MONETARY BASE CONTROL

PART 6

Setting short term interest rates

SETTING SHORT-TERM INTEREST RATES: £M3 AND OTHER INDICATORS

The new arrangements are intended to reduce the visibility of the guiding hand of the authorities and also to let the market play some part in the determination of interest rates of differing maturities. The system is described in the first paper prepared for the seminar: "Monetary Control: The New Arrangements".

2. It has also been established that the movement of £M3 relative to the target range is not the only factor to be taken into account in deciding the level of the interest rate band. The purpose of this paper is to describe the factors to which we should give attention and the circumstances in which an increase or reduction in the level of the band might be considered appropriate. We are not seeking a simple formula which will provide the correct response to all conceivable circumstances, but neither do we want to re-think our position each month from first principles.

3. We shall be operating within the framework of the medium-term strategy. This was designed with the intention that the deceleration of monetary growth should be achieved without relying on an excessive level of interest rates. In that sense, but only in that sense, we have an objective for the level of short-term interest rates themselves. This has been an important consideration in fiscal policy decisions, most notably in this year's budget. It cannot, however, be given much weight in setting short-term interest rates, month by month, unless it can be demonstrated that such a move is consistent with the overall strategy, and with a reduction in the growth rate of money and prices.

4. The new arrangements are designed, amongst other things, to remove a perceived bias towards delay in an administered MLR system. We shall not, therefore, wish to build any such bias into the new system, and should, indeed, consider a decision to keep the level of the band unchanged as needing just as much justification as a decision to raise or lower it.

200/1

5. The interest rate band will be relatively narrow, and its main purpose will be simply to allow for the imprecision of control. The instructions to the market operators will be to keep rates within the band. This does not mean, however, that we cannot, or should not, respond to market pressures. These will show up not only as movements within the band, but also as movements in rates at longer maturities which the authorities do not influence so directly. Thus, the first of the factors to be considered when setting rates is the experience of market conditions in the preceding period.

Market conditions

6. The authorities cannot be wholely passive in the market, since there would then be no reason why the outcome for any of the monetary aggregates should accord with our intentions. If, however, we make our intentions clear to the market, then we may find that market sentiment is useful as an indicator to us of future developments in the factors which govern our decisions. Thus, if the market believes that the rate of monetary growth or inflation is likely to accelerate, there will be upward pressure on interest rates - so long as the market believes that these are amongst the factors which influence the authorities in setting interest rates. If the market expects monetary growth or inflation to accelerate, and we have no reason to believe that view is incorrect, then we may well decide to make a move in interest rates immediately rather than wait for the monetary growth or inflation to manifest itself in fact. The situation has parallels in the management of an exchange rate: sometimes the market can see the "fundamentals " more clearly than the monetary authorities.

7. Money market conditions, especially in the longer maturities, will reflect such expectations, but more "technical" factors such as the flow of funds day-by-day into and out of the exchequer will also be important, especially at the very short end. Thus, last summer there was sustained and strong upward pressure on rates during periods when the PSBR was being overfunded. The system will work rather differently after the reserve assets requirement is abolished, but conditions of the same general kind can recur (for example, in the aftermath of the Civil Service dispute). Such "technical"

pressures are not, in general, likely to signal new information which is relevant to the achievement of targets for the monetary aggregates, or the economy more generally. Typically, we will want to resist such pressure, whether up or down, to the extent necessary to keep interest rates within the band.

8. Market conditions more generally, including the foreign exchange market and the gilts market as well as money markets, may also on occasion influence the timing of interest rate changes. If these markets are unsettled for any reason, there will remain a strong inhibition against the authorities initiating a movement of interest rates, particularly a movement in an unexpected direction. It would be particularly difficult to lower interest rates at a time when the exchange rate was falling.

Sterling £M3

9. The Budget Speech confirmed that the targets for £M3 will continue as the centrepiece of the economic strategy. The emphasis is on meeting the target for the year as a whole, rather than month-by-month. It should be possible to keep the confidence of the markets in the face of short-term fluctuations in £M3, provided that assurance can be given of a consistent underlying trend. Moreover we do not have the instruments to achieve very precise control if we wished it. This must influence the way in which we monitor movements in the target aggregate and respond to divergences in either direction.

10. The first stage of analysis must be, as always, to estimate the effects of known distortions to the outturn figures. Last year the after-effects of the corset scheme were important; this year it is the Civil Service dispute; round-tripping has also been a recurrent problem. The next stage is to look at identifiable factors influencing the short-term outlook. The result is a view of the current trend, based on the movement over the past six months together with the prospect for the next three months.

