Macroeconomic frameworks in the new global economy

November 2002

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Contents

		Page
Foreword by the Chancellor of the Exchequer, Gordon Brown MP		
Chapter 1	Introduction	1
Chapter 2	Requirements for macroeconomic frameworks in a globalised world	3
Chapter 3	The application of constrained discretion	9
Chapter 4	The UK experience	17
Chapter 5	Conclusion	27

Foreword by the Chancellor of the Exchequer, Gordon Brown MP

In the new global economy, it is clear that all countries are inextricably and inescapably linked to one another, and that although globalisation brings great gains it also creates risks. Macroeconomic stability and sustainable economic growth remain prerequisites to delivering these gains - and so the international financial community, members of the G20, and all other countries must demonstrate the sound macroeconomic policies that deliver the conditions for stability and growth.

When I became Chancellor in 1997, this Government reaffirmed the UK's commitment to achieving high and stable levels of growth and employment. But we recognised that – in the context of the new globalised economy - this goal would require a wholly new monetary and fiscal framework. We knew that the discretion necessary for effective economic policy in a globalised economy could only be possible within an institutional framework that commanded market credibility and public trust. And that this required a long-term approach to policymaking, openness, transparency and clear and accountable divisions of responsibility.

So the new monetary and fiscal framework Britain needed had to be based on clear policy rules, well-established procedures, and an openness and transparency not seen in the past. The reforms were built on three pillars:

- **first, a monetary policy framework with an independent Monetary Policy Committee responsible for setting interest rates to meet the Government's inflation target;**
- **second, a fiscal policy framework which is delivering sound public finances through a Code for Fiscal Stability, firm fiscal rules and better planned public spending focusing on the quality of public services provision; and**
- **third, new institutions such as the Financial Services Authority to ensure financial stability through transparency, responsibility and clear lines of accountability.**

The macroeconomic framework the Government introduced in 1997 is already producing real benefits, as the UK now enjoys low and stable inflation, and sound public finances. This puts us in a strong position to benefit from the opportunities brought about by globalisation and to cope with the risks, including the challenges posed by the current global economic environment.

The recurrence of financial crises in recent years – in parts of Latin America for example - shows that we must now build a new consensus at international level, with a new and broader emphasis on the conditions for high and stable levels of growth and employment, and ensure that all countries have in place the macroeconomic, financial, structural and social policies for long-term success in the global economy. For this reason the UK has been active in international institutions such as the G20 and the IMF, sharing our experiences and encouraging the development of transparent macroeconomic frameworks to avoid the crises of the past.

I now believe that, just as through independence of the Bank of England we set down a new rules based system for one modern nation, we can, for the world community of nations achieve also a new rules based system of international economic governance in pursuit of the objectives of stability, development and prosperity. This should be founded on clear procedures – with all countries, rich and poor, pursuing agreed codes and rules for fiscal and monetary transparency, and for corporate and social standards – and on a new openness and transparency – with the IMF as independent from political influence in its surveillance of economies as an independent central bank is in the operation of monetary policy. In this way we can safeguard international financial stability, and ensure that everyone shares in the prosperity globalisation can bring.

Gordon Brown
November 2002

Introduction

I.1 Globalisation has the potential to deliver substantial economic benefits to all countries – but it also creates major challenges for policymakers. Financial crises and continuing poverty in large parts of the world demonstrate that though globalisation can help create greater prosperity, by itself it is not enough to ensure that prosperity is shared by all.

I.2 This paper focuses on how macroeconomic frameworks should be designed in order to maximise the benefits and minimise the risks associated with globalisation. Experience has shown that macroeconomic frameworks must command credibility, while encompassing sufficient flexibility to respond to shocks. Thus frameworks must be underpinned by clear objectives, strong institutions and transparency.

I.3 It addresses the challenges facing macroeconomic policymakers in developed and developing countries alike, and describes new economic approaches that can help build foundations for high and stable employment and growth.

I.4 The paper has been drafted as a UK contribution to the 2002 Ministerial meeting of the G20, a forum in which developed and developing countries can work together to address through economic cooperation the challenges posed by globalisation. By drawing on the experiences of countries like the UK, it is hoped that countries starting out on the path to globalisation can enjoy a smoother transition to full participation in a globalised world.

I.5 This paper draws on the recent British experience. A new macroeconomic framework was established in the UK in 1997, with operational responsibility for monetary policy transferred to the Bank of England, and the creation of a new fiscal policy framework. This has resulted in an improved macroeconomic performance, with low and stable inflation and sound public finances (further details on the UK's macroeconomic policy framework are set out in the Treasury publication "Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability"). While this paper focuses on the UK experience with macroeconomic policy, there are different ways to achieve the same goal, and different country characteristics mean that the best way to achieve them is likely to vary across countries. Nevertheless, the underlying principles are generally applicable and should underpin policy frameworks in all countries, so that they can gain maximum benefit from globalisation.

I.6 These principles are likely to be particularly important in emerging markets, many of which started participating in the process of globalisation relatively recently, and are just beginning to open up their capital accounts. These countries are likely to have less well developed institutions and may not have had a chance to establish credibility by building up a track record, and so have much to gain from applying these principles in establishing a sound and credible framework.

I.7 The international financial architecture is also being developed to help countries create stronger macroeconomic frameworks through the application of internationally agreed codes and standards, improved surveillance, and greater international economic cooperation.

I.8 Chapter 2 considers the impact of globalisation on macroeconomic policy-making, discusses the implications for the design of macroeconomic frameworks, and identifies the principles upon which sound macroeconomic frameworks should be based. Chapter 3 discusses the application of these principles to monetary and fiscal policy in turn. Chapter 4 looks at the UK's recent experience of macroeconomic policy-making and describes the way the UK has designed its new macroeconomic framework in order to fulfill the principles identified in Chapter 2. Chapter 5 concludes and describes how the UK's new macroeconomic framework is coping with the current global economic downturn.

2 REQUIREMENTS FOR MACROECONOMIC FRAMEWORKS IN A GLOBALISED WORLD

2.1 Globalisation brings new opportunities to newly-opened economies. Greater trade and investment flows lead to lower prices and more choice, larger markets and economies of scale and faster adoption of new technology. More competition between firms and exposure to world best practice encourages development of more efficient, responsive and innovative domestic economies. Free movement of capital provides access to more capital for investment, diversification opportunities and better returns, and generates a more efficient allocation of resources. Thus globalisation can play a major role in enhancing growth and living standards.

2.2 However, there are also risks associated with globalisation which need to be properly managed by policy-makers. The recurrence of financial instability and crisis across the world over the last two decades demonstrates the risks associated with fast moving and liquid global capital markets. Opening up to globalisation too early and too quickly is dangerous. Countries must put in place appropriate policies and institutional arrangements first. Strong macroeconomic frameworks are essential for maintaining stability, which is a key pre-requisite for economic growth and prosperity in a globalised world.

2.3 Closer economic integration means that the impact of *country specific* shocks will be moderated, as some of the impact will be absorbed outside the domestic economy. However, countries will be exposed to a greater range of *external* economic shocks which will be transmitted more quickly. Macroeconomic and financial stability therefore requires more robust policy frameworks in the context of open capital markets and volatile asset prices. Policy must also be designed to promote greater flexibility in product and labour markets, and the macroeconomic framework must ensure the economy is robust to shocks and able to respond appropriately.

2.4 Greater competition in goods and capital markets as a result of globalisation also increases the importance of establishing the right policy framework in order to compete successfully. This has implications for both structural policies, such as policies to enhance skills and promote domestic competition, and macroeconomic policies, which must provide a stable economic environment supported by an appropriate exchange rate regime in order to create a stable platform for investment.

IMPLICATIONS OF GLOBALISATION FOR MACROECONOMIC POLICY-MAKING

2.5 Increased access to global capital has many potential benefits:

- by shifting capital to investment projects which are likely to earn the highest return, overall global welfare increases substantially;
- access to foreign capital markets allows countries – including those with low domestic savings rates – to invest now, to lay the foundations for increased incomes and wealth in the future;
- greater scope for international diversification provides higher returns, and offsets the losses associated with potential downturns in the domestic economy; and
- foreign direct investment also brings substantial benefits in terms of expertise in management and technology.

