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## BRITAIN'S POLICY AND BRITAIN'S PLACE IN THE INTERNATIONAL FINANCIAL COMMUNITY

Keynote speech given by Nigel Lawson MP, Financial Secretary to the Treasury, at the Financial Times 1980 Euromarkets conference, Inter-Continental Hotel, London, on Monday 21 January 1980

I welcome this opportunity to explain to an international audience, expert in finance, what the new British Government is trying to achieve. Since the War, British economic policy has been characterised by a preference for state regulation over the free functioning of markets and by high Government spending relative to the ability of our economy to produce. We have encountered repeated economic difficulties as expectations - both popular and political - have outstripped performance. Time and again that gap has been closed by inflation, by controls and by short term crisis measures.

The new Government is striving to break free from that tradition. We are helped by a growing mood of realism in our people. The connection between our relative productivity and our relative standard of living is at last beginning to be recognised. We are also helped by North Sea oil which has removed the external financial constraint that made it so difficult for British Governments to persist in a clear line

of policy for any length of time. As a result of these developments, we have decided that the time has come to abolish controls that have outlived their usefulness (if indeed they ever had any), to leave markets free to allocate resources efficiently and above all to combat inflation by a sustained and realistic medium term policy inspired by a clear sense of direction and not, as so often in the past, one enforced in fits and starts by sudden crises, or distorted by illusions about the practical effects of incomes policies.

### Inflation and the PSBR

Our first priority is to get down the rate of inflation. We seek to do that by tight fiscal and monetary policies. This is neither easy nor painless and we do not expect quick results. But we are determined to succeed. Our policy has - for the time being - meant higher interest rates than we would wish to have. It means cuts in public expenditure which, although essential to the policy's success, create transitional problems as expectations based on false assumptions about the capacity of our economy are forced to come to terms with reality. The age of optimism is over. The age of realism is upon us. Some

people have argued that we can, for the time being at least, avoid the unpleasant choice between cutting public expenditure and increasing taxation by allowing the PSBR for the coming financial year to rise. I cannot regard the prospect of an increasing PSBR with the equanimity of some commentators.

Let me start with two simple facts. The first is a statistic. The PSBR is at present about  $4\frac{1}{2}\%$  of total gross domestic product - compared with an average of only  $2\frac{1}{2}\%$  in the 1960s. So it is large - and much larger than it was a decade or so ago. The second is an economic relationship. That is, the PSBR and the growth of the money supply and interest rates are very closely related. Too high a PSBR requires either that the Government borrow heavily from the Banks - which adds directly to the money supply; or, failing this, that it borrows from individuals and institutions, but at ever-increasing rates of interest, which place an unacceptable squeeze on the private sector.

From these two facts comes one conclusion, and one conclusion only - that the PSBR is too large. We have therefore made it a central objective



of our policy to achieve a downward trend in the PSBR as a percentage of GDP in the medium term.

So what, then, of the short term, and of the recession which has been widely forecast for the coming year? It has often been argued that the PSBR tends - and should be allowed - to fluctuate with the cycle. It is true that, in a recession it will tend to increase through diminished tax receipts and increased social security benefits, other things being equal. But we need to see this against the background of the secular downward trend to which the Government is committed. Taken together the cycle and the medium-term trend might be expected to produce a "stepped" PSBR profile, with the PSBR not changing much as a proportion of GDP in recession years, but falling fairly sharply in non-recession years.

So the PSBR forms an important part of our macro-economic analysis. But it is a very long step indeed from this to the suggestion that a given PSBR has any direct implications for the level of economic activity. In other words, the PSBR is affected by the cycle, but cannot in itself have much effect on the cycle - assuming, that is,

that the Government maintains its adherence to a money supply target.

And, I can assure you, that assumption is correct.

This leaves us with determinants of demand - and hence the level of activity - which are radically different from those which dominated the post-war Keynesian world. The normal "Keynesian" stimulus of an increase in the PSBR depended crucially on the high PSBR being allowed to feed through into greater growth in the money supply than would otherwise have been the case. But in the world of monetary targets, the level of demand is effectively determined by the rate of inflation. A rate of inflation higher than the monetary target will cause demand to be depressed, as a smaller volume of goods is purchased at a higher price; similarly, a rate of inflation lower than the monetary target will give rise to a boost to demand. In other words, what matters is the rate of change in the real money supply.

