PART 2

MT

CONFIDENTIAL FILING

THE CHANCELLOR'S MANSION HOUSE SPEECHES

5
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MINISTERS

SPEECHES + BROADCASTS

PART 1: OCT 1979

PART 2: NOV 1987

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~4.11.87~~							
~~19.10.88~~							
~~18.10.89~~							
~~18.10.90~~							
~~29.10.92~~							
PART CLOSED							

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PART 2 ends:-

AA to HMT 29.10.92

PART 3 begins:-

HMT to MF 14.6.93

PERSONAL

File PMG

10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

29 October 1992

Dear Owen

MANSION HOUSE SPEECH

I do not usually write letters about administrative foul-ups, but I do feel compelled to put pen to paper in this case.

Let me set out what happened. At about 1045 last night, I realised I had not seen a copy of the latest draft of the Mansion House speech. I rang you and you told me it had been faxed over to us at 8pm. I assumed that Mary had seen it and asked the Duty Clerk to dig out a copy for me. After some investigation, he discovered that it had been faxed over to us at 1030pm, without anyone having alerted us. And only the first 7 of 14 pages had been received. Both these points are clear from the information printed on the top of the fax. The Duty Clerk rang your office and one of your clerks (who by then was the only person still there) undertook to dig out a copy and send it over immediately. A copy duly arrived at 1125. Almost at the same time, the Prime Minister rang down inquiring why he had not yet seen the speech. A copy was immediately taken up to him.

It was only this morning, at about 0745am, that we realised that the version walked over last night was an earlier draft. This meant that the Prime Minister had wasted precious time looking at the wrong draft. And his comments to the Chancellor about the need for amendment were made on the basis of the wrong draft.

There are several lessons to be learned from this. First, are your instructions to your outer office on how to deal with urgent material adequate? If you gave the material to your clerks at 8pm, why was it not faxed to us until 1030pm? Did it just sit around in a pile?

Second, why was it faxed to us rather than walked over by a messenger? For something as long as 14 pages, it is probably quicker to get it walked round. And it is certainly safer and more reliable.

Third, where important material is faxed over to us, it is essential that you alert the Duty Clerk here to the fact that it is coming. You probably do not realise the set up here. The relevant fax machine is in our filing section, and unattended during the evening. The Duty Clerk sits in the

Private Office. So, unless he knows a fax is coming, it may sit there unnoticed for some time.

Could I say in conclusion that I do not criticise the action of the particular clerk in your office who had to deal with this on his own at 11.00 pm: he or she could not necessarily be expected to know which was the latest version of the speech. But better procedures could have stopped us ever getting into that position. I hope you will ensure these problems do not arise again.

Yours

Alex

ALEX ALLAN

Owen Barder, Esq.,
H.M. Treasury.

chex.kf/mh/41

cc Alex
Sarah
MF

Treasury Chambers, Parliament Street, London, SW1P 3AG
071-270 3000

29 October 1992

Mrs Mary Francis
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Dear Mary,

CHANCELLOR'S MANSION HOUSE SPEECH

... I attach the final version of this speech.

I am also sending copies to the Private Secretaries of other Cabinet Ministers.

MRIDUL HEGDE

MANSION HOUSE SPEECH

My Lord Mayor, Mr Governor, my Lords, Ministers, Aldermen, Mr Recorder, Sheriffs, ladies and gentlemen, I am very pleased once again to have the honour of addressing this distinguished audience.

Economic background

2. It is just six weeks since we left the ERM. But it is already clear that the decision marked a watershed. Though the aims of government policy remain the same, we are now in an entirely different policy environment. We are outside the ERM and are likely to remain so for some time. And with a floating pound we have had more flexibility to reduce interest rates without prejudice to our goal of permanently low inflation.

3. But the wider world has changed too.

4. Most significantly, there has been a further deterioration in the prospects for the world economy. Despite sharp cuts in interest rates, the US economy remains weak. At the same time, the Japanese economy has slowed sharply.

5. Closer to home, events in Europe have been dominated by Germany's unique economic circumstances. Having faced exceptionally high real interest rates over the last year as Germany dealt with the consequences of reunification, we are now

having to contend with a rapid German slowdown, further depressing activity throughout the region.

6. Here in Britain, the frustrated hopes of the last year have led to a decline in business and consumer confidence, and this has been exacerbated by recent events. A deteriorating world environment, political uncertainties, a spate of industrial redundancies and the removal of a central pillar of the Government's monetary policy - this is an unusual, indeed an extraordinary, set of events. So it is not at all surprising that the surveys of business and consumer opinion that we have seen since 16 September have revealed confidence to be weaker.

7. Lord Mayor, I want to set out tonight why I believe that confidence can be recovered; and, more importantly, how the new conditions can be turned to Britain's advantage and at long last bring us out of recession.

Rebalancing policy

8. Our first priority has been to re-establish a stable and predictable policy framework. Since sterling was forced out of the ERM, we have re-emphasised the continuity of the Government's objectives - and re-affirmed our belief in sound money, low taxes, open markets and free trade.

9. But as the dust settles on the events of the last few weeks, it is crucial to recognise the relaxation of policy that has already been made.

10. The significant depreciation in sterling seen over the last six weeks - not just against the currencies of Europe, but also against the dollar - undoubtedly gives British exporters greater opportunities to win business in foreign markets.

11. And the greater flexibility we now have outside the ERM, together with the reduction there has been in German market rates, has also allowed me to take a further two points off interest rates. British industry now has interest rates which, apart from a few months in 1988, are the lowest since 1978. They are also the lowest in the European Community.

12. These developments have undoubtedly enhanced the prospects for recovery. But they have done so in a way that is sensible, responsible - and entirely appropriate our own economic circumstances.

13. Lord Mayor, soon after we left the ERM, I said in my speech to the Interim Committee of the IMF that monetary policy, at least in the last few months of our membership, had been tighter than was required to keep inflation on a downward track. That does not mean that the painful war we waged against inflation over the last few years was not worthwhile. Far from it - that was a war we had to win.

14. But the goal of the Government's macro-economic policy has never been simply to defeat inflation. Low inflation is not just an end in itself; it is also the means to sustainable growth and secure employment. Indeed, it is the vital precondition for the economic stability upon which a nation's future prosperity and living standards ultimately depend.

15. But just as prosperity can be jeopardised by too lax a monetary policy and too high a rate of inflation, so too, we have always recognised that policy can become too tight.

16. Leaving the ERM was a setback, but it <u>has</u> given us the opportunity to rebalance our policy to take greater account of the risks to the world economy. This does not mean that the Government has gone soft on inflation. But the dramatic progress we have made in getting inflation down does allow me now to give greater weight to securing an early resumption of growth.

<u>Out of recession</u>

17. The Prime Minister has spoken about the Government's hopes for recovery and of our determination to see Britain put this long and difficult recession behind us.

18. First and foremost, that means that Government and industry need to work together to re-build confidence. But economic confidence is an elusive quality; it cannot simply be drawn like

a rabbit from a conjurer's hat. I may be dressed as a magician, but I am, in fact, just the Chancellor of the Exchequer.

19. But what the Government can do is to set out as clearly and precisely as possible how we intend to steer the economy back towards the growth we all want to see.

20. I have drawn attention already to the relaxation of monetary conditions I have made over the last few weeks. That was fully justified by the excellent medium-term prospects for inflation; and in making decisions about further cuts in interest rates, I shall continue to take no risks with our long-term inflation goal. But as Noel Coward might have said, cheap money is not as potent as cheap music. If slashing interest rates were all that was required to generate growth, there would not be a single poor country left in the world. But let me assure you - I have no desire to keep interest rates any higher than is necessary to meet the Government's inflation objectives.

21. Over the medium-term, Lord Mayor, the prospects for interest rates in this country will depend as much on fiscal policy as on the monetary stance. And that is why the new public expenditure plans I shall be announcing in the Autumn Statement are so important.

22. Last July, I set up a new system for the control of public spending, with two aims in mind. First, to ensure that the Government's spending plans are fully within the country's means.

Nothing would damage business confidence more than a perception that the Government's fiscal plans did not add up. While it is perfectly sensible to allow the PSBR to rise at a time of recession, a tight fiscal position over the medium-term is absolutely essential if I am to keep interest rates down.

23. Second, I wanted to ensure that public money was directed towards the Government's priorities. In the package I shall be announcing on 12 November, my priorities will be to promote recovery and the long-term prosperity of the British economy. It must make strategic sense to ensure that, wherever possible, spending on the infrastructure is maintained at a time of recession.

24. But if capital programmes are to come first, Government has to take a lead from industry and keep a firm grip on its current expenditure. And I have also been determined to find ways of giving the private sector a greater role in financing capital projects. I am determined to ensure that our rules allow that to happen and I shall be announcing my proposals in the Autumn Statement.

25. I know that many people have been concerned, over the years, that the Government does not adequately distinguish between current and capital spending. There are good reasons for this, and in practice there are some difficult borderlines, particularly when it comes to human capital. But having looked at this issue again, I have concluded that the time has come to make a change.

From the first Unified Budget in December 1993, I have decided that the Government accounts should be drawn up in a way which makes a proper distinction between current and capital transactions. I believe this will help to underpin the Government's commitment to infrastructure investment in the longer run.

Growth

26. Lower interest rates supported by sensible public expenditure priorities will put the economy on course for recovery. But the key to improving the economy's growth performance over the longer-term is continuing supply-side reform.

27. So the Government will be pressing on with our programme of deregulation and privatisation; with our reforms of education and our policies to promote fair competition both at home and abroad. A successful conclusion of the GATT round and the completion of the Single Market will provide enormous opportunities for British industry. British firms must be fully involved in the European market. That is why the Government attaches so much importance to ratifying the Maastricht Treaty. We cannot afford to be left on the fringes while our partners make the rules.

28. But growth does not come from governments. It comes from individuals. It comes from businesses up and down the country responding to the pressure to become competitive.

29. Above all, growth comes from human nature. At any time, in any field of activity, behind any commercial endeavour, there is always an individual, pushing at the frontiers of knowledge, striving for improvement. It is the human spirit and the desire of human beings to achieve, that, in the long run makes growth the natural course of affairs.

30. The Government cannot talk the economy out of recession. We cannot press a button and see the economy spring to life. But we can examine every development, every policy option, every idea and ask ourselves - does this support industry? Will it help confidence? Will this get the economy going? That is what we shall be doing in the weeks and months ahead.

Forecasting

31. Lord Mayor, I want now to turn to the process by which the Government's policy is formed and particularly to the much-discussed question of economic forecasting.

32. Much of the criticism of the Treasury's forecasting record has been misplaced. The last few years have been extremely difficult ones for forecasters all over the world. Everywhere, governments and international organisations, as well as academic and private sector forecasters have been getting it wrong.

33. It is not difficult to see why. Forecasters today are pioneering uncharted territory. Alan Greenspan recently referred

to the impossibility of predicting how and when the US will emerge from a recession based on debt problems the like of which have not been seen for 60 years. There are similar problems throughout the industrialised world.

34. And there is, of course, a more fundamental problem with which forecasters always have to grapple. Forecasting means trying to predict the decisions of millions of individuals, all - thank goodness - with the freedom to spend, invest or save as they chose. They go about their business as it pleases them, blissfully unaware of the economic laws which are supposed to govern their behaviour. With these forces to contend with, the surprise is not that forecasters sometimes get it wrong, but that they ever get it right!

35. In such difficult circumstances, no-one has a monopoly of wisdom, and the Treasury had always paid close attention to the work of outside forecasters. I want to take that further.

36. I propose to invite a number of independent forecasters to join a new Forecasting Panel, to meet at regular intervals, and then publish an assessment. This would include the full range of forecasts made by individual panel members, as well as some summary of the central view and the risks attached to it.

37. The Treasury will, of course, retain its own forecasting capability. But my proposals will underline that the Treasury forecast is only one of several which inform Government policy

decisions and that such decisions do not depend on a single point estimate of future developments.

38. This change should help to strip away some of the mystique which surrounds forecasting and in this way, lead to a better elucidation of policy itself.

Monetary policy

39. My Lord Mayor, I turn now to monetary policy.

40. I set out a few weeks ago how monetary policy will operate now the pound is floating. This contains an important innovation: an explicit target range of 1-4 per cent for inflation. The Government aims to get inflation in the lower part of that range by the end of this Parliament.

41. In judging whether we are on track to meet that objective, we will take account of the behaviour of the monetary aggregates, narrow and broad; of asset prices, particularly house prices; other indicators of inflationary pressure; and of course, the exchange rate. Overall, policy will operate broadly in the way that it does in many other countries, like the United States, Japan and Germany.

42. But I think there are three aspects of this policy which are worth elaborating. One is that prospective, not current, inflation will be our guide. Monetary adjustments take time to

have effect, and a low inflation rate today is not in itself a reliable cue for a relaxation of policy.

43. Another issue is the role of the exchange rate. Some people insist that movements in the exchange rate are just a change in relative prices which need not affect the rate of inflation. Others argue more pragmatically that disinflationary forces are currently so strong, that such pressures pose no threat.

44. I am not persuaded by either of these arguments. The first might apply to a large, relatively closed economy, but it certainly does not hold for Britain. And those who blithely contemplate an ever lower exchange rate clearly have not understood what import higher costs mean for business. It would be a brave man who totally discounts the risk of these being passed through to domestic prices.

45. Finally, there is the argument that this set-up is too judgemental. Sometimes I think that this charge is levelled mainly by people working in the financial markets, who would simply like me to make their lives easier.

46. We are, of course, moving from a largely rules-based system to one that is more discretionary. But in the final analysis, all policy regimes rely on judgement. The difference is merely one of degree.

47. The need for judgement is obviously greater outside the ERM, which makes it all the more important that it is exercised in a consistent way. I propose, therefore, to implement three changes to make the formation of policy more transparent and our decisions more accountable.

48. First, I intend to publish a Monthly Monetary Report following the regular meetings which take place between the Governor and myself. This will, apart from certain market sensitive items, set out the information on which our policy judgements are based, showing the bad news with the good, from month to month.

49. Second, whenever a change in interest rates takes place - and this cannot, of course, conform to any timetable - we will provide an account of our reasoning, much as we did when I cut interest rates on 16 October. By comparing the accounts over time, the markets will be able to make up their own minds about whether or not a consistent approach is being applied.

50. Finally, I have asked the Governor to provide a regular report on the progress being made towards the Government's inflation objective. This will be published in the Bank's Quarterly Bulletin.

51. Together with my initiative on forecasting, these changes mark a welcome shift away from the excessive secrecy which has up to now shrouded much of the policy-making process. They will, I

believe, lead to an improvement in the way economic debate is conducted in this country.

52. My Lord Mayor, openness and accountability. Clear policies, steadily pursued. Sound money, low inflation, a firm approach to public expenditure and a determined attempt to ensure that resources are allocated to programmes and projects that will support Britain's recovery. These are the objectives the Government has set itself and these are the objectives we will continue to pursue, with purpose, vigour and determination.

mhs/8

CONFIDENTIAL

cc Sir T Burns
Mr Budd 29.10
Mr Kroll 12.30
Mr S J Davis

Mrs Francis No 10
Mr Tucker (BOE)
cc dta, myf, SHogg

REVISED DRAFT - NOT YET SEEN BY CX.

MANSION HOUSE SPEECH - DRAFT

My Lord Mayor, Mr Governor, my Lords, Ministers, Aldermen, Mr Recorder, Sheriffs, ladies and gentlemen, I am very pleased once again to have the honour of addressing this distinguished audience.

Economic background

2. It is just six weeks since we left the ERM. But it is already clear that the decision marked a watershed. Though the aims of government policy remain the same, we are now in an entirely different policy environment. For the time being, a floating pound has replaced our membership of the ERM and we have had more flexibility to reduce interest rates without prejudice to our goal of permanently low inflation.

3. But the wider world has changed too.

4. Most significantly, there has been a further deterioration in the prospects for the world economy. Despite sharp cuts in interest rates, the US economy remains weak. At the same time, the Japanese economy has slowed sharply.

5. Events in Europe have been dominated by Germany's unique economic circumstances. Having faced exceptionally high real interest rates over the last year as Germany dealt with the consequences of reunification, Europe is now having to contend

with a rapid German slowdown, further depressing activity throughout the region.

6. Here in Britain, the frustrated hopes of the last year have led to a decline in business and consumer confidence, and this has been exacerbated by recent events. A deteriorating world environment, political uncertainties, a spate of industrial redundancies and the removal of a central pillar of the Government's monetary policy - this is an unusual, indeed an extraordinary, set of events. So it is not at all surprising that the surveys of business and consumer opinion that we have seen since 16 September have revealed confidence to be weaker.

7. Lord Mayor, I want to set out tonight why I believe that confidence can be recovered; and, more importantly, how the new conditions can be turned to Britain's advantage and at long last bring us out of recession.

Rebalancing policy

8. Our first priority has been to re-establish a stable and predictable policy framework and to stick to it. And that is why, since sterling was forced out of the ERM, we have re-emphasised the continuity of the Government's objectives - re-affirming our belief in the fundamental building blocks of a dynamic economy - sound money, low taxes, open markets and free trade.

9. But as the dust settles on the events of the last few weeks, it is crucial to recognise the relaxation of policy that has already been made.

10. The significant depreciation in sterling seen over the last six weeks - not just against the currencies of Europe, but also against the dollar - undoubtedly gives British exporters greater opportunities to win business in foreign markets.

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13. Lord Mayor, soon after we left the ERM, I said in my speech to the Interim Committee of the IMF that monetary policy, at least in the last few months of our membership, had been tighter than was required to keep inflation on a downward track. That does not mean the painful war we waged against inflation over the last few years was not worthwhile. Far from it - that was a war we had to

win. [While inflation was high our first priority had to be to reduce it.]

14. But the goal of the Government's macro-economic policy has never been simply to defeat inflation. Low inflation is not just an end in itself; it is also the means to sustainable growth and secure employment. Indeed, it is the vital precondition for the economic stability upon which a nation's future prosperity and living standards ultimately depend.

15. But just as prosperity can be jeopardised by too lax a monetary policy and too high a rate of inflation, so too, we have always recognised that policy can become too tight.

16. Leaving the ERM was a setback, but it has given us the opportunity to rebalance our policy to take greater account of the risks to the world economy. This does not mean that the Government has gone soft on inflation. But the dramatic progress we have made in getting inflation down does allow me now to give greater weight to securing an early resumption of growth.

Out of recession

17. Last week the Prime Minister spoke about the Government's hopes for recovery and of our determination to see Britain put this long and difficult recession behind us.

18. First and foremost, that means that Government and industry need to work together to re-build confidence. But economic confidence is an elusive quality; it cannot simply be magicked like a rabbit out of a conjurer's hat. I may be dressed as a magician, but I am, in fact, just the Chancellor of the Exchequer.

19. But what the Government can do is to set out as clearly and precisely as possible how we intend to steer the economy back towards the growth we all want to see.

20. I have drawn attention already to the relaxation of monetary conditions I have made over the last few weeks. That was fully justified by the excellent medium-term prospects for inflation; and in making decisions about further cuts in interest rates, I shall continue to take no risks with our long-term inflation goal. If slashing interest rates were all that was required to generate growth, there would not be a single poor country left in the world. [As Noel Coward might have said, cheap money is not as potent as cheap music.] But let me assure you - I have no desire to keep interest rates any higher than is necessary to meet the Government's inflation objectives.

21. Over the medium-term, Lord Mayor, the prospects for interest rates in this country will depend as much on fiscal policy as on the monetary stance. And that is why the new public expenditure plans I shall be announcing in the Autumn Statement are so important.

22. Last July, I set up a new system for the control of public spending, with two aims in mind. First, to ensure that the Government's spending plans are fully within the country's means. Nothing would damage business confidence more than a perception that the Government's fiscal plans did not add up. While it is perfectly sensible to allow the PSBR to rise at a time of recession, if I am to keep interest rates lower, a tight fiscal position over the medium-term is absolutely essential.

23. Second, I wanted to ensure that public money was directed towards the Government's priorities. In the package I shall be announcing on 12 November, the overriding priority will be to support programmes that will contribute to recovery and sustain the long-term prosperity of the British economy. It must make strategic sense to ensure that, as far as possible, spending on the infrastructure is maintained in a recession.

24. But if capital programmes are to come first, Government has to take a lead from industry and keep a firm grip on its own current spending - pay costs and efficiency. I have also been determined to find ways of giving the private sector a greater role in financing capital projects. I intend to make sure that our rules allow that to happen and I shall be announcing my proposals in the Autumn Statement.

25. I know that many people have been concerned, over the years, that the Government does not draw a proper distinction between current and capital spending. There are good reasons for this,

and in practice, there are some difficult borderlines, particularly when it comes to human capital. But I have been looking at this issue again, and I have concluded that the time has come to make a change. From the first Unified Budget in December 1993, I have decided that the Government accounts should be drawn up in a way which makes a proper distinction between current and capital transactions. I believe this will help underpin the Government's commitment to infrastructure investment in the longer run.

Growth

26. Lower interest rates supported by sensible pubic expenditure priorities will put the economy on course for recovery. But the key to improving the economy's growth performance over the longer-term is continuing supply-side reform.

27. So the Government will be pressing on with our programme of deregulation and privatisation; with our reforms of education and our policies to promote fair competition both at home and abroad. A successful conclusion of the GATT round and the completion of the Single Market will provide enormous opportunities for British industry. British firms must be fully involved in the European market. We cannot afford to be left on the fringes while our partners set the rules.

28. But growth does not come from governments. It comes from individuals. It comes from businesses up and down the country responding to the pressure to become competitive.

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Forecasting

31. Lord Mayor, I want now to turn to the process by which the Government's policy is formed and particularly to the much-discussed question of economic forecasting.

32. Much of the criticism of the Treasury's relative forecasting record has been inaccurate. The last few years have been extremely difficult ones for forecasters all over the world. Everywhere, governments and international organisations, as well

as academic and private sector forecasters have been getting it wrong.

33. It is not difficult to see why. Forecasters today are pioneering uncharted territory. Alan Greenspan recently referred to the impossibility of predicting how and when the US will emerge from a recession based on debt problems the like of which have not been seen for 60 years. There are similar problems throughout the industrialised world.

34. And there is, of course, a more fundamental problem with which forecasters always have to grapple. Forecasting means trying to predict the decisions of millions of individuals, all - thank goodness - with the freedom to spend, invest or save as they chose. They go about their business as it pleases them, blissfully unaware of the economic laws which are supposed to govern their behaviour. With these forces to contend with, the surprise is not that forecasters sometimes get it wrong, but that they ever get it right!

35. In such difficult circumstances, no-one has a monopoly of wisdom, and the Treasury had always paid close attention to the work of outside forecasters. Tonight, I want to announce a new initiative to take that further. [In a word, my Lord Mayor, I intend to introduce competition into the Treasury's forecasting business].

36. I propose to invite a number of independent forecasters to join a new Forecasting Panel, to meet at regular intervals, and then publish an assessment. This would include the full range of forecasts made by individual panel members, as well as some summary of the central view and the risks attached to it.

37. The Treasury will, of course, retain its own forecasting capability. But my proposals will make more evident the reality that the Treasury forecast is only one of several which inform Government policy decisions and that such decisions do not depend on a single point estimate of future developments.

38. This change should help to strip away some of the mystique which surrounds forecasting and in this way, lead to a better elucidation of policy itself.

Monetary policy

39. My Lord Mayor, I could hardly finish the annual Mansion House speech without devoting some time to monetary policy.

40. I set out a few weeks ago how monetary policy will operate now the pound is floating. This contains an important innovation: an explicit target range of 1-4 per cent for inflation. The Government aims to get inflation in the lower part of that range by the end of this Parliament.

