Policy frameworks in the UK and EMU

EMU study

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This study has been prepared by HM Treasury to inform the assessment of the five economic tests

This study has benefited from comments by Christopher Allsopp, working in a personal capacity as an academic consultant to HM Treasury. All content, conclusions, errors and omissions in this study are, however, the responsibility of HM Treasury alone.

This is one of a set of detailed studies accompanying HM Treasury's assessment of the five economic tests. The tests provide the framework for analysing the UK Government's decision on membership of Economic and Monetary Union (EMU). The studies have been undertaken and commissioned by the Treasury.

These studies and the five economic tests assessment are available on the Treasury website at:

www.hm-treasury.gov.uk

For further information on the Treasury and its work, contact:

HM Treasury Public Enquiry Unit
1 Horse Guards Road
London
SW1A 2HQ

E-mail: public.enquiries@hm-treasury.gov.uk

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Executive Summary

1 Experience has shown that effective frameworks for macroeconomic policy can make a significant contribution to prosperity and economic stability. This study examines the robustness of the frameworks for macroeconomic policy in both the UK and the euro area, and the implications for the UK in achieving the Government's objective of high and stable levels of growth and employment in or out of Economic and Monetary Union (EMU). It looks at fiscal policy, monetary policy and financial stability, as well as macroeconomic policy coordination. The study is most relevant to the fifth of the Government's five economic tests for EMU entry, which asks whether EMU will "*promote higher growth, stability and a lasting increase in jobs*".

Direct comparison not possible

2 A single model for the policy framework is not appropriate in all circumstances, and there may be more than one route to achieving stability. A simple comparison between the UK and the euro area frameworks would not be appropriate because the euro area policy framework is, in a number of ways, necessarily different to the framework operating in the UK: the euro area framework has been designed to apply to a number of countries which have pooled responsibility for certain functions in EMU, while the UK framework applies solely to the UK. Any comparison also needs to consider not just what conditions prevail now in the euro area, but what those conditions would be were the UK to be a participating member of EMU.

Continued evolution

3 Comparison is also made more complex by the fact that neither the UK nor the euro area policy frameworks are static. Both frameworks are still relatively young and both continue to evolve in response to changing circumstances and experience. The study therefore focuses not just on evidence to date, but also tries to assess how the frameworks might develop in the future, particularly in light of the imminent enlargement of the EU and the changes in economic circumstances that this might bring.

Basis for assessment

4 The study assesses robustness by considering three key objectives that a robust policy framework should aim to achieve: credibility, flexibility and legitimacy. These objectives can be achieved through the principle of 'constrained discretion'. Long-term stability requires an overall framework which constrains macroeconomic policy to achieve clear long-term and sustainable goals, but which allows discretion to respond flexibly to shocks. Such a framework should command legitimacy, that is, public and parliamentary support, at all points in the economic cycle.

Differences and similarities

5 This study shows that there are a number of similarities between the UK and the euro area policy frameworks. In particular, in both cases there seems to be broad agreement, in line with the academic consensus, that monetary policy should have primary responsibility for managing aggregate demand so as to maintain low inflation, with the primary objective of fiscal policy to maintain sound public finances over the medium term to long term.

6 The UK would continue to operate with its current policy framework outside EMU. Therefore, the differences between the frameworks are the focus of this study since these are of most analytical importance in determining what impact membership of EMU would have on macroeconomic stability in the UK.

Changes that EMU entry would mean for the UK

7 Were the UK to join EMU, it would adopt the euro area's monetary policy framework, with interest rates set by the European Central Bank (ECB) for the euro area as a whole, including the UK.

8 Fiscal policy remains the responsibility of Member States, in or out of EMU. The UK is already covered by many of the requirements of the EU fiscal policy framework. In particular, the UK must endeavour to avoid excessive deficits, though joining EMU would mean that sanctions could be imposed if budget deficits were judged to be excessive and the Government failed to take corrective action.

9 Inside EMU, the UK would be a member of the Eurogroup. This is an informal forum for discussion between euro area Economics and Finance Ministers designed to promote effective policy coordination.

10 EMU membership would not require material changes to the UK's arrangements to ensure financial stability.

Monetary policy: many similarities

11 There are many similarities between the monetary policy frameworks in the UK and the euro area. In particular:

- interest rate decisions are taken by an independent central bank with a statutory mandate to ensure price stability and, without prejudice to that, to support growth and employment;
- both frameworks incorporate a substantial degree of transparency in the form of publishing analysis and providing data;
- both command a high degree of credibility in terms of conditioning private sector expectations that inflation objectives will be met; and
- the monetary authorities have been able to play a role in stabilising the economy during the recent downturn.

… though some differences

12 There are, however, some key differences:

- in the euro area, the ECB defines price stability, while in the UK the Government does;
- unlike the Bank of England's Monetary Policy Committee (MPC), the ECB does not have an explicitly symmetric inflation target;
- the ECB assigns a formal, more prominent role to monetary growth figures;
- the ECB does not publish the minutes of meetings or a record of the voting patterns of its Governing Council;
- there are fewer formal mechanisms to hold the ECB to account; and
- the composition of the decision-making bodies is different, especially in terms of size and regional make-up.

13 Both monetary frameworks are relatively new and the ECB itself is a new institution. The operation of monetary policy has to be seen as an evolving process. The Bank of England has instigated reviews of its monetary policy decision-making since the framework was established in 1997, while the ECB has taken steps to increase the clarity of its strategy and is currently reviewing its monetary policy strategy. The process of EU enlargement will also present significant challenges to the way the ECB operates. The EMU study by HM Treasury *The United States as a monetary union* shows how the US Federal Reserve has evolved over the last century.

Fiscal policy

14 Both the UK's fiscal framework and the EU's Stability and Growth Pact (SGP) are designed to ensure sound public finances, as a pre-requisite to achieving stable long-term economic growth. However, a comparison between the respective fiscal policy frameworks is not straightforward because of the different environments in which they operate: the UK framework is designed to ensure sound public finances just for the UK, while the EU framework is designed to ensure consistency between the overall objectives of a number of decentralised fiscal authorities, each with their own national frameworks.

UK fiscal framework

15 The UK fiscal framework is based on five key principles of fiscal management – transparency, stability, responsibility, fairness and efficiency – enshrined in the Code for Fiscal Stability. The Code requires the Government to set out the rules by which it intends to operate fiscal policy. These are:

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

16 By providing a legislative basis for the way in which fiscal policy is determined in the UK, the Code is the bedrock of the credibility of the UK fiscal framework. Setting the rules over the economic cycle allows for the necessary flexibility in the UK system, while accountability and legitimacy is achieved through the mechanisms in place for regular reporting to Parliament, especially the Treasury Select Committee, and the public.

EU fiscal framework

17 The EU fiscal policy framework generally applies to all Member States, though there are certain provisions that apply only to countries participating in EMU. The EU fiscal policy framework operates at three levels:

- the Excessive Deficit Procedure (EDP) agreed as part of the EC Treaty;
- the SGP set down in a Council Resolution and two Council Regulations; and
- the Code of Conduct which contains agreed guidelines for the interpretation of the SGP.

18 Together these elements set out rules and mechanisms for achieving effective coordination between fiscal authorities and for ensuring sound public finances across the EU. Crucially, the framework is intergovernmental which is the basis of its legitimacy. Like the UK framework, the EU framework represents a significant step forward in recognising the importance of long-term budgetary discipline and a number of important measures have been instituted to improve the surveillance of policies and to encourage a longer-term approach to fiscal planning.

19 The EU fiscal framework was successful in encouraging fiscal consolidation from the mid 1990s, spurred by the conditions for EMU entry. However, in more recent times budgetary consolidation has stalled or gone into reverse, a particular problem in light of population ageing. This, together with the challenges posed by EU enlargement, has prompted debate about how the current framework can best be improved and its credibility maintained.

Policy coordination

20 In principle, policy coordination can bring substantial gains, helping to produce an optimal policy mix and supporting overall economic stabilisation.

Fairly straightforward in the UK …

21 Policy coordination in the current UK system is fairly straightforward. There is a single monetary authority and one main fiscal authority which have complementary objectives, both set by the Government. Policy coordination is assisted by high levels of information sharing between the two authorities.

… but more complex in the euro area

22 The situation is necessarily more complex in the euro area, where there is a single monetary authority but multiple fiscal authorities. This means that there is a need not only for coordination between the monetary and fiscal authorities but also between the individual fiscal authorities. Effective coordination between the fiscal authorities is an important precursor to effective coordination between the fiscal and monetary authorities – individually each fiscal authority will have only a limited impact on the ECB's decision making, but collectively they can have a large effect.

23 There are no mechanisms for formal coordination in the euro area; rather, an intergovernmental approach forms the basis for policy coordination and economic governance in EMU, and there are several mechanisms for information-sharing between the relevant authorities. The UK Government strongly supports the intergovernmental approach, although it is not clear that the information-sharing mechanisms are currently used to their full potential.

Financial stability

24 Arrangements for ensuring financial stability are an important component of the macroeconomic policy framework. The key goal of the UK's financial stability arrangements is to prevent the emergence of a systemic crisis that could threaten the stability of the financial system and therefore the entire economy. The UK has established clear responsibilities for the three public authorities with roles in this field – HM Treasury, the Bank of England and the Financial Services Authority – with a clear structure for coordination between them. Arrangements are in place for undertaking lender of last resort operations.

25 There is no EU or EMU level responsibility for financial supervision, which remains the preserve of individual countries. The UK Government, like many others, believes that lender of last resort operations remain a national responsibility for euro area members. While steps have recently been taken to clarify the position of how official support operations would function in practice, a clearer assertion of the position would be helpful to avoid a lack of clarity which could hamper the response to a crisis.

Conclusions

26 The broad parameters of the policy frameworks of the UK and the euro area have a number of similarities. In both frameworks, monetary policy is primarily directed at achieving price stability and the interest rate decisions of both the Bank of England and the ECB are independent from direct political control. Similarly, in both frameworks fiscal policy is primarily aimed at ensuring the sustainability of government finances.

27 There are also some key differences, some but not all of which reflect the different environments in which the frameworks operate. But both frameworks are relatively young and both continue to evolve. Since it took control of euro area monetary policy, the ECB has made several changes, including the biennial publication of staff macroeconomic projections and moving to monthly rather than fortnightly decisions on interest rates. This evolution continues. The ECB is currently reviewing its monetary policy strategy and is also considering the challenges to effective decision-making posed by EU enlargement.

28 On fiscal policy, too, there have been developments in the overall framework since it was first agreed in 1992. In 1997, Member States agreed the SGP and in 2001 they agreed a new Code of Conduct setting out guidelines for the interpretation of the SGP. Debate has continued on how best the fiscal policy framework can evolve to deal with new challenges, such as the global economic downturn and EU enlargement, without harming its credibility. Member States have recently agreed on the need for further development of the interpretation of the SGP, including to take more account of the effects of the economic cycle and the need to avoid pro-cyclical policies, the importance of the long-term sustainability of the public finances (including through a strategy to meet the challenges of ageing) and taking full account of the role of debt and paying greater attention to the quality of public finances.

29 The UK Government plays a full part in discussing these issues with its EU partners and will continue to play an active role in the debate, inside or outside of EMU, reflecting its commitment to a well-functioning single currency. The Government's approach in these and any other discussions will continue to be underpinned by its aim to secure robust policy frameworks which achieve the objectives of credibility, flexibility and legitimacy.

1 INTRODUCTION

Relevance of the study

1.1 This study examines the robustness of the frameworks for macroeconomic policy in both the UK and the euro area, and the implications for the UK in achieving the goal of macroeconomic stability in or out of Economic and Monetary Union (EMU). Long-term economic stability helps businesses, individuals and the Government to plan effectively for the long term, improves the quality and quantity of investment in physical and human capital and helps to raise productivity. It is therefore of central importance in delivering the Government's objective of high and stable levels of growth and employment.

1.2 In the context of possible UK membership of EMU, this study addresses three key questions relating to macroeconomic policy frameworks in the euro area:

- how does the macroeconomic policy framework operate in EMU?
- how would the UK policy framework have to change if the UK were to decide to join EMU?
- overall, does the euro area policy framework display the robustness required to maintain credibility, flexibility and legitimacy over time?

The 1997 assessment

1.3 HM Treasury's October 1997 assessment of the five economic tests did not examine the issue of policy frameworks. This was for two reasons:

- first, the changes to the UK's macroeconomic policy framework initiated in 1997 had not been in place for long enough to evaluate their effectiveness; and
- second, EMU was not yet underway, so it was unclear how the euro area policy framework would operate in practice. While the framework is still relatively new, there is now sufficient evidence to enable an analysis and assessment.

What is a policy framework?

1.4 In order to provide a comprehensive analysis of what EMU membership might mean for UK macroeconomic policymaking, this study considers the overall frameworks for policy and not just the decision-making structures.

1.5 The term 'policy framework' is used in this study to include the objectives of policy and the principles underlying them, the assignment of instruments to objectives, the institutional arrangements, the operating procedures and the policy decisions taken.

Why policy frameworks are important

1.6 Policy frameworks matter because the ways in which policy decisions are taken on taxation, public spending, interest rates and financial regulation have a major impact on how effectively the economy functions and therefore on the prosperity of a country. For example, the macroeconomic framework which the UK Government has introduced since 1997 has produced real benefits, in the form of low and stable inflation and sound public finances. Previous economic failings often reflected inappropriate policy objectives (for example, exchange rate targets for monetary policy) or inappropriate decision-making procedures (for example, taking decisions on interest rates without clear objectives or accountability, or a sufficient focus on the long term).

Three pillars of the macroeconomic framework

1.7 The reforms to the UK macroeconomic framework made since 1997 have been built on three pillars:[1]

- first, a **monetary policy** framework with an independent Monetary Policy Committee (MPC) 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, clear and prudent fiscal principles and better planned public spending; and
- third, new institutions such as the Financial Services Authority (FSA) to ensure **financial stability**, through transparency, responsibility and clear lines of accountability.

1.8 In the context of the EMU decision, a fourth pillar is relevant, relating to the mechanisms governing **coordination between the policymaking institutions**. In the UK, the Government has established a clear framework for coordination between the monetary and fiscal authorities. This study therefore examines the frameworks for, and approaches to, monetary policy, fiscal policy, monetary and fiscal policy coordination and financial stability, both in the UK and the euro area.

The relevant comparison

1.9 However, a simple comparison between the UK and the euro area policy frameworks would not be appropriate because:

- the relevant comparison involves anticipating the situation which would prevail with the UK inside EMU; and
- it is important to recognise that the euro area policy framework is operating in a different environment from that of the UK.

UK's needs might change in EMU

1.10 In the context of the EMU decision, consideration needs to be made of how the UK's macroeconomic policy needs might change if it were to join EMU. In particular, without an independent monetary policy, there could be a need for fiscal policy to play a greater stabilisation role at the national level. This is discussed in the EMU study by HM Treasury *Fiscal stabilisation and EMU*.

Different environments…

1.11 It is also necessary to acknowledge that the euro area policy framework has to be different in construction to the UK policy framework, and the UK would have to recognise this were it to decide to join. EMU membership carries with it both rights and responsibilities, which need to be taken into account.

