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16 October 1986

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, Thursday 16 October.

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MANSION HOUSE SPEECH

I propose tonight to divide my speech into three sections.

I shall first say something about the City and the Big Bang, then more about the current state of the financial markets, and finally turn to the outlook for the British economy.

As everyone here tonight is all too well aware, the Big Bang is now only eleven days away.

But some of you may not be aware that we meet this evening on the anniversary of an earlier big bang. One which in its far reaching effects was even greater than the changes we are contemplating in the City. A change which all the speed generated by modern technology comes nowhere near matching. I refer of course to the implementation of the Gregorian calendar in 1582 which at a stroke moved the world on by ten days. Actually it did not quite do that because it took Britain another couple of hundred years to come into line. This time at least, we have been a little quicker. Which perhaps is just as well.

The City and Big Bang

Big Bang, and all it stands for, is above all a response to intense international competitive pressures. The major financial centres are fast becoming part of a global market in which innovation is a way of life, and traditional distinctions, between national and international markets, and between different kinds of financial institutions, are becoming increasingly blurred.

Few sectors of the British economy have had to move so far or so fast to stay ahead of the international game. A fair share of the credit for all this must go to Nicholas Goodison and his team, for their far sighted leadership. And I know that he in turn welcomes the further halving of stamp duty, to ½ per cent, that October 27 will bring.

The Government has had to move swiftly too. Constructing a credible regulatory framework, flexible enough to cope with continuing change, has already absorbed an immense amount of legislative time and effort.

No-one here tonight needs reminding that the Big Bang is only a beginning. A great prize is within our grasp. A thriving financial sector is crucial to the success of any free enterprise economy. But what we have here in London is much more than that: a national asset of enormous potential, whose success will bring great benefits to the whole country.

Of course, competition and change bring with them high risks as well as high rewards - not least for those individuals whose telephone-number salaries have attracted so much attention.

It is quite likely that the new climate will prove too bracing for some. And if it does, it should go without saying that it will not be the job of the authorities to prevent financial companies from going out of business, though there is a clear responsibility to minimise the risk of their customers being dragged down with them.

And let me add this. I am in no doubt that the system will be better able to weather the occasional storm if those who profit from freer markets take the opportunity to strengthen their capital base.

The banking system's experience with sovereign debt in the 1970s is instructive. Banks have made considerable and necessary progress in increasing their capital ratios since 1982. Other financial institutions might usefully consider whether this episode holds lessons for them too.

Meanwhile, I do not share the pessimism of those who fear that British players will account for a disproportionate share of the casualties. However level the playing field, the home team is not without its advantages. British firms have moved swiftly to attract new capital. And I am encouraged by the knowledge that London survived as a major financial centre through four decades of exchange controls partly because, in the areas where British firms were free to compete internationally - such as insurance and foreign currency business - they did so successfully against all comers.

We welcome those of all nations in the City of London. But the Government is committed to obtaining reciprocal treatment for British firms in other financial centres.

In particular, my Ministerial colleagues and I have made this position clear to the Japanese authorities, and I am pleased to say that in the past year or so five more UK-owned houses have been granted licences to operate in Tokyo. More are in the pipeline.

As an ultimate sanction, the Financial Services Bill, shortly to become law, will give the Government statutory powers to refuse to authorise, or to restrict or even to remove the authorisation of, any financial institutions whose national authorities do not provide reciprocal facilities for British firms.

The authorities are also alert to the risk that predatory pricing could erode the benefits of the increased competition we seek. Whatever the short-run benefits to the consumer, such practices are ultimately anti-competitive, and potentially destabilising for the system as a whole.

Whatever happens, one casualty no-one can afford is London's reputation for integrity and sound dealing.

The Government attaches the highest importance to effective supervision, investor protection, and the energetic prosecution of fraud.

The task of providing, in the Financial Services Bill, a comprehensive framework for investment business of all kinds has been little short of Herculean. But the next step is no less demanding: to get the new systems up and running with the minimum of delay - and to make sure that they work.

At the same time, following the review I initiated, the Bank of England has greatly increased the resources it devotes to banking supervision, and the new Board of Banking Supervision is already in operation. I hope shortly to introduce a new Bill to strengthen the statutory framework within which supervision is conducted.

The arrangements we are putting in place will not, of course, operate in watertight compartments. Lead supervisors will be nominated for financial conglomerates whose activities span several supervisory regimes. And close co-operation between supervisors will clearly be needed.

