

English Policy on Interest Rates, 1958-62

Looking back from 1962, it seems likely that history will point to international monetary events as the most important monetary developments in the five years since the British 1957 crisis. These years have also, however, seen some interesting monetary developments internally: the greatly increased reliance on moral suasion, spread over a wider field of financial institutions; the acceleration, at long last, of attempts to collect and to publish a reasonable minimum of monetary information; the new ritual of the "Special Deposits"; and the adoption of a conscious and positive policy in relation to long-term rates of interest. This last development is one of great importance in relation to the development of British economic policy generally, and of all the innovations it is the most interesting for economists. The present article is confined to this development of a rate-of-interest policy. First the circumstances leading to the Bank of England's change of front in the bond market in 1958 are discussed; this is followed by a discussion of the actual developments and of the circumstances that made the market peculiarly ready to follow an official lead; finally, there is consideration whether the authorities should try to guide the bond rate to a different level.

I

A variety of developments lay behind the change of front in the bond market during 1958. The crisis of 1957, marking as it seemed to do the failure of the policies of the middle-fifties, shook the authorities into a willingness to break with the past. Through the middle 1950's, operations in the bond market had been dominated by the desire to lengthen the structure of the debt, in order to get a firmer control on bank liquidity, but it had been inhibited, in the earlier years at least, by remnants of the cheap money policy

of the immediate post-war period, and throughout by distaste for the higher service cost implied in any rise in interest rates. There was also throughout the period an unwillingness to attract attention to the fact that a decline in bond prices might be the result of the operations of the government, which was itself the debtor. Any emphasis on this possibility — an emphasis that would surely result from an obviously deliberate reduction of bond prices — would, the authorities believed, react adversely on “government credit” so that the market’s appetite for bonds — and therefore the progress of the funding operations — would be irretrievably damaged. It was thought tolerable to make successive increases in Bank Rate, but the connection between these movements and the gradual decline in bond prices was obscure enough for the authorities to escape any charge of manipulating the bond market. The Government Broker therefore cautiously adjusted his prices to suit the mood of the market which, it was always plausible to pretend, was governed by factors independent of the Broker’s own operations and attitudes.

After the 1957 crisis, these inhibitions were, in some degree, broken down. It will be remembered that the 1957 crisis had two aspects: the development over a period of months of an inflation psychosis at home, and an accelerated loss, over weeks rather than months, of foreign confidence in sterling, despite the comparatively healthy state of the current balance of payments. The former of these developments had already brought the authorities, as they pursued their policy of funding at market levels, face to face with an altogether higher structure of interest rates, before the external crisis supervened. The latter impelled them, rightly or wrongly, to push Bank Rate to a level not hitherto envisaged in the post-war period, and to hold it there for six months. The spectacular developments of this year were, by undermining the basis of expectations of future rates of interest, to have important consequences on the scope for official policy. This will be argued below; meanwhile, it is important to remember that there were two sides to this crisis — the internal and the external — and that the measures taken to relieve the crisis did not have equal impact on the two sides. While the foreign exchange difficulty was seen to be immediately relieved, and apparently more by the jump in Bank Rate than by any of the other measures, there was more than a suspicion that the deeper-seated difficulties, of which the prolonged

weakness of the gilt-edged market was a symptom, had not been removed. The combination, of striking success on the one side and partial failure on the other, was uniquely effective in destroying any remaining faith in the continuance of low interest rates. For the partial failure to bring about a fundamental readjustment meant that the frights of 1957 might easily recur, while the success in securing immediate relief in the foreign exchange crisis meant that, when trouble did come again, a sharp dose of dear money was again likely to be brought into play. To adopt an apt word used by Professor Hicks in this context (1), there seemed after September 1957 to be at least a serious risk that the British authorities would continue to “jab” at short rates, and to jab more sharply — and perhaps more frequently — than ever before.

