Paul Temperton

UK Monetary Policy

The Challenge for the 1990s

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Preface

Over the last year, when I have told enquirers the subject of this book, the most common response has been: 'is there still a UK monetary policy?'. The question is understandable, given that the 1980s saw a marked changes in the conduct of UK monetary policy and, especially, the abandonment of targets for the growth of broad money. Indeed, data for sterling M3-the cornerstone of UK monetary policy at the start of the last decade-are no longer published. But this change in the role played by broad money does not mean that there is no monetary policy. There is one, and it is important that we continue to have one. The discussion of the development of UK monetary policy over the last thirty years in Chapter 1 points out that, although the presentation of monetary policy has changed markedly, there have been relatively few periods in which there has been little concern with monetary developments. Monetary policy has taken various forms including maintainance of a fixed exchange rate, a target for broad money, simultaneous targets for several monetary aggregates, an unannounced exchange rate target and conditional targets for the exchange rate and monetary growth. Although periods without a clearly defined policy have been few, they have without exception led to macroeconomic problems-in particular, rising inflation.

During the 1990s, the most important issue facing UK monetary policy makers will be progress towards European Economic and Monetary Union (EMU). If full EMU were to be achieved then there would be no role for an independent UK monetary policy - short-term interest rates would be set at the EC level. This, and the other diverse issues raised by the question of EMU, form the subject of Chapter 7. Although full EMU is not an immediate prospect, progress towards it is of utmost importance. In particular, UK membership of the Exchange Rate Mechanism (ERM) of the European Monetary System forms an important part of Stage One of the Delors plan for EMU. The issues raised by ERM entry are discussed in Chapter 9, after an examination in Chapter 8 of the practical problems the UK authorities had with using the exchange rate as a monetary indicator and an intermediate target of monetary policy in the 1980s. In particular, Chapter 8 examines the period from March 1987 to March 1988 when the UK authorities 'capped' sterling's value against the Deutschemark.

Given that the form of UK monetary policy has often changed in the last decade, it would be foolhardy in a book which looks at the issues facing policy in the 1990s to concentrate just on the one issue of the exchange rate. An important section of the book is, therefore, allocated to the role of the monetary aggregates. The changing measures of the money supply form the subject of Chapter 2; and Chapters 3 and 4 discuss the analysis of narrow and broad money, respectively. Chapter 5 focuses on funding policy, which will be of special importance as the UK faces the prospect of a continued public sector debt repayment. A full chapter - Chapter 6 - is taken up in discussing the problems that have been experienced in setting targets for, and assesing the behaviour of, broad money.

A pragmatic approach to aggregating the information on monetary conditions - embracing the role of the exchange rate, narrow and broad money, real interest rates and asset markets - is launched in Chapter 10. The aim is to provide a method of quantifying the 'lets look at everything' approach which currently characterises the Treasury's view.

The subject of greatest day-to-day importance for observers of UK monetary policy - the operations of the Bank of England in the money market - is discussed in Chapter 11.

Although the intention is for each of the chapters to stand alone as discussions of the key issues facing policy, overall conclusions are drawn together in the final chapter.

Thanks must go to the many people who helped in the production of the book. First, and foremost, Nicky, my wife, who not only managed to cope with a resident author for the best part of a year - latterly whilst expecting an addition to the Temperton household - but who also proved to be a tireless critic and proof reader. Without her it really would not have been possible. Philip Reece must be praised for being the last in a line of desk-top publishing operators struggling to shape the text into the confines dictated by Ventura. Amongst the people who read and commented on a draft version of the book Roger Clews at the Bank of England, Peter Lilley at the Treasury and Sir Alan Walters must be thanked not only for speedily checking references but also for offering additional helpful comments. Charles Goodhart went even further than could reasonably be expected in his examination of the draft and it is regretted that not all his suggestions could be incorporated given the time constraint; that will have to be the task for any second edition. I do, of course, take full responsibility for any errors which remain.

