PO-CH/NL/0240

PART B

Part B.

CONFIDENTIAL
(Circulate under cover and
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Begins: 14/10/86.
Ends: 17/10/86.

PO -CH /NL/0240
PART B

Chancellor's (Lawson) Papers:

THE MANSION HOUSE SPEECH
1986

DD's: 25 Years

20/12/95.

PO -CH /NL/0240
PART B

SM2/57

Mr Hudson
All good ideas. Mike Neilson may be able to help on X.
RL.
16/10.

FROM: A P HUDSON
DATE: 14 OCTOBER 1986

CHANCELLOR

cc Mrs Lomax
Miss O'Mara

MANSION HOUSE SPEECH

Three overnight thoughts on the section on Big Bang.

(a) Jobs

Perhaps we could make a bit more of the increase in jobs in the financial sector. Either we could gloss it by saying something like "so much for those who regard the financial sector as, at best, an optional extra in the economy." Or, better, we could try to find an interesting comparison with other sectors over a 7 year period. I shall pursue the latter during the morning. X

(b) Wider share ownership

Could we work in a point on short-termism? "The 1100 and more companies who have introduced employee share schemes since 1979 have recognised the long-term benefits of giving their employees a financial stake in the success of the company. The same applies to companies who have given their key executives 1984 share option schemes."

(c) Stamp Duty

Big Bang will trigger the further cut in Stamp Duty. I realise this is not an entirely happy memory for all concerned. But it may merit a mention perhaps towards the top of page 2 of the present draft. "The Government has had to move swiftly too. The further reduction in

429/20

Stamp Duty from 27 October will reduce one barrier to competition. And constructing a credible regulatory framework ..."

AH

A P HUDSON

12.46

CONFIDENTIAL

FROM: A P HUDSON

DATE: 14 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

... Further to my minute of yesterday, I attach the first four pages of the section on the economy, which were not circulated before today's announcement.

APH

A P HUDSON

SM/MH

~~SECRET~~

CONFIDENTIAL

~~to Mr Allen~~

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 <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.

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

FROM: **P N SEDGWICK**
DATE: 14 OCTOBER 1986

SIR T BURNS

cc Mr S Davies
Miss O'Mara
Mr Hudson AH 14.10.

MANSION HOUSE SPEECH ON ECONOMIC PROSPECTS

I thought that it would be worth letting you have some comments from Stephen Davies and me on the Domestic economy section of the draft Mansion House Speech before the Chancellor's meeting at 5.30 pm (which I am to attend).

2. In general we think that this draft gives away - if that is the right terminology - too much of the forecast that will be published in the Autumn Statement.

3. In particular I suggest

(i) that we delete - or at least scale down drastically - the paragraph on inflation next year; this goes into far too much detail before there has been a decision on how to present the inflation forecast in the autumn statement (eg what the Autumn Statement will say about the mortgage rate, the prospects for which might be clearer by then);

(ii) that we either delete the paragraph on the scaling down of oil revenues or make it quite clear, which the present text does not, that the Chancellor is discussing what was considered to be the prospective loss at budget time; our latest view is that in 1986-87 the loss of oil revenues is somewhat greater (because of lower than expected average oil prices) whereas non-oil revenues are a little more buoyant than expected at budget time, and we will need to present this minor change to the prospects for government revenues very carefully in the Autumn Statement;

and (iii) that at this stage we refrain from giving the impression that we are providing a forecast that the growth in domestic demand will continue at the present rate; the paragraph (on P.8) that contains the proposition could be redrafted to make it absolutely clear that it is about trends in the very short term.

P.N.S

P N SEDGWICK

0447D

14.10.86

THE GOVERNOR

Copies to Mr Loehnis
Mr George
Mr Walker
Mr Flemming
Mr Warland
DGPS

MANSION HOUSE SPEECH

I attach a further version of this speech.

Governor's Office HO-P
14 October 1986

J R E Footman (4121)

cc Sir P. Middleton
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
Mr Hudson

Comments on the previous version are with the Chancellor.

AH

0708A

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. Consummation of the proposed merger between the Stock Exchange and ISRO will, if I may say so, represent a fitting culmination to these years of achievement.

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 terms.

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 uncertainties that they breed, not least among 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. Thanks to

lower oil prices, the exchange rate change needed to effect the current account adjustment need not add to the risk of renewed inflation. But in the short term, 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. Part of the solution must be a sharp reduction in the general level of pay settlements. Recent indications 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.

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 monetary policy is progressively to squeeze out inflation, and the major 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 overshot in the United States and even in Germany and Japan. In all of 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.

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 measure have been growing uncomfortably fast.

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 refused to be rushed into hasty policy decisions by this period of market turbulence, and have acted to moderate the more erratic movements in both the domestic and foreign exchange markets. But it would be a great mistake to interpret this determination not to be swept off one's feet in the short run as a reluctance to take necessary policy action at the appropriate moment - as our action on Tuesday showed. Markets deliver important signals; but they also generate a degree of hubbub and it may take time to distinguish the true signal above the noise.

8 My Lord Mayor, great changes in the City are due to be implemented next month: after three years of preparation the changes known as the Big Bang are about to be implemented. They mark the largest changes that have taken place in the City in the lifetimes of anyone present tonight, and 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 These developments in the way in which business is done and in the membership rules of the Stock Exchange were of course quite deliberately intended to open up the market to competition. There is every sign that they have succeeded in releasing a great burst of energy and talent, not only in the Stock Exchange but in many other financial markets. All this is very healthy and welcome, but we need to keep in mind that competition brings risks

as well as benefits and can be a destructive as well as a constructive force. Regulation is being modified to accomodate and promote competition, and to ensure that markets are well conducted and investors reasonably protected. Of course, there may be losses, and it is possible that some of the participants in these highly competitive markets will eventually withdraw. No one should regard that as a failure. Moreover there are clear limits to the extent to which regulators can or should influence the conduct of business.

10 Consequently it will be vital for all participants in markets to exercise a degree of restraint. Market-makers and broker-dealers will naturally strive to secure a market share which will support the capital committed to their business. But if this leads to excessive margin-cutting, they will store up trouble for themselves; and we could not regard with equanimity a situation in which market share was acquired aggressively through predatory pricing - in the longer run, this could work to undermine the competition that we have striven to introduce. Similarly, I should like to see institutional investors recognise their interest in being able to deal with a wide array of soundly-based intermediaries, and that they will exercise restraint on their use of their bargaining power. I hope also that we will continue to avoid levels of gearing in the corporate sector as a whole which, although sometimes acceptable in favourable market conditions, could prove to be seriously destabilising if markets become unfavourable.

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.

PWP.

THE MANSION HOUSE SPEECH

- IS 1% ENOUGH?

- 1% on base rates represents the Chancellor trying to buy monetary stringency on the cheap.

- Pressure is likely to resume soon for even higher rates, unless the Chancellor is able to come up with a new policy initiative on Thursday. 1% is too little, too late.

- There are a number of measures the Chancellor could take to restore confidence, including restrictions on credit, a resumption of over-funding, or a move to Money GDP targets. But none seems likely.

- We expect the Mansion House speech to be "a snow job", with the Chancellor trying to stand on his action in raising rates, and arguing that the inflation, balance of payments, and growth prospects are not as bad as many outside forecasters suggest.

- The market's hopes for EMS entry will have received a dowsing from the increase in rates. This will not help reaction in the gilt market.

ROGER BOOTLE

14th OCTOBER 1986

For the second time in a week the City is all agog to hear what the Chancellor of the Exchequer has to say in what is billed as a major speech. If the City was understanding of the need for a bit of political knockabout at the seaside, it has the right to expect something more substantial at the Mansion House. For the Government's monetary policy is in a mess and the financial markets are nervous and cynical. At long last, today the Chancellor has decided to act by forcing base rates up by 1%, thus apparently setting himself up for a tough speech on Thursday. But the markets are unlikely to regard this action, coming as it does just after a period of benign neglect during the Tory Party Conference, as either tough or decisive. In these circumstances the Chancellor's words will command at least as much attention as his action. Specifically, can he assure markets that 1% on interest rates is enough?

The Background

Last year's Mansion House speech, though full of the usual platitudes about the role of the City, the benefits of competition and the Government's achievements, was far from being a damp squib of a speech. This was the occasion when the Chancellor effectively suspended the £M3 target and announced the end of over-funding. So it is not inappropriate to expect something serious this Thursday.

The Chancellor also tried to clarify the framework of monetary policy. And in many ways it was his very explicitness last year which makes his task more difficult this year. He said:

> "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 markets' 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 half years."

And:

> "If the performance of one indicator were to deteriorate we would need convincing evidence from the other indicators before concluding that this was acceptable."

And again:

> "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."

It is not going to be easy to square these statements with the current position. On its trade weighted index sterling is 16% lower than when Mr. Lawson spoke at the Mansion House last year. Against the Deutschemark it has fallen by 25%. Since the Budget the pound has fallen by 11% and 16% respectively. Meanwhile £M3 at the latest count was growing at 18 1/4%, year-on-year, and no less than 22 1/2% over the last six months annualised.