While all this was going on, to push both the authorities and the market into different attitudes, representatives of the Treasury and the Bank of England were, week after week through the second half of 1957, giving evidence before the Radcliffe Committee. It seems possible that these unprecedented discussions had some influence in bringing about a change of view, if only by forcing the authorities to think things out more clearly. They had not previously had to explain themselves with any care, and it would be strange if the effort to satisfy the prolonged and persistent questioning had not led to some modification of previous views. These were not, it must be emphasised, men defending a carefully prepared intellectual position, whose reaction to unsympathetic questioning might well have been increasingly obstinate resistance. They were men who, however fervent their original belief in the rectitude of their measures, had been shaken by the course of events: even the most confident among them appeared to feel that something had gone not quite right, and they wondered — some of them certainly did — where they had gone wrong. In this frame of mind they could learn from the intellectual struggle, a struggle in which questioners and questioned were co-operating in the effort to elucidate policies that had been evolved by the hunch of technical experience rather than by any elaborate process of reasoning. It is not necessary, for the present purpose, to assume that the official witnesses were convinced by arguments sometimes

(1) J. R. HICKS, *The Future of the Rate of Interest*, Manchester Statistical Society, March 12, 1958, p. 16.

put forward by members of the Committee: it is enough that, under this process of questioning, official witnesses evolved for themselves new slants on their familiar problems. The trend of the Committee's questions showed that the Committee was intensely interested in interest-rate policy, in both short and long markets: in what the authorities had done, in the reasons for their actions, in their views on the results of their actions, and in their reasons for not having acted differently. It must also have been obvious to the official witnesses that at least some members of the Committee were disposed to be critical of the timidity of the authorities in their handling of interest rates, and that there was some feeling that policy in recent years had given us the worst of both worlds. Altogether, these discussions with the Radcliffe Committee did invite fresh thinking on the use to be made of interest rates.

Another circumstance leading to the new development of policy in this field was the kind of opportunity afforded, not just momentarily, by market conditions in the first half of 1958. In giving evidence to the Radcliffe Committee, the Governor of the Bank of England had resisted suggestions for more deliberate action to change long-rates, basing his position largely on the damage that would be inflicted on government credit if the Government Broker were to reduce the prices of bonds deliberately, substantially and openly (2). During the winter of 1957-58, however, there was a dramatic change — a switch-back change — in the general economic situation, causing a reversal of trends in the bond market. Confidence in the immediate future of sterling was re-established and the international short capital movements swung around in favour of sterling, so removing the case that had been made for the high short rates established in London in September 1957. Simultaneously it became apparent that there had been a business down-turn in the United States, and indeed in the world generally, including Britain. Inflation fears, though not destroyed, abated. Therefore, short rates in London were brought down sharply and buyers returned to the gilt-edged market at rising prices. If the official view favoured higher long rates than "market conditions" were producing, deliberate action could now be taken to support the level of long rates (i.e. prevent bond prices from rising) *without*

(2) For the Bank of England's views on this matter in 1957, see Committee on the Working of the Monetary System, Minutes of Evidence, Qus. 1841-1898 (5th Nov. 1957).

incurring the odium of imposing on bondholders an absolute loss of market value. Consistently with the view that a deliberate reduction of bond prices would damage government credit, the authorities could resist a market tendency towards lower long rates. It was one thing to *reduce* bond prices; it was quite another to *hold them down*, as a matter of deliberate policy. It had been possible to act in this way, though only for a brief period, in February 1957 (3), but in the first half of 1958 the opportunity became a major one, such as the British authorities had not had for some years. This opportunity they took. The exact date of the innovation is not clear. It was avowed, without any precise dating and in characteristically guarded terms, in evidence to the Radcliffe Committee on 27th November 1958 (Qu. 11919), but all the indications (including those officially given on that occasion) are that the new policy had then been in operation for several months. Probably the change came about February 1958: at any rate, it was noticeable that Stock Exchange representatives giving evidence on 25th April took it for granted that the official operations generally ruled the structure of bond prices (Qus. 7312-3), and press comment showed widespread realisation, during the summer of 1958, that a change of policy had occurred. Since that time the British authorities have guided their operations in the bond market not simply by a desire to lengthen the structure of the debt as rapidly as possible, though this has remained an object of policy; the distinguishing feature of their policy from 1958 onwards has been a new care for long rates, as influences on the general behaviour of the economy.