41. In judging whether we are on track to meet that objective, we will take account of the behaviour of the monetary aggregates, narrow and broad; of asset prices, particularly house prices; other indicators of inflationary pressure; and of course, the exchange rate. Overall, policy will operate in a way that is broadly similar to other countries, like the United States, Japan and Germany.

42. There are three aspects of this policy which are worth elaborating. One is that prospective, not current, inflation will be our guide. Monetary adjustments take time to have effect, and a low inflation rate today is not in itself a reliable cue for a relaxation of policy.

43. Another is the role of the exchange rate. Some people insist that movements in the exchange rate are just a change in relative prices which, need not affect the rate of inflation. Others argue more pragmatically that disinflationary forces are currently so strong, that such pressures pose no threat.

44. I am not persuaded by either of these arguments. The first might apply to a large, relatively closed economy, but it certainly does not hold for Britain. And those who blithely contemplate an ever lower exchange rate clearly have not understood what import higher costs mean for business. It would be a brave man who totally discounts the risk of these being passed through to domestic prices.

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markets will be able to make up their own minds about whether or not a consistent approach is being applied.

50. Finally, I have asked the Governor to provide a regular report on the progress being made towards the Government's inflation objective. This will be published in the Bank's Quarterly Bulletin.

51. Together with my initiative on forecasting, these changes mark a welcome shift away from the excessive secrecy which has up to now shrouded much of the policy-making process. They will, I believe, lead to an improvement in the way economic debate is conducted in this country.

52. My Lord Mayor, openness and accountability. Clear policies, steadily pursued. Sound money, low inflation, a firm approach to public expenditure and a determined attempt to ensure that resources are allocated to programmes and projects that will support Britain's recovery. These are the objectives the Government has set itself. By pursuing them, we can re-build the confidence that has been lost over the last few weeks and move forward with renewed hope for the future.

2755

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cc Sir Robert Fellowes CVO
Buckingham Palace

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

11 November 1991

T P Sutton Esq
Principal Private Secretary
Lord President's Office
Privy Council Office
Whitehall
London
SW1A 2AT

Dear Tim,

THE MANSION HOUSE AND THE STATE OPENING OF PARLIAMENT

As you know, the State Opening of Parliament and the Queen's Speech coincided this year with the Lord Mayor's dinner for the Bankers and Merchants of the City of London. This meant that the Chancellor's Mansion House speech, which represents an important annual statement of the Government's financial policy, did not receive the attention and prominence it might otherwise have done.

The Chancellor realises of course that the date of the Mansion House speech is not the only consideration in determining the date of the State Opening of Parliament. But he thought it might be helpful to let you know that the 1992 Mansion House speech is scheduled for Thursday, 29 October. I would be very grateful if you could take this into account when deciding the Parliamentary programme next year.

I am copying this note to Andrew Turnbull, Murdo Maclean and Sonia Phippard.

Yours.

JEREMY HEYWOOD
Principal Private Secretary

cst.jf/keep/mansionhou

FROM: J D PORTES
DATE: 31 OCTOBER 1991
EXTN: 5021

MR SAUNDERS

cc PS/CST
PS/MST
PS/FST
PS/EST
Sir T Burns
Mr Wicks
Mr Monck
Mr Budd
Mr Scholar
Mrs Lomax
Mr Evans
Mr Robson
Mr Bostock
Mr Gray
Mr Gieve
Mr Culpin
Mr Sedgwick
Mr Riley
Mr Bent
Mr Mercer
Mr Pratt
Mr Hibberd
Mr Gibbs
Mr Ross Goobey
Dr Robinson
Mr Tyrie
Mr Lightfoot
Mr Potter No 10
Mr Tucker BoE

CHANCELLOR'S MANSION HOUSE SPEECH

I attach the final version.

J D PORTES

Introduction

1. My Lord Mayor, Mr Governor, Your Excellencies, My Lord Chamberlain, My Lords, Fellow Ministers, Mr Mayor of Buenos Aires, Aldermen, Sheriffs, Ladies and Gentlemen, this is no less than the sixth time I have been privileged to attend this distinguished occasion. But it is the first time I have had the pleasure to rise as Chancellor to respond to your toast "prosperity to the public purse and the health of the Chancellor of the Exchequer". I can assure you that it is a great thrill and honour to do so - even if, wearing these garments, I am reminded of George V's remark that there are better ways to make a speech than wearing thirty pounds on your head and carrying a sceptre.

Exchange rate mechanism

2. When John Major addressed this gathering last year, it was just a fortnight after sterling's entry into the Exchange Rate Mechanism. We recognised then that two issues were of special importance. The timing; it was crucial to get that right; and second, once the decision to join had been made, we would have to make our membership work.

3. Last October sterling was at a realistic level relative to other ERM currencies. But even so, it was important to avoid a rapid loss of competitiveness. Hence our emphasis at the time on prospective inflation. Since then both the

headline and the underlying rate of inflation have fallen sharply.

4. Financial markets and businesses have come to recognise the strength of our commitment to the ERM. And I am happy to reaffirm it tonight. But that discipline imposes obligations on both Government and industry to control costs so as to maintain Britain's competitiveness.

5. In manufacturing, unit labour costs have actually fallen over the past 3 months. Progress has been less evident in parts of the service sector. But it too will have to respond, as increasingly it faces foreign competition. And we have already announced our intention to extend performance-related pay throughout the public sector.

6. One widely expressed fear was that the ERM might lead to conflict between the policies needed to keep sterling stable and those required to control inflation. We have always recognised that such conflicts might be possible in the short run. But, over time, internal and external considerations are likely to point in the same direction.

7. That has certainly been our experience over the past year. Sterling has remained comfortably within its bands. And despite a rise in German rates, our interest rates have been cut by $4\frac{1}{2}$ percentage points since John Major's announcement. Britain's interest rate differential with Germany is at its lowest in a decade.

8. Lower interest rates have not just happened. They have had to be earned by our cautious and prudent approach to monetary policy, and by our commitment to the disciplines of ERM membership. I have cut interest rates only when it has been safe to do so. That may have disappointed some in the short term, but it has laid the foundation for long term success.

The UK economy

9. Nonetheless, I am well aware that the last year has been a difficult one for business. I shall set out my detailed economic forecast next Wednesday, when I present my first Autumn Statement to Parliament. But tonight I want to explain why we can be confident about Britain's economic prospects.

10. The UK, along with many other countries, including the US, Australia, and Canada, has been in recession for much of the past year. In the late 1980s, consumers and businesses borrowed excessively, and this led to growth rates which proved unsustainable and ultimately inflationary. Some adjustment was necessary. And it has been painful.

11. In Britain we are now on the road to recovery. Retail sales are on an upward trend; the monthly increase in unemployment has fallen sharply; imports of raw materials and capital goods are up. Narrow money, which tends to rise

in line with money GDP, has moved into he upper half of its target range.

12. The vital extra ingredient is confidence. How often have I been told that recovery would not start until confidence was restored? Well, the clear message of a variety of recent business surveys is that confidence is returning.

13. The most important of these is the latest CBI Quarterly Trends Survey. In the past this survey has been a good predictor of turning points in the economy. And so we can take great comfort from the fact that optimism about the business situation is now positive for the first time since 1988. Output expectations too are up again.

14. Confidence doesn't come from politicians' speeches. Confidence comes from consistency, steadfastness, and prudence. The recent rise in confidence is fully justified. Let me tell you why:

- first, our inflation is now below the European Community average, and is set to fall further.

- second, that prospect is underpinned by the remarkable success of British business in controlling costs and boosting competitiveness;

- third, as we saw in the 198 s, falling inflation brings increased profitability. And rising profits allow manufacturers to invest, to train, and to create jobs;

- fourth, we have seen that British business, immeasurably stronger after the supply side reforms of the last decade, can beat the world. Even in the depths of recession, our share of world trade has been rising;

- and finally, most important of all, this recovery will be non-inflationary. And for that reason it will be sustained. It will provide the ideal conditions for investment, for enterprise and for jobs. There can be no better basis for confidence.

Broad money and funding policy

15. Concern has been expressed about the recent slow growth of broad money - in Britain, largely composed of bank and building society deposits. But our experience is not an isolated one. Worldwide, broad money grew faster than incomes through much of the 1980s, largely as a result of financial liberalisation and capital market integration. So the stock of broad money in relation to GDP is currently very high. And we in Britain may now be reaching the point where

nominal incomes will grow as fast as, or faster, than broad money.

16. In this country the low growth of broad money has largely been the result of the behaviour of the investing institutions, as they purchase more securities. Neither this, nor the shift from bank borrowing to equity finance, gives cause to doubt that we are emerging from recession.

17. Nobody can ignore the questions posed by these developments. But, taken together with the other indicators I have mentioned, I do not believe that the recent period of low money growth is likely to prevent recovery.

18. Nevertheless, some have suggested that we should try to increase broad money growth by abandoning the full fund rule; in other words that we should issue fewer gilts than required to finance the PSBR, and make up the difference with very short-term borrowing.

19. I have to say that I very much doubt economic behaviour would change materially if financial institutions and overseas investors held more money balances and fewer gilts. At most, short term interest rates may rise relative to long rates. Not, I imagine, what most of you are looking for at the moment.

20. What we <u>do</u> know from the early 1980s is that departures from a full fund approach can produce major uncertainties and

distortions in the markets. Both the authorities and the markets have benefited from adherence to the full fund rule. It will continue to serve us well.

British Telecom

21. Like the gilts market, the Stock Exchange must continually adapt to changing conditions. Successive privatisations have altered traditional ways of doing business. And the Government's forthcoming BT share sale will take this a good deal further.

22. A feature of this sale will be a tender offer open to both UK institutions and overseas investors. The tender price will determine the UK retail price, which for the first time will not be set until the end of the offer period. This will reduce uncertainty for the small investors who we wish to encourage.

23. And this structure also means that there is no need to underwrite the offer. No doubt this is less than welcome to some of you here tonight. But even underwriters are taxpayers, and I am sure that they appreciate more than anyone that this unprecedented approach will result in a direct saving to the taxpayer of over £40m.

24. We are also taking measures to encourage the development of retail share shops in the UK. Investors will get coupons, redeemable at one of eight Share Shops, which

they can use to buy and sell any shares not just BT shares. We hope this will encourage people to become active investors, buying and selling shares in more than one company.

25. I am delighted to be able to announce tonight that over 3½ million people have already registered their interest in the offer. And about 90 per cent of these have selected a Share Shop.

Supervision

26. Less happily for financial markets, this year has seen investigations into misconduct in the securities markets in New York, Tokyo, Frankfurt, and Milan. And the headlines have been dominated by the closure of BCCI.

27. I shall not preempt Lord Justice Bingham's enquiry. Nonetheless, I would like to make a couple of preliminary observations.

28. First, the closure of BCCI showed the enormous disruption that is unavoidable if a retail bank closes abruptly. There is simply no way in such cases of warning depositors without precipitating a crisis which will do just as much damage to depositors as closure itself.

29. Second, BCCI and other cases this year have brought out the international character of financial services.

Supervisory and legal structures both here and abroad need to meet that challenge.

30. That does not mean setting up a supranational leviathan to oversee the industry worldwide. But we do need to build on the progress already made within the Community and the Basle Group; to improve coordination between supervisors and to agree common minimum standards.

31. To give just two examples: we need to ensure that there are no "black holes" in international groups. Subsidiaries and associates are sometimes located in offshore centres whose transactions are invisible to supervisors in the main financial centres. And we need to look again at who bears the cost of protecting deposits in international banks; there is much to be said for the principle that the country of incorporation should also be the country to pay for deposit protection.

EMU

32. Economic and monetary union is the issue of the moment. And quite rightly so. The current negotiations are of great concern to the City and to business. But the issues under discussion are not just financial and economic, they are deeply political. They have profound implications for the way we are governed. In Britain we have long recognised that. And we have made it crystal clear throughout that we could not accept any changes to the Treaty of Rome that would

bind the UK to move to a single currency without a separate decision by the United Kingdom Government and Parliament.

33. But, in my view, it would have been unthinkable for the United Kingdom simply to turn its back on the EMU negotiations. Our economic future is increasingly bound up with that of Europe.

34. Monetary integration in Europe is a process that is already underway. It does not come from Governments alone. We've seen, in the last decade, the increasing integration of capital markets. We've seen, for example, closer monetary links between Germany and the Benelux countries. The key point about these developments is that they have evolved naturally, through the market. That must be our guiding principle as we consider the possibility of a single currency.

35. The future role of the ecu amongst the major world currencies will be of great significance to the City, which has already established a clear lead in the ecu market. We wish to build on that. The Government's ecu bond and Treasury Bill programme has played a key role, and I am pleased to announce tonight our intention of launching a 3-year ecu note programme next year, after the current EMU negotiations are concluded.

36. Those negotiations have been lengthy and complex. It's been hard going. But, as you know, we have now received the

latest text from the Dutch Presidency. And I am glad to say that it shows that our constructive approach is bearing fruit. The new text reflects many of the points I have been pressing, and it goes a long way towards meeting our concerns. But there is still much work to be done. I will carry on negotiating in good faith. The Government's aim is an agreement at Maastricht which satisfies the aspirations of us all.

Eastern Europe

37. It has been an extraordinary and remarkable year. Twelve months ago I little imagined that I would be addressing this dinner tonight, as Chancellor. And nor would I have believed that as Chancellor of the Exchequer of the United Kingdom I would be so involved, through the G7 group of Finance Ministers, in the affairs of the Soviet Union. The events in the Soviet Union of the last year have been the most remarkable of my lifetime. And the peoples and leaders of the Soviet Union now face critical decisions.

38. It is not for us to make those decisions for them. Only the peoples of the Soviet Union can determine their political and economic future; only they can resolve their problems. But we have a responsibility to point the way. To help to ensure that the transition to democracy and the market economy is secured and made permanent.

39. That is why we, and other Western countries, stand prepared to offer emergency food and medical assistance on a large scale this winter. And it is why we set up the Know-How Fund for the Soviet Union which will provide practical advice and technical assistance to Soviet businesses and entrepreneurs.

40. One of the Soviet Union's most pressing needs is for the development of an efficient banking system, as President Nazarbaev of Kazakhstan made clear to me this morning. The City can help by providing training, by seconding staff and by offering technical advice. Is there any reason why every major financial institution represented here tonight should not take into their offices Soviet personnel - excellent business contacts for the future - to help them learn how a modern financial services industry operates? The Soviets themselves have told me that they would find this invaluable.

41. And there is another financial institution in London that has a special role to play in Eastern Europe and the Soviet Union; the European Bank for Reconstruction and Development, now established in London. We worked hard to get it here. The Government's belief was that London was its natural location and that its presence would bring great opportunities to the City. So I hope the City will work closely with the EBRD in helping to provide the flow of investment needed by the emerging private sector in these countries.

42. I know that to many of you here choosing whether to invest scarce resources in Eastern Europe or the Soviet Union, the risks appear high and the rewards uncertain. I understand that. It is for you to make your own commercial judgements. But I can only say, from my own experience, that I know our main competitors - the Germans, the French - are taking a long term view. I hope UK business will do the same.

43. It has been an eventful and a dramatic year, a year of surprises. We who live in these times are more privileged than most of those who came before us and will come after us. For the great watersheds of history are few. The collapse of Communism is a mighty sea-change in the affairs of mankind. It presents daunting problems and offers immense opportunities - not only to those who are at last escaping from the political systems that have impoverished them - but to us, the heirs of a civilisation founded on the ideals of freedom and democracy and brought to maturity by the benefits of the free market.

44. Above all, we are privileged, as few are or are likely to be, not just to see our ideals triumph but to have the opportunity of bringing new hope to countless millions of our fellow men and women. That is a challenge for all of us.

CONFIDENTIAL

PRIME MINISTER

MANSION HOUSE SPEECH

You saw the draft of the Chancellor's Mansion House speech over the weekend. I described it as "traditional"; you commented that it was "safe". The Chancellor decided over the weekend that it was rather too traditional and safe!

Accordingly, he will recast the speech, mainly to highlight and bring forward a more positive piece on the prospects for economic recovery.

The Chancellor wants to discuss the speech at your bilateral on Wednesday. I understand the Chancellor would like to announce the timing of the Autumn Statement (6 November) during the Mansion House speech.

BHP

BARRY H. POTTER

28 October 1991

jd c:\wpdocs\economic\mansion

CONFIDENTIAL

Andrew
Barry
Mr Wall
For information
Gus

GUS

MANSION HOUSE SPEECH

I thought you might like an update on the BBC and its plans to cover the Prime Minister's speech.

Rather than cover the whole event as in years past the BBC has decided to broadcast only the Prime Minister's speech live. They will do so in an extended World Tonight, beginning at 9.30pm. This means that they will push to have a very prompt start to his speech.

The BBC has not dealt with this matter well, only recently informing the Lord Mayor of their plans. They are fighting a rearguard action to get some coverage of his speech, albeit without much hope of success.

By the way, did you know that the Lord Major pays for this bash out of his own pocket - about £70,000 this year?

Jonathan

JONATHAN HASLAM
25 October 1991

chex.kf/jp/38

1. AT
2. CF.

Prime Minister

To see — an early draft of the Chancellor's Mansion House speech.

Traditional style & content

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

25 October 1991

BHP
25/10

Paul Tucker Esq
PS/Governor
Bank of England
Threadneedle Street
LONDON EC2R 8AH

Safe enough.

OK — on EMU + EMU.

25.10

Dear Paul,

CHANCELLOR'S MANSION HOUSE SPEECH

I attach the latest draft of the Chancellor's speech. I would be interested to see the Governor's speech when a draft is available.

I am copying this letter to Barry Potter at No.10.

Yours,

J D PORTES

Introduction draft 6 pm 25/10

1. My [Lord Mayor, Ladies and Gentlemen], it is with very great pleasure that I rise for the first time to respond to your toast "prosperity to the public purse and the health of the Chancellor of the Exchequer". I hope it will be the first of many.

Broad money and funding policy

2. I think I should preface my traditional discourse on funding policy by a brief explanation of our views on the significance of the current slow growth in broad money. This has caused concern not only here but also abroad, most notably in Japan and the United States of America.

3. As wealth has risen and competition in financial markets has increased, we saw a dramatic shift towards broad money as a secure and profitable asset. Throughout the 1980s broad money grew rapidly as its velocity fell. But it seems likely that this process of adjustment is now coming to an end. We may well now be reaching the point when broad money balances will grow no faster than nominal incomes.

4. I would also note that the most rapid move away from broad money has been by non-bank financial institutions, such as pension funds. This reflects a voluntary change in portfolio behaviour rather than renewed recession. So too does the shift this year by companies away from bank

borrowing towards equity finance. Most indicators - including narrow money, which has remained squarely in the target range I set for it at Budget time - now point to recovery. Of course we watch these developments closely. But we do not believe they are a cause for alarm.

5. The question of broad money growth is of course closely related to the government's actions in the gilts market. The re-emergence of a period of public sector borrowing has meant that the authorities are back in the business of selling gilts. All concerned have had to relearn their old tricks - or perhaps I should say, to rediscover their traditional expertise.

6. I have been enormously impressed by the success with which the market has readjusted to this turnround. Since January there have been [ ] of gilt issues, including three very successful auctions. And yet we have seen yields fall over the same period by nearly 1 per cent.

7. In returning to active funding we have continued to hold fast to the full fund rule. I am deeply sceptical of the argument that we should try to stimulate broad money growth by underfunding. The case for a more discretionary funding policy rests on the proposition that monetary conditions can be loosened while the general level of interest rates is left unchanged. But I very much doubt whether economic behaviour would change materially if

financial institutions and overseas investors held more money balances and fewer gilts.

8. What we do know from the early 1980s is that departures from a full fund approach can produce major uncertainties and distortions in the markets. Both the authorities and the markets have benefited from adherence to the full fund rule. It will continue to serve us well.

British Telecom

9. Like the gilts market, the Stock Exchange must continually adapt to changing conditions. Successive privatisations have increasingly introduced competition and altered traditional ways of doing business. And the Government's forthcoming BT share sale will take this a good deal further.

10. The offer will be divided into two elements; a UK retail element, and one open to both UK institutions and overseas investors. In the latter, shares will be sold by a tender, which will take place at the end of the retail sale. The tender price will in turn determine the UK retail price, which will be at a discount. This process will mean that the price to all investors will be market-driven. And it means that the offer will not be at risk to external events during the offer period.

11. Another departure from past practice is that the offer will not be underwritten. The variable price structure makes underwriting unnecessary and unhelpful. This unprecedented approach will result in a saving to the taxpayer of over [].

12. In order to promote wider share ownership, the retail offer has been designed to encourage the development of retail share shops in the UK. Investors will get coupons, redeemable at one of eight chains of Share Shops, which they can use to buy and sell any shares - not just BT shares. After that they will be invited to become permanent clients of that share dealing service.

13. The City stands to gain a lot from the success of the offer. It is a truly global offering on a truly level playing field.

Supervision

14. In other respects the year has been a difficult one for financial markets worldwide. We have seen investigations into misconduct in the securities markets in New York, Tokyo, Frankfurt, and Milan. And the headlines have been dominated by the closure of BCCI.

15. The Governor and I have appointed Lord Justice Bingham to examine the matter so far as it bears on the UK supervisory authorities. Nonetheless, I would like to make a few preliminary observations.

16. First, the closure of BCCI showed the enormous disruption and hardship that comes inevitably from the abrupt closure of a retail bank. There is simply no way in such cases of warning depositors without precipitating a crisis which will do just as much damage to depositors in general as closure itself.

17. Second, BCCI and other cases this year have brought out the international character of financial services. BCCI was not a British bank and its activities extended across some 70 countries. Supervisory and legal structures both here and abroad need to meet that challenge.

18. It is neither practicable or desirable to set up a supranational regulator to oversee the industry worldwide. What we have to do is to build on the progress we have already made within the Community and the Basle Group; to improve coordination between supervisors and to agree common minimum standards.

19. To give just two examples: we need to ensure that there are no "black holes" in international groups - subsidiaries and associates are often located in offshore centres whose transactions are invisible to supervisors in the main financial centres. And we need to look again at who bears the cost of protecting deposits in international banks; there is much to be said for the principle that the country

which takes the lead in supervising a group should also be the country to pay for the protection of deposits.

20. My third observation is that the BCCI episode has demonstrated again the unavoidable limitations of regulation. While we are all determined to root out crime and fraud in the financial world, beyond a certain point excessive regulation will not add to the security of depositors and investors but will simply stifle enterprise and leave everyone the poorer.

Exchange rate mechanism

21. When John Major addressed this distinguished gathering last year, it was just a fortnight after our entry into the ERM. Adherence to the ERM was neither a radical departure from our previous approach to the control of inflation, nor a short-term fix. A year on, it is worth reviewing how matters have turned out.

22. We recognised then that two issues were of crucial importance. The first was that the timing of entry should be well chosen. The second was that once the decision to join was made, we should make our membership work.

23. Last October was a good time to join. Sterling was at a sensible level relative to other ERM currencies. But even so, we could not afford a rapid loss of competitiveness.

Hence our emphasis on prospective inflation as one of the conditions for membership.

24. I believe that employers, workers and the foreign exchange markets now recognise that we have turned our back on the easy option of devaluation. The growth of average earnings has fallen sharply. Most welcome of all, unit labour costs in manufacturing have actually fallen over the past 3 months.

25. That imposes obligations on us all. I have already announced plans to introduce a radical extension of performance-related pay in the public sector. And in the private sector we have seen great strides in manufacturing, exposed as it is to the pressures of foreign competition. Progress has been less evident in parts of the service sector. But it too will increasingly face foreign competition. Employers and workers in services will have to learn to control their costs.

