

2. Why monetary control needs to be reformed

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In the decade of the 1960s Bank Rate was changed 24 times. In the two years and three months since the beginning of 1977 Minimum Lending Rate has been changed 27 times; in 1977 alone it was changed 18 times.

The much increased frequency of interest rate moves in recent years is striking, but it might not be a reason for concern if it reflected a more delicate and finely-judged response to changing circumstances. But that has hardly been the case. The authorities have, without hesitation, altered MLR by much larger amounts in shorter periods than would once have been considered possible. In 1976 MLR varied from 9 per cent in April to 15 per cent in October; in 1977 from 14 per cent in January to 5 per cent in October; and in 1978 from 6½ per cent in March to 12½ per cent in November. In the 1960s, by contrast, the greatest Bank Rate shift in any one year was only 2½ per cent—from 5½ per cent in May 1967 to 8 per cent in November.

Moreover, the interest rate cycle seems to have become progressively more violent and abrupt. The latest episode has aroused particularly strong criticism. MLR, which had a record increase of 2½ per cent to 12½ per cent on November 9 last year, was raised to 14 per cent on February 8. This made the real rate of interest on bank overdrafts to small companies about 6 or 7 per cent, which is almost without parallel. But only three weeks later, after a buying stampede into the gilt-edged market, MLR was lowered to 13 per cent. Speculation about the timing and size of further reductions continues.

Are these gyrations needed? Can the extreme interest rate volatility of the late 1970s be justified?

Or are these the symptoms of serious weaknesses in the mechanism of monetary control? The argument of this article will be that they cannot be justified and that consideration should be given to reforming certain aspects of the British financial system.

Money supply control

The first question to ask is why the authorities have self-consciously allowed or encouraged such large interest rate fluctuations; and the short answer is that, with the adoption of explicit monetary targets, far more attention is paid to the quantity of money than to its price. The point is fully understood by the Bank of England. In a speech on June 18 1976, Mr Richardson, the Governor, said that, 'It is clear that close adherence to a target applying to one of the dimensions of monetary policy, namely the stock of money, may provoke greater instability in the other dimension of interest rates'. The speech was the first occasion on which targets were officially adumbrated—and it was, perhaps, a warning of what was to come.

However, like most short answers, it is not fully satisfactory. Central banks in many other countries have chosen to subject themselves to the discipline of monetary targets, but they have not experienced the same degree of interest rate volatility as in Britain. In West Germany, for example, the Lombard rate was constant at 3½ per cent from December 16 1977 until January 19 this year when it was raised to 4 per cent; and in the United States there is a reluctance to move Federal funds rate, the main instrument for regulating the aggregates, by more than ¼ per cent in any single episode of policy adjustment. German and American monetary control has not been

noticeably inferior to Britain's.

Moreover, a good case can be made for saying that several MLR changes have been extreme, unnecessary and damaging. In 1976 13 per cent MLR established on September 10 would probably have been sufficient to bring the money supply under control. But MLR was increased to 15 per cent on October 7. Sterling M3, which had grown at an annual rate of 15 per cent in the six months to September, actually fell in the subsequent six months. The reduction in MLR to 5 per cent on October 14 1977 was a similar mistake in the opposite direction. In the six months up to the decision, sterling M3 went up at an annual rate of 14 per cent; in the following six months the rate was nearly 20 per cent. In other words, interest rate policy exaggerated the deviation of money supply growth from its target ranges.

The pursuit of monetary targets is not by itself, therefore, the complete explanation for interest rate volatility. But it may form one part of the story. The other, more critical part is the instability of the present arrangements for financing the government's borrowing requirement.

The aim of interest rate changes

When MLR is raised it is designed to reduce money supply growth in two ways. First, by causing more expensive overdrafts, bank lending to the private sector should in theory be deterred.

In practice, no statistically reliable link between interest rates and loan demand has been discovered. That there is some relationship between interest rates and credit pressures from the private sector nevertheless seems very probable on common-sense grounds. Interest rate changes impact on some financial institutions, such as building societies and hire purchase companies, very directly. The difficulty is that these effects, even if powerful, are not easy to identify and may be subject to long, variable lags. For these reasons, the private sector's responsiveness to interest rate changes does not assist the Bank of England in short-term regulation of the monetary aggregates.

The second mechanism is that an MLR increase is intended to stimulate sales of gilt-edged securities outside the banking system. By this means, the public sector borrowing requirement can be financed without an increase in the Treasury bill issue and, hence, in bank deposits and the money supply. The idea is that if MLR goes up, the probability of a later reduction is increased; and if yields on gilts are expected to follow MLR, gilts have become more attractive to potential buyers.

The gilt sales mechanism

But there is a flaw here: expectations about yields on long-dated gilts may be different from expectations about MLR. Moreover, some inherent defects in the present arrangements for official gilt sales exacerbate the difficulties. Gilts are sold either at issue or through 'taps' (where the government broker supplies the stock at a price in line with the market, only raising it gradually as the market advances); in both cases, the price is given. It follows that when the market price differs from the official price, there is excess demand or supply.