2.6 It also means that investors are able to move their money from one country to another very quickly. In particular, capital can be taken out of a country in response to poor policies, or even in response to fears about the possibility of poor policies in future. In the 1990s, a number of countries experienced financial crises which originated in, or were exacerbated by, large and rapid capital outflows, including Korea, Brazil, Russia, the UK, and in 1993 a number of countries in the Exchange Rate Mechanism. In order to attract and retain domestic and foreign capital, policy-makers in all countries need to put in place sound and credible macroeconomic frameworks underpinned by sound financial sectors, to achieve stability and to manage market expectations.

2.7 Open capital accounts also mean that shocks from other countries will be transmitted quickly across borders, for example through changes in the exchange rate, interest rates and capital and trade flows. This means the macroeconomic policy framework should ensure the economy is sufficiently robust to cope with such shocks, but should also incorporate sufficient flexibility to respond appropriately.

2.8 Countries which have built up a track record of credibility have had more room to respond to shocks in a discretionary way, without undermining that credibility and putting stability at risk. Countries without such a track record can increase credibility through greater transparency and clear frameworks for policy-making. This should also enable capital markets to better distinguish the risks associated with different economies, and so minimise the probability of contagion when a crisis does occur. These principles are equally relevant for both developed and emerging markets. The challenge for all countries is to manage shocks while enhancing credibility at the same time.

CONSTRAINED DISCRETION

2.9 Different country's experiences in dealing with financial crises indicate that some types of macroeconomic frameworks are less exposed to shocks and respond better when shocks hit. What is needed is an overall framework which constrains macroeconomic policy to achieve clear long-term and sustainable goals consistent with achieving macroeconomic stability, and so builds credibility and confidence, but which also allows the discretion necessary to respond flexibly to shocks.

2.10 Some frameworks allow policy-makers to operate with **complete discretion**: taking each situation as it comes, and responding in the way that seems most appropriate at the time. But history suggests such an approach is unlikely to build credibility. Policy-makers find it hard to commit to resisting short-term pressures or shape expectations without a clear framework to guide them[1], and the resulting uncertainty about future policy actions can lead to higher risk premia.

2.11 Other macroeconomic frameworks forgo discretion altogether in favour of **fixed rules**, such as a money supply growth rule or a nominal fiscal policy target. By 'tying its hands' to a fixed rule, a government forces itself to commit to its long-term policy goal. A credible commitment should reduce inflation expectations and long-term interest rates.

2.12 But rigid rules-based frameworks can run into a number of difficulties, which are likely to be more acute in economies becoming integrated into the world economy:

- the relationships on which such rules are based tend to break down in the face of financial deregulation, changing technology and widening consumer choice;

[1] In part, this stems from the "time inconsistency" problem: policy-makers find it hard to commit to long-term goals if short-term pressures point in another direction. For example, if countries attempt to run monetary policy without a binding commitment to low inflation, governments have a short-run incentive to boost inflation, in order to lower unemployment below its natural rate. But people can anticipate this, and adjust prices and wages accordingly. The end result is higher inflation, but without any output gain even in the short term.

- rigid rules do not allow any flexibility to respond to economic shocks, leading to substantial costs of adjustment and, at the extreme, irresistible pressure on the rule itself. If a fixed rule becomes too costly to maintain, it will tend to undermine credibility, rather than support it[2]. For example, a rigid fiscal policy rule which requires offsetting adjustments irrespective of an economy's cyclical position could exacerbate the cycle and undermine public support for the policy[3].

2.13 Experience suggests that a more robust framework for policy, which maintains stability but adapts appropriately to shocks, is neither complete discretion, nor fixed rules, but **'constrained discretion'**[4]. In other words, long-term stability requires an overall framework which constrains macroeconomic policy to achieve clear long-term and sustainable goals, but which gives discretion to respond flexibly to shocks. If policy-makers have a sufficiently credible commitment to long-term stability, then they will be able to exercise discretion in response to shocks without damaging long-term expectations.

PRINCIPLES OF CONSTRAINED DISCRETION

2.14 Policy credibility will be enhanced, and therefore more effective, if the objectives of policy are clear and if the way in which those objectives are to be pursued is clear.

2.15 The key principles for a framework of credible 'constrained discretion' are:

- clear and sound long-term policy objectives consistent with achieving macroeconomic stability;
- pre-commitment, through institutional arrangements and procedural rules; and
- maximum openness and transparency, and clear accountability.

Long-term policy objectives

2.16 Shifting the policy focus towards sustainable long-term goals requires governments to set realistic and appropriate objectives for macroeconomic policy which are clearly defined, and against which performance can be judged. For example, the UK has introduced a clear, single, symmetric inflation target. The symmetry of the target means it is clear that inflationary and deflationary pressures will be resisted equally, and there is no dual targeting of inflation and the short-term exchange rate.

2.17 But by themselves, long-term objectives cannot deliver credibility. Simply announcing a low inflation target is not sufficient to build a reputation for low inflation; governments must also demonstrate their commitment to achieving this objective.

[2] See for example Allen Drazen and Paul R. Masson. "Credibility of Policies vs Credibility of Policy-makers." *Quarterly Journal of Economics*, August 1994.

[3] A more sophisticated rules-based framework would be to spell out in advance when the rule might be adjusted (a "state-contingent" rule). For example, the monetary policy rule might make an exception for an oil price shock. However, there will always be a tendency to draw the exceptions too widely, undermining the credibility of the rule; e.g. if the exception to the rule is not "oil price shocks" but rather "supply shocks" in general, the room for debate over whether the target is met widens substantially.

[4] "Open Macroeconomics in an Open Economy" Speech by Ed Balls, Chief Economic Adviser to the Treasury, to the Scottish Economic Society, 22 October 1997, and published in the Scottish Journal of Political Economy (1998) pp. 113–32 and summarised in "Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability", edited by Ed Balls and Gus O'Donnell, HM Treasury, Palgrave 2002.

2.18 One way to build up credibility is to establish a track record of delivering an objective consistently over time. For example, by achieving its inflation target over a number of years, a country can build up credibility that it will continue to conduct monetary policy to deliver the objective. But building up a track record takes time. The key question for countries that have not established credibility is whether there are actions they can take to build it up in advance of establishing a proven track record.

2.19 This leads to the second and third principles – bolstering credibility through institutional arrangements and procedural rules, and through greater transparency and accountability.

Strong institutional arrangements and clear procedural rules

2.20 The second principle suggests that credibility can be enhanced by designing procedures and institutions so as to ensure they support long-term stability. The more difficult it is for the government to fail to deliver, or to change its objectives, the more likely it is that the public and investors will believe that decisions are being taken for sound long-term reasons.

2.21 One important element in building sound institutions is to avoid conflicts of interest, or the risk of them. Where one aspect of policy has to be compromised in order to meet another policy objective, credibility will be lost. Experience shows that it is better for monetary policy, fiscal policy, debt management and financial regulation to have separately identified objectives, with responsibility for achieving them clearly attributable to one institution.

2.22 Ideally, it would be preferable to identify a separate institution for each policy objective. In the UK, for example, the Bank of England has been given a clear responsibility for operating monetary policy, the Financial Services Authority has responsibility for financial services regulation, and the Debt Management Office has operational responsibility for carrying out the Government's debt management policy. Giving institutions a single objective can help improve performance, because the institution can then focus its efforts more directly. It can also enhance accountability, because it is easier to judge whether or not the objective has been met.

2.23 Potential conflicts of interest can also be avoided by distancing day-to-day decision making from political influence. For example, the creation of an independent central bank with a clearly defined remit to achieve low inflation can build credibility by removing a potential source of inflationary bias.

2.24 The management of fiscal policy inevitably involves wider economic and social objectives. Nonetheless, governments can still put in place procedures to build credibility, for example through explicit fiscal rules, legal requirements that commit governments to set long-term objectives and account for their performance, and public expenditure management procedures to ensure that spending plans are consistent with the fiscal objectives of the government as a whole.

2.25 A number of recent crises have their origin in market concerns that institutional arrangements for policy may not survive political change. In this situation stable institutions, strengthened where possible by legislative frameworks that are more robust to political change, can build credibility. Even for those countries who believe they have built a reputation for sound macroeconomic policy, there is a risk that credibility may be lost if the institutional framework is not in place to support it going forward. This is particularly true if the credibility of the existing policy stance is built on the reputation or track record of an individual, rather than an institution with a firm underpinning.