26. One widely expressed fear about membership of the ERM was that there would be a conflict between the policies needed to keep sterling within its ERM band and the policies required to control inflation. We have always recognised that such conflicts might be possible in the short run, but on the whole, I believe that internal and external considerations are likely to point in the same direction.

27. As I said in my evidence to the Treasury and Civil Service Committee [last November] "The foreign exchange markets are not fools... They will look at the fundamental conditions of the UK economy and above all, inflation." I am happy to tonight reaffirm that declaration of faith in the market.

28. Over the last year sterling has remained comfortably within its bands. And despite a rise in German rates, interest rates have been cut by $4\frac{1}{2}$ percentage points since John Major's announcement. It is a measure of our success that Britain's interest rate differential with Germany is now at a lower level than at any time since [1981].

29. The reduction in interest rates has been earned through the cautious and prudent approach we have adopted towards monetary policy, buttressed throughout by our membership of the ERM. That approach has also brought inflation down to the sort of levels enjoyed by our main European competitors.

30. So I believe we can look back on the first year of membership of the ERM with some satisfaction. The hopes of those who supported our entry have been fulfilled and the fears of those who opposed it have proved unfounded.

EMU

31. The control of monetary policy is of course a subject which goes to the heart of political and economic debate. So

the current negotiations about economic and monetary union, and in particular the question of a single currency, are profoundly political. In Britain we have long recognised that. Throughout the negotiations we have made it crystal clear that there could be no question of any changes to the Treaty of Rome that would bind the UK to move to a single currency without a separate decision by the United Kingdom Government and Parliament.

32. Of course there are many in the City and in business who believe that a European currency would bring large economic benefits. In recent years our economic future has become increasingly bound up with that of our European partners. [ ] of our trade is now with other EC member states compared with [ ] 10 years ago. Capital market integration has proceeded apace. All this - not just the actions of governments - is part and parcel of economic and monetary union.

33. There is a common thread in these developments. They are processes which have evolved through the market. That should be the guiding principle as we consider the possibility of a single currency in the future. For example, the very close monetary links between Germany and the Benelux countries have evolved in parallel with, not in advance of, the wider economic links between those countries.

34. That is why I have argued consistently in the EMU negotiations that a premature move to a single currency would

be disastrous for Europe; it could lead to significant economic dislocation. And there is now a healthy consensus on the need for economic convergence as a precondition for any move to currency union.

35. Similarly, we have consistently sought to focus attention on the next steps, the so called stage 2 of EMU, rather than considering only the details of any eventual full monetary union. I welcome the support we have received in emphasising the role that a harder ecu can play in promoting convergence - an endeavour in which you in the City have played a major part.

36. We are seeking to ensure that the new Treaty allows the fullest possible scope for the operation of markets. For example, our clearing and payments systems are vital to the City and the economy as a whole. In this country they are run by the private sector. Of course the Bank of England has an important role to play, as would the European System of Central Banks in any future monetary union. But that does not mean that the ESCB would need to own or run the system.

37. We have this week received the latest Dutch text on EMU. We will be negotiating on this in the next few weeks. We have always been confident that we can negotiate a Treaty which satisfies the aspirations of us all.

38. We are determined to ensure that neither in Stage 2 or Stage 3 is there any confusion of responsibility for monetary

policy. There cannot be two hands on the monetary tiller. Whether or not we choose to be part of any future single currency zone, we have an interest in ensuring that monetary stability is preserved.

Eastern Europe

39. A firm commitment to sound money and free markets will provide the framework within which the City can grasp the opportunities provided by the evolution of the European Community. But those opportunities must not be restricted to the present boundaries of the Community. I welcome the agreement last week to establish the European Economic Space, which will help create the biggest free trade area in the industrialised world.

40. And politics and geography combine to give the Community a special responsibility towards the newly emerging democracies of Eastern Europe. The City, as Europe's largest financial centre, with our bankers, our stockbrokers, our accountants and our lawyers, is ideally placed to play a leading part in the provision of expert assistance to the emerging financial markets of Central and Eastern Europe.

41. The UK's Know-How Fund is already active in helping UK firms provide advice on privatisation, establishing accounting systems, creating clearly defined tax systems, and creating viable commercial banks which take proper account of the risks of lending. I was delighted to read that two weeks

ago 11 officials from the Czechoslovak financial services industry began a training programme devised by the Stock Exchange and its member firms and funded by the Know How Fund. This is exactly the sort of imaginative, private sector led project the Know How Fund was designed to support.

42. It was London's reputation as a financial centre and the skills of those of you who work here that helped us gain the agreement that the European Bank for Reconstruction and Development should be located in London.

43. The EBRD has more ambitious aims and principles than earlier multilateral banks, and its activities are explicitly targeted on private sector development. The Bank will be providing loans, investing in equity, and providing technical assistance direct to the emerging private sectors of Eastern Europe and the Soviet Union. I hope the City will work closely with the EBRD in helping to provide the flow of investment these countries need.

44. The events of the last few years in Eastern Europe, and now in the Soviet Union, represent perhaps the most important political and economic changes of our lifetimes. I know that to many of you here, choosing whether to invest scarce resources in Eastern Europe or the Soviet Union, the risks appear high and the rewards uncertain. And I certainly do not want to pre-empt your commercial judgement. But I have to say that already your main competitors - the Germans, the

French - are active. They are taking the longer-term view. I hope UK business will do the same.

The UK economy

45. Finally, I know my speech would not be complete without a few words on the state of the British economy. I do not intend to say much tonightBut I would like to take this opportunity to emphasise three important points.

46. First, the recession has been the unfortunate but inevitable result of the excessive borrowing and inflationary growth that preceded it. The speed with which the economy moved into recession was painful but it does mean that we have achieved the necessary adjustment rapidly and that we can now resume economic growth confident that inflation is under control.

47. Second, while there has been a sharp fall in domestic demand, the performance of exports has been most encouraging despite a difficult world environment.

48. And third, the pain of adjustment has been more evenly spread through the economy than in the previous two recessions.

49. We are now coming out of recession. Consumer confidence has recovered; retail sales are on an upward trend; the monthly increase in unemployment has fallen sharply; imports of raw materials and capital goods are up.

50. Many businessmen tell me that recovery will not start until confidence is restored. Confidence is returning. This is apparent in recent surveys from the Association of British Chambers of Commerce, the Institute of Directors, and Dun and Broadstreet. And the latest CBI Quarterly Trends Survey, with its long and well-established track record, is the most important and persuasive evidence seen yet. It points to greatly increased optimism about the general business situation, better prospects for output and profitability and an excellent outlook for exports.

51. This confidence is fully justified. It is justified because we are embarking on a recovery which will not be allowed to run out of control. That is my pledge. We should be neither surprised nor disappointed if the recovery starts slowly. That is what we expected. We have brought inflation down and we shall bring it down further. A sustainable, non-inflationary recovery will provide the ideal conditions for investment and enterprise. There is no better basis for confidence.

Peroration

52. It has been an eventful and an exciting year, both for me personally and for the City. Developments in the Soviet Union, in particular, are posing huge challenges and there will be immense opportunities, as well as risks. But undoubtedly the most important development, for those of us concerned with finance and economics, is the growing consensus that market based solutions provide a way to prosperity that controlled economies cannot deliver. I know that recognition will be as welcome to you as it is to me.

[3100 words]

25 JAN 1951

PRIME MINISTER

Governor's Speech also attached.

CHANCELLOR'S SPEECH TO THE MANSION HOUSE

I attach a copy of the final version of the speech. You might like to note the following:

Paragraph 5

You suggested deletion of the second sentence. The Chancellor has retained it, but substituted "development" for "change". This makes it clearer that we are talking about a modification of monetary policy, not a move away from it.

Paragraph 7

The going rate is now "so-called".

Paragraph 9

The sentence about ERM being the cornerstone of our strategy has been deleted, as has the explicit reference to raising or lowering of interest rates to stay within the band. The reference is now much more oblique.

Paragraph 16

The reference to allocating interest rates to the maintenance of the exchange rate is clearly put into the mouths of the commentators.

Paragraph 17

The phrase "and we will not do it" has been dropped.

Paragraph 18

The final sentence re-drafted as you suggested.

Paragraph 27

The opening sentence stating that "we do remain open to the evolution of such a currency" has been dropped, and the hard ecu is now described as "evolving towards" rather than "becoming" a single currency.

Paragraph 30

Pejorative comparison of our economic performance with that of the Community has been dropped.

AT

18 October 1990

jd c:\wpdocs\pps\speech

CHANCELLOR'S SPEECH TO MANSION HOUSE: 18 OCTOBER 1990

It is now very nearly a year since I returned to the Treasury after a brief parole in the Foreign Office. I believe I am probably the only politician to have prepared the Treasury's public spending posture for a bilateral with the Foreign Secretary; conducted that bilateral as Foreign Secretary; and announced the outcome as Chancellor. As the public expenditure round continues I must comment that such a sequence of events does have its advantages. And to be strictly fair I should add that I am glad none of my Cabinet colleagues has that advantage this year.

UK Economy

2. From the outset it seemed likely that 1990 would be an uncomfortable year and so it has proved. Economic policy has been dominated by the struggle to get control of the inflationary pressures that were evident in the large current account deficit and, of course, in the inflation figures themselves.

3. The cause of the problem was excess demand. And the remedy that we put in place was a firm monetary policy that is now clearly working.

4. All the monetary aggregates now tell the same story. Annual growth of narrow money, M0, has been reduced in every month since April and is now within its target range; M4 growth has fallen steadily throughout this year to reach its lowest point since June 1987. We have seen a welcome recovery in the savings ratio from 4.9 per cent in the third quarter of 1988 to 7.7 per cent in the second quarter of 1990. And in the last few months, there has been a marked change also in the real indicators in the economy. Over the next few months we are likely to see a further reduction of that excess demand pressure that has been the root of higher inflation.

5. Earlier this month sterling entered the Exchange Rate Mechanism. This event marks a significant development in the conduct of monetary policy. The news was greeted with rapture in some quarters, and with deepest gloom in others. Neither of these extreme reactions seems to me to be right. What entry to the ERM amounts to is an extra dimension to our monetary discipline. I have no doubt it will bring benefits for the UK. But I do not agree with those who argue that the ERM will bring those benefits in the short-term and then have long-term costs. Precisely the reverse is true. Entry will require tough action in the short-term to ensure low inflation thereafter. The disciplines of the system will force both the Government and the private sector to make difficult choices.

6. For the private sector, I am thinking in particular of the control of costs including labour costs. The days have gone in which businesses could simply negotiate around the RPI and assume that a falling exchange rate would keep them competitive with their European rivals. Keeping our costs in line with, or lower than, those elsewhere in the Community is now essential.

7. And it is, of course, the Directors and Managers of British companies who must ensure that they stay competitive. The Government cannot do it for them. It will be no use businessmen bewailing the dominance of the so-called "going rate" in general while meekly accepting it as an unavoidable cost in their own firms. Within the ERM that approach will lead to only one result: lost markets, redundancies, plant closures, and ultimately company failures.

8. I put the point starkly because I want to ensure that message is fully understood. It is as relevant to pay in the boardroom as it is to pay on the shop-floor.

9. For the Government too, membership of the ERM will be a discipline. We have an obligation to hold sterling in its band, and it is an obligation which we will meet through the normal instruments of monetary policy. That does not mean we ignore

other monetary indicators. Making a success of the ERM depends upon making a success of monetary policy. And that will require continuing attention to monetary conditions in this country. This is precisely the way other members of the ERM operate their policy.

10. One of the enormous complications for the conduct of policy in the 1980s has been the inconsistency in behaviour of various monetary aggregates, very probably because of the speed of financial liberalisation. The problem is that different indicators can at the same time give completely contradictory messages. Thus it is possible to argue that in 1980 not enough attention was given to narrow money; and in 1986 that broad money should have been the focus of greater attention. One comforting development has been that for some time now, the messages coming from both broad and narrow money have been the same; possibly because the biggest effects of financial liberalisation have begun to work themselves through.

11. Before we could join the ERM we needed to be sure that inflationary pressures were on the way down. As usual, there has been a lag between the peak in economic growth and the peak in inflation - indeed, on this occasion that lag has been particularly long. But - although oil prices have yet to feed through fully into the headline figures - it is now clear that inflation itself is near its peak and will fall markedly over the next year. There was therefore no further reason for delay in entering the mechanism. And it was, of course, those very same conditions that indicated that a reduction in interest rates was now appropriate.

12. I decided, therefore, to announce the two moves at the same time. In doing so I was influenced by the risk that a reduction in interest rates before entry into the ERM would have been misunderstood as a signal that I was seeking to weaken the exchange rate in readiness for joining - which I was not; or alternatively, that entry was a long way off - which it was not. Both interpretations might have weakened the exchange rate and

damaged the prospect of entering at a central rate that would make our counter-inflationary intentions clear from the start. I took the view, therefore, that the markets should be aware of both those factors at the same time - hence the joint announcement. To be frank, I thought that was the most straightforward and sensible way to proceed, and I still do.

13. We decided to enter with 6 per cent margins to give sterling an opportunity to settle down in view of the uncertainties which necessarily attend an important market development of this kind. As circumstances permit, we will move to the narrow $2^1/_4$ per cent bands.

14. Returning to inflation, the indications are that this will fall throughout next year, and especially quickly from April onwards as both the underlying rate improves and some of the unusual adverse factors drop out. However, notwithstanding this improved prospect, interest rates will be reduced further only when it is clearly safe to do so.

15. The ERM also has implications for fiscal policy. Throughout the 1980s fiscal policy has been used to support monetary policy and it is crucial we maintain this approach in the future.

16. Some commentators have suggested that interest rates are, in some sense, allocated to maintaining the exchange rate and are therefore not available to help achieve other objectives. They argue therefore that in consequence membership will require a more active fiscal policy. I have no doubt that it would be a huge mistake to return to frequent mini-budgets and fiscal fine-tuning. It is not necessary, its effects are not wholly predictable and, in my limited experience, one Autumn Statement and one Budget a year are quite sufficient! However, the overall fiscal balance will be important in the future just as, in practice, it has been in the past.

17. As the economy has slowed it has become inevitable that large cyclical Budget surpluses would diminish. The boom in corporation

tax collection has come to an end for the time being and, as I indicated to the Treasury Committee of the House of Commons some years ago, an economic slowdown inevitably brings renewed pressures on public expenditure, which may no longer fall as a proportion of GDP. But I do not believe we should change our medium-term objective of a balanced Budget. That would not make sense.

18. To summarise, there is no doubt about the problems of 1990. I do not promise that 1991 will be easy either: we will continue to need tight monetary and fiscal policies and our commitment to the ERM will reinforce that discipline on industry and on Government. But we will, I am sure, begin to see the benefits in a substantial fall in inflation. That will be important progress. And with inflation back under control, British business will be well placed to take advantage of the enormous opportunities which our policies have created.

Europe

19. I should like to turn to Europe. In recent years we have played an important and constructive role in shaping the Community. I have no doubt that we will continue to do so in future. This is vital to the future of the City and of industry. Of course, whenever we voice doubts about a proposal emanating from Brussels, there will be those ready to call us halfhearted Europeans or accuse us of trying to disrupt the Community. Equally, whenever we put forward positive proposals to make Europe work better, there will be those who accuse us of pre-emptive surrender. Both are wrong.

20. Our record as good Europeans is excellent. It was Britain that was instrumental in seeking a Budget deal that kept the Community viable; Britain which has helped remove the worst excesses of the CAP; and Britain which has implemented more single market measures than all but one of our Community partners. Many so-called 'good Europeans' are in practice very bad Europeans when it comes to opening up their markets to competition.

21. Often, when we voice doubts about European initiatives, we succeed in persuading our partners that our approach is practical, realistic and "communautaire". A case in point is the Commission's advocacy of a withholding tax. This would have been harmful to the Community and would have damaged the City's ability to compete worldwide. The UK has played a substantial part in devising, and bringing near to agreement, a more acceptable alternative scheme.

22. I believe that an important test of Britain's commitment to Europe is our desire to see the Community evolve together. We do not want to see it split into two tiers with an inner core speeding ahead. This would not strengthen the EC. And it could damage it gravely. It is against that background that I hope our partners will judge our proposals for the development of EMU beyond Stage 1.

23. In recent months I have been encouraged by the direction that debate has taken. Increasingly the focus of attention is on the practical steps after Stage 1 as our partners in Europe recognise that the pre-requisite to further integration is convergence of economic performance. Moreover, there is an inherent absurdity in arguing about the length or date of Stage 2 before determining what should be in it.

24. Our proposals for a European Monetary Fund and a hard ecu are well known. They provide an evolutionary approach based on the market and choice. They recognise that economic convergence is far from satisfactory. For the present differences between the relative performances of the twelve are striking. Annual rates of inflation in the Community range from $2^{1}/_{2}$ to 22 per cent; short-term interest rates range from 8 to 18 per cent; and public sector budget balances range from a surplus of 3 per cent of GDP to a deficit of over 17 per cent. And the degree of flexibility in the economies of member states varies considerably.

25. Our proposals were heavily influenced by advice and guidance from within the City. They were also, of course, worked up in co-operation with the Bank of England. Indeed, if I may digress for a moment, I should say that one of the most agreeable aspects of the last year has been working so closely with the Governor and his team. But returning to our proposals, they were intended to advance the debate on EMU and offer a way to keep the Community moving forward together.

26. As we draw nearer to the inter-governmental conference in December, we shall continue to take a practical and constructive approach. But no one should misinterpret our position. Joining the ERM did not commit us to adopting, and cannot oblige us to accept, the imposition of a single currency in Europe.

27. But I have made it perfectly plain that under the UK's proposals, the hard ecu could ultimately evolve towards a single currency if it were the wish of governments and peoples that it should be used in preference to their own national currencies. But I have also indicated that it is neither necessary nor desirable to take a decision of that kind now.

28. While the debate continues we are looking for practical ways in which the existing basket ecu can be developed. In 1988, we launched the ecu Treasury Bill programme and since then LIFFE have introduced an ecu interest rate contract. Tonight I can announce some further modest moves in that direction. The Bank of England is already consulting Gilt Edged Market Makers about the basis on which they can extend their dealings to cover ecu bonds as well as the sterling instruments they already trade. I welcome that. I am now giving consideration to an ecu bond issue, at the appropriate time, which would demonstrate further our attachment to the ecu and would strengthen London's important position in this rapidly growing market. Another practical step which we shall support is the proposal that member states' contributions to the European Development Fund should in future be denominated in ecu.

29. Our commitment to Europe is also demonstrated by our support for the nations of Eastern Europe and our conviction that they too must have the opportunity to become members of the Community. The European Bank for Reconstruction and Development in London will be an important means of assisting market economies to emerge in those countries. And the choice - which I warmly welcome - of London as the site is a tribute to the City's unique experience in finance and privatisation.

30. In summary, Mr Lord Mayor, I look forward to the 1990s as the decade in which we will make further improvements in our economic performance; in which we will continue to play a leading role in creating an open and liberal Community; and in which we can look forward to London consolidating its position as the financial centre of Europe. We should aim for nothing less. And accept nothing else.

FOR RELEASE ON
DELIVERY AT 21.00 HRS

Prime Minister ②

The Bank of E' Governor's speech. First draft covers ERM entry. 'X' is intended to demonstrate Bank & Government were agreed on interest rate cut at same time as ERM entry.

BTTP
18/10

Speech given by

THE RT HON ROBIN LEIGH-PEMBERTON
GOVERNOR OF THE BANK OF ENGLAND

at the Lord Mayor's Banquet for
The Bankers and Merchants of the City of London
on Thursday 18 October 1990

ERM ENTRY

It is a particular pleasure to follow the Chancellor of the Exchequer tonight. This is his first attendance at this splendid occasion as Chancellor and therefore as the star attraction, and I know the merchants and bankers welcome him to it most warmly, as I do. I believe that all of us here recognise that that welcome is his due, both by virtue of the unflinching resolution with which he has pursued the necessary counter-inflationary policy; and by the way in which he has brought to fruition something which will be to the benefit of our economy, which I know is warmly appreciated by everyone here, and which has long been my ambition.

There has been a good deal of comment on how ERM entry fits into the broader canvas. I do not want to go into this, except to say that what is immediately relevant is that, having joined the ERM and thus having made a major new commitment, we should be in a better position to play an influential role in the debate about greater monetary integration in the Community and in the realisation of the Single Market programme, to which we are enthusiastically committed.

What about the more immediate impact of ERM membership on markets, industry and the economy generally? For financial markets, entry resolves an uncertainty that had been building up tantalisingly over recent months, during which sterling's value rose significantly. Industry had of course repeatedly demanded entry over five years or more; and will also welcome the resolution of uncertainty, not least because ERM membership will allow long-term decisions, especially investment plans, to be based on a more stable exchange rate.

Industry will also benefit from the lower inflation that ERM membership will help bring. But I must repeat that the ERM is no miracle cure for our economic problems and no soft option - though perhaps with the present combination of interest and exchange rates, industry is unlikely to be under any illusions on this point. This is clear enough from the French experience. They have shown since 1983 how an inflationary situation can be turned round within the ERM; but since France was already a member of the ERM and could not therefore benefit in 1983 from the potential positive effect on expectations of entering the Mechanism, the French government was obliged to allow unemployment to rise in order to signal its determination to hold its position in the system and to get on top of inflation.

There are lessons in this for us - and I mean for both sides of the wage bargaining process. Our ability to compete - and thus to preserve or create jobs - will deteriorate unless both wage

settlements and productivity growth move rapidly towards Continental performance. But if those concerned recognise the disciplines inherent in ERM membership and reflect this in their approach to what lies ahead, I am hopeful that we can match the French performance at a lower social cost.

We did, of course, combine ERM entry with a one percentage point cut in interest rates. Perhaps the first thing to make clear about this is that, when taking the decision we knew that, while the real economy was softening and inflationary pressures were easing, the inflation rate itself had not yet peaked. Because of this, some in the financial markets said the interest rate cut was premature. To such doubters I would make three points: first, the most recent economic and monetary data provide clear evidence that the conditions necessary to reduce inflation are now coming into place; secondly, at 14%, interest rates remain high; and thirdly, the continuing restraining influence of high real interest rates has been considerably reinforced by ERM entry itself. It would be quite wrong to see the steps taken a fortnight ago as designed to bring about any significant easing of our policy stance.

Others have said that the interest rate reduction was both too small and too late; that we should do more, and quickly. But I am afraid that that would not be compatible with getting inflation decisively lower. In fact, complaints about policy, from whatever source, would have been more appropriate when monetary conditions became too relaxed. For some time now we have been working to reduce the unsustainable rate of growth of domestic demand that was allowed to develop by low interest rates a few years ago. Easy credit conditions not only fuelled demand, but did so partly by encouraging firms and individuals to take on debt which, in the event, they have struggled to support - and in some sad cases have failed.

The lessons of excessive floating rate borrowing were learned painfully by the developing world about ten years ago, and are no less true for British firms now, or indeed for British households. Our determination to maintain a tight policy will, I am afraid, not allow any immediate easing in this pain. All I can say is that it is necessary to get us back on track - to restore the conditions for sustainable non-inflationary growth. We must correct the consequences of past mistakes, and I am confident that we will be helped in this by the discipline of the ERM - a discipline on policy-makers, on lenders and borrowers, and on wage bargainers.