…and different remits

1.12 A straight comparison would also be inappropriate because of the different remit for policy in certain areas. For instance, the euro area's fiscal policy rules are designed to impose limits on the operation of fiscal policy in individual countries to facilitate the operation of EMU, not to provide comprehensive rules. They should therefore focus on specific areas that could be more difficult in a monetary union. This is examined in more detail in Section 4.

[1] See the Chancellor of the Exchequer's foreword to Balls and O'Donnell (2002).

The analytical approach

Robustness: credibility, flexibility and legitimacy...

I.13 The study aims to assess the **robustness** of the macroeconomic policy frameworks. A robust framework will achieve three key objectives: credibility, flexibility and legitimacy:

- **credibility** means that a policy framework commands trust;
- **flexibility** means that the framework allows policy to react sensibly to unanticipated shocks, without harming credibility;
- while **legitimacy** means there is entrenched public support for the framework.

...through constrained discretion

I.14 These objectives can be achieved through the principle of **'constrained discretion'**,[2] that is, long-term stability requires an overall framework which constrains macroeconomic policy to achieve clear long-term and sustainable goals, but which allows 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. In this way the framework will have legitimacy at all points of the economic cycle.

I.15 In order to assess robustness against these key objectives, the study looks at the policy frameworks in the UK and the euro area from three perspectives:

- **looking backward** – assessing performance so far to draw lessons for how the frameworks might operate in the future. This is done through a comprehensive analysis of the evidence to date, relating performance to that in other countries and at other times;
- **looking at the present** – drawing on the academic literature to examine whether the current frameworks accord with the theory of how policy frameworks are best organised; and
- **looking forward** – considering how the frameworks are evolving and what they might look like in the future, particularly in the light of the imminent enlargement of the EU and the changes in economic circumstances that this might bring.

Moving target

I.16 Neither the UK nor the euro area policy frameworks are static. Both frameworks are still relatively young and both continue to evolve in response to changing circumstances and experience. This means that this study is trying to assess a moving target. It is for this reason that the study looks not only at the present and the past, but also considers what the frameworks might look like in the future.

Differences and similarities

I.17 A key issue is the changes to the UK framework that would result if the UK were to decide to join EMU. While there are a number of similarities between the UK and the euro area policy frameworks, as this study shows, the differences are analysed in greater detail because these are of most analytical importance in determining what impact UK membership of EMU would have on macroeconomic stability in the UK.

I.18 This study demonstrates how reforms since 1997, drawing on the lessons of previous decades, have created a much more robust macroeconomic policy framework in the UK. The enhancements to the UK framework, designed to achieve credibility, flexibility and legitimacy, have themselves weakened one of the possible arguments for EMU entry, namely to help deliver greater macroeconomic stability. The UK's macroeconomic framework now commands a high degree of credibility, as illustrated for example by the fact that UK inflation

[2] See HM Treasury (2002d).

expectations have rarely moved very far away from the $2^1/_2$ per cent inflation target since 1997. As Mélitz notes in his contribution to the EMU study *Submissions on EMU from leading academics "...since the Monetary Policy Committee acquired control over monetary policy, the quality of central bank performance has improved greatly".*

1.19 As set out in the EMU study by HM Treasury *The five tests framework*, the assessment of the case for UK membership of EMU is assessed against the counterfactual that the UK continues to operate with its current policy framework outside of EMU. This explains why this study focuses its analysis on the euro area policy framework and the differences that UK membership of EMU would imply compared with the current UK framework, rather than providing a detailed assessment and analysis of the UK framework itself. The latter has been set out in previous Treasury publications (see, for example, HM Treasury, 1998a, 1999a and 1999b).

1.20 The Chancellor noted in his evidence to the Treasury Select Committee in February 2003 that *"...there are two routes to stability for the modern British economy. One is through the Bank of England and the monetary and fiscal regime that we have set up, which is achieving a high degree of stability, and the other is through the European Central Bank arrangements which is also achieving a degree of stability in the euro area"*.[3] Looking forward, both frameworks face significant challenges in an uncertain global economy. They will need to be able to respond to a range of economic shocks and be robust enough to deal with changing domestic and external circumstances.

Outline of the study

1.21 The study is structured as follows:

- Section 2 sets out the key features, principles and objectives of the UK and the euro area policy frameworks, and describes the academic consensus on how macroeconomic policy should operate;
- Section 3 considers monetary policy. It describes the situation now and assesses the changes that joining EMU would mean for the UK framework;
- Section 4 examines fiscal policy, again describing the changes that EMU membership would involve and assessing the frameworks. The section also explains the motivation for euro area-wide fiscal rules;
- Section 5 considers the coordination of monetary and fiscal policies in the UK and the euro area;
- Section 6 discusses the arrangements for ensuring financial stability in the UK and the euro area, with a particular focus on official support operations; and
- Section 7 sets out the conclusions of the study.

[3] Evidence given by the Chancellor of the Exchequer and Treasury officials to the Treasury Select Committee on 27 February 2003. Available at http://www.parliament.uk/commons/selcom/treahome.htm.

2 Overview of Key Features, Principles and Objectives

Introduction

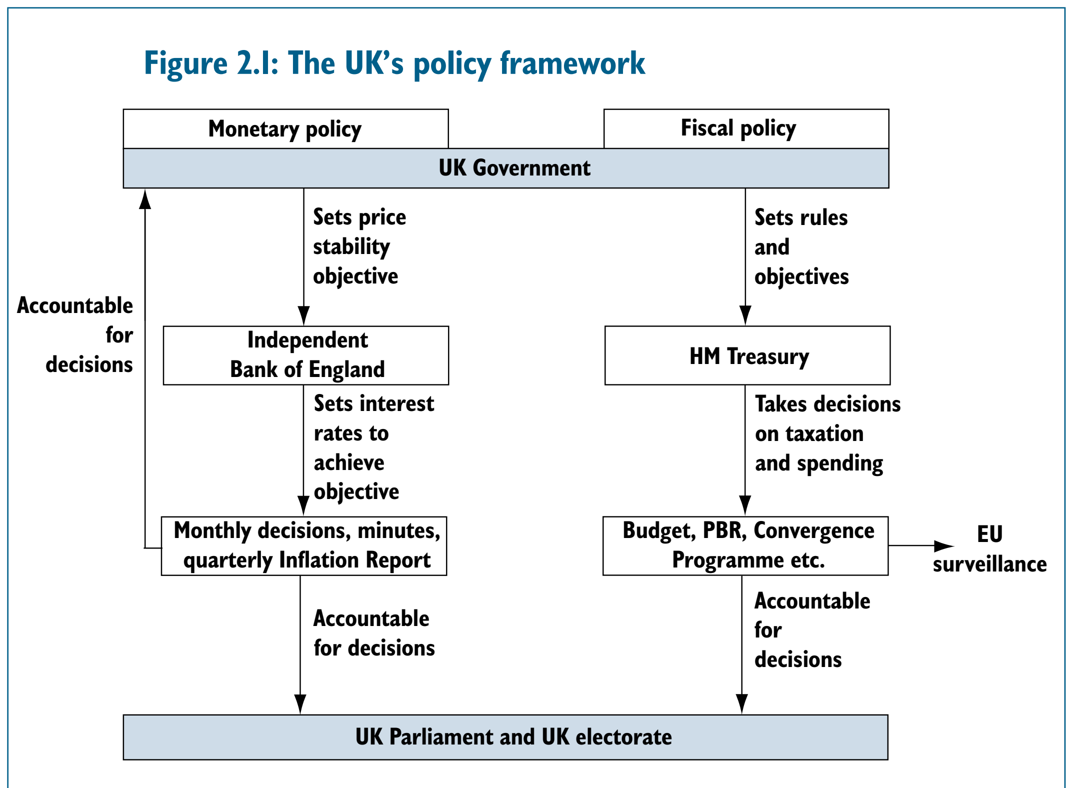
2.1 This section outlines the background which forms the basis for an assessment of the economic policy frameworks in the UK and the euro area. It discusses the key features of the current frameworks, looking at the UK first and then at the euro area. It goes on to consider the principles and objectives of macroeconomic policymaking, which provide the economic bounds within which any policy framework operates.

The main features of the current frameworks

The UK framework

2.2 Figure 2.1 provides a schematic overview of the current UK frameworks for monetary and fiscal policy.

Figure 2.1: The UK's policy framework



Monetary policy

2.3 The UK's monetary policy framework was introduced in 1997. The primary objective of monetary policy in the UK is to maintain price stability and, without prejudice to that, to support the Government's economic policy objectives, including for growth and employment. The Government sets the objectives for monetary policy, specifying a symmetric target for the rate of inflation.[1] The Monetary Policy Committee (MPC) of the Bank of England has full operational independence in setting interest rates to meet the Government's inflation target, which applies at all times. The voting record and minutes of the monthly MPC meetings are published and the MPC is accountable to the Government and to Parliament (via the Treasury Select Committee). Sterling's exchange rate against other currencies is left to float, though the likely effects of its movements on inflation are taken into account by the MPC in its decision making.

[1] In the Government's remit for the Monetary Policy Committee, confirmed once a year.

Fiscal policy

2.4 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. The objectives are implemented through the Government's fiscal rules, set over the economic cycle, and the operation of fiscal policy is also guided by the provisions of the Code for Fiscal Stability[2] and the Government's EU commitments. The Government is accountable to Parliament and the UK electorate for all key aspects of its conduct of fiscal policy.

Policy coordination

2.5 The UK's macroeconomic policy framework ensures that there is appropriate coordination between fiscal and monetary policy, primarily (but not solely) because the Government sets the objectives for both monetary and fiscal policy. Policy coordination is also promoted through the clarity and transparency of both arms of policy and the presence at MPC meetings of a (non-voting) Treasury representative who is able, in particular, to provide information on fiscal policy.

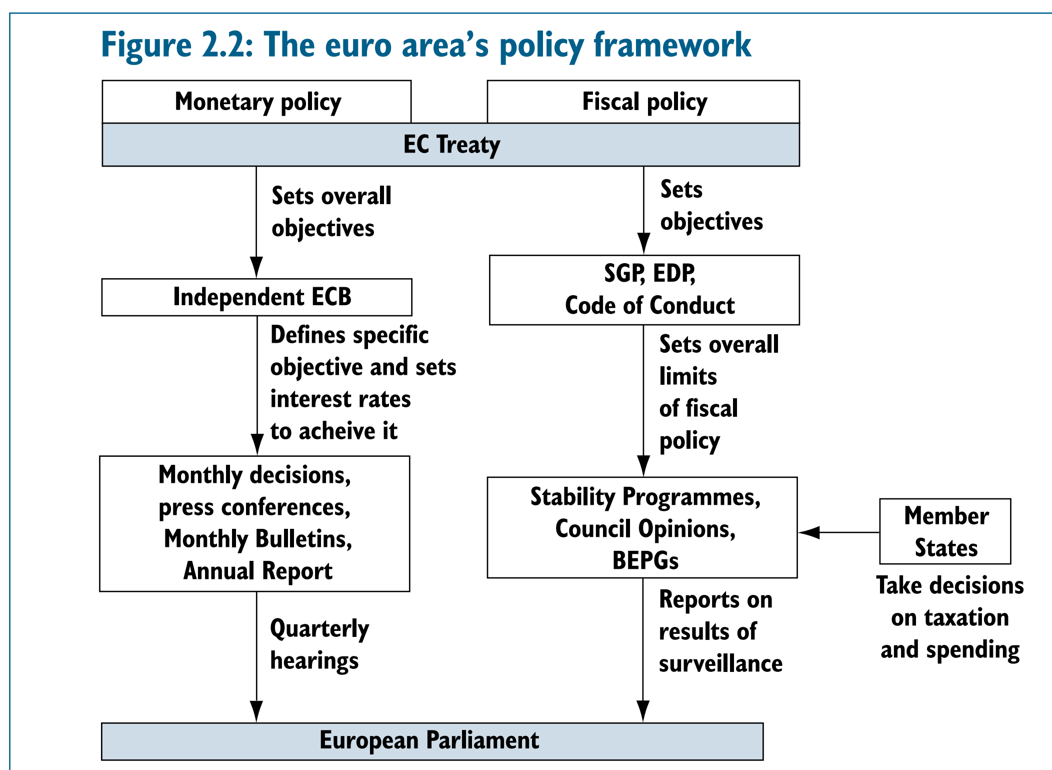
Financial stability

2.6 The Treasury, the Financial Services Authority (FSA) and the Bank of England have joint responsibility for ensuring financial stability in the UK. The division of responsibilities between the three institutions is set out clearly in the 1997 Memorandum of Understanding.[3]

The euro area framework

2.7 Figure 2.2 provides an overview of the euro area's current macroeconomic policy framework. As discussed in more detail later, a number of these aspects of the policy framework apply and operate at an EU, rather than specifically euro area, level. For example, all EU Member States commit to many of the requirements of the Stability and Growth Pact (SGP), whether they are members of EMU or not. The main elements of the policy framework were agreed by the Heads of State or Government of all EU Member States at the Maastricht Intergovernmental Conference in 1992 as part of the EC Treaty.

Figure 2.2: The euro area's policy framework



[2] Approved by Parliament on 9 December 1998.

[3] Available at http://www.hm-treasury.gov.uk.

Monetary policy

2.8 The euro area's monetary policy framework was introduced at the start of stage three of EMU. The primary objective of monetary policy in the euro area is, like in the UK, to maintain price stability and, without prejudice to that, to support the general economic policies in the Community. The broad objectives of the monetary policy of the European Central Bank (ECB), an independent institution established to implement the single monetary policy of the euro area, are set out in the EC Treaty. The Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute), also agreed by Heads of State or Government, provides detailed operating rules for the ECB. While the EC Treaty and ESCB Statute set out the primary objective of price stability, the ECB has the freedom to define what this means in practice. There is no nominal exchange rate between members of the euro area – all have a single currency – but the nominal euro exchange rate floats against the currencies of other countries.

Fiscal policy

2.9 In the EU the main objective for fiscal policy is to safeguard sound government finances as a means to strengthen the conditions for price stability and for strong sustainable growth conducive to employment creation.[4] Fiscal policymaking is decentralised in the EU, with no central determination of fiscal policy. Decisions on tax and public spending are a matter for national governments, in line with the EU principle of subsidiarity. But the EC Treaty, together with the Council Regulations that make up the SGP,[5] set overall limits for deficits and debt levels in all EU Member States. Members of the euro area have a legal commitment to avoid "*excessive*" deficits, as defined: if the Council of EU Economic and Finance Ministers (ECOFIN) judges the deficit of a euro area member to be excessive, and that member does not take action to rectify the excessive deficit, the Council can ultimately impose sanctions on the country concerned, but only if that deficit has not been caused by "*exceptional and temporary*" circumstances which have been defined in the SGP. Member States not participating in stage three of EMU are expected to "*endeavour*" to avoid excessive deficits and cannot be subject to sanctions.

2.10 As part of the fiscal policy process, the European Commission and ECOFIN monitor national fiscal policies and plans of all EU Member States. This surveillance feeds into the Broad Economic Policy Guidelines (BEPGs), agreed by ECOFIN each year, which include recommendations for the overall stance and direction of fiscal policy alongside a description of monetary policy and detailed ideas for reforming structural policies.[6] Within this process, the national fiscal authorities of each Member State have autonomy over fiscal policy – they set the specific objectives of policy and make policy decisions about the overall stance of fiscal policy and tax and spending policies.

