANSION HOUSE SPEECH

The Chancellor has ~~a few further~~ the following comments on the new draft you sent over this afternoon.

2. In paragraph 3 he feels it is very important that the Governor should not say that the fall in the exchange rate has gone "beyond the point at which the dangers of renewed inflation can be ignored", nor that "this is not to say that renewed inflation is unavoidable". This could have a damaging effect on inflationary expectations, and carries the danger of suggesting that we want to see a rise in the exchange rate: that could lead the markets to expect a further rise in interest rates, since the exchange rate has not in fact moved up. He also feels that - for similar reasons - it is unwise to say explicitly that sterling has declined "further than is necessary to offset the impact of lower oil prices". He therefore suggests that those passages are omitted, and the order very slightly changed, so that the speech runs:

> "With lower oil prices we need the prospect of an improving non-oil trade balance. And, thanks to lower oil prices, the exchange rate change necessary to effect the current account adjustment need not add to the risk of renewed inflation. But in the past our competitive position has been eroded by failure to contain cost increases. For the future, much depends on wages."

3. He suggests that "burgeoning trade deficits" is replaced by "a deterioration in the trade balance".

4. He feels that the beginning of paragraph 4 is unnecessarily negative. It starts by saying "Monetary policy cannot ... nor, more generally, can it ...". He suggests that these sentences should be deleted, so that the paragraph started by saying "The role of monetary policy is ...".

5. While he would not wish to press ~~[illegible]~~ the change suggested above in paragraph 4 if the Governor is particularly wedded to the present form of words, he does feel particularly strongly about the points made in paragraphs 2 and 3 above.

CONFIDENTIAL

cc
Mr F. Butler
Mr Monck
Mr Culpin
Mr MacAuslan
Mr Shaw

PWP

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

John Turner Esq
Private Secretary to the Secretary of State for Employment
Department of Employment
Caxton House
Tothill Street
London
SW1H 9NF

6 October 1986

Dear John

PARTY CONFERENCE SPEECH

The Chief Secretary discussed your Secretary of State's proposed Party Conference speech with him on the telephone today.

The Chief Secretary said he had reservations about your Secretary of State promising "to say to all who are under 25 and are called in for interviews if we cannot find you a job either directly through a job club or if you cannot set yourself up in business we will provide you with a training course for up to 6 months leading to a recognised vocational qualification". The Chief Secretary said he was happy for this guarantee to be given for a pilot scheme but he had reservations about it in the context of possible nationwide extension of the pilot if it proved successful. Your Secretary of State assured the Chief Secretary that were the pilot to be successful, and were he to decide that he wanted this offer to be part of an extended nationwide scheme, he would be prepared to reduce expenditure on other programmes to fund that commitment.

The Chief Secretary also questioned your Secretary of State's desire to refer to a possible 2,000 job clubs by the end of the summer. Your Secretary of State pressed very hard that this be included. The Chief Secretary accepted this on the basis that it would mean no addition to provision, and a decision to go beyond 2,000 would only be taken if it proved to be necessary and cost effective.

Yours,

Jill

JILL RUTTER
Private Secretary

CONFIDENTIAL

41/3070F

FROM: J W GRICE
6 October 1986

MR CASSELL

cc PPS
Mr Peretz

BANK STUDY INTO BROAD MONEY

Mr Allan's minute to me of 15 September (attached) underlined the importance that the Chancellor places on agreeing a line on the results of the Bank's study before the Mansion House speech. Since then Mr Peretz and I have asked the Bank to send us the results several times. I spoke again to Gordon Midgely on Friday to chase progress. Midgely told me that it was unlikely that we would be able to see the results for a few days yet. Apparently, he does not feel that he can let us see anything until he has spoken to Eddie George and received his comments. But of course Eddie has been preoccupied in recent days and has not had time to talk about this study (or even, perhaps, to read it).

The trouble is that we are now only eight working days from October 16, the day of the Mansion House speech. That means that we need to prise something out of the Bank as soon as possible. Accordingly, you may feel that you want to raise this issue directly with Eddie; otherwise time will be very short.

J W G

J W GRICE

Ch
To be aware. I shall weigh in with PS/Gov if necessary

AA

Thanks. 2. What is current state of Mansion House draft, & when will I see it? FRI is distinctly no later! N.

SM1/15

Mr Peretz

Do you want to mention this again after the [illegible] meeting? October 16 is not that far away.

Mr Grice

Thanks. In fact I reminded John Townend last night!

DLP 24/9

FROM: A C S ALLAN
DATE: 15 SEPTEMBER 1986

~~MR GRICE~~ 90/B

JWG 24/9/86

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Kelly

BANK STUDY INTO BROAD MONEY

I reported to the Chancellor what you had told me about the Bank study of broad money: that it was now being written up, and that the plan was for the Governor to use it in a speech at Loughborough on 22 October. The Chancellor feels that it is very important that we do see the results before the Mansion House Speech, (a) because the Governor will clearly have done so, and (b) because at the very least it would look bad for the Chancellor to say something at the Mansion House if the Governor is going to say the opposite at Loughborough. He feels we need to agree a line on the results of the study before the Mansion House.

ACSA

A C S ALLAN

Mr Grice

We spoke to Mr Coleby, who agreed to send me the material. Remind me in a few days' time if he hasn't

DLP 7/9

Mr Peretz

I explained to Mr Allan last week the situation on this study - he telephoned me to ask. 2. I will phone Gordon Midgeley before this afternoon's meeting to see what more can be prised out of him now that he will have had chance to discuss the study with Eddie and George. If I get nowhere, is this something we shd raise with Eddie after the meeting?

JWG.
16/9/86

A/211

12.38

FROM: A P HUDSON

DATE: 7 October 1986

1. ~~APH~~ SC
Meeting being arranged for Tues pm or Wed am

2. PWP

MRS LOMAX

cc Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Evans
Mr Scholar
Mr Peretz
Mr Culpin

MANSION HOUSE SPEECH

This is just to record that the Chancellor would like to see a draft of the Mansion House speech for the weekend. I understand you are working to this timetable.

2. Clearly, some parts of the speech cannot sensibly be written for that deadline, but it would be helpful to have as much as possible.

APH

A P HUDSON

3104/38

FROM: MRS J R LOMAX
DATE: 10 OCTOBER 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Mr Hudson
Mr Ross Goobey

some on w/ short-termism! finance v industrial contrast ~~of~~ leader @ CBI Glasgow (see the FT leader on Glasgow speech): this appears in speech, since rather late in the day & as a by-product of PBPs. Needs fuller & separate treatment - even when going alongside PBPs and say this under cap.

MANSION HOUSE SPEECH

I attach some draft material on the Big Bang for your Mansion House speech. It is deliberately on the long side, since it is not yet clear how much you will want to say on either monetary policy or the economy.

2. I gather the section on monetary policy is waiting on your meeting later today. Mr Hudson is providing a possible outline for the economy section.

If anything, the Big Bang stuff is a little (too) short

RL.

RACHEL LOMAX

1500 words

3104/37

MANSION HOUSE SPEECH: DRAFT

It is just over a fortnight since I returned from the annual meetings of the IMF and World Bank in Washington. As I had occasion to observe then, the past few weeks have seen an almost unhealthy preoccupation, in the markets and in the press, with very short-term concerns.

Flag

With Big Bang less than a fortnight away, I want tonight to offer a longer-term perspective on the changes that are taking place in financial markets and what they mean both for policy and for the rest of the economy.

Big Bang

Big Bang, and all it stands for, is above all a response to intense international competitive pressures. Deregulation and new technology have transformed financial markets worldwide. The major financial centres are fast becoming part of a global market, in which innovation is a way of life, and traditional distinctions between national and international markets, and between different kinds of financial institutions, are becoming increasingly blurred.

Few sectors of the British economy have had to move so far or so fast to stay ahead of the international game. The Government has had to move swiftly, too. Constructing a credible regulatory framework, flexible enough to cope with continuing change, has already taken up absorbed an immense amount of legislative time and effort.

No one here tonight needs reminding that the Big Bang is only a beginning. I look forward to giving a progress report at this occasion next year.

MHS Goodison

The proposal to merge ISRO and the Stock Exchange, and to create an International London Stock Exchange, could mark a further historic step towards integrating the markets for domestic and international securities mar~~ket~~.

1st Chairman (Spkr @ Banquet)

Major challenges lie ahead for everyone concerned - for the new self regulatory bodies and the authorities, as well as for market practitioners.

* Maintaining London's pre-eminence has, of course, been far more than a matter of national pride: a thriving financial sector is crucial to the success of a free enterprise economy.

The development of a more efficient ~~London~~ capital market in London will bring benefits for borrowers and lenders alike. The Government has an obvious interest in developing a more liquid gilts market. Industry too should have access to cheaper and more flexible financing. New markets in futures, options and swaps are already greatly increasing companies' ability to cope with volatile interest rates and exchange rates. New instruments thus serve to reduce risk.

much too compressed

Have to think carefully about how to put this.

The City is at the heart of one of Britain's fastest growing and most successful industries, with an impressive record in creating new jobs. [figures] London's success will generate new ideas and opportunities whose influence will be felt far beyond the Square Mile, to the ultimate benefit of smaller companies and private investors who have no aspirations to dabble in international capital markets.