IMPROVEMENTS IN THE CITY

Our entry into the ERM comes just over two years before the planned completion of the 1992 legislative programme. Taken together, the new monetary framework and the advent of the internal market in the Community will significantly change the environment for the financial services industry. More than ever therefore, the City must be equipped to compete effectively. I am glad to say that a great deal of progress has been made in this respect, and perhaps you will allow me just a few moments, my Lord Mayor, to enumerate some of the achievements of the past twelve months.

First of all, there is much to applaud in the institutional arrangements for trading. I am thinking in particular of The International Stock Exchange's reorganisation, which will boost its efficiency and give a sharper focus to its activities; of the imminent establishment of the London Derivatives Exchange, through the merger of LIFFE and the London Traded Options Market; and the welcome news that the non-financial futures exchanges are moving in the same direction.

Advances are also being made with the City's settlement systems, which on this occasion last year I highlighted as a priority. The Bank of England has recently launched the Central Moneymarkets Office; and the Stock Exchange is on target to meet its October 1991 deadline for starting the TAURUS system. Both systems will replace existing paper-based settlement arrangements, and will take us a long way to catching up with competing centres. But I should not omit to stress that more is still needed if we are to take the lead in the settlement and payments area.

Improvements have not been confined to market systems. The regulators have also done much to allay the criticism they faced a few years ago. The Securities and Investments Board has simplified its rule-book; the Self Regulatory Organisations are working towards the same goal; and some welcome streamlining of the SRO structure is in prospect, through the prospective merger of The Securities Association with the Association of Futures Brokers and Dealers.

These and other changes are individually, and even more collectively, major achievements. But we cannot sit back and wait for others to recognise our strengths. We need to promote them -

and that means individual firms, trade associations, government agencies and others. I therefore draw considerable satisfaction from the current plans to reorganise and strengthen the British Invisible Exports Council - or rather British Invisibles, as we should now call it. Equally, I welcome the Corporation's initiative to finance a study of the comparative costs of doing business in the City. And I also look forward to the results of the Transport Task Force which, my Lord Mayor, you have set up to follow on the useful work of the City Commuter Services Group. Transport is an area where much improvement is needed.

As most of you will know, the Bank has been closely involved with many of the developments I have touched on. Our actions in this area are guided by one overriding aim, and let me therefore leave no-one in any doubt about this. I am absolutely determined that the City should remain the pre-eminent - not just leading, I mean pre-eminent - financial centre in this time zone. And that determination is matched only by my confidence that we shall do so - confidence which is based on the major contribution which you, as practitioners, make and must continue to make to its achievement.

chex.kf/jg1/44

CONFIDENTIAL

TPM

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

17 October 1990

Barry Potter Esq
Private Secretary to
the Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister
You will want to see this, in particular
- para 9 on interest rate policy in ERM
- para 16 on fiscal policy in ERM
- para 23-27 on ERM when the "peoples and governments" formulation is repeated
- para 28 on an ECU gilt.

AT 18/10

Dear Barry

MANSION HOUSE SPEECH

... I attach the latest draft of the speech for the Mansion House tomorrow night. I should draw your attention to one particular passage in which the Chancellor proposes to say that he is considering the issue of an ecu bond (which would, of course, be denominated in the existing basket ecu).

The objectives would be to promote our drive on the hard ecu and to help sustain London's position in the long term ecu market against Continental competition. Issuing ecu bonds, which would provide a useful addition to our foreign currency reserves would build on the success of our ecu Treasury Bill programme.

The Chancellor has not yet taken a firm view on the appropriate size and terms of an ecu offering. The decision on timing will also need to be taken carefully. So the Chancellor proposes to say nothing about it in his speech and to keep our plans under regular review.

Yours

JG

JOHN GIEVE
Principal Private Secretary

TIME 8.45 PM

DRAFT OF 17 OCTOBER 1990

MANSION HOUSE SPEECH

My Lord Mayor, Mr Governor, My Lords, Aldermen, Mr Recorder, Sheriffs, Ladies and Gentlemen, it is now nearly a year since I returned to the Treasury after a brief parole in the Foreign Office. I believe I am probably the only politician to have prepared the Treasury's public spending posture for a bilateral with the Foreign Secretary; conducted that bilateral as Foreign Secretary; and announced the outcome as Chancellor. As the public expenditure round continues I must comment that such a sequence of events does have it advantages.

UK Economy

2. From the outset it seemed likely that 1990 would be an uncomfortable year and so it has proved. Economic policy has been dominated by the struggle to get control of the inflationary pressures that were evident both in the inflation figures themselves and in the large current account deficit.

too much money

3. The cause of our problem was excess demand. And the remedy that we put in place of a firm monetary policy is now clearly working.

4. All the monetary aggregates now tell the same story. Annual growth of narrow money, M0, has been reduced in every month since April and is now within its target range; M4 growth has fallen steadily throughout this year to reach its lowest point since June 1987. We have seen a welcome recovery in the savings ratio from 4.9 per cent in the third quarter of 1988 to 7.7 per cent in the second quarter of 1990. And in the last few months, there has been a clear change also in the indicators of activity, employment and confidence. Over the next few months we are likely to see a further reduction of the excess demand pressure that has been at the root of higher inflation.

5. Earlier this month sterling entered the Exchange Rate Mechanism. This event marks a significant change in the conduct of monetary policy. The news was greeted with rapture in some quarters, and with deepest gloom in others. Neither of these extreme reactions seems to me to be right. What entry to the ERM amounts to is an extra dimension to our monetary discipline. I have no doubt it will bring benefits for the UK. But I do not

agree with those who argue that the ERM will bring short-term advantages and then have long-term costs. Precisely the reverse is true. Entry will require tough action in the short-term to ensure low inflation thereafter. The disciplines of the system will force both the Government and the private sector to make difficult choices.

6. For the private sector, I am thinking in particular of the control of costs including labour costs. The days have gone in which businesses could simply negotiate around the RPI and assume that the exchange rate would keep them competitive with their European rivals. Keeping our costs in line with, or lower than, those elsewhere in the Community is now essential.

7. It is, of course, the Directors and Managers of British companies who must ensure that they stay competitive. The Government cannot do it for them. It is no use businessmen bewailing the dominance of the "going rate" in general while meekly accepting it as an unavoidable cost in their own firms. Within the ERM that approach will lead to only one result: lost markets, redundancies, plant closures, and ultimately company failures.

No such thing as a so-called going rate.

8. I hope we have managed to make that message fully understood. It is as relevant to pay in the boardroom as it is to pay on the shop-floor.

9. For the Government too, membership of the ERM will be a discipline. It has become the cornerstone of our strategy. We have an obligation to hold sterling in its band, and it is an obligation which we will meet. If, to stay within the band, we are required either to raise or lower interest rates, raise or lower them we will. That is the nature of the new obligation we have undertaken. But that does not mean we ignore other monetary indicators. Making a success of the ERM means making a success of monetary policy. And that will require continuing attention to monetary conditions in this country just as it does in the other members of the ERM.

10. One of the enormous complications for the conduct of policy in the 1980s has been the inconsistency in behaviour of various monetary aggregates, very probably because of the speed of financial liberalisation. The problem is that different indicators can at the same time give completely contradictory messages. Thus it is possible to argue that in 1980 not enough attention was given to narrow money; and in 1986 broad money should

have been the focus of greater attention. One comforting development has been that for some time now, the messages coming from broad and narrow money have been the same; possibly because the biggest effects of financial liberalisation have begun to work themselves through.

11. Before we could join we needed to be sure that inflationary pressures were on the way down. As usual there has been a lag between the peak in economic growth and the peak in inflation - indeed that lag has been particularly long on this occasion. But it is now clear that - although oil prices have yet to feed through fully into the headline figures - inflation itself is near its peak and will fall markedly over the next year. There was therefore no further reason for delay in entering the mechanism. But, of course, those very same conditions also indicated that a reduction in interest rates was now appropriate.

12. I decided, therefore, to announce the two moves at the same time. In doing so I was influenced by the risk that a reduction in interest rates before entry into the ERM would have been taken either as a signal that I was seeking to weaken the exchange rate in readiness for joining - which I was not; or alternatively, that entry

was a long way off - which it was not. Both interpretations might have weakened the exchange rate and damaged the prospect of entering at a central rate that would make our counter-inflationary intentions clear from the start. I took the view, therefore, that the markets should be aware of both those factors at the same time - hence the joint announcement. To be frank, I thought that was the most straightforward and sensible way to proceed, and I still do.

13. We decided to enter with 6 per cent margins to give sterling an opportunity to settle down, in view of the uncertainties which necessarily attend an important market development of this kind. As circumstances permit, we will move to the narrow $2^{1}/_{4}$ per cent band.

14. Returning to inflation, I expect to see this fall throughout next year, and especially quickly from April onwards as both the underlying rate improves and some of the unusual adverse factors drop out. However, notwithstanding this improved prospect, interest rates will only be reduced further when it is clearly safe to do so.

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support monetary policy and it is crucial we maintain this approach in the future.

16. Some commentators have suggested that membership will require a more active fiscal policy because interest rates are, in some sense, allocated to maintaining the exchange rate and are therefore not available to help achieve other objectives. I have no doubt that it would be a huge mistake to return to frequent mini-budgets and fiscal fine-tuning. It is not necessary and, in my limited experience, one Autumn Statement and one Budget a year are quite sufficient!

17. As the economy has slowed it has become inevitable that large cyclical Budget surpluses would diminish. The boom in corporate tax collection has come to an end for the time being and, as I indicated to the Treasury Committee of the House of Commons some years ago, an economic slowdown inevitably brings renewed pressures on public expenditure, which may no longer fall as a proportion of GDP. But I do not believe we should change our medium-term objective of a balanced Budget. That would not make sense and we will not do it.

18. To summarise, there is no doubt about the problems of 1990. I do not promise that 1991 will be easy

either: we will continue to need tight monetary and fiscal policies and our commitment to the ERM will reinforce that discipline on industry and on Government. But we will, I am sure, begin to see the benefits in a substantial fall in inflation. And with inflation back under control, British business will be well placed to take advantage of the enormous opportunities which lie in the years ahead.

Europe

19. In recent years we have played an important and constructive role in shaping the Community. I have no doubt that we will continue to do so in future. This is vital to the future of the City and to industry. Of course, whenever we voice doubts about a proposal emanating from Brussels, there will be those ready to call us halfhearted Europeans or accuse us of trying to disrupt the Community. Equally, whenever we enter a debate to defend or promote British and European interests there will be those who accuse us of pre-emptive surrender. Both are wrong.

20. Our record as good Europeans is excellent. It was Britain that was instrumental in seeking a Budget deal that kept the Community viable; Britain which has

helped remove the worst excesses of the CAP; and Britain which has implemented more single market measures than all but one of our Community partners. Many so-called 'good Europeans' are in practice very bad Europeans when it comes to opening up their markets to competition.

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22. I believe that an important test of Britain's commitment to Europe is our desire to see the Community evolve together. We do not want to see it split into two tiers with an inner core speeding ahead. This will not strengthen the EC. And it could damage it gravely. It is against that background that I hope our partners will judge our proposals for the development of EMU beyond Stage 1.

23. In recent months I have been encouraged by the direction that debate has taken. Increasingly the focus of attention is on the practical steps after Stage 1 as our partners in Europe recognise that the pre-requisite to further integration is convergence of economic performance. Moreover, there is an inherent absurdity in arguing about the length or date of Stage 2 before determining what it should be: we need to decide what kind of monetary institution will develop and what functions it should have.

24. Our proposals for a European Monetary Fund and a hard ecu are well known. They provide an evolutionary approach based on the market and choice. They recognise that economic convergence is far from satisfactory. For the differences between the relative performances of the twelve are striking. Annual rates of inflation in the Community range from 2½ to 22 per cent; short-term interest rates range from 8 to 18 per cent; and public sector budget balances range from a surplus of 3 per cent of GDP to a deficit of over 17 per cent. And the inherent flexibility of the economies of member states is vastly different.

25. Our proposals were heavily influenced by advice and guidance from within the City - including, of course,

the Bank of England - and I am happy to acknowledge that. They were intended to advance the debate on EMU and offer a way to keep the Community moving forward together.

26. As we draw nearer to the inter-governmental conference in December, we shall continue to take a practical and constructive approach. But no one should misinterpret our position. Joining the ERM did not commit us to adopting, and cannot oblige us to accept, the imposition of a single currency in Europe.

27. But we do remain open to the evolution of such a currency. For I have made it perfectly plain that under the UK's proposals, the hard ecu could ultimately become a single currency if that were truly the wish of governments and peoples. But I have also indicated that it is neither necessary nor desirable to take a decision of that kind now.

28. While the debate continues we are looking for practical ways in which the existing basket ecu can be developed. Tonight I can announce some modest moves in that direction. The Bank of England is already consulting Gilt Edged Market Makers about the basis on which they deal in ecu bonds as well as sterling. I

welcome that. I am now giving consideration to an ecu bond issue, at the appropriate time, which would demonstrate further our attachment to the ecu and would strengthen London's important position in this rapidly growing market. Another practical step which we shall support is the proposal that member states' contributions to the European Development Fund should in future be denominated in ecu.

29. Our commitment to Europe is also demonstrated by our support for the nations of Eastern Europe and our conviction that they too must have the opportunity to become members of the Community. The location of the European Bank for Reconstruction and Development in London - which I warmly welcome - will be an important means of assisting market economies emerge in those countries. And the choice of London as the site is a tribute to the City's unique experience in finance and privatisation.

30. In summary, Mr Lord Mayor, I look forward to the 1990s as the decade in which we will build on the gains of the 1980s; in which we will bring our economic performance up to that of the best in Europe; in which we will ~~play a central~~ [to have a leading] role in creating an open and constructive Community; and in which we can look

forward to London consolidating its position as the financial centre of Europe. We should aim for nothing less. And accept nothing else.

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MANSION HOUSE SPEECH: 19 OCTOBER 1989

It is with very great pleasure that I rise once again to reply to your generous and encouraging toast of "prosperity to the public purse and the health of the Chancellor of the Exchequer".

Over the years I have touched on a number of subjects at this grand occasion. But there is one above all that I have felt to be most appropriate for this audience and I propose to return to it tonight.

I refer, of course, to the Government's monetary policy. For monetary policy is at the heart of macroeconomic policy in a free economy, and thus plays the central role in the battle against inflation.

The key to operating a sound monetary policy is to take correct and timely decisions on interest rates. The task is not easy, at least not without the benefit of hindsight. But it cannot be ducked.

There are two indicators, in particular, to which we look in reaching those decisions: the monetary base, more familiarly known as M0, and the exchange rate.

M0, which we have targeted continuously since 1984, has consistently exhibited a stable relationship with money GDP, which is the essential attribute of any intermediate target. For the key to sound macroeconomic policy is to focus on the path of gross domestic product in money terms, and thus on inflation itself. So it is important to ensure that M0 comes back within its published target range, and stays within it.

But policy cannot be based on M0 alone. First, there is other evidence of monetary conditions, which it would be foolish to ignore. Second, M0 is for the most part a coincident indicator. This is very useful as it is many months before a reasonably

reliable estimate of money GDP is available, but it does mean that M0 gives little early warning of inflationary pressures to come.

In an increasingly integrated world, the exchange rate is both a key indicator of monetary conditions, and a most important part of the transmission mechanism through which monetary policy affects inflation. So we have always assigned it a major role in the assessment of monetary conditions.

Let me quote what I said on the subject in my 1985 Budget speech:

"There are those who argue that if we stick to sound internal policies, the exchange rate can be left to take care of itself. In the long run that may well be true, but significant movements in the exchange rate, whatever their cause, can have a short-term impact on the general price level and on inflationary expectations. This process can acquire a momentum of its own, making sound internal policies harder to implement. So benign neglect is not an option.

That is why I have repeatedly argued that it is necessary to take the exchange rate into account in judging monetary conditions. There is no mechanical formula which enables us to balance the appropriate combination of the exchange rate and domestic monetary growth needed to keep financial policy on track, but a balance still has to be struck, and struck in a way that takes no chances with inflation."

These arguments remain as valid now as they were then. We cannot allow the necessary rigour of monetary policy to be undermined by exchange rate weakness. This means that interest rates will have to remain high for some time to come.

Broad money, of which M4 is the best measure, used to be considered a useful leading indicator. I know it still has its aficionados. But the plain fact is that for the past ten years now, broad money has proved to be an unreliable guide. Had monetary policy been set on the basis of broad money targets alone

over that period it would have generated a series of erratic and often perverse changes of tack. Let me give some examples:-

- In 1980 and 1981 broad money was growing very rapidly indeed, well above its then published target range, yet disinflationary pressure was clearly, by any standards, intense.

- In early 1985 we recognised, from other evidence, that a sharp tightening of policy was required. M4's behaviour at the time gave little or no indication of this.

- And I believe we would be equally mistaken today, were we to pay undue attention to the latest figures for broad money and lending, which fly in the face of the clear evidence that policy is biting, and that money demand is already slowing.

I know there are those who hanker after some simple one-dimensional rule, and take the absence of one as evidence of confusion. I wish life were as simple as that. The plain fact is that operating monetary policy in a modern economy with a sophisticated financial system is inevitably difficult and complex. It would be foolish to ignore any relevant information or to try to rely exclusively on a single indicator.

This is not a peculiarly British phenomenon. It is exactly the same story in other major countries. Let me quote once again:-

> "In view of the apparent variability, particularly over the short-run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly - gathering information on prices, real activity, financial and foreign exchange markets, and related data."

That was Chairman Greenspan of the Federal Reserve, giving evidence to the Banking Committee of the US Senate a couple of months ago. But it is an equally valid description of how policy is operated in most major economies. It may be that the markets are readier to accept this coming from the head of an independent central bank. But we all live in the same world.

It is implicit in all I have said so far that interest rates are the essential instrument of monetary policy. However, I am urged by some to consider instead a return to some form of direct credit controls. Such a step would clearly be unattractive in itself, because of the distortions and inefficiencies it would create. But a more fundamental objection is that it is simply not a serious option in today's highly competitive and open financial markets, and in the absence of exchange controls. Nor, for precisely the same reasons, is it considered an option in other developed countries such as the US and Germany. Any attempt to impose restrictions on UK lending institutions would very soon be as full of holes as a colander, not least because of offshore flows.

It has nevertheless been alleged recently that Germany does indeed use credit controls, operated through their use of reserve ratios for the banking system. This is a complete misunderstanding. In fact, like us, the German authorities regard interest rates as their essential monetary instrument. The reserve ratio, which in practice is rarely changed, is the mechanism by which the German authorities generate the money market shortages necessary to give them control over interest rates. We achieve precisely the same effect by different technical means. To suppose that the German reserve ratio requirement somehow separately doubles as a direct credit control, let alone a consumer credit control, is moonshine.

Funding Policy

Let me now turn to funding policy.

The purpose of funding is to ensure that the public sector as a whole does not inject liquidity into the economy - but nor should it extract liquidity from it.

In recent years, the tightness of our fiscal policies has, of course, meant that, instead of funding a borrowing requirement we are defunding, or unfunding, a debt repayment: so we have had reverse gilt auctions and seen the Bank of England regularly purchasing gilts, rather than selling them, in the secondary market. But the principle remains what it has always been: to ensure that the Government conducts its financial affairs so as to have a broadly neutral effect on liquidity.

There are some who argue that we should set this principle aside and return to the practice of deliberate over-funding in order to control the published figures for the broad money aggregates, which we indeed did for a time in the early 1980s, and in particular during my first two years as Chancellor.

If this offered a better way of curbing inflation, I would of course gladly go back to it. But it would not do so. Quite apart from the limitations of broad money, which I have already described, any money drained out of the system by selling gilts over and above the Government's funding requirements, or by buying in fewer gilts than these requirements dictate, would simply have to be injected into the system elsewhere. If it were not, the outcome would be higher interest rates than those the authorities consider necessary.

Moreover in today's circumstances it would mean using part of the public sector surplus to acquire short-term assets, rather than reduce long-term Government debt, thus injecting money into the system at the shorter end of the market rather than the longer end. Since such money would be more likely to end up financing

consumption, it is not at all clear why this should be considered desirable.

It is also worth recalling why over-funding was abandoned in 1985. It was creating distortions in the financial markets which were undesirable in themselves, and made policy harder to operate. The full fund policy avoids such distortions. It also means that as the Government reduces its debt it makes space for other borrowers in the sterling bond market. Since the beginning of 1988-89 the nominal value of gilts on issue has fallen by £13 billion, while over £16 billion of other sterling bonds have been issued. This replacement of public sector borrowing by the private and overseas sector incidentally exposes the fallacy that the Government has been artificially depressing long-term yields.

But, and this is important, we do not seek to implement the full fund rule rigidly month by month or even necessarily year by year.

In particular, as I said at this same occasion two years ago, while it remains the policy to ensure that, over time, any net intervention is sterilised, that will be done as and when appropriate, and not necessarily within the financial year in which the intervention takes place. Intervention is by its nature a short-term operation. It would clearly be foolish to blunt its impact by simultaneously reinjecting liquidity into the system. Given the extent of recent intervention, it is reasonable to expect that we may end up with some degree of overfund in the current financial year, to be carried over and reversed thereafter.

Before I leave the subject of funding policy I have two modest announcements to make. First, as many of you will know, last year marked the centenary of a landmark in the management of the National Debt: Goschen's consolidation operation, carried out while he was Chancellor in 1888. A century later, as the quantity of gilts in the market declines, we have been considering whether holders should be given the opportunity to convert some of the smaller, less liquid, stocks into larger, more liquid, issues.

I have accordingly decided to proceed with an experimental gilt conversion offer for a pair of stocks. Details will be released by the Bank of England tomorrow morning. Depending on the response, other conversion offers may follow.

My second announcement concerns Treasury Bills. Recent developments in the money markets have made it necessary to increase the size of the weekly Treasury Bill issue. Although most of these bills have been bought by banks and building societies some have been sold to the private and overseas sectors. They thus count as funding within the present definition, and have to be offset by additional purchases of gilts under the full fund rule. Such additional purchases themselves add to any surpluses in the money market, and thus further increase the requirement for additional Treasury Bills.

When the sums at stake were relatively small, this was of little practical consequence. But as the Treasury Bill issue has grown in size, it has come to seem increasingly anomalous to chase our own tails in this way. Accordingly, we have decided to treat Treasury Bill sales as outside the definition of funding, irrespective of who buys them.

EMU

I referred earlier to the role of the exchange rate in the conduct of monetary policy. This has recently been given a new dimension, by the important debate within the European Community over the issue of economic and monetary union. Let me repeat that we are fully committed to Stage 1 of the Delors recipe for economic and monetary union. Both the cause of European unity and the anti-inflation process in Europe will be strengthened by removing capital controls and by liberalising many of the rules preventing currency substitution - all within the context of the EMS.

As the Prime Minister made clear after the Madrid European Council earlier this year, once our own inflation has come down and

progress has been made with the abolition of exchange controls and other key aspects of the single market, the way will be clear for sterling to participate fully in the EMS.

Where we part company with the Delors recipe is in its prescriptions for what should follow Stage 1.

In the first place, any such prescriptions are premature.

No one can predict the path on which the Community will be thrust as a result of the massive changes involved in Stage 1. The competitive forces set free will transform the Community as we know it today. They will ultimately lead to an unprecedented integration of member states' economies. Our own experience of financial liberalisation has shown that its effects are fundamental and far-reaching. It can take many years for them to work through the system. Why then should we try to decide now - before Stage 1 has even begun - precisely how any later stages of the progressive realisation of EMU should be carried forward? Instead, evolution and learning by doing should be our guides.

