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MANSION HOUSE SPEECH

Attached is the text of the speech made by the Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP, at the Lord Mayor's banquet for bankers and merchants of the City of London at the Mansion House tonight.

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MANSION HOUSE SPEECH: 19 OCTOBER 1989

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".

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.

I refer, of course, to the Government's monetary policy. For monetary policy is at the heart of macroeconomic policy in a free economy, and thus plays the central role in the battle against inflation.

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.

There are two indicators, in particular, to which we look in reaching those decisions: the monetary base, more familiarly known as M0, and the exchange rate.

M0, which we have targeted continuously since 1984, has consistently exhibited a stable relationship with money GDP, which is the essential attribute of any intermediate target. For the key to sound macroeconomic policy is to focus on the path of gross domestic product in money terms, and thus on inflation itself. So it is important to ensure that M0 comes back within its published target range, and stays within it.

But policy cannot be based on M0 alone. First, there is other evidence of monetary conditions, which it would be foolish to ignore. Second, M0 is for the most part a coincident indicator. This is very useful as it is many months before a reasonably reliable estimate of money GDP is available, but it does mean that M0 gives little early warning of inflationary pressures to come.

In an increasingly integrated 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 affects inflation. So we have always assigned it a major role in the assessment of monetary conditions.

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 the 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."

These arguments remain as valid now as they were then. We cannot allow the necessary rigour of monetary policy to be undermined by exchange rate weakness. This means that interest rates will have to remain high for some time to come.

Broad money, of which M4 is the best measure, used to be considered a useful leading indicator. I know it still has its aficionados. But the plain fact is that for the past ten years now, broad money has proved to be an unreliable guide. 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 tack. Let me give some examples:-

- In 1980 and 1981 broad money was growing very rapidly indeed, well above its then published target range, 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. M4's behaviour at the time gave little or no indication of this.

- And I believe we would be equally mistaken 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 policy is biting, and that money demand is already slowing.

I know there are those who hanker after some simple one-dimensional rule, and take the absence of one as 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 exclusively on a single indicator.

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."

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 most major economies. It may be that the markets are readier to accept this coming from the head of an independent central bank. But we all live in the same world.

It is implicit in all I have said so far that interest rates are the essential instrument of monetary policy. However, I am urged by some to consider instead a return to some form of direct credit controls. Such a step would clearly be unattractive in itself, because of the distortions and inefficiencies it would create. But a more fundamental objection is 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, for precisely the same reasons, is it considered an option in other developed countries such as the US and Germany. Any attempt to impose restrictions on UK lending institutions would very soon be as full of holes as a colander, not least because of offshore flows.

It has nevertheless been alleged recently that Germany does indeed use credit controls, operated through 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 essential monetary instrument. The reserve ratio, which in practice is rarely changed, is the mechanism by which the German authorities generate the money market shortages necessary to give them control over interest rates. We achieve precisely the same effect by different technical means. To suppose that the German reserve ratio requirement somehow separately doubles as a direct credit control, let alone a consumer credit control, is moonshine.

Funding Policy

Let me now turn to funding policy.

The purpose of funding is to ensure that the public sector as a whole does not inject liquidity into the economy - but nor should it extract liquidity from it.

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 seen 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 financial affairs so as to have a broadly neutral effect on liquidity.

There are some who argue that we should set this principle aside and return to the practice of deliberate over-funding in order to control the published figures for the broad money aggregates, which we indeed did for a time in the early 1980s, and in particular during my first two years as Chancellor.

If this offered a better way of curbing inflation, I would of course gladly go back to it. But it would not do so. Quite apart from the limitations of broad money, which I have already described, any money drained out of the system by selling gilts over and above the Government's funding requirements, or by buying in fewer gilts than these requirements dictate, would simply have to be injected into the system elsewhere. If it were not, the outcome would be higher interest rates than those the authorities consider necessary.

Moreover 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. Since such money would be more likely to end up financing consumption, it is not at all clear why this should be considered desirable.

