C's speeches

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THE CHANCELLOR'S MANSION HOUSE SPEECH

Attached is the text of the speech to be 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: 4 NOVEMBER 1987

On this great annual occasion of the Lord Mayor's dinner for the bankers and merchants of the City of London - and this is now the fifth time I have stood up here as Chancellor - it is customary to say something about the City.

But there are other speeches to come, and I can be brief.
Foremost among those other speeches, of course, will be that of the Governor, who will also be playing his fifth innings here in that capacity.
The excellent working relationship he and I have built up over that period is one that I value very highly indeed, and it clearly assumes a special importance during the difficult time through which we are now passing.
I am immensely grateful to him.

I would also like to salute the City for the way in which it has comported itself throughout almost three weeks of a financial blizzard which blew in from across the Atlantic, with a ferocity few of us have experienced in our lifetime.
Throughout that period, the markets have continued trading without disruption, and without even the curtailment of normal trading hours.
And in the midst of it all, the biggest share issue the world has ever seen was able to go ahead, with the London sub-underwriters ready, willing, and able to absorb the stock with relative ease.

I pay tribute to the Association of British Insurers, who, at the height of the BP controversy, declared

> "ABI members are quite prepared for the issue to go ahead and they will of course meet the obligations they have undertaken. There is no question of the ABI membership seeking to put pressure on Government to have the BP issue postponed."

And I pay tribute, too, to my fellow-guest, the Chairman of the Stock Exchange, Nicholas Goodison, who with characteristic forthrightness made clear that in his opinion, too, the BP share issue should go ahead.

I may be old-fashioned, but in my judgement, had I bowed to the pressure from some quarters to abandon the issue, which had been fully underwritten and - in London, at least, sub-underwritten too - it would have done irreparable harm to the good name and reputation of the City.
That weighed heavily with me in reaching my decision.

As it is, the City can hold up its head with pride.
It has demonstrated to the world, in the clearest possible way, that, so far from being simply a fair weather market, it can handle a storm better than any other financial centre in the world.

That said, let me now move on to discuss the wider question of why the world equity market collapse occurred, what its implications may be, and what needs to be done.

A movement of this magnitude, of this rapidity, requires a threefold explanation.
That is to say, it requires an explanation in financial market terms, in terms of economic fundamentals, and in political terms.
Unless all three elements had been present, I do not believe that the severity of what we have just been through, and the position in which we now find ourselves, could have occurred.

In market terms, it was clear that the longest bull market ever known was bound to come to an end sooner or later.
Over the past five years alone, share prices in both London and New York had trebled <u>in real terms</u>, rising far faster than company profitability and creating a growing gap between the return on equities and the return on bonds.
Though few of us foresaw the speed at which the markets would move when the turn came, this was clearly too good to last.

So far as the economic fundamentals are concerned, many of us had been warning, not for months but for years, of the dangers to the world economy inherent in the massive imbalances afflicting the three largest economies.
At the heart of this problem lay the huge budget and current account deficits of the United States, and the resulting dramatic

shift from a large creditor position built up over decades to a ballooning domestic and external indebtedness.
But there was also the counterpart of this in excessive current account surpluses of Japan and Germany.

It was precisely to deal with these world problems that the Finance Ministers of the major industrial nations have intensified their co-operation over the past two or three years.
A major reduction in the dollar exchange rate, coupled with the promise of action to reduce the US budget deficit, was agreed at the Plaza meeting of the G5 in September 1985.
And both have taken place.
Both the yen and the deutsche mark rose, in pretty short order, by as much as 50 per cent or so against the dollar, and the US federal budget deficit was cut from some $221 billion in 1985-86 to an estimated $148 billion in 1986-87, a fall of about a third - an improvement even greater than the ambitious target the US authorities had originally set themselves.

Hence our decision, at the Louvre meeting in February of this year, to work together to bring about a period of exchange rate stability.
This was both so as to allow time for the massive parity changes that had taken place to work their way through into reduced trade imbalances, and also to bring about a better climate for world economic growth than that provided by the wild gyrations of the dollar in the early 'eighties.