II

The power has been used to enforce rates within a range of 5 and 6½ per cent, the longest period of such high rates in the last two hundred years, with the sole exception of the years at and immediately after the end of the 1914-18 war. Taking the index shown in the Bank of England's Quarterly Bulletin, the yield on long-dated government securities stood at 5.8 per cent at

(3) This incident underlines the fact that a willingness to experiment was favoured by a change in the climate of opinion, as shown by the discussions in the Radcliffe Committee, and not simply by those discussions themselves.

the beginning of 1958; it was allowed to fall only to 5.4 by the end of 1958, and was held around $5\frac{1}{4}$ through 1959. Thereafter it was raised rapidly, to 6 in June 1960; at this level it was held until April 1961, then up to $6\frac{1}{2}$ in July and nearly $6\frac{3}{4}$ in September 1961. Since that date it has been brought down gradually, reaching about $6\frac{1}{4}$ in March 1962.

While this movement of long rates has been carefully regulated by the operations of the Government Broker in the bond market, short rates have been moved up and down in a manner much closer to traditional patterns (4), and primarily with an eye on the external situation. When sterling has been weak, Bank Rate has been raised, most sharply of all when, in July 1961, it was necessary not only to increase the interest differential in favour of London but also to instil confidence (5). When sterling has been strong, especially if interest rates have been declining elsewhere, the opportunity has been taken to drop short rates in London. From the point of view of the U.K. balance of payments and, less importantly, from the point of view of the U.K. Treasury, a high Bank Rate is expensive. It is therefore imposed only when the foreign exchange situation forces the authorities into disagreeable defensive action, and, when conditions ease, Bank Rate is dropped as quickly and as quietly as possible. This is, I hasten to add, not quite the whole story, for there have been times (most notably in the first half of 1960) when the authorities have hoped that the movement of short rates might have some quick influence, in the right direction, on the pressure of domestic demand. Whether this was ever more than a pious hope is an open question; but a sentence in a recent official statement indicates a modicum of faith as well as hope (6). Any such domestic consideration was, however, only

(4) I say "traditional patterns" in the plural, because there is no single traditional pattern. In the history of Bank Rate, every decade has been different from every other.

(5) The Bank of England had in March 1961 in effect borrowed substantial amounts from certain central banks ("the Basle arrangements") and it was necessary in the summer to cover these sums by borrowing from the I.M.F. It was therefore essential that the steps taken by the British authorities should include action of a kind that would command the respect of central bankers and others in a position to influence crucial I.M.F. decisions.

(6) "Nevertheless, the pressure exerted by the banks, and the high cost of bank accommodation, had the effect of substantially reducing advances to several categories of borrowers... this was, in particular, one of the influences behind the reduction in stocks held by the distributive trades" (Bank of England, Quarterly Bulletin, March 1962, p. 4). It will be noted that the reader is given *two* factors (the pressure exerted by the banks,

incidental to a movement of Bank Rate; the dominant consideration has throughout this period always been the foreign exchange situation — *forcing* a rise at one time, *permitting* a reduction at another.

As it has become increasingly obvious that the movements of Bank Rate have been dominated by the needs of the international short capital position, it might have been supposed that the behaviour of the *structure* of interest rates would revert to its late nineteenth-century pattern when, through a somewhat different process, Bank Rate also swung quickly up and down in reflection of the international short capital position. At that time long-rates remained extraordinarily stable, not merely from month to month but also from year to year and even, apart from their dip in the 1890's, from decade to decade. This stability was not produced by any official operations in the long market; in the main it was the uncontrolled market reflection of expectations that short rates would continue to swing up and down within their customary range. In 1958-62, however, the long rates have not exhibited anything like this stability, nor have they shown any signs of returning to the levels that were consistent with comparable swings of Bank Rate in earlier periods. At the same time, there has been no evidence, either in the official statistics (no longer completely impenetrable, but merely opaque) or in market reports, of any massive official operations to deflect markets from their "natural" course. What seems to have happened is that by continuous but unspectacular operations the central bank has quietly guided long rates to the levels — by historical standards, extraordinarily high in relation to short rates — desired for the purposes of economic policy.