Of course, competition and change carry high risks as well as high rewards, not least for the individuals whose salaries have attracted so much attention.

The new climate will be too bracing for some.

But I do not share the pessimism of those who fear that British players will account for a disproportionate share of the casualties. However level the playing field, the home team is ~~always at a slight~~ not without its advantages. And I ~~take comfort from the thought~~ am encouraged by the fact that London survived as a major financial centre through four decades of exchange controls partly because, in the areas where British firms were free to compete - such as insurance and foreign currency business - they showed a strongly international bent. London's success in Euromarkets of all kinds

Again, figs would help to lend substance

We have made it clear, too, that while our financial system works without prejudice to nationality, the Government is committed

* NO: SOME [illegible] & more than that. Pre-eminence NOT [illegible] - look @ Germany et al. But to be the financial centre of Europe & perhaps of the world is a great prize & national asset, with great benefits to economy.

to obtaining reciprocal treatment for British firms in other financial centres.

My Ministerial colleagues and I have made this position clear to the Japanese authorities and I am pleased to say that in the past year or so 7 UK houses have been granted licenses to operate in Tokyo. More are in prospect.

As a final sanction, the Government is taking statutory powers, in the Financial Services Bill, ~~to allow it~~ to refuse ~~to authorise,~~ or ~~to~~ remove authorisation of ~~from,~~ any financial institutions, including banks, whose national authorities do not provide reciprocal facilities for British firms.

That said, British players will certainly face stiff competition from some well capitalised and experienced foreign concerns.

The first line of defence must always be sound management. There is no long-term advantage in the single minded pursuit of market share, at the expense of a prudent assessment of market opportunities and realistic pricing of risk.

And the system as a whole will be better able to cope with the occasional failure if those who profit from freer markets take the opportunity to strengthen their capital base.

The banking system's experience with sovereign debt in the 1970s is instructive. Banks have made considerable progress in increasing their capital ratios since 1982. But other financial institutions might usefully consider whether there are lessons for them too.

<u>Regulation</u>

One casualty no-one can afford is London's reputation for integrity and sound dealing.

The Government attach the highest importance to effective supervision, investor protection and the energetic prosecution of fraud.

As the Home Secretary recently announced, the Government has decided to accept most of the Roskill Committee's recommendations, including the creation of a new Serious Fraud Office for the investigation and prosecution of the most complex and serious cases.

Reorder? 1. FS Bill 2. BS Act 3. Roskill

yes

The Building Societies' Act has already received Royal Assent and comes into force on 1 January next year.

The Financial Services Bill is now passing through its final Parliamentary stages. The next task is to get the new systems up and running without delay -and to make sure that they work.

FS Bill needs a bit more than this, I fear

To complete the picture, the Bank of England has greatly increased the resources devoted to banking supervision, and the new Board of Banking Supervision is already in operation. I hope shortly to introduce a new Bill to strengthen the statutory framework within which the Bank operates.

I well understand the concerns of those who argue that economic regulation has costs; and who point to the risk that, by insisting on high standards here, we will put ourselves at a competitive disadvantage relative to centres with laxer regimes.

(Gresham's Law)

But a competitive bidding down of regulatory standards is in no one's interest. ~~While~~ I believe this is increasingly recognised in other major financial centres, both among the key players and the regulatory authorities. But the rapid pace of change in financial markets makes it impossible to be complacent.

Worth? name

Improved international co-operation and uniformity of standards must be high on the agenda of all supervisors, both in the securities field and in banking.

Stress this

Wider share ownership

The Government's commitment to promoting a wider spread of individual share ownership gives it ~~a particular~~ an additional interest in maintaining high standards of integrity in financial markets and ensuring effective investor protection.

no: still has 2m — 3rd largest reassessment

Over the past 7 years more families have felt able to increase their ownership of assets beyond their own home. The most significant single step was ~~of course~~ the privatisation of British Telecom, which started with 2 million shareholders and still retains over 1½ million two years later. The TSB issue - albeit something of a special case - ~~attracted no fewer than 5~~ has started life as a PLC with 3 million ~~applications~~ shareholders.

No. of shareholders doubled (before TSB)

The PEP scheme which I introduced in my last Budget offers a further opportunity to increase the number of individual shareholders. With the enthusiastic co-operation of a number of institutions, including the Stock Exchange and some of the clearing banks and building societies, the details of this scheme are now virtually finalised, and I hope to lay the necessary regulations before Parliament in the near future in good time for the scheme to start as planned next January.

This popular enthusiasm for share ownership comes at a time when new technology will offer increasing scope for cutting costs on small share deals. So There is at last a real prospect of reversing the long-term trend to institutional ownership of British industry.

I hope industry for its part will give a positive welcome to the increasing number of small shareholders - even if it involves them in some extra costs.

As some recent take-over battles have shown, the small shareholder often develops a loyalty to the company in which he invests, if it serves him well over the years, which leads him to take a longer term view than many large institutional investors.

Wider share ownership is thus one answer to those industrialists who complain that their ability to take decisions in the long-term interest of their company is inhibited by an excessive emphasis placed on short-term performance by fund managers.

If there is some substance in this complaint - and I suspect there is - companies will need to be alive to the potential risks as well as the opportunities presented by Big Bang.

Long-term relationships may need active nurturing through a period of institutional upheaval. And companies might well consider how far the demand for short-term performance can be traced back to the pressures they themselves exert, as managers of their own pension funds.

One thing is clear: British industry cannot afford to take a short-term view - on investment, research and development expenditure, industrial training or pay.

Whatever our prowess as an exporter of financial services - and I believe it will continue to be considerable - our future employment and prosperity will always depend on achieving excellence over a wide range of economic activities.

SM/MH

This section can be much shorter, ~~[illegible]~~ & it will [illegible] – [illegible] [illegible] and [illegible].

MANSION HOUSE SPEECH:

DRAFT SECTION ON WORLD AND DOMESTIC ECONOMY

World Economy

When we met last year, the world oil price stood at [$30] a barrel. By January, it had fallen to $22, and in April to $10, before coming back to round about the present figure of [$14-15].

It is a measure of the underlying resilience of the world economy, and of the United Kingdom economy within it, that the world has adjusted to this dramatic fall without the disastrous effects which many predicted. To reverse a well known advertisement, we have not made a crisis out of a drama.

The fall in the oil price was, of course, much in our minds at the international meetings a fortnight ago in Washington. Understandably, press reports of these meetings tended to emphasise the differences of view, and the arguments. But I am sure that the fundamental points, on which we have come to agree over the years, are more important than the more specific questions [of tactics and timing], on which there will obviously be differences from time to time.

- We agree on the cardinal importance of controlling inflation. And we agree that the way to do this is through monetary and fiscal policies.

- We agree on the need to improve the supply performance of our economies. And more and more countries are coming to realise that the way to do this is by liberating market forces. A consensus is fast developing on the virtues of privatisation, deregulation - not just in financial markets but in other areas too - reduction of income tax, and tax reform to reduce distortions.

- We agree on the need for free markets to operate at the international level, as well as domestically. When I spoke to you last year, I said that a theme of the international meetings had been recognition of the need to halt the protectionist tide. A major step forward was taken last month in Uruguay, with the agreement to hold a further GATT round covering not only manufactured goods but agriculture and services as well.

It is vital that the will to co-operate which led to the successful conclusion of talks in Uruguay is carried through to actual agreements when the talks begin. Given the will, international co-operation <u>is</u> feasible, as we have demonstrated.

- Just over a year ago, Finance Ministers of the major industrial countries met in the Plaza Hotel in New York. We agreed on closer international co-operation on economic management, and in particular, on exchange rates.

- Beyond that, when we met in Tokyo in June, we agreed to improve the process by which we work towards greater consistency in economic policy, and are making use of agreed indicators in our analysis of developments.

This co-operation has been achieved partly because governments are concentrating more and more on policies which will make for sustainable, non-inflationary growth in the medium-term. This must be a better approach than making dramatic changes of policy to deal with short-term problems.

The familiar imbalances in the world economy have become a recurring theme of these speeches. The fiscal deficit in the United States remains much too high; as does the Japanese current account surplus. Progress in reducing these imbalances has been much slower than we would have wished. There are signs that next year may see changes in the right direction: there is a better prospect of a reduced US deficit; and the Japanese Government has announced measures to [boost domestic demand].

The changes in exchange rates should help to reduce the imbalances. But they will certainly not be sufficient on their own.

A dominant influence on world growth has, of course, been the fall in the oil price. The initial effect has been to slow down the growth of world activity. Countries whose income has fallen have reduced their imports rapidly, weakening the export performance of the industrial countries and some others. Industrial production in the major industrialised countries has therefore shown little advance so far this year.

But this pattern comes as no surprise. After each of the massive oil price increases in the seventies, there was a delay of several months before output was decisively affected. So the benefits of cheaper oil have yet to emerge.

In a speech a few months ago, I suggested that the present period merely represented a pause before growth picks up. Others have shared this view, and I see no reason to change it. I expect domestic demand in the industrialised countries to start to grow more rapidly, and I remain optimistic about the outlook for the world economy over the next year.