This easily surpasses the top of the 11-15% target range which surprised gilt operators by its generosity when announced in the Budget. And dear old little M0, although growing within its target range, has shown distinct signs of acceleration over the last few months. How can the Chancellor, with reference to the criteria he himself set out last year, argue that 1% on interest rates is enough?

The Dangers of 1%
The authorities have decided to try to buy the markets off cheaply with an increase in interest rates of only 1%. This will enable the Chancellor to claim in the Mansion House speech that he is prepared to take decisive action to maintain the anti-inflationary thrust of monetary policy. But it is unlikely to cut much ice. Indeed in many ways, 1% on base rates is about the worst thing the authorities could have done. It will have little effect on the problem of burgeoning credit growth, and will do little to offset the political, competitiveness, and oil-based worries besetting the pound. The market will feel that further increases are on the way. Meanwhile, the markets' hopes that Britain may be about to join the EMS will have taken something of a dowsing. In our view, therefore, the Chancellor has made a mistake by raising rates by 1%.

There were three options:

i. To face out the crisis and do nothing;

ii. To raise interest rates decisively (2% or more);

iii. Join the EMS.

Given that the Chancellor has opted for only 1%, he has the option of trying to back this up with further measures, or at least with words in Thursday's speech. What could he say to strengthen his case.

A Possible Defence
In last year's speech, one of the Chancellor's most significant phrases was:

"The inflation rate is judge and jury."

Although RPI inflation is currently picking up somewhat, he can try to argue that the recorded RPI rate has been below the underlying rate and that it is about to catch up, or even perhaps temporarily to overshoot it, while the underlying rate is little changed. To back this up he can point to the offsetting effects of lower oil and commodity prices against the effect of a lower pound. And there is a good deal in these arguments. Even with the lower pound, we do not see inflation moving much above 4% by the end of next year. But these arguments are wearing a bit thin. Whatever the ability to contain the upward movement of inflation next year, short of a major downward shift in wage inflation, (which we do not expect) the trend looks adverse, and any **further** sterling weakness would pose dangers of a major increase in inflation both next year and in 1988. And all chance of getting the downward shift in wage inflation would then be gone.

The Chancellor can also point to the argument that sterling has needed to be a good deal lower to make up for the hole in the current account of the balance of payments left by lower oil revenues. And he can seek to confound the pessimistic forecasts of the now ageing Turks (a favourite pastime of his) by arguing that a lower pound will have a beneficial effect on international competitiveness and hence head off the looming balance of payments problems.

Options for Modifying the Policy Framework
The market is unlikely to receive well any attempts by the Chancellor at tinkering with targets. And he is unlikely to waste much effort in this direction. If he **does** do something the most likely candidate variable is Money GDP whch has been appearing with increasing prominence in policy statements over the years. But the Chancellor himself has admitted that having a figure for Money GDP does not obviate the need for operational guidelines for monetary policy. It would, therefore, be difficult to make much of an increase in the status of Money GDP.

A definite option is to restore over-funding as a means of offsetting buoyant bank credit growth. On money-theoretical grounds this makes a good deal of sense, and the various practical objections which have been raised against over-funding have, in my view, been grossly overdone. (See our Economic Strategist, September 1986.) But the Chancellor chose to abandon over-funding in the Mansion House speech last year. It would hardly look good to reintroduce it in the Mansion House speech this year!

Another option is to do something directly about credit growth. The case looks strong. In the year to August bank lending to individuals for house purchase increased by nearly 26%. Nor was this increase at the obvious expense of the building societies, whose mortgage lending increased in the year to the 3rd quarter of 1986 by nearly 20% (as against 17 1/4% in calendar 1985).

Moreover, other lending to individuals has been buoyant, up 18% on the year, and total consumer credit, (which includes some categories which appear in the banking figures) is up by over 40% in the year to August.

There is little doubt that if the Chancellor were serious about regaining control of monetary conditions he could achieve the objective by a combination of restrictions on mortgage and perhaps other consumer lending, backed up, if necessary, by renewed over-funding. But the Chancellor will find this difficult. And not only for political reasons. Restrictions on credit are against his philosophy. Moreover, whatever the straightforwardly monetary worries and inflationary dangers posed by a lower exchange rate, there is little sign of the real economy over-heating. Our guess is that the Chancellor will forsake the chance to restrain credit growth.

Conclusions
We feel that the Chancellor's best option was to do nothing. Alternatively, decisive action earlier would have restored confidence. Having increased rates by 1%, we now feel that there is little chance of avoiding further increases, unless the Prime Minister can be persuaded to relent on her opposition to the EMS.

FROM: FC/DP

But the fall in the exchange rate that has now taken place has gone beyond what was necessary and desirable to match the fall in the oil price. Without a rise in interest rates to compensate, monetary ~~conditions~~ would have become looser.

15/10/86.

Reference

CODE 18.78

CHANCELLOR OF THE EXCHEQUER

FROM: A.P. HUDSON

DATE: 15 October

CHANCELLOR

MANSION HOUSE SPEECH: JOBS IN FINANCE

1. I attach a table comparing June 1986 with June 1979 for the Banking, Finance, and Insurance sector.

2. Jobs have increased by 25%, from 1.6 m to 2 m, i.e. a better figure than in the present draft.

3. Possible points to make:

(a) largest % rise of any sector;

(b) well ahead of the average for services;

(c) more than offsets the job losses in (e.g.) textiles;

(d) job gains in financial sector ~~over~~ more than double the losses in (e.g.) motor vehicles.

My feeling is that (a) is the best one, and that (c) and (d) take us into very ~~[illegible]~~ awkward territory. We don't want ~~headlines like~~ ~~[illegible]~~ people to misread it as not caring about manufacturing because we can all be bank clerks.

APH

15.10.

JUNE 1979 to JUNE 1986.

THOUSANDS

	BANKING, FINANCE, INSURANCE	SERVICE EMPLOYMENT	MANUFACTURING EMPLOYMENT	EMPLOYED LABOUR FORCE
JUNE 1979	1623·6	13,210	7,127	24,775
JUNE 1986	2028·9	13,899	5,349	24,056
CHANGE	405·3	689	-1778	-719
% CHANGE	25·0	5·2	-24·9	-2·9

Manufactury	Metal Manu.	Chemicals	Mech Eng.	Office machinery, electrical	Motor vehicles	Other transport equipment	Metal goods nes.	Food, drink, tobacco.	Textiles	Timber	Paper products.
	-262·5	-91·2	-251·0	-109·1	-186·9	-111·8	-128·2	-121·8	-296·4	-152·1	-61·2

Services.	Wholesale distribn	Retail distribn	Hotels + catery	Transport	Postal services	Public admin	Edu +	medical	other services
	118·7	72·0	132·4	-197·9	+11·3	-117·8	-17·0	146·5	143·8
% Δ	10·8	3·4	14·1	-19·0	2·7	-13·0	-4·0	12·4	11·4

Ch.

Figures from D. Peretz on personal debt ratios.

Table 2: Debt/Income and Gearing Ratios

	Debt/Income (%) UK	Debt/Income (%) US+	Gross Liquidity Ratio (%) +	Gearing ø (%) UK
1976-80 (average)	49.8	77.0	67.3	3.6
end year				
1981	53.4	76.6	69.6	5.3
1982	59.1	76.1	73.1	5.2
1983	64.7	79.3	76.1	5.3
1984	70.2	81.2	79.9	6.6
1985	75.7	88.1	82.4	7.7
1986 [4]	82.7		86.2	

\+ Household sector, numbers provided by the Bank. No final figures for 1985 are as yet available, but the sharp rise reflects a rapid rise in debt and low growth of post-tax incomes.

ø interest payments to income.

\+ liquid assets (£ bank deposits, building society shares and deposits and national savings) divided into income (personal disposable income).

4 forecast - still confidential.

OIL REVENUES AND EXPORTS

As a result of the fall in the oil price, from $27 a barrel at the end of last year to around $15 now, the contribution per quarter of North Sea oil to the current account has fallen by about £½ billion, which is around 2½ per cent of our exports of non-oil goods and services.

1250/015

FROM: A ROSS GOOBEY
DATE: 15 October 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Hudson
Mr Cropper
Mr Tyrie

MANSION HOUSE SPEECH

You may already have been satisfied in your search for a light-hearted comment by the Gregorian calendar.

2. If not, might I suggest the following:

"This is the fourth time I have risen to speak on this occasion and I sense the passage of time, especially when I see the age of some of those young men who will be analysing my words tomorrow. It is no longer merely the case that the policemen are looking younger, but that the people who say that policemen are looking younger are themselves looking younger. The economic analysis in the City is now often in the hands of young men who were at primary school when monetary policy first rose to prominence".

ARG

A ROSS GOOBEY

FROM: THE GOVERNOR'S OFFICE

BANK OF ENGLAND, THREADNEEDLE STREET, LONDON, EC2R 8AH
FAX NO: 01-601 4953

FACSIMILE TRANSMISSION RECORD

CLASSIFICATION:

FROM: John Footman

TO: Alex Allan

DATE OF TRANSMISSION: 15.10.86

TIME OF TRANSMISSION: 4.10 pm

TELEPHONE ACKNOWLEDGEMENT REQUIRED YES/~~NO~~

~~MESSAGE~~:

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

Comments
as soon as possible, please.