11. The assessment also needs to look further ahead than the next three months. The short-term response of £M3 to changes in interest rates seems, typically, to be quite small relative to the response in the longer-term. In these circumstances, there is clearly a danger

of over-correction in response to deviations from the target path if the authorities attempt control over too short a period. We have never believed that it was possible to correct all deviations within a period as short as three months. A more realistic horizon would be about six to twelve months - in other words we should, even in the early months of the target year, direct our assessment towards the measures necessary to deliver the right level of £M3 at the end of the year and beyond. This suggests a need for a forecast which focuses on conditions nine months hence.

12. Unfortunately monetary forecasting is a particularly hazardous occupation. Typically the error margin for a forecast of £M3 twelve months ahead is about 4%. Nevertheless we will want to take account of all the relevant information we now have that has clear implications for future monetary growth. If such information was ignored there would be occasions when interest rates were moved up or down to correct divergences which were believed to be transitory. This would tend to increase the volatility of the money supply as well as interest rates. It would also mean turning a blind eye to early warnings that conditions were likely to become too tight or too slack.

13. If interest rate decisions are to be based on forecasts of £M3 as well as outturns, it is important that the reasoning behind these forecasts is clear and convincing. Sometimes we can point to particular events in the future which can be predicted with reasonable confidence - the receipt of our EEC refund last year was a good example. Sometimes we can point to events in the recent past which will undoubtedly have implications for the future - a recent change in interest rates or the exchange rate would be a good example. We must also take account of the prospects for economic activity generally and for inflation, insofar as they are relevant to monetary developments, to the PSBR for example, and to bank lending - although, again, uncertainty must reduce the weight given to such forecasts.

14. Having assessed the underlying trend in £M3, and considered what information there is about the prospects nine months ahead, the next step in principle should be to calculate the scale of interest rate change that would bring the target aggregate back to the centre of the

range within the nine-month forecast period. A calculation of this kind cannot, in practice, be made with any certainty or precision. A wide aggregate like £M3 responds not only to the level of interest rates, but also to the structure of relative interest rates in ways which are complicated and not at all well understood. Indeed the possibility of a perverse reaction in the short run, £M3 increasing as a result of higher short-term interest rates, cannot be ruled out.

15. The effects of short-term interest rates on £M3 include:

(a) higher interest rates will reduce bank lending, but this effect seems slow acting;
(b) higher interest rates will increase the incomes of some individuals and institutions, but on the other hand, some will suffer capital losses; on balance, this should reduce the demand for money, but again it will take time to work;
(c) higher interest rates will make interest-bearing bank deposits <u>more</u> attractive, but on the other hand if the rise is thought to be temporary, gilts will be even more attractive; on balance this could produce a substantial reduction in £M3 almost immediately, but the effect is difficult to predict;
(d) higher interest rates will reduce economic activity and inflation, especially if the exchange rate is strengthened; this will reduce the demand both for bank lending and for bank deposits.

The latest estimates suggest that a rise in short-term interest rates of one percentage point will, on average, reduce £M3 after nine months by 1 to 2 percentage points. But these estimates keep changing; and the effects also depend on tactical decisions of the authorities in the gilt-edged market. There is no satisfactory way of replacing the process of forecasting and policy assessment by a purely mechanical procedure.

16. Last year, faced with a serious over-run on £M3, we decided that an interest rate increase was not an appropriate response. Instead, some quite stringent fiscal measures were taken in this year's Budget. This instrument was chosen partly because the monetary problem was associated with an over-run on the PSBR, and partly because interest rates were already at a high level. This illustrates the general point that an increase in interest rates will not always be the appropriate response to excessive monetary growth. Sometimes a fiscal policy solution will be preferred, or else a change in the funding programme.

The Other Monetary Aggregates

17. A separate paper, "The Role of the Narrow Aggregates", discusses M1 and M0 either as alternatives to a £M3 target or as elements in a system of multiple targets. The analysis of various periods in the past suggests that the narrow aggregates do contain information which should be taken into account in interpreting the movements of £M3 and in interest rate decisions. We need to establish as routine an appropriate procedure for making use of this information.

18. Each year a target is set for £M3. It would be possible at the same time to estimate the growth of M1 which was compatible, according to the information then available, with the achievement of the £M3 target. This would reflect medium-term trends in the velocity of circulation of the two aggregates, recent and prospective movements in interest rates and no doubt a variety of "special factors". The result of this calculation could then form the basis for a guideline relating to the movements in M1 in the following twelve months. During the year we would then monitor the outturn and prospect for M1 over the same time span as we apply to £M3. Unexpected movements in M1, irrespective of what was happening to £M3, would be considered an important element in the interest rate decision.