I well understand the concern of those who argue that regulation imposes economic costs; and who point to the risk that, by insisting on high standards here, we will put ourselves at a competitive disadvantage relative to centres with laxer regimes - leading to a new version of Gresham's law, with badly supervised centres gaining at the expense of the well supervised.

This is a concern I take very seriously. But the remedy is clear. All supervisors, and particularly those in the major financial centres, must put international co-operation and co-ordination high on their list of priorities. And we are doing that.

Finally, on this section of my remarks, let me add this.

On a number of recent occasions, I have expressed concern at the fact that British industry is still much too inclined to take the short-term view.

This manifests itself in too little spent on training, too little on research and development, and too much on pay.

But short-termism is not merely an affliction of industry: it is our national ailment. And certainly in the view of industry itself, the most virulent form of the disease is to be found among the City institutions and the financial markets.

Many industrialists and businessmen feel strongly that their ability to take decisions in the long-term interests of their companies is inhibited by an excessive emphasis on short-term performance by fund managers, and by the City's vested interest in large movements on exchange rates and interest rates.

Of course, it is always easier to see the mote in the other man's eye than the beam in one's own. The boards of large industrial corporations, for example, might pause to consider how far the demand for short-term performance can be traced back to the pressure they themselves exert on the managers of their own pension funds. And the financial markets are affected by forces that originate far outside these shores.

But I have to say that I suspect business and industry have a point, and that the distinguished gathering here tonight would do well to reflect upon it. Certainly bad blood between industry and finance is bad for Britain, and all of us need to do whatever we can to eradicate its causes.

Financial Policy and the Markets

On this august occasion, last year, I set out our financial strategy in the clearest terms. In April of this year, in a speech to the Lombard Association, I explained at some length how monetary policy - and also fiscal policy, but in particular monetary policy - is conducted, within the context of that strategy.

Since both the strategy and its implementation remain precisely as I set out in those two speeches, you will be glad to know that I do not propose to weary you by repeating it yet again tonight.

There are, I know, those who still complain of being confused - and judging by what they write, some are indeed confused. But they are either simply complaining that the world is a complicated place, which sadly is all too true, and is something that grown-ups have to come to terms with; or else they are so wedded to confusion that it would be grossly improper to try and separate them from it.

Today's figures for the PSBR for September, and thus for the first six months of the financial year, show that public borrowing is broadly on track. And this is in a context in which the United Kingdom, unlike many other countries, has experienced a gently declining ratio of public debt to national income, at a time of falling inflation. So there is no problem on the fiscal front.

Broad money and credit have been growing fast, and I understand the concern that has been aroused on that score. As I pointed out last year, it was clear that the liberalisation of the financial system, the end of mortgage rationing, and the increased competition between financial institutions would lead to a steady increase in the ratio of broad money to GDP. This, indeed, has been a consistent feature of the 1980s. There is every sign that people are holding the increased amounts of broad money quite willingly. And so long as this is so, its growth is not inflationary.

One aspect of this is that the ratio of personal debt to personal income has risen. But the rise has been matched by a similar growth in personal holdings of liquid assets, and the personal debt ratio is still below the comparable figure in the United States.

So neither broad money nor credit was a trigger for this week's rise in interest rates.

What could not be ignored was that more reliable indicators, such as narrow money, as measured by MO, and in particular the exchange rate, were indicating an easing of monetary conditions.

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Given the precipitate collapse of the oil price, it was inevitable and indeed necessary that the exchange rate should fall so as to enable - after the inevitable delay known as the J-curve - non-oil exports to rise to offset at least the greater part of the fall in oil export revenues. But there are clearly limits to the necessary and desirable extent of that fall.

Moreover, the growth of MO, although well within its target range, has edged upwards, and in all the circumstances it seemed desirable to seek to bring it back towards the centre of the range.

It was therefore necessary, in order to maintain the financial strategy on track, to raise interest rates.

I know there are some - the small businessman, the home owner: people whose interests are at the heart of this Government's concerns - who are disappointed that I have had to raise interest rates at all. And of course I understand that. But the determination to defeat inflation and the willingness to take the necessary action are one and the same thing. You cannot will the end without accepting the means.

There are others - in the City: or at least among those who write for the City - who have recently delighted in depicting the level of short-term interest rates as the outcome of a constant epic struggle between the Chancellor, always seeking to bring interest rates down, and the markets, ever seeking to push them up. Or vice versa.

I have to confess that I find this picture a trifle fanciful.

Short-term interest rates, as I pointed out in my Lombard Speech, are the essential instrument of monetary policy.