0708A

MANSION HOUSE SPEECH

1 This is an occasion for looking back with the outgoing Lord Mayor as well as looking forward, 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. 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 in dollar terms of oil prices.

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 obverse 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 uncertainties that they breed, not least among 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 seeing this in the major industrial economies.

3 In the United Kingdom, much attention has been focussed on 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. 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 short term, 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.

MOM: Not Govt's view.

This is not to say that renewed inflation is unavoidable. Much depends on wages. Our performance to date on productivity comes nowhere near to warranting the 4-5% annual growth in real income implied by the recent gap between the growth in overall earnings and retail prices. Room does exist for some rise in living standards, but we should not forget past experience of too rapid a rise in consumption all too easily leading to burgeoning trade deficits. Part of the solution must be a sharp reduction in the general level of pay settlements. Recent indications 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.

MOM: Leads with chin.

MOM: Devalues monetary policy. Aim is to squeeze out inflation. Done that. Never expected it to do anything else.

4 Monetary policy cannot directly reduce the rise in labour costs; nor, more generally, can it bring about the improvements in industrial innovation and efficiency which are needed to take advantage of the opportunities now available to British producers in world markets. The role of monetary policy is progressively to squeeze out inflation, and the major 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 overshot in the United States and even in Germany and Japan. Many of these countries target relatively narrow aggregates which are sensitive to nominal interest rates. These have fallen last year, reducing the cost of holding narrow

money. Inflation has fallen too, indeed faster in the UK, so that real interest rates remain higher everywhere than in the 1970s. This is particularly true in the UK where it contributes to growth in demand for broad money.

6 In our own case MO, although still within its target band, has shown some recent acceleration and the target aggregate for broader money, £M3, has been growing for much of the last year well above its 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 its sensitivity 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, liquidity and credit have in fact been growing uncomfortably fast and markets have not failed to perceive this.

7 Recently there has been heavy 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 refused to be rushed into hasty policy decisions by this period of market turbulence, and have acted to moderate the more erratic movements in both the domestic and foreign exchange markets. But it would be a great mistake to interpret this determination not to be swept off one's feet in the short run as a reluctance to take necessary action at the appropriate moment - as our action on Tuesday showed. Markets deliver important signals; but they also generate a degree of hubbub and it may take time to distinguish the true signal as it emerges from the noise.

8 My Lord Mayor, great changes in the City are to take place this month: after three years of preparation the reforms known as the Big Bang are about to be implemented. They are the largest changes to have taken place in the City in the lifetimes of anyone present tonight, and represent a triumph of adaptability and vision on the part of the old and the new members of the Stock Exchange who have embraced reform so positively.

9 These developments in the way in which business is done and in the membership rules of the Stock Exchange were of course quite deliberately intended to open up the market to competition. There is every sign that they have succeeded in releasing a great burst of energy and talent, not only in the Stock Exchange but in many other financial markets. All this is very healthy and welcome, but we need to keep in mind that competition brings risks as well as benefits and can be a destructive as well as a constructive force. Regulation is being modified to accomodate and promote competition, and to ensure that markets are well conducted and investors reasonably protected. Of course, some firms may overreach themselves. There may be losses, and it is possible that some of the participants in these highly competitive markets will eventually withdraw. No one should regard that as a failure of the new system. There are clear limits to the extent to which regulators of any kind can or should influence the conduct of business.

10 Consequently it will be vital for all market participants to exercise a degree of restraint. Market-makers and broker-dealers will naturally strive to secure a market share which will support the capital committed to their business. But if this leads to excessive margin-cutting, they will store up trouble for themselves. Again, if market share is acquired aggressively through predatory pricing, it could work, in the longer run, to undermine the increased competition that we have striven to introduce. Similarly, I should like to see institutional investors recognise their interest in being able to deal with a wide array of soundly-based intermediaries, and I hope that they will exercise restraint on their use of their bargaining power. I hope also that we will continue to avoid levels of gearing in the corporate sector as a whole which, although perhaps acceptable in favourable conditions, could prove to be seriously destabilising when times become harder.

CONFIDENTIAL

MR 4/20

PWP

FROM: A P HUDSON

DATE: 15 OCTOBER 1986

SIR P MIDDLETON

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR
PS/C&E
PS/Governor

MANSION HOUSE SPEECH

I attach the first section of the Chancellor's revision of the Mansion House Speech. Please could I have any final comments as soon as possible?

APH

A P HUDSON

MANSION HOUSE SPEECH

[Introduction to come.]

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 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 Nicholas 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. Indeed, I look forward to giving a progress report at this occasion next year.

Meanwhile, the proposal to merge ISRO and the Stock Exchange, and to create an International Stock Exchange in London, could mark a further important 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 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 of enormous potential, whose success 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 gilt-edged market, which will allow the PSBR to be funded on finer terms.

Last but by no means least, 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 business services now employ 2 million people - a 15 per cent increase on 1979.

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-number salaries have attracted so much attention.

Inevitably, the new climate will prove 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 knowledge 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 internationally - such as insurance and foreign currency business - they did so successfully against all comers.

We have made it clear, too, that while we welcome those of all nations in the City of London, the Government is committed to obtaining reciprocal treatment for British firms in other financial centres.

In particular, 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 licences to operate in Tokyo. More are in prospect.

As a final sanction, the Government is taking statutory powers in the Financial Services Bill, which will shortly reach the Statute Book, to allow it to refuse to authorise, or indeed 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 increased competition we seek. I have to say that whatever the short-run benefits to the consumer, such practices are ultimately anti-

competitive and potentially destabilising for the system as a whole.

That is not to deny that there may be occasional failures: of course there will be. It is not the Government's job to prevent financial companies from going out of business, 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 as a whole. But the private sector has a part to play too. 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 and necessary progress in increasing their capital ratios since 1982. But other financial institutions might usefully consider whether this episode holds lessons for them too.

Regulation

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

The Government attaches 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 mark a major advance in the battle against fraud.

I am confident too that the new legislation we are in the process of putting on the Statute Book 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 Services Bill is now passing through its final Parliamentary stages. The task of providing a comprehensive framework for investment business of all kinds has been little short of Herculean. But the next step is no less demanding: to get the new systems up and running with the minimum of delay - and to make sure that they work.

To complete the picture, the Bank of England has greatly increased the resources it devotes 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 banking supervision is conducted.

These arrangements will not, of course, operate in watertight 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.

Of course I well understand the concern of those who argue that regulation imposes 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 - leading to a new version of Gresham's law, with badly supervised centres gaining at the expense of the well supervised.

So far I see no sign of a competition in laxity of this kind. Indeed there is increasing recognition in all major financial centres that a competitive bidding down of regulatory standards would be in no-one's interest.

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

All supervisors - in securities as well as in banking - and particularly those in the major financial centres, must always 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.

Effective investor protection is all the more important given the Government's commitment to popular capitalism.

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 quoted company with no fewer than 3 million shareholders. These are figures on a scale never previously thought possible.

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 very 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 should offer increasing scope for cutting costs on small share deals. So there is at last a real prospect for reversing the long-term trend to ever-increasing institutional ownership of British industry.

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

MR 4/20

CONFIDENTIAL

PWP

FROM: A P HUDSON

DATE: 15 OCTOBER 1986

SIR P MIDDLETON

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR
PS/C&E
PS/Governor

MANSION HOUSE SPEECH

I attach the concluding section of the Chancellor's revision of the Mansion House Speech. Middle section on monetary policy to follow. Again, please could I have any final comments as soon as possible?

APH

A P HUDSON

The Economy

Since I spoke here last year, the world has 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 in particular the oil price have all changed by massive amounts.

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

As the fifth largest oil producing nation in the world the UK has been more affected than most by lower oil prices. But despite this the pattern of developments this year has been broadly in line with what I forecast at the time of the Budget.

Domestic demand has risen rapidly this year as expected. At the same time, inflation has fallen sharply to under 3 per cent - better than envisaged and the lowest for nearly 20 years. Even excluding the effect of mortgage rates, which somewhat idiosyncratically we include in the Retail Price Index, inflation is now only a little above 3 per cent.

What has been disappointing is the growth of world trade, and thus of UK exports, particularly over the last quarter of last year and the first quarter of this. Imports to the industralised 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, overall UK output growth so far this year has been rather less than I envisaged at the time of the budget. But I do not expect that slower growth to continue for long and output growth next year should be faster than this year and faster than foreseen at the time of the Budget. Already there are encouraging signs. In particular, despite last month's freak figures, it is clear that exports have resumed the vigorous growth they showed before the pause began.

So looking ahead to 1987, while domestic demand is likely to grow at about the same rate as this year, exports should continue the better performance of recent months.

Following the exaggeratedly sharp fall in inflation this year, it will be difficult to avoid some increase next year. Clearly, we are currently benefiting from the sharp fall in the oil price and most other commodities to an extent that will not continue. But at the same 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 will probably continue to run at a little over 3 per cent.

