7 Funding the PSBR and Monetary Growth

As discussed in Chapter 6, the authorities maintain an important degree of control over short term interest rates. Their desire to do this rests on the belief that movements in interest rates have an important influence on the behaviour of the monetary aggregates, the exchange rate and the performance of the real economy. With the monetary aggregates at the centre of economic and financial policies, it is perhaps the first linkage which has been considered of prime importance in recent years. The link between interest rates and the behaviour of narrower monetary aggregates may, in some circumstances, be quite clear: a rise in the rate of interest on bank time deposits may, for example, lead to switching into these from non-interest bearing deposits, thus leading to slower growth of non-bank M1. Similarly, a rise in interest rates may induce switching into interest bearing deposits from cash, thus facilitating control of M0.

The link between interest rates and control of the broad monetary aggregates, in particular £M3, is not so straightforward. In the first place, a rise in interest rates may attract funds into interest bearing bank deposits and away from, say, gilt edged stock, thus raising £M3. In terms of the counterparts to £M3, a rise in interest rates is likely, in the short term (by raising the ‘interest bill’ faced by bank customers) to lead to an increase in the demand for credit. Furthermore, higher interest rates tend to raise the PSBR, also through higher interest charges. Thus, as discussed in detail in Chapter 3, short term control over £M3 by means of variations in interest rates may not be feasible.

Indeed, in terms of the counterparts to £M3 growth only sales of government debt to the non-bank private sector are controllable, to any extent, by the actions of the authorities on a month-to-month basis: short term control of the PSBR seems virtually impossible; the demand for bank credit is largely insensitive to the actions of the authorities on a month-to-month basis (even with a system of direct controls); and external counterparts and net non-deposit liabilities are very volatile month to month. The
funding programme is capable of some short term management by the authorities. Their influence should not, however, be exaggerated. In the market for government debt, as in the money markets, the authorities act in an environment which is heavily influenced by market forces. At times, market expectations can be such that it is difficult for the government’s funding programme to make any progress at all, let alone be subjected to careful fine tuning by the authorities.

During the 1980s, however, short term control of broad money growth took on increasing importance. Coleby¹, commenting on this, stated:

From 1976 onwards [when published monetary targets were introduced]... it became increasingly necessary not only to attempt over target periods as a whole to compensate by debt management for variations in other elements of the monetary forecast, but to keep closely to target throughout the period so as to avoid disturbances to markets. For once the actual figure departed from the target path, the expectation formed that there would be a compensating change in the level of debt sales pressed on the market, with a resulting change in yields. Demand was either dampened, if the target was being overshot, or stimulated, if the target was being undershot, threatening an explosive departure from the target path, and corresponding volatility in yields and interest rates.

In short, there was a tendency for there to be periods of ‘feast’ and ‘famine’ in the market for government debt. The authorities made a serious attempt to overcome this problem, trying to set the course of funding on a more stable month-to-month path. This involved changes in both the types of government debt which were issued and in the techniques used for selling debt.

In this chapter we examine the range of instruments which is currently available to the authorities. Gilt edged securities (gilts) remain the most important funding instruments: Chapter 8 deals with that market in more detail.

(i) Types of government debt

Government debt can be classified as either ‘marketable’ or ‘non-marketable’ depending on whether it may or may not be sold to a third party. The total outstanding stock of government debt in market hands (i.e. excluding debt held by the Bank, government departments, the Northern Ireland