In such circumstances an increase in the PSBR does anything but raise the level of activity for any length of time. Instead, all it does is to increase interest rates, thus squeezing the private sector in a way

which cancels out the value of the original fiscal boost. In so far as there is any net effect, it is to change the pattern of the economy by benefiting consumption - especially by the Government - to the detriment of investment (including house purchase via the mortgage rate).

We could, it is true, give a net boost to demand via the PSBR if we chose at the same time deliberately to move to a higher monetary target. But this would at best only be a very short term boost indeed, which would soon be transmuted into still higher inflation. Indeed, given the key part that expectations play in the economy, there would probably not even be a short-term boost. For in present circumstances a deliberate slackening of monetary targets would be likely to cause a major shock to confidence, both in the domestic and international financial markets, from which the only escape route would be a painful "crisis" package of the kind we have, over the years, come to know all too well.

Sceptics may point to those seemingly golden days in the 1950s and (to a diminishing extent) in the 1960s, when we did appear to see an increase in the PSBR, combined with an accommodating monetary policy,

cause some somewhat fitful expansion of the real economy. But in those days double-digit inflation was unknown - at least in the UK. A degree of money illusion persisted, and wage bargainers in particular to a considerable extent ignored inflation. Moreover businessmen for their part were usually willing to believe that a Keynesian stimulus to output could be sustained long enough to justify a more confident and expansionist policy. And of course a fixed exchange rate prevented fiscal expansion from undermining itself as rapidly as occurs in the floating rate world of today. It was all a form of confidence trick which - however benign its short- and even medium-term consequences - , cannot be played today.

For as the expansionary policies of the 1950s and 1960s gradually gave way under the weight of the inflation which they had caused, so the behaviour of various sectors of the economy has changed in nature. Money illusion is now dead and wage bargainers understand the facts of inflation every bit as well as economists do; businessmen are openly sceptical about the Government's ability to manufacture growth; and the foreign and domestic markets have become far quicker and more sensitive in their appraisal of events. Just as the sectors of the



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economy have learnt, so too must the Government. Above all, this means recognising that the search for easy solutions is futile; and that there is no alternative to maintaining a firm hold on monetary growth, and in particular a firm grip on the public sector borrowing requirement.

The old-fashioned doctrine of the balanced budget was nothing like as foolish as it was later made out to be. But without going as far as that, I would certainly say this. The new Government's economic policy is frequently described as monetarist. It would be equally apt to describe it as fiscalist.

#### The Supply Side of the Economy

The Government's second objective is to improve the supply side of the economy. This is the only lasting route to higher output and employment. As a nation, we have learnt the hard way that expanding monetary demand does not - except perhaps in the very short term - produce greater prosperity or more jobs. In to-day's world you cannot spend your way out of recession. The only consequence of attempting to do so is higher inflation.

Since taking office eight months ago we have already taken a number of important steps to improve the long-term performance of the economy. We have made a major start in reducing the heavy burden of income tax which penalised hard work, responsibility and success, and destroyed personal incentive. In the Budget we cut income tax overall by £4½ billion in a full year; and the hitherto insane higher rates of taxation are now close to average European levels. It remains our objective to reduce the basic rate of income tax to 25 per cent. We have introduced various measures to get markets to operate efficiently again. It is, as you know, our intention to reduce the size of the state sector of industry by returning a number of enterprises to the private sector. Again we have made a start with our announcement of plans to introduce a private sector stake into British Airways and we are looking into ways of getting private sector participation in various other public corporations. We have made clear to the National Enterprise Board that we expect them to involve the private sector as far as possible in their future ventures. Last but not least, we have scrapped four key areas of state intervention which distorted and politicised the economy with little or no lasting benefit:

pay controls, price controls, dividend controls and exchange controls.

### Exchange Controls

I believe that this last decision, to abolish exchange controls, will prove to be one of the most significant acts of Government policy affecting Britain's place in the international financial community that has been taken since the War. I do not believe that its true significance has yet been understood. To read some of the comments that have appeared in the Press one might almost have supposed that it was part of a short-term manipulative policy of the traditional kind. Most commentators seem ~~to have~~ focussed on the short-run effects either on the exchange rate or on domestic monetary conditions.

It was not that type of decision at all. Such comments themselves reflect the obsession with the short-term that has distorted British economic policy for so long. The decision to abolish exchange control was part of the Government's fundamental long-term strategy. Certainly, we chose a time to implement the decision when sterling was strong. But we were not trying to achieve any particular value for the exchange rate or some quick gain in international competitiveness.