The high level of long rates has been justified by the underlying capital scarcity. The sources of the extreme demand for capital have frequently been described: the need to "catch up" after a decade (the thirties) of insufficient replacement, in both the private and the public sector; post-war reconstruction; the tremendous re-orientation of British industry required by the foreign trading position after the war (a re-orientation that has taken place on a scale not often realised outside Britain); the technical advance of the chemical and allied industries heavily dependent on capital; the

and the high cost of bank accommodation), and then the singular, "this was one of the influences"; presumably the evidence (its nature is unspecified) on which the statement is based does not allow distinction between effects of the two factors.

radical changes in the sources of energy and in methods of transport; and the rising standards of housing desired by a population which continues to grow. On the supply side, there was in the early post-war years an unusually low level of saving, as individuals tried to restore a more normal balance between their real assets and their financial assets. In the early post-war years, while the last factor was powerful, the imbalance in the capital situation was too extreme to be dealt with in any tolerable fashion by the market mechanism of high rates of interest. For a variety of reasons, interest rates were in fact held at levels which were not merely too low to reflect the immediate capital situation (this was deliberate policy) but also eventually proved unduly low in relation to the more permanent factors sustaining the demands. Hence the need for continuing physical controls and other obstacles to the investment programmes of both public and private sectors. Whatever had been the intentions underlying cheap money policies in the earlier years, this continuing disequilibrium in the capital market was in no sense part of a deliberate policy. The consequently excessive pressure of demand did, of course, help to make full employment easy to maintain, but it was not for this reason that the British authorities were slow to encourage the rising tendency of interest rates in the middle-fifties. Until 1957 they were, indeed, only half-hearted about the rise in long-term rates, a rise they seemed to regard as an unfortunate consequence of the levels to which they were having, for balance-of-payments reasons, to push short rates.

Given this official attitude, it is not surprising that markets did not, after the 1957 crisis passed, show signs of settling at altogether higher levels of long rates. There was, however, a new degree of uncertainty. People in the market, as well as those in authority, were beginning to recognize the fact that, in a fundamental sense, long rates had been unduly low in the middle 'fifties. But the behaviour of the market in the winter of 1957-58, and the detailed movement of the structure of rates, gave no assurance that the events of the middle 'fifties would not be repeated. There were still many who believed that the exchange crisis was the dominant event and that, once it was overcome, all interest rates — and not only the short ones — could fall back to their old level. If the contrary view was to prevail, a lead had to be given. From Fe-

bruary onwards such a lead was given, by the action of the authorities at the long end of the market; and this lead was successful in establishing the new range of long rates so firmly that there has been no return to the ideas of 1953-55.

III

Before jumping to the conclusion that the British authorities have proved the feasibility of a novel weapon of central banking, it is important to recognise that circumstances were peculiarly favourable to this action. The general case against attempts to manipulate the long rate is that the market will have its own ideas of the future course of rates and that the authorities will therefore be able to alter the structure of rates only by pressing to extremes their power to alter the maturity structure of the bonded debt in the hands of the private sector. The outstanding feature of the 1958 situation, however, was the *absence* of any firm market view. The old basis of market expectations had been undermined, and nothing had been put in its place. Expectations were in a quite extraordinarily fluid state, and the market was therefore unusually open to a lead from the authorities. The authorities could impose their rates on the market, without any great disturbance of the maturity structure of the debt.

The reasons for this unusual fluidity of market opinion deserve some attention. Formerly, there had been in peace-time Britain long periods when 3 per cent was the normal level for long-term government bonds. Short rates had oscillated over a fairly wide range, but the anchorage of long rates went undisturbed. If short rates went above the norm, people expected them to come down; if short rates went below the norm, people expected them to go up. In such circumstances, official operations could have done little to modify the position of long rates, except by starving the market of long maturities (to push long rates down) or glutting it (to push long rates up). A mere "lead" to markets would not have been enough. Now, in 1958, there were three circumstances undermining traditional views of a normal level.

The first of these was the development of the inflation psychosis. People were not sure what inflation meant for interest rates, but the market had an instinct (and, in spite of Professor Kennedy's argu-

ment (7), their instinct was right) that continuing expectation of inflation implied a level of interest rates above the level normal to times when reasonable stability in the value of money had been taken for granted. Now they thought that the prospect of inflation *might* mean another level of rates.