Policy coordination

2.11 Within the euro area, coordination is needed not only between the fiscal and monetary authorities ('fiscal-monetary' coordination) but also between the various fiscal authorities of the members that make up the euro area ('fiscal-fiscal' coordination). This is a key difference with the UK, where a single main fiscal authority means there is a need only for fiscal-monetary coordination.

2.12 In the euro area, **fiscal-fiscal coordination** largely takes place within the framework of the Stability and Growth Pact (SGP), which allows for information-sharing and assessment of individual Member States' fiscal positions, for example in the Economic and Financial Committee (EFC)[7] and in the Eurogroup[8] and ECOFIN. There is no centralisation of fiscal policy in the EU, nor formal coordination in the euro area to achieve a desired overall euro area fiscal stance.

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[4] Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997. Available at http://www.europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htm.

[5] Council Regulation (EC) No 1466/97 and Council Regulation (EC) No 1467/97 of 7 July 1997. Available at http://www.europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htm.

[6] Though, as established by Article 269 of the Treaty, these recommendations are non-binding.

[7] The EFC is the main supporting committee to ECOFIN on macroeconomic policy. It was established under Article 114 of the EC Treaty, and its members are senior officials in the economics and finance ministries and national central banks of EU Member States and the European Commission and ECB. ECOFIN is also supported by the Economic Policy Committee (EPC), whose members are also senior officials in the economics and finance ministries and central banks of EU Member States, but which focuses more on structural issues.

[8] Eurogroup is an informal grouping of euro area Economics and Finance Ministers that is designed to aid policy coordination. Eurogroup can invite representatives from the Commission and the ECB to its meetings. Eurogroup is discussed in Section 5.

2.13 There are no formal mechanisms for **fiscal-monetary coordination** in the euro area, though information-sharing takes place through attendance at relevant meetings – the President of ECOFIN/Eurogroup may attend meetings of the ECB Governing Council (though without the right to vote) and the ECB President can be invited to attend ECOFIN when the Council is discussing matters relating to the ESCB. The ECB are members of the EFC and they attend Eurogroup. Regular publications are also a useful way of information-sharing between the relevant institutions, including the ECB's Monthly Bulletin and Member States' annual Stability Programmes.

Financial stability

2.14 Financial supervision and regulation are the responsibility of individual countries within the euro area, as are offical support operations. However, there are arrangements to promote co-operation between supervisors and regulators at an EU level, including new committees planned to facilitate co-operation between national banking, securities and insurance regulators, reporting to the new Financial Services Committee (FSC), a sub-committee of the EFC.

THE PRINCIPLES AND OBJECTIVES OF MACROECONOMIC POLICY

2.15 The remainder of this section surveys the theoretical debate as to how macroeconomic policy frameworks *should* operate. It also relates this theoretical debate back to the systems in place in the UK and the euro area.

Robustness

2.16 As already noted this study assesses the **robustness** of the policy frameworks in the UK and the euro area, where robustness is defined in terms of the objectives of credibility, flexibility and legitimacy, achieved through the principle of 'constrained discretion'. See Balls and O'Donnell (2002) for a discussion of constrained discretion.

Constrained discretion

2.17 Some policy frameworks allow policymakers to operate with **complete discretion:** taking each situation as it comes, and responding to the way that seems most appropriate at the time. But history suggests that such an approach is unlikely to build credibility. Policymakers find it hard to commit to resisting short-term pressures or shape expectations without a clear framework to guide them,[9] and the resulting uncertainty about future policy actions can lead to higher risk premia, complicating and undermining the task of building credibility.

2.18 Other macroeconomic frameworks forego discretion altogether in favour of **fixed rules**. By 'tying its hands' to a fixed rule, a government forces itself to commit to its long-term policy goal, but rigid rules-based frameworks can run into a number of difficulties:

- the relationships on which such rules are based tend to break down in the face of deregulation of financial and other markets, changing technology and widening consumer choice; and
- 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.[10]

[9] In part, this stems from the 'time-inconsistency' problem: policymakers 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 wages and prices accordingly. The end result is higher inflation, but without any gain even in the short term. See Kydland and Prescott (1977).

[10] See, for example, Drazen and Masson (1994).

2.19 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'**. In other words, long-term stability requires an overall principled framework which constrains macroeconomic policy to achieve clear long-term and sustainable goals, but which gives discretion to respond flexibly to shocks in a forward-looking setting.

2.20 As set out in Balls (2001), a framework based on the principle of 'constrained discretion' should allow three objectives to be achieved: credibility, flexibility and legitimacy.

Credibility

2.21 A **credible** framework is one in which the policymaker's commitment to long-term stability commands trust from the public, business and markets, and there is no expectation that the policymaker will 'veer off' the long-term course in response to short-term pressures. As Blinder (1999)[11] argued, credibility means people believe policymakers will do what they say.

2.22 Policy credibility will be enhanced, and therefore more effective, if the objectives of policy are clear and the way in which those objectives are to be pursued is clear. With a policy focus on sustainable long-term goals, governments are required to set realistic and appropriate long-term objectives for macroeconomic policy which are clearly defined, consistent with achieving stability, and against which performance can be judged.

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

2.24 One way to build up credibility is to establish a track record of delivering an objective consistently over time. But building up a track record takes time, and credibility might also be achieved by institutional arrangements and procedural rules, and through greater transparency, openness and clear accountability.

Flexibility

2.25 A robust framework will also provide sufficient short-term **flexibility** to allow policymakers to respond optimally to unforeseen shocks, and be able to adapt to changing economic conditions, without jeopardising the credibility of the long-term goals. If policymakers 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 – without long-term goals credibility may suffer in the face of short-term flexibility – but a framework which has credibility at one particular point in time could lose credibility in the longer term if it is unable to adapt. Achieving the right trade-off requires careful design.

Legitimacy

2.26 **Legitimacy** is also important. Policy frameworks exist in a vacuum if they don't garner enduring public and parliamentary support for their goals. This means there needs to be a consensus about goals and about institutions and methods, so that policymakers can take difficult decisions, when necessary, in the public interest without paying a heavy cost in terms of public support. Transparency and accountability of frameworks are key to ensuring democratic legitimacy.

Three objectives closely related

2.27 These three objectives are closely related. The ability of policymakers to respond flexibly and decisively to surprise economic events is critical for establishing a track record for delivering long-term stability without huge swings in inflation, output and unemployment. Insufficient flexibility to respond as economic circumstances change implies big swings in output and unemployment which can quickly undermine legitimacy as well as credibility.

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[11] Blinder was arguing this in the context of central banks, and said that "*A central bank is credible if people believe it will do what it says*" (page 4).

2.28 Without a credible framework which commands trust and a track record for making the right decisions, it is hard for policy to respond flexibly without immediately raising the suspicion that the policymaker is about to sacrifice long-term goals for stability in return for a short-term gain.

Monetary policy

2.29 The literature on monetary policy recognises these three objectives of policy frameworks, expressing them in terms of a distinction between the short term and the long term. Allsopp (2002a) and Wyplosz (2002) for example, suggest that, in the long term, monetary policy should ensure price stability[12] but that, in the short term, it can play a role in stabilising output without endangering the long-term objective. Indeed in many circumstances, the symmetric targeting of inflation will itself serve to stabilise output but not at the expense of employment.[13]

Fiscal policy

2.30 In fiscal policy, too, there is an emerging consensus based on a similar distinction between the short-term and medium to long-term roles of fiscal policy (Allsopp 2002a and Wyplosz 2002):

- in the medium to long term, fiscal policy should be set to ensure the sustainability of a government's fiscal position. It is particularly important to avoid the possibility of a situation in which the burden of financing government debt becomes unbearable, and debt moves on to an explosive path; but
- in the short term, fiscal policy should support monetary policy in stabilising output over the cycle, for example through the 'automatic stabilisers', the process by which spending tends to rise and tax revenues fall in a downturn and vice versa in an upturn.

2.31 Following Barro (1979),[14] some have doubted whether fiscal policy can smooth output, but the prevailing consensus is that it can, at least to some extent. This could be because there are a large number of people who do not smooth consumption because they are liquidity constrained or 'myopic'.[15] This is not the same as saying that governments should return to 'fine-tuning'; rather, that fiscal stabilisation has a potential role to play in smoothing the path of the economy, in particular through the 'automatic stabilisers' but also through carefully targeted discretionary fiscal policy. These issues are discussed further in the EMU study by HM Treasury *Fiscal stabilisation and EMU*.

Policy coordination

2.32 Taking monetary and fiscal policy together, it is now widely agreed that monetary policy should have primary responsibility for managing aggregate demand so as to maintain low inflation, with the primary objective of fiscal policy to maintain sound and equitable public finances over the medium to long term and seeking to improve underlying growth prospects, while recognising different circumstances in the UK and the euro area which may affect the emphasis put on each.

2.33 Sections 3 and 4 of the study look at the operation of monetary policy and fiscal policy in detail and assess how the UK and the euro area frameworks measure up against the objectives of credibility, flexibility and legitimacy.

[12] Greenspan (2002) describes this as meaning that there is *"an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms"*.

[13] See Alesina *et al.* (2001), who describe inflation-targeting as *an "employment-friendly strategy"*.

[14] Whose argument is based on the fact that forward-looking consumers discount tax changes understanding they will need to be paid for later.

[15] Mankiw (2000) provides an interesting model containing liquidity-constrained agents.

2.34 In any policy framework it is important that the relevant monetary and fiscal authorities have clarity over each others' reaction functions. This is common to both the UK and the euro area. The particular circumstances of EMU, in which there is a single monetary authority and currently 12 fiscal authorities makes achieving clarity over reaction functions more complicated. This is discussed in more detail in Section 5.

3 Monetary Policy

Were the UK to join EMU, it would adopt the euro area's monetary policy framework, with interest rates set by the ECB for the euro area as a whole, including the UK.

There are similarities between the monetary policy framework in the UK and the euro area. In particular:

- **interest rate decisions are taken by an independent central bank with a statutory mandate to ensure price stability and, without prejudice to that, to support growth and employment;**
- **both frameworks incorporate a substantial degree of transparency in the form of publishing analysis and providing data;**
- **both command a high degree of credibility in terms of conditioning private sector expectations that inflation objectives will be met; and**
- **unlike the outcomes seen with some previous frameworks, the monetary authorities have been able to play a role in stabilising the economy during the recent downturn.**

There are, however, some key differences:

- **in the euro area, the ECB defines price stability, while in the UK the Government does;**
- **unlike the MPC, the ECB does not have an explicitly symmetric inflation target;**
- **the ECB assigns a more prominent role to monetary growth figures;**
- **the ECB does not publish the minutes of meetings or a record of the voting patterns of its Governing Council;**
- **there are fewer formal mechanisms to hold the ECB to account; and**
- **the composition of the decision-making bodies is different, especially in terms of size and regional make-up.**

Both institutions, but especially the ECB, are relatively new. The operation of monetary policy has to be seen as an evolving process. The ECB, for example, is currently reviewing its monetary policy strategy. Moreover, the process of EU enlargement presents significant challenges to the way the ECB operates.

INTRODUCTION

3.1 This section considers the theoretical basis for the design of monetary policy, before describing the frameworks for the operation of monetary policy in the UK and the euro area. It then explains how EMU membership would change the UK system, focussing on an assessment of the two frameworks against the three objectives of credibility, flexibility and legitimacy. This highlights both the broad similarities between the frameworks and important differences.

Theoretical basis

3.2 Allsopp (2002a) identifies six features of the 'developing consensus' on the design of monetary policy:[1]

- there is no long-run trade-off between nominal developments and the real economy. That is, in the long run, an expansionary monetary policy will not increase output and employment;
- it is essential to establish a credible, non-accommodating policy to control the price level and inflation;

[1] See also Allsopp and Vines (2000).

- the primary responsibility for the control of inflation should be assigned to monetary policy;
- monetary policy should be conducted by an independent central bank;
- the principal instrument of policy is the short-term interest rate; and
- the central bank's long-term responsibility for controlling inflation should be carried out at minimum cost in terms of deviations of output from potential and deviations of inflation from target.

3.3 As Allsopp notes, the third, fourth and fifth of these propositions are more contentious than the others, and alternative arrangements have been adopted in the past. However, they are now widely accepted in the economic policy and central banking community.

3.4 Moreover, as is clear from the descriptions below, the current monetary policy frameworks in the UK and the euro area include all of these features. In both the UK and the euro area, an independent central bank is assigned the task of delivering price stability, principally through the policy instrument of the short-term interest rate. The sixth feature is expressed in the subsidiary objectives of both banks. The Bank of England Act 1998 charges the MPC with maintaining price stability and, subject to that, with supporting the economic policies of the Government, including for employment and growth.[2] The EC Treaty charges the ECB with maintaining price stability and, without prejudice to that, supporting the general economic policies of the European Community.[3]

KEY FEATURES OF THE FRAMEWORKS

The UK framework[4]

3.5 In May 1997, the UK Government announced the establishment of a new monetary policy framework for the UK, setting price stability as the primary objective of monetary policy and, without prejudice to that, a secondary objective to support the Government's economic policy objectives, including for growth and employment. Operational responsibility for meeting the Government's monetary policy objectives was transferred to the newly created Monetary Policy Committee (MPC) of the Bank of England.

3.6 The introduction of this new framework was a reaction to the UK's poor inflation record for most of the 30 years prior to 1997, reflecting numerous shortcomings in the design and conduct of UK monetary policy. These included inappropriate or unclear objectives, poor coordination with fiscal policy, ill-defined roles and responsibilities (creating the impression that policy decisions could be based on short-term political considerations) and a lack of transparency (which hindered accountability and meant that policymakers were unable to build credibility). The Government's new monetary policy framework was aimed at addressing these shortcomings.

3.7 On 12 June 1997, the Government published its remit for the MPC, in which it specified an inflation target and outlined the measures by which the MPC would be held to account for meeting the target. After operating on a de facto basis for 12 months, the new monetary policy framework was formalised by the Bank of England Act, which came into force in June 1998.

[2] Section 11 of the 1998 Bank of England Act. Available at http://www.hmso.gov.uk/acts/acts1998/19980011.htm.

[3] Article 105(1) of the EC Treaty.

[4] For more detail on the UK monetary policy framework, see HM Treasury (1999a).

3.8 Since May 1997, UK decisions on interest rates have been taken by the independent MPC, with the Bank of England operating in the money markets to effect the MPC's decisions. The MPC is chaired by the Governor of the Bank of England. Its eight other members comprise four officials from the Bank[5] and four independent external experts appointed by the Chancellor of the Exchequer for three-year terms.[6] The independent members must have relevant knowledge or experience. A representative of HM Treasury also attends MPC meetings, but cannot vote on decisions. These arrangements are set out in the Bank of England Act 1998.

Objectives

3.9 Section 11 of the 1998 Act sets the Bank of England the objectives of maintaining price stability, and, subject to that, supporting the economic policy of the Government, including its objectives for growth and employment. The Treasury defines price stability and specifies the Government's target inflation rate in the Government's remit for the MPC. The Act requires the Government to restate the remit at least once every year. This is typically done by the Chancellor in the Budget.