But the problems go even deeper than that. Having correctly identified the central importance of establishing the single market as the first step on the route, the Delors Report then proposes in the so-called Stages 2 and 3 an abrupt shift to a centralist and bureaucratic agenda that poses grave threats to any known form of democratic accountability.

That is why the United Kingdom will be suggesting an alternative way forward. What we will be suggesting is a natural extension of Stage 1, building on its twin pillars of the creation of a genuine single market and the fuller development of the EMS.

I have referred to this as a regime of competing national currencies, within the framework of the EMS. Needless to say this is not a matter, as some have fancifully suggested, of requiring the village shopkeeper in Much-Binding-in-the-Marsh to accept payment in Drachma. He would be as free to decide what forms of

cash he will accept as he is to decide whether or not to accept a particular credit card.

Its essence is not mandatory, but permissive: removing as far as is practicable the remaining legal and other impediments to the free use and interchangeability of all Community currencies. Impediments, for example, that prevent savings institutions from holding assets denominated in other Community currencies.

Quite apart from the economic benefits to be gained from a greater degree of exchange rate stability, the competition between currencies that all these changes will intensify will be healthy, even bracing. National governments will have every incentive to minimise inflation and to compete for the status of non-inflationary anchor within the EMS, the role currently occupied by the deutschemark. Market forces will tend to lead to convergence of monetary policy around the best - not the average - and so improve the prospects for a low-inflation Community.

In short, the essence of the UK's approach to this issue is precisely the same as it is to other current issues on the European agenda: it is evolutionary and market-based.

There is a very real danger that any attempt to take any other route will end in tears.

UK Economy

The past eight years have been a period of almost unprecedented expansion for the British economy, culminating in the unexpected, and unsustainable, growth spurt of 1987 and 1988.

I warned here a year ago that this was likely to be followed by a year or two of slower growth as the economy caught its breath. The slowdown has not happened as quickly as I expected. In particular, personal savings have fallen further than anyone, inside or outside the Treasury, expected. But the slowdown is

clearly under way and equally clearly has further to go, before the economy resumes its long-run upward trend.

During this necessary adjustment process, inflation - whose underlying rate, excluding the distorting effect of mortgage interest payments, has at no time over the past six and a half years exceeded 6 per cent - will gradually abate, and the current account deficit will gradually narrow, although it is bound to take time.

But in the perspective of history, what will stand out about this period is not the short term vagaries of the economic cycle, which will always be with us, but the long term improvement in the supply performance of the British economy. An improvement so clearly shown in the quantity and quality of business investment, and the greatly improved productivity and profitability of British industry.

The people of Britain may have temporarily forgotten the habit of thrift. That is undoubtedly a short term problem. But at the same time they have rediscovered the spirit of enterprise. And that is the greatest prize of all.

PRIME MINISTER

MANSION HOUSE SPEECH

ATTACHED IS THE SECTION OF THE MANSION HOUSE SPEECH DEALING WITH MONETARY POLICY. THE FIRST PART IS A DEFENCE OF THE STATUS QUO. AT PARA. 12 THE CHANCELLOR SEEKS TO EXPLAIN THE GOVERNMENT'S ATTITUDE TOWARDS THE EXCHANGE RATE. HE IS ARGUING THAT, WHILE THERE IS NO SPECIFIC TARGET, THE GOVERNMENT WILL NOT ACQUIESCE IN A WEAK POUND WHICH WOULD UNDO THE TIGHTNESS BROUGHT ABOUT BY THE BUDGET SURPLUS AND HIGH INTEREST RATES. I HAVE MARKED SOME CHANGES TO KEEP THE LANGUAGE CLOSER TO PREVIOUS STATEMENTS IN ORDER TO MAKE CLEAR THAT THERE IS NO CHANGE OF POLICY.

THE CHANCELLOR THEN GOES ON TO REAFFIRM THE GOVERNMENT'S OPPOSITION TO OVERFUNDING, THOUGH THERE IS A MINOR CHANGE OF EMPHASIS. THE CHANCELLOR MAKES CLEAR THAT, TAKING ONE YEAR WITH ANOTHER, THE EFFECTS OF INTERVENTION WILL CONTINUE TO BE STERILISED, BUT WHERE THERE HAS BEEN INTERVENTION TO LEAN AGAINST A WEAK POUND, THE TIGHTENING OF LIQUIDITY WHICH RESULTS WILL NOT BE UNWOUND IMMEDIATELY. THIS MEANS THAT FOR A WHILE SUCH INTERVENTION WILL REINFORCE INTEREST RATES.

THERE IS A PROPOSAL FOR A CONVERSION ISSUE. THIS IS NO MORE THAN A PIECE OF TIDYING UP - A SMALL, LIGHTLY TRADED STOCK IS TAKEN IN AND REPLACED BY ISSUE OF A LARGER, MORE HEAVILY TRADED, MATURITY. THIS COULD EITHER LENGTHEN OR SHORTEN THE AVERAGE MATURITY OF GILTS ACCORDING TO THE PAIR OF STOCKS CHOSEN, BUT I WOULD EXPECT THE EFFECT TO BE TO SHORTEN UNLESS THERE WAS A CLEAR COST ADVANTAGE THE OTHER WAY.

FINALLY, THERE IS A TECHNICAL CHANGE TO THE DEFINITION OF FUNDING BY EXCLUDING TREASURY BILLS SOLD TO BUILDING SOCIETIES.

AT

18 OCTOBER, 1989.

JD46

NO.10 DOWNING ST.

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..(from PG).....

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FROM....Duty clerk.....

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..Dick/Diana,..Please pass to AT asap
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(9)

Monetary Policy

I turn now to monetary policy.

2. First, the fundamentals. Policy continues to be operated, as it has been for the last decade, within a medium-term framework of financial, that is to say nominal, magnitudes. That framework is set out each year at Budget time, in the MTFS. The objective is the defeat of inflation. Let there be no doubt of that. The path may not always be smooth, as recent events have shown, but the aim remains unchanged, and imperative.

3. Within this framework, monetary policy plays the central role in the battle against inflation. Short-term interest rates are the essential instrument of monetary policy. So the key to operating a sound monetary policy is to take correct and timely decisions on interest rates. The task is not easy, and always easier with the benefit of hindsight. But it cannot be ducked.

4. It requires a constant and comprehensive assessment of monetary conditions. This involves first of all monitoring the performance of the target monetary aggregate, M0, in relation to its target range.

5. When I spoke at the Mansion House four years ago I said, if I may quote :-

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"I realise that MO has not yet acquired many friends in the square mile, despite the evidence of its relatively stable relationship with transactions in the economy and the steady trend in its velocity of circulation."

6. I believe it has more friends today. It has continued since 1985 to show a stable relationship with money GDP, which is and must be the most important single attribute for a monetary aggregate chosen for target purposes. So the performance of MO in relation to its target range remains central to an assessment of monetary conditions.

7. But it would be wrong to base policy on MO alone. First, there is other evidence of monetary conditions, which it would be foolish to ignore. Second, MO is of its nature a mainly contemporaneous indicator, giving little early warning of inflationary pressures to come.

8. Broad money, of which M4 is now the most sensible measure, used to be considered a useful forward looking indicator. I know it still has its devotees. But the truth is that broad money has in recent years proved thoroughly unreliable. If monetary policy had been set on the basis of broad money targets alone over that period it is clear that it would have generated a series of erratic and frequently perverse changes of policy. I will give some examples:-

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- the same thing happened in 1986. Had we followed M4, on autopilot as it were, we would have - quite inappropriately - loosened policy in the autumn of 1986, at a time when it was clearly correct to tighten it, as we did.

- and I believe we would make a similar mistake today, were we to pay undue attention to today's figures for broad money and lending, despite all the evidence that monetary policy is biting, and that money demand is already slowing.

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and increased borrowing, including borrowing to pay higher interest charges, often being the first reaction of companies and individuals to tighter economic conditions. This is a further reason why broad money remains unsuitable for target status. There is no sense in setting a target for an aggregate that reacts perversely, in the short-run, to the instrument of policy.

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> "In view of the apparent variability, particularly over the short-run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly - gathering information on prices, real activity, financial and foreign exchange markets, and related data."

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17. I am urged by some to consider a return to some form of credit controls. Undesirable as such a step would be in itself, and I believe it would be highly undesirable, those who propose it should recognise that it is simply not an option in today's highly competitive and open financial markets, and in the absence of exchange controls. Indeed it is not an option in other developed countries such as the US, Germany, or even Japan. Any attempt to impose restrictions on lending by institutions such as banks and building societies would quickly be circumvented through offshore flows, and domestic disintermediation, for example through the sterling commercial paper market.

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Funding Policy

I turn now to funding policy.

19. The purpose of funding, quite simply, is to ensure that the public sector as a whole neither injects liquidity into the economy nor extracts liquidity from it in any systematic way. This purpose led us to adopt, from the start, the rule which I explained on this very occasion six years ago, in these words:-

> "The broad aim of funding policy will continue to be to fund the Public Sector Borrowing Requirement, by raising finance ... from the UK private sector and from external flows ...Over the medium term there should be no systematic tendency either to overfund, or to underfund, the borrowing requirement."

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Overfunding

21. That principle has been tried and tested, and I intend that it continue to guide our actions. But there have been voices urging us to set aside the full fund rule and return to the policy of deliberately overfunding which in practice we followed for a time in the early 1980s.

22. If this change of policy offered a new and painless way of maintaining tight monetary conditions, I would enthusiastically espouse it. But I am clear that it would not do so. In today's circumstances it would mean using part of the budget surplus to acquire short-term assets rather than reduce long term Government debt, placing money at the shorter end of the market rather than the longer end. That would tend to put upward pressure on long-term interest rates and crowd out the long-term corporate borrowing which has financed so much investment in recent years. At the same time the money placed at short end of the market would be more likely to end up financing consumption. None of this commends itself as at all desirable.

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29. While the sums at stake were not large this situation merited no special action. But, as the Treasury bill issue has grown in size, it has come to seem increasingly curious that issues of these short-term market instruments should be defined as funding when this definition itself nullified to a significant degree the purpose of issuing Treasury bills. Our practice is, accordingly, now to regard Treasury bill sales as outside the definition of funding, irrespective of who buys them.

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Debt portfolio structure

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31. These considerations led in 1988-89 to a concentration of the repurchases of gilts at the longer end of the maturity spectrum, reflecting the Government's view that its longer term debt looked relatively expensive borrowing. More recently, however, changes in yield relativities have caused the authorities to make their gilt repurchases over a wider range of maturities, in particular in very short maturity stocks, whose purchase is now more attractive on cost as well as on liquidity grounds.

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MANSION HOUSE: DRAFT OF 18 OCTOBER

It is with very great pleasure that I rise once again to reply to your generous and encouraging toast of "prosperity to the public purse and the health of the Chancellor of the Exchequer".

2. Over the years I have touched on a number of subjects at this grand occasion. But there is one above all that I have felt to be most appropriate for this audience and I propose to return to it tonight.

3. I refer, of course, to the Government's monetary policy. For monetary policy plays the central role in the battle against inflation. Short-term interest rates are the essential instrument of monetary policy. So the key to operating a sound monetary policy is to take correct and timely decisions on interest rates. The task is not easy, at least not without the benefit of hindsight. But it cannot be ducked.

4. To assist us in this task, we seek to keep the monetary base, M0, within a published target range.

5. When I spoke at the Mansion House four years ago I said, if I may quote: -

> "I realise that M0 has not yet acquired many friends in the square mile, despite the evidence of its relatively

stable relationship with transactions in the economy and the steady trend in its velocity of circulation."

6. I believe it has more friends today. It has continued since 1985 to show a stable relationship with money GDP, which is and must be the most important single attribute for a monetary aggregate chosen for target purposes. For the essence of sound economic policy must always be to focus on the nominal framework of money GDP.

7. But it would be wrong to base policy on M0 alone. First, there is other evidence of monetary conditions, which it would be foolish to ignore. Second, M0 is primarily a contemporaneous indicator, giving little early warning of inflationary pressures to come.

8. Broad money, of which M4 is the most sensible measure, used to be considered a useful forward looking indicator. I know it still has its devotees. But the plain fact is that for the past ten years now, broad money has proved to be unreliable. Had monetary policy been set on the basis of broad money targets alone over that period it would have generated a series of erratic and often perverse changes of policy. Let me give some examples:-

- In 1980 and 1981 broad money was growing very rapidly indeed, well above its target range, yet disinflationary pressure was clearly, by any standards, intense.

- In early 1985 we recognised, from other evidence, that a sharp tightening of policy was required to prevent inflationary pressure re-emerging. M4's behaviour at the time gave little or no indication of this.

- The same thing happened in 1986. Had we followed M4, on autopilot as it were, we would have - quite inappropriately - loosened a policy in the Autumn of 1986, at a time when it was clearly correct to tighten it, as we did.

- And I believe we would make a similar mistake today, were we to pay undue attention to the latest figures for broad money and lending, which fly in the face of the clear evidence that monetary policy is biting, and that money demand is already slowing.

9. But both M0 and M4 are purely domestic indicators. In an increasingly open world, the exchange rate is both a key indicator of monetary conditions, and a most important part of the transmission mechanism through which monetary policy bears down on inflation.

10. Let me quote what I said on the subject in my 1985 Budget speech:

> "There are those who argue that if we stick to sound internal policies, the exchange rate can be left to take care of itself. In the long run that may well be true, but significant movements in the exchange rate, whatever their cause, can have a short-term impact on the general price level and on inflationary expectations. This process can acquire a momentum of its own, making sound internal policies harder to implement. So benign neglect is not an option.
>
> That is why I have repeatedly argued that it is necessary to take the exchange rate into account in judging monetary conditions. There is no mechanical formula which enables us to balance the appropriate combination of exchange rate and domestic monetary growth needed to keep financial policy on track, but a balance still has to be struck, and struck in a way that takes not chances with inflation."

11. These arguments remain as valid now as they were then. We cannot allow the necessary rigor of monetary policy to be undermined by exchange rate weakness.

12. I know there are some who hanker after some simple one-dimensional rule, and suspect the absence of one to be evidence of confusion. I wish life were as simple as that.

The plain fact is that operating monetary policy in a modern economy with a sophisticated financial system is inevitably difficult and complex. It would be foolish to ignore any relevant information or to try to rely on only one indicator.

13. This is not a peculiarly British phenomenon. It is exactly the same story in other major countries. Let me quote once again:-

> "In view of the apparent variability, particularly over the short-run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly - gathering information on prices, real activity, financial and foreign exchange markets, and related data."

14. That was Chairman Greenspan of the Federal Reserve, giving evidence to the Banking Committee of the US Senate a couple of months ago. But it is an equally valid description of how policy is operated in the UK, or for that matter in other major countries such as Germany and Japan.

15. I said that interest rates are the essential instrument of monetary policy. This is only natural, since interest rates represent the price of money and credit.

16. I am urged by some to consider a return to some form of credit controls. Undesirable as such a step would be in itself, because of the distortions and inefficiencies it would create, those who propose it fail to see that it is simply not a serious option in today's highly competitive and open financial markets, and in the absence of exchange controls. Nor indeed is it an option in other developed countries such as the US and Germany. Any attempt to impose restrictions on lending by institutions such as Banks and Buildings Societies would quickly be circumvented through offshore flows, and through domestic disintermediation, for example through the sterling commercial paper market.

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requirement somehow separately doubles as a direct credit control is simply poppycock.

Funding Policy

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

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financial affairs so as to have a broadly neutral effect on liquidity.

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22. If this offered a new and painless way of maintaining tight monetary conditions, I would enthusiastically espouse it. But it would not do so. In today's circumstances it would mean using part of the public sector surplus to acquire short-term assets, rather than reduce long-term Government debt, thus injecting money into the system at the shorter end of the market rather than the longer end. That would tend to put upward pressure on long-term interest rates at the expense of the long-term corporate borrowing which has financed so much investment in recent years. At the same time the money injected at the short end of the market would be more likely to end up financing consumption. It is not immediately clear that this would be desirable.

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its debt it makes space for other borrowers in the sterling bond market. Since the beginning of 1988-89 the nominal value of gilts on issue has fallen by £16 billion, while over £16 billion of other sterling bonds have been issued. This crowding-in by the private [and overseas - check] sector illustrates the fallacy of those who suppose that the Government has been artificially depressing long-term yields.

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<u>Conversion</u>

26. Before I leave the subject of funding policy, however, I have two modest announcements to make. First, as many of you

will know, last year marked the centenary of a landmark in the management of the National Debt: Goschen's consolidation operation, carried out while he was Chancellor in 1888. A century later, as the quantity of gilts in the market declines, we have been considering whether holders should be given the opportunity to convert some of the smaller, less liquid, stocks into larger, more liquid, issues.

27. I have accordingly decided to proceed with an experimental gilt conversion offer for a pair of stocks. Details will be released by the Bank of England tomorrow morning. This operation will give those who wish to do so the opportunity to switch their holdings from one existing gilt-edged stock into another, so increasing its size and liquidity. Depending on the response, other conversion offers may follow.

Treasury Bills

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EMU

1 I referred earlier to the role of the exchange rate in the conduct of monetary policy. This has recently been given a new dimension, by the debate within the European Community over the issue of economic and monetary union. During what has come to be known as Stage I of that process, both the cause of European unity and the anti-inflation process in Europe will be strengthened by removing capital controls and by liberalising many of the rules preventing currency substitution - all within the context of the EMS.

2 The competition between currencies and monetary policies that all these changes will bring about can only be healthy. National governments will have every incentive to minimise inflation and to compete for the status of non-inflationary anchor within the EMS, the role currently occupied by the deutschemark. Market forces will tend to lead to convergence of monetary policy around the best - not the average - and so improve the prospects for a low-inflation Europe.

3 The essence of the UK's approach to all this is evolutionary and market-based. We seek to build on the two main pillars of Stage 1 - namely the single market and the European Monetary System - and the anti-inflationary discipline they provide. Removal of the exchange controls still operated by some countries fully within the EMS will heighten the pressure on governments to run sound policies. And as the Prime Minister made clear after the Madrid

European Council earlier this year, once our Community partners have abandoned the protection of these controls and made progress in removing other financial restrictions and unfair subsidies, the way will be clear for the UK to participate fully in the EMS.

4 Thus Stage I of the Delors recipe for Economic and Monetary Union is something to which we are fully committed. But there are major flaws in its prescriptions for later stages. The report correctly identified the central importance of establishing the single market as the first stage on the route. But it then proposed a complete shift in the so-called Stages 2 and 3 to a centralist, bureaucratic, and indeed undemocratic approach to change. I shall be putting a paper setting out the UK approach to my Community Finance Minister colleagues before we meet next month.

5 The plain fact is that no-one can predict the path on which the Community will be thrust as a result of the massive changes involved in Stage 1. The competitive forces set free will transform the Community as we know it today. They will lead to the increasing integration of member states' economies. Our own experience of financial liberalisation has shown that these effects are fundamental and far-reaching and can take many years to work through fully. Why then try to decide now - before Stage I has even begun - precisely how any later stages of the progressive realisation of EMU should be carried forward? Evolution and learning by doing should be our guides. That is why what we shall be suggesting is a

natural extension of Stage I: removing to the greatest practicable extent national legal impediments to the free use and interchangeability of all community currencies.

6 Needless to say, this is not a matter, as some fancifully suggest, of requiring the corner shopkeeper in Much-Binding-in-the-Marsh to accept payment in Drachma. He would be as free to decide that for himself as he is to decide whether or not to accept a particular credit card. What is at issue is the removal of restrictions preventing savings institutions, for example, from holding assets denominated in other community currencies. In this way, the system of genuinely competing currencies, within the context of the EMS, will be completed.

UK ECONOMY

The past eight years have been a period of almost unprecedented expansion for the British economy, culminating in the unexpected growth spurt of 1987 and 1988.

2. I warned here a year ago that this was likely to be followed by a year or two of slower growth as the economy caught its breath. That slowdown is now clearly underway, and equally clearly has further to go, before the economy resumes its long-run upward trend.

3. During this inevitable adjustment process, inflation - whose underlying rate, excluding the distorting effect of mortgage interest payments, has at no time over the past six and a half years exceeded 6 per cent - will gradually abate, and the current account deficit gradually narrow.

4. But in the perspective of history, what will stand out about this period is not the short-term vagaries of the business cycle, which will always be with us, but the long-term improvement in the supply performance of the British economy. An improvement so clearly shown in the quantity and quality of business investment, and the greatly improved productivity and profitability of British industry.

5. The people of British may have temporarily forgotten the habit of thrift. But they have rediscovered the spirit of enterprise. And that is the greatest prize of all.

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4. To assist us in this task, we seek to keep the monetary base, M0, within a published target range.

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"I realise that M0 has not yet acquired many friends in the square mile, despite the evidence of its relatively

MANSION HOUSE: DRAFT OF 18 OCTOBER

It is with very great pleasure that I rise once again to reply to your generous and encouraging toast of "prosperity to the public purse and the health of the Chancellor of the Exchequer".

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> "I realise that M0 has not yet acquired many friends in the square mile, despite the evidence of its relatively

stable relationship with transactions in the economy and the steady trend in its velocity of circulation."

6. I believe it has more friends today. It has continued since 1985 to show a stable relationship with money GDP, which is and must be the most important single attribute for a monetary aggregate chosen for target purposes. For the essence of sound economic policy must always be to focus on the nominal framework of money GDP.

7. But it would be wrong to base policy on M0 alone. First, there is other evidence of monetary conditions, which it would be foolish to ignore. Second, M0 is primarily a contemporaneous indicator, giving little early warning of inflationary pressures to come.

8. Broad money, of which M4 is the most sensible measure, used to be considered a useful forward looking indicator. I know it still has its devotees. But the plain fact is that for the past ten years now, broad money has proved to be unreliable. Had monetary policy been set on the basis of broad money targets alone over that period it would have generated a series of erratic and often perverse changes of policy. Let me give some examples:-

- In 1980 and 1981 broad money was growing very rapidly indeed, well above its target range, yet disinflationary pressure was clearly, by any standards, intense.

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- In 1980 and 1981 broad money was growing very rapidly indeed, well above its target range, yet disinflationary pressure was clearly, by any standards, intense.

- In early 1985 we recognised, from other evidence, that a sharp tightening of policy was required to prevent inflationary pressure re-emerging. M4's behaviour at the time gave little or no indication of this.

- The same thing happened in 1986. Had we followed M4, on autopilot as it were, we would have - quite inappropriately - loosened a policy in the Autumn of 1986, at a time when it was clearly correct to tighten it, as we did.

- And I believe we would make a similar mistake today, were we to pay undue attention to the latest figures for broad money and lending, which fly in the face of the clear evidence that monetary policy is biting, and that money demand is already slowing.

9. But both M0 and M4 are purely domestic indicators. In an increasingly open world, the exchange rate is both a key indicator of monetary conditions, and a most important part of the transmission mechanism through which monetary policy bears down on inflation.

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10. Let me quote what I said on the subject in my 1985 Budget speech:

> "There are those who argue that if we stick to sound internal policies, the exchange rate can be left to take care of itself. In the long run that may well be true, but significant movements in the exchange rate, whatever their cause, can have a short-term impact on the general price level and on inflationary expectations. This process can acquire a momentum of its own, making sound internal policies harder to implement. So benign neglect is not an option.
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> That is why I have repeatedly argued that it is necessary to take the exchange rate into account in judging monetary conditions. There is no mechanical formula which enables us to balance the appropriate combination of exchange rate and domestic monetary growth needed to keep financial policy on track, but a balance still has to be struck, and struck in a way that takes not chances with inflation."

11. These arguments remain as valid now as they were then. We cannot allow the necessary rigor of monetary policy to be undermined by exchange rate weakness.