You cannot fine-tune your exchange rate by this or any other means.

No; what we have done is to remove a damaging distortion to the proper functioning of capital markets. In particular, it was our intention that, by so doing, the rate of return on capital invested in this country should move up in to line with that on capital invested in other industrialised countries. Exchange controls have often been defended as an incentive to domestic investment as well as a protection against speculation. In fact, there is no evidence whatever that they helped domestic investment. The evidence tends to support the opposite view that they made it more difficult for exporting industries to exploit overseas markets. Furthermore, although as I have said we were not trying to achieve any particular rate for sterling, it is nonetheless true that the competitiveness of British industry should over time benefit from the abolition of exchange control as the exchange rate is likely to be lower than it would otherwise have been. Our manufacturing sector will no longer have to take the full force of the adjustment of our balance of payments to increasing North Sea oil production. Because of the abolition of exchange controls, our capital market will be free during the period of peak North Sea oil production to direct capital resources either to overseas or to domestic investment according to where the return is expected

to be greatest. The emphasis on profitability

in the financing of domestic investment will strengthen our domestic industrial base; and the return from profitable investments overseas will provide us with foreign exchange earnings to replace income from North Sea oil when production begins to decline.

Exchange controls have been tried as a defence against speculation not only in this but in many other countries. In no case has experience justified the confidence that has so often been placed in them. Their existence can (and in the British case probably did) lull governments into a false sense of security which causes them to ignore the longer term consequences of imprudent fiscal and monetary decisions. If a government's basic economic policies are such as to forfeit the confidence of world markets, no exchange control regime that can possibly be devised - and it is hard to imagine one more draconian than the one we abolished - can protect that economy from higher inflation and lost output.

#### Exchange controls and monetary policy

One consequence of the decision to abolish exchange controls is, of course, the virtual amalgamation of the domestic and external markets

for sterling. Some commentators, pointing to this fact, have suggested that the effect is to cause us to lose control of our money supply. That simply isn't so. The closer intergration of the domestic and external markets has not fundamentally affected our ability to control the money supply. Interest rates and fiscal policy will continue to be the main weapons, and these will affect conditions in both domestic and external sterling markets in much the same way as they have affected conditions in the domestic sterling market hitherto. The abolition of exchange controls has indeed increased the scope for evasion of direct controls, such as the Supplementary Special Deposits Scheme; but direct controls are not fundamental or essential to monetary control. Even if exchange controls had not been abolished the SSD scheme could not have been retained for much longer because of the increasing distortions it causes within domestic financial markets. The Chancellor of the Exchequer made it clear in his Statement on 15 November that he did not see it as a permanent feature of the system of monetary control. Meanwhile, for as long as it continues to remain in force, the Bank of England has obtained assurances from the banks that they will not deliberately seek to evade its effects by shifting offshore transactions which would ordinarily be done in London in sterling. The Treasury and



the Bank of England will soon jointly be issuing a consultative document on methods of monetary control, including systems of monetary base control. This will enable us to explore fully, with all the interested parties, practical ways in which we might improve the effectiveness of the basic weapons of monetary control. I do not, of course, know precisely where these discussions will lead. But one thing is clear. Monetary control, to be effective, must be essentially directed towards borrowers rather than lenders; and this means that there is no substitute either for appropriate levels of interest rates - however generated - or, above all, for a strict curb on government borrowing.

#### Exchange controls and the City of London

Meanwhile, abolition of exchange controls gives the City of London new opportunities to serve the world financial community and to help the recovery of Britain's economic fortunes. The City will be able to offer its customers a wider range of services than ever. To take one example - UK banks are now able to lend sterling to non-residents for financing third country trade in sterling and indeed for any other purposes. Our financial institutions are now free of the substantial

administrative burdens of controls. They will no longer have to waste time and money on applying for various permissions and checking that they and their customers are abiding by various regulations.

It is now especially important that our financial institutions should be freed from artificial barriers hindering their efficiency and flexibility. One very good domestic reason is that we depend to no small degree on the invisible earnings of the City of London, which amounted to a net £2.3 billion in 1978 alone. With our visible trade balance leaving much to be desired, it is particularly important from a national point of view that we do everything we can to increase invisible earnings.