3.10 The UK framework has been set up to ensure that there is a clear separation of roles and responsibilities between the Government's role, creating and overseeing the monetary policy framework, and the Bank of England's task of implementing monetary policy so as to meet the Government's inflation target. Clear roles and responsibilities are necessary to ensure that each party understands, and is accountable for, exactly what it is required to achieve.

3.11 The current remit defines price stability in terms of a single, symmetric inflation target of 2½ per cent for the 12-month increase in the Retail Prices Index excluding mortgage interest payments (RPIX), which applies at all times. Importantly, this target is symmetric, so that deviations below the target are treated as seriously as deviations above. The symmetric target means that monetary policy is neither unnecessarily loose nor unnecessarily tight and, in effect, allows policy makers to aim for the highest level of growth and employment consistent with keeping inflation at the Government's target.

Strategy

3.12 If inflation deviates by more than one percentage point above or below target, the remit requires the Governor of the Bank of England to explain in an 'Open Letter' to the Chancellor:

- the reasons for the deviation;
- the action the MPC proposes to take;
- the expected duration of the deviation; and
- how this approach meets the Government's remit.

3.13 Importantly, the one percentage point thresholds *do not* define a target range. Their function is to define the points at which the Chancellor expects an explanatory letter because the actual inflation rate is appreciably away from its target. The system accepts that there could be circumstances where this is the best outcome.

3.14 The MPC takes into account all information it considers relevant to its monetary policy decisions. Broadly, these can be categorised into decisions on:

- money and asset prices;
- demand and output;
- the labour market;
- global economic conditions; and
- costs and prices.

[5] Its two Deputy Governors plus an official with executive responsibility within the Bank for monetary policy analysis and an official with executive responsibility within the Bank for monetary policy operations.

[6] The three-year terms are in principle renewable.

3.15 Prior to each meeting, Bank staff provide the MPC with reports and statistics on economic developments and key issues, and any other matters which the MPC might request. This permits a thorough assessment of the information relevant to the inflation outlook. The MPC is required to consider regional and sectoral issues and a network of regional agents report back on local business conditions and sectoral developments. In addition, the MPC may question the Treasury representative to the MPC at its meetings to ensure that it is well briefed on fiscal policy and other issues.

3.16 Each quarter, the MPC agrees its forecast for inflation over the coming period. The MPC sees a forward-looking assessment of inflation as very important, while making clear that there is no mechanical link between the inflation forecast and the setting of monetary policy.[7]

Decision-making procedures

3.17 The 1998 Act requires the MPC to meet at least once a month, and at any other time if summoned by the Governor.[8] The MPC generally meets on either the first or second Wednesday and Thursday of the month, announcing its decision on interest rates at noon on the second day. Six members (of whom two have to be either the Governor or Deputy Governors of the Bank) form a quorum.

Communication and accountability

3.18 The dates of MPC meetings are published well in advance. The MPC must publish minutes of its meetings within six weeks, although in practice it publishes them within two weeks of the meeting. In addition to the considerations leading to the decision, the minutes record the votes of each member (members are individually responsible for their decisions). The Committee is also required to publish a quarterly Inflation Report containing a review of its decisions, an assessment of developments in the economy, and in inflation in particular, along with a forecast for inflation and an indication of its expected approach to meeting its objectives.[9] Finally, the Governor must write an Open Letter to the Chancellor if inflation deviates by more than one percentage point, in either direction, from the inflation target.

3.19 The MPC is accountable to:

- the Government for the remit set (meeting the inflation target and supporting the Government's overall economic policy objectives);
- the Court of Directors of the Bank of England, which reviews the MPC's performance and procedures on an ongoing basis, with especial regard to the Bank's use of regional and sectoral information. The Court receives a monthly report from the MPC on its activities;[10]
- Parliament through regular reports and evidence given to the Treasury Select Committee;[11] and
- the public, via the institutions above and directly through the publication of the minutes of MPC meetings, the quarterly Inflation Report and an extensive programme of communication.

3.20 The MPC's interactions with its key stakeholders are represented schematically in Figure 3.1.

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[7] See, for example, Bank of England (2000). It is thus not the straightforward inflation forecast-targeting regime suggested by Svensson (1997).

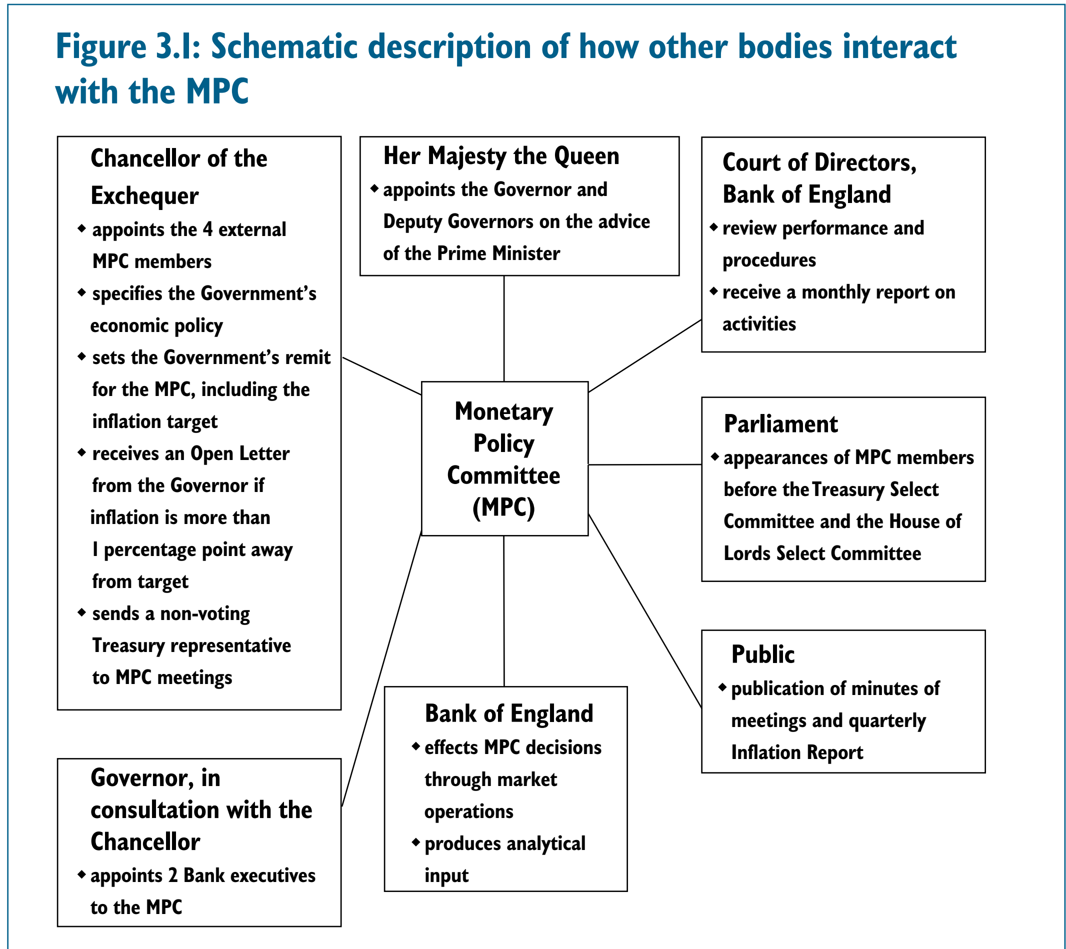
[8] An exceptional meeting was held after the terrorist attacks on the US of 11 September 2001.

[9] Inflation Reports are published in February, May, August and November each year.

[10] In addition, in October 2000, Donald Kohn of the US Federal Reserve, presented an in-depth report on the monetary policy process and monetary analysis in the Bank of England to the non-executive directors of the Court. See Kohn (2000).

[11] Which has at least two sessions a year dedicated to monetary policy, where Members of Parliament can question MPC members on their decisions and performance.

Figure 3.1: Schematic description of how other bodies interact with the MPC



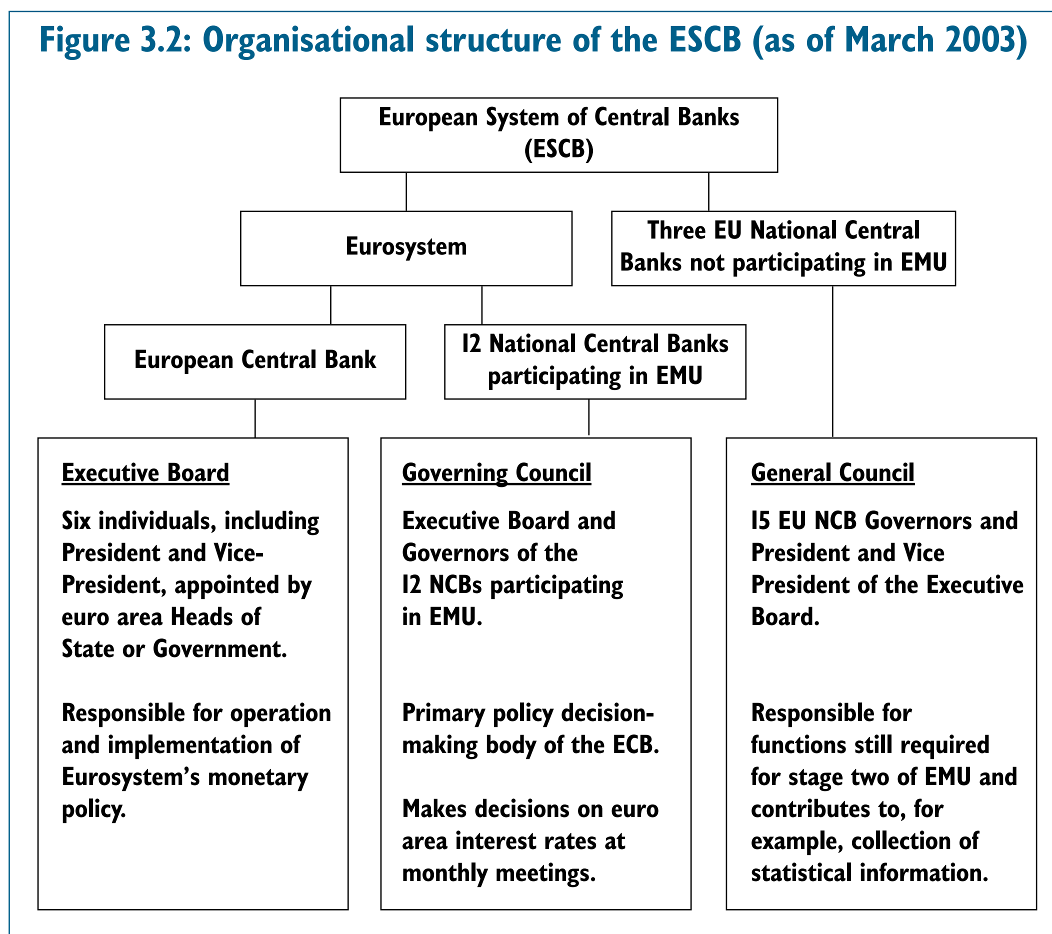
The euro area framework[12]

3.21 On 1 January 1999, at the start of stage three of EMU, the European Central Bank (ECB) assumed responsibility for the single monetary policy in the euro area. The EC Treaty sets out the overall framework for monetary policy in EMU, and gives it its legal basis. The Treaty gives responsibility for monetary policy to an independent central bank, the ECB, and like in the UK sets the achievement of price stability as the primary objective for monetary policy. Without prejudice to that, monetary policy should support the general economic policies in the Community.

3.22 The Treaty and the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute), a protocol attached to the Treaty, established the ECB and European System of Central Banks (ESCB) as from 1 June 1998.

3.23 Figure 3.2 shows the organisational structure of the ESCB and the Eurosystem. The ESCB comprises all EU National Central Banks (NCBs), while the Eurosystem comprises the NCBs of countries participating in EMU. The ESCB and the Eurosystem have no legal personality of their own. Their operation is governed by the decision-making bodies of the ECB: the Governing Council; the Executive Board; and, as long as there are Member States outside EMU, the General Council.

[12] More detail on the monetary framework for the euro area can be found in ECB (2001) and HM Treasury (2003a).



3.24 The Governing Council of the ECB makes the monetary policy decisions for the euro area. The Governing Council is made up of the six members of the Executive Board and the Governors of the NCBs of the countries participating in EMU. The six members of the Executive Board are appointed by Heads of State or Government for eight-year terms[13] from among persons of recognised standing and professional experience in monetary or banking matters (Article 112(2)(b) of the EC Treaty). The Executive Board includes the President and Vice-President of the ECB.

3.25 Under the EC Treaty, the ECB is independent from all other Community institutions. Article 108 states that no members of the Eurosystem *"shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body"*.

3.26 The ECB is thus entirely 'instrument independent'.[14] Like the Bank of England, it alone has the ability to change the level of its designated policy instrument, the ECB repo rate, in order to achieve its goals. However, although it is also free to set the precise definition of price stability, it is not completely goal independent, since it does not set the ultimate objectives of policy.

[13] The original members were given shorter terms, in order to stagger the times of their departures and therefore to ensure continuity.

[14] Adopting the distinction identified by Debelle and Fischer (1994).

Objectives **3.27** The ECB's overall objectives are outlined in the EC Treaty, which states (Article 105(1)) that:

> *"The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community..."*

3.28 As set out in ECB (1998), the ECB officially defines price stability as year-on-year inflation, as measured by the Harmonised Index of Consumer Prices (HICP), of below 2 per cent in the medium term. Box 3.1 discusses this definition in more detail. Many outside commentators have concluded on the basis of a range of evidence that the ECB's range is between 1 and 2 per cent on the HICP measure. Such a 'notional' inflation range may provide some idea of the ECB's approach to price stability in practice. Looking at outturns since January 1999 inflation has averaged 2 per cent in the euro area.

Box 3.1: The ECB's definition of price stability

The EC Treaty does not provide a quantitative definition of price stability, leaving the ECB to interpret this objective.[a] On 13 October 1998, the ECB announced its 'stability-oriented monetary policy strategy',[b] defining price stability as *"a year on year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 per cent"*. This definition of price stability is to be *"maintained over the medium term"*. There is no definition of a lower bound for prices, but the ECB has made clear that the wording 'year on year increase' implies that persistent price decreases (i.e., deflation) would not be consistent with price stability.[c]

The ECB has further noted that there could be a measurement bias in HICP inflation,[d] which, for example, does not fully take account of quality changes in the basket of goods included in the calculations. Although the ECB has never quantified the possible size of the measurement bias, ECB President Duisenberg has on occasion hinted that in practice the ECB attempts to keep inflation between 1 and 2 per cent: when appearing in front of the Economic and Monetary Committee of the European Parliament on 17 February 2003,[e] Duisenberg stated that, *"in practice, we are more inclined to act when inflation falls below 1 per cent and we are also inclined to act when inflation threatens to exceed 2 per cent in the medium term."* Gali (2001) has also argued that the ECB's reference value for M3 growth (discussed below) suggests an inflation target in the range 1-2 per cent.