Finally, although it is never wise to draw too many conclusions from the outturn for a single month, it is encouraging that today's unemployment figures show the biggest fall since we first took office more than 7 years ago. Job vacancies, too, are at their highest level since 1979. And it bears repeating that since the last general election a million new jobs have been created, and total employment has risen for 13 successive quarters - the longest period of uninterrupted growth in employment this country has known for almost 30 years.

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 Government, we have consistently sought to do just that. 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. And within that framework, we have always emphasized our long-term policies of tax reduction, tax reform, privatisation, and wider share ownership, which I reaffirmed in another place last week.

Industry, and commerce too, needs to look to the long-term, to seize the opportunities that are there for British firms which can compete in world markets. This means calculated risk-taking, more research and development, more training, and a more hard-headed approach to pay and costs.

The events of the past year have once again 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 brought about that strength.

MH/INT

I propose tonight to divide my speech into three sections.

I shall first say something about the City and the Big Bang, then more about the current state of the financial markets, and finally turn to the prospects of the British economy.

As everyone here tonight is all too well aware, the Big Bang is now only eleven days away.

But some of you may not be aware that we meet this evening on the anniversary of an earlier big bang. One which in its far reaching effects was even greater than the changes we are contemplating in the City. A change which all the speed generated by modern technology comes nowhere near matching. I refer of course to the implementation of the Gregorian calendar in 1582 which at a stroke moved the world on by 10 days. Actually it did not quite do that because it took Britain another couple of hundred years to come into line. This time at least, we have been a little quicker. Which perhaps is just as well.

SM/MH

APH
16.10 [illegible]

MANSION HOUSE SPEECH

[Introduction to come.]

The City and
Big Bang

AA

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. A fair share of the credit for all this must go to Nicholas Goodison and his team, for their far sighted leadership. And I know that he in turn welcomes the further halving of stamp duty, to ½ per cent, that October 27 will bring.

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

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

APH: Having said "Inevitably", do we want "if..."?

~~Inevitably~~ It is quite likely that, the new climate will prove too bracing for some. And ~~if it does,~~ it should go without saying that it will not be the ~~Government~~ authorities's job to prevent financial companies from going out of business, ~~though~~ th ~~the~~ lter is ~~Government has a clear responsibility to minimise the risk of their customers being dragged down with them.~~

APH: Omit here? We have investor protection later on.

APH: Management will need to ~~balance~~ bear in mind long-term needs as well as short term advantage.

~~The first line~~ Let me make one thing clear.

~~But~~ 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 and necessary progress in increasing their capital ratios since 1982. Other financial institutions might usefully consider whether this episode holds lessons for them too.

APH: Not v. clear. Omit?

Meanwhile, 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 knowledge 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 internationally [- such as insurance and foreign currency business -] they did so successfully against all comers.

APH: Drafting.

~~We have made it clear, too, that while~~ We welcome those of all nations in the City of London. But the Government is committed to obtaining reciprocal treatment for British firms in other financial centres.

In particular, 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

HPE: [redacted] ×

~~seven~~ five more ~~London~~ UK-owned houses have been granted licences to operate in Tokyo. More are in the pipeline.

AA Cut?

As an ultimate sanction, ~~the Government is taking statutory powers in~~ the Financial Services Bill, ~~which will~~ shortly to become law, ~~reach the Statute Book~~, will ~~provide~~ give the Government statutory powers ~~to allow it~~ to refuse to authorise, or to restrict or even to remove the authorisation of, any financial institutions, including banks, whose national authorities do not provide reciprocal facilities for British firms.

?

The authorities are also alert to the risk that predatory pricing could erode the benefits of the increased competition we seek. Whatever the short-run benefits to the consumer, such practices ~~are~~ do not make for greater competition in the long run ~~ultimately anti-competitive~~, and indeed could ~~can be~~ ~~potentially~~ destabilise ~~ing for~~ the system as a whole.

APH

X

Regulation

Amidst the changes and opportunities brought by Big Bang, we ~~One aspect of~~ ~~must not forget the~~ need to maintain ~~One casualty no-one can afford is~~ London's reputation for integrity and sound dealing.

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

The task of providing, in the Financial Services Bill, a comprehensive framework for investment business of all kinds has been little short of Herculean. But the next step is no less demanding: to get the new systems up and running with the minimum of delay - and to make sure that they work.

At the same time, the Bank of England has greatly increased the resources it devotes 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 ~~banking~~ that supervision is conducted.

~~In addition, as the Home Secretary recently announced, the Government has decided to accept most of the Roskill Committee's recommendations on fraud, including the creation of a ~~new~~ Serious Fraud Office.~~

AA.

[The arrangements we are putting in place will not, of course, operate in watertight compartments. Lead supervisors will be nominated for financial conglomerates, whose activities span several supervisory regimes. And close co-operation between supervisors will clearly be needed both to monitor the implementation of the new framework, and to ensure that it continues to reflect changing market activities.]

Cut to shorten?
AHH

I well understand the concern of those who argue that regulation imposes 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 - leading to a new version of Gresham's law, with badly supervised centres gaining at the expense of the well supervised.

This is a concern I take very seriously.

APH X But the remedy is clear. All supervisors, ~~in securities as well as in banking~~ - and particularly those in the major financial centres, must put international co-operation and co-ordination high on their list of priorities. And we are doing that.

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

APH : ? ~~that~~ harmonisation must be our ultimate goal.

Popular Capitalism

Effective investor protection is all the more important given the Government's commitment to popular capitalism. The number of individual shareholders has ~~more~~ than doubled since 1979, so

Drop. ~~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 some 2 million individual shareholders two years on. More recently the TSB - albeit something of a special case - has started life as a quoted company with no fewer than 3 million shareholders, and a recent survey suggested that over half of them ~~over half of whom~~ have never owned shares before. These are figures on a scale never previously thought possible.

EB

The Personal Equity Plan scheme which I introduced in my last Budget offers a further encouragement for ordinary people to hold shares. With the constructive co-operation of the Stock Exchange, ~~and some of~~ the clearing banks, and other institutions, the details of this scheme are now more or less finalised, and I shall be laying the necessary regulations before Parliament as soon as the House reassembles, in good time for the scheme to start as planned next January.

Mr Cassell

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 at last a real prospect of ~~for~~ reversing the long-term trend to ever-increasing institutional ownership of British industry.

Drop down to here.

Finally, on this section of my remarks, let me add this.

In a speech in Scotland last month, while paying tribute to the dramatic improvement there has been in the performance of British industry, I expressed concern at the fact that industry is still much too inclined to take the short-term view.

This manifests itself in too little spent on training, too little on research and development, and too much on pay.

But short-termism is not merely an affliction of industry: it is our national ailment. And certainly in the view of industry itself, the most virulent form of the disease is to be found among the City institutions and the financial markets.

Many industrialists and businessmen feel strongly that their ability to take decisions in the long-term interests of their compan~~y~~ies is inhibited by an excessive emphasis on short-term performance by fund managers, and by the City's vested interest on large movements on exchange rates and interest rates,

Of course, it is always easier to see the mote in the other man's eye than the beam in one's own. The Boards of large industrial corporations, for example, might pause to consider how far the demand for short-term performance can be traced back to the pressure they themselves exert on the managers of their own pension funds. And the financial markets are affected by forces that originate far outside these shores.

But I have to say that I suspect business and industry have a point, and that the distinguished gathering here tonight would do well to reflect upon it. Certainly bad blood between industry and finance is bad for Britain, and all of us need to do whatever we can to eradicate its causes.

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

~~Monetary~~ Financial Policy & the financial markets

On this august occasion, last year, I set out our financial strategy in the clearest terms. In April of this year, in a speech to the Lombard Association, I explained ~~very fully~~ at some length, how~~, in the context of that strategy,~~ monetary policy - ~~and~~ also fiscal policy, but in particular monetary policy - is conducted, in the context of that strategy.

APH

~~Since~~ Both the strategy, and ~~the~~ its implementation ~~of policy in the context of that strategy~~ remain precisely as I set out in those two speeches, you will be glad to know that I do not propose to weary you by repeating it yet again tonight.

There are, I know, those who still complain of being confused - and judging by what they write, some are indeed confused. But they are either simply complaining that the world is a complicated place, which sadly is all too true, and is something that ~~all of us~~ grown-ups have to come to terms with; or else they are so wedded to confusion that it would be grossly improper to try and separate them from it.

Ch.

So let me merely say a brief word or two about the rise in short term interest rates the Bank of England ~~I decided to bring about~~ signalled earlier this week.

Ch.

There is no problem on the fiscal front. As today's figures for the PSBR for September and thus for the first ~~6~~ six months of the financial year ~~have~~ show~~n~~, public borrowing is ~~broadly~~ on track. And this is in the context of what has for some years now been a gently declining ratio of public ~~national~~ debt to national income.

R. Norgrove

Ch x

Ch.

C

~~But I judged~~ the Governor and that monetary conditions had become somewhat easier, and needed to be tightened. This was not prompted directly by the growth of broad money and credit, although I understand the concern that has been aroused on this score. As I pointed out last year, it was clear that the liberalisation of the financial system, the end of mortgage rationing, and the increased competition between financial institutions would lead to a steady increase in the ratio of personal debt to personal income. But this rise in the personal debt ratio – to a level which is still below that of the USA – ~~to around 80 per cent~~ has been matched by a similar growth in personal holdings of liquid assets, ~~which now amount to some 85 per cent of personal incomes (and should not therefore be inflationary)~~. ~~Moreover even the present high ratio of personal debt to personal income~~ and ~~remains below the comparable figures of 90 per cent in the United States~~.