Sir TB would want to take a close look @ this. This section, too, might be a bit shorter – see last year.

Domestic Economy

The impact of the oil price fall on the UK economy has been broadly the same as for the world economy.

Of course, as the fifth largest oil producing nation we have been more affected than most, but the dire prophecies of the gloom and doom merchants have not been fulfilled. Indeed, although the Exchequer lost some £5½bn in prospective oil revenues this year, I was still able to cut taxes slightly in the last Budget, while remaining firmly within the framework of the medium-term financial strategy.

When was 'underlying' RPI last ≤ 3¼%?

As with the world economy generally, the inflation benefits of the price fall have come through before the benefits for growth. For the past ~~two~~ months, inflation has stood at ~~2.4 per cent~~ under 3% – the lowest for nearly 20 years. As I said in Washington, the underlying rate is not quite as low as that – perhaps around 3¼ per cent. [Outlook]

There should by now be no doubt about the firmness of our resolve on inflation. Not only are we determined that there should be no resurgence of inflation. Our aim is to eliminate it altogether.

Again in line with the world picture, overall output growth has been slower than envisaged, after 4 years of steady growth of about 3 per cent a year. And exports are flatter. [There are a number of encouraging developments in the UK which give me confidence in maintaining my view that this is merely a pause before faster growth resumes.]

- Exports are showing signs of picking up.

- Investment is at an all-time high. Manufacturing investment grew by 6 per cent in 1985, and investment in the construction and service industries grew by 8 per cent.

- Manufacturing productivity, in the second quarter of this year, was over 30 per cent above its trough in 1980 - an average growth of 5 per cent a year for over 5 years.

- Industrial relations are again in good order, with the number of disputes at the lowest level for almost 50 years.

The effect of lower oil prices has been felt particularly in the current account of the balance of payments. [Can we repeat Washington message, ie that non-oil exports will have to rise, but a lower real exchange rate will contribute to this, and that it has been achieved, but will take time to bring results?]

This will prob. be better handled next week's passage: we don't want the XR & [illegible] more than once

The most intractable problem remains unemployment. It bears repeating that since June 1983, nearly a

figs are that day: will want to focus remarks on that million new jobs have been created, and total employment has risen for 12 successive quarters - the longest period of continuous growth for 20 years. Unemployment remains at its high level because of the growth in the workforce.

We have sought to tackle unemployment through measures which will contribute to the long-term growth and development of the economy. Thus for young people we have concentrated on schemes such as the new 2-year Youth Training Scheme, which make for a more highly skilled workforce in future. And youth unemployment is now below the Common Market average, and falling. For the long-term unemployed, we offer, for example, assistance for those who want to set up their own businesses, who may then create jobs for others.

[The better outlook for the economy is the best reason for confidence that unemployment will come down.]

Conclusion

One of the themes of my speech today has been the rapid changes in the world economy. Against this background, it is tempting to focus exclusively on short-term considerations. But the very fact of rapid change makes it all the more important to concentrate on objectives for the medium and long-term, and how best to achieve them.

We have tried to do this in Government. The medium-term financial strategy has been, and will continue to be, a discipline for us, and a stable framework within which the private sector can plan. We have always made clear our policies of tax reduction, tax reform, privatisation, and wider share ownership, which I reaffirmed last week.

[Looking ahead is also important in the financial markets. The firms who succeed after Big Bang will need strong strategic leadership, as well as shrewd dealers.]

Perhaps most important of all, industry needs to look to the long-term, to seize the opportunities that will come the way of British firms which can compete in world markets. This means more research and development, better training, and a more realistic approach to pay and costs.

The events of the past year have revealed the underlying strength of the British economy. I can assure you, my Lord Mayor, that I shall do all in my power to maintain the policies which created that strength.

FROM: A P HUDSON
DATE: 19 September 1986

NOTE FOR THE RECORD

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Lavelle
Mr Evans
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Ross Goobey

MANSION HOUSE SPEECH

The Chancellor held a meeting yesterday to discuss the outline of the Mansion House speech (Mr Peretz's 17 September minute).

Themes

2. The Chancellor identified three themes for the speech.

a. Globalisation could be the framework for the section on financial markets. This should include the possibility of an international approach to supervision.

b. Short-termism in industry had been a useful theme in the speech to the Scottish CBI, and could be developed further.

c. Wider share ownership would be topical, and would have a broader appeal. Figures would be available by then for the number of new shareholders resulting from the TSB flotation. It should also be possible to say more about Personal Equity Plans, though the regulations would not be published by then.

Structure

3. The Chancellor hoped that this year's speech could be shorter than last year's. He suggested that the structure should be:

- Big Bang, financial markets, and wider share ownership;

- Monetary policy and the exchange rate;

- World and domestic economy.

Big Bang

4. The points in the early paragraphs of the outline on Big Bang should be kept very short, because they were by now very familiar.

5. On the opportunities presented by Big Bang, he would make the point that London had competed successfully in financial markets where there had not been restrictions, eg. foreign exchange and Eurobonds. This suggested that London could also compete successfully in equities.

6. On the likelihood of casualties, a reference should be made to the very high salaries, pointing out that with high rewards went high risks.

7. The Chancellor suggested two further points about the risks of Big Bang: first, many of the innovations had been risk-reducing instruments, and that it was wrong to suggest that innovation only added to risk; and second, there was a need to strengthen the capital base of the banks.

8. There was no need to say explicitly that Big Bang was good for the small investor. The way to approach the point was that in the final sentence of paragraph 6 on page 3 of the outline.

Monetary policy

9. The Chancellor saw nothing to say about monetary policy, beyond that it was proceeding satisfactorily. He did not want to say anything about the exchange rate unless he had to. But this section could not be drafted until much nearer the time.

The economy

10. The section on the economy would follow closely what was said in Washington. The Chancellor hoped he would be able to end on an upbeat note.

Next steps

11. The Chancellor asked Mrs Lomax to draft the section on Big Bang, Mr Cassell and Mr Peretz to draft the section on monetary policy, and Sir T Burns to draft the section on the economy.

APH

A P HUDSON

SM2/33

FROM: A P HUDSON
DATE: 10 OCTOBER 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Ross Goobey

MANSION HOUSE SPEECH

At your meeting on ~~19~~ 18 September, you suggested that the structure for this year's speech should be:

- Big Bang, financial markets, and wider share ownership;

- Monetary policy and the exchange rate;

- World and domestic economy.

2. I attach a draft section on Big Bang by Mrs Lomax, and a draft of my own on the economy. The latter is very much a sighting shot, based on what was said in Washington and previously. It will need a lot of attention next week, in the light of reactions to the Forecast.

3. We shall also draft the section on monetary policy next week.

4. We have arranged a meeting to discuss the speech at 5.30pm on Tuesday 14th. If copy recipients have comments on the section on the economy, in particular, I shall try to incorporate them into a second draft before then.

APH

A P HUDSON

Ch.

MANSION HOUSE

See also latest state of play on Bank's study of broad money - Mr Cassell's note at the back of this folder.

Many thanks. (to Rachel & you).
See comments AH
passim.
I have sketched out a (no lines or) humdrum policy passage in m/s below. (Not even typed just yet!)
One or two good jokes badly needed for the grammar.
N.

Man Ho – monetary policy section

TOKYO SUMMIT 1986
迎賓館
AKASAKA PALACE

10/10/86.

The policy is an outline @ last year's Man Ho & in Lombard speech.

So a few words [only] on its implementation in the light of recent events.

The PSBR is on track, as today's figs show, so no problem on fiscal front.

But recent indications that monetary conditions too loose. Now broad money & credit — difficult to interpret, but growth of personal debt rather simply a sign of the evolution of the economy & of people's habits: still well below that of US & matched by growth of personal holdings of liquid assets.

No: indications provided by M0 & XR. Given the oil price collapse, inevitable & welcome that XR should fall so enable — when J-curve has worked thru' — rising non-oil exports to offset fall in oil export revenue. (Inwards to into reg?). But that fall has now gone far enough. As for M0 growth, this is still well within target range, but above midpoint & tending to rise. So, esp in light of XR fall, needs to be brought back to mid pt.

TOKYO SUMMIT 1986

迎賓館
AKASAKA PALACE

However interest rates in the UK are high at present (relative to differential with US nominal & - conjecturally - real rates); & all Tory concerns 1½ p.c. all that is req'd.

In the period afterwards of the Washington meeting, market was trying to drive ½ 2½ below. So long as that would be case, I was not prepared to move @ all: the pressure/storm was bound to blow itself out, & it did.

Then as soon as calm had been restored, the 1½ move I had judged appropriate was implemented.

12.42

SECRET

FROM: A P HUDSON

DATE: 13 October 1986

SIR P MIDDLETON

cc Sir T Burns
Mr Culpin

MANSION HOUSE SPEECH: MONETARY POLICY

... I attach the Chancellor's outline of the monetary policy section of the Mansion House speech.

APH

A P HUDSON

P.S. I understand that the Chancellor said this morning that he would want to refer to German Central Bank Money in the section on broad money. Apparently, the German target has been exceeded for the first time since 1975.