I have no doubt that this was the right course to pursue.
But the correction of imbalances on the scale that had earlier been allowed to arise is bound to take time, and impatience is always liable to set in.
Particularly when political doubts - the third dimension of the stock market slide - began to arise.
Doubts about whether the United States, despite their genuine success in 1986-87, had the political will to reduce still further a budget deficit that was still far too large.
Doubts, too, about whether the United States had the political will to hold interest rates at whatever level was necessary, not merely

to maintain dollar stability, but also to ensure that the deficit, so long as it endured, was soundly financed.
And doubts about whether some other countries would fully accept the implications for their own economies of maintaining currency stability.

It is, indeed, ironic that an apparent unwillingness of the United States to raise interest rates because of an exaggerated fear that this might tip the economy into recession has led to a collapse on Wall Street, whose recessionary threat is very much greater.

Of course, even financial clouds have silver linings.

In the United States, for example, the necessary slowdown in the growth of domestic demand in relation to output - if the trade balance is to improve, as it must - is now likely to be achieved.
And without the higher interest rates which would have added to the burdens of the debtor nations.
At the same time, the sudden loss of wealth suffered by the share-owning people of America is likely to cause them to want to save rather more of their income, thus facilitating the financing of the Budget deficit without so much reliance on sceptical foreigners.
All this is welcome.

But the need for the US Budget deficit to continue to fall significantly remains crucial.
As is now widely recognised, the key is that the current talks between the US Administration and Congress should lead to early agreement on a clear and credible package of measures to continue the reduction achieved in 1986-87.
This should go beyond the $23 billion to which the President is committed under the new Gramm-Rudman Act, and preferably with at least some increase in some form of taxation as part of that package.

This is essential, not simply because reduction of the US Budget deficit is necessary in economic terms, but also because this has now become the touchstone of whether the United States has the political will to make hard choices and to do what needs to be done.

It will be a key element in rebuilding market confidence.

And if such an agreement is soon reached between the Administration and the Congress, then I believe the other major nations of the world would agree to making it part of a wider international accord involving among other things a reduction in interest rates.

I fully understand - and sympathise with - the hesitations of those who are fearful of risks of inflation.
I have many times made it clear in the management of UK monetary policy that I am as conscious as anyone of such risks.
But if interest rates were the right levels three weeks ago, then it is unlikely that those levels are still right after all that has happened since.

I also fully understand - and share - the view that it is for the United States, where the heart of the problem lies, to give assurance of the necessary steps on the fiscal front before others can confidently make a major move on the monetary front.

Moreover, any wider international accord should not, in my judgement, stop there.
We should also take the opportunity to reaffirm the Louvre agreement, making whatever minor - and I stress the word 'minor' - adjustment is necessary in the light of recent events, with the United States in particular committing itself with deeds as well as words to supporting in the market place whatever is agreed, and if necessary visibly equipping itself with the funds to do so.
Others, too, will have to play their part.

By contrast, a so-called free fall of the dollar would solve nothing: it would merely risk a resurgence of US inflation and ensure a further disruption to world trade.
And the idea that somehow exchange rate stability promoted stock market instability, with the corollary that exchange rate instability would promote stock market stability, is manifest poppycock.
Indeed, it was the threat of a breakdown in the Louvre agreement that in part triggered the Wall Street collapse.

I profoundly hope and believe that that threat will not be invoked again.

Nothing could be more counterproductive.

As I made clear in my speech to the Annual Meeting of the IMF in September, the system of managed floating that would best serve the needs of the world economy would have as its objective the need "to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way".

What is needed in the world today, above all, is the avoidance of any major blow to industrial confidence.

It was not the 1929 crash that caused the depression of the 1930s, but the policy response to it: the failure to provide adequate liquidity to the system, leading to a rash of bank failures, which in turn led to further monetary tightening; and of course the lurch into beggar-my-neighbour trade policies.

I believe we not only must but will avoid both these dangers.

The lessons have been learned.

In the United States, President Reagan has made clear his refusal to follow the protectionist path of Smoot-Hawley, and the Congress must ensure that on this dangerous issue the will of the President prevails.

And on the monetary front, the United States authorities have been quick to ensure that the liquidity of the system will be preserved.

For our part, I moved at an early stage to reverse half of August's rise in interest rates, not simply because some reduction was appropriate in the changed circumstances, though it was.

But I also felt it right, in the light of what was undoubtedly a shock, to signal clearly that the authorities were sensitive to the dangers that some might understandably fear.

Today I decided it was right to act again and reverse the other half.