Thus my objective has to be to keep them, on average, at whatever level is necessary to produce monetary conditions that bear down on inflation.

In current circumstances, the Governor and I judged that this required a rise in interest rates of one per cent, giving a substantial margin over equivalent dollar rates and implying UK rates of something like eight per cent in real terms.

Given this assessment, to have moved in the fevered and turbulent market atmosphere of the fortnight that followed the Washington meetings would not have been sensible. It would inevitably have meant a rise of two per cent, as indeed the press were predicting at the time, which would have been excessive. And, as I have said before, and shown by my actions in January and February, I have no more wish to see monetary conditions too tight than I have to see them too lax.

It therefore seemed sensible to wait until calm had been restored to the markets, and then make the appropriate move. Which is what duly took place.

I do not conceal that there is necessarily a large element of judgement in this, both of monetary conditions and of market tactics. But the record speaks for itself. We have brought inflation down to the lowest for twenty years. We have combined that with sustained growth and rising living standards. And that is a combination which has eluded many of our predecessors, of both parties. We have done it by sticking to policies of sound money and free markets. And that is the way we intend to continue.

Outlook for the UK Economy

Finally, I turn to the outlook for the UK economy.

Since I spoke here last year, the world has been going through a difficult phase of adjusting to the major shifts in relative prices which have occurred over the past year or so. The dollar, commodity prices, and in particular the oil price have all changed by massive amounts.

The initial effect of these upheavals has been to slow down somewhat the growth of world activity. But just as, after each of the massive oil price increases in the seventies, there was a delay of some months before output was adversely affected, so the benefits to economic activity from cheaper oil are only now beginning to emerge. I would expect to see a gradual quickening in the pace of world economic growth over the next year.

In this country, domestic demand has risen rapidly this year, as expected at the time of the Budget. Inflation has fallen even more sharply than forecast. Even excluding the effect of mortgage rates, which somewhat idiosyncratically we include in the Retail Price Index, inflation is now only a little above three per cent, and I would expect it to continue at around this level over the next few months.

What has been disappointing is the growth of world trade, and thus of UK exports, particularly over the last quarter of last year and the first quarter of this. Imports to the industrialised countries have accelerated along with higher domestic demand, but the oil and commodity producers have cut back their imports much faster than expected.

As a result, after almost five years of steady growth of approaching three per cent a year, overall UK output growth so far this year has been rather less than I envisaged at the time of the Budget. But I do not expect that pause to continue, and output growth next year should be faster.

Already there are encouraging signs. Over recent years, in sharp contrast to the previous pattern, we have maintained our volume share of world trade in manufactures. And despite last month's freak trade figures, it is clear that exports have resumed the vigorous growth they showed before the pause began.

Looking ahead to 1987, while domestic demand is likely to grow at about the same rate as this year, exports should continue the better performance of recent months. This should produce balanced growth at a sustainable pace. And that should help to allay some of the exaggerated fears that have been expressed about the effect of the oil price collapse on the balance of payments.

Finally, although it is never wise to draw too many conclusions from the outturn for a single month, it is encouraging that today's unemployment figures show the biggest fall since we first took office more than seven years ago. Job vacancies, too, are at their highest level since 1979. And it bears repeating that since the last general election a million new jobs have been created, and total employment has risen for thirteen successive quarters - the longest period of uninterrupted growth in employment this country has known for almost thirty years.

Conclusion

One of the themes of my speech today has been the rapid changes in the world economy. Against this background, it is tempting to focus exclusively on short-term considerations. But the very fact of rapid change makes it all the more important to concentrate on objectives for the medium and long-term, and how best to achieve them.

As a Government, we have consistently sought to do just that. The Medium-Term Financial Strategy has been, and will continue to be, a discipline for us, and a stable framework within which the private sector can plan. The ultimate objective is - and will remain - the complete elimination of inflation. Within that framework, we have put in place a series of policies to improve the supply side of the economy - policies of deregulation, of tax reduction, of tax reform, of privatisation, and of wider share ownership, all of which will bring increasing benefits over time.

That is why the prospects are good. When I speak to you next year, though we shall no doubt have seen more turbulence, we shall also have seen further successes. We shall then be in our seventh successive year of steady economic growth, with inflation remaining low. We shall be competing in a fast-changing world, and we shall be doing so in a spirit of enterprise and confidence.

The events of the past year have once again revealed the underlying strength of the British economy. I can assure you, my Lord Mayor, that I shall do all in my power to maintain the policies which brought about that strength.