APH

12.42

SECRET

FROM: A P HUDSON

DATE: 13 October 1986

SIR P MIDDLETON

cc Sir T Burns
Mr Culpin

MANSION HOUSE SPEECH: MONETARY POLICY

... I attach the Chancellor's outline of the monetary policy section of the Mansion House speech.

APH

A P HUDSON

P.S. I understand that the Chancellor said this morning that he would want to refer to German Central Bank Money in the section on broad money. Apparently, the German target has been exceeded for the first time since 1975.

APH

SECRET

MANSION HOUSE - MONETARY POLICY SECTION

The policy is as outlined in last year's Mansion House Speech and in Lombard Speech.

So a few words only are needed on its implementation in the light of recent events.

The PSBR is on track, as today's figures show, so no problem on fiscal front.

But recent indications that monetary conditions too loose. Not broad money and credit - difficult to interpret, but growth of personal debt ratio simply a sign of the evolution of the economy and of people's habits: still well below that of US and matched by growth of personal holdings of liquid assets.

No: indications provided by MO and exchange rate. Given the oil price collapse, inevitable and [necessary] that real exchange rate should fall to enable - when of course has worked through - rising non-oil exports to offset fall in oil export revenues. (Indications of % rise required). But that fall has now gone far enough. As for MO growth, this is still well within target range, but above mid point and tending to rise. So especially in light of exchange rate fall, needs to be brought back to mid point.

However interest rates in UK are high at present (refer to differential with US nominal and - [conjecturally] - real rates); and all things considered 1% increase all that is required.

In the ? aftermath of the Washington meetings, market was trying to draw a 2% hike. So long as that remained the case, I was not prepared to move at all: the phase/storm was bound to blow itself out, and it did.

Thus as soon as calm had been restored, the 1% move I have judged appropriate was implemented.

13.10.86

CONFIDENTIAL COVERING SECRET

NO 2 OF 4 COPIES

PERMANENT SECRETARY

CHANCELLOR
SIR T.BURNS

You have been asked by the Chancellor to draft the monetary passage in the Mansion House speech.

2. I attach a couple of pages of thoughts about what might be said, from the viewpoint of both an ex-market consumer and a political adviser.

3. I apologise for the amateurish layout, but, in the circumstances, I thought it better to bash it out on my own word-processor.

ARG

ALASTAIR ROSS GOOBEY

SECRET

The operation of monetary policy has not changed in essence since this time last year. The interpretation of broad money indicators remains clouded by the unprecedented rise in the velocity of circulation, partly caused no doubt by the current changes in financial markets, which have their consequences in the liquidity profile of many participants. Narrow money still gives the best current indication of conditions, its velocity change being much more steady, and having proved a better predictive tool than almost any other. Asset prices are carefully monitored, with more attention being paid to the stock market than hitherto as its effects on the individual become more widespread. The exchange rate however has usually been the precursor of changes in the authorities' interpretation of monetary policy. It is by no means a sufficient reason for a change in policy of itself, but, if confirmed by the other indicators, will still create a presumption of change.

? Surely goes too far.

The modest rise in interest rate which the authorities initiated earlier this week is a good indicator of how policy works in practice. In July, when interest rates were last reduced in most G5 countries, sterling M3 was already running at above the top of the range indicated in my March Budget, and PSL2, having remained steady in its growth rate for some time, had also shown some acceleration. The stock market had fallen back from its April high, but remained well above its year-ago level. House prices, on average, had risen sharply in the first two quarters of 1986, and the year-on-year rate of growth had accelerated. But the exchange rate had remained relatively strong, particularly against the weak dollar. It was certainly stronger than analysis had suggested would have been justified by the more than fifty per cent fall in oil prices. M0 was at the low end of its target range. Interest rates were widely expected to fall in the UK as well, but the authorities judged that there was enough evidence to suggest caution, and rates remained unchanged between May and October.

What then changed between July and October? There was no acceleration in the broad money indicators, the stock market had ceased to show any obvious trend, and house price rises are currently showing signs of a decelerating advance. M0 however has risen above the middle of its target range and, more particularly, the exchange rate has fallen. Although I have no reason to expect M0 to move outside its target range, and today's PSBR figure shows that, after six months, there is no reason to change broad expectations for the financial year's outcome, the indicators suggested that a modest tightening was required.

Since most of this information has been in the public domain for the past three weeks, we have been criticised, and not just from predictable quarters, for a delay in taking action. I say to you tonight that only ten days ago, there were widespread calls for a rise in interest rates of a degree not justified at all by the degree of monetary ease

SECRET

which I have just described. At that time there was a consensus that the September money supply would show a further acceleration in broad money aggregates, for what they are currently worth as an indicator, but which would be taken as a sign of increasing slackness. As a General Election approaches, it is also inevitable that market operators will become more sensitive to the possible changes in policy that a General Election might produce. This is not the occasion to make partisan comments, and what I say is merely observation of palpable truths; the very possibilty of a change of government, any change in which would involve a more relaxed attitude to fiscal policy, or even that this government may be prepared to relax its fiscal stance in the run-up to an election, will make the holding of sterling seem, for the period of those conferences, a less attractive policy.

The government demonstrated last week that it is by no means going to relax its fiscal stance for electoral reasons. The policies announced last week are all designed to achieve greater value for money. There is some redistribution within departments between programmes, but no significant extra overall spending involved. The move in interest rates this week has been made in a calmer atmosphere, and represents a suitable response to current monetary indicators. Let no-one misunderstand me: if indicators suggest that another upward move is neccesary, then that action will be taken. We will not be dictated to by the constraints of short-termism to do more than is necessary.

successive

Meanwhile there are increasing signs that the pause in economic activity in both the world and the United Kingdom to which I have been referring since May, is coming to an end. The initial downward adjustment to world trade caused by the fall in the purchasing power of the oil-producers is being succeeded by the greater consumption of the oil consumers. I am far too old a hand to suggest that this month and last month's unemployment figures represent the change in trend we have all been working towards, but there can be no doubt that the recent experience has been much improved since the disappointing late winter figures. I predict with some ~~confidence that,~~ when I rise to speak to you this time next year, ~~possibly before an election which from an economic viewpoint I would not mind being held in 1988~~, the economy will be in its seventh year of economic growth averaging not far short of 3 per cent, government spending will remain under control, and ~~although we may have seen the cyclical trough of retail prices,~~ inflation will still be within the range about which we became complacent in the 1950s and 60s. Monetary policy will, as now, be no looser but no tighter than that required to exert a continued downward pressure on the ~~secular~~ rate of inflation. This government will never be complacent about ~~the~~ inflation, ~~rate,~~ knowing ~~that a little bit here or there soon leads inexorably to a lot more and the~~ sort of problems which the last seven years have seen us drag ourselves painfully out of.

As a result,

underlying

SECRET

From: SIR PETER MIDDLETON

Date: 13 October 1986

CHANCELLOR

cc Sir T Burns
Mr Cassell
Mr Peretz
Mr C Kelly
Mr Culpin
Mr Hudson
Mr Ross Goobey

MANSION HOUSE

... I attach a draft. It omits Germany where narrow money appears to be more of a problem than broad. And it does not refer at all to intervention though a sentence could easily be fitted into paragraph 5. I have deliberately kept it short, with occasional optional words.

P E MIDDLETON

The Governor's speech, which I have just seen, contains some similar thoughts. He does refer to intervention so we shall need to establish a common position.

DRAFT Incorporated in full draft

On this occasion, last year, I set out our financial strategy in the clearest terms. The Government was determined to reduce inflation further. There was only one way. By continuously monitoring the indicators of monetary conditions, and ensuring that they were consistent with continued lower inflation. If one indicator deteriorated, we would require convincing evidence from the others before concluding that this was acceptable.

2. We have done exactly that. And done it against an exceedingly difficult world background, with periods of great turbulence.

3. Last year I pointed to the Plaza accord to facilitate a fall in the dollar. And the dollar has indeed fallen. By over 20% against all currencies. Against the mark it is down by 43% and against the yen by 54%. Looked at over the year, the smoothness of the adjustment has been remarkable. But such changes cannot take place without some upheaval and times of intense speculation in financial markets.

4. This time last year I did not know that oil prices were going to fall by half, with profound effects both on output and financial balances throughout the world.

5. You will not therefore be surprised to hear that the pursuit of a constant policy has not been easy. At times we have had to move a little here and there with the storm. But we have never lost sight of our great purpose. And we have refused to be buffetted by every small wind [reference to January 1986]. Throughout we have been guided by our strategy, and guided by it we shall continue to be.

6. So we did not rush to make a change in interest rates in the supercharged atmosphere of the last four weeks [before and after the Washington meetings]. Even though it was clear to us as well as the markets that some change would be needed. The excessive expectations and exaggerated comment which were being generated could have led to excessively high interest rates.

11.44

CONFIDENTIAL

FROM: A P HUDSON
DATE: 13 October 1986

SIR P MIDDLETON

cc Sir T Burns
Sir G Littler
Mr Cassell
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mrs Lomax
Mr Culpin
Mr Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Ross Goobey

GOVERNOR'S MANSION HOUSE SPEECH

... We have just received 3pm the attached copy of the present draft of the Governor's Mansion House Speech.

2. Please could we have any comments as soon as possible.

APH

A P HUDSON

Ch.

