24 Economic Stabilisation: The Use of Monetary Policy†

Our purpose in this chapter is to consider the way in which monetary policy influences aggregate demand and how far monetary measures can be used to generate the additional £90 m. of demand we require in the fourth quarter of 1963.

Let us begin by recalling (i) how monetary policy operates: that is, the variables which the monetary authority can influence; and (ii) the ways in which, according to our theory, manipulation of these variables may influence aggregate demand and the balance of payments.

1 Monetary Variables

As we outlined earlier, monetary policy works by influencing (i) the supply of money; (ii) the interest rate (or cost of money); and (iii) the availability of money.

The money supply we have already defined. And in earlier chapters we defined the rate of interest as the rate of return on British government irredeemable bonds. This definition, useful enough in developing our simple model, we must now elaborate distinguishing in particular between rates of interest which are determined administratively (i.e. fixed by some financial institution such as a bank) and those which are determined by the daily interaction of demand and supply in a market (such as the rate on irredeemables). The former, by convention, are often related to Bank Rate and respond only slowly, if at all, to situations of excess demand or supply. The latter are explained by market processes. This does not mean that we regard the two sets of rates as entirely independent of one another. But simply that, over a limited range, a measure of independence probably exists. Thus we can argue that (i) market rates are related to the demand for and supply of money – as explained in Chapter 11 – and can be identified with the rate on British government irredeemables, while (ii) administered rates respond little to excess demand (supply) situations and are often related to Bank Rate. The significance of this distinction is that in operating upon them the monetary authority has to take different

† This chapter relates to the situation before September 1971.
actions and its degree of immediate control is probably greater over
the latter than the former.

The 'cost of money' thus reflects both types of rate.

The 'availability of money' we define as the ease with which, at
any given rate of interest, money can be borrowed from financial
institutions. We need to introduce this concept because the market
for loans is not perfect. When a bank, for whatever reasons, is
curtailing loans and advances, it rations advances, at a (broadly)
invaniant interest rate, between competing borrowers. A borrower
denied an advance when the overdraft rate is 6 per cent will not get
one by offering to pay 8–9 per cent. The rate charged (i.e. the price
of the loan) is not an allocative device as it is in a competitive market
where, in accordance with the usual demand and supply apparatus,
the available funds go to those who (assuming that they are equally
acceptable risks) are able and willing to pay a price sufficiently high
to clear the market. 'Availability', in short, reflects the degree of
severity of rationing in the loan market. It is the counterpart of the
concept of 'administered' rates which do not respond quickly, if at all,
to the usual forces of demand and supply.

These then are the principal variables (which we shall call the
'monetary variables') through which the monetary authority may
seek to influence aggregate demand and the balance of payments.
Before we ask how the monetary authority can vary them, let us
recall how, according to our model, variation of them would effect
aggregate demand and the external position. In examining this
problem we shall, consistently with the theory of Chapter 11, treat
the market rate of interest as being determined by the supply of and
demand for money. Hence the influence of the former variable will
be assumed to make its impact on expenditure mainly through market
interest rates.

If the money supply influences expenditure mainly via interest
rates what is the logic of listing it as a separate monetary variable?
To this question there are two answers. The first is that mainly does
not mean exclusively. As we shall see later, the availability of bank
advances may depend on the money supply and there are other less
direct and obvious ways in which the money supply may exert an
influence. The second answer is that the explicit inclusion of both
market rates and the money supply reminds us that the monetary
authority can control one or the other but not both. In practice,
therefore, the monetary authority will have to choose between aiming
at a target set of market rates (and providing the public with whatever
money supply it demands at these rates) or aiming at a target money
supply (and letting the public determine the rates at which the target