12. I know there are some who hanker after some simple one-dimensional rule, and suspect the absence of one to be evidence of confusion. I wish life were as simple as that.

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The plain fact is that operating monetary policy in a modern economy with a sophisticated financial system is inevitably difficult and complex. It would be foolish to ignore any relevant information or to try to rely on only one indicator.

13. This is not a peculiarly British phenomenon. It is exactly the same story in other major countries. Let me quote once again:-

> "In view of the apparent variability, particularly over the short-run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly - gathering information on prices, real activity, financial and foreign exchange markets, and related data."

14. That was Chairman Greenspan of the Federal Reserve, giving evidence to the Banking Committee of the US Senate a couple of months ago. But it is an equally valid description of how policy is operated in the UK, or for that matter in other major countries such as Germany and Japan.

15. I said that interest rates are the essential instrument of monetary policy. This is only natural, since interest rates represent the price of money and credit.

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16. I am urged by some to consider a return to some form of credit controls. Undesirable as such a step would be in itself, because of the distortions and inefficiencies it would create, those who propose it fail to see that it is simply not a serious option in today's highly competitive and open financial markets, and in the absence of exchange controls. Nor indeed is it an option in other developed countries such as the US and Germany. Any attempt to impose restrictions on lending by institutions such as Banks and Buildings Societies would quickly be circumvented through offshore flows, and through domestic disintermediation, for example through the sterling commercial paper market.

17. It has been suggested recently that Germany is an example of a country that uses credit controls, with their use of reserve ratios for the banking system. This is a complete misunderstanding. In fact, like us, the German authorities regard interest rates as their monetary instrument. Also like us, they control interest rates by relieving the banking system's daily shortfall of liquidity, making funds available at a rate of the authorities' choosing. The reserve ratio, varied if it should prove necessary, is simply the mechanism by which the German authorities ensure that the monetary market shortages exist so that they retain control of interest rates. We achieve precisely the same effect in the UK - I believe in a more sophisticated way - by selling Treasury bills as necessary to create money market shortages and hence maintain control of interest rates. To suppose that the German reserve ratio

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requirement somehow separately doubles as a direct credit control is simply poppycock.

Funding Policy

18. Let me now turn to funding policy.

19. The purpose of funding, quite simply, is to ensure that the public sector as a whole on balance neither injects liquidity into the economy nor extracts liquidity from it. This purpose led us to adopt, some time ago, the rule which I explained on this very occasion six years ago, in these words:-

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

20. In recent years, the tightness of our fiscal policies has, of course, meant that, instead of funding a borrowing requirement we are defunding, or unfunding, a debt repayment: so we have had reverse gilt auctions and the Bank of England regularly purchasing gilts, rather than selling them, in the secondary market. But the principle remains what it has always been: to ensure that the Government conducts its

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financial affairs so as to have a broadly neutral effect on liquidity.

Overfunding

21. There are those, however, who argue that we should set aside the full fund rule and return to the policy of deliberately overfunding, which in practice we followed for a time in early 1980s.

22. If this offered a new and painless way of maintaining tight monetary conditions, I would enthusiastically espouse it. But it would not do so. In today's circumstances it would mean using part of the public sector surplus to acquire short-term assets, rather than reduce long-term Government debt, thus injecting money into the system at the shorter end of the market rather than the longer end. That would tend to put upward pressure on long-term interest rates at the expense of the long-term corporate borrowing which has financed so much investment in recent years. At the same time the money injected at the short end of the market would be more likely to end up financing consumption. It is not immediately clear that this would be desirable.

23. It is also worth recalling why overfunding was abandoned in 1985. It was creating distortions in the financial markets which were undesirable in themselves, and made policy harder to operate. The full fund policy avoids such distortions. It also means that as the Government reduces

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24. But as I have said on earlier occasions, we do not seek to implement the full fund rule rigidly month by month or even necessarily year by year.

25. In particular, as I said at this same occasion two years ago, while it remains the policy to ensure that, over time, any net intervention is sterilised by appropriate unfunding or defunding, that will be done as and when appropriate, and not necessarily within the financial year in which the intervention takes place. Intervention is by its nature a short-term operation. It would clearly by foolish to blunt its impact by simultaneously re-injecting liquidity into the system. Given the extent of recent intervention, it is reasonable to expect that there will be a degree of overfunding in the current financial year, to be carried over and reversed thereafter.

Conversion

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27. I have accordingly decided to proceed with an experimental gilt conversion offer for a pair of stocks. Details will be released by the Bank of England tomorrow morning. This operation will give those who wish to do so the opportunity to switch their holdings from one existing gilt-edged stock into another, so increasing its size and liquidity. Depending on the response, other conversion offers may follow.

Treasury Bills

28. My second announcement concerns Treasury Bills. Recent developments in the money markets have made it necessary to increase the size of the weekly Treasury Bill issue. Although most of these bills have been bought by banks and building societies some have been sold to the private and overseas sectors, and hence count as funding within the present definition, requiring additional purchases of gilts under the full fund rule. Such additional purchases themselves add to any surpluses in the money market, and thus increase the requirement for additional Treasury Bills.

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EMU

1 I referred earlier to the role of the exchange rate in the conduct of monetary policy. This has recently been given a new dimension, by the debate within the European Community over the issue of economic and monetary union. During what has come to be known as Stage I of that process, both the cause of European unity and the anti-inflation process in Europe will be strengthened by removing capital controls and by liberalising many of the rules preventing currency substitution - all within the context of the EMS.

2 The competition between currencies and monetary policies that all these changes will bring about can only be healthy. National governments will have every incentive to minimise inflation and to compete for the status of non-inflationary anchor within the EMS, the role currently occupied by the deutschemark. Market forces will tend to lead to convergence of monetary policy around the best - not the average - and so improve the prospects for a low-inflation Europe.

3 The essence of the UK's approach to all this is evolutionary and market-based. We seek to build on the two main pillars of Stage 1 - namely the single market and the European Monetary System - and the anti-inflationary discipline they provide. Removal of the exchange controls still operated by some countries fully within the EMS will heighten the pressure on governments to run sound policies. And as the Prime Minister made clear after the Madrid

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European Council earlier this year, once our Community partners have abandoned the protection of these controls and made progress in removing other financial restrictions and unfair subsidies, the way will be clear for the UK to participate fully in the EMS.

4 Thus Stage I of the Delors recipe for Economic and Monetary Union is something to which we are fully committed. But there are major flaws in its prescriptions for later stages. The report correctly identified the central importance of establishing the single market as the first stage on the route. But it then proposed a complete shift in the so-called Stages 2 and 3 to a centralist, bureaucratic, and indeed undemocratic approach to change. I shall be putting a paper setting out the UK approach to my Community Finance Minister colleagues before we meet next month.

5 The plain fact is that no-one can predict the path on which the Community will be thrust as a result of the massive changes involved in Stage 1. The competitive forces set free will transform the Community as we know it today. They will lead to the increasing integration of member states' economies. Our own experience of financial liberalisation has shown that these effects are fundamental and far-reaching and can take many years to work through fully. Why then try to decide now - before Stage I has even begun - precisely how any later stages of the progressive realisation of EMU should be carried forward? Evolution and learning by doing should be our guides. That is why what we shall be suggesting is a

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natural extension of Stage I: removing to the greatest practicable extent national legal impediments to the free use and interchangeability of all community currencies.

6 Needless to say, this is not a matter, as some fancifully suggest, of requiring the corner shopkeeper in Much-Binding-in-the-Marsh to accept payment in Drachma. He would be as free to decide that for himself as he is to decide whether or not to accept a particular credit card. What is at issue is the removal of restrictions preventing savings institutions, for example, from holding assets denominated in other community currencies. In this way, the system of genuinely competing currencies, within the context of the EMS, will be completed.

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averaging pool mixing

Worried about the next
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MR. TURNBULL

Prime Minister

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Treasury would welcome reactions.
It looks satisfactory - in places
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That said, the Prime Minister will want to look carefully at what is presently said both about ERM, EMU and the exchange rate. If it was possible to feed back any reactions by early afternoon our time that would be very helpful. The Chancellor is himself working on the speech this afternoon and evening.

I am loping it may be possible to fax out to you late tonight our time a revised draft reflecting the Chancellor's own work. But I am not terribly optimistic about that. It may be we will not have anything further to fax out until early tomorrow morning our time; and by then timing will be very tight in relation to finalisation of the text.

PAUL

PAUL GRAY
18 October 1989

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DRAFT 17 OCTOBER 1989

STOCK MARKET, EMU ETC.

[Politenesses]

For a while earlier this week, it looked as if, as in 1987, I would have to devote the greater part of my remarks this evening to the state of the equity market. Monday's falls in stock markets around the world were for many an uncomfortable echo of events two years ago. Happily, the markets have, this time, stabilised much more rapidly than on that occasion.

Nonetheless scares of this type remind us, as I commented last year, of the extent to which we now live in a global marketplace. Equally the rapid return to stability demonstrates very clearly the underlying strength of the world economy. That strength could not have come about without the globalisation of business, the freer trade and the open markets that we have seen increasingly through the '80s.

But the changes that lie ahead of us are at least as significant as those of the '80s. For we are now approaching the realisation of that vision which brought

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us into the European Community - the common market. The programme of changes on which we are now embarked - the creation of a single market (the so-called "Stage 1" of EMU) - will completely transform our economies. Long-standing barriers to the movement of people, goods and services - not least financial service - will go; opportunities for business will be dramatically increased; so too will the competitive pressures on business, as consumers demand - and get - better quality goods and services or lower prices.

But all this is far from being a reality yet. There is a great deal to be done to make 1992 happen. For instance, of the [X] measures identified as essential for the single market, the greater part have still to be negotiated and adopted in Brussels, never mind implemented in all member countries. And our own experience of financial liberalisation suggests the effects take many years to work through fully.

All the more regrettable, then, that so much time and energy is now being taken up by a question that need not and indeed cannot be sensibly resolved now - namely how best to move further towards economic and monetary union once we have established the single market and all twelve countries have joined the ERM.

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CHANCELLOR'S MANSION HOUSE SPEECH

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PAUL GRAY

18 October 1989

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DRAFT 17 OCTOBER 1989

STOCK MARKET, EMU ETC.

[Politenesses]

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Monetary Policy

I turn now to monetary policy.

2. First, the fundamentals. Policy continues to be operated, as it has been for the last decade, within a medium-term framework of financial, that is to say nominal, magnitudes. That framework is set out each year at Budget time, in the MTFS. The objective is the defeat of inflation. Let there be no doubt of that. The path may not always be smooth, as recent events have shown, but the aim remains unchanged, and imperative.

3. Within this framework, monetary policy plays the central role in the battle against inflation. Short-term interest rates are the essential instrument of monetary policy. So the key to operating a sound monetary policy is to take correct and timely decisions on interest rates. The task is not easy, and always easier with the benefit of hindsight. But it cannot be ducked.

4. It requires a constant and comprehensive assessment of monetary conditions. This involves first of all monitoring the performance of the target monetary aggregate, MO, in relation to its target range.

5. When I spoke at the Mansion House four years ago I said, if I may quote :-

"I realise that MO has not yet acquired many friends in the square mile, despite the evidence of its relatively stable relationship with transactions in the economy and the steady trend in its velocity of circulation."

6. I believe it has more friends today. It has continued since 1985 to show a stable relationship with money GDP, which is and must be the most important single attribute for a monetary aggregate chosen for target purposes. So the performance of MO in relation to its target range remains central to an assessment of monetary conditions.

7. But it would be wrong to base policy on MO alone. First, there is other evidence of monetary conditions, which it would be foolish to ignore. Second, MO is of its nature a mainly contemporaneous indicator, giving little early warning of inflationary pressures to come.

8. Broad money, of which M4 is now the most sensible measure, used to be considered a useful forward looking indicator. I know it still has its devotees. But the truth is that broad money has in recent years proved thoroughly unreliable. If monetary policy had been set on the basis of broad money targets alone over that period it is clear that it would have generated a series of erratic and frequently perverse changes of policy. I will give some examples:-

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- in 1980 and 1981 broad money was growing very rapidly indeed, yet disinflationary pressure was clearly, by any standards, intense.

- in early 1985 we recognised, from other evidence, that a sharp tightening of policy was required to prevent inflationary pressure re-emerging. M4's behaviour at the time gave little or no indication of this.

- the same thing happened in 1986. Had we followed M4, on autopilot as it were, we would have - quite inappropriately - loosened policy in the autumn of 1986, at a time when it was clearly correct to tighten it, as we did.

- and I believe we would make a similar mistake today, were we to pay undue attention to today's figures for broad money and lending, despite all the evidence that monetary policy is biting, and that money demand is already slowing.

9. The continued growth of broad money and lending at this stage is, indeed, not altogether surprising. For a further characteristic of broad money is that in the short-run it can react perversely to a rise in interest rates - with deposits becoming more attractive to hold,

and increased borrowing, including borrowing to pay higher interest charges, often being the first reaction of companies and individuals to tighter economic conditions. This is a further reason why broad money remains unsuitable for target status. There is no sense in setting a target for an aggregate that reacts perversely, in the short-run, to the instrument of policy.

10. The exchange rate is a key indicator of monetary conditions; it is also a most important transmission mechanism through which monetary policy bears down on inflation. So movements in sterling, both in the index and in rates against the other major currencies, may be of great significance.

11. Let me quote what I said on the subject in my 1985 Budget Speech:

> "There are those who argue that if we stick to sound internal policies, the exchange rate can be left to take care of itself. In the long-run that may well be true, but significant movements in the exchange rate, whatever their cause, can have a short-term impact on the general price level and on inflationary expectations. This process can acquire a momentum of its own, making sound internal policies harder to implement. So benign neglect is not an option.

That is why I have repeatedly argued that it is necessary to take the exchange rate into account in judging monetary conditions. There is no mechanical formula which enables us to balance the appropriate combination of exchange rate and domestic monetary growth needed to keep financial policy on track, but a balance still has to be struck, and struck in a way that takes no chances with inflation."

12. These arguments remain as powerful now as they were then. [While a specific exchange rate objective would only make sense within the context of a formal exchange rate arrangement, as is provided by the ERM] Maintaining a firm exchange rate remains central to the operation of monetary policy.

13. But the authorities, I am sorry to say, have been accused of confusion, indeed of twin confusions in policy : a general imprecision about the objectives of monetary policy; and a specific lack of clarity about whether policy gives primacy to internal or external objectives.

14. Both criticisms are misguided. Operating monetary policy in a modern economy with a sophisticated financial system is inevitably difficult and complex. It would be foolish to ignore any relevant information,

or to try to rely on only one indicator. Other major developed countries operate policy in precisely the same way as we do, taking account of a range of evidence in decisions about the level of interest rates. Let me quote again:

> "In view of the apparent variability, particularly over the short-run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly - gathering information on prices, real activity, financial and foreign exchange markets, and related data."

15. That was Chairman Greenspan of the Federal Reserve, giving evidence to the US Senate Committee on Banking, Housing and Urban Affairs this August. But it is an equally valid description of how policy is operated in the UK, or for that matter in other major countries such as Germany and Japan.

16. I said that interest rates are the instrument of policy. This is natural, since interest rates represent the price of money and credit.

17. I am urged by some to consider a return to some form of credit controls. Undesirable as such a step would be in itself, and I believe it would be highly undesirable, those who propose it should recognise that it is simply not an option in today's highly competitive and open financial markets, and in the absence of exchange controls. Indeed it is not an option in other developed countries such as the US, Germany, or even Japan. Any attempt to impose restrictions on lending by institutions such as banks and building societies would quickly be circumvented through offshore flows, and domestic disintermediation, for example through the sterling commercial paper market.

18. It has been suggested recently that Germany is an example of a country that uses credit controls, with their use of reserve ratios for the banking system. This is a simple misunderstanding. In fact, like us, the German authorities regard interest rates as their monetary weapon. Also like us, they control interest rates by relieving the banking system's daily shortfall of liquidity, making funds available at a rate of the authorities' choosing. The reserve ratio, varied if it should prove necessary, is the mechanism the German authorities use to ensure that the money market shortages exist so that they retain control of interest rates. We achieve the same effect in the UK - I believe in a more sophisticated way - by selling Treasury bills, as necessary to create money market shortages and hence

maintain control of interest rates. To suppose that the German reserve requirement somehow separately doubles as a credit control is a pure confusion.

Funding Policy

I turn now to funding policy.

19. The purpose of funding, quite simply, is to ensure that the public sector as a whole neither injects liquidity into the economy nor extracts liquidity from it in any systematic way. This purpose led us to adopt, from the start, the rule which I explained on this very occasion six years ago, in these words:-

> "The broad aim of funding policy will continue to be to fund the Public Sector Borrowing Requirement, by raising finance ... from the UK private sector and from external flows ...Over the medium term there should be no systematic tendency either to overfund, or to underfund, the borrowing requirement."

20. In recent years, the tightness of our fiscal policies has, of course, meant that, instead of funding a borrowing requirement we are defunding, or unfunding, a debt repayment: so we have had reverse gilt auctions, and the Bank of England regularly purchasing gilts rather than selling them in the secondary market. But

the principle remain what it has always been: to ensure that the Government conducts its financial affairs so as to have a broadly neutral effect on liquidity.

Overfunding

21. That principle has been tried and tested, and I intend that it continue to guide our actions. But there have been voices urging us to set aside the full fund rule and return to the policy of deliberately overfunding which in practice we followed for a time in the early 1980s.

22. If this change of policy offered a new and painless way of maintaining tight monetary conditions, I would enthusiastically espouse it. But I am clear that it would not do so. In today's circumstances it would mean using part of the budget surplus to acquire short-term assets rather than reduce long term Government debt, placing money at the shorter end of the market rather than the longer end. That would tend to put upward pressure on long-term interest rates and crowd out the long-term corporate borrowing which has financed so much investment in recent years. At the same time the money placed at short end of the market would be more likely to end up financing consumption. None of this commends itself as at all desirable.

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23. It is also worth recalling why overfunding was abandoned in 1985. It was creating distortions in the financial markets which were undesirable in themselves, and made policy harder to operate. The full fund policy avoids such distortions. It also means that as the Government reduces its debt it makes space for other borrowers in the sterling bond market. Since the beginning of 1988-89 the nominal value of gilts on issue has fallen by £16 billion, while over £16 billion of other sterling bonds have been issued.

24. The full fund rule is a clear rule, but it is not a rigid rule. As I have said on earlier occasions, we do not seek to implement the rule rigidly month by month or even necessarily year by year.

25. That said, as I have always made clear, the Government operates the "full fund" policy flexibly. In particular, as I said at this same occasion two years ago, while it remains the policy to ensure that, over time, any net intervention is sterilised by appropriate unfunding or defunding, that will be done as and when appropriate, and not necessarily within the financial year in which the intervention takes place. Intervention is by its nature a temporary operation. It would be a mistake to blunt its impact, immediately, by reinjecting liquidity into the system. Given the extent of recent intervention, it now seems likely that

there will be a degree of overfunding in the current financial year, to be carried over and reversed thereafter.

Conversion

26. Before I leave the subject of funding policy, however, I have three further points to make. First, as many of you will know, last year marked the centenary of a landmark in the management of the National Debt: Goschen's consolidation operation, carried out while he was Chancellor in 1888. A century later, as the quantity of gilts in the market declines, we have been considering whether holders should be given the opportunity to convert some of the smaller, less liquid, stocks into larger, more liquid, issues.

27. It is good for both Government and investors that the liquidity of the gilts market should be maintained. And it is good for other borrowers in the sterling bond market too. I have therefore decided to proceed with an experimental gilt conversion offer for one pair of stocks. Details will be released by the Bank of England tomorrow morning. This operation will give those who wish to do so the opportunity to switch their holdings from one existing gilt-edged stock into another, so increasing its size and liquidity. Depending on the outcome, other conversion offers may follow.

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Treasury bills

28. My second point is about a minor but useful modification which we are making to the full fund rule. Recent developments in the money markets have made it desirable to increase the size of the weekly Treasury bill issue. Although most of these bills have been bought by banks and building societies some have been sold to the private and overseas sectors and hence count as funding within the present definition, requiring additional purchases of gilts under the full fund rule. Such additional purchases themselves add to any surpluses in the money market, and thus increase the requirement for additional Treasury bills.

29. While the sums at stake were not large this situation merited no special action. But, as the Treasury bill issue has grown in size, it has come to seem increasingly curious that issues of these short-term market instruments should be defined as funding when this definition itself nullified to a significant degree the purpose of issuing Treasury bills. Our practice is, accordingly, now to regard Treasury bill sales as outside the definition of funding, irrespective of who buys them.

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Debt portfolio structure

30. My last observation on funding policy concerns the structure of the Government's remaining debt. Now that the public sector is repaying debt it is possible to pay more attention to this, both to secure lower debt servicing costs and to reduce the Government's reliance on borrowing in the form of more liquid instruments.

31. These considerations led in 1988-89 to a concentration of the repurchases of gilts at the longer end of the maturity spectrum, reflecting the Government's view that its longer term debt looked relatively expensive borrowing. More recently, however, changes in yield relativities have caused the authorities to make their gilt repurchases over a wider range of maturities, in particular in very short maturity stocks, whose purchase is now more attractive on cost as well as on liquidity grounds.

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Bring i passage in conditions from last para of p3 and need to add the 2 extra conditions - ending of the financial restrictions - further progress made in elimination of subsidies which [illegible] Rex laid down at Madrid + stated in her subsequent statement to Hse.

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These competitive pressures can only be good news for those who want to see a low inflation Europe. But even after Stage 1 is complete, their effect will be muted by a number of unnecessary restrictions that will still be in place. For example some countries restrict the currency in which pension funds and life assurance companies may hold their assets, or forbid the issue of foreign currency debt by their residents, or the

purchase of their Government debt by overseas residents. Our proposal is that, as a priority post-1992, all restrictions of this kind should be examined and, where possible, removed, so that the competition between currencies and thus between monetary policies is further sharpened.

This is not, as some people fancifully suggest, a matter of paying for a pint of beer at your local with Italian Lira or Greek Drachma. The proposal is a serious one. And one that avoids a grave flaw in the Delors alternative. With competing currencies, the pressure will be for community monetary policies to harmonise at the level of the best. The most charitable assessment of the Delors proposals is that they would lead to harmonisation on the average. But that <u>is</u> a charitable assessment. In fact, by eliminating competition between monetary policies, the Delors prescription risks a higher inflation rate in Europe. And if that happened, member states and their Parliaments would have no way of bringing the central banking system to account for its mistakes.

That, then, is the prospective cost of Delors. Its proponents would set against this the prospect of reduced transaction costs with a single currency. You

need only try cashing a cheque in Florida when your bank account is in Delaware to realise that a single currency is no guarantee of low transaction costs.

This, then, is where the second strand of our alternative approach comes into play. Much will have been achieved already in Stage 1, for greater mobility of people, goods and capital is bound to bring improved and cheaper community-wide payment systems, whether electronic, plastic, or paper, and simpler and cheaper currency exchange arrangements too. But there will be more to be done after Stage 1 - notably by tackling the remaining barriers [examples] to the use of relatively cheap means of payment, and by developing technologies that are geared to these transactions.

Monetary Policy

I turn now to monetary policy.

2. First, the fundamentals. Policy continues to be operated, as it has been for the last decade, within a medium-term framework of financial, that is to say nominal, magnitudes. That framework is set out each year at Budget time, in the MTFS. The objective is the defeat of inflation. Let there be no doubt of that. The path may not always be smooth, as recent events have shown, but the aim remains unchanged, and imperative.