Openness, transparency and accountability

2.26 Recent crises have also highlighted the importance of governments providing clear and transparent information about the state of the economy, economic goals and the means to achieve them. The public and markets need to have confidence in data provided by governments, for example information on foreign exchange reserves.

2.27 Greater transparency about policy can also make it easier for governments to respond to shocks through discretionary policy actions without damaging long-term credibility, if they clearly explain why they are undertaking such actions and how the expected outcome is consistent with long-term goals and policy frameworks.

2.28 Greater transparency means it is easier to hold policy-makers to account for their performance. The public are able to examine the arguments and issues that lie behind policy decisions and are given a thorough explanation of those decisions.

2.29 Credibility can be further enhanced through formal accountability procedures. For example, in the UK, legislation requires that the minutes of the MPC and the voting record of individual members are published on a regular and timely basis, along with a quarterly Inflation Report. The Bank of England is also required by law to report publicly, if inflation moves too far away from its inflation target, on why it missed the target and what actions it proposes to get back to the symmetric target.

2.30 Openness, transparency and accountability are likely to be particularly beneficial in countries where institutions are weak and do not have a strong track record. Thus the application of these principles is likely to be particularly important in emerging markets, many of whom started participating in the process of globalisation relatively recently, and are just beginning to open up their capital accounts. Greater transparency also helps to educate the financial markets, so that they can better discriminate between economies, and thus minimises the risk of contagion.

Implications for international financial architecture

2.31 The need for sound and sustainable macroeconomic policy frameworks and the principles of openness, transparency and accountability have been integral parts of the sustained effort in recent years to improve the operation of the international financial system.

2.32 The system of internationally accepted codes and standards aims to improve the quality of policy-making in all countries, by advocating that countries set out their own long-term objectives, put in place proper procedures, and promote the openness and transparency needed to keep markets informed. Codes and standards are in place covering fiscal policy, monetary policy, banking supervision and other key aspects of public policy.

2.33 The International Monetary Fund's (IMF) Article IV surveillance mechanism has also adapted to these new priorities. The IMF and World Bank produce Reports on the Observance of Standards and Codes (ROSCs), which assess countries' progress, and these now routinely inform IMF surveillance. Nearly 60 per cent of IMF members have completed or committed to complete a ROSC, and over two thirds of the ROSCs completed have been published. The IMF has also taken other steps, following the conclusion of its biennial review of surveillance, to improve the focus and quality of its bilateral surveillance and strengthen surveillance in programme countries. The key to this is an increased focus on external sustainability, vulnerabilities, and sustainable growth and the policies to achieve it. About 60 per cent of Article IV reports are now published.

2.34 The Financial Sector Assessment Programme (FSAP) promotes the development of sound financial systems, thereby helping countries to foster sustainable growth and strengthen their resilience to financial crisis and contagion. In addition to using ROSCs, FSAP missions use stress tests and financial soundness indicators to assess the health of the financial sector and potential vulnerabilities. Nearly 50 per cent of IMF members have participated or committed to participate in the FSAP. The FSAP has also significantly increased the depth and breadth of coverage of the financial sector in Fund surveillance.

2.35 The Contingent Credit Line (CCL) is also an important part of the IMF crisis prevention armoury, acting as a precautionary line of defence to be made readily available against balance of payments difficulties arising from contagion. Although no emerging market has yet used the facility, a review in January 2003 should overcome initial difficulties and confirm the principle of using IMF financing proactively to recognise good performance and help safeguard a strong policy framework in the face of turbulence in international capital markets.

2.36 The aim is better IMF advice to countries – through surveillance and in the context of Fund Programmes. Better frameworks for macroeconomic policymaking are needed to reduce the incidence of crisis, and hence to reduce vulnerability to contagion in an increasingly globalised world. There is some evidence that investors in emerging markets are beginning to discriminate more between countries based on fundamentals – the dispersion of spreads on emerging market debt has increased, and the correlation between changes in emerging market spreads has fallen in recent years[5]. This suggests that the risks of contagion from one country affected by a crisis to others initially unaffected is less than might have been the case only a few years ago. Indeed, while bond spreads have risen in some countries in Latin America in response to recent economic difficulties, there has been little impact on spreads in emerging markets in Asia. But more needs to be done to educate the private sector and ensure adequate information is available to enable them to make efficient investment decisions.

[5] "The International Financial System: A New Partnership" Speech by Mervyn King, Deputy Governor of the Bank of England, to the Indian Council for Research on International Economic Relations, New Delhi, India, 9 August, 2001.

3 THE APPLICATION OF CONSTRAINED DISCRETION

MONETARY POLICY

Long-term objectives

3.1 The long-run goal of monetary policy should be price stability, which is an essential pre-condition for high and stable levels of growth and employment. High inflation – which usually means more variable inflation – discourages long-term planning and investment but a deflationary bias must also be avoided. The appropriate definition of price stability, and the optimal inflation rate, are likely to differ between countries and over time. But whatever the definition of the objective, it is important that it should be clear and stable.

3.2 Many countries now have in place an explicit inflation target for monetary policy, and an independent central bank to implement it. A credible commitment to a long-run inflation target can have significant, and almost immediate, benefits. In the UK, for example, the new monetary policy framework introduced in May 1997 led to an initial decline in market expectations of inflation from over 4 per cent to 3.5 per cent, and they have since fallen to a level close to the 2.5 per cent target. This resulted in lower long-term interest rates and yield spreads relative to other countries.

Domestic nominal anchors

3.3 Price stability requires an anchor for inflation expectations. The two most frequently adopted domestic anchors are monetary growth targeting and inflation targeting. An external anchor – the exchange rate – is also discussed.

Monetary growth targeting

3.4 Monetary growth targeting is a 'rules-based' approach to policy. It relies on a stable and predictable relationship between money supply and inflation. Although the monetary targeting approach was adopted in the 1980s in many industrial countries, it was undermined as the money supply and inflation relationship changed due in part to financial deregulation and the development of globally integrated capital markets[1]. Moreover, as it became clear that monetary targets were not delivering the results that had been expected, policy-makers tried to modify them by setting different target ranges or by targeting different indicators. This lack of transparency and openness further undermined policy credibility.

Inflation targeting

3.5 An inflation target shifts the focus of policy to the final objective, thereby enhancing the clarity and the discipline of monetary policy, and providing policy-makers with potentially greater scope to respond to shocks. Inflation targets have been adopted in Australia, Brazil, the UK and South Africa amongst others.

3.6 Countries (particularly emerging markets and developing countries[2]) thinking about introducing inflation targeting need to consider a number of factors:

- **the fiscal position**. Inflation targeting may not initially be credible in countries that have historically relied on inflation to finance government deficits and erode debt. These countries need to implement parallel fiscal reforms;
- **health of the financial and corporate sectors**. Robust prudential regulation and supervision will be needed to help the financial and corporate sectors to cope;

[1] MAIS Lecture by the Chancellor of the Exchequer at City University, 19 October 1999 available at www.hm-treasury.gov.uk.

[2] Kenneth Kasa, "Will Inflation Targeting Work in Developing Countries?", Federal Reserve Bank of San Francisco (2001) and "Adopting Inflation Targeting: Practical Issues for Emerging Market Countries", IMF Occasional Paper (2000), Number 202.

- **transmission mechanisms** from policy instruments to inflation. Successful inflation targeting relies on a good understanding of transmission channels, and on a sound methodology for inflation forecasts.

3.7 The role of the exchange rate is particularly important in an inflation targeting framework. In many small, open economies – which are often subject to large external shocks – it has a significant effect on inflation. An inflation targeting framework has to fully take account of the exchange rate as a channel for inflation formation for monetary policy to be effective. But it is important to distinguish between this, and an explicit regime which targets the exchange rate. Dual targeting of inflation and the short-term exchange rate should be avoided, as it is likely to result in ambiguity in the objective for monetary policy and consequently a lack of clarity and credibility arising from the potentially conflicting objectives.

3.8 Another consideration is whether the inflation target should be symmetric, and therefore treat inflation above target as seriously as inflation below target or deflation. An asymmetric target that aims to reduce inflation to a set level or less is likely to introduce a deflationary bias into policy. A symmetric target ensures that deflation is regarded just as seriously as excessive inflation with policy responding accordingly.