Paul Temperton June 1990

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(i) 1949 to 1967: a fixed $/£ exchange rate

During the 1950s and early 1960s, the UK economy grew at a rate which was sufficient to keep unemployment at a very low level. Economic policy was aimed at 'managing demand' so as to achieve a level of economic activity which was sufficient to obtain 'full employment'. The principal constraint on this demand management policy was the maintenance of the value of the exchange rate at $2.80/£. When economic growth became too rapid and the balance of payments deteriorated, economic policy would become more restrictive in order to moderate demand, correct the balance of payments position and hence moderate pressure on the exchange rate. In the period of correction, any balance of payments deficit was met largely by running down the official foreign exchange reserves.

The policy of maintaining economic activity at (or close to) the full employment level led to a steady increase in the public sector's involvement in the economy. One indication of this is given by the ratio of general government expenditure to GDP: as is shown in Figure 1.1, this rose from 38% in 1955 to around 50% in the early 1970s (and subsequently reached almost 55% in the mid and late 1970s).

Inflation, in large part pulled by the continually high level of demand in the economy, also displayed a clear upward trend. Comparing the levels of inflation reached at comparable times in each of the business cycles since the mid-1950s inflation rose steadily, as can be seen from Table 1.1.

Figure 1.1: Ratio of general government expenditure to GDP

SOURCE : DATASTREAM

Although later on in the 1960s monetary policy was concerned primarily with the management of the level of nominal interest rates and the control of bank lending to the private sector, policy decisions were still driven by the need to maintain the fixed exchange rate. From 1964 the authorities imposed quantitative ceilings on bank lending to the private sector. Within these ceilings, guidance was given as to which sectors of the economy available credit should be channelled: broadly, companies which required finance for

Table 1.1: Inflation trends, 1958-1981*

Date:	Inflation Rate (% p.a.):
December 1958	1.9
January 1963	2.7
March 1967	3.5
February 1972	8.1
August 1975	26.9
May 1981	11.7

* the dates chosen are those corresponding to the troughs in each of the business cycles

exporting or investing were favoured at the expense of the personal sector. Policy was not explicitly concerned with the growth of any measure of the money supply.

Monetary data were collected from 1959[1] but the accepted view was that the relationship between the money supply and prices and incomes in the economy was so unpredictable that it was highly unlikely to be a useful variable to examine for policy purposes.

(ii) 1967 to 1971: the IMF, broad money and deregulation

Maintenance of the dollar/sterling exchange rate at $2.80/£ lasted from 1949 to 1967. In 1967, when a prolonged period of restrictive policies had failed to produce any correction of the balance of payments deficit, the exchange rate was devalued from $2.80/£ to $2.40/£ and the UK obtained a loan from the IMF in order to bolster the foreign exchange reserves. The conditions attached to the loan obliged the UK to restrict the public sector borrowing requirement (PSBR), restrain finance to the private sector and hence bring about more moderate Domestic Credit Expansion (DCE). The relationship between the PSBR, bank lending, government debt sales and DCE could be expressed within the new flow of funds accounting framework in a way which brought a greater coherence and consistency to the analysis of fiscal and monetary policies. As the size of the PSBR was constrained by the need to meet this restriction on DCE, the use of discretionary changes in the government's budgetary position to manage demand became more restricted. Although control of this credit measure was thus forced upon the UK by the IMF, two other key developments also led to greater attention being placed on money and credit.

First, as inflation rose and became more volatile, the behaviour of nominal interest rates became a much less reliable guide to the stance of monetary policy. The expected real interest rate is equal to the nominal interest rate less the expected rate of inflation and is a better guide to the stance of monetary policy. When inflation is low and stable, changes in nominal interest rates are associated with commensurate changes in real interest rates; but in times of high and volatile inflation, inflationary expectations become much more difficult to assess. Hence, the authorities cannot know with any degree of certainty the prevailing real interest rate. In the late 1960s, this problem led to the search for an alternative guide to monetary conditions.

Second, econometric work which had been carried out on the monetary data collected since 1959 came up with the conclusion that the demand for money could be satisfactorily explained by a few other economic variables - prices, incomes and interest rates. Moreover, the studies implied that control of the growth of the money supply could be achieved by acceptable variations in short-term interest rates. Thus money could be controlled by changing interest rates and direct controls may not be needed. At the time, there was a general movement towards favouring more competition in banking. Given this background and the evidence of the econometric studies, direct controls on lending were abandoned in September 1971: the authorities placed greater emphasis on changes in interest rates as a way of influencing the demand for credit.

