

Wanted to see the new &
max decisions - E & Europe
concerns under democratic control

Prime Minister

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DRAFT 17 OCTOBER 1989

STOCK MARKET, EMU ETC.

[Politenesses]

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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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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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However, the problem is not simply that the current discussion is premature. It goes deeper than that. For the plain fact is that the main proposals on the table - those set out in the Delors report - are unacceptable in a number of crucial respects. In particular, having correctly identified the central importance of establishing the single market as the first stage on the route, they then propose a complete shift in the so-called Stages 2 and 3 to a centralist, bureaucratic, and indeed undemocratic approach to change. [More?]

The UK has therefore undertaken the task of showing that there are alternative routes to economic and monetary union, and I shall be putting the outline of one such alternative to my EC Finance Minister colleagues before we meet next month.

The essence of the UK's approach is evolutionary and market-based. It seeks 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 within the ERM will heighten the pressure on Governments to run sound policies. And as the Prime Minister made clear after the Madrid Council, once our community partners have abandoned the

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In a Community without capital controls and with all currencies in the ERM, there will be a high degree of competition between currencies. People in one country will be free to use other community currencies in a whole range of financial transactions, most importantly savings, investment, insurance and the like. Inevitably, for these purposes low inflation currencies will be favoured over high inflation ones. National Governments will want to match the performance of the best, for to lag behind will mean not only loss of prestige, but also of seigniorage and of tax revenues.

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

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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, 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 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. So the performance of M0 in relation to its target range remains central to an assessment of monetary conditions.

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 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,

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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.

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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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

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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However, the problem is not simply that the current discussion is premature. It goes deeper than that. For the plain fact is that the main proposals on the table - those set out in the Delors report - are unacceptable in a number of crucial respects. In particular, having correctly identified the central importance of establishing the single market as the first stage on the route, they then propose a complete shift in the so-called Stages 2 and 3 to a centralist, bureaucratic, and indeed undemocratic approach to change. [More?]

The UK has therefore undertaken the task of showing that there are alternative routes to economic and monetary union, and I shall be putting the outline of one such alternative to my EC Finance Minister colleagues before we meet next month.

The essence of the UK's approach is evolutionary and market-based. It seeks 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 within the ERM will heighten the pressure on Governments to run sound policies. And as the Prime Minister made clear after the Madrid council, once our community partners have abandoned the

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protection of these controls, - a step the UK took almost ten years ago to the day - and ^{once}~~one~~ we have brought our own inflation down further, the way will be clear for the UK to participate in the ERM.

In a Community without capital controls and with all currencies in the ERM, there will be a high degree of competition between currencies. People in one country will be free to use other community currencies in a whole range of financial transactions, most importantly savings, investment, insurance and the like. Inevitably, for these purposes low inflation currencies will be favoured over high inflation ones. National Governments will want to match the performance of the best, for to lag behind will mean not only loss of prestige, but also of seigniorage and of tax revenues.

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

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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.

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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 is 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

x 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.

x 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 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. So the performance of M0 in relation to its target range remains central to an assessment of monetary conditions.

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 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 ^{would be} ~~is~~ provided by the ERM] Maintaining a firm exchange rate remains ~~central~~ ^{crucial} to the operation of monetary policy. ^{and it} ~~is~~ ^{crucial if he} ~~is~~ ^{to be understood.}

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.