Institutional arrangements

3.9 One obvious institutional change to enhance credibility is an independent central bank. Delegation of responsibility to an independent body can solve the time inconsistency problem, whereby governments are tempted to exploit the short-run output-inflation trade-off for short-run political gain[3]. It is important though to distinguish between target independence and operational, or instrument, independence. The government itself might want to retain responsibility for setting the objective of monetary policy and designing the framework to ensure that the objective of monetary policy remains accountable to the public through the political system. The central bank would then be responsible for delivering the objective. Making the central bank also responsible for setting the inflation target may introduce potentially destabilising conflicts between the goals of the monetary authority and the government. But if the government sets the operational goals for both fiscal and monetary policy this tension should be minimised as its preferences in both policy areas should be mutually consistent[4].

Openness and transparency

3.10 Procedures designed to improve openness and transparency include the publication of voting records, minutes of decision making committees, inflation forecasts and the publication of the target range itself. Regular publications, press conferences and speeches will further aid openness and build credibility in the framework.

3.11 Transparency can also play a role in defining the flexibility of policy in response to shocks. For example, in some countries, such as the UK and Brazil, this is dealt with using an 'open letter' system. If inflation deviates from target by more than a pre-defined amount, the central bank governor is required to write a letter to the finance minister setting out the reasons why inflation has moved so far away from the target, the policy action being taken to deal with it, and the period within which inflation is expected to return to target. Thus the framework ensures that the response of policy to shocks will be transparent, without over-defining that response in advance.

3.12 The publication of information on UK foreign currency reserves is in line with – and in some cases in excess of – the IMF's special Data Dissemination Standard. This means that considerably more detail on asset composition is provided; there is no distinction between the spot and forward books and all data is published on a marked- to-market basis.

[3] "The New UK Monetary Arrangements: A View from the Literature", Charles Bean, CEPR, 17 March 1998.

[4] "UK Policy Coordination: The Importance of Institutional Design" G. O'Donnell and A. Bhundia; *Fiscal Studies*, 2001.

Exchange rate regimes

3.13 The exchange rate can provide an alternative nominal anchor for monetary policy. Countries have put in place a variety of different exchange rate regimes, ranging from a rigidly fixed regime (e.g. through monetary union or a currency board), to regimes that peg the exchange rate to a greater or lesser degree. At the other extreme, a freely floating rate requires domestic monetary policy to provide the nominal anchor.

3.14 Fixed exchange rate regimes are often adopted as part of a stabilisation programme. Fixing to a low inflation currency means that the country can, if this link is credible, 'inherit' the anti-inflation credibility of the country to which it has fixed. For an economy with relatively open capital flows, a fixed exchange rate regime means that there is no role for an independent monetary policy.

3.15 However, a fixed exchange rate does not allow any scope for 'constrained discretion' in response to shocks. Since it sets a rigid rule, shocks have to be absorbed elsewhere in the economy, if stability is to be maintained.

3.16 Thus, if a country wants to establish a fixed exchange rate as part of a longer term policy framework, the conditions which must be met to minimise the risk of destabilising shocks are specific and demanding: the economy must be very open, with a high share of trade with the country to which it is pegged, the economy and financial system must already extensively rely on its partner's currency, and the shocks it faces must be similar. It must also be willing to give up monetary independence for its partner's monetary credibility; this means that its fiscal policy must be flexible and sustainable, and it must have flexible labour and product markets to cope with shocks when the exchange rate can't adjust. The real credibility of any peg thus does not come from the peg itself, but from putting in place the wider institutional arrangements that support the regime and which facilitate adjustment. Experience suggests that a peg in itself cannot be relied upon to be the driver for the essential, wider-ranging reforms.

3.17 Some have argued that in a world of international capital mobility, it is not credible for countries which are open to capital flows to run intermediate forms of exchange rate regime in the long-term. This is because they do not have the institutional backing provided by more rigid regimes, such as currency boards, so lack sufficient credibility and strength to withstand speculative attacks. Thus only the extreme ends of the spectrum, (of freely floating or very rigid regimes such as monetary union or a currency board) are feasible[5].

3.18 But even with a very rigid fixed exchange rate regime, such as a currency board, the same conditions apply, i.e. monetary and fiscal policy have to operate in a way consistent with it. A fixed exchange rate regime cannot be expected to solve a country's economic problems if the appropriate macroeconomic framework is not in place. Argentina's recent experience demonstrates the difficulties of sustaining a fixed exchange rate regime, even where a currency board is used.

Capital account liberalisation

3.19 Until recently there was broad consensus that countries should remove capital controls, and remove them quickly, as they act as a barrier to foreign investment and portfolio diversification. But recent experience, not least the Asian financial crisis, has shown that the

[5] "Exchange rate regimes: Is the Bipolar view correct?" Stanley Fischer, paper prepared for a lecture to the American Economic Association (January 2001).

sequencing of liberalisation with reform is crucial. There are risks associated with rapid capital account liberalisation, unless countries have already in place a well functioning macroeconomic policy framework, open and transparent policy making and an effective structure for financial regulation.

3.20 Experience suggests that countries with pegged exchange rates that have yet to open up their capital account should liberalise their capital accounts gradually whilst at the same time pursuing the institutional arrangements that will allow them to operate in a world of increasing capital flows.

3.21 One approach is for countries to draw up their own specific 'road maps' for opening up their capital accounts. Such maps should cover the speed of liberalisation and the appropriate reforms (strengthening the financial sector, including through enhanced banking supervision, stronger bankruptcy laws and property rights) needed to make it a success. In countries which have weak financial sectors and are at the earlier stages of liberalisation, there may be a case for measures to discourage excessive short-term capital inflows whilst encouraging longer-term flows where, for example, such measures are a temporary means of facilitating the reforms needed to ensure orderly and sustainable liberalisation.

3.22 When a crisis does occur, a country may have little choice but to resort to a payment suspension or comprehensive debt restructuring. In such cases, the official sector should be prepared to support a country that must impose temporary capital controls or a standstill on its debts as part of an orderly process of crisis resolution. Greater private sector involvement in resolving crises is essential in a world of open capital markets. Investors must bear the consequences of their investment decisions if the right incentives are to be provided for the efficient allocation of investment capital. Thus big IMF bail-outs must not become a standard element of the official sector's response to crises.

3.23 Better mechanisms are required to facilitate sovereign debt restructuring where that is needed. The incorporation of clauses into sovereign bond contracts which facilitate collective action and majority restructuring should become standard market practice. More formal mechanisms to facilitate sovereign debt restructuring should also continue to be pursued.

FISCAL POLICY

Long-term objectives

3.24 Fiscal policy has a number of objectives, such as promoting equity, and the provision of public goods. But the pursuit of these objectives is constrained by the need to maintain sustainable public finances over the long term. In the UK framework this is specified in terms of the ratio of public debt to GDP.

3.25 Ideally, a sound fiscal position should be compatible with allowing the automatic stabilisers to operate over the economic cycle. However, discretionary fiscal policy is a less suitable tool for active demand management, especially if a country has an independent monetary policy. Tax and spending changes take time, and there is a risk that a counter-cyclical fiscal policy may inadvertently become a pro-cyclical policy. The political and social costs associated with fiscal retrenchment make it hard to reverse tax and spending increases, thereby turning what was intended as a temporary increase into a permanent change. Nonetheless, under a fixed exchange rate or monetary union arrangement, where there is a greater likelihood that monetary policy will not always suit perfectly the conditions in an individual country, fiscal policy may be more effective and have a bigger role to play.

3.26 Fiscal sustainability is a pre-condition for macroeconomic stability. This requires sound and sustainable public finances, while allowing appropriate flexibility. In assessing fiscal sustainability, the UK takes into account:

- the economic cycle: by allowing the automatic stabilisers to operate symmetrically over the cycle, fiscal policy can support monetary policy in smoothing economic fluctuations in the face of variations in demand. Focusing on cyclically-adjusted fiscal balances is therefore important when assessing the appropriateness of budgetary policies;
- sustainability: low levels of debt enhance the sustainability of the public finances, give more room for manoeuvre to allow the automatic stabilisers to operate and provide a sound basis for investment in priority public services, or reforms to promote productivity, employment and fairness; and
- public investment: in the context of sound public finances and economic stability, public investment not only raises welfare through the provision of high quality public services, but can also help raise the overall productive potential of the economy.