D. Norgrove

~~But~~ This is not in itself inflationary.

broad money to money GDP. One aspect has been growth of

TB/DLCP: Omit – ~~it~~ goes on about pers. sector. NB co. deposits. Discussed at meeting.

C

Broad money and credit have been growing fast, and I understand the concern that has been aroused on that score. As I pointed out last year, it was clear that the liberalisation of the financial system, the end of mortgage rationing, and the increased competition between financial institutions would lead to a steady increase in the ratio of broad money to GDP. This, indeed, has been a consistent feature of the 1980s. There is every sign that people are holding the increased amounts of broad money quite willingly. And so long as this is so, its growth is not inflationary.

One aspect of this is that the ratio of personal debt to personal income has risen. But the rise has been matched by a similar growth in personal holdings of liquid assets, and the personal debt ratio is still below the comparable figure in the United States.

So neither broad money nor credit was a trigger for this week's rise in interest rates.

~~So this on its own would not have given any grounds for concern. But~~ What could not be ignored was that more reliable indicators, such as narrow money, as measured by MO, and in particular the exchange rate, were indicating an easing of monetary conditions.

Given the precipitate collapse of the oil price, it was inevitable and indeed necessary that the exchange rate should fall so as to enable - after the inevitable delay known as the J curve - non-oil exports to rise to offset at least the greater part of the fall in oil export revenues.

DLCP: that can occur without it requiring offsetting action to keep policy on course.

Bank:

But there are clearly limits to the necessary and desirable extent of ~~that~~ a fall. Moreover~~, at the same time,~~ the growth of MO, although well within its target range, ~~was edging~~ has edged upwards, and in all the circumstances ~~I judged it~~ it seemed desirable to seek to bring it back towards the centre of the range.

It was therefore necessary, in order to maintain the financial strategy on track, to raise interest rates.

N. Lawe A

A

~~There~~ have recently ~~been those who~~ delighted in depicting the level of short-term interest rates as the outcome of a constant epic struggle between the Chancellor, always seeking to bring interest rates down, and the markets, ever seeking to push them up. Or vice versa.

APH: drafting.

674/69

A.

I know there are some - the small businessman, the home owner: people whose interests are at the heart of this Government's concerns - who are disappointed that I have had to raise interest rates at all. And of course I understand that. But the determination to defeat inflation and the willingness to take the necessary action are one and the same thing. You cannot will the end without accepting the means.

~~That~~ There are others - in the City: or at least among those who write for the City - who

I have to confess that I find this picture a trifle fanciful.

Short-term interest rates, as I pointed out in my Lombard Speech, are the essential instrument of monetary policy.

Thus my objective has to be to keep them, on average, at whatever level is necessary to produce monetary conditions that bear down on inflation.

EST wants ref. to exchange rate. APH thinks not. Enough said already.

~~following the fall in the exchange rate,~~

In current circumstances, ~~we~~ ~~I~~ the Governor and I judged that this required a rise in interest rates of 1 per cent ~~to 11 per cent~~, giving a margin of ~~[6~~ 5½ per cent~~]~~ admost 6 over equivalent dollar rates and implying VIC ... something like ~~[7½~~ 8 per cent~~]~~ in real terms.

~~Bank (E. George) want "we" to show no row between us & them, of yesterday's press.~~

DLCP:

Given this assessment, to have moved in the fevered and turbulent market ~~market~~ atmosphere of the fortnight that followed the Washington meetings would not have been sensible. It would inevitably have meant a rise of 2 per cent, as indeed the press were predicting at the time, which would have been excessive. ~~And~~ I have no more ~~wish~~ desire to see monetary conditions too tight than I have to see them too lax.

And, as I have said before, and shown by my actions in January and February,

? ~~4 ref. to Jan. 88~~

It therefore seemed sensible to wait until calm had been restored to the markets, and then make the appropriate move. Which is what duly took place.

I do not conceal that there is necessarily a large element of judgement in this, both of monetary conditions and of market tactics. B ~~What I would claim is that the record shows I have exercised the necessary judgement, consistently, over a period of years, in a way which has delivered low inflation with sustained growth.~~

Outlook ~~Prospect~~ for

The Economy

Finally, I turn to the outlook ~~prospect~~ for the UK economy.

Since I spoke here last year, the world has 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 in particular the oil price have all changed by massive amounts.

The initial effect of these upheavals has been to slow down somewhat the growth of world activity. But just as, after each of the massive oil price increases in the seventies, there was a delay of some months before output was adversely affected, so the benefits to economic activity from cheaper oil are only now beginning to emerge. I would expect to see a gradual quickening in the pace of world economic growth over the next year.

As the fifth largest oil producing nation in the world, the UK has been more affected than most by

But ~~I have been~~ exercising ~~that~~ judgment as Chancellor ~~for over 3 years, and~~ the record speaks for itself. We have bought inflation down to the lowest for 20 years. We have combined that with sustained growth and rising living standards. And that is a combination which has eluded many of our predecessors. ~~of both parties~~s. We have done it by sticking to policies of sound money and free markets. And that is the way we intend to continue.

lower oil prices. But despite this the pattern of developments this year has been ~~broadly~~ for the most part been in line with what I envisaged at the time of the Budget time.

EB: drafting

In this [illegible],

Domestic demand has risen rapidly this year, as expected at the time of the Budget. At the same time, inflation has fallen even more sharply than forecast, to the lowest levels for nearly 20 years. Even excluding the effect of mortgage rates, which somewhat idiosyncratically we include in the Retail Price Index, inflation is now only a little above 3 per cent, and I would expect it to continue at around this level over the next few months.

What has been disappointing is the growth of world trade, and thus of UK exports, particularly over the last quarter of last year and the first quarter of this. 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~~ expected.

MOM: Not quite 5 yrs at 3%.

As a result, after almost 5 years of steady growth ~~of about~~ approaching 3 per cent a year, overall UK output growth so far this year has been rather less than I envisaged at the time of the Budget. But I do not expect that ~~slower growth~~ pause to continue ~~for long~~, and output growth next year should be ~~both~~ faster. ~~than this year and faster than foreseen at the time of the Budget.~~

APH

Rec. ~~maintained~~ ~~share of trade~~

Dom P / Jan

TB/ Mom: Meeting

AF4

in sharp contrast to the previous pattern,
Over recent years, we have maintained our volume share of ~~manufactured~~ world trade in manufactures.

Already there are encouraging signs. ~~In particular,~~ And despite last month's freak trade figures, ~~it is clear that~~ becoming exports have steady resumed the vigorous growth they showed before the pause began. ~~and that we are continuing to hold our share of world trade.~~ ~~This should,~~ I hope, this will help to allay some of the exaggerated fears that have been expressed about the effect of the oil price collapse on the balance of payments.

~~In short~~, looking ahead to 1987, while domestic demand is likely to grow at about the same rate as this year, exports should continue the better performance of recent months. ~~So we shall have the prospect of balanced growth, which, and~~

Ut TB sentence.

~~Thus growth next year should be faster than this~~

~~So next year's faster growth will be balanced growth, which~~

This should produce balanced growth at a sustainable pace, which.

Finally, although it is never wise to draw too many conclusions from the outturn for a single month, it is encouraging that today's unemployment figures show the biggest fall since we first took office more than 7 years ago. Job vacancies, too, are at their highest level since 1979. And it bears repeating that since the last general election a million new jobs have been created, and total employment has risen for 13 successive quarters - the longest period of uninterrupted growth in employment this country has known for almost 30 years.

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.

To be ~~moved~~ recast by RPC.

As a Government, we have consistently sought to do just that. 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. ~~And~~ Within that framework, we have put in place a series of policies to improve the supply side of the economy - policies of deregulation, of tax reduction, of tax reform, of privatisation, and of wider share ownership, all of which will bring increasing benefits over time.

The ultimate objective is - and ~~always~~ will ~~be~~ remain - the complete elimination of inflation.

That is why the prospects are good. When I speak to you next year, though we shall no doubt have seen more turbulence, we shall also have seen further successes. We shall then be in our seventh successive year of steady economic growth, ~~while~~ with inflation ~~remains~~ remaining low. ~~And we shall be that much closer to the complete elimination of inflation which is the ultimate objective of current policies.~~

We shall ~~[illegible]~~ be competing in a ~~fast-moving and~~ fast-changing world, ~~but~~ and we shall be doing so in a spirit of enterprise and confidence

The events of the past year have once again 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 brought about that strength.

cc PW7
Sir P. Middleton
Sir T. Burns
Mr Cassell
Mr Peretz
Mr Culpin

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

15 October 1986

John Footman Esq
Private Secretary to the
Governor
Bank of England
Threadneedle Street
LONDON
EC2

Dear John,

GOVERNOR'S MANSION HOUSE SPEECH

The Chancellor has 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 the change suggested in paragraph 4 above, if the Governor is wedded to the precise form of words, he does feel particularly strongly about the points made in paragraphs 2 and 3 above.