19. At present we do not publish even a forecast of M1, although a qualitative indication was given in this year's Budget Speech. If the procedure of setting guidelines for M1 came to play a more important part in interest rate decisions, we would need to consider whether it would be advantageous to make a more explicit public reference to it.

20. At a later stage a similar procedure might be applied to MO, but in the coming year its movements are likely to be distorted by the change in the cash ratio. The narrow aggregates should be espcially valuable when £M3 is believed to be subject to serious distortion. Currently, for example, the growth of MO is of particular interest as it is relatively undistorted by the Civil Service dispute.

21. Last year we also made frequent reference to the wider aggregates, especially PSLI, since they were likely to be less distorted than £M3 by the ending of the corset. The growth of more vigorous competition between banks and building societies suggests a rather similar role for PSL2 in the future. This year we have also seen a remarkably rapid increase in residents' foreign currency deposits, made possible by the abolition of exchange control. This suggests an enhanced role for M3, which had attracted little attention in previous years.

22. Recent analysis of money supply movements over a long period of time suggests that a useful relationship may exist between £M3 and the total of all financial assets held by the private sector. This total, the gross financial wealth of the sector, is potentially the widest wide aggregate of all. Quarterly data is now available, and even monthly movements can be estimated approximately. We expect to make more use of this data in interpreting monetary conditions in the future.

<u>External Considerations</u>

23. Over the past year, intervention in the foreign exchange markets has been confined to short-term smoothing and it is assumed that this policy will continue, irrespective of whether the rate is rising or falling. It is appropriate, however, that external considerations should be given some weight in se t ting short-term interest rates. This does not mean that the Government has or should have an objective for the exchange rate. On the other hand, the exchange rate will influence our judgments through its effects on inflation and the growth of nominal incomes in the domestic economy.

24. Forecasts of the exchange rate have been unreliable and the way it is influenced by relative interest rates remains very uncertain.

Nevertheless, movement in overseas rates are relevant information when we are considering interest rate movements in the UK, since differentials do have some effect on the exchange rate and the exchange rate does have an effect on prices. As mentioned above, conditions in the exchange market may also on occasion be important to the timing of interest rate moves, especially when such a move could be misinterpreted as a change in the nature of our policy either towards the monetary targets or towards the exchange rate itself.

Nominal Incomes

25. The purpose of the monetary targets is to control nominal incomes and ultimately the price level. In interpreting movements in the monetary aggregates, it is always necessary to set them in that context. Last year it was partly the relatively slow growth of nominal incomes which led to the decision to permit some over-shooting of the target for £M3. That decision is potentially reversible if the growth of nominal incomes were for any reason to speed up again.

26. We have made use on several occasions recently of the idea of a national cash limit. Within the framework of the monetary strategy there is, in effect, a constraint on gross domestic product as current prices, although no explicit target, or even forecast, has ever been announced for this total. The idea, without quantification, has been used in setting out the implications of public sector spending for the private sector, and the implications of pay settlements for employment. It is also relevant to the setting of short-term interest rates.

27. Quarterly figures for current price gdp are only available several months in arrears. There is normally however sufficient information in the monthly indicators to build up quite a good estimate for the movement of nominal incomes on a reasonably up-to-date basis, although some guesswork would undoubtedly be involv e d. We will aim to assemble enough information to give an estimate of the level of nominal incomes in the current quarter and its growth over the preceding six month period. This can then be set alongside the trend in the monetary aggregates calculated for the same months.

In the same way we can look ahead at the prospect for nominal incomes over the next nine months consistent with the latest indicators and the latest view of the economic forecasters.

28. Outturn and prospect can then be compared with the growth rate of nominal incomes expected when the target was set for £M3. This growth rate, which would normally be based on a forecast published at Budget time, would then become a guideline for monitoring performance, similar to that proposed for M1. At present we do not publish a forecast including gross domestic product at current prices explicitly, but if we ch ose to do so, the extra information divulged would not be very significant.

29. The growth of nominal incomes is partly a real growth of output and partly inflation. Obviously our attitude to the two parts is not in the long run the same. Behind the idea of a constraint on nominal income is some view of the sustainable growth of real output. If we changed our view about that rate - the underlying growth of productive potential - then we might well wish to change our view of the appropriate growth in nominal incomes, and even of the money supply. But unless we do change our view in this way, our response to deviations of nominal incomes from the guidelines would be much the same, whether they were deviations in volume or in price. It is not appropriate therefore to include output (or employment) as such amongst the factors taken into account in setting interest rates.