Institutional arrangements

3.27 The institution which sets fiscal policy should also control the policy mechanisms to deliver it. If individual parts of the public sector are not brought together under a common planning process then the risk is that they may undermine the achievement of the overall fiscal objective. Therefore, the whole of the public sector (including regional or sectoral bodies) needs to be included. The framework should also be clear as to the short-term objectives and how they are expected to be met, and their consistency with longer-term objectives.

3.28 Pre-commitment can best be achieved by following fiscal rules which allow some room for flexibility to respond to shocks, for example, the UK's two fiscal rules, which are underpinned by the Code for Fiscal Stability (see Box 4.1). A number of emerging market countries have introduced (or are introducing) Fiscal Responsibility Laws to enhance the medium-term credibility of fiscal policy, such as Brazil and India. This marks a substantial shift away from pure discretion.

Transparency and accountability

3.29 Governments should give a clear statement of their fiscal objectives and any operating rules they choose to adopt. Where departures are made from those rules, these should be fully explained and justified. It can also help to have independent auditing of key assumptions underpinning the fiscal projections. A number of countries have introduced legislative requirements for governments to set long-term objectives, account for their performance, and provide transparent and timely budget reports: for example New Zealand's Fiscal Responsibility Act, Australia's Charter of Budget Honesty and the UK's Code for Fiscal Stability.

3.30 The IMF's Code for Fiscal Transparency emphasises the following key principles:

- clarity of roles and responsibilities, reflecting the importance of establishing clear boundaries between the Government's fiscal, monetary, and public corporation activities;
- public availability of information, to promote the timeliness and comprehensive reporting of budget information;

- open budget preparation, execution, and reporting, to ensure the appropriate levels of coverage, accessibility and integrity of fiscal information, ensuring where possible that such reporting is consistent with international accounting and statistical standards; and
- independent assurances of integrity – so that the public can be assured of the credibility of the information presented.

The budgetary process

3.31 The budget process must weigh up the competing claims of individual parts of the public sector against the government's overall objectives, including the demands of longer-term fiscal sustainability. Where sources of revenue are limited, the budget process should be able to reallocate funds towards high-priority areas and, where necessary, identify areas where budgetary savings can be made.

3.32 Many countries have adopted multi-year projections as a means of ensuring the consistency of current fiscal projections with the demands of medium-term sustainability. This helps to bring a consolidated approach to budget planning by integrating tax, expenditure, and debt plans and focuses attention on the consistency of the fiscal projections with the government's fiscal objectives.

3.33 There is, however, a risk that such projections lead to an overly optimistic view of the strength of the fiscal position. In particular, there is often a tendency to overstate the growth potential of the economy, and understate future spending pressures, leading to the illusion that more resources are available than is actually the case. A cautious approach should be taken to the assumptions used for key economic variables such as the trend growth rate. This avoids the risk of costly policy reversals. There may also be a useful role for an independent audit of the assumptions underlying the fiscal projections to further boost accountability. For example, the US publishes competing sets of budget assumptions. The UK also now publishes an End of Year Fiscal Report, which provides retrospective information on the public finances, and long-term fiscal projections that show the sustainability of public finances over a 30 year horizon.

Public debt management

3.34 Recent crises have highlighted the importance of sound debt management practices for maintaining overall stability. However, often debt management is seen as an adjunct to fiscal or monetary policy, rather than an important area of policy in its own right. This leads to problems if short-run fiscal or monetary considerations are allowed to override prudent debt management.

3.35 Excessive reliance on short-term, floating rate, and foreign currency debt leave a country exposed to interest rate and currency risks and hence vulnerable to financing crises. If the credibility of macroeconomic settings is in doubt, a debt portfolio which is too heavily weighted towards these types of debt may imply a substantial increase in the cost of debt servicing and, in the extreme, push an economy into crisis, as happened in Thailand and Korea.

3.36 The guidelines for public debt management prepared by the IMF and World Bank provide a comprehensive framework for debt management. Among the key principles emphasised in the draft guidelines are:

- the risks in the government's debt management strategy should be carefully monitored and evaluated. Debt managers should be aware of the trade-offs between cost and risk;
- there should be sufficient coordination between the fiscal, monetary and debt management authorities. Responsibilities of the respective bodies should be clearly defined and publicly disclosed. Ideally, responsibility for debt management and monetary policy should be separated;
- the government should publish regularly information on its financial position, including the composition of the debt portfolio and any financial assets. Debt management operations should be transparent and predictable;
- the accountability framework for debt management should be publicly disclosed. The integrity of the debt management process needs be assured, including the use of regular auditing by external auditors, and clear monitoring and reporting procedures; and
- debt managers should consider fully the impact of contingent liabilities on the government's portfolio.

COORDINATION OF MONETARY AND FISCAL POLICY

3.37 Some have expressed concern that central bank independence will lead to less effective coordination of monetary and fiscal policy, and that by separating responsibility for monetary and fiscal policy the two sets of policymakers would find it more difficult to have both arms of policy working in the same direction.

3.38 But this view is too simplistic. Even if monetary and fiscal policy decisions are made by the same set of policymakers, they may not be well coordinated. In the case of the UK, the IMF concluded that "experience before 1997 shows that having both policy instruments under the control of the government provides no guarantee of effective policy coordination.[6]"

3.39 In practice, a monetary policy conducted by an independent authority is likely to help reinforce incentives for prudent fiscal policy. For a given inflation target, a looser fiscal stance will tend to lead to a tightening of monetary policy. Hence the payoff to fiscal loosening is reduced.

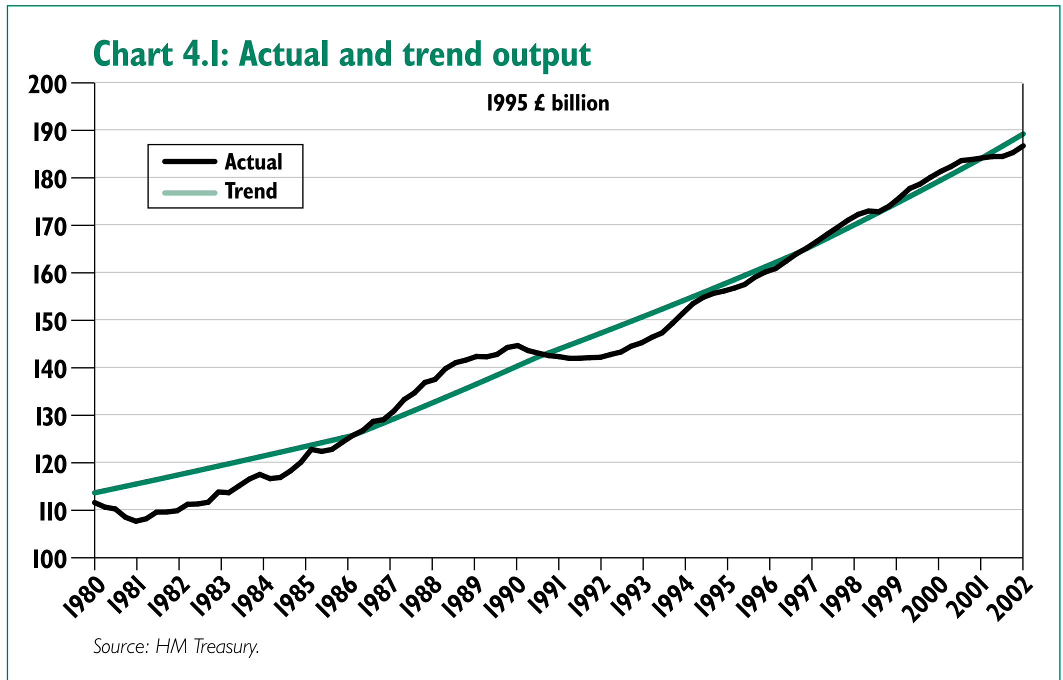
3.40 Nonetheless, there are important coordination issues which may arise when the responsibilities for monetary and fiscal policy are separated; for example, Blake and Weale (1998)[7] demonstrate that where the monetary and fiscal authority must learn each other's policy objective and reaction function, then there may be considerable welfare losses, particularly if their initial guesses are some way from the true outcome. This highlights the need for transparency, clear objectives and responsibilities, and appropriate procedures and mechanisms to ensure effective policy coordination takes place.