If the market price is above the official price, as happens with some new issues, there can be a hectic scramble to buy stock. This is what happened on February 22, when two stocks, Exchequer 13½ per cent 1987 and Treasury 13¾ per cent 2000-03, were heavily oversubscribed and an 'outright brawl' (the quote is from the *Financial Times*) developed on the third floor of the Bank of England, as agents for financial institutions tried to present their applications in time.

If the market price is below the official price, on the other hand, no one wants to buy stock from the government broker. It is this situation which can be dangerous. When the authorities are unable to maintain the momentum of their funding programme, the money supply grows quickly because the government has to finance the budget deficit from the banking system. As the deterioration in the money supply is perceived, the gilt market becomes more bearish, the gap between the market and the official price widens and the scope for the authorities to sell gilts is further reduced. A self-

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validating cycle of bearishness is engendered.

The logical reply might seem to be for the authorities to reduce the official 'tap' price to the market level. But they do this with reluctance and, even then, only if the difference between the market and the official price is very large. When the market price is just a shade—say, 1 or 2 points—beneath the 'tap', the government broker does not lower the official price to the market level. The reason is that a small reduction in the official price might not ensure subsequent gilt sales on a sufficient scale. In consequence, the authorities cannot activate sales of government stock by manipulating the gilt-edged market. They are in the unhappy position of being large forced sellers who cannot change their price—and, even worse, their dilemma is well known to other market participants.

How, then, can the Bank promote gilt sales? The answer is through increases in MLR. Sometimes, indeed, the money markets sense that a change is needed before the Bank acts; but sometimes it decides on overkill to guarantee that interest rate expectations are turned. An ultra-short-term rate, that at which the Bank lends to the discount market overnight or for a few days, is therefore being used to change views about yields on stocks which can have 30 years to redemption.

Instability of the system

The system of monetary management is unstable. Quite apart from the perverse interaction of low official gilt sales, faster money supply growth and expectations of further interest rate rises, fluctuations in gilt market sentiment are quickly communicated to short-term interest rates. The gilt market has always, and with justice, been proud of its sophistication and intelligence; in few other financial markets are such large amounts of stock transacted with such ease or with so narrow spreads between buying and selling prices. But the market is nevertheless highly susceptible to temporary shocks, from bad labour news, from sudden changes in the popularity of the pound on the foreign exchanges, from disappointing central government borrowing requirement figures and so on. It is not always appropriate, and it can be quite wrong, for these transient news developments to be reflected in short-term interest rates.

Instead, there is a good case for arguing that interest rates should be managed to achieve steady expansion of private sector credit, particularly such variables as bank lending to industry, the growth of hire purchase debt and building society mortgage commitments. Monetary policy would then be contributing to macro-economic stability rather than being, as it is at present, an aspect of macro-economic instability.

In coming weeks, reform of the system of

selling public sector debt will be debated in the financial press and elsewhere. The advantages and disadvantages of regular tenders or auctions, of government stocks, compared to the 'tap' arrangements have already been widely discussed. But, in a recent television interview, Mr John Page, the Chief Cashier at the Bank of England, described the present system as 'very good'—and, publicly at least, that remains the official view.

However, disquiet about the turbulence of the gilt-edged market is growing. Some institutions are worried that the speculative gains of recent weeks might add more weight to the pressure for direction of investment. It is certainly very difficult to see what benefits society gains from massive swings in gilt prices.

Perhaps part of the problem is that the gilt-edged market is being asked to do too much. In the 1950s and 1960s the public sector borrowing requirement was never more than 4 per cent of national income and it averaged 2 per cent. Since 1973 it has consistently exceeded 4 per cent of national income. The supply of new gilt-edged stock has risen correspondingly. Moreover, neither the local authorities nor the public corporations have been issuing much debt in their own names since 1976. The focus of investment in public sector debt has been very much on the gilt market—and all the effects of changes in opinion about British economic policy have been concentrated there. The government began to diversify its funding efforts in 1978 by offering more attractive National Savings instruments and drawing company liquidity into Certificates of Tax Deposit. But these are peripheral improvements. The kernel of the problem, the instability of the authorities' methods of selling public sector debt, has not been touched.

Conclusion

Interest rate volatility is in itself a great evil: it imposes many costs on the economy through its disturbance of business and financial planning. Monetarists have long accepted that large interest rate changes may be an inevitable accompaniment of money supply targets. But they were thinking of movements in long-term interest rates to smooth the progress of public sector debt sales. With the present system of monetary control in Britain, long-term rates are relatively insensitive to official guidance and changes in monetary policy have to be signalled through MLR.

The consequences have been unfortunate. No other leading industrial country has seen such spectacular interest rate fluctuations in the 1970s; and real interest rates of well over 5 per cent have been established for the first time since the early 1920s (when the price level was falling). It is difficult to agree with the official verdict that the British system of monetary control is 'very good'.