But — and this is the second of our three circumstances — there was no firm adherence to any particular rate of inflation, such as might have given a guide to the difference between the old norm and the new norm appropriate to an inflationary world. Whether inflation were to continue at say 2 per cent per annum or at 5 per cent would, it was supposed, make a world of difference to the level at which long rates would settle; and people could not make any sensible guess as to which rate of inflation would hold. Indeed, there were some who, fondly imagining that the new courage of governments in using monetary measures meant that inflation had been conquered, thought there might be no further depreciation of money. There were not many who carried optimism to this length, but there was enough mixture of opinion in the market to prevent the emergence of any firm view.

Thirdly, there was a new uncertainty as to how short rates (admittedly under direct official control) would be made to behave. There had been a long period when short rates had been unchanged, followed by a period (1951-1957) that had every appearance of experiment rather than the adoption of a coherent and settled new policy; then came the shock tactics of 1957 itself. It was anything but clear that there had been a return to the "traditional" habits that had underlain the normal 3 per cent long rate. Indeed, the future development of policy with short rates was about as

(7) "Inflation and the Bond Rate" by CHARLES KENNEDY, in *Oxford Economic Papers* (N.S.), Vol. 12, No. 3, Oct. 1960, pp. 269-273. Kennedy criticises the Radcliffe Committee's argument on this point (Report, para 572), and concludes that "While it is no doubt true that a realization of continuing inflation must lead to an alteration in the relative yields of bonds and equities, there is no reason why equilibrium should not be restored by a rise in equity prices rather than a fall in bond prices". He was correct in his criticism of the inadequacy of the argument the Radcliffe Committee stated — in reflection of widely-held opinion — but he overlooked one important aspect. Bonds, as assets to hold, in some degree share the nature of money, and fall into disgrace with it; but this is not the whole story. When monetary assets (among which for this purpose bonds are included) fall into disgrace, people try to contract their holdings of them: *but not of all classes equally readily*. "Cash" in the pocket (or "in the bank") tends to be maintained, but such assets as bonds can be released without inconvenience: therefore bonds fall relatively to cash. This is the truth that justifies the instinct of the financial journalists (and others!).

uncertain as it could be, and this uncertainty was increased rather than dispelled by the changes made in short rates — and the official explanations — in 1960 and 1961.

Circumstances thus played into the hands of the authorities, who proceeded in 1958 and subsequently to give the market a clear lead which has since kept long rates in a new high range.

IV

Two important questions arise, in reflection upon this novel episode. (1) Can Central banks expect to enjoy such power over long rates in future? And (2) have the British authorities, in exercise of their power, hit on the right level, or have they perhaps pushed the long rate to too high a level?

On the question whether central banks can ordinarily expect to be able to exercise such power, we must remember that what the British authorities essentially did was to give the lead to a market that had lost all basis for firm expectations. It was only because market expectations were unusually fluid that the authorities could succeed with so little effort. All the relevant evidence collected by the Radcliffe Committee tended to show that in the British system both borrowers and lenders easily move the maturities of their liabilities and assets: the bond market is essentially a single market. In such a market, a marginal redistribution of the maturity structure of the National Debt would not, by itself, make much impression on the *structure* of rates (i.e. on the long rate relatively to the short rate). A very large redistribution of maturities might make an impression, because there come points when debt-holders in the private sector will accept further change in their maturity-distributions only on appreciable change in relative prices; but the monetary authorities ordinarily do not want to make a large redistribution, and in 1958-62 the British authorities did not have to make any large redistribution. If, however, relatively small market operations are sufficient to create new *expectations*, the structure of rates does undergo a change.

There may be more scope in other countries, where bond markets are more imperfect. If lenders and borrowers have more rigid maturity-distribution preferences, comparatively small open-market-operations could provoke changes in the structure of rates. Comment on the appetite of the U.S.A. market for Treasury bonds

of various lengths sometimes appears to imply that the American bond market is imperfect in this sense. Even in such a case, however, the authorities can bring about a change of rate-structure more readily if they can bring about a change in the state of market expectations. And in the British 1958-62 episode it was essentially the unusually fluid state of market expectations that gave the authorities their chance. The causes of that extraordinarily fluidity were of an unusual nature; it follows that this outstanding technical success cannot be regarded as opening out prospects that frequent manoeuvres, either in Britain or elsewhere, will enjoy equal success.