Some points to think about on p.3, on inflation, at the very least. Officials' comments to follow.

APH

0708A

GOVERNOR'S SPEECH

DRAFT OF 13 OCT.

MANSION HOUSE SPEECH

My Lord Mayor, Mr Chancellor, My Lords, Aldermen, Mr Recorder, Sheriffs, Ladies and Gentlemen

Sir Nicholas, in proposing the toast, has once again given us a most eloquent and impressive speech. The Bankers and Merchants of the City are enjoying ever-closer relations with the Stock Exchange; and as they gather on the eve of the Big Bang, which is to transform so much of the City and its way of doing business, it is only fitting that they should hear so important a contribution from Sir Nicholas. He has presided with great dignity and skill over this often very difficult period of transition. The achievement of the old and new members of the Stock Exchange is in many senses a collective one; but even so I doubt that we could have have come so far or achieved so much without his inspiring leadership. It is, if I may say so, most appropriate that following the recent merger with the International Securities Regulatory Organisation, Sir Nicholas is now officially Chairman of the "International Stock Exchange of the United Kingdom and the Republic of Ireland": though happily we can continue to refer to it as "The Stock Exchange".

1 This is an occasion for looking backwards with the outgoing Lord Mayor as well as looking forwards, as to varying degrees the Financial Markets always do. As the Big Bang approaches our forward agenda is more than usually full; and I shall turn in a moment to some of the competitive and regulatory issues that we still face. But the past 12 months have been eventful too. I spoke here last year fresh from the Plaza meeting at which the Governments and Central Banks of the Group of 5 countries undertook to concert their efforts to bring about a substantial realignment of the dollar's exchange rates. I doubt whether any of us present at that meeting expected to see, over the following 12 months, a further 20% fall in the dollar combined with the simultaneous decline in dollar interest rates: this was, in last year's language, a soft landing indeed. It was made possible by the disinflationary impulse of a halving of oil prices in dollar and sterling terms: and they have of course fallen even further in terms of the yen and the deutschmark.

2 What the fall in the oil price has not done, contrary to some expectations, is to prompt a sudden burst of non-inflationary growth - the counterpart of the stagflation which followed the oil price rises in the 1970s. The fact is that all such shocks are initially deflationary - not only because losers adjust more quickly than gainers, but also as a result of the uncertainty that they breed and the damage that they are liable to do to financial intermediaries. Nonetheless the oil consumers of the world have benefitted from an increase in real income which will stimulate their demand for other goods, and we are now beginning to see this in the major industrial economies.

?

3 In the United Kingdom, a central question has been the exchange rate. With lower oil prices we needed the prospect of an improving non-oil trade balance; but our competitive position had been eroded by past failure to contain cost increases. [Over a run of years, the exchange rate change needed to effect this adjustment to the current account is probably not big enough fully to offset the beneficial effects on inflation of lower oil prices.] [But with its recent weakness sterling has in fact declined further than is necessary to offset the impact of lower oil prices on the current account, and beyond the point at which the dangers of renewed inflation can be ignored.] This is not to say that renewed inflation is unavoidable. Much depends on wages. Our productivity performance to date comes nowhere near to warranting the 4-5% annual growth in real income implied by the recent gap between overall earnings growth and retail price inflation. [Room does exist for some rise in living standards but,] as we have recently seen, too rapid a rise in consumption can all too easily be translated into a burgeoning trade deficit. The only solution is for there to be a sharp reduction in the general level of pay settlements in the pay round which is just beginning. Recent indications of the level of settlements offer some hope, but settlements averaging 5 1/2% are no lower than in 1983 when inflation was nearly 5%, or twice its present level.

I take it this sentence is trying to say that the net result will still be lower inflationary pressure. But the way it's written doesn't seem to convey that.

DLCP: targeting!

NO

Surely try to ~~?~~ make this more positive and tie it to policy.

See below

Implies Govt. powerless.

? Make living standards point here, as you have, that tax reductions + lower inflation mean need only v. small % rise to raise living standards.

4 Monetary policy cannot directly improve labour cost performance; nor, more generally, can it bring about the improvements in industrial innovation and efficiency which are needed to take advantage of the substantial opportunities now available to British producers in world markets.] The role of

MOM: Demeans MTFS

monetary policy is progressively to squeeze out inflation, and the economic distortions to which it gives rise, as an essential precondition for any sustained expansion in activity and employment. That has been our consistent aim over many years, and we have had a considerable measure of success. We are determined to ensure that this monetary discipline is maintained. The difficulties we are encountering in operating in turbulent markets and at a time of rapid financial change, will not be allowed to jeopardise that fundamental long-term objective.

5 Our problems in pursuing monetary targetry in present conditions are not new, and, although currently more severe than elsewhere, they are by no means unique to this country. Monetary targets are being overrun in the US, Germany and Japan among others. In all these countries, while nominal interest rates have fallen, inflation has fallen faster, so that real interest rates are higher than for some time. These changes may be contributing to abnormally rapid growth in the demand for both narrow and broad money.

DLCP: Shd say that what has changed is MO + XR, not £M3.

6 In our own case, though MO is still within its target band, it has shown some recent acceleration and the broader monetary target aggregate, £M3, has been growing for much of the last year well above its 11-15% target range. One factor which has rendered the growth of £M3 more erratic than that of other aggregates is the process of financial change and in particular the sensitivity of £M3 to the ebb and flow of the competition between banks and building societies to mediate between depositors and home buyers. £M3 is related to bank intermediation. If this expands at the

expense of other intermediaries money may grow without either total liquidity or total credit expanding as much. Even so, these other measures have been growing uncomfortably fast.

DLCP: Cut this down

7 Together with trade and wage developments the perception that liquidity and credit were growing fast contributed to speculation against sterling at a time of particular uncertainty about the outcome of meetings relating to interest rates abroad and oil prices. As in January we have responded by intervening in the foreign exchange markets. It is not sensible to move interest rates by large amounts at times of market turbulence if other tactical responses are available. It would be a great mistake if the determination not to be swept off one's feet in the short run were to be interpreted as a failure to recongise the reality of the situation or to have identified the measures which will require to be implemented at the appropriate moment. Markets deliver noisy signals and the true signal may need time to distinguish itself from the noise.

8 My Lord Mayor, great changes in the City are due to be implemented next month: after years of preparation the changes known as the Big Bang are here. They represent a triumph of adaptability and vision on the part of the old and the new members of the Stock Exchange who have embraced the changes so positively.

9 Reform of the trading practices and in the membership rules of the Stock Exchange were of course quite deliberately intended to open up the markets to competition. There is every sign already that they have succeeded in releasing a great burst of energy and

talent. But competition can be a destructive as well as a constructive force. That is part of the reason why new regulatory arrangements are also being introduced. There are natural and proper limits, however, on the extent to which regulators can or should influence the behaviour of market practitioners. Consequently, it will be vital that all participants in markets exercise a degree of restraint over their own exuberance. Market-makers and broker-dealers will naturally strive to secure a market share which will support the capital which they have committed to their business. But if this leads to excessive margin-cutting they will store up trouble for themselves and the markets. Conversely institutional investors will need to place some restraint on their natural wish to take advantage of their bargaining power in such competitive conditions.

10 Even those who raise funds on the markets may be well advised to turn away some opportunities which may come their way in the new environment. I have particularly in mind here the temptations of leveraged takeovers. We have seen developments abroad which I would not like to see imitated here, and we will need to give further thought to the issues involved.

My Lord Mayor, I too must now exercise restraint. However brash and conglomerated the bankers and merchants may become in this brave new world; however early the City's day may start and however short our lunch breaks may become; the traditional hospitality of the Mansion House will remain one of the essential parts of our year. May I thank you and the Lady Mayoress for so splendidly continuing the tradition tonight, and for all that you have done for the City during your period of office. Let us hope that when we come to reflect upon the changes that have come to fruition during your term, we may see in them the beginning of a new efflorescence of the City as a leading world financial centre.

FROM: MISS C E C SINCLAIR
DATE: 13 October 1986

PS/CHANCELLOR

cc Mr Cassell
Mr Scholar
Mrs Lomax
Mr Culpin
Mr Hall
Mr Ilett
Mr Hudson
Mr Ross Goobey

MANSION HOUSE SPEECH

I have see the draft material for this speech attached to Mrs Lomax's minute of 10 October.

page 8 in revised version

2. I do not think the paragraph on page 5 referring to PEPs strikes quite the right note. I suggest that the second sentence should be amended by deleting "enthusiastic" and replacing it by "positive". I would also omit the reference to the building societies. In practice they have shown little interest in PEPs, given their other preoccupations. And as you know, the Halifax recently made it clear that they were not intending to offer a PEP from 1 January.

Ch.

I want to check a couple of details with Carolyn Sinclair. But on the basis of this note, perhaps the sentence could read:

"With the cooperation of the Stock Exchange and other [institutions], I have now [almost] finalised the details of the scheme. I hope to lay the necessary regulations ..."

pp [signature]
CAROLYN SINCLAIR

AH

14. 10.

12.45

CONFIDENTIAL

FROM: A P HUDSON

DATE: 13 October 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Ross Goobey

MANSION HOUSE SPEECH

... I attach a revised version of the section on the Economy. I have shortened the section on the World Economy, as you suggested. Sir T Burns has recast much of the section on the Domestic Economy. Miss O'Mara has also made some helpful comments.

