H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-270 5238
Facsimile: 270 5244
Telex: 9413704

PLEASE NOTE EMBARGO

NOT FOR PUBLICATION, BROADCAST
OR USE ON CLUB TAPES BEFORE 21.15 HRS
ON THURSDAY 18 OCTOBER 1990

18 October 1990

MANSION HOUSE SPEECH

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

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
LONDON SWIP 3AG

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

1. 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.

2. 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.

3. 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.

4. 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.

5. 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.

6. 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.

7. 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.

8. 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.

9. 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> 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.

10. 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.

11. 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.

12. 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.

13. 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.

14. 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.

15. 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.

16. 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.

17. 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.

<u>Europe</u>

18. 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.

19. 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.

20. 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.

21. 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.

22. 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.

23. 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.

24. 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.

25. 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.

26. But I have made it perfectly plain that under the UK's proposals, the hard ecu could ultimately evolve towards a single currency if 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.

27. 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.

28. 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.

29. 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.