V

The second question that arises is whether the authorities have perhaps pushed the long rate up to too high a level; at least whether, although 6 or 6½ might have been appropriate in 1960-61, a much lower level has become appropriate in 1962. In this context it is important to remember that, if the analysis of earlier paragraphs is correct, the process of pushing down interest rates, if extreme creation of liquidity is to be avoided, must not be too rapid. Equally relevant is the fact that adjustment of long rates to a different "gear" has most of its effects in stimulating the demand for capital development only after a considerable time-lag. If we want capital-planning in 1964, 1965 and 1966 to be based on a 4 or 5 per cent bond rate, rather than a 6 per cent bond rate, the authorities have no time to lose: they must begin pushing the bond rate down now, in the hope of having pushed it far enough down in the course of 1962 and 1963 for the planners of 1964 and 1965 to get into their heads a different basis of calculation. All the evidence indicates that capital planning on a big scale is not adjusted to fine movements in long rates, but that the capital planners do have in mind somewhat conventionalised and rounded rates which can be altered only by a decided and not merely momentary movement in the actual rate. The authorities are thus faced with the difficult problem of forecasting, in effect, the "equilibrium" rate of some years ahead. An extraordinarily difficult task, certainly; but one that must not be shrugged off. There is no reason for the defeatist view that to make the effort and get the wrong answer will lead to a worse result than if no effort at all were made. We have to risk such a result, in all economic policy

as well as in much else of life. Most capital planning, both public and private, has to be based on assumptions equally shrouded in the mists of time.

We have therefore to make the best guess we can at what, in an old fashioned way, may be called "the equilibrium rate" in the years immediately ahead. This rate must be such as will encourage full use in capital development of the amount that will be saved (including government saving, company saving, and personal saving) if the community's resources are fully employed; and the authorities have to make the monetary situation fit this rate, exerting such influence as they can to avoid an unduly weak position for dealing with whatever contingencies lie beyond the immediate period.

What are the prospects of the demand schedule for capital development and the supply schedule of savings? On the demand side, many of the factors that have dominated the capital situation, through the 'fifties and into the 'sixties, still look at least as powerful as they did. An addition may be a new incitement to investment as industry adjusts itself to the Common Market. On the other hand, there is a sense in which the long post-war boom may at last have come to an end. The gaps in the country's capital equipment, caused by its starvation in the 'thirties and destruction during the war, have, at least to superficial appearance, been filled; even housing arrears have been substantially worked off. What remains — and it is a formidable remainder — is a continuing demand for the capital construction to satisfy the requirements of a rising standard of living: housing on an altogether superior standard, fuel and power on a scale that would have seemed fantastically extravagant to our grandfathers, and all the ancillaries (roads, car parks, steel works, etc.) of the automobile. There is, however, one big difference between this demand and the capital demand that dominated the long post-war boom: the demands of 1945-57 were extraordinarily compelling and persistent, and not readily checked by any tolerable rise in interest rates, whereas the continuing demands of the nineteen-sixties are rather of the kind that can be satisfied in greater or in less degree, where capital charges are likely to weigh more in the decision. This will hold even though many of the capital decisions fall to be made in the public sector: to take two topical examples, the "Victoria Tube" (which could make a critical difference to the efficiency of transport in London) and the Channel Tunnel both await government decision,

but delays would probably melt away if long-term interest rates were cut by one or two per cent.