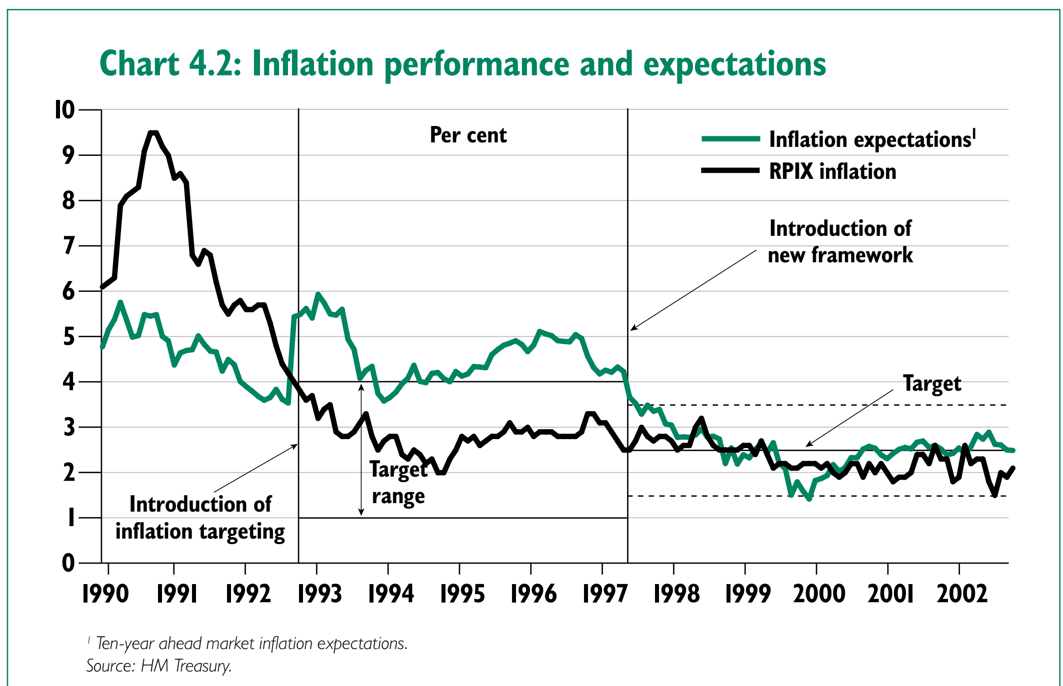
[6] "United Kingdom: Selected Issues", IMF Staff Country Report (1999), Number 99/44.

[7] Blake, Andrew P. and Martin Weale. "Costs of Separating Budgetary Policy from Control of Inflation: a Neglected Aspect of Central Bank Independence" Oxford Economic Papers, 50(3), July 1998.

4 The UK experience

4.1 During the 1980s and early 1990s, the lack of a credible macroeconomic framework in the UK led to substantial volatility in output, inflation and interest rates. However, from 1997 onwards, changes made to the monetary and fiscal policy frameworks consistent with the principles of constrained discretion identified in Chapter 2, have resulted in an improved macroeconomic performance, with low and stable inflation, and sound public finances.





MONETARY POLICY

4.2 A broad consensus now exists that low and stable inflation is an essential precondition for achieving high levels of growth and employment. But historically, the UK's inflation performance has been very poor, despite attempts to tackle the problem through a variety of different policy measures.

4.3 During the early 1980s, the UK government undertook to control inflation through monetary targeting, setting targets for the M3[1] measure of the money supply for several years in advance, in tandem with projections for the fiscal deficit. However, repeated overshooting of the target led to an upwards revision, along with the introduction of various other monetary targets. At the same time, the exchange rate began to gain more weight in the assessment of the stance of monetary policy, and later as an intermediate target.

4.4 By 1987 monetary policy had shifted to a policy of pegging the pound informally to the Deutsche Mark (DM), 'shadowing the DM'. The stance of monetary policy remained relatively easy until mid-1988, when it became clear that the level of economic activity was considerably more robust than previously thought. This forced a sharp correction in monetary policy: interest rates were raised dramatically over the following year. However, by the end of 1990 the UK was in recession and the interest rate was falling again.

4.5 The attempt, at the beginning of the 1990s, to achieve credibility through Exchange Rate Mechanism (ERM) membership failed as well. Linking the anti-inflationary commitment to a fixed exchange rate target at a time when the German reunification supply shock was pulling the anchor currency – the Deutsche Mark – in a direction in which Britain was not in a position to go, meant that the right economic decisions were not taken.

4.6 The UK entered the ERM in October 1990, during a period in which the Bundesbank was increasing interest rates. This meant that interest rates in the UK could not be reduced quickly enough in response to the recession in 1991 and 1992. This placed increasing pressure on the exchange rate, with Sterling moving to the lower end of its band and growing evidence from the traded sector and the domestic economy that the exchange rate and the level of interest rates it demanded could not be maintained.

4.7 Statements that the ERM was central to the government's economic strategy, and the attempt to sell DM denominated bonds to increase the fiscal cost of failure to maintain the parity, proved insufficient to establish policy credibility, and made it much harder to regain credibility once the policy failed[2]. Sterling was eventually withdrawn from the ERM in 1992 in the wake of considerable exchange market turbulence.

4.8 This was a case where monetary policy was directed at an inappropriate objective, at the expense of price and output stability. Then when economic pressures proved too much and the nominal anchor broke, the government was left with the credibility of its long-term goals undermined. This demonstrates why trying to achieve credibility through adherence to fixed and rigid intermediate policy rules is destabilising and unlikely to succeed, and why a framework of constrained discretion offers a more credible foundation for policy.

4.9 The UK subsequently adopted a new monetary policy framework, which centred on direct targeting of inflation. Moves were also made to improve the transparency and accountability of policy. While inflation did fall subsequently, the arrangements still lacked credibility; inflation expectations were persistently above the target range. This was because

[1] M3 is the earliest measure of broad money, comprised of private and public sectors' sterling and foreign currency deposits with UK banks, and notes and coin in circulation with the public.

[2] "Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability" edited by Ed Balls and Gus O'Donnell, HM Treasury, Palgrave 2002.

monetary policy remained firmly in the hands of the Chancellor until 1997, when the new Government moved to place the operational responsibility for monetary policy in the hands of a new, independent Monetary Policy Committee (MPC). Inflation expectations instantly fell, and have since mid-1998 remained in line with the symmetric 2·5 per cent target.

4.10 Until these reforms were introduced, monetary policy repeatedly failed to maintain price stability:

- the objectives of monetary policy were not specified properly;
- monetary policy was not sufficiently forward-looking;
- roles and responsibilities were not clear and consistent;
- monetary policy decisions were made by politicians, not experts; and
- monetary policy was not transparent or accountable.

4.11 These inadequacies of the monetary policy framework meant that even when an apparently firm and irrevocable monetary target was chosen (such as entry into the ERM), the Government lacked the credibility to persuade the public of its commitment to the objective. As the government's credibility diminished, the costs of maintaining the exchange rate peg rose, and the probability of exit increased. If targets are to be durable, they must be backed by the appropriate institutional framework to ensure they are credible.

4.12 The new monetary policy framework introduced in 1997 is based on the three key principles identified in Chapter 2:

- **clear and sound long term policy objectives**: the inflation target is set by the Government to achieve price stability. The symmetry in the Government's inflation target ensures that outcomes below target are treated as seriously as outcomes above target. In this way monetary policy helps to support the Government's wider economic policy objective of high and stable levels of growth and employment;
- **pre-commitment** to long-term stability through strong institutional arrangements and procedural rules. The Bank of England's Monetary Policy Committee has full operational independence and is responsible for setting interest rates to meet the Government's inflation target; and
- **maximum openness and transparency, and clear accountability**: the Bank of England Act lays down guidelines for the publication of MPC members' voting records, prompt reporting of minutes of the monthly MPC meetings and the Bank of England's quarterly Inflation Report, and the 'open letter' system in the event that the target is missed. There is also a strengthened role for Parliament.

4.13 The need for greater clarity and transparency of objectives and to create clear accountability through the establishment of appropriate institutional arrangements meant that the Bank of England was given a clear responsibility for operating monetary policy, and the Financial Services Authority was set up as a single integrated financial services regulator. The Debt Management Office was set up as an executive agency with operational responsibility for carrying out the Government's debt management policy.