3. Within this framework, monetary policy plays the central role in the battle against inflation. Short-term interest rates are the essential instrument of monetary policy. So the key to operating a sound monetary policy is to take correct and timely decisions on interest rates. The task is not easy, and always easier with the benefit of hindsight. But it cannot be ducked.

4. It requires a constant and comprehensive assessment of monetary conditions. This involves first of all monitoring the performance of the target monetary aggregate, MO, in relation to its target range.

5. When I spoke at the Mansion House four years ago I said, if I may quote :-

"I realise that MO has not yet acquired many friends in the square mile, despite the evidence of its relatively stable relationship with transactions in the economy and the steady trend in its velocity of circulation."

6. I believe it has more friends today. It has continued since 1985 to show a stable relationship with money GDP, which is and must be the most important single attribute for a monetary aggregate chosen for target purposes. So the performance of MO in relation to its target range remains central to an assessment of monetary conditions.

7. But it would be wrong to base policy on MO alone. First, there is other evidence of monetary conditions, which it would be foolish to ignore. Second, MO is of its nature a mainly contemporaneous indicator, giving little early warning of inflationary pressures to come.

8. Broad money, of which M4 is now the most sensible measure, used to be considered a useful forward looking indicator. I know it still has its devotees. But the truth is that broad money has in recent years proved thoroughly unreliable. If monetary policy had been set on the basis of broad money targets alone over that period it is clear that it would have generated a series of erratic and frequently perverse changes of policy. I will give some examples:-

- in 1980 and 1981 broad money was growing very rapidly indeed, yet disinflationary pressure was clearly, by any standards, intense.

- in early 1985 we recognised, from other evidence, that a sharp tightening of policy was required to prevent inflationary pressure re-emerging. M4's behaviour at the time gave little or no indication of this.

- the same thing happened in 1986. Had we followed M4, on autopilot as it were, we would have - quite inappropriately - loosened policy in the autumn of 1986, at a time when it was clearly correct to tighten it, as we did.

- and I believe we would make a similar mistake today, were we to pay undue attention to today's figures for broad money and lending, despite all the evidence that monetary policy is biting, and that money demand is already slowing.

9. The continued growth of broad money and lending at this stage is, indeed, not altogether surprising. For a further characteristic of broad money is that in the short-run it can react perversely to a rise in interest rates - with deposits becoming more attractive to hold,

and increased borrowing, including borrowing to pay higher interest charges, often being the first reaction of companies and individuals to tighter economic conditions. This is a further reason why broad money remains unsuitable for target status. There is no sense in setting a target for an aggregate that reacts perversely, in the short-run, to the instrument of policy.

10. The exchange rate is a key indicator of monetary conditions; it is also a most important transmission mechanism through which monetary policy bears down on inflation. So movements in sterling, both in the index and in rates against the other major currencies, may be of great significance.

11. Let me quote what I said on the subject in my 1985 Budget Speech:

> "There are those who argue that if we stick to sound internal policies, the exchange rate can be left to take care of itself. In the long-run that may well be true, but significant movements in the exchange rate, whatever their cause, can have a short-term impact on the general price level and on inflationary expectations. This process can acquire a momentum of its own, making sound internal policies harder to implement. So benign neglect is not an option.

That is why I have repeatedly argued that it is necessary to take the exchange rate into account in judging monetary conditions. There is no mechanical formula which enables us to balance the appropriate combination of exchange rate and domestic monetary growth needed to keep financial policy on track, but a balance still has to be struck, and struck in a way that takes no chances with inflation."

12. These arguments remain as powerful now as they were then. [While a specific exchange rate objective would only make sense within the context of a formal exchange rate arrangement, as is provided by the ERM] Maintaining a firm exchange rate remains central to the operation of monetary policy.

13. But the authorities, I am sorry to say, have been accused of confusion, indeed of twin confusions in policy : a general imprecision about the objectives of monetary policy; and a specific lack of clarity about whether policy gives primacy to internal or external objectives.

14. Both criticisms are misguided. Operating monetary policy in a modern economy with a sophisticated financial system is inevitably difficult and complex. It would be foolish to ignore any relevant information,

or to try to rely on only one indicator. Other major developed countries operate policy in precisely the same way as we do, taking account of a range of evidence in decisions about the level of interest rates. Let me quote again:

> "In view of the apparent variability, particularly over the short-run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly - gathering information on prices, real activity, financial and foreign exchange markets, and related data."

15. That was Chairman Greenspan of the Federal Reserve, giving evidence to the US Senate Committee on Banking, Housing and Urban Affairs this August. But it is an equally valid description of how policy is operated in the UK, or for that matter in other major countries such as Germany and Japan.

16. I said that interest rates are the instrument of policy. This is natural, since interest rates represent the price of money and credit.

17. I am urged by some to consider a return to some form of credit controls. Undesirable as such a step would be in itself, and I believe it would be highly undesirable, those who propose it should recognise that it is simply not an option in today's highly competitive and open financial markets, and in the absence of exchange controls. Indeed it is not an option in other developed countries such as the US, Germany, or even Japan. Any attempt to impose restrictions on lending by institutions such as banks and building societies would quickly be circumvented through offshore flows, and domestic disintermediation, for example through the sterling commercial paper market.

18. It has been suggested recently that Germany is an example of a country that uses credit controls, with their use of reserve ratios for the banking system. This is a simple misunderstanding. In fact, like us, the German authorities regard interest rates as their monetary weapon. Also like us, they control interest rates by relieving the banking system's daily shortfall of liquidity, making funds available at a rate of the authorities' choosing. The reserve ratio, varied if it should prove necessary, is the mechanism the German authorities use to ensure that the money market shortages exist so that they retain control of interest rates. We achieve the same effect in the UK - I believe in a more sophisticated way - by selling Treasury bills, as necessary to create money market shortages and hence

maintain control of interest rates. To suppose that the German reserve requirement somehow separately doubles as a credit control is a pure confusion.

Funding Policy

I turn now to funding policy.

19. The purpose of funding, quite simply, is to ensure that the public sector as a whole neither injects liquidity into the economy nor extracts liquidity from it in any systematic way. This purpose led us to adopt, from the start, the rule which I explained on this very occasion six years ago, in these words:-

> "The broad aim of funding policy will continue to be to fund the Public Sector Borrowing Requirement, by raising finance ... from the UK private sector and from external flows ...Over the medium term there should be no systematic tendency either to overfund, or to underfund, the borrowing requirement."

20. In recent years, the tightness of our fiscal policies has, of course, meant that, instead of funding a borrowing requirement we are defunding, or unfunding, a debt repayment: so we have had reverse gilt auctions, and the Bank of England regularly purchasing gilts rather than selling them in the secondary market. But

the principle remain what it has always been: to ensure that the Government conducts its financial affairs so as to have a broadly neutral effect on liquidity.

Overfunding

21. That principle has been tried and tested, and I intend that it continue to guide our actions. But there have been voices urging us to set aside the full fund rule and return to the policy of deliberately overfunding which in practice we followed for a time in the early 1980s.

22. If this change of policy offered a new and painless way of maintaining tight monetary conditions, I would enthusiastically espouse it. But I am clear that it would not do so. In today's circumstances it would mean using part of the budget surplus to acquire short-term assets rather than reduce long term Government debt, placing money at the shorter end of the market rather than the longer end. That would tend to put upward pressure on long-term interest rates and crowd out the long-term corporate borrowing which has financed so much investment in recent years. At the same time the money placed at short end of the market would be more likely to end up financing consumption. None of this commends itself as at all desirable.

23. It is also worth recalling why overfunding was abandoned in 1985. It was creating distortions in the financial markets which were undesirable in themselves, and made policy harder to operate. The full fund policy avoids such distortions. It also means that as the Government reduces its debt it makes space for other borrowers in the sterling bond market. Since the beginning of 1988-89 the nominal value of gilts on issue has fallen by £16 billion, while over £16 billion of other sterling bonds have been issued.

24. The full fund rule is a clear rule, but it is not a rigid rule. As I have said on earlier occasions, we do not seek to implement the rule rigidly month by month or even necessarily year by year.

25. That said, as I have always made clear, the Government operates the "full fund" policy flexibly. In particular, as I said at this same occasion two years ago, while it remains the policy to ensure that, over time, any net intervention is sterilised by appropriate unfunding or defunding, that will be done as and when appropriate, and not necessarily within the financial year in which the intervention takes place. Intervention is by its nature a temporary operation. It would be a mistake to blunt its impact, immediately, by reinjecting liquidity into the system. Given the extent of recent intervention, it now seems likely that

there will be a degree of overfunding in the current financial year, to be carried over and reversed thereafter.

Conversion

26. Before I leave the subject of funding policy, however, I have three further points to make. First, as many of you will know, last year marked the centenary of a landmark in the management of the National Debt: Goschen's consolidation operation, carried out while he was Chancellor in 1888. A century later, as the quantity of gilts in the market declines, we have been considering whether holders should be given the opportunity to convert some of the smaller, less liquid, stocks into larger, more liquid, issues.

27. It is good for both Government and investors that the liquidity of the gilts market should be maintained. And it is good for other borrowers in the sterling bond market too. I have therefore decided to proceed with an experimental gilt conversion offer for one pair of stocks. Details will be released by the Bank of England tomorrow morning. This operation will give those who wish to do so the opportunity to switch their holdings from one existing gilt-edged stock into another, so increasing its size and liquidity. Depending on the outcome, other conversion offers may follow.

Treasury bills

28. My second point is about a minor but useful modification which we are making to the full fund rule. Recent developments in the money markets have made it desirable to increase the size of the weekly Treasury bill issue. Although most of these bills have been bought by banks and building societies some have been sold to the private and overseas sectors and hence count as funding within the present definition, requiring additional purchases of gilts under the full fund rule. Such additional purchases themselves add to any surpluses in the money market, and thus increase the requirement for additional Treasury bills.

29. While the sums at stake were not large this situation merited no special action. But, as the Treasury bill issue has grown in size, it has come to seem increasingly curious that issues of these short-term market instruments should be defined as funding when this definition itself nullified to a significant degree the purpose of issuing Treasury bills. Our practice is, accordingly, now to regard Treasury bill sales as outside the definition of funding, irrespective of who buys them.

Debt portfolio structure

30. My last observation on funding policy concerns the structure of the Government's remaining debt. Now that the public sector is repaying debt it is possible to pay more attention to this, both to secure lower debt servicing costs and to reduce the Government's reliance on borrowing in the form of more liquid instruments.

31. These considerations led in 1988-89 to a concentration of the repurchases of gilts at the longer end of the maturity spectrum, reflecting the Government's view that its longer term debt looked relatively expensive borrowing. More recently, however, changes in yield relativities have caused the authorities to make their gilt repurchases over a wider range of maturities, in particular in very short maturity stocks, whose purchase is now more attractive on cost as well as on liquidity grounds.

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CF - PC.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

19 October 1988

Paul Gray Esq
10 Downing Street

Note
Agreed to paras 11 + 35
discussed in Team.
ARG
25/10

Dear Paul,

MANSION HOUSE SPEECH

I attach the latest draft. The Chancellor will be finalising it after tomorrow morning's meetings.

Yours sincerely,

Andrew Hudson

ps4/1Ha

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MANSION HOUSE SPEECH: FIFTH DRAFT

Introduction

1. It is with very great pleasure that I rise once again at this great annual occasion to respond to the toast "prosperity to the public purse" and the health of the Chancellor of the Exchequer". Not least because the toasting your recent predecessors have done has been so conspicuously successful. I refer not so much to my health - though there is nothing wrong with that, I am glad to say - but to the prosperity of the public purse.

2. Last year, for only the second occasion since our Queen ascended the throne, this country secured a Budget surplus. This year, that surplus will be even larger. And I intend to see that there is a substantial surplus next year, too.

3. This the sixth time I have had the honour of speaking to you here as Chancellor. But that is a puny score compared with the record of my fellow-guest, the Chairman of the Stock Exchange, Nicholas Goodison, who will shortly be entertaining and edifying us for the twelfth year in succession, a record unmatched since the war. But this is also ~~Nicholas,~~ sadly, the last time ~~you~~ he

will be doing this particular turn, and I would like to take the opportunity to pay tribute to his outstanding achievements during his long ~~10 year~~ tenure of office. He led the Stock Exchange out of the Restrictive Practices Court, through Big Bang, and in to the modern world. He has presided with wisdom and real leadership over the most far reaching changes any one can remember in a vitally important part of the City. By acting as mid-wife to the International Stock Exchange, he has played a critical and decisive part in consolidating London's position as a global financial centre. And he has consistently championed the cause of wider share ownership. I thank him most warmly for all he has done, and wish him, and his successor well for the future.

Global Markets

4. When we last dined here, a year ago, it was in the aftermath of the world wide Stock Market crash that has come to be known as Black Monday, An event which, among other things, was a perhaps uncomfortably vivid reminder of the extent to which we now live in a global market place.

5. Although we now take it for granted that the financial sector is one of the most international of all, this was not really the case for most of the post-war period. While Governments throughout the world, rightly determined to avoid the damage done by protectionism in the 1930s, committed themselves to free trade and open

markets, far reaching controls on the movement of capital became accepted, for the most part, as a fact of life. But over the past few years all that has changed; and we now have a degree of freedom that has probably not existed since before the First World War - with the development of information technology making the global financial market-place even more of a reality than it was then.

6. This has obvious implications, first of all, for the co-ordination of prudential supervision, where the Basle Committee has done such important work. I warmly welcome the historic agreement on capital adequacy reached earlier this year, in which Robin Leigh-Pemberton and Peter Cooke played such a key role.

7. But the consequences of global markets go far beyond questions of supervision, to the very heart of the conduct of economic policy.

8. Finance Ministers and Central Bank Governors today have to come to terms with a world in which the amount of mobile capital is far larger than it has ever been before.

9. This has a number of advantages. Savers have a wider range of opportunities, and borrowers have access to a much larger pool of funds. There is now no reason why investment should be financed exclusively from domestic sources. Net capital flows between countries

are inevitable and desirable, and may last for some years in the same direction, with current account imbalances as the inevitable counterpart.

10. But by the same token, the scale of mobile capital imposes a discipline on policy, irrespective of the state of the current account balance.

11. Monetary policy has had to adapt, since the expansion in global capital flows has increased the potential for exchange rate volatility, as we have seen with the dollar. As a result, all the major countries have now recognised the need to pursue policies that will achieve and maintain a reasonable degree of exchange rate stability. And for over three years, now, there has been international co-operation to that end.

12. And for those who wish to know in greater detail what that co-operation is about, I can do no better than refer to the official history of the Bank of England, where you will find a description by a senior Bank official in 1937 of the essential characteristics of the system of managed floating that had followed the collapse of the gold standard a few years earlier. A key characteristic, he wrote, and I quote, was

> "Readiness on the part of the Governor and of the Bank to be identified with an exchange policy which is never formulated, explained or justified, but which is all the time having cumulative effects that

must eventually thrust themselves upon public attention."

13. But the discipline imposed by mobile capital extends beyond the exchange rate. To attract the savings needed to finance investment, whether those savings originate at home or abroad, countries need to maintain an overall policy stance that commands the confidence of investors.

14. That clearly means a sound fiscal and monetary policy and a firm stand against inflation. But it also means regulatory and tax policies that make for business success. For example, no country can afford a tax regime which drives away top managers, entrepreneurs, and scientists, any more than a tax regime which deters capital investment. It was to ensure that Britain can retain, attract and motivate such people that I introduced the far-reaching personal tax reforms contained in this year's Budget.

15 So the globalisation of markets has implications going well beyond the operation of the markets themselves. It affects the whole conduct of economic policy. And it may be no coincidence that the 1980s have seen not merely global integration of markets, but a growing global consensus on an economic policy based on sound money and less government intervention in the economy.

16. That conclusion has profound implications for our approach to the completion of the single European market in 1992.

17. I have spoken before about the two routes which Europe could adopt: either on the one hand, liberalisation and deregulation to the greatest extent practicable; or, on the other, the bureaucratic imposition of harmonised regulation based on some average of the existing practices, good and bad alike, of the various member states.

18. It is vital, not just for this country but for Europe as a whole, that the first approach is adopted. For the Community cannot insulate itself from the global market, any more than an individual country can. There is abundant evidence of the benefits of free trade - indeed, that is the reason for completing the single market in the first place. But these benefits will be put at risk if Europe fails to respond to the challenges offered by the wider world market. The Fortress Europe mentality is profoundly damaging to the single market ideal, which above all must be about making the European economy more competitive in world markets.

19. The question of access to the single market is, of course, of particular interest to the City, not least given the widespread concern about Commission proposals

to make access to the internal market in financial services and banking conditional on the achievement of reciprocity. Let me make it clear that those proposals are a long way from being agreed. The British Government, for one, has made plain its commitment to reducing barriers and to opening markets. In financial services, more than almost any other sector, all countries would stand to lose if the Community were to try to erect a wall between itself and the rest of the world. Before long, the business would simply go elsewhere.

20. As the Heads of Government put it, at the European Council meeting at Hanover in June:

> "The internal market should not close in on itself. In conformity with the provisions of GATT, the Community should be open to third countries, and must negotiate with those countries where necessary to secure access to their markets ...".

21. This is the spirit in which the UK has always approached reciprocity: as a tool for improving access to other markets, not as a pretext for restricting access to our own.

22. The right approach is the one adopted in the recently approved Capital Liberalisation Directive. Those Community countries who had not already done so agreed not just to abolish remaining restrictions on

capital movements between Member States, but to seek to achieve the same degree of liberalisation erga omnes - that is, with the rest of the world as well. And they did so, frankly, because no other approach makes sense in today's global markets.

23. Finally on 1992, let me say this.

24. There are some who claim that the single market can operate successfully only if Europe moves to monetary union, by which they mean a common currency.

25. This is manifest nonsense: a view held only by politicians who know nothing about economics and by economists who are oblivious to the realities of politics.

26. The current talk about all this is not new. It has surfaced before, at the time of the Werner Report of 1970. If I may quote from what I wrote in the Sunday Times at the time, some eighteen years ago:

> "A national currency lies at the very heart of national sovereignty. A common currency is something that can only properly follow political union: it cannot precede it. It is significant that whereas the Zollverein or customs union paved the way to the German Federation a century ago, it was only after Prussia and Bismarck had achieved a political union, with blood and iron, that a common German

currency could be borne."

And so far as the European Community is concerned that political union is not on the agenda.

27. I think I can fairly claim to have demonstrated my commitment to international financial co-operation, both among the major powers and within Europe; and I would like to see that co-operation taken further. But I find myself in wholehearted agreement with Herr Karl-Otto Pohl, the Chairman of the German Bundesbank, when he wrote recently:

> "One does not have to be a defeatist about European integration to doubt whether there is really political scope for such fundamental decisions and the sacrifices of national sovereignty that would be required by the creation of a European central bank and currency."

28. 1992 will offer both opportunities and challenges to British businesses. I know that, in the past year, the City has got down to the necessary hard thinking about how best to prepare itself. Given the right framework, which this Government will work for, I have no doubt that you will benefit from the wider opportunities in Europe, as you have done elsewhere in the world.

Funding and monetary policy

29. To return to the home front, I mentioned at the start of my remarks how we have progressed from public

sector borrowing to the net repayment of public sector debt.

30. But this does not affect our overall funding policy.

30. 31. But this does not affect our overall funding policy which remains the same as it has been in recent years: a full fund, which neutralises the impact of the public sector on the monetary system and does neither less nor more than that. I said a full fund but I should perhaps now say a full unfund over the year as a whole.

31. 32. That means, in our new circumstances, and taking full account of the need to fund any underlying net increase in our foreign exchange reserves, that the Bank of England are now required to purchase gilts rather than to sell them, thus bringing about the reduction in the national debt. It does not necessarily mean that the required unfunding will be fully completed within the course of the financial year, as I explained on this occasion last year. But it does mean, among other things, that there will be no more gilt auctions for the foreseeable future.

32. 33. The strength of the public finances provides an important buttress to monetary policy in the fight against inflation.

33. When I spoke here last year, in the immediate

aftermath of the stock market crash, I said that this country was well placed to cope with the repercussions of the crash, and that the improved performance of recent years would not be blown away by a financial blizzard.

34. There were some, I recall, who thought that was verging on the Panglossian. In the event, the economy has forged ahead.

35. As far as monetary policy is concerned, the ride has not always been a smooth one. At times interest rates have had to come down, first in response to the crash itself, and later when the objective of reasonable exchange rate stability came under threat. At other times, interest rates have had to go up, as the evidence of the strength of domestic demand became increasingly apparent. But the point is that the necessary action has been taken, and taken promptly, to maintain the appropriate degree of tightness, taking the effect of interest rates and the exchange rate together.

36. And I have little doubt that historians of the future will judge that the loosening of monetary policy in the wake of the crash, even though it may have stored up some problems later on, was infinitely to be preferred to the terrifying risks attendant on doing nothing at that fragile time.

37. Meanwhile, the tightening of monetary policy last

summer has already had an impact on the housing market, with price rises slowing and new mortgage commitments sharply down. This is particularly important, given the central role that the housing market has played in the sharp decline in the savings ratio in this country. And there are some tentative indications that retail sales may also be slowing. ~~though it is never wise to read too much into one set of data.~~

38. Inevitably, however, it will take some time before the full effects come through. But although I cannot share the almost magical properties assigned to interest rate changes by those who profess to see enormous consequences in the reduction of base rates to 7½ per cent for all of two weeks, interest rates <u>will</u> do the job - which, of course, is why every other major nation relies on them in the conduct of policy. And in Britain today, with the personal sector a net payer of interest for the first time ever, interest rates can be expected to be more effective than at any time in the past.

39 ~~40~~. As a result, inflation is likely to peak, at only a little above its present level, during the course of next year. But it may well take until the following year before we see a significant reduction in the current

account deficit. Meanwhile, let me repeat that interest rates will remain as high as it takes, for as long as it takes, to get on top of inflation.

41. After several years of strong growth at a little over 3 per cent a year we have now had two years - 1987 and 1988 - in which growth has been rather faster. Following that spurt, it is now likely that we will see a year or two of slower growth as the economy catches its breath.

42. But that is no cause for alarm. The underlying supply performance of the economy has improved dramatically as a result of the policies we have pursued - including deregulation, competition, and improved incentives - and it will be possible to combine the necessary slowing down with what is, by historical standards, a perfectly respectable growth rate.

43. Over the past six years the growth of UK output has averaged over 3½ per cent a year, while inflation has averaged some 4½ per cent, and employment has risen by getting on for 2 million. At the same time, we have held our share of world trade in manufactured goods after decades of decline.

44. All in all, it is an impressive performance, born out of the determination to pursue supply side reform within a sound macro-economic framework. It has been an

effective combination, and it will remain the thrust of this Government's economic policy.

45. I can assure you, my Lord Mayor, that the Government will continue to do all in its power to ensure that the years ahead are years of prosperity, not just for the public purse, but for the whole nation.

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MANSION HOUSE SPEECH: FIFTH DRAFT

Introduction

1. It is with very great pleasure that I rise once again at this great annual occasion to respond to the toast "prosperity to the public purse" and the health of the Chancellor of the Exchequer". Not least because the toasting your recent predecessors have done has been so conspicuously successful. I refer not so much to my health - though there is nothing wrong with that, I am glad to say - but to the prosperity of the public purse.

2. Last year, for only the second occasion since our Queen ascended the throne, this country secured a Budget surplus. This year, that surplus will be even larger. And I intend to see that there is a substantial surplus next year, too.

