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C:AT (slh)

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.

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- 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.

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.

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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

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

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.

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 be 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

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

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.

29. While the sums at stake were relatively small, this situation merited no special action. But as the Treasury Bill issue has grown in size, it has come to seem increasingly anomalous 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 the Treasury Bills in the first place. Accordingly, we now regard Treasury Bill sales as outside the definition of funding, irrespective of who buys them.

EMU

X / 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. P 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

Y 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.

X 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. P 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.

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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- 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.

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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.

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 be 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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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

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

X / 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. P 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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