[a] Forder (2002) is one of few to argue that no interpretation is needed.
[b] See ECB (1998).
[c] See ECB (2001), page 39. The possibility of a deflationary bias was a common fear at the euro's introduction (see Krugman, 1998), not least because some argued that the Bundesbank had a deflationary bias (see Collignon, 2001 and Clarida and Gertler, 1996).
[d] ECB (2001). This measurement bias is believed to be common in measures of price inflation – see Boskin *et al.* (1996) for the US, and ONS (1999) for the UK.
[e] Available at http://www.europarl.eu.int/comparl/econ/pdf/emu/speeches/20030217/fulltext.pdf.

Strategy

3.29 The ECB (1998) describe a 'two pillar' approach to achieving the price stability target, as follows:

- the **first pillar**: this assigns a prominent **role for money**, signalled by the announcement of a quantitative reference value for the annual growth rate of a broad monetary aggregate (M3) – currently set at 4½ per cent; and
- the **second pillar:** this is a broadly-based assessment of the **outlook for price developments** and the risks to price stability in the euro area as a whole.

3.30 The ECB Governing Council considers a range of indicators under these two pillars, including monetary aggregates (under the first pillar) and output gap measures, wage developments, exchange rates and equity prices (under the second pillar).[15] The ECB has also developed two macroeconometric models which are used to produce projections in alternate quarters, and some details of which were published in June 2001: the 'area wide model', in which behavioural relationships are estimated at the euro area level; and (in conjunction with NCBs) the multi-country model, the projections from which (so-called 'staff' projections) have been published every June and December since December 2000. The ECB have made clear that these projections play an important but limited role in the ECB's monetary policy making, not least because they are always based on specific assumptions (for example, about oil prices or exchange rates) which can change rapidly, making the projections outdated.

Decision making procedures

3.31 Although the Treaty requires only ten meetings per year, the ECB's Governing Council meets roughly every two weeks; since November 2001 decisions on interest rates have typically been taken only at the first meeting of each month. The Governing Council also has the option to convene meetings at other times if necessary.[16] Article 10 of the ESCB Statute provides for decisions to be taken by vote. Each member of the Governing Council has one vote, with the President having the casting vote in the event of a split decision. In practice, the Governing Council appears to prefer to take decisions by consensus.[17] The European Commission and the Eurogroup Presidency can send non-voting representatives to Governing Council meetings.

3.32 As with other central banks, decisions are taken on an area-wide basis. In its 1999 Annual Report the ECB stated that:

> *"The Eurosystem must act as a single unit and as a truly European body, which means that decisions always need to be taken from an area wide perspective. Monetary policy is one and indivisible; it cannot react to situations in individual countries or regions in the euro area."*

3.33 Thus, developments in individual countries should only influence the ECB's actions to the extent that they impact on the achievement of price stability across the euro area as a whole.

[15] See ECB (2001).

[16] It chose to convene an emergency Governing Council meeting for the first time after the terrorist attacks on the US of 11 September 2001.

[17] See, for example, ECB President Duisenberg's press conference remarks of 12 September 2002. Available at http://www.ecb.int.

Box 3.2: The effects of enlargement on the ECB's operating procedures

Under current institutional arrangements, the Governing Council of the ECB comprises six Executive Board members and the Governors of all countries participating in EMU. Were all of the accession countries to join EMU, together with the existing EU members who are not currently members of EMU, the size of the Governing Council could expand from 18 to as many as 33 (27 NCB Governors and the six members of the Executive Board).

The Treaty of Nice, ratified on 1 February 2003, paved the way for amendments to the operating procedures of the Governing Council in response to EU enlargement, through the addition of an 'enabling clause' to Article 10 of the ESCB Statute.

On 3 February 2003, the ECB (2003) made proposals for such amendments. These suggest a system of rotation of voting rights among the NCB Governors once they exceed a certain number; the Executive Board would retain permanent votes. Once EMU membership rises above 21 countries, the NCB Governors would be split into three groups, based on their share of euro area GDP (⅚ of the total weight) and the size of their financial sector (⅙ of the total weight). The first group would contain the five largest countries and share four votes; the second group would contain the next largest countries numbering half the total of EMU members (rounded up if necessary) and share eight votes; the third group would consist of the remaining countries and share three votes.

The ECB recommends that within each group NCB Governors would have voting rights for equal amounts of time. In a 27-member euro area,[a] this would give the NCB Governors in the first group a vote 80 per cent of the time, in the second group 57 per cent and in the third group 38 per cent.

As required by the Nice 'enabling clause', the Commission and the European Parliament have given their Opinion on the ECB Recommendation, though neither Opinion is binding. The European Commission (2003) suggest:

- **limiting the overall number of votes in the Governing Council below the ceiling set in the ECB's proposals, in the interests of further strengthening the speed and efficiency of decision-making;**
- **using shares of population in equal weight to GDP, rather than a measure of financial market activity, in determining country size;**
- **clarification over the frequency of sequencing of rotation within the groups;**
- **that decisions on rotation be taken and announced well in advance and in a transparent way; and**
- **that more comprehensive reforms, such as a 'monetary policy board', might need to be considered at some point but that these are not possible within the constraints of the Nice 'enabling clause'.**

The European Parliament (2003) has rejected the ECB proposals, calling for a solution to be adopted at the next Intergovernmental Conference, in which 'operational' decisions would be taken by a nine member Executive Board and 'strategic and general monetary policy' decisions would be taken by the full Governing Council acting on a double majority.[b]

At the 2003 Spring European Council, Heads of State or Government agreed the change unanimously. The proposed amendments must be ratified by all Member States, in accordance with their respective constitutional and parliamentary requirements, before entering into force.

[a] In a scenario where the 15 current EU Member States and the 12 accession countries listed in the Declaration on the enlargement of the EU (annexed to the Treaty of Nice) all participated in EMU.

[b] This would require both a majority of Member States based on population *and* a majority of Member States based on GDP and some measure of their financial sector.

Communication and accountability

3.34 The ECB has been granted a high degree of independence, but the Treaty establishes a set of minimum legal reporting requirements to explain the conduct of monetary policy. The ECB must publish quarterly reports on its activities, and address an annual report to the European Parliament, ECOFIN, the European Commission and the European Council on its activities in the previous and current year.

3.35 The ECB has chosen to go beyond these requirements in some respects, for example by holding a press conference with the President and Vice President after the first meeting of each month. The ECB also publishes monthly bulletins that explain interest rate decisions and discuss key data, and since December 2000 it has published the Eurosystem staff's macroeconomic projections twice a year. Parliamentary accountability is enhanced through quarterly appearances of the ECB President at public hearings of the European Parliament's Economic and Monetary Affairs Committee. The President reports on the ECB's monetary policy decisions and answers questions.

Enlargement and the ECB

3.36 Enlargement of the euro area, which is expected ultimately to follow EU enlargement, will have a substantial impact on the institutional set-up of the ECB, as discussed in Box 3.2.

3.37 Table 3.1 summarises the UK and euro area monetary policy frameworks. It shows that there are many similarities between them. But there are some important differences. These are analysed in detail below.

Table 3.1: Monetary policy frameworks compared

	European Central Bank	Bank of England
Objectives		
Objective	Price stability	Price stability
	Without prejudice to price stability, to support the general economic policies in the Community	Without prejudice to price stability, to support Government's economic policy objectives, including for growth and employment
Quantification of price stability objective	Inflation of less than 2 per cent over the medium term (HICP measure)	Symmetric inflation target, 2½ per cent at all times (RPIX measure)
Objectives set by	EC Treaty, quantification of primary objective by ECB	UK Government
Strategy		
Main policy instrument	ECB repo rate	Bank of England repo rate
Definition of monetary policy strategy	Twin pillar approach	Inflation targeting
Announcement of prominent indicators	Reference value for M3 growth	No specific indicators
Decisions / meeting procedures		
Number of members of decision-making body	18 (currently)	9 (fixed)
	President, Vice President, four members of Executive Board, 12 governors of NCBs participating in EMU	Governor, two deputy governors, two executive directors, four external experts appointed by the Chancellor
Voting procedures	One-person one-vote, with the President having the casting vote	One-person one-vote, with the Governor having the casting vote
External participants in monetary decision meetings	President of ECOFIN and Commission member in non-voting capacities	HM Treasury representative in non-voting capacity
Communication		
Frequency of reports	Monthly bulletins and annual report	Quarterly and annual reports
Press Conferences	Monthly	Quarterly
Publication of minutes of meetings	No	Yes, after 2 weeks
Publication of individual votes	No	Yes, after 2 weeks
Publication of forecasts	Staff projections, twice a year	Bank forecasts, quarterly
Accountability		
Parliamentary oversight	Regular hearings in European Parliament	Regular hearings in UK Parliament
Can the fiscal authority instruct the central bank?	No	Yes, in extreme economic circumstances
How can central bank law be changed?	Treaty change, requiring unanimity of Heads of Government at IGC and subsequent ratification by Member States	Act of Parliament
Is there 'punishment' for poor performance?	No	No, though significant inflation deviations require an 'Open Letter'

COMPARISON OF THE FRAMEWORKS

How would EMU membership change the UK's framework?

3.38 UK membership of EMU would result in the UK adopting the euro area's monetary policy framework. Monetary policy would be determined by the ECB for the euro area as a whole, including the UK. The UK's official interest rate would be identical to the official interest rate in other euro area countries.

3.39 More specifically the Bank of England would become a member of the Eurosystem, and the Bank's Governor would have a seat on the Governing Council. But, as noted in Box 3.2, the precise voting arrangements will depend on decisions yet to be taken. The UK would also have a vote in the European Council on future appointments to the Executive Board, and a UK national would be eligible to become a member of the Board.[18]

3.40 At present, the UK is not subject to the ECB's interest rate decisions. If it were to join EMU, it would be. Comparing the way in which interest rate decisions are reached by the ECB to the way in which they are reached by the MPC is therefore important.

Basis for comparison

3.41 In making this assessment, the literature suggests five key criteria, based on the three objectives of credibility, flexibility and legitimacy introduced in Sections 1 and 2:[19]

- **sound objectives** – are the objectives of the frameworks economically sensible, in both the short term and the long term?
- **credibility** – do people believe it will do what it says and will stick to its long-term objectives?
- **flexibility** – does policy have the flexibility to respond optimally to unanticipated events? Do the frameworks enable early and forward-looking action in the face of economic fluctuations?
- **transparency** – is the functioning of the frameworks transparent, aiding predictability and accountability?
- **accountability** – as Buiter (1999) puts it, *"Accountability is a good in itself, as well as an important instrument of quality control"* (page 7).

3.42 These criteria are used to assess first the similarities between the UK and the euro area monetary policy frameworks and then the differences.

Similarities in performance against criteria

Objectives

3.43 Table 3.1 highlights the many similarities between the monetary policy frameworks of the UK and the euro area. For example, in line with the consensus for monetary policy outlined at the start of this section, both have an overall policy objective to maintain price stability and, without prejudice to that, to support wider economic policies.

[18] Under Article 112(2)(b) of the Treaty, which currently does not apply to the UK. Of course, whatever their nationality, Governing Council members are expected to act with reference to the economic conditions of the euro area as a whole.

[19] Credibility and flexibility are closely linked and as well as looking at them in isolation, they can also be considered together, by examining whether the objectives of a policy framework are economically sensible for both the short term and long term. As noted in Section 2, transparency and accountability both contribute to legitimacy.

Credibility: two routes...

3.44 As noted in Section 2, broadly speaking, there are two approaches to ensuring the credibility of the monetary authority:[20]

- by building up a substantial track record of low inflation and stable output; or
- by quickly implementing reforms of institutions and processes which mean that private agents have little reason to doubt the intentions and competence of the policymaking body.

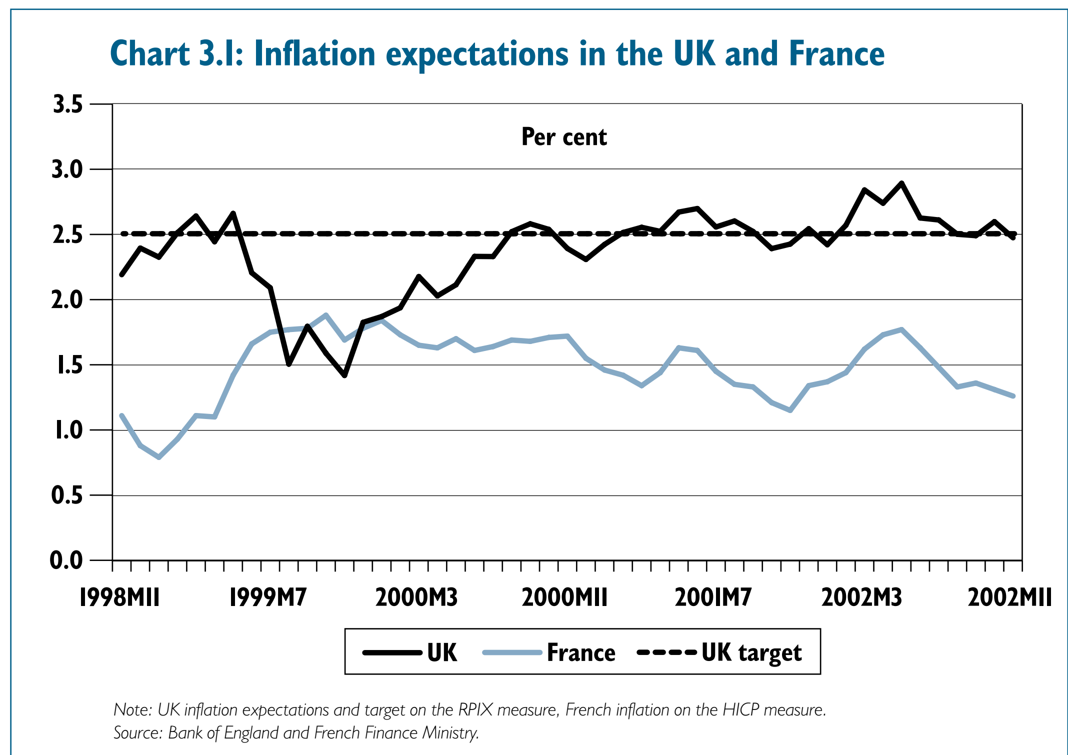
3.45 The ECB, following in the footsteps of Germany's highly successful Bundesbank and adopting some of its operating procedures, can be seen principally as pursuing the first route. In the UK's case, this route was not available in 1997,[21] and the second route was pursued instead.

...with the same destination

3.46 One way of measuring credibility is by looking at expectations of inflation by financial market participants. Though there are differences in the approaches taken, both the ECB and the Bank of England have been successful in building credibility on this measure. Inflation expectations can be measured by calculating so called 'break-even inflation rates', measuring the difference between yields on nominal and index-linked bonds. France has for some time been the only euro area country to issue 10-year index-linked bonds but it is a reasonable proxy as it is fairly representative of the euro area as a whole. Chart 3.1 shows inflation expectations in France and the UK.[22]

3.47 Inflation expectations in the UK have been firmly anchored around the $2\frac{1}{2}$ per cent inflation target in recent years. Expectations of inflation in France have typically been within a band of 1 to 2 per cent. This is consistent with the interpretation of some commentators that this range is the ECB's definition of price stability (see Box 3.1), and suggests that markets expect the bank to succeed in fulfilling its commitment to low inflation.

Chart 3.1: Inflation expectations in the UK and France



Note: UK inflation expectations and target on the RPIX measure, French inflation on the HICP measure.
Source: Bank of England and French Finance Ministry.

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[20] See Balls (2001).

