PRIME MINISTER

Governor's Speech also attached.

CHANCELLOR'S SPEECH TO THE MANSION HOUSE

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

Paragraph 5

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

Paragraph 7

The going rate is now "so-called".

Paragraph 9

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

Paragraph 16

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

Paragraph 17

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

Paragraph 18

The final sentence re-drafted as you suggested.

Paragraph 27

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

Paragraph 30

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

AT AT

18 October 1990

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CHANCELLOR'S SPEECH TO MANSION HOUSE: 18 OCTOBER 1990

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

UK Economy

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Europe

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

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

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

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

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

24. Our proposals for a European Monetary Fund and a hard ecu are well known. They provide an evolutionary approach based on the market and choice. They recognise that economic convergence is far from satisfactory. For the present differences between the relative performances of the twelve are striking. Annual rates of inflation in the Community range from $2^1/_2$ to 22 per cent; short-term interest rates range from 8 to 18 per cent; and public sector budget balances range from a surplus of 3 per cent of GDP to a deficit of over 17 per cent. And the degree of flexibility in the economies of member states varies considerably.

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

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

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

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

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

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

Prime Minister

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

BHP
18/10

FOR RELEASE ON
DELIVERY AT 21.00 HRS

Speech given by

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

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

ERM ENTRY

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

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

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

Dollar?

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

There are lessons in this for us - and I mean for both sides of the wage bargaining process. Our ability to compete - and thus to preserve or create jobs - will deteriorate unless both wage settlements and productivity growth move rapidly towards Continental performance. But if those concerned recognise the disciplines inherent in ERM membership and reflect this in their approach to what lies ahead, I am hopeful that we can match the French performance at a lower social cost.

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

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

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

IMPROVEMENTS IN THE CITY

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

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

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

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

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

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

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