2. Mrs Lomax has redrafted the section on Big Bang [note below].

APH

A P HUDSON

SM/MH

This not circulated

THE ECONOMY

In surveying economic developments over the past year and the prospects for the future, it is not difficult to pick out the most important single event.

When we met last year, the world oil price stood at just under $30 a barrel. By January, it had fallen to $22, and in July to below $10, before coming back to round about the present figure of $14-15.

Monetary Policy and the Exchange Rate

This has, of course been a key part of the background against which we have been operating monetary policy.

On this occasion, last year, I set out our financial strategy in the clearest terms. The Government was determined to reduce inflation further. There was only one way. By continuously monitoring the indicators of monetary conditions, and ensuring that they were consistent with continued lower inflation. If one indicator deteriorated, we would require convincing evidence from the others before concluding that this was acceptable.

Not circ'd

We have done exactly that. And done it against an exceedingly difficult world background, with periods of great turbulence.

Last year I pointed to the Plaza accord to facilitate a fall in the dollar. And the dollar has indeed fallen. By over 20 per cent against all currencies. Against the mark it is down by 43 per cent and against the yen by 54 per cent. Looked at over the year, the smoothness of the adjustment has been remarkable. But such changes cannot take place without some upheaval and times of intense speculation in financial markets.

This time last year I did <u>not</u> know that oil prices were going to fall by half, with profound effects both on output and financial balances throughout the world.

You will not therefore be surprised to hear that the pursuit of a constant policy has not been easy. At times we have had to move a little here and there with the storm. But we have never lost sight of our great purpose. And we have refused to be buffetted by every small wind [reference to January 1986]. Throughout we have been guided by our strategy, and guided by it we shall continue to be.

Not circ'd

So we did not rush to make a change in interest rates in the supercharged atmosphere of the last four weeks [before and after the Washington meetings]. Even though it was clear to us as well as the markets that some change would be needed. The excessive expectations and exaggerated comment which were being generated could have led to excessively high interest rates. Instead we waited for a period of calm. And then acted in line with the needs of our strategy.

My judgement is this. Public borrowing, as today's figures show, is on track. Monetary conditions had however eased.

A lot is said about broad money and credit, but this was not on its own a matter of serious concern. [The growth of broad money has not accelerated over the last few months. But more importantly] Financial liberalisation and changing habits have made these measures too difficult to read for the time being.

The problem was that more reliable indicators such as MO and the exchange rate pointed to some countervailing adjustment in interest rates.

It was of course inevitable - and right - that sterling should fall following the halving in the oil price. But sterling's decline had gone beyond the point where oil seemed to be the only factor at work. And in the light of this it was desirable to seek to bring the growth of MO, which is still in its target range, back towards the centre.

I judge that interest rates of 11 per cent at the short end, a margin of [7 per cent] over dollar rates, and up to 8 per cent in real terms are quite sufficient given the prospects.

And the prospects are good. When I speak to you next year, though I expect we shall have seen more turbulence, we shall also have seen further successes. I shall be looking forward to even greater success in 1988. We shall then have had 7 years of economic growth. Inflation will be at 1950s and 1960s levels. And we shall be that much closer to the complete elimination of inflation which is the ultimate objective of current policies.

I shall stick to present policies in the future as in the past. And I shall do so because they succeed.

Circulated from here.

World Economy

Turning from the details of monetary policy and the exchange rate to the world economy more generally, I

am struck by the way in which the consensus among Finance Ministers is spreading from broad economic strategy into microeconomic policies.

- We agree on the cardinal importance of controlling inflation. And we agree that the way to do this is through monetary and fiscal policies.

- We agree on the need to improve the supply performance of our economies. And more and more countries are coming to realise that the way to do this is by liberating market forces, through privatisation, deregulation, and tax reduction.

- We agree on the need for free markets to operate at the international level, as well as domestically. When I spoke to you last year, I said that a theme of the international meetings had been recognition of the need to halt the protectionist tide. A major step forward was taken last month in Uruguay, with the agreement to hold a further GATT round covering not only manufactured goods but agriculture and services as well.

FROM: MRS J R LOMAX
DATE: 13 OCTOBER 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Mr Hudson
Mr Ross Goobey

MANSION HOUSE SPEECH

I attach a redraft of the section on the speech dealing with the Big Bang, taking in your comments and some further thoughts of my own.

2. I am not quite sure I have achieved the desired effect on short-termism, though I have inserted a trailer early in the speech and re-jigged the final section to give it more prominence. Do you want to repeat some of the CBI material? Or say something new?

3. You also wanted to beef up the reference to British firms' success in those international activities which have not been, in some sense, protected. Having checked with DTI and the Bank, I doubt whether this can be pushed any further. The foreign exchange and insurance examples stand up reasonably well. But the Bank's view is that UK houses (as distinct from London) have performed rather poorly in Euromarkets. Their share of the market has remained steady at around 10 per cent, at a time when UK borrowing has risen substantially. This week's Economist makes the same point: "Euromarkets are centred in London and have always been open to all. Yet, Warburg apart, British firms do not feature as serious players in the Euro equity market. In the Eurobond

market, the top five runners are all foreign....even before of the Big Bang only eight of the top twenty brokerage firms in the City are still in British hands".

4. I have had two additional thoughts: the first is about predatory pricing, and is directed at the Japanese. This is a serious worry in the City and a warning shot across the bows would be well received. But it raises the question of what we are going to do about it, and I am not sure what the answer is. You will want to think carefully whether to use it. (I suspect the Bank would on balance favour something like this).

5. The second thought is an answer to the Economist's criticism that the new legislation misses an important opportunity. I have put something in about close co-operation between supervisors, lead supervisors, and the need to monitor the new arrangements carefully etc.

6. Incidentally I doubt if Sir N Goodison would find it helpful to be referred to as the new chairman of the International Stock Exchange, ahead of next month's vote. I think the reference will go from the Governor's speech too. I have substituted a less specific tribute.

RL.

RACHEL LOMAX

FROM: MRS J R LOMAX
DATE: 13 OCTOBER 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Mr Hudson
Mr Ross Goobey

MANSION HOUSE SPEECH

I attach a redraft of the section on the speech dealing with the Big Bang, taking in your comments and some further thoughts of my own.

2. I am not quite sure I have achieved the desired effect on short-termism, though I have inserted a trailer early in the speech and re-jigged the final section to give it more prominence. Do you want to repeat some of the CBI material? Or say something new?

3. You also wanted to beef up the reference to British firms' success in those international activities which have not been, in some sense, protected. Having checked with DTI and the Bank, I doubt whether this can be pushed any further. The foreign exchange and insurance examples stand up reasonably well. But the Bank's view is that UK houses (as distinct from London) have performed rather poorly in Euromarkets. Their share of the market has remained steady at around 10 per cent, at a time when UK borrowing has risen substantially. This week's Economist makes the same point: "Euromarkets are centred in London and have always been open to all. Yet, Warburg apart, British firms do not feature as serious players in the Euro equity market. In the Eurobond

market, the top five runners are all foreign....even before of the Big Bang only eight of the top twenty brokerage firms in the City are still in British hands".

4. I have had two additional thoughts: the first is about predatory pricing, and is directed at the Japanese. This is a serious worry in the City and a warning shot across the bows would be well received. But it raises the question of what we are going to do about it, and I am not sure what the answer is. You will want to think carefully whether to use it. (I suspect the Bank would on balance favour something like this).

5. The second thought is an answer to the Economist's criticism that the new legislation misses an important opportunity. I have put something in about close co-operation between supervisors, lead supervisors, and the need to monitor the new arrangements carefully etc.

6. Incidentally I doubt if Sir N Goodison would find it helpful to be referred to as the new chairman of the International Stock Exchange, ahead of next month's vote. I think the reference will go from the Governor's speech too. I have substituted a less specific tribute.

RL

RACHEL LOMAX

MANSION HOUSE SPEECH: DRAFT

It is just over a fortnight since I returned from the annual meetings of the IMF and World Bank in Washington. As I had occasion to observe then, the past few weeks have seen an almost unhealthy preoccupation, in the markets and in the press, with very short-term concerns. Myopia is not of course the monopoly of financial markets: indeed I am on record as describing short sight as British industry's besetting weakness.

Maybe the two phenomena are not unrelated: it is sometimes suggested that the myopic tendencies of British industry are reinforced by the growing influence of financial markets, with their heavy emphasis on short-term performance.

With Big Bang less than a fortnight away, it is a disturbing thought, and one I shall return to later tonight. However - if only to set an example - I want to start by offering a longer-term perspective on the changes that are taking place in financial markets and what they mean both for policy and for the rest of the economy.

Big Bang

Big Bang, and all it stands for, is above all a response to intense international competitive pressures. Deregulation and new technology have transformed financial markets worldwide. The major financial centres are fast becoming part of a global market in which innovation is a way of life, and traditional distinctions, between national and international markets, and between different kinds of financial institutions, are becoming increasingly blurred.