[21] As argued in Barrell's contribution to the EMU study *Submissions on EMU from leading academics*.

[22] UK inflation expectations and target are based on the RPIX inflation measure, while French inflation expectations are on the HICP inflation measure. This explains much of the numerical difference between them. See Box 3.4.

3.48 In October 2001, the French Finance Ministry started to issue bonds linked to euro area-wide inflation, rather than to French inflation alone. Though there are as yet insufficient data from which to draw firm conclusions, the yields on these bonds provide some support for the above analysis; euro area inflation expectations have moved within a band of 1.7 to 2.2 per cent since first calculated in March 2002.[23] The slightly higher average inflation expectation suggests that investors expect euro area inflation to be close to 2 per cent over the medium term. This could imply that investors believe the ECB to have a central inflation target of 2 per cent, consistent with inflation outcomes over the last four years. But care should be taken not to read too much into such a limited data series.

Flexibility

3.49 The credibility of the two monetary policy frameworks provides them with a high degree of flexibility in response to shocks. Since the long-term nominal anchor is not in doubt, inflation may be allowed to vary in the short term if necessary to stabilise output. Such flexibility is particularly important if the trade-off between output and inflation is not so clear at low levels of inflation, as argued by Begg *et al.* (2002).[24]

3.50 In the UK framework, the 'Open Letter' system (see para 3.18) is designed to allow a flexible response, as Balls (2001) explains:

> *"Some have assumed it [the Open Letter system] exists for the Chancellor to discipline the MPC if inflation goes outside the target range. In fact, the opposite is true. In the face of a supply shock, such as a big jump in the oil price, which pushed inflation way off target, the MPC could only get inflation back to 2½ per cent quickly through a draconian interest rate response – at the expense of stability, growth and jobs. Any sensible monetary policymaker would want a more measured and stability orientated strategy to get inflation back to target. And it is the Open Letter system which both allows that more sensible approach to be explained by the MPC and allows the Chancellor publicly to endorse it."*

3.51 The euro area too has room for manoeuvre in this respect, particularly because its objective for inflation is designated as "2 per cent or less *over the medium-term*" (emphasis added). This medium-term emphasis can be seen as a recognition of the importance of maintaining low inflationary expectations, while providing the flexibility to respond to shocks. Issing *et al.* (2001) have stated that *"...a longer time horizon allows a more measured response to unforeseen shocks, thereby avoiding 'unnecessary' volatility in output, employment and interest rates"* (page 23).[25]

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[23] See http://www.francetresor.gouv.fr/oat/us/oatei_072012.html.

[24] See also Jaeger (2002).

[25] In a similar vein, Issing *et al.* (2001), page 68, where it is pointed out that the objective of price stability *"...do[es] not imply...that the ECB should completely disregard the consequences of its policy on output. On the contrary, exogenous shocks that create a trade-off between output and inflation developments should be met by measured, rather than aggressive, response, in order to avoid exacerbating the volatility of interest rates and output".*

Transparency **3.52** The Bank of England and the ECB also publish a great deal of information about their operation, such as the ECB's monthly bulletins and the Bank of England's quarterly Inflation Reports. These outline the latest economic developments as the banks see them, and provide some idea of their thinking. Both also publish annual reports, and members of both banks often make speeches at conferences and seminars. The banks have both published substantial information on how monetary policy works – see, for example, MPC (1999) on the monetary transmission mechanism, and ECB (2001) on the monetary policy strategy. Some differences in the degree of transparency remain, however, as discussed below.

Accountability **3.53** In terms of accountability, both the Bank of England and the ECB have shown themselves willing to explain their decisions to Parliament. ECB officials frequently appear before the Economic and Monetary Affairs Committee of the European Parliament, while MPC members appear before the Treasury Select Committee of the UK Parliament. There are, however, some differences in terms of other measures of accountability, discussed below.

Similarities in terms of outcomes

3.54 There are also similarities in terms of good performance on outcome measures,[26] assessed:

- by examining the variability of inflation and output over the periods of operation of the frameworks; and
- by estimating 'Taylor rules',[27] and comparing interest rate decisions to those that a Taylor rule would suggest.

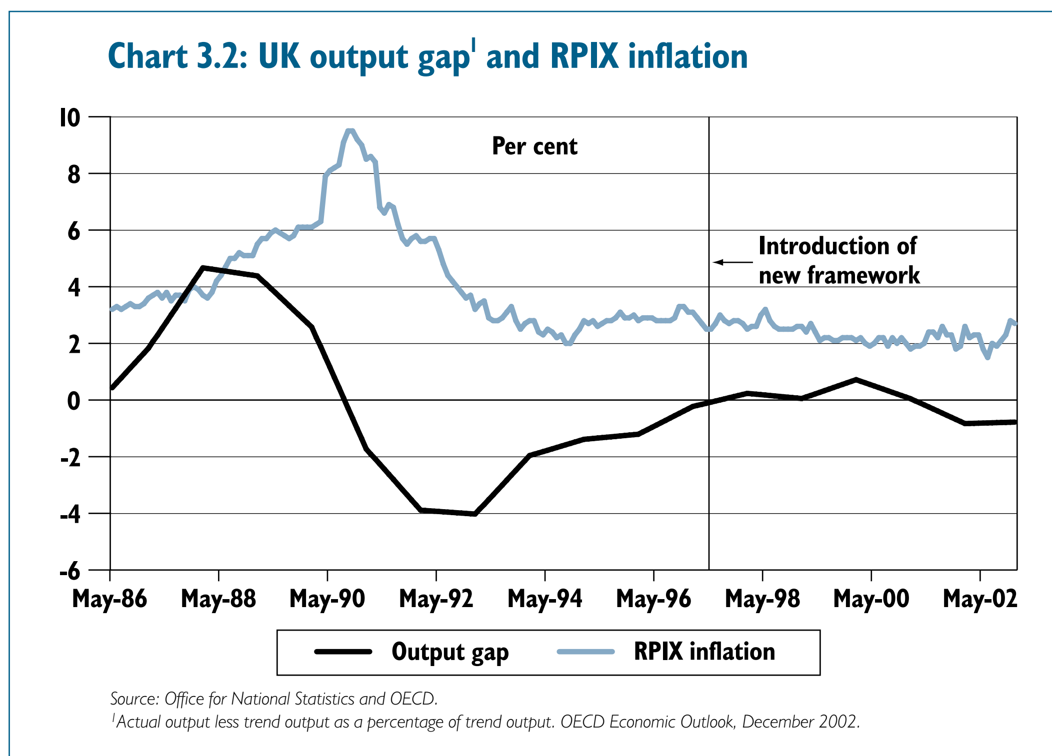
3.55 Both are imperfect measures – the former because inflation and output will be affected by many factors apart from monetary policy, such as supply and demand shocks (including policy shocks), the latter because a simple rule cannot hope to take into account all of the relevant information. The measures are also limited because of the short track records of the policy frameworks. Nonetheless, they can provide some ex post perspectives on the monetary policy decisions, and are commonly used by outside commentators.

The UK – low inflation, stable output... **3.56** Inflation and output have been relatively stable in the UK and the euro area in the past few years. An improvement in performance is particularly notable in the UK's case. Since the introduction of the new framework in 1997, output has been subject to far fewer damaging swings than in previous periods, and inflation has stayed close to the 2½ per cent target throughout (see Chart 3.2).

[26] Though one would never expect their performances to be identical, given the different shocks the economies have faced.

[27] Based on Taylor (1993).

Chart 3.2: UK output gap[1] and RPIX inflation



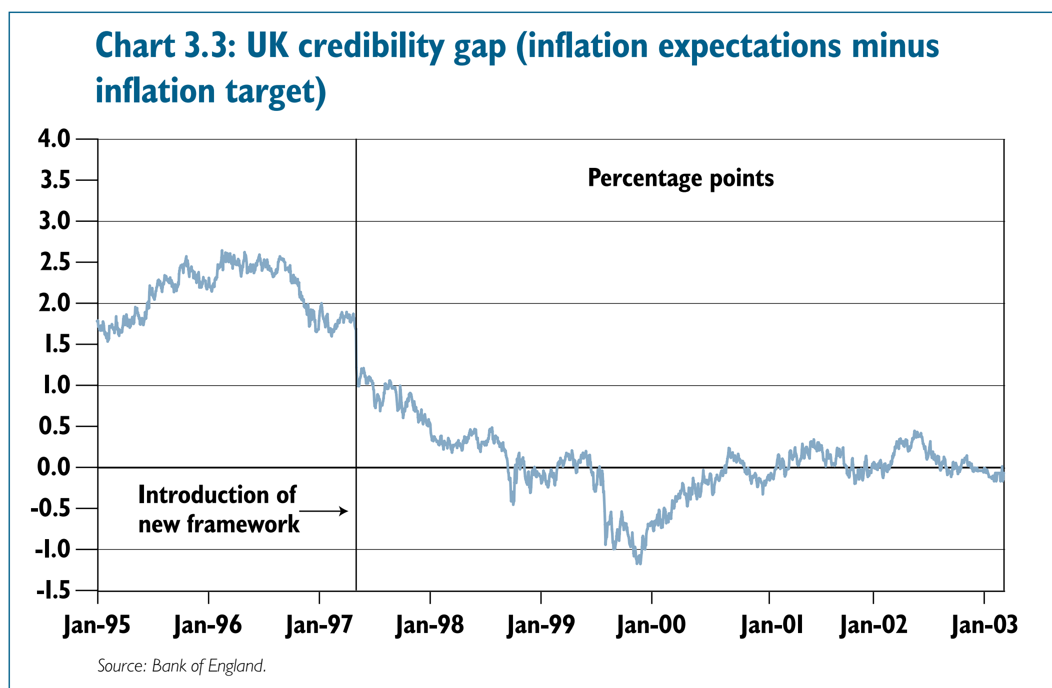
Source: Office for National Statistics and OECD.

[1]*Actual output less trend output as a percentage of trend output. OECD Economic Outlook, December 2002.*

... and high credibility

3.57 Moreover, in the UK, the 'credibility gap'[28] has fallen since the granting of operational independence to the Bank of England. While the inflation-targeting framework established in 1992[29] was successful in keeping inflation low, inflation expectations remained stubbornly high. The gap between expected inflation and the inflation target fell markedly following the introduction of the new monetary policy framework in May 1997, and has remained negligible since (see Chart 3.3).[30]

Chart 3.3: UK credibility gap (inflation expectations minus inflation target)



Source: Bank of England.

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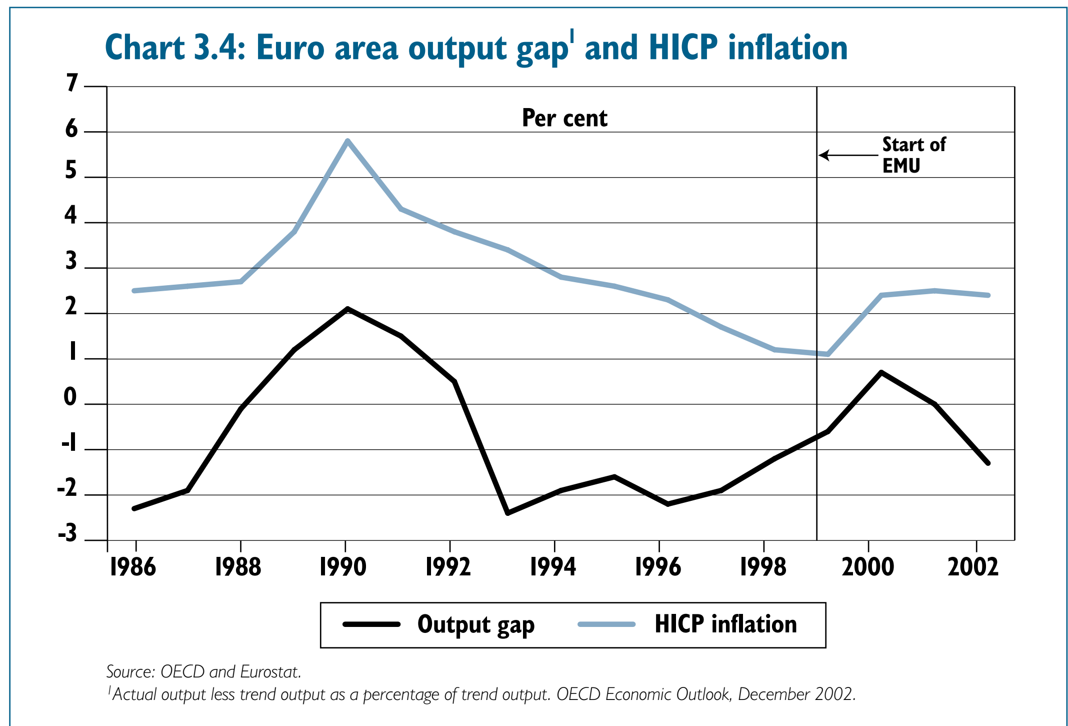
[28] That is, the gap between the inflation target and inflation expectations derived from asset prices.

[29] RPIX inflation was targeted directly in the UK for the first time from October 1992, following the departure of sterling from the Exchange Rate Mechanism (ERM) in September 1992. See HM Treasury (1999a).

[30] It is assumed that the UK was in effect targeting inflation of 2½ per cent in the period between June 1995 and May 1997, reflecting the then Government's announcement in June 1995 that a target of 2½ per cent or less was to apply.



Source: OECD and Eurostat.
[1]Actual output less trend output as a percentage of trend output. OECD Economic Outlook, December 2002.

The euro area

3.58 In the euro area, inflation and output have also been relatively stable in recent years, with output fluctuating less in the recent downturn than it did in the early 1990s (see Chart 3.4).

3.59 Inflation has, however, averaged the 2 per cent medium-term ceiling since the start of EMU.[31] This could reflect the difficulties of keeping inflation at such a low rate in a large and heterogeneous economic area. But it could also reflect many other factors.

Taylor rule analysis

3.60 Taylor rules can provide a cross-check of actual policy against what a simple rule based on the output gap and the deviation of inflation from target would suggest – they are explained in Box 3.3. In both the UK and the euro area, actual interest rates and rates implied by a simple Taylor rule have been similar (see Chart 3.5).[32] Perhaps most importantly, compared with some past policy regimes, the current frameworks for monetary policy have allowed monetary policy to perform a stabilising role – interest rates have gone up when demand and inflation were expected to be strong, and down when they were expected to be weak.

[31] In 28 of the 50 months between January 1999 and February 2003 inflation has been above 2 per cent.

[32] Other analyses reach similar conclusions – see, for example, Begg *et al.* (2002) and UBS Warburg (2002). In Chart 3.5, the euro area inflation target is assumed to be 1 1/2 per cent on the HICP measure; the UK inflation target is assumed to be 2 1/2 per cent on the RPIX measure; and the neutral real interest rate is assumed to be 2 per cent in the lower case and 3 per cent in the upper case, in both the UK and the euro area.

