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

AT

18 October, 1989.

JD46

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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.

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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:-

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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,

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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.

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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 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 to the operation of monetary policy} essential if the tightness constraint of monetary policy is not to be undermined.

Better to add this as it makes contrast clearer?

Stick to formulation he has used before.

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.

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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.

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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.

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

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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."

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

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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

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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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