Yours
Alex

A C S ALLAN
Principal Private Secretary

MR 4/20

CONFIDENTIAL

RP

FROM: A P HUDSON

DATE: 15 OCTOBER 1986

SIR P MIDDLETON

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR
PS/C&E
PS/Governor

MANSION HOUSE SPEECH

I attach the first section of the Chancellor's revision of the Mansion House Speech. Please could I have any final comments as soon as possible?

APH

A P HUDSON

SM/MH

MANSION HOUSE SPEECH

[Introduction to come.]

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 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 Nicholas 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. Indeed, I look forward to giving a progress report at this occasion next year.

Meanwhile, the proposal to merge ISRO and the Stock Exchange, and to create an International Stock Exchange in London, could mark a further important 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 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 than that: a national asset of enormous potential, whose success 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 gilt-edged market, which will allow the PSBR to be funded on finer terms.

? [Last but by no means least,] 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.

~~Reg'l jobs an [illegible]~~?

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 business services now employ 2 million people - a 15 per cent increase on 1979.

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-number salaries have attracted so much attention.

Inevitably, the new climate will prove 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 knowledge 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 internationally - such as insurance and foreign currency business - they did so successfully against all comers.

We have made it clear, too, that while we welcome those of all nations in the City of London, the Government is committed to obtaining reciprocal treatment for British firms in other financial centres.

In particular, 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 licences to operate in Tokyo. More are in prospect.

As a final sanction, the Government is taking statutory powers in the Financial Services Bill, which [will] should shortly reach the Statute Book, to allow it to refuse to authorise, or indeed 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 increased competition we seek. I have to say that whatever the short-run benefits to the consumer, such practices are ultimately anti-

competitive and potentially destabilising for the system as a whole.

That is not to deny that there may be occasional failures: of course there will be. It is not the Government's job to prevent financial companies from going out of business, 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 as a whole. But the private sector has a part to play too. 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 and necessary progress in increasing their capital ratios since 1982. But other financial institutions might usefully consider whether this episode holds lessons for them too.

Regulation

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

The Government attaches 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 mark a major advance in the battle against fraud.

I am confident too that the new legislation we are in the process of putting on the Statute Book 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.

Meanwhile,

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 task of providing a comprehensive framework for investment business of all kinds has been little short of Herculean. But the next step is no less demanding: to get the new systems up and running with the minimum of delay - and to make sure that they work.

To complete the picture, the Bank of England has greatly increased the resources it devotes 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 banking supervision is conducted.

These arrangements will not, of course, operate in watertight 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.

Of course I well understand the concern of those who argue that regulation imposes 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 - leading to a new version of Gresham's law, with badly supervised centres gaining at the expense of the well supervised.

So far I see no sign of a competition in laxity of this kind. Indeed there is increasing recognition in all major financial centres that a competitive bidding down of regulatory standards would be in no-one's interest.

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

All supervisors - in securities as well as in banking - and particularly those in the major financial centres, must always 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.

Effective investor protection is all the more important given the Government's commitment to popular capitalism.

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 quoted company with no fewer than 3 million shareholders. These are figures on a scale never previously thought possible.

The ~~PEP~~ Personal Equity Plan 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 very 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 should offer increasing scope for cutting costs on small share deals. So there is at last a real prospect for reversing the long-term trend to ever-increasing institutional ownership of British industry.

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

MR 4/19

CONFIDENTIAL

PhP

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

15 October 1986

Miss Catherine Bradley
Secretary of State's Office
Department of Trade and Industry
1-19 Victoria Street
London

Dear Catherine,

MANSION HOUSE SPEECH

I enclose a copy of the section on the 'Big Bang' from the Mansion House Speech, which the Chancellor will be delivering tomorrow evening. Please could you let me have any comments as soon as possible.

Yours sincerely,

Andrew Hudson

A P HUDSON

SM/MH

MANSION HOUSE SPEECH

[Introduction to come.]

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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 very 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 should offer increasing scope for cutting costs on small share deals. So there is at last a real prospect for reversing the long-term trend to ever-increasing institutional ownership of British industry.

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

016/3062

CONFIDENTIAL

PWP

From: DAVID PERETZ

Date: 15 October 1986

MR HUDSON

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Culpin
Mr Kelly

GOVERNOR'S MANSION HOUSE SPEECH

I see that paragraph 3 of the latest draft of the Governor's speech still includes the suggestion that the fall in sterling has gone "beyond the point at which the dangers of renewed inflation can be ignored".

2. I still think this is dangerous. It could all too easily be interpreted as meaning that we want the exchange rate to rise - just the message we do <u>not</u> want to foster just at present. For if the market thought that Tuesday's rise in interest rates was designed to raise the exchange rate then it would be a very natural supposition that, since the exchange rate has not risen very much, a further rise in interest rates is in the offing.

3. At a minimum, could we suggest either deleting the words quoted above; or adding a further sentence after the sentence that says "This is not to say that renewed inflation is unavoidable" on the following lines:-

> "Indeed, it was to avoid the risk of renewed inflationary pressures that interest rates were raised by 1% earlier this week, to compensate for the relaxation in monetary conditions that the lower exchange rate would otherwise have indicated."

DLP

D L C PERETZ

pwp

Speech given by

ROBIN LEIGH-PEMBERTON
GOVERNOR OF THE BANK OF ENGLAND

at the Lord Mayor's Dinner for
the Bankers and Merchants of the City of London
on Thursday 16 October 1986

1 This is an occasion for looking back with the outgoing Lord Mayor as well as looking forward, 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. 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 a 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, in dollar terms, of oil prices.

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 obverse 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 uncertainties that they breed, not least among 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 seeing this in the major industrial economies.

3 In the United Kingdom, much attention has been focussed on the exchange rate. With lower oil prices we needed the prospect of an improving non-oil trade balance. But thanks to lower oil prices the exchange rate change that has occurred, and which is fully sufficient to effect the necessary current account adjustment, need not add to the risk of renewed inflation. In the past, however, our competitive position has been eroded by failure to contain cost increases, so much depends on wages. Our performance to date on productivity comes nowhere near to warranting the 4-5% annual growth in real income implied by the recent gap between the growth in overall earnings and retail prices. Room does exist for some rise in living standards, but we should not forget past experience of too rapid a rise in consumption all too easily leading to growing trade deficits. Part of the solution must be a sharp reduction in the general

level of pay settlements. Recent indications 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.

4 Monetary policy cannot directly reduce the rise in labour costs; nor, more generally, can it bring about the improvements in industrial innovation and efficiency which are needed to take advantage of the opportunities now available to British producers in world markets. The role of monetary policy is progressively to squeeze out inflation, and the major 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, whether broad or narrow, are being overshot in the United States and even in Germany and Japan. Narrow aggregates tend to be sensitive to nominal interest rates. These have fallen last year, reducing the cost of holding narrow money. Inflation has fallen too, indeed faster in the UK, so that real interest rates remain higher everywhere than in the 1970s. This is particularly true in the UK where it contributes to growth in demand for broad money.

6 In our own case MO, although still within its target band, has shown some recent acceleration and the target aggregate for broader money, £M3, has been growing for much of the last year well above its 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 its sensitivity to the ebb and flow of the competition between banks and building societies. £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, liquidity and credit have in fact been growing uncomfortably fast and markets have not failed to perceive this.

7 Recently there has been heavy 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 refused to be rushed into hasty policy decisions by this

period of market turbulence, and have acted to moderate the more erratic movements in both the domestic and foreign exchange markets. But it would be a great mistake to interpret this determination not to be swept off one's feet in the short run as a reluctance to take necessary action at the appropriate moment - as our action on Tuesday showed. Markets deliver important signals; but they also generate a degree of hubbub and it may take time to distinguish the true signal as it emerges from the noise.

8 My Lord Mayor, great changes in the City are to take place this month: after three years of preparation the reforms known as the Big Bang are about to be implemented. They are the largest changes to have taken place in the City in the lifetimes of anyone present tonight, and represent a triumph of adaptability and vision on the part of the old and the new members of the Stock Exchange who have embraced reform so positively.

9 These developments in the way in which business is done and in the membership rules of the Stock Exchange were of course quite deliberately intended to open up the market to competition. There is every sign that they have succeeded in releasing a great burst of energy and talent, not only in the Stock Exchange but in many other financial markets. All this is very healthy and welcome, but we need to keep in mind that competition brings risks as well as benefits and can be a destructive as well as a constructive force. Regulation is being modified to accommodate and promote competition, and to ensure that markets are well conducted and investors reasonably protected. Of course, some firms may overreach themselves. There may be losses, and it is possible that some of the participants in these highly competitive markets will eventually withdraw. No one should regard that as a failure of the new system. There are clear limits to the extent to which regulators of any kind can or should influence the conduct of business.