Box 3.3: Taylor rules – an exposition

Taylor (1993) argued that a simple policy rule based on inflation and output deviations provided a reasonable fit for US Federal Reserve interest rate decisions since 1986. Taylor (1999) has since claimed that these rules have desirable properties across a wide variety of possible models of the economy, and they have frequently been used as an ex post rule of thumb against which to assess whether interest rates have been set at roughly the right level.[a]

The Taylor rule assigns weights to the deviation of inflation from target and the deviation of output from potential (i.e., the output gap, which can be seen as a proxy for future inflationary pressure), and adds these to the neutral interest rate assumption (the inflation target added to the equilibrium real interest rate) to get the preferred nominal interest rate. Thus,

$$i = r + \pi^* + a(\pi - \pi^*) + b(y - y^*),$$

where *i* is the nominal interest rate, *r* is the neutral (equilibrium) real interest rate, π^* is the inflation target, $\pi - \pi^*$ is the deviation of actual inflation from target and $y - y^*$ is the output gap.

In the simplest formulations of the Taylor rule, which are used in this study, the weights on inflation and the output gap (*a* and *b*) are both 0.5. Bean (1998b) shows that varying these weights does not change the rule's proposed interest rates dramatically.[b] **If *a* and *b* are 0.5, inflation 0.5 percentage points below target, the output gap -0.5 per cent, the inflation target 2.5 per cent and the equilibrium real interest rate 2.5 per cent, then the Taylor rule suggests that the nominal interest rate should be 4.5 per cent.**

Of course, Taylor rules are *rules*, and illustrative ones at that, for the setting of interest rates based on a limited number of variables. Their estimates are typically different from the actual rates chosen by central banks, which use discretion to determine rates based on a wider range of information.

Taylor rules are therefore intrinsically limited.[c] **Most commentators think that, at best, such simple rules *"can have a useful complementary role alongside all the other information within a pragmatic approach to monetary policy"*.**[d] **For the purposes of this study, analysis in terms of Taylor rules is supplementary to other methods of analysis, not a substitute for them.**

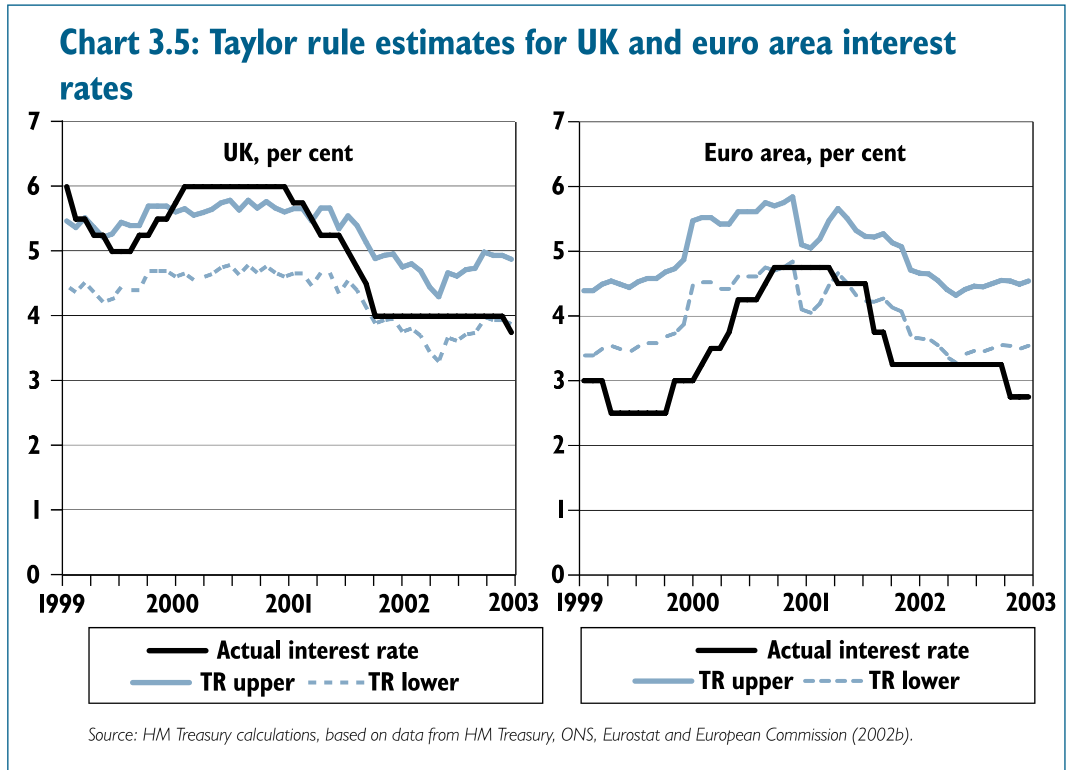
[a] Notably by the authors of the CEPR's Monitoring the European Central Bank series – see, for example, Alesina *et al*. (2001) and Begg *et al.* (2002). The convergence test, and the EMU study *The United States as a monetary union*, also use Taylor rule analysis.

[b] Other extensions include using core inflation rather than headline inflation and using forecasts for inflation and / or output. See, for example, European Commission (2001).

[c] Svensson (2002) provides a detailed critique.

[d] Stuart (1996), page 281.

Chart 3.5: Taylor rule estimates for UK and euro area interest rates



Source: HM Treasury calculations, based on data from HM Treasury, ONS, Eurostat and European Commission (2002b).

Comments by the IMF and OECD

3.61 The IMF and OECD have also been generally positive about the performance of both monetary policy frameworks:

- for example, the IMF (2003a) in their review of the UK economy, conclude that *"the inflation-targeting framework has performed impressively, as attested by low inflation expectations over the past five years"* (page 34);
- the OECD (2002) has noted for the UK that *"In the light of historical inflation volatility ... inflation can fairly be judged to have stayed remarkably close to target."* (page 37).
- the IMF (2002b) states that, over the past year, euro area *"monetary policy had responded appropriately to the changing risks to growth and price stability"* (page 7), in the face of a particularly challenging environment.

Differences

3.62 Notwithstanding the many similarities between the frameworks for monetary policy, there are also potentially significant differences.

Objectives: price range versus inflation targeting

Different objectives

3.63 One apparent difference between the frameworks is the specific level of their inflation objectives, with the euro area's 2 per cent medium-term ceiling appearing somewhat lower than the UK's 2½ per cent target. However, these objectives are based on different measures of inflation. Box 3.4 compares the RPIX and HICP measures of inflation.

Box 3.4: RPIX and HICP price indices[a]

The UK inflation target is formulated in terms of the UK Retail Prices Index excluding mortgage interest payments (RPIX), while the euro area objective is based on the euro area Harmonised Index of Consumer Prices (HICP). HICPs have been constructed for each EU country, including the UK, and they are designed to facilitate inflation comparisons between countries.

Both indices use the same raw price data, but there are a number of methodological and coverage differences:

- **different formulae: the HICP aggregates prices at the basic level by taking the geometric means of individual price quotes. RPIX uses arithmetic means;**
- **different product coverage: in particular, the HICP excludes several components of housing costs, such as housing depreciation, which together have a weight of around 7.5 per cent in the RPIX; and**
- **different household coverage: HICP expenditure weights are based on the purchasing patterns of all households and foreign visitors, while RPIX excludes the expenditure of both the richest households and those pensioner households that derive over three quarters of their income from state benefits.**

[a] See HM Treasury (1998b) for more details.

Target symmetry

3.64 Another difference between the frameworks is the extent to which the inflation level aimed for is explictly symmetric. In the UK, the symmetry of the inflation target makes clear that deviations below target are taken as seriously as those above, ensuring that monetary policy is neither unnecessarily loose nor unnecessarily tight. An asymmetric target could provide policymakers with an incentive to drive inflation as low as possible to ensure they met their target comfortably, even if this had detrimental consequences for output and employment. Moreover, it might not provide sufficient incentives for fiscal consolidation or structural reforms, as the government does not know that its actions will be met by an easing of monetary policy (see Section 5). As Pisani-Ferry (2002) puts it, the ECB "*has not acknowledged that it follows an inflation targeting strategy and that it is willing to counter potentially deflationary shocks with the same energy as inflationary ones.*" (page 10). However, as stated in Box 3.1, ECB President Duisenberg has recently suggested that the ECB would be as concerned about inflation below 1 per cent as about inflation above 2 per cent.

Credibility: intermediate targets

ECB's greater prominence for money

3.65 Unlike the UK, the euro area framework assigns a special role to monetary aggregates. In theory, therefore, monetary developments play a key part in ECB decision making.

3.66 Historically, the relationship between monetary growth and inflation has been rather unstable at times, especially in the face of financial deregulation, changing technology and widening consumer choice.[33] This would argue against giving a special role to monetary data. As Bean (1998a) puts it,

> *"Targeting the money supply as an intermediate indicator of monetary policy makes sense only if there is both a reasonably stable and predictable relationship between movements in the money supply and the final objective of monetary policy...and if the movements in the former lead movements in the latter"* (page 43).

[33] These were major problems during the UK's early 1980s attempts to target monetary aggregates.

3.67 That said, the ECB does not appear to follow monetary data dogmatically, but rather as a useful leading indicator, as indeed does the Bank of England. Chart 3.6 shows that the ECB has been prepared to raise interest rates when monetary growth has been below the $4^{1}/_{2}$ per cent reference value, and to cut them when it has been above it. Like the Bundesbank before it, the ECB has been willing to exceed the monetary reference value if it feels this to be appropriate for achieving its ultimate objectives.

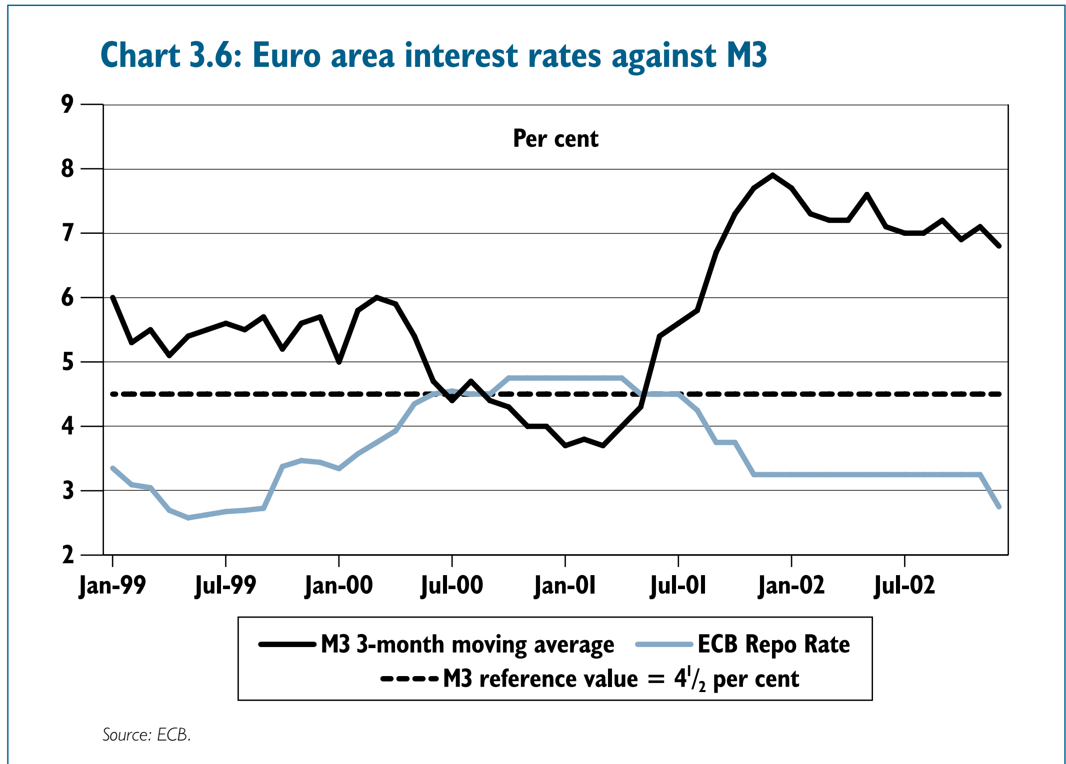


Chart 3.6: Euro area interest rates against M3

Source: ECB.

3.68 The ECB has been hampered in the information it has obtained from M3 by the increasingly erratic and volatile behaviour of the aggregate, with frequent statistical corrections. M3 has only been at or below the $4^{1}/_{2}$ per cent reference value for a total of less than 12 months over the entire period since January 1999.[34]

3.69 In the particular circumstances of the ECB's foundation, assigning a special role for monetary growth had two particular justifications:

- it may have helped the ECB to inherit some of the Bundesbank's credibility, as the Bundesbank also gave a prominent position to monetary targets; and
- in the early days of EMU, when aggregate euro area indicators were still relatively new, it was thought that M3 data might in theory provide more reliable information than output or inflation estimates.

3.70 Overall, the ECB appears to take a pragmatic approach to monetary growth in its actual decision making, suggesting that the role officially assigned to it in the framework is unlikely to make a substantial difference to outcomes. But it could make more of a difference in terms of effectively communicating the ECB's strategy to the outside world, potentially harming transparency and clarity. Gali (2001) observes that: "*The coexistence of two pillars, yielding potentially conflicting signals, can only introduce noise to the monetary policy process, making the communication of policy decisions less transparent, and leading to confusion among the public.*"[35] And Begg *et al.* (2002) are much more critical, as discussed later.

[34] See Gros (2001).

[35] See also Alesina *et al.* (2001), who state that "*There are respected ECB watchers who believe that the ECB is a 'monetary growth-rate targeter' and who speculate that everything else is actually of minor importance in setting its policy. It would be good communication for the ECB to put a decisive end to these views*" (page 48).

Credibility: composition of decision-making bodies

Getting the right people to do the job

3.71 Using a broad definition of credibility, as advocated by Allsopp (2002a), it is important to consider whether those entrusted with making policy decisions can be expected to do the job well.[36] Differences between the UK and the euro area monetary policy frameworks are considered in terms of the size and regional make-up of the decision-making body.

Size of decision-making body

3.72 The Governing Council of the ECB currently has 18 members while the MPC has nine.[37] It has been argued that this difference in size could affect the decisions reached, particularly because of the ECB's expressed preference for a consensual style. For instance, Giavazzi (2003) feels that "*Today's council of 18 members is already too large. It therefore has a bias towards the status quo – interest rates are sometimes kept unchanged simply because it proves difficult to gather consensus in favour of change*".[38] As noted in Box 3.2, the ECB's proposals for the Governing Council's composition post-enlargement envisage a maximum of 21 voting members.

Regional make-up

3.73 Perhaps of more relevance in a body made up of representatives from a number of different 'constituencies' is the risk of regional biases entering decision making. Set against a six-member Executive Board, the current 12 NCB representatives represent a majority. Though the Treaty (Article 108) precludes Governing Council members acting in the interests of their country alone, rather than the euro area as a whole, this might not prevent some regional bias creeping into decisions or the perception that it has. In this respect, the composition of the ECB compares unfavourably with other central banks' decision-making bodies: the US Federal Reserve has five voting regional representatives,[39] compared with seven central Governors; while of the 17 members that previously decided Bundesbank rates, nine were Länder heads, compared with eight permanent directors.

A potential problem...

3.74 If NCB Governors vote with regard to national, rather than euro area, interests, the area's smaller countries would possess more weight in decision-making than their share of GDP would suggest is sensible. More generally, voting on the basis of national interests could lead to sub-optimal outcomes for the euro area as a whole because of different shocks, monetary transmission mechanisms or national preferences over, for example, the trade-off between inflation and output.[40]

3.75 Of course, with the minutes of Governing Council meetings unpublished, it is difficult to discern whether the regional composition of the Governing Council has had an impact on decision making. Evidence from the US Federal Reserve suggests that regional bias could be an issue there.[41]

[36] This definition is broader than that used in most of the literature following Barro and Gordon (1983), which sees credibility principally in terms of not having an incentive to produce surprise inflation in order to manufacture a temporary increase in output.