As for liquidity, the maintenance of a stable exchange rate for sterling, within the framework of the Louvre agreement, to which we remain committed, has meant a higher level of intervention than used to be the case - most of it, so far, in the direction of increasing the reserves.

You will have seen the exceptionally large increase of getting on for $7 billion in October, published yesterday.

I read in this morning's newspapers that the market is in such a nervous state that it is worried at one and the same time both about the extra liquidity this inflow produces and the funding that would be required to mop it up.

That really is going a little far.

But it is right that I should make my position clear.

To prevent there being excessive liquidity in the economy, our policy is to ensure that, over time, any net intervention is sterilized - in other words, fully funded.

And that will be done, as and when appropriate, although not necessarily entirely within the financial year in which the intervention takes place.

In particular, while the funding programme will continue, it would clearly not be sensible in the present delicate market conditions to extract liquidity on a major scale.

Nor, however, should there be any doubt of our commitment to maintain a stable exchange rate, with the rate against the deutschemark being of particular importance.

It gives industry most of what it wants, and provides a firm anchor against inflation.

And we now have very substantial reserves with which to maintain that stability in the future.

Thus the Government is playing its full part to bring about a smooth adjustment to the shock caused by the fall in the stock market.

There will nonetheless be some very real effects, which it is not within the power of Government to eliminate.

These need not be large, provided business and industry do not lose the confidence that has been built up and that has made such an important contribution to Britain's economic resurgence.

There will be some inevitable effect on demand from the falls in financial wealth: people will see that their financial assets have shrunk and will adjust their spending accordingly.
But, in the UK, the direct effect of that may not be very large, and will reduce any risk of overheating there may have been, with the fire-hoses trained on just that sector where the risk was most evident, thus removing any concern about a resurgence of inflation.

This so-called "wealth effect" will be most evident in the United States, and will inevitably have some dampening effect on world trade.
But there is, again, no reason to expect the effects on the UK to be substantial: UK industry is increasingly well equipped to compete in world markets.
And I have already indicated how, provided the governments of the industrial countries co-operate, and undue monetary tightening is avoided, world recession can, and I believe will, be avoided.

I mentioned a moment ago that one other way in which the UK might be affected would be through a loss of confidence within business and industry.
There is no cause whatever for businessmen to talk themselves into a negative, safety-first mentality, even though I can understand some of their anxieties.
Some, for example, are concerned that their company's market capitalisation has been slashed by up to 30 per cent.
In fact, in most cases, their market capitalisation is now much the same as it was a year ago, when they had few if any worries on this score.
Indeed, the fact that share prices are at about the same level as they were a year ago is something that needs very much to be borne in mind when assessing the likely scale of the economic effects of the stock market falls.

As the Director General of the CBI said yesterday, industry should have no terror of the present squall and "now is the time to look beyond the turbulence of the markets and invest for growth".
I believe that British industry will increasingly recognise this.

For the UK is well placed to cope with the repercussions of the stock market fall, given the general health and enviable soundness of the British economy, and not least the strength of our public finances.

As it happens, I published only yesterday the Autumn Statement which, among other things, contains my latest forecast for the evolution of the British economy in 1988, and this has been widely reported in today's newspapers.
So there is no need to repeat myself this evening.
But the picture is undoubtedly one of an economy that is vigorous, strong and healthy.
A PSBR of only £1 billion: who would have expected that as little as a few years ago?
Growth faster than any other major nation in the world, so that even some slowdown will still leave us expanding at a very respectable rate.
The underlying rate of inflation remaining low.
And our unit labour costs in manufacturing expected in 1988, as in 1987, to rise less than in our major industrial competitors.

The plain fact is that, as a result of sound policies consistently pursued over a number of years, we are now enjoying the benefits of a virtuous circle.
Low inflation, public expenditure under control and sound public finances have led to sustained growth and thus the ability progressively to lower tax rates, which in turn has brought about improved confidence and better business performance.

This is not something that will be blown away by a financial blizzard, however violent it may seem at the time.
Nor, although we are influenced by it, are we in Europe inescapably dependent on the fortunes of the US economy, as recent movements in the London stock market might suggest.

Above all, we are fortunate in this country that the financial storm - if it had to come - has come at a time when the Government has just been granted by the British people - and granted decisively - the strength of a further term of office.
I can assure you, my Lord Mayor, that we shall put that strength to good use.