4.14 The new arrangements have removed the suspicion of short-term political influence over monetary policy and ensure that interest rates are set in a forward-looking manner to meet the Government's symmetric inflation target.

4.15 The monetary framework is designed to be able to cope with unforeseen shocks and to leave room for pre-emptive policy responses. For example, the MPC responded to the global slowdown during 2001 by cutting interest rates seven times, and by 2 percentage points altogether from 6 per cent to 4 per cent. In the old system, such a policy response from the Chancellor might have been interpreted as a sign of crisis. But the Bank of England's handling of the situation stabilised the economy and boosted confidence[3]. This pre-emptive action helped to ensure that activity remained strong throughout the year.

4.16 As monetary policy in the UK is set to achieve the inflation target, the exchange rate is allowed to float. The exchange rate enters monetary policy decisions only to the extent that it affects the inflation outlook. The symmetic inflation target is thus the sole target for monetary policy and the right way to achieve a stable and competitive pound in the medium term, consistent with price stability. It is considered that the best way to achieve this under the existing framework, is by providing a stability-focused macroeconomic framework.

FISCAL POLICY

4.17 Over the 1980s and early 1990s, fiscal policy often added to volatility and instability. Temporary, cyclical improvements in the fiscal position were misinterpreted as permanent, structural improvements, and the resulting over-optimistic forecasts led to a loosening of fiscal policy in 1988, at a time when the economy was already growing significantly above trend.

4.18 As the economy returned to trend, the fiscal position rapidly deteriorated and the surplus fell faster than forecast in successive Budgets. During the ensuing downturn, tax increases and spending restraint were required to return the public finances to a sustainable path. These decisions undermined the effective operation of the automatic stabilisers thereby amplifying the economic instability, and the restraint in public spending restricted the ability of departments to plan for the medium term, particularly damaging public investment.

4.19 Partly in response to these events, a new fiscal framework was established in 1998, consistent with the principles of constrained discretion identified in Chapter 2. The new framework is based on five principles of fiscal management:

- transparency in the setting of fiscal policy objectives, the implementation of fiscal policy and the publication of the public accounts;
- stability in the fiscal policy-making process and in the way fiscal policy impacts on the economy;
- responsibility in the management of the public finances;
- fairness, including between generations; and
- efficiency in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.

[3] "Deliving Economic Stability", speech by Ed Balls, Chief Economic Adviser to the Treasury, to the Oxford Business Alumni Annual Lecture, 12 June 2001.

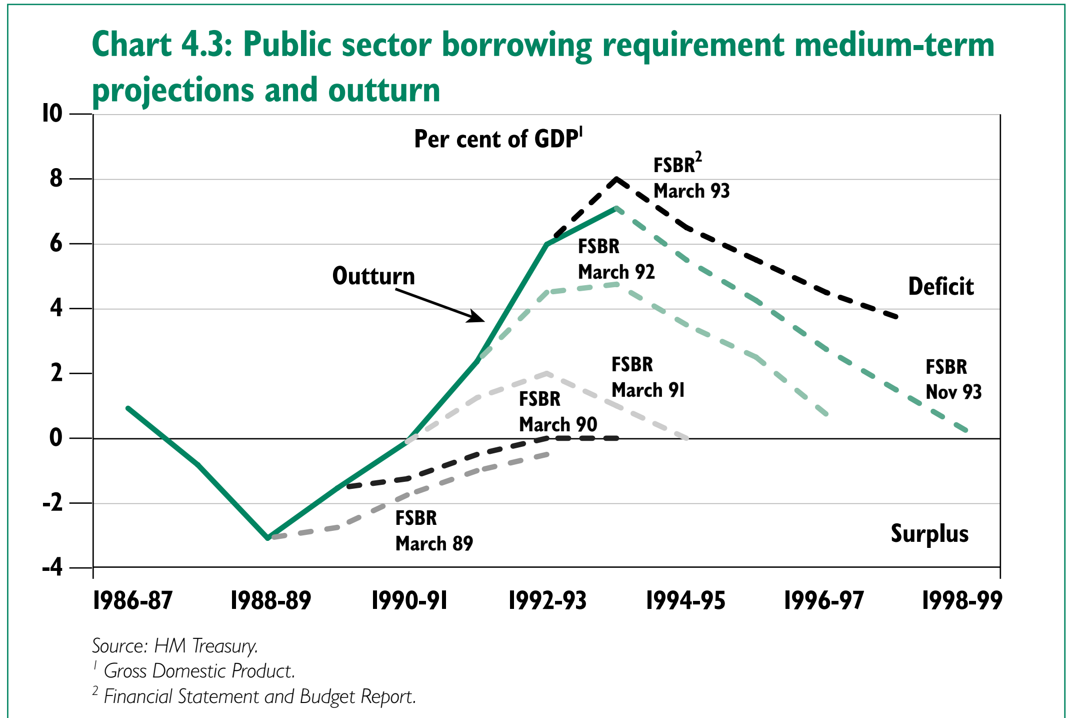


Chart 4.3: Public sector borrowing requirement medium-term projections and outturn

Source: HM Treasury.
[1] *Gross Domestic Product.*
[2] *Financial Statement and Budget Report.*

4.20 These principles were enshrined in legislation and in the Code for Fiscal Stability. The Code explains how these principles are to be reflected in the formulation and implementation of fiscal policy. In addition, the Code requires the Government to set out its fiscal policy objectives and the rules by which it intends to operate fiscal policy over the life of the Parliament. This is set out in greater detail in the box below.

Box 4.1: The Code for Fiscal Stability – key provisions

Under the Code enshrined in legislation, the Government will undertake the following commitments. It will:

- **conduct fiscal and debt management policy in accordance with a specific set of principles;**
- **state explicitly its fiscal policy objectives and operating rules, and justify any changes to them;**
- **operate debt management policy to achieve a specific primary objective;**
- **disclose, and quantify where possible, all decisions and circumstances which may have a material impact on the economic and fiscal outlook;**
- **ensure that best-practice accounting methods are used to construct the public accounts;**
- **publish a Pre-Budget Report to encourage debate on the proposals under consideration for the Budget;**
- **publish a Financial Statement and Budget Report (FSBR) to discuss the key Budget decisions and the short-term economic and fiscal outlook;**
- **publish an Economic and Fiscal Strategy Report (EFSR) outlining the Government's long-term goals and strategy for the future;**
- **publish a specific range of information from its economic and fiscal projections, including estimates of the cyclically-adjusted fiscal position;**
- **invite the National Audit Office (NAO) to audit changes in the key assumptions and conventions underpinning the fiscal projections;**
- **produce a Debt Management Report outlining the Government's debt management plans;**
- **refer all reports issued under the Code to the House of Commons Treasury Committee; and**
- **ensure the public have full access to the reports issued under the Code.**

4.21 The Government's key objectives for fiscal policy are:

- over the medium-term to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- over the short-term to support monetary policy and in particular to allow the automatic stabilisers to play their role in smoothing the path of the economy.

4.22 These objectives are implemented through the Government's two fiscal rules, against which the performance of fiscal policy can be judged:

- the golden rule, which states that over the economic cycle the Government will borrow only to invest and not to fund current spending; and
- the sustainable investment rule, which states that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

4.23 The fiscal framework constrains discretion while allowing flexibility in two key respects:

- both rules are set over the economic cycle, enabling fiscal policy to support monetary policy in smoothing the economic cycle by allowing the automatic stabilisers to operate freely; and
- the golden rule clearly distinguishes between current and capital spending, allowing the Government to borrow for capital spending which provides benefits to both current and future generations and so it is appropriate that the cost be spread over time in the form of interest and debt repayments. To protect public investment and ensure the rules are met, capital and current spending are now planned and managed separately. This focuses adjustment on current spending, while ring-fencing investment, thus preventing a repeat of mistakes from the past, in which public investment was cut whenever the government needed to tighten the fiscal stance, leading to chronic under investment in public services.

4.24 Reporting on the performance of the public finances against the fiscal rules and published projections is an important element of a transparent fiscal policy, and one of the principles of fiscal management set out in the Code for Fiscal Stability. In accordance with this principle and the requirements of the Code, each Budget and Pre-Budget Report includes analysis of outturns as well as estimates of the trend level of output and cyclically-adjusted fiscal indicators to give a better indication of the underlying position of the economy. Long-term fiscal projections are also provided to show the sustainability of public finances over a 30 year period. In order to further enhance the reporting of fiscal developments, End of Year Fiscal Reports will also be published from now on, to provide more retrospective information on the public finances, and their performance against the fiscal rules and published forecasts and plans.