Real Interest Rates

30. The interest rate cut of November 1980 was largely a response to the decline in the rate of inflation. One line of argument linked this to the growth of nominal incomes, but there was another which was based on the consequent movement in real interest rates. As inflation slows down the stringency of a given nominal interest rate increases. It is plausible, although not at all well documented, that real rather than nominal interest rates influence private sector saving, investment and borrowing decisions.

31. There is no straightforward way of measuring real interest rates, since they depend on the rate of inflation in the future rather than

the past. The best we can do is to examine the implications of inflation forecasts, which will in turn be heavily influenced by experience of inflation in the recent past. In practice, we cannot expect to gain much insight from trying to measure real interest rates, especially now that the rate of inflation is changing relatively slowly.

32. In the past interest rates have not kept pace with actual changes in the rate of inflation; thus rapid rates of inflation have typically been associated with negative real interest rates and low inflation with positive real interest rates. As the rate of inflation slows down, therefore, it is not to be expected that the interest rate will necessarily keep pace. Much depends on the way inflationary expectations are now based; it cannot be assumed that the experience of the last few years has left perceptions unchanged. There does not seem to be a sufficient basis on which guidelines for real interest rates could be devised. But the presumption remains that short-term interest rates will, other things being equal, move down gradually as inflation abates.

Policy Decisions

33. This paper has reviewed the information relevant to decisions about short-term interest rates:

(i) Market Conditions - as we may want to follow the lead of the market, when we consider it is based on a sound interpretation of monetary and other developments.

(ii) The Current Trend in £M3 - over a period of about six months back and three months forward, after adjusting for known distortions;

(iii) The Prospect for £M3 - up to about nine months ahead, but discounting for the unavoidable uncertainty surrounding all financial forecasting;

(iv) The Other Monetary Aggregates - especially M1, for which we might establish a guideline based on the forecast of a growth rate compatible with the £M3 target;

(v) External Considerations - not because we have an exchange rate target, but because depreciation contributes to inflation;

(vi) Nominal Incomes - monitoring outturn against guideline for the value of gross domestic product at current prices, but not the split between price and volume;

and (vii) Real Interest Rates - to the extent that we can measure them.

34. It would be both artificial and arbitrary to attach fixed mathematical weights to each factor. There is a general presumption that £M3 has some primacy over the other indicators. The starting point, therefore, is a judgement of the level of interest rates needed to meet the target for £M3 within a horizon of six to twelve months (we cannot hope for more precise control than that). The events of last year, however, suggest that short-term interest rates cannot always be guided by actual or prospective movements in £M3 alone. At the least, those movements need to be interpreted in a wider context. We need an assessment of why £M3 is growing (or expected to grow) faster or slower than intended. If that assessment shows that there is something odd about the behaviour of £M3 relative to other indicators, we may be persuaded that the general presumption of its primacy has to be discarded in this case.

35. One source of such evidence is the narrow aggregates. We have no targets for either M1 or the monetary base, but we could have a guideline for M1 believed to be consistent with the achievement of the £M3 target. If the relative movement of the aggregates diverged significantly from that predicted, we would regard that as justifying examination of the possibility that £M3 was (as last year) giving a misleading signal.

36. We need also to look beyond the movements in £M3, to try and see what they mean for the achievement of the ultimate objective of reducing inflation. There are exceptions to the rule that the relation of £M3 to nominal incomes is stable and predictable even in the medium term. We have to be on the lookout for changes in institutions (the

relative importance of banks and other financial institutions as intermediaries for example) or in private sector behaviour (the relationship of income to financial wealth for example) which will change the significance of the target aggregate. If changes of this sort occur, and are likely to be longlasting, then the response must either be to change our intentions for £M3 or else to change the path of nominal incomes we expect as a consequence. We cannot keep both.

37. One way of interpreting the movements in monetary aggregates therefore is to set them alongside the behaviour of nominal incomes relative to pre-set guidelines. Usually this procedure will confirm the conclusions that would follow from looking at the money supply alone: excessive monetary growth will usually go with actual or prospective excess in nominal incomes, and vice versa. If it does not, we would want to look again at the judgements behind the forecasts of nominal incomes. Only when we are reasonably confident that those forecasts are well-based would we wish to qualify the normal rule that monetary aggregates are the main influence on short-term interest rate decisions.

38. The considerations set out in this paper are in line with the broad statements in the Budget Speech about the factors taken into account in setting short-term interest rates. Nevertheless, if this approach is confirmed, there would be advantage in setting out for the public in rather more detail the way in which the factors are assessed and their contribution to the overall judgment. This would take the form of a statement describing the regime in general terms, made when the new arrangements come into force, rather than a commentary on particular interest rate movements that develop at a later stage.

9.7.81