Few sectors of the British economy have had to move so far or so fast to stay ahead of the international game. Supposedly ~~conservative, even~~ fusty, City institutions have shown a capacity for radical long-term thinking that the rest of British industry might do well to emulate.

A fair share of the credit for all this must go to Sir N Goodison and his team, for their far sighted leadership.

The Government has had to move swiftly too. Constructing a credible regulatory framework, flexible enough to cope with continuing change, has already absorbed an immense amount of legislative time and effort.

No one here tonight needs reminding that the Big Bang is only a beginning. I look forward to hearing a progress report at this occasion next year.

The proposal to merge ISRO and the Stock Exchange, and to create an International Stock Exchange in London , could mark a further historic step towards integrating domestic and international securities markets.

Major challenges lie ahead for everyone concerned - for the new self regulatory bodies and the authorities as well as for market practitioners.

A great prize is within our grasp, if we can rise to these challenges. The chance to make London the undisputed financial capital not just of Europe, but perhaps of the world too.

A thriving financial sector is crucial to the success of any free enterprise economy. But what we have here in London is much more: a national asset with enormous potential, whose development will bring great benefits to the whole country.

Borrowers and lenders alike stand to gain from the development of more efficient capital markets. The Government - and the taxpayer - have an obvious interest in a more liquid gilts market, which will allow the PSBR to be financed on finer terms.

A more vigorous capital market will expand the range of possibilities for industry too, enabling companies to tap new sources of funds: to hedge a wider variety of risks, through new markets in futures, options and swaps: and to finance investment and expansion, through new instruments, capable of meeting an increasing range of individual needs.

The City is the heart of one of Britain's fastest growing and most successful industries, with an impressive record in creating new jobs. Financial and ~~borrowers~~ business services now employ 2 million people - a 15% increase on]979.

London's success will generate new ideas and opportunities whose influence will be felt far beyond the Square Mile, to the ultimate benefit of smaller companies and private investors who have no aspirations to dabble in international capital markets.

Of course, competition and change carry high risks as well as high rewards - not least for those individuals whose telephone digit salaries have attracted so much attention.

The new climate will be too bracing for some.

But I do not share the pessimism of those who fear that British players will account for a disproportionate share of the casualties. However level the playing field, the home team is not without its advantages. British firms have moved swiftly to attract new capital. And I am encouraged by the thought that London survived as a major financial centre through four decades of exchange controls partly because, in the areas where British firms were free to compete[- such as insurance and foreign currency business -]they showed a strongly international outlook.

We have made it clear, too, that while our financial system works without prejudice to nationality, the Government is committed to obtaining reciprocal treatment for British firms in other financial centres.

My Ministerial colleagues and I have made this position clear to the Japanese authorities and I am pleased to say that in the past year or so ~~7 UK~~ 5 more UK-owned houses have been granted licenses to operate in Tokyo. More are ~~in prospect.~~ on the table. ~~We expect this~~

As a final sanction, the Government is taking statutory powers in the Financial Services Bill to allow it to refuse to authorise, or to remove authorisation from, any financial institutions, including banks, whose national authorities do not provide reciprocal facilities for British firms.

That said, British players will certainly face stiff competition from some well capitalised and experienced foreign concerns.

The first line of defence must always be sound management. There is no long-term advantage in the single minded pursuit of market share, at the expense of a prudent assessment of market opportunities and realistic pricing of risk.

Let me add that the authorities are alert to the risk that predatory pricing could erode the benefits of the freer competition we have sought so actively. Our attitude is plain. Whatever the short-run benefits to the consumer, such practices are ultimately anti-competitive and potentially de-stabilising for the system as a whole.

That is not to deny that there may be occasional failures: there may very well. It is not the Government's job to prevent financial companies from going out of business through their own mis-management - though the Government has a clear responsibility to minimise the risk of their customers being dragged down with them.

The Government also has a duty to maintain the soundness and integrity of the financial system. But the private sector has a part to play too. And I am in no doubt that the system will be better able to weather the occasional storm if those who profit from freer markets take the opportunity to strengthen their capital base.

The banking system's experience with sovereign debt in the 1970s is instructive. Banks have made considerable progress in increasing their capital ratios since 1982. But other financial institutions might usefully consider whether this episode holds lessons for them too.

<u>Regulation</u>

One casualty no-one can afford is London's reputation for integrity and sound dealing.

The Government~~s~~ attach the highest importance to effective supervision, investor protection and the energetic prosecution of fraud.

On fraud, as the Home Secretary recently announced, the Government has decided to accept most of the Roskill Committee's recommendations, including the creation of a new Serious Fraud Office. The new office will build on the experience gained in running the Fraud Investigation Group, which I announced two years ago. It will house a team with expertise in tackling the most serious and complex cases, taking them all the way through from investigation to prosecution.

Its creation will, I am confident, mark a major advance in the battle against fraud.

I am confident too that new legislation will provide a greatly improved framework for regulating financial services, capable of providing clear ground rules, while retaining the flexibility needed to keep pace with changing market structures.

The Building Societies' Act has already received Royal Assent and comes into force on 1 January next year.

The Financial Service Bill is now passing through its final Parliamentary stages. The task of providing a comprehensive framework for all investment business has been truly Herculean. The next task is no less demanding; to get the new systems up and running without delay - and to make sure that they work.

To complete the picture, the Bank of England has greatly increased the resources devoted to banking supervision, and the new Board of Banking Supervision is already in operation. I hope shortly to introduce a new Bill to strengthen the statutory framework within which the Bank operates.

These arrangements will not, of course, operate in water tight compartments. Lead supervisors will be nominated for financial conglomerates, whose activities span several supervisory regimes. And close co-operation between supervisors will be needed, both to monitor the implementation of the new framework, and to ensure that it continues to reflect changing market activities.

[I would not be rash enough to claim that the framework we have put in place will last for all time, given the changes to financial markets still in prospect. But I predict that it will stand us in good stead for some years to come.]

Of course I well understand the concerns of those who argue that regulation has economic costs; and who point to the risk that, by insisting on high standards here, we will put ourselves at a competitive disadvantage relative to centres with laxer regimes.

We hear a lot too of the risk that a version of Gresham's law will operate - with weak supervision driving out the strong.

I am glad to say I see no sign yet of a "competition in laxity". Indeed there is an increasing recognition in New York and Tokyo that a competitive bidding down in regulatory standards would be in no-one's interest.

But the rapid pace of change in financial markets makes it impossible- -and dangerous - to be complacent.

All supervisors - in securities as well as in banking - and particularly those in the major financial centres, must put international co-operation high on their list of priorities.

The harmonisation of regulatory standards raises formidable conceptual as well as practical problems. But there can be no dodging the issue: that must be our ultimate goal.

I make no apology for dwelling at some length before this audience on the preoccupations of financial institutions and markets. But it is important for the rest of British industry to be alive to the potential risks as well as the opportunities presented by Big Bang.

I have already referred to British industry's propensity to take a short-term view: to investment, research and development expenditure, industrial training and pay.

It is a luxury few can afford.

Certainly the country cannot afford it. Whatever our prowess as an exporter of financial services - and I believe it will continue to be considerable - our future employment and prosperity will always depend on achieving excellence over a wide-range of economic activities.

Some industrialists put the blame on financial markets. They claim that their ability to take decisions in the long-term interests of their company is inhibited by an excessive emphasis on short-term performance by fund managers.

If there is some substance in this complaint - and I suspect there is - those industrialists will need to devote some effort over the next few years to nurturing long-term relationships with their investors. They might also consider how far the demand for short-term performance can be traced back to the pressure they themselves exert, as managers of their own pension funds.

Wider share ownership

The encouragement that this Government is giving to a wider spread of individual shareholding should help, since the small shareholder often develops a loyalty to the company in which he invests which leads him to take a longer-term view than many large institutional investors.

Over the past 7 years more and more families have felt able to increase their ownership of assets beyond their own homes. Even before the TSB flotation, the number of individual shareholders had doubled since 1979. The biggest single step was the privatisation of British Telecom, a company which still retains over 2 million shareholders two years on. More recently the TSB - albeit something of a special case - has started life as a plc with no fewer than 3 million shareholders.

The PEP scheme which I introduced in my last Budget offers a further opportunity to increase the numberof individual shareholders. With the positive ~~enthusiastic~~ co-operation of a number of institutions, including the Stock Exchange and some of the clearing banks ~~and building societies~~, the details of this scheme are now virtually finalised, and I hope to lay the necessary regulations before Parliament in the near future in good time for the scheme to start as planned next January.

CECS ✓

This popular enthusiasm for share ownership comes at a time when new technology should offer increasing scope for cutting costs on small share deals. So there is a last a real prospect for reversing the long-term trend to institutional owernship of British industry.

[~~For the reasons I have given~~] I hope industry for its part will give a positive welcome to the increasing number of small shareholders - even if it involves them in some extra costs.

SM/MH

~~SECRET~~

CONFIDENTIAL

~~cc Mr Allan~~

RS/~~Governor~~

THE ECONOMY

In surveying economic developments over the past year and the prospects for the future, it is not difficult to pick out the most important single event.

When we met last year, the world oil price stood at just under $30 a barrel. By January, it had fallen to $22, and in July to below $10, before coming back to round about the present figure of $14-15.