So much for the demand side. On the supply side, the greatest difficulty lies not in guessing at government saving or at company saving, but in making any kind of judgement about personal saving. (It will be recalled that we are not attempting to say what *will be* the level of saving, but what it would be if the country's resources remained fully employed, since the object of the exercise is to find what level of interest rates would be most conducive to full employment without excessive pressure of demand). On personal saving, the present state of knowledge allows us no guidance from recent experience. For, after the burst of dissaving in the immediate post-war period, the nineteen-fifties saw in Britain, unexpectedly, a great surge of personal saving. This rise in saving has done more than anything else, perhaps, to make the British economy reasonably manageable; yet, vitally important as it has been, no one really knows how to explain it. At first it could be supposed to be simply a return to normal tendencies after the post-war replenishment of real assets; but we have not just returned to a new plateau of personal saving — the rise apparently continues. The effective rise in interest rates came too late in the period to have had time to be an important causal factor, though it may have contributed something. Possibly the most important factor at work has been the desire of people with increasing income and full employment to use a larger part of this greater wealth for additions to their capital. Another factor, encouraging any such tendency to devote a larger part of rising income to capital accumulation, is the increase in varied facilities for investment of personal savings: facilities offered by insurance companies, building societies, investment trusts in great variety — all of which have developed and have become much more widely known.

If this guess as to the development of personal savings is anywhere near the mark, the level of savings in full employment in the 'sixties may continue to be very high, and may even go higher. In these circumstances, rates of interest must be low enough to encourage the adoption of capital development schemes on an appropriately extensive scale. This may not mean much change in the level of investment in private industry. Much of the capital may be absorbed by better housing, which is almost certainly highly interest-elastic. Most of all the difference may be felt in the public

sector — and it may be that more extensive capital development in the public sector is what could in these years make more difference than anything else to the efficiency of the British economy; but such investment will be most wisely conceived if it is measured against (though not necessarily finally decided by) the right rate of interest.

How far the authorities should press a policy of reducing long-term interest rates does depend partly on the elasticity of demand for capital development in various directions, and perhaps also on the view that people take of the broad desirability of such capital developments. (If, for the sake of argument, none of them were liked, the appropriate action would be fiscal measures to encourage a higher level of current consumption). But interest rate policy must also depend very much on what is going to happen to the level of saving. Just why personal savings have risen so strongly, and whether the higher level of interest rates has any responsibility for this growth, are questions whose thorough investigation are among the most urgent items in the consideration of economic policies in Britain. Without these answers, the British authorities can have little basis for the exercise of their new-found power over long-term interest rates.

The "real" factors are, however, not quite the whole of the story, unless the market has complete confidence in the long-term stability of the value of money. If there is any continuing expectation of inflation at a significant rate, the demand for any assets that partake of the nature of money — and government bonds do ordinarily have some such quality — will be adversely affected, relatively to the demand for "real" assets. As has been explained above, and despite Professor Kennedy's criticism, the financial journalists' instinct has been right, in believing that continuing expectation of inflation makes for higher interest rates (8). The interest rate has to be considered therefore in relation to the inflation prospects (9). If governments look like being successful in their anti-inflation policies, the bond rates can be lower than in a world that resigned itself to inflation. This is not to deny that interest rate policy itself has some bearing on the control of

(8) Cf. footnote on p. 120.

(9) I emphasise that it is to the *prospect* that matters here: the actual rate of inflation experienced has no direct relevance.

inflation: in the 'fifties, one of the difficulties of controlling demand was that interest rates were generally too low. Interest rate policy has still a part to play in action against inflation — the right determination of interest rates in relation to the underlying capital situation helps to keep the pressure of total demand right — but this has become, in the latest phase in the development of economic policy, a minor aspect of interest-rate policy. The major aspect — the main reason for trying to get the long rate right — continues to be the desirability of securing *both* full employment of resources *and* optimum distribution of the resources the community is disposed to devote to future use. If an increasingly wealthy community is disposed to devote a rising proportion of resources to future use, and neither the war-time exhaustion nor the sudden widening of capital opportunities that characterised the last generation are to be repeated, and we have some success in our attempts to reconcile full employment with a stable value of money, long-term rates of interest must come down.

All this is on the assumption that the market in British government securities continues to be dominated by conditions in Britain itself. If, on the other hand, Britain's entry into the Common Market and the strengthening of international monetary co-operation should lead to a substantial internationalisation of the bond market, both the supply conditions and the demand conditions will become altogether more complex. Equally, however, the power of a single country's monetary authority will be compromised; in short, the British will be both less able than now to judge how interest rates should move, and less able than now to guide them in a desired direction.

London
May 1962.

R. S. SAYERS