10 Consequently it will be vital for all market participants to exercise a degree of restraint. Market-makers and broker-dealers will naturally strive to secure a market share which will support the capital committed to their business. But if this leads to excessive margin-cutting, they will store up trouble for themselves. Again, if market share is acquired aggressively through predatory pricing, it could work, in the longer run, to undermine the increased competition that we have striven to introduce. Similarly, I should like to see institutional investors recognise their interest in being able to deal with a wide array of soundly-based intermediaries, and I hope that they will exercise restraint on their use of their bargaining power. I hope also that we will continue to avoid levels of gearing in the corporate sector as a whole which, although perhaps acceptable in favourable conditions, could prove to be seriously destabilising when times become harder.

FROM: F CASSELL
16 October 1986

MR HUDSON

cc Sir P Middleton
Sir T Burns
Mr Riley
Mr Culpin

MANSION HOUSE SPEECH

The statement on page 9 that for some years now there has been a declining ratio of national debt to national income is not borne out by the most readily available statistics.

These show that the ratio, after falling steeply in the years of high inflation, has been broadly flat since then.

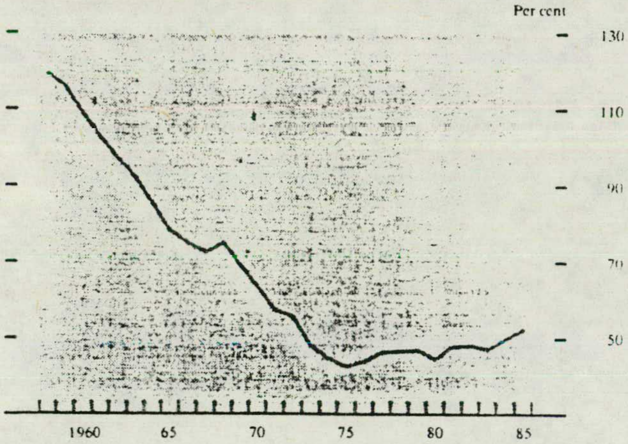
Indeed the charts published in the BEQB, latest versions attached, suggest a gently rising trend for national debt in recent years - though a broadly flat trend for public debt.

It would be safer to omit the whole sentence. The only version that would fit the figures is a weaker one, perhaps making a favourable international comparison:

> "And this is in a context in which the United Kingdom, unlike many other countries, has experienced ~~been able to maintain~~ a gently declining ~~broadly flat~~ ratio of public debt to national income ~~.~~ at a time of falling inflation."

F CASSELL

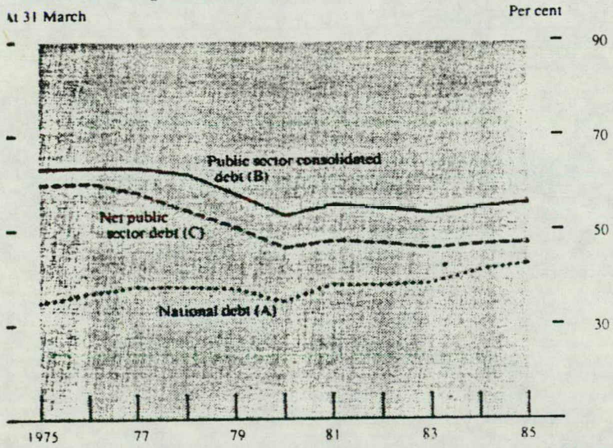
Chart 1
National debt as a proportion of GDP[a]



(a) National debt (including foreign currency debt but excluding official holdings) outstanding at end-March, as a percentage of GDP at current prices in the years ending 31 March.

Measures of public sector debt in relation to GDP[a]

At 31 March



(a) Average measure of GDP at current market prices in four quarters centred on 31 March

SM/MH

VERSION OF 16.10.86., 9am.

MANSION HOUSE SPEECH

[Introduction to come.] Thus AM

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 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 Nicholas Goodison and his team, for their far sighted leadership. And I ~~am~~ know that he in turn welcomes the further halving of stamp duty, to 1/2 per cent, that October 27th will bring.

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. But a ~~Indeed, I look forward to giving a progress report at this occasion next year.~~

~~Ch, Did you want "giving" or "hearing"? See below. AH~~

~~Meanwhile, the proposal to merge ISRO and the Stock Exchange, and to create an International Stock Exchange in London, could mark a further important 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 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 than that: a national asset of enormous potential, whose success 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 gilt-edged market, which will allow the PSBR to be funded on finer terms.

Last but by no means least, 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 business services now employ 2 million people - a 15 per cent increase on 1979.

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-number salaries have attracted so much attention.

Inevitably, the new climate will prove too bracing for some. And if it does, it ~~[illegible]~~ should go without saying that it will not be the

from p 6

Meanwhile, ~~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 knowledge 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 internationally - such as insurance and foreign currency business - they did so successfully against all comers.

~~B from p 6~~

We have made it clear, too, that while we welcome those of all nations in the City of London, the Government is committed to obtaining reciprocal treatment for British firms in other financial centres.

In particular, 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~~ seven more ~~UK~~ London houses have been granted licences to operate in Tokyo. More are in ~~prospect.~~ the pipeline.

8Tet/

As ~~a final~~ an ultimate sanction, the Government is taking statutory powers in the Financial Services Bill, as ~~which will shortly reach the Statute Book,~~ to allow it to refuse to authorise, or ~~indeed~~ to restrict or even to remove the authorisation ~~from,~~ of 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 also alert to the risk that predatory pricing could erode the benefits of the increased competition we seek. ~~I have to say that~~ Whatever the short-run benefits to the consumer, such practices are ultimately anti-

competitive and potentially destabilising for the system as a whole.

~~That is not to deny that there may be occasional failures: of course there will be. It is not the~~ Government's job to prevent financial companies from going out of business, though the Government has a clear responsibility to minimise the risk of their customers being dragged down with them.

to p 4

A

~~The Government also has a duty to maintain the soundness and integrity of the financial system as a whole. But the private sector has a part to play too.~~ But 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.

to p 4

B

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

Regulation

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

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

In addition, ~~On fraud~~, as the Home Secretary recently announced, the Government has decided to accept most of the Roskill Committee's recommendations, on fraud, 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.

to p.8

Its creation will mark a major advance in the battle against fraud.

I am confident too that the new legislation we are in the process of putting on the Statute Book 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 Services Bill is now passing through its final Parliamentary stages.~~ The task of providing, in the Financial Services Bill, a comprehensive framework for investment business of all kinds has been little short of Herculean. But the next step is no less demanding: to get the new systems up and running with the minimum of delay - and to make sure that they work.

~~To complete the picture,~~ At the same time, the Bank of England has greatly increased the resources it devotes 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 banking supervision is conducted.

from p. 7

~~These~~ The arrangements that are put in place will not, of course, operate in watertight 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.

~~Of course~~ I well understand the concern of those who argue that regulation imposes 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 - leading to a new version of Gresham's law, with badly supervised centres gaining at the expense of the well supervised.

~~So far I see no sign of a competition in laxity of this kind. Indeed there is increasing recognition in all major financial centres that a competitive bidding down of regulatory standards would be in no-one's interest.~~

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

But the reality is clear.

All supervisors - in securities as well as in banking - and particularly those in the major financial centres, must ~~always~~ put international co-operation (and co-ordination) 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.

L

Popular Capitalism

Effective investor protection is all the more important given the Government's commitment to popular capitalism.

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~~ some 2 million individual shareholders two years on. More recently the TSB - albeit something of a special case - has started life as a quoted company with no fewer than 3 million shareholders, over half of whom have never owned shares before. These are figures on a scale never previously thought possible.

The ~~PEP~~ Personal Equity Plan scheme which I introduced in my last Budget offers a further ~~opportunity to increase the number of individual shareholders.~~ encouragement for ~~[illegible]~~ ordinary ~~individuals~~ people to hold shares. With the ~~enthusiastic~~ constructive ~~co-operat~~ co-operation ~~of a number of institutions, including~~ of the Stock Exchange and ~~some of~~ some of the clearing banks and ~~building societies~~ other institutions, the details of this scheme are now ~~virtually~~ more or less finalised, and I ~~hope to lay~~ shall be laying the necessary regulations before Parliament ~~in the very near future~~ as soon as the House reassembles, 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 should offer increasing scope for cutting costs on small share deals. So there is at last a real prospect for reversing the long-term trend to ever-increasing institutional ownership of British industry.

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

Monetary Policy

On this august occasion, last year, I set out our financial strategy in the clearest terms. In April of this year, ~~in the wake of the Budget,~~ in a speech to the Lombard Association, I explained ~~at considerably greater length, and~~ very fully, how, in the context of that strategy, monetary policy - and also fiscal policy, but in particular monetary policy - is conducted.

Since both the strategy and the implementation of policy in the context of that strategy remain precisely as I set out in those two speechs, you will be glad to know that I do not propose to weary you by repeating it yet again tonight.

There are, I know,

Those who still complain of being confused - and judging by what they write, some are indeed confused.

But they are either simply complaining that the world is a complicated place, which sadly is all too true, and is something that all of us have to come to terms with; or else they are so wedded to confusion that it would be grossly improper to try and separate them from it.

So let me merely say a brief word or two about the rise in short term interest rates I decided to bring about earlier this week.

As today's figures for the PSBR for September and thus for the first 6 months of the financial year have shown, public borrowing is broadly on track. And this is in the context of what has for some years now been a declining ratio of national debt to national income.

