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17 October 1990

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Private Secretary to
the Prime Minister
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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
- paras 23-27 on EMU where 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

JGL

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

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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 (money supply) pressure that has been at the root of higher inflation.

for the worse!

5. Earlier this month sterling entered the Exchange Rate Mechanism. [This event marks a significant change (development x) 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

Delete

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

No such thing as a going rate!

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 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.

No

That means we are prepared to lower interest rates even when monetary signals require them to stay where they are. That way lies new inflationary pressures – Lawsonian inflation.

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 through the normal instruments of monetary policy. [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. No 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 <u>1980</u> not enough attention was given to narrow money; and in <u>1986</u> 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.

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 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. Confidence. we have created

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.

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 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 evolve towards ~~become~~ a single currency if ~~that were truly~~ that it should be used in preference to their own national currencies 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 continue a leading ~~play a central~~ 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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