It is also worth recalling why over-funding 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 £13 billion, while over £16 billion of other sterling bonds have been issued. This replacement of public sector borrowing by the private and overseas sector incidentally exposes the fallacy that the Government has been artificially depressing long-term yields.

But, and this is important, we do not seek to implement the full fund rule rigidly month by month or even necessarily year by year.

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, 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 reinjecting liquidity into the system. Given the extent of recent intervention, it is reasonable to expect that we may end up with some degree of overfund in the current financial year, to be carried over and reversed thereafter.

Before I leave the subject of funding policy 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.

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. Depending on the response, other conversion offers may follow.

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. They thus count as funding within the present definition, and have to be offset by additional purchases of gilts under the full fund rule. Such additional purchases themselves add to any surpluses in the money market, and thus further increase the requirement for additional Treasury Bills.

When the sums at stake were relatively small, this was of little practical consequence. But as the Treasury Bill issue has grown in size, it has come to seem increasingly anomalous to chase our own tails in this way. Accordingly, we have decided to treat Treasury Bill sales as outside the definition of funding, irrespective of who buys them.

EMU

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 important debate within the European Community over the issue of economic and monetary union. Let me repeat that we are fully committed to Stage 1 of the Delors recipe for economic and monetary union. 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.

As the Prime Minister made clear after the Madrid European Council earlier this year, once our own inflation has come down and progress has been made with the abolition of exchange controls and other key aspects of the single market, the way will be clear for sterling to participate fully in the EMS.

Where we part company with the Delors recipe is in its prescriptions for what should follow Stage 1.

In the first place, any such prescriptions are premature.

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 ultimately lead to an unprecedented integration of member states' economies. Our own experience of financial liberalisation has shown that its effects are fundamental and far-reaching. It can take many years for them to work through the system. Why then should we try to decide now - before Stage 1 has even begun - precisely how any later stages of the progressive realisation of EMU should be carried forward? Instead, evolution and learning by doing should be our guides.

But the problems go even deeper than that. Having correctly identified the central importance of establishing the single market as the first step on the route, the Delors Report then proposes in the so-called Stages 2 and 3 an abrupt shift to a centralist and bureaucratic agenda that poses grave threats to any known form of democratic accountability.

That is why the United Kingdom will be suggesting an alternative way forward. What we will be suggesting is a natural extension of Stage 1, building on its twin pillars of the creation of a genuine single market and the fuller development of the EMS.

I have referred to this as a regime of competing national currencies, within the framework of the EMS. Needless to say this is not a matter, as some have fancifully suggested, of requiring the village shopkeeper in Much-Binding-in-the-Marsh to accept payment in Drachma. He would be as free to decide what forms of cash he will accept as he is to decide whether or not to accept a particular credit card.

Its essence is not mandatory, but permissive: removing as far as is practicable the remaining legal and other impediments to the free use and interchangeability of all Community currencies. Impediments, for example, that prevent savings institutions from holding assets denominated in other Community currencies.

Quite apart from the economic benefits to be gained from a greater degree of exchange rate stability, the competition between currencies that all these changes will intensify will be healthy, even bracing. 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 Community.

In short, the essence of the UK's approach to this issue is precisely the same as it is to other current issues on the European agenda: it is <u>evolutionary</u> and <u>market-based</u>.

There is a very real danger that any attempt to take any other route will end in tears.

<u>UK Economy</u>

The past eight years have been a period of almost unprecedented expansion for the British economy, culminating in the unexpected, and unsustainable, growth spurt of 1987 and 1988.

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. The slowdown has not happened as quickly as I expected. In particular, personal savings have fallen further than anyone, inside or outside the Treasury, expected. But the slowdown is clearly under way and equally clearly has further to go, before the economy resumes its long-run upward trend.

During this necessary 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 will gradually narrow, although it is bound to take time.

But in the perspective of history, what will stand out about this period is not the short term vagaries of the economic 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.

The people of Britain may have temporarily forgotten the habit of thrift. That is undoubtedly a short term problem. But at the same time they have rediscovered the spirit of enterprise. And *that* is the greatest prize of all.