But I judged that monetary conditions had become somewhat ~~lax,~~ easier, and needed to be tightened. This was not prompted by ~~A great deal has been written about~~ the growth of broad money and credit, (although ~~even though~~ I understand the concern that has been aroused on this score.) ~~but this on its own would not have given grounds for concern.~~ As I foreshadowed last year, it was clear that the liberalisation of the financial system, the end of mortgage rationing, and the increased competition between financial institutions would lead ~~It is clear that financial liberalisation and a changing way of life are leading~~ to a steady increase in the ratio of personal debt to personal income. But this ~~rising~~ rise in the personal debt ratio (to around 80 per cent) has been matched by a similar growth in personal holdings of liquid assets, (which now amount to some 85 per cent of personal incomes and should not therefore be inflationary.) ~~and~~ Moreover even the present high ratio of personal debt to personal income ~~also~~ remains ~~well~~ below the comparable figure in the United States of 90 per cent.

So, ~~to repeat,~~ this on its own would not have given any ~~cause~~ grounds for ~~action.~~ concern. But what could not be ignored was that more reliable indicators, such as narrow money, as measured by MO, and in particular the exchange rate, were indicating an easing of monetary conditions.

Given the precipitate collapse of the oil price, it was inevitable and indeed necessary that the exchange rate should fall so as to enable - after the inevitable delay known as the J curve -non-oil exports to rise to offset at least the greater part of the fall in oil export revenues.

(are clearly)

But ~~not only are~~ there limits to the necessary and desirable extent of that fall. ~~but its very occurrence has to be taken into account.~~ Moreover, at

~~At~~ the same time, the growth of MO, although well within its target range, was edging upwards, and in all the circumstances I judged it desirable to seek to bring it back towards the centre of the range.

Therefore

~~In other words,~~ It was necessary, in order to maintain the financial strategy on track, to raise interest rates.

(have recently been)

There ~~are~~ those who delight in depicting the level of short-term interest rates as the outcome of a constant epic struggle between the Chancellor, always seeking to bring interest rates down, and the markets, ever seeking to push them up — or vice versa.

I have to confess that I find this picture a trifle fanciful.

Short-term interest rates, as I pointed out in my Lombard Speech, are the essential instrument~~s~~ of monetary policy.

Thus my objective has to be to keep them, on average, at whatever level is necessary to produce monetary conditions that bear down on inflation.

In current circumstances, I judged that this required a rise of 1 per cent to 11 per cent, giving a margin of [6 per cent] over equivalent dollar rates and implying something like [7½ per cent] in real terms.

Given this assessment, to have moved in the fevered and turbulent market market atmosphere of the fortnight that followed the Washington meetings would not have been sensible. It would inevitably have meant a rise of 2 per cent, as indeed the press were predicting at the time, which would have been excessive. And I have no more wish to see monetary conditions too tight than I have to see them too lax.

It therefore seemed sensible to wait until calm had been restored to the markets, and then make the appropriate move. Which is what duly took place.

~~There are, inevitably, those who doubt our resolve to stop there. They doubted it in January, when we similarly raised interest rates by 1 per cent. We declined then to be buffeted by every small puff of wind, and it is the same today.~~

I do not conceal that there is necessarily a large element of judgement in this, ~~but~~ both of monetary conditions and of market tactics. What I would claim is that the record shows I have exercised the necessary judgement, consistently, over a period of years, in a way which has delivered low inflation with sustained growth. ~~a combination which has eluded many before me.~~

The Economy

Since I spoke here last year, the world has 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 in particular the oil price have all changed by massive amounts.

The initial effect of these upheavals has been to slow down somewhat the growth of world activity. ~~But this pattern should have come as no surprise.~~ But just as, After each of the massive oil price increases in the seventies, there was a delay of ~~many~~ some months before output was ~~decisively~~ adversely affected, so the ~~The~~ benefits to economic activity from cheaper oil are only now beginning to emerge. ~~and~~ So I would ~~remain optimistic about the outlook for the world economy~~ expect to see a gradual quickening in the pace of world economic growth over the next year.

As the fifth largest oil producing nation in the world, the UK has been more affected than most by lower oil prices. But despite this the pattern of developments this year has been broadly in line with what I ~~forecast~~ envisaged at the time of the Budget.

Domestic demand has risen rapidly this year, as expected. At the same time, inflation has fallen even more sharply than forecast, to the lowest levels ~~to under 3 per cent - better than envisaged and the lowest~~ for nearly 20 years. Even excluding the effect of mortgage rates, which somewhat idiosyncratically we include in the Retail Price Index, inflation is now only a little above 3 per cent, and I would expect it to continue at around this level ~~[illegible]~~ over the next few months.

What has been disappointing is the growth of world trade, and thus of UK exports, particularly over the last quarter of last year and the first quarter of this. 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, overall UK output growth so far this year has been rather less than I envisaged at the time of the budget. But I do not expect that slower growth to continue for long and output growth next year should be both faster than this year and faster than foreseen at the time of the Budget. Already there are encouraging signs. In particular, despite last month's freak figures, it is clear that exports have resumed the vigorous growth they showed before the pause began, and that we are continuing to hold our share of world trade. This should, I hope, ~~[illegible]~~ allay some of the exaggerated fears that have been expressed about the ~~[illegible]~~ effect of the oil price collapse on the balance of payments.

~~So~~ In short, looking ahead to 1987, while domestic demand is likely to grow at about the same rate as this year, exports should continue the better performance of recent months. ~~and reach new~~

Following the exaggeratedly sharp fall in ~~inflation~~ this year, it will be difficult to avoid some increase next year. Clearly, we are currently benefiting from the sharp fall in the oil price and most other commodities to an extent that will not continue. But at the same 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 will probably continue to run at a little over 3 per cent.

Finally, although it is never wise to draw too many conclusions from the outturn for a single month, it is encouraging that today's unemployment figures show the biggest fall since we first took office more than 7 years ago. Job vacancies, too, are at their highest level since 1979. And it bears repeating that since the last general election a million new jobs have been created, and total employment has risen for 13 successive quarters - the longest period of uninterrupted growth in employment this country has known for almost 30 years.

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 Government, we have consistently sought to do just that. 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. And within that framework, we have placed a series of ~~supply~~ policies to ~~s~~ improve the supply side of the economy – policies of deregulation, of tax ~~always emphasized our long-term policies of tax~~ reduction, of tax reform, of privatisation, and of wider share ownership, all of which will bring ~~them~~ increasing benefits over time. ~~which I reaffirmed in another place last week~~.

TAKE IN (A) HERE

~~Industry, and commerce, too, needs to look to the long-term, to seize the opportunities that are there for British firms which can compete in world markets. This means (among other things) calculated risk-taking, more research and development, more training, and a more hard-headed approach to pay and costs.~~

The events of the past year have once again 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 brought about that strength.

Instead we waited for a period of calm. And then acted in line with the needs of our strategy.

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

8. 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.

9. The problem was that more reliable indicators such as M0 and the exchange rate pointed to some countervailing adjustment in interest rates.

10. 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 M0, which is still in its target range, back towards the centre.

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

A

That is why

~~12.~~ ~~And~~ the prospects are good. When I speak to you next year, though ~~I expect~~ we shall no doubt 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 steady economic growth, while Inflation ~~will be at 1950s and 1960s levels.~~ remains low. And we shall be that much closer to the complete elimination of inflation which is the ultimate objective of current policies.

be in our seventh successive

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

8

3744/035

FROM: P D P BARNES
DATE: 16 October 1986

MR HUDSON C.X.

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr M Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR
PS/C & E
PS/Governor

MANSION HOUSE SPEECH

The Economic Secretary has seen your minute of 15 October to Sir P Middleton.

2. He has two comments on the Monetary Policy section:-

(i) At the end of the first complete paragraph on page 3 to add "as a significant component of monetary conditions."

(ii) At the beginning of the second paragraph on page 4 after "in current circumstances" to add "following the fall in the exchange rate."

PB

P D P BARNES
Private Secretary

3744/036

CONFIDENTIAL

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 16 October 1986

✓ AH 16.10

MR HUDSON 2.

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Evans
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Hall
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR
PS/C & E
PS/Governor
Mr Norgrove No. 10

MANSION HOUSE SPEECH

The Economic Secretary has seen your minute to Sir P Middleton of 16 October, enclosing the final draft of the Mansion House Speech.

2. The Economic Secretary thought that on page 10, paragraph 3, the sentence "but there are clearly limits to the necessary and desirable extent of that fall," could be interpreted as implying the existence of an exchange rate target. He suggests that this would be undesirable.

PB

P D P BARNES
Private Secretary

SM2/73

PWP

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

17 October 1986

David Norgrove Esq
10 Downing Street
LONDON SW1

Dear David,

MANSION HOUSE SPEECH

I attach the final version of the Mansion House Speech, which the Chancellor delivered last night.

I am copying this to Private Secretaries to Cabinet Ministers, Murdo MacLean (Chief Whip's office), and Trevor Woolley (Sir Robert Armstrong's office).

Yours sincerely,

Andrew Hudson

A P HUDSON