4.25 Since 1997, the public finances have been transformed and returned to a sustainable position. Fiscal policy is now directed firmly towards maintaining sound public finances over the medium term, based on strict rules. But these rules also allow fiscal policy to support monetary policy over the economic cycle. This approach together with the new monetary policy framework, makes the economy more robust to external shocks, and provides the platform of stability necessary to maximise the benefits and minimise the risks associated with globalisation. Lower unemployment and sound public finances have also enabled the Government to release substantial new resources for priority public services while still meeting the fiscal rules.

COORDINATION OF MONETARY AND FISCAL POLICY

4.26 In the UK, the new macroeconomic framework also puts in place procedures to ensure that there is appropriate coordination between fiscal and monetary policy. This is achieved in three main ways:

- most importantly, coordination is achieved because the Government sets the objectives for both monetary and fiscal policy. Indeed, both arms of policy have the same fundamental objective of helping to achieve long-term growth and employment by delivering economic stability[4]. Monetary policy does this by aiming to deliver price stability, while fiscal policy aims to deliver sound public finances. If the Government did not set an inflation target that was consistent with its fiscal objectives, the MPC would through its monetary policy decisions, counteract any fiscal impulse that puts at risk the inflation target;

[4] "UK Policy Coordination: The Importance of Institutional Design" O'Donnell G, and Bhundia, A; Fiscal Studies, 2001.

- because the objectives of both arms of policy are clear, and the procedures transparent, both sets of policy makers are aware of what the other is trying to achieve and how the other will react to their policy decisions; and
- this process is aided by the presence at Monetary Policy Committee meetings of a (non-voting) representative from HM Treasury who is able, in particular, to provide information on fiscal policy. This includes detailed presentations on the Budget and the Pre-Budget Report.

4.27 Enhanced transparency built into the Bank of England Act 1998 and the Code for Fiscal Stability requires the MPC and the Treasury to put greater emphasis on communicating the policy stance not only to expert commentators but also the general public. Greater clarity in macroeconomic policy enhances public debate and scrutiny of the mix of monetary and fiscal policy and has helped to establish credibility.

4.28 In addition, fiscal policy is constrained by the inflation target because the Treasury must take into account the likely response of the MPC to different fiscal policy settings. Thus when deciding on the fiscal stance, the Treasury is effectively setting the policy mix. The clarity of objectives for both monetary and fiscal policy, based on a symmetric inflation target and clear fiscal rules, has therefore enhanced the co-ordination of monetary and fiscal policy.

FINANCIAL STABILITY AND DEBT MANAGEMENT

4.29 Capital market liberalisation in the UK has been accompanied by a series of measures to upgrade prudential and other elements of supervision of financial firms and markets. One of the key themes of reform has been the move towards greater clarity and consistency of objectives. Previously, regulatory responsibility for different areas of financial services was divided between the Bank of England and a number of other regulatory bodies. However, responsibility is now held by a single integrated financial services regulator, the Financial Services Authority (FSA).

4.30 This was deemed necessary, not only to ensure consistency, but because the distinctions between the banking, securities, and insurance sectors have become increasingly blurred. A single regulator, with a single set of objectives also provides greater accountability, and constitutes a more efficient use of scarce regulatory resources.

4.31 The FSA has statutory objectives to: maintain confidence in the financial markets; provide appropriate consumer protection; increase public awareness of financial issues; and fight financial crime. It must ensure that the costs of regulation are outweighed by the benefits. In fulfilling its objectives, the FSA must have regard for the need of the UK to have a competitive, dynamic and innovative financial sector.

4.32 The Bank of England retains responsibility for the overall stability of the financial system, involving work to strengthen market infrastructure, monitor developments in financial markets worldwide and, in exceptional circumstances, undertake liquidity or capital support operations to prevent or limit the impact of financial crisis on the financial system.

4.33 The UK Debt Management Office (DMO), was established on 1 April 1998. The DMO's brief is to carry out the Government's debt management policy of minimising financing costs over the long term, taking account of risk, and to manage the aggregate cash needs of the Exchequer in the most cost-effective way, in both cases consistently with the objectives of monetary and any wider policy considerations.

4.34 In institutional terms, the DMO is legally and constitutionally part of HM Treasury, but as an executive agency, it operates at arm's length from Ministers. The Chancellor of the Exchequer determines the policy and financial framework within which the DMO operates, but delegates to the Chief Executive operational decisions on debt and cash management, and day-to-day management of the office.

4.35 The separate responsibilities of the Chancellor and other Treasury Ministers, the Permanent Secretary to the Treasury, and the DMO's Chief Executive are set out in a published Framework Document. This also sets out the DMO's strategic objectives and its Chief Executive's lines of accountability to Parliament for the DMO's performance and operations both in respect of its administrative expenditure and the Debt Management Account which records all its issuance and trading transactions. Each year the DMO is set a number of specific performance targets in respect of its objectives, its service to the market and its efficiency.

5 Conclusion

5.1 Governments which pursue, and are judged by the markets to be pursuing, sound monetary and fiscal policies, can attract inflows of investment capital at higher speed, in greater volume and at a lower cost than even ten years ago. Moreover, if governments are judged to be pursuing sound, long-term macroeconomic policies and credible institutional procedures, they are better able to use discretionary monetary, or indeed fiscal, policy to deal with macroeconomic shocks which need to be accommodated in the short term. Thus a sound and credible macroeconomic framework is crucial if a country is to maximise the benefits and minimise the risks associated with globalisation.

5.2 The best way to achieve this is to put in place a framework based on constrained discretion. This should be underpinned by clear and sound long-term policy objectives, pre-commitment through institutional arrangements and procedural rules, openness, transparency, and clear accountability.

5.3 The UK has established an institutional framework which provides the necessary backdrop for a stable and credible macroeconomic policy. This puts the UK in a strong position to benefit from the opportunities brought by globalisation and to cope with the risks, including the challenges posed by the current global economic environment.

5.4 The synchronised slowdown of growth in the US, Europe and Japan was a major influence on developments in the UK economy during 2001. In contrast to previous episodes of faltering global prospects and rising uncertainty, the application of constrained discretion and the resulting platform of low inflation and sound public finances delivered by the Government's new macroeconomic framework, has enabled policy to sustain growth in the UK.

5.5 The application of constrained discretion within the UK enabled the flexible use of monetary and fiscal instruments based on a symmetric inflation target and clear fiscal rules defined over the economic cycle to mitigate the effects of the global slowdown:

- as the world economy turned down in 2001, the independent Monetary Policy Committee (MPC) of the Bank of England reduced interest rates on four occasions in the first eight months of the year consistent with meeting its symmetric inflation target. Further reductions after the terrorist atrocities of 11 September helped to restore business and consumer confidence to their previous levels and to mitigate any further drags on activity amidst already very difficult global conditions; and
- fiscal policy supported monetary policy by allowing the automatic stabilisers to operate, thereby sustaining demand over the course of the year while meeting the fiscal rules with a margin for caution and fully financing spending plans to 2006. Policy was able to respond flexibly because the fiscal rules are set over the economic cycle.

5.6 At the same time, adherence to the inflation target and the fiscal rules maintained stability and confidence in the economy:

- robust household demand played a key role in supporting economic growth with consumer confidence underpinned by the series of interest rate cuts by the MPC; and

- the labour market remained resilient to the sharp slowdown in world growth in 2001. Employment continued to rise and unemployment remained at its lowest rate for 25 years, providing further evidence that the Government's macroeconomic framework working in tandem with its structural reforms have yielded substantial supply-side gains. In short, the UK has been better placed to deal with the slowdown in the world economy because of policy action taken on the basis of a symmetric inflation target and fiscal rules set over the economic cycle. Monetary and fiscal policy has therefore cushioned the impact of the economic cycle while maintaining inflation at historically low levels, releasing resources for public investment, and maintaining the public finances on a sound and sustainable footing.

5.7 By building a track record of credibility over a long period of time, countries can buy themselves more room to respond to shocks across the economic cycle, in a discretionary way, without undermining that credibility and putting stability at risk. The challenge for all countries is to manage the shocks that globalisation can bring, while enhancing credibility at the same time.