Monetary Policy and the Exchange Rate

This has, of course been a key part of the background against which we have been operating monetary policy.

On this occasion, last year, I set out our financial strategy in the clearest terms. The Government was determined to reduce inflation further. There was only one way. By continuously monitoring the indicators of monetary conditions, and ensuring that they were consistent with continued lower inflation. If one indicator deteriorated, we would require convincing evidence from the others before concluding that this was acceptable.

We have done exactly that. And done it against an exceedingly difficult world background, with periods of great turbulence.

Last year I pointed to the Plaza accord to facilitate a fall in the dollar. And the dollar has indeed fallen. By over 20 per cent against all currencies. Against the mark it is down by 43 per cent and against the yen by 54 per cent. Looked at over the year, the smoothness of the adjustment has been remarkable. But such changes cannot take place without some upheaval and times of intense speculation in financial markets.

This time last year I did not know that oil prices were going to fall by half, with profound effects both on output and financial balances throughout the world.

You will not therefore be surprised to hear that the pursuit of a constant policy has not been easy. At times we have had to move a little here and there with the storm. But we have never lost sight of our great purpose. And we have refused to be buffetted by every small wind [reference to January 1986]. Throughout we have been guided by our strategy, and guided by it we shall continue to be.

So we did not rush to make a change in interest rates in the supercharged atmosphere of the last four weeks [before and after the Washington meetings]. Even though it was clear to us as well as the markets that some change would be needed. The excessive expectations and exaggerated comment which were being generated could have led to excessively high interest rates. Instead we waited for a period of calm. And then acted in line with the needs of our strategy.

My judgement is this. Public borrowing, as today's figures show, is on track. Monetary conditions had however eased.

A lot is said about broad money and credit, but this was not on its own a matter of serious concern. [The growth of broad money has not accelerated over the last few months. But more importantly] Financial liberalisation and changing habits have made these measures too difficult to read for the time being.

The problem was that more reliable indicators such as MO and the exchange rate pointed to some countervailing adjustment in interest rates.

It was of course inevitable - and right - that sterling should fall following the halving in the oil price. But sterling's decline had gone beyond the point where oil seemed to be the only factor at work. And in the light of this it was desirable to seek to bring the growth of MO, which is still in its target range, back towards the centre.

I judge that interest rates of 11 per cent at the short end, a margin of [7 per cent] over dollar rates, and up to 8 per cent in real terms are quite sufficient given the prospects.

And the prospects are good. When I speak to you next year, though I expect we shall have seen more turbulence, we shall also have seen further successes. I shall be looking forward to even greater success in 1988. We shall then have had 7 years of economic growth. Inflation will be at 1950s and 1960s levels. And we shall be that much closer to the complete elimination of inflation which is the ultimate objective of current policies.

I shall stick to present policies in the future as in the past. And I shall do so because they succeed.

World Economy

Turning from the details of monetary policy and the exchange rate to the world economy more generally, I

World Economy

Turning from the details of monetary policy and the exchange rate to the world economy more generally, I

am struck by the way in which the consensus among Finance Ministers is spreading from broad economic strategy into microeconomic policies.

MOM: Spreading consensus.

- We agree on the cardinal importance of controlling inflation. And we agree that the way to do this is through monetary and fiscal policies.

- We agree on the need to improve the supply performance of our economies. And more and more countries are coming to realise that the way to do this is, as in the UK, by liberating market forces, through privatisation, deregulation, and tax reduction.

HPE: developing and indebted.

mom

h

- We agree on the need for free markets to operate at the international level, as well as domestically. When I spoke to you last year, I said that a theme of the international meetings had been recognition of the need to halt the protectionist tide. A major step forward was taken last month in Uruguay, with the agreement to hold a further GATT round covering not only manufactured goods but agriculture and services as well.

- Co-operation between Finance Ministers was taken further when we met in Tokyo in June, when we agreed to improve the process by which we work towards greater consistency in economic policy. // This co-operation has been achieved partly because governments are concentrating more and more on policies which will make for sustainable, non-inflationary growth in the medium-term. This must be a better approach than making dramatic changes of policy to deal with short-term problems.

HPE

HPE

~~The~~ Both primary producers and industrialised countries have been going through a difficult phase of adjusting to the major shifts in relative prices which have occurred over the past year or so. The dollar, commodity prices, and oil price have all changed by huge amounts. Inevitably some aspects of that transition were not fully foreseen.

HPE new page

The initial effect has been to slow down the growth of world activity. But this pattern comes as no surprise. After each of the massive oil price increases in the seventies, there was a delay of several months before output was decisively affected. The benefits of cheaper oil have yet to emerge, and I remain optimistic about the outlook for the world economy over the next year.

Domestic Economy

As the fifth largest oil producing nation the UK has been more affected than most by lower oil prices. But even so the broad pattern of developments this year has been in line with expectations at the time of the Budget.

The Budget itself was prepared against the background of falling oil prices. I used a $15 oil price in preparing the arithmetic and although it fell below that figure for a time it has proved a useful working assumption.

P. Sedgwick: Delete or make clear that £5½ bn was Bgt forecast.

On this basis, The Exchequer lost some £5½ billion in prospective oil revenues this year but I was still able to cut taxes slightly and keep Public Sector Borrowing at around 2 per cent of GDP. [You will have seen from the figures published today that so far we remain on track.]

Domestic demand has risen rapidly this year as we expected. And inflation has fallen sharply to under 3 per cent today - better than forecast anticipated and the lowest for nearly 20 years. Even excluding the beneficial effects of lower mortgage rates it has been only a little above 3 per cent.

But we have been disappointed by the growth of world trade. Imports to the industrialised countries have accelerated along with higher domestic demand but the oil and commodity producers have cut back their imports much faster than anticipated.

As a result, after 5 years of steady growth of about 3 per cent a year, UK output growth this year has been slower than I envisaged at the time of the budget. But I do not expect that slower growth to continue for long and next year output growth should be both faster than this year and faster than ~~anticipated~~ I forecast at Budget time. Already there are encouraging signs. After a slowdown earlier in the year, manufacturing output rose by ~~0.6~~ half a per cent in the three months to August, compared with the previous 3 months.

P. Sedgwick.

While domestic demand ~~[is expected to]~~ should grow next year / in 1987 at about the same rate as this year, exports should continue the better performance of recent months. In particular, the exports of non-oil developing countries should benefit from the strong domestic demand growth in the industrialised countries, and in time this should translate into a recovery of imports from the industrialised world.

P. Sedgwick wd delete or scale down.

Following the sharp fall in inflation this year, it will be difficult to avoid some increase next year.

MOM

cannot expect to continue to
Obviously we are currently benefiting from the sharp
fall in the oil price and most other commodities to
the same as we are now
an extent that will not continue. But at the same
certainly falling too
time inflationary expectations are being ratcheted
down and I do not expect to see much change in the
underlying inflation rate in the months immediately
ahead. Excluding the mortgage rate inflation may
or slightly higher in
continue to run at a little above 3 per cent. That
same measure may rise a little in the first half of
benefits
next year as the beneficial effects of lower oil
prices fade but I expect it to return close to 3 per
cent by the end of next year.

There should be no doubt about the firmness of our resolve on inflation. Not only are we determined that there should be no resurgence of inflation. Our aim is to eliminate it altogether.

current account

The most intractable problem remains unemployment although there are hopeful signs in today's figures, which show that seasonally adjusted unemployment fell by 22000 in September. Vacancies are at their highest level since the end of 1979. And it bears repeating that since June 1983, nearly a million new jobs have been created, and total employment has risen for 13 successive quarters - the longest
employment approaching 30
period of continuous growth for 20 years.
Unemployment has failed to respond in the same way primarily because of the growth in the workforce.

[We have sought to tackle unemployment through measures which will contribute to the long-term growth and development of the economy. Thus for young people we have concentrated on schemes such as the new 2-year Youth Training Scheme, which make for a more highly skilled workforce in future. And youth unemployment is now below the Common Market average, and falling. For the long-term unemployed,

a wide range of measures from our Restart programme,

we offer, [for example, assistance for those who want

which eases them back into the job market,

to set up their own businesses, ~~who may then~~ create

and so

jobs for others.]

Conclusion

One of the themes of my speech today has been the rapid changes in the world economy. Against this background, it is tempting to focus exclusively on short-term considerations. But the very fact of rapid change makes it all the more important to concentrate on objectives for the medium and long-term, and how best to achieve them.

As a Govt we have set out econ policies in med-term framework

[We have tried to do this in Government.] The medium-term financial strategy has been, and will continue to be, a discipline for us, and a stable framework within which the private sector can plan. We have always made clear our policies of tax reduction, tax reform, privatisation, and wider share ownership, which I reaffirmed last week.

The fin. mkts equally need to look ahead.

[Looking ahead is also important in the financial ~~markets~~. The firms who succeed after Big Bang will need strong strategic leadership, as well as shrewd dealers.]

Perhaps most important of all, industry needs to look to the long-term, to seize the opportunities that will come the way of British firms which can compete in world markets. This means more research and development, better training, and a more realistic approach to pay and costs.

The events of the past year have revealed the underlying strength of the British economy. I can assure you, my Lord Mayor, that I shall do all in my power to maintain the policies which created that strength.