3. This the sixth time I have had the honour of speaking to you here as Chancellor. But that is a puny score compared with the record of my fellow-guest, the Chairman of the Stock Exchange, Nicholas Goodison, who will shortly be entertaining and edifying us for the twelfth year in succession, a record unmatched since the war. But this is also ~~Nicholas,~~ sadly, the last time ~~you~~ he

will be doing this particular turn, and I would like to take the opportunity to pay tribute to his outstanding achievements during his long ~~10 year~~ tenure of office. // He led the Stock Exchange out of the Restrictive Practices Court, through Big Bang, and in to the modern world. He has presided with wisdom and real leadership over the most far reaching changes any one can remember in a vitally important part of the City. By acting as mid-wife to the International Stock Exchange, he has played a critical and decisive part in consolidating London's position as a global financial centre. And he has consistently championed the cause of wider share ownership. // I thank him most warmly for all he has done, and wish him, and his successor well for the future.

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markets, far reaching controls on the movement of capital became accepted, for the most part, as a fact of life. But over the past few years all that has changed; and we now have a degree of freedom that has probably not existed since before the First World War - with the development of information technology making the global financial market-place even more of a reality than it was then.

6. This has obvious implications, first of all, for the co-ordination of prudential supervision, where the Basle Committee has done such important work. I warmly welcome the historic agreement on capital adequacy reached earlier this year, in which Robin Leigh-Pemberton and Peter Cooke played such a key role.

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are inevitable and desirable, and may last for some years in the same direction, with current account imbalances as the inevitable counterpart.

10. But by the same token, the scale of mobile capital imposes a discipline on policy, irrespective of the state of the current account balance.

11. Monetary policy has had to adapt, since the expansion in global capital flows has increased the potential for exchange rate volatility, as we have seen with the dollar. As a result, all the major countries have now recognised the need to pursue policies that will achieve and maintain a reasonable degree of exchange rate stability. And for over three years, now, there has been international co-operation to that end.

12. And for those who wish to know in greater detail what that co-operation is about, I can do no better than refer to the official history of the Bank of England, where you will find a description by a senior Bank official in 1937 of the essential characteristics of the system of managed floating that had followed the collapse of the gold standard a few years earlier. A key characteristic, he wrote, and I quote, was

> "Readiness on the part of the Governor and of the Bank to be identified with an exchange policy which is never formulated, explained or justified, but which is all the time having cumulative effects that

must eventually thrust themselves upon public attention."

13. But the discipline imposed by mobile capital extends beyond the exchange rate. To attract the savings needed to finance investment, whether those savings originate at home or abroad, countries need to maintain an overall policy stance that commands the confidence of investors.

14. That clearly means a sound fiscal and monetary policy and a firm stand against inflation. But it also means regulatory and tax policies that make for business success. For example, no country can afford a tax regime which drives away top managers, entrepreneurs, and scientists, any more than a tax regime which deters capital investment. It was to ensure that Britain can retain, attract and motivate such people that I introduced the far-reaching personal tax reforms contained in this year's Budget.

15 So the globalisation of markets has implications going well beyond the operation of the markets themselves. It affects the whole conduct of economic policy. And it may be no coincidence that the 1980s have seen not merely global integration of markets, but a growing global consensus on an economic policy based on sound money and less government intervention in the economy.

16. That conclusion has profound implications for our approach to the completion of the single European market in 1992.

17. I have spoken before about the two routes which Europe could adopt: either on the one hand, liberalisation and deregulation to the greatest extent practicable; or, on the other, the bureaucratic imposition of harmonised regulation based on some average of the existing practices, good and bad alike, of the various member states.

18. It is vital, not just for this country but for Europe as a whole, that the first approach is adopted. For the Community cannot insulate itself from the global market, any more than an individual country can. There is abundant evidence of the benefits of free trade - indeed, that is the reason for completing the single market in the first place. But these benefits will be put at risk if Europe fails to respond to the challenges offered by the wider world market. The Fortress Europe mentality is profoundly damaging to the single market ideal, which above all must be about making the European economy more competitive in world markets.

19. The question of access to the single market is, of course, of particular interest to the City, not least given the widespread concern about Commission proposals

to make access to the internal market in financial services and banking conditional on the achievement of reciprocity. Let me make it clear that those proposals are a long way from being agreed. The British Government, for one, has made plain its commitment to reducing barriers and to opening markets. In financial services, more than almost any other sector, all countries would stand to lose if the Community were to try to erect a wall between itself and the rest of the world. Before long, the business would simply go elsewhere.

20. As the Heads of Government put it, at the European Council meeting at Hanover in June:

> "The internal market should not close in on itself. In conformity with the provisions of GATT, the Community should be open to third countries, and must negotiate with those countries where necessary to secure access to their markets ...".

21. This is the spirit in which the UK has always approached reciprocity: as a tool for improving access to other markets, not as a pretext for restricting access to our own.

22. The right approach is the one adopted in the recently approved Capital Liberalisation Directive. Those Community countries who had not already done so agreed not just to abolish remaining restrictions on

capital movements between Member States, but to seek to achieve the same degree of liberalisation erga omnes - that is, with the rest of the world as well. And they did so, frankly, because no other approach makes sense in today's global markets.

23. Finally on 1992, let me say this.

24. There are some who claim that the single market can operate successfully only if Europe moves to monetary union, by which they mean a common currency.

25. This is manifest nonsense: a view held only by politicians who know nothing about economics and by economists who are oblivious to the realities of politics.

26. The current talk about all this is not new. It has surfaced before, at the time of the Werner Report of 1970. If I may quote from what I wrote in the Sunday Times at the time, some eighteen years ago:

> "A national currency lies at the very heart of national sovereignty. A common currency is something that can only properly follow political union: it cannot precede it. It is significant that whereas the Zollverein or customs union paved the way to the German Federation a century ago, it was only after Prussia and Bismarck had achieved a political union, with blood and iron, that a common Ger-

currency could be borne."

And so far as the European Community is concerned that political union is not on the agenda.

27. I think I can fairly claim to have demonstrated my commitment to international financial co-operation, both among the major powers and within Europe; and I would like to see that co-operation taken further. But I find myself in wholehearted agreement with Herr Karl-Otto Pohl, the Chairman of the German Bundesbank, when he wrote recently:

> "One does not have to be a defeatist about European integration to doubt whether there is really political scope for such fundamental decisions and the sacrifices of national sovereignty that would be required by the creation of a European central bank and currency."

28. 1992 will offer both opportunities and challenges to British businesses. I know that, in the past year, the City has got down to the necessary hard thinking about how best to prepare itself. Given the right framework, which this Government will work for, I have no doubt that you will benefit from the wider opportunities in Europe, as you have done elsewhere in the world.

Funding and monetary policy

29. To return to the home front, I mentioned at the start of my remarks how we have progressed from public

sector borrowing to the net repayment of public sector debt.

30. ~~But this does not affect our overall funding policy.~~

30. ~~31.~~ But this does not affect our overall funding policy which remains the same as it has been in recent years: a full fund, which neutralises the impact of the public sector on the monetary system and does neither less nor more than that. I said a full fund but I should perhaps now say a full unfund over the year as a whole.

31. ~~32.~~ That means, in our new circumstances, and taking full account of the need to fund any underlying net increase in our foreign exchange reserves, that the Bank of England are now required to purchase gilts rather than to sell them, thus bringing about the reduction in the national debt. It does not necessarily mean that the required unfunding will be fully completed within the course of the financial year, as I explained on this occasion last year. But it does mean, among other things, that there will be no more gilt auctions for the foreseeable future.

32. ~~33.~~ The strength of the public finances provides an important buttress to monetary policy in the fight against inflation.

33. When I spoke here last year, in the immediate

aftermath of the stock market crash, I said that this country was well placed to cope with the repercussions of the crash, and that the improved performance of recent years would not be blown away by a financial blizzard.

34. There were some, I recall, who thought that was verging on the Panglossian. In the event, the economy has forged ahead.

35. As far as monetary policy is concerned, the ride has not always been a smooth one. At times interest rates have had to come down, first in response to the crash itself, and later when the objective of reasonable exchange rate stability came under threat. At other times, interest rates have had to go up, as the evidence of the strength of demand became increasingly apparent. But the point is that the necessary action has been taken, and taken promptly, to maintain the appropriate degree of tightness, taking the effect of interest rates and the exchange rate together.

36. And I have little doubt that historians of the future will judge that the loosening of monetary policy in the wake of the crash, even though it may have stored up some problems later on, was infinitely to be preferred to the terrifying risks attendant on doing nothing at that fragile time.

37. Meanwhile, the tightening of monetary policy last

summer has already had an impact on the housing market, with price rises slowing and new mortgage commitments sharply down. This is particularly important, given the central role that the housing market has played in the sharp decline in the savings ratio in this country. And there are some tentative indications that retail sales may also be slowing. ~~though it is never wise to read too much into one set of data.~~

38. Inevitably, however, it will take some time before the full effects come through. But although I cannot share the almost magical properties assigned to interest rate changes by those who profess to see enormous consequences in the reduction of base rates to 7½ per cent for all of two weeks, interest rates will do the job - which, of course, is why every other major nation relies on them in the conduct of policy. And in Britain today, with the personal sector a net payer of interest for the first time ever, interest rates can be expected to be more effective than at any time in the past.

~~39.~~ 39 ~~40~~. As a result, inflation is likely to peak, at only a little above its present level, during the course of next year. But it may well take until the following year before we see a significant reduction in the current

are you happy to say it will take until 1990?

account deficit. Meanwhile, let me repeat that interest rates will remain as high as it takes, for as long as it takes, to get on top of inflation.

41. After several years of strong growth at a little over 3 per cent a year we have now had two years - 1987 and 1988 - in which growth has been rather faster. Following that spurt, it is now likely that we will see a year or two of slower growth as the economy catches its breath.

42. But that is no cause for alarm. The underlying supply performance of the economy has improved dramatically as a result of the policies we have pursued - including deregulation, competition, and improved incentives - and it will be possible to combine the necessary slowing down with what is, by historical standards, a perfectly respectable growth rate.

43. Over the past six years the growth of UK output has averaged over 3½ per cent a year, while inflation has averaged some 4½ per cent, and employment has risen by getting on for 2 million. At the same time, we have held our share of world trade in manufactured goods after decades of decline.

44. All in all, it is an impressive performance, born out of the determination to pursue supply side reform within a sound macro-economic framework. It has been in

effective combination, and it will remain the thrust of this Government's economic policy.

45. I can assure you, my Lord Mayor, that the Government will continue to do all in its power to ensure that the years ahead are years of prosperity, not just for the public purse, but for the whole nation.

MR 1/28

UNCLASSIFIED

ce BG

FROM: A C S ALLAN
DATE: 4 November 1987

SIR P MIDDLETON

cc: PS/CST
PS/FST
PS/PMG
PS/EST
Sir T Burns
Sir G Littler
Mr Cassell
Mr H P Evans
Mrs Lomax
Mr Peretz
Mr R I G Allen
Miss O'Mara
Mr Cropper
Mr D Norgrove - No.10

ce BL and returns pse.

MANSION HOUSE SPEECH

... I attach the final version of the Mansion House Speech. I am most grateful to everyone for supplying comments on earlier drafts at very short notice.

ACSA

A C S ALLAN

MANSION HOUSE SPEECH: 4 NOVEMBER 1987

On this great annual occasion of the Lord Mayor's dinner for the bankers and merchants of the City of London - and this is now the fifth time I have stood up here as Chancellor - it is customary to say something about the City.

But there are other speeches to come, and I can be brief.
Foremost among those other speeches, of course, will be that of the Governor, who will also be playing his fifth innings here in that capacity.
The excellent working relationship he and I have built up over that period is one that I value very highly indeed, and it clearly assumes a special importance during the difficult time through which we are now passing.
I am immensely grateful to him.

I would also like to salute the City for the way in which it has comported itself throughout almost three weeks of a financial blizzard which blew in from across the Atlantic, with a ferocity few of us have experienced in our lifetime.
Throughout that period, the markets have continued trading without disruption, and without even the curtailment of normal trading hours.
And in the midst of it all, the biggest share issue the world has ever seen was able to go ahead, with the London sub-underwriters ready, willing, and able to absorb the stock with relative ease.

I pay tribute to the Association of British Insurers, who, at the height of the BP controversy, declared

> "ABI members are quite prepared for the issue to go ahead and they will of course meet the obligations they have undertaken. There is no question of the ABI membership seeking to put pressure on Government to have the BP issue postponed."

And I pay tribute, too, to my fellow-guest, the Chairman of the Stock Exchange, Nicholas Goodison, who with characteristic forthrightness made clear that in his opinion, too, the BP share issue should go ahead.

I may be old-fashioned, but in my judgement, had I bowed to the pressure from some quarters to abandon the issue, which had been fully underwritten and - in London, at least, sub-underwritten too - it would have done irreparable harm to the good name and reputation of the City.
That weighed heavily with me in reaching my decision.

As it is, the City can hold up its head with pride.
It has demonstrated to the world, in the clearest possible way, that, so far from being simply a fair weather market, it can handle a storm better than any other financial centre in the world.

That said, let me now move on to discuss the wider question of why the world equity market collapse occurred, what its implications may be, and what needs to be done.

A movement of this magnitude, of this rapidity, requires a threefold explanation.
That is to say, it requires an explanation in financial market terms, in terms of economic fundamentals, and in political terms.
Unless all three elements had been present, I do not believe that the severity of what we have just been through, and the position in which we now find ourselves, could have occurred.

In market terms, it was clear that the longest bull market ever known was bound to come to an end sooner or later.
Over the past five years alone, share prices in both London and New York had trebled <u>in real terms</u>, rising far faster than company profitability and creating a growing gap between the return on equities and the return on bonds.
Though few of us foresaw the speed at which the markets would move when the turn came, this was clearly too good to last.

So far as the economic fundamentals are concerned, many of us had been warning, not for months but for years, of the dangers to the world economy inherent in the massive imbalances afflicting the three largest economies.
At the heart of this problem lay the huge budget and current account deficits of the United States, and the resulting dramatic

shift from a large creditor position built up over decades to a ballooning domestic and external indebtedness.
But there was also the counterpart of this in excessive current account surpluses of Japan and Germany.

It was precisely to deal with these world problems that the Finance Ministers of the major industrial nations have intensified their co-operation over the past two or three years.
A major reduction in the dollar exchange rate, coupled with the promise of action to reduce the US budget deficit, was agreed at the Plaza meeting of the G5 in September 1985.
And both have taken place.
Both the yen and the deutsche mark rose, in pretty short order, by as much as 50 per cent or so against the dollar, and the US federal budget deficit was cut from some $221 billion in 1985-86 to an estimated $148 billion in 1986-87, a fall of about a third - an improvement even greater than the ambitious target the US authorities had originally set themselves.

Hence our decision, at the Louvre meeting in February of this year, to work together to bring about a period of exchange rate stability.
This was both so as to allow time for the massive parity changes that had taken place to work their way through into reduced trade imbalances, and also to bring about a better climate for world economic growth than that provided by the wild gyrations of the dollar in the early 'eighties.

I have no doubt that this was the right course to pursue.
But the correction of imbalances on the scale that had earlier been allowed to arise is bound to take time, and impatience is always liable to set in.
Particularly when political doubts - the third dimension of the stock market slide - began to arise.
Doubts about whether the United States, despite their genuine success in 1986-87, had the political will to reduce still further a budget deficit that was still far too large.
Doubts, too, about whether the United States had the political will to hold interest rates at whatever level was necessary, not merely

to maintain dollar stability, but also to ensure that the deficit, so long as it endured, was soundly financed.
And doubts about whether some other countries would fully accept the implications for their own economies of maintaining currency stability.

It is, indeed, ironic that an apparent unwillingness of the United States to raise interest rates because of an exaggerated fear that this might tip the economy into recession has led to a collapse on Wall Street, whose recessionary threat is very much greater.

Of course, even financial clouds have silver linings.

In the United States, for example, the necessary slowdown in the growth of domestic demand in relation to output - if the trade balance is to improve, as it must - is now likely to be achieved.
And without the higher interest rates which would have added to the burdens of the debtor nations.
At the same time, the sudden loss of wealth suffered by the share-owning people of America is likely to cause them to want to save rather more of their income, thus facilitating the financing of the Budget deficit without so much reliance on sceptical foreigners.
All this is welcome.

But the need for the US Budget deficit to continue to fall significantly remains crucial.
As is now widely recognised, the key is that the current talks between the US Administration and Congress should lead to early agreement on a clear and credible package of measures to continue the reduction achieved in 1986-87.
This should go beyond the $23 billion to which the President is committed under the new Gramm-Rudman Act, and preferably with at least some increase in some form of taxation as part of that package.

This is essential, not simply because reduction of the US Budget deficit is necessary in economic terms, but also because this has now become the touchstone of whether the United States has the political will to make hard choices and to do what needs to be done.

It will be a key element in rebuilding market confidence.

And if such an agreement is soon reached between the Administration and the Congress, then I believe the other major nations of the world would agree to making it part of a wider international accord involving among other things a reduction in interest rates.

I fully understand - and sympathise with - the hesitations of those who are fearful of risks of inflation.
I have many times made it clear in the management of UK monetary policy that I am as conscious as anyone of such risks.
But if interest rates were the right levels three weeks ago, then it is unlikely that those levels are still right after all that has happened since.

I also fully understand - and share - the view that it is for the United States, where the heart of the problem lies, to give assurance of the necessary steps on the fiscal front before others can confidently make a major move on the monetary front.

Moreover, any wider international accord should not, in my judgement, stop there.
We should also take the opportunity to reaffirm the Louvre agreement, making whatever minor - and I stress the word 'minor' - adjustment is necessary in the light of recent events, with the United States in particular committing itself with deeds as well as words to supporting in the market place whatever is agreed, and if necessary visibly equipping itself with the funds to do so.
Others, too, will have to play their part.

By contrast, a so-called free fall of the dollar would solve nothing: it would merely risk a resurgence of US inflation and ensure a further disruption to world trade.
And the idea that somehow exchange rate stability promoted stock market instability, with the corollary that exchange rate instability would promote stock market stability, is manifest poppycock.
Indeed, it was the threat of a breakdown in the Louvre agreement that in part triggered the Wall Street collapse.

I profoundly hope and believe that that threat will not be invoked again.
Nothing could be more counterproductive.

As I made clear in my speech to the Annual Meeting of the IMF in September, the system of managed floating that would best serve the needs of the world economy would have as its objective the need "to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way".

What is needed in the world today, above all, is the avoidance of any major blow to industrial confidence.
It was not the 1929 crash that caused the depression of the 1930s, but the policy response to it: the failure to provide adequate liquidity to the system, leading to a rash of bank failures, which in turn led to further monetary tightening; and of course the lurch into beggar-my-neighbour trade policies.

I believe we not only must but will avoid both these dangers.
The lessons have been learned.
In the United States, President Reagan has made clear his refusal to follow the protectionist path of Smoot-Hawley, and the Congress must ensure that on this dangerous issue the will of the President prevails.
And on the monetary front, the United States authorities have been quick to ensure that the liquidity of the system will be preserved.

For our part, I moved at an early stage to reverse half of August's rise in interest rates, not simply because some reduction was appropriate in the changed circumstances, though it was.
But I also felt it right, in the light of what was undoubtedly a shock, to signal clearly that the authorities were sensitive to the dangers that some might understandably fear.
Today I decided it was right to act again and reverse the other half.

As for liquidity, the maintenance of a stable exchange rate for sterling, within the framework of the Louvre agreement, to which we remain committed, has meant a higher level of intervention than

used to be the case - most of it, so far, in the direction of increasing the reserves.
You will have seen the exceptionally large increase of getting on for $7 billion in October, published yesterday.
I read in this morning's newspapers that the market is in such a nervous state that it is worried at one and the same time both about the extra liquidity this inflow produces and the funding that would be required to mop it up.
That really is going a little far.
But it is right that I should make my position clear.

To prevent there being excessive liquidity in the economy, our policy is to ensure that, over time, any net intervention is sterilized - in other words, fully funded.
And that will be done, as and when appropriate, although not necessarily entirely within the financial year in which the intervention takes place.
In particular, while the funding programme will continue, it would clearly not be sensible in the present delicate market conditions to extract liquidity on a major scale.

Nor, however, should there be any doubt of our commitment to maintain a stable exchange rate, with the rate against the deutschemark being of particular importance.
It gives industry most of what it wants, and provides a firm anchor against inflation.
And we now have very substantial reserves with which to maintain that stability in the future.

Thus the Government is playing its full part to bring about a smooth adjustment to the shock caused by the fall in the stock market.
There will nonetheless be some very real effects, which it is not within the power of Government to eliminate.
These need not be large, provided business and industry do not lose the confidence that has been built up and that has made such an important contribution to Britain's economic resurgence.

There will be some inevitable effect on demand from the falls in financial wealth: people will see that their financial assets have shrunk and will adjust their spending accordingly.
But, in the UK, the direct effect of that may not be very large, and will reduce any risk of overheating there may have been, with the fire-hoses trained on just that sector where the risk was most evident, thus removing any concern about a resurgence of inflation.

This so-called "wealth effect" will be most evident in the United States, and will inevitably have some dampening effect on world trade.
But there is, again, no reason to expect the effects on the UK to be substantial: UK industry is increasingly well equipped to compete in world markets.
And I have already indicated how, provided the governments of the industrial countries co-operate, and undue monetary tightening is avoided, world recession can, and I believe will, be avoided.

I mentioned a moment ago that one other way in which the UK might be affected would be through a loss of confidence within business and industry.
There is no cause whatever for businessmen to talk themselves into a negative, safety-first mentality, even though I can understand some of their anxieties.
Some, for example, are concerned that their company's market capitalisation has been slashed by up to 30 per cent.
In fact, in most cases, their market capitalisation is now much the same as it was a year ago, when they had few if any worries on this score.
Indeed, the fact that share prices are at about the same level as they were a year ago is something that needs very much to be borne in mind when assessing the likely scale of the economic effects of the stock market falls.

As the Director General of the CBI said yesterday, industry should have no terror of the present squall and "now is the time to look beyond the turbulence of the markets and invest for growth".
I believe that British industry will increasingly recognise this.

For the UK is well placed to cope with the repercussions of the stock market fall, given the general health and enviable soundness of the British economy, and not least the strength of our public finances.

As it happens, I published only yesterday the Autumn Statement which, among other things, contains my latest forecast for the evolution of the British economy in 1988, and this has been widely reported in today's newspapers.
So there is no need to repeat myself this evening.
But the picture is undoubtedly one of an economy that is vigorous, strong and healthy.
A PSBR of only £1 billion: who would have expected that as little as a few years ago?
Growth faster than any other major nation in the world, so that even some slowdown will still leave us expanding at a very respectable rate.
The underlying rate of inflation remaining low.
And our unit labour costs in manufacturing expected in 1988, as in 1987, to rise less than in our major industrial competitors.

The plain fact is that, as a result of sound policies consistently pursued over a number of years, we are now enjoying the benefits of a virtuous circle.
Low inflation, public expenditure under control and sound public finances have led to sustained growth and thus the ability progressively to lower tax rates, which in turn has brought about improved confidence and better business performance.

This is not something that will be blown away by a financial blizzard, however violent it may seem at the time.
Nor, although we are influenced by it, are we in Europe inescapably dependent on the fortunes of the US economy, as recent movements in the London stock market might suggest.

Above all, we are fortunate in this country that the financial storm - if it had to come - has come at a time when the Government has just been granted by the British people - and granted decisively - the strength of a further term of office.
I can assure you, my Lord Mayor, that we shall put that strength to good use.

PART 1 ends:-

HMT TO DNW 17.10.96

PART 2 begins:-

HMT TO SIR P. MIDDLETON 4.11.97