(iii) 1972 to 1973: floating exchange rates and fiscal expansion

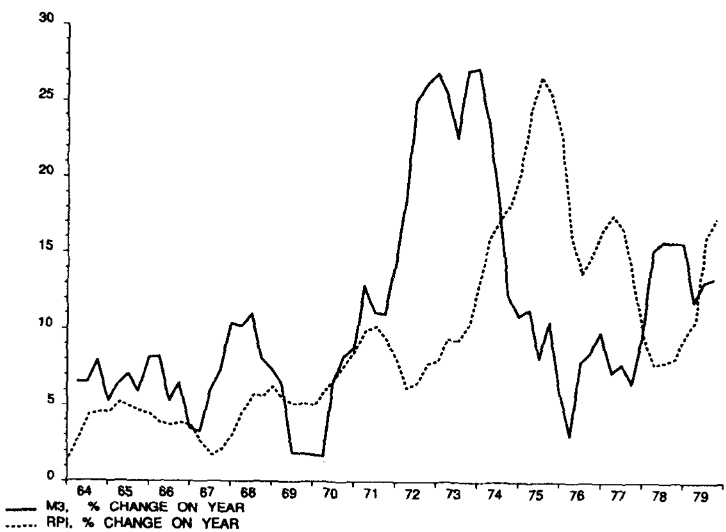
At around the same time, the US authorities suspended the dollar's convertibility into gold, and the postwar system of fixed exchange rates was abandoned. After a short experiment in the 'snake' (the European fixed exchange rate system), the UK authorities decided to 'float' sterling on 23 June 1972. Shortly before that, the Conservative government had embarked on a highly expansionary fiscal policy in the March 1972 Budget. The combination of such a stimulative fiscal policy and the new-found freedom of the banks to meet a strong demand for credit (financed by the increasingly popular liability management technique of bidding for deposits) produced a high level of demand in the economy and severe inflationary pressures ensued.[2] Despite sharp rises in interest rates, rapid growth of money and credit persisted. Bank lending to the private sector grew by 33%, and M3 by 28%, in 1973. The econometric relationships based on the data of the 1960s (suggesting M3 could be brought under control by varying interest rates) had clearly 'broken down' in the face of the structural change in the banking system. Narrow measures of money, however, grew only modestly during the period: M1, for example, grew by only 5% (perhaps because money shifted from sight deposits to time deposits in response to the higher level of interest rates). Given the divergent movements of broad and narrow measures of money, interpretation of monetary conditions was not straightforward. With hindsight, however, the rapid growth of M3 in 1972 and 1973 was seen to provide a good advance indication of the behaviour of inflation in 1974 and 1975 (see Figure 1.2).

(iv) 1974 to 1976: evolution towards targets for broad money

Even without that evidence, and in the face of the 'breakdown' of the econometric equations for M3, 'the course of M3 was a fairly strong policy constraint after 1973'.[3] Containment of M3, however, once again came to rely on a form of direct control on the banking system; the Supplementary

Special Deposits Scheme (SSD or, more commonly, the 'corset') was introduced in December 1973. M3's key attribute appeared to be the way in which it could be expressed in terms of its 'credit counterparts' - DCE (in turn reflecting the PSBR, the extent to which it was financed by debt sales to the non-bank private sector and bank lending to the private sector) and the influence of external flows. The counterparts framework has been the central feature of the analysis of developments in the UK broad money supply since that time.

Figure 1.2: Broad money and inflation, 1964 to 1979



SOURCE : DATASTREAM

The first monetary targets were informal, specifying guidelines and anticipated outturns for broad money growth and domestic credit. In the Budget of 6 April 1976, Denis Healey (Chancellor of the Exchequer) said that 'after two years in which M3 has grown a good deal more slowly than GDP, I would expect their respective growth rates to come more into line in the coming financial year'. Later on in the year, statements about the expected behaviour of the monetary aggregates became more definite. According to Fforde 'the UK authorities had become caught in a spiral of declining confidence' in 1976.[4] Exchange rate weakness, coupled with continuing