There is also the wider international perspective which is the theme of your conference. This year oil exporters' surpluses may reach \$100 billion. If the world economy is not to seize up, it will be necessary for the bulk of that money to be recycled to countries running current account deficits induced by higher oil prices. This will be no small task. Its accomplishment will require the

City of London - the world's most important international banking centre - to bring all its expertise and experience to bear on it.

### The Euro-markets

You would not expect me, in this forum, to conclude without referring to the current debate about controlling the euro-markets, although I do not intend to dwell on this at any great length as I notice that later speakers are going to address you on particular aspects of this issue. Many anxieties have been raised about the role of the euro-markets in the world economy; some of them have tended to cast the euro-markets as a malign influence behind many of the economic ills with which the world is beset at present. I believe these fears to be largely misdirected, since the root causes of such phenomena as world inflation, currency instability and so on are much more fundamental. With the increasing economic integration of the economies and financial markets of the free world, there are bound to be problems of adjustment if the policies and performance in the various economies are not compatible.



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remarkable growth of the /markets- at between 25 and 30% per annum in recent years - naturally in itself raises questions about its future; in particular, the growing exposure of international banks to countries with substantial balance of payments deficits, or with an uncertain political outlook, raises important questions about the level of risk that may be associated with international lending. Recent developments have undoubtedly reinforced these concerns. Yet there are no easy, generalised solutions; at a time when still higher oil prices will impose further strains on the balance of payments of many countries, any abrupt reduction of lending, however caused, would only serve to increase the risks. The approach which the UK authorities have adopted, and which is most likely to ensure that the business of international lending is conducted on a sound basis, is to focus on improving the techniques of prudential supervision.

The extension of the euro-markets among the world's financial centres

means that for any approach which focusses on prudential supervision the authorities must have a complete picture of a bank's worldwide operations. The Bank of England, who are the relevant authority in the UK, have always sought to assess the position of a UK bank on the basis of its consolidated position worldwide as well as of its UK operations alone. Steps have been taken recently, in line with international efforts in this area, to enhance their capacity to analyse, on a more frequent basis than hitherto, the consolidated positions of UK banks in relation to their capital adequacy, and risk exposures. Reporting arrangements have recently been put in place which enable the Bank of England to monitor the country risk exposure of UK banks on a worldwide basis. I am conscious that, while the principle of consolidated reporting is relatively straightforward, there are a number of practical difficulties in implementing the required reporting arrangements (some involving definitions and accounting practice and other local legislation relating to banking secrecy). I am sure, however, that the banks concerned will readily appreciate the motives of the UK authorities in seeking this additional information and will, as usual, co-operate with them in arriving at mutually acceptable and reasonably based arrangements.

There is, of course, no automatic benefit from assembling figures on a fully consolidated basis. The operations of the overseas branch or subsidiary will continue to be subject to the monetary and supervisory controls imposed by the host country. Where these are already restrictive, little change of behaviour is likely to occur. But in some centres there are few restrictions of any kind, or few relating to offshore operations. If, however, at least one supervisory authority is looking at the overall situation of each major international bank or **banking** group on a fully consolidated basis, the apparent freedom to expand operations out of certain centres will disappear, as both the bank's own management and the supervisory authority will be able to assess the effect on the bank as a whole and effect any necessary adjustments by applying their normal criteria for capital and liquidity adequacy.

Central banks and other supervisory authorities have in recent years engaged in far more international co-operation, following the impetus imparted by the Herstatt collapse in 1974. The Bank of England played a leading role in the subsequent setting up of a standing committee of Group of Ten countries' bank supervisors under the aegis of the Bank for International Settlements. This Committee has provided the forum



for a detailed examination of a number of supervisory issues which affect the international operations of banks. In particular it has discussed the principles of consolidation which I have described above and promoted their universal adoption. Applied consistently by the supervisory authorities of the major banking centres, these principles should achieve a desirable constraint on individual banks tempted to expand their international operations unduly, and to help to ensure that the overall growth rate of international lending is kept within reasonable bounds.

### Conclusion

I have chosen on this occasion to stress the theme of the British Government's central economic policies - the reduction of inflation by sound monetary and fiscal policies pursued consistently over a period of years; and the removal of artificial barriers to the proper functioning of markets. These are clear responsibilities of the state.

This Government's rejection of direct and physical controls certainly does not mean that we believe that governments and central banks have nothing to do. I hope I have shed some light this morning on what we believe their proper task to be.

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