[37] The MPC's size is somewhat closer to the international average; for example, the US Federal Reserve has 12 voting members, the Swedish Riksbank 6, the Bank of Canada 6 and the Reserve Bank Board of Australia 9.

[38] See also Buiter (1999), Fitoussi and Creel (2002).

[39] The seven other regional representatives also attend meetings of the Federal Open Market Committee. The New York Fed representative always votes; the remaining four votes rotate amongst the other 11 regions.

[40] See Bean (1998a) and De Grauwe (2002c).

[41] Meade and Sheets (2002).

...worsened by enlargement

3.76 De Grauwe (2002c) argues that regional bias could become a greater problem following the enlargement of the EU. Since the accession countries are generally smaller than existing euro area members, any problem of small country bias could be exacerbated. Moreover, the Balassa-Samuelson effect[42] means that the new members could be expected to have higher equilibrium inflation rates than the euro area average, which could result in a bias towards a tighter monetary policy than would be suggested by conditions in the area as a whole. However, the ECB's proposals for reform of the Governing Council's composition post-enlargement could be expected to mitigate this problem (see Box 3.2).

3.77 Notwithstanding these possible problems, in terms of inflation outcomes the Governing Council's actual decisions are generally agreed to have been good on the whole (see OECD 2001, and IMF, 2002b), suggesting that effective decisions can still be made at its relatively large size, and with its high degree of regional representation.

Transparency

3.78 Commentators have raised three particular issues of transparency of monetary frameworks:

- clarity of objectives;
- publication of minutes of meetings; and
- clarity of communication.

Clarity of objectives

3.79 Commentators have raised questions about the clarity of the ECB's objective, arguing that it may be that the ECB in practice targets inflation in a range of 1 to 2 per cent, and treats deviations below the range as seriously as deviations above it. But since this is not explicit, it is difficult for fiscal policymakers and market participants to assess.[43]

3.80 Questions have also been raised about the definition of 'the medium term' – the time period over which the ECB aims to deliver inflation below 2 per cent. ECB President Duisenberg has given some indication, stating that "*Over the medium term – by which I mean within a time span of one and a half years to two years – inflation will be under 2 per cent again*".[44] In itself this provides helpful additional information though it is a shorter time frame for the medium term than is normally used and an official definition of the time period that the ECB is interested in could further improve understanding.

Publication of minutes

3.81 The Bank of England is required to publish minutes of all MPC meetings, including members' voting records, but the ECB is not. The ESCB Statute explicitly protects the secrecy of ECB meetings,[45] and it is up to the ECB to decide how much information to reveal. Thus far, it has decided not to publish minutes, even in an anonymised form.[46] No record of voting patterns is made available. Other things equal, this could damage accountability and reduce credibility if the public fear that decisions are not being taken for the right reasons.

[42] See the EMU study by HM Treasury *Prices and EMU*.

[43] See, for example, Svensson (2001), who argues that the current system fails to provide a reliable anchor for inflation expectations.

[44] In reply to a question at the 10 May 2001 press conference. Available at www.ecb.int.

[45] Article 10.4 states that "*The proceedings of the meetings shall be confidential*".

[46] Anonymity could be especially important for the ECB if publicity would encourage members of the Governing Council to see matters in a national, not area-wide, light.

3.82 Bini-Smaghi and Gros (2001), though, argue that published minutes "*would result in shifting the true debate to informal meetings of the Governing Council, while formal meetings would only record pre-packaged consensus with no or little discussion*".[47] While this is possible, eye-witness accounts suggest that the publication of the MPC's minutes does not shift the wide-ranging and productive debate,[48] though of course the context of the two decision-making bodies are rather different as the ECB sets monetary policy for a group of countries in the euro area. Some have suggested that published minutes could be anonymised to deal with the different context.

3.83 The European Parliament, in its resolution on the ECB's 2001 Annual Report,[49] agreed that minutes would be useful. It regretted that steps have not been taken to publish the arguments which are discussed at the ECB Governing Council and called for more transparency through *"the publication of summary minutes explaining the arguments submitted in Governing Council discussions in an anonymous way, thus preserving confidentiality."*

Clarity of communication

3.84 Another important issue is the clarity with which monetary policy strategy is communicated. Clear communication can help to make obvious the monetary authority's reaction function to markets and the general public, thus increasing the predictability of its decisions. While external commentators have typically praised the MPC's effectiveness in communicating its policy,[50] some have felt that the ECB's communication has at times been unclear and that this has led to surprises in the markets. For example, the OECD stated in its 2001 review of the euro area that:

> "*...a 'communication gap' has persisted, as acknowledged by ECB officials themselves, in the sense that the verdict of ECB watchers has typically been more favourable on policy decisions than on the explanations thereof.*"[51]

3.85 This communication gap – which might exist either between the ECB and the markets and/or between the ECB and the fiscal authorities – could reflect the intrinsic difficulties in getting a consistent message across to 12 heterogeneous countries not only with different languages, but also very different media, cultural and central banking traditions.[52]

Financial markets evidence

3.86 However, analysis of financial market data provides only limited support for the view that ECB behaviour is unpredictable. Chart 3.7 plots the change in 3-month EURIBOR implied rates and the change in 3-month LIBOR rates following interest rate decisions by the ECB (in the case of EURIBOR rates) and the MPC (in the case of LIBOR rates) respectively. This can be used as an indicator of the extent to which the decision was a surprise to financial markets, with a change of greater than 10 basis points likely to be at least a mild surprise.[53]

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[47] In the abstract to the paper.

[48] On the basis of his attendance at 21 MPC meetings, Buiter (1999) says that the *"free, frank and uninhibited exchange of views is not discouraged"* by published minutes (page 13).

[49] European Parliament, Press Release, 20 June 2001. Available at http://www.europarl.eu.int/press/index_en.htm.

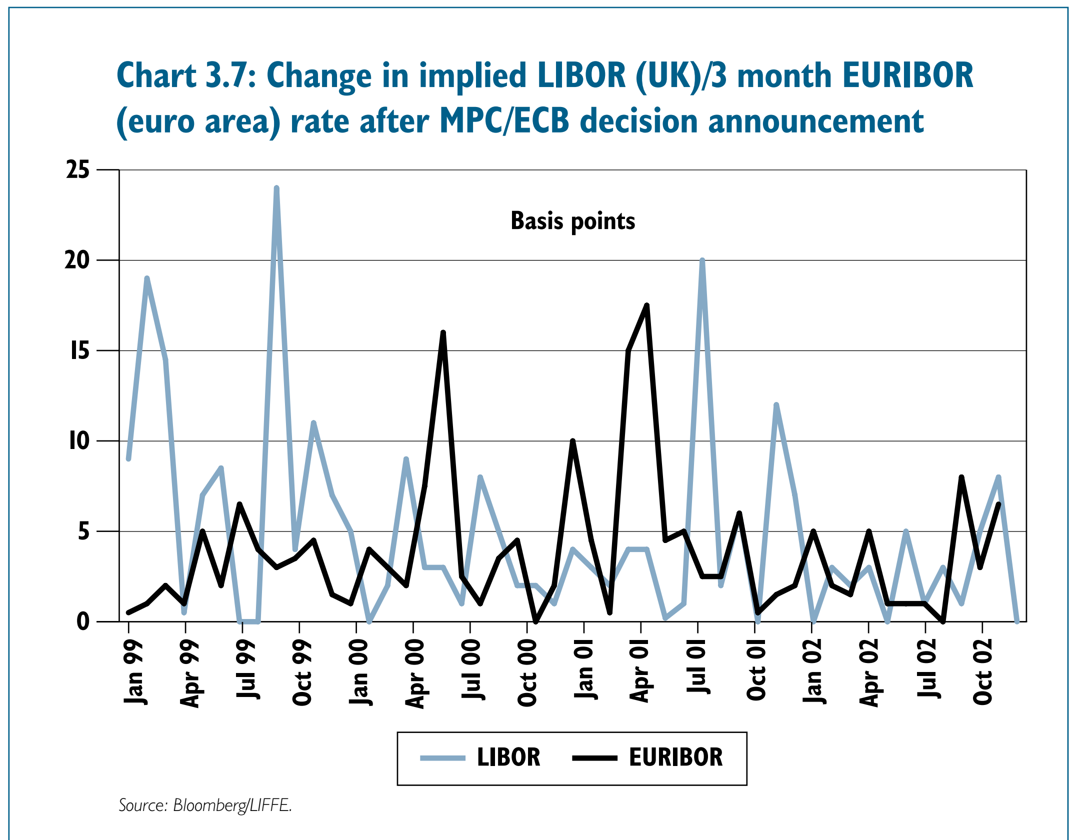
[50] See, for example, IMF (2003b).

[51] OECD (2001), page 128. Issing (2000) also notes an emerging 'communication gap', attributing it to the recipients of the ECB's messages. See also Favero *et al.* (2000).

[52] And a multiplicity of trading locations, as noted by Fitoussi and Creel (2002).

[53] Goldman Sachs (2001) uses the same methodology.

Chart 3.7: Change in implied LIBOR (UK)/3 month EURIBOR (euro area) rate after MPC/ECB decision announcement



Source: Bloomberg/LIFFE.

3.87 Chart 3.7 shows that financial markets have typically predicted the banks' decisions, but there have been some surprises in both cases (typically in months when new Inflation Reports have been published by the Bank of England, and particularly in Spring 2000 and Spring 2001 for the ECB).[54] In neither case does the evidence point to behaviour being persistently unpredictable.

Increased clarity recently

3.88 Recently the ECB has tried both to improve communication with the markets,[55] and improve the predictability of its decisions. For example, President Duisenberg made clear at the 7 November 2002 press conference that the Governing Council had "*discussed extensively the arguments for and against a cut...*". Markets were not surprised when a 50 basis point interest rate cut followed in December. Similarly, during a G7 meeting towards the end of February 2003, President Duisenberg said that "*The weaker outlook, as we see it, should contribute to lower inflationary pressure*". These comments were reinforced by other Governing Council members in the following days and weeks, and a 25 basis point cut followed on 6 March.

3.89 Overall, transparency is generally considered to be quite high in both frameworks. For example, Bini-Smaghi and Gros's (2001) index of transparency[56] places the Bank of England top of six central banks, on 24 out of 30 points, with the ECB in second place, scoring 19.

[54] In a detailed analysis of the market predictability of decisions, Ross (2002) broadly concurs, finding that the ECB and the Bank of England are both relatively predictable, but noting that "*the market has had difficulty anticipating – at least in our calculations - large changes and cuts in policy interest rates*" by the ECB (page 24).

[55] For example, through the publication of its book *The Monetary Policy of the ECB* (ECB, 2001).

[56] Though the authors call it an indicator of both transparency and accountability, all but one of the 15 criteria are concerned more specifically with transparency. The index should be seen as indicative only, as the choice of criteria could affect the results.

Accountability

3.90 Transparency is closely related to accountability, and both are important in ensuring that a framework is considered legitimate and has the robustness to endure changing circumstances. Despite the similarities identified earlier in terms of accountability, some have suggested that further improvements could be made to the ECB's parliamentary accountability. Some members of the European Convention's Working Group on Economic Governance, for example, consider that there is scope for improving the accountability of the ECB, including through enhancing the ECB's reporting to the European Parliament, giving the European Parliament a greater role in the designation of ECB board members, and providing for the obligatory publication of minutes. Accountability to national parliaments has also been an issue for some Member States, including the UK where it has been a feature of Treasury Select Committee inquiries.

Two significant differences

3.91 In its most formal sense, accountability to the people (via the executive), is achieved by the government being able to impose sanctions on the central bank or – in the extreme – by the government being able to re-define the framework, or overrule decisions.[57] As discussed above, the UK and euro area monetary policy frameworks are quite similar in terms of their levels of parliamentary accountability, but there are two major differences between them with respect to a more formal version of accountability:

- **changes to central bank law**. The UK Government sets the objectives of monetary policy even though the Bank of England implements it. So, should the MPC perform ineffectively, or should its objectives differ from those of the public or the Government, the Government could alter its remit, reviewed annually, or introduce a new Act of Parliament. The Open Letter gives the Bank a chance to explain its performance.[58] A change to the ECB's position would be more difficult to bring about, since the ECB sets its own price stability objective. Any change to this situation would require a Treaty change which would need the unanimous agreement of all EU Member States, and ratification according to national procedures; and
- **'override clauses'**. Article 108 of the EC Treaty makes clear that, even in extreme situations, the ECB's independence cannot be overruled. This is not the case in the UK, where "*The Treasury, after consultation with the Governor of the Bank, may by order give the Bank directions with respect to monetary policy if they are satisfied that the directions are required in the public interest and by extreme economic circumstances.*"[59]

3.92 These differences could in principle make it more likely that the ECB will have different objectives from the euro area's citizens, or that it will adopt the wrong policies to meet those objectives. This could harm the ECB's legitimacy.

Possible developments

3.93 The Bank of England undertakes fairly regular reviews of various aspects of its monetary policy strategy. For example, Kohn (2000) on monetary policy processes and the work of monetary analysis and Pagan (2003) on modelling and forecasting.[60]

[57] Forder (2002) sees accountability principally in these terms.

[58] Though political factors could make any major change to the Bank of England's position difficult to implement, unless it was widely seen to be underperforming. See Allsopp (2002a).

[59] Bank of England Act 1998, page 30. Available at http://www.hmso.gov.uk/acts/acts1998/19980011.htm.

[60] In the context of the EMU debate some commentators (for example, Barrell 2002) have carried out comparative assessments of the UK and euro area arrangements.

ECB strategy review

3.94 Enlargement will obviously play a key role in the future set-up of the ECB Governing Council, as discussed in Box 3.2.

3.95 Separate to the debate on the structure of a post-enlargement ECB, the ECB has announced that it will undertake a review of its current monetary policy strategy. At the ECB press conference on 5 December 2002, President Duisenberg said that *"we will make a serious assessment and evaluation of the monetary policy strategy in the course of ... the first half of next year."*[61] He confirmed this during his 6 March press conference,[62] and added that the Governing Council expected to have a first discussion towards the end of April 2003, with the intention to complete the review in the course of May.

Academic ideas for reform

3.96 A number of academics have suggested possible reforms. They can be divided into changes to improve objectives, to aid credibility, to improve transparency and to increase accountability. Some of the most prominent ideas are discussed in Box 3.5.

CONCLUSIONS

Changes necessitated by EMU

3.97 Were the UK to join EMU, interest rates would be set by the ECB for the euro area as a whole, including the UK, rather than by the Bank of England for the UK alone. Decisions on interest rates would be made according to the ECB's decision-making framework. For this reason, a comparison between the UK and euro area monetary policy frameworks is useful in assessing the framework changes that EMU membership would require.

Many similarities...

3.98 There are many similarities between the monetary policy frameworks in the euro area and the UK. In particular, they both adhere to the consensus view in the economic literature, that an independent central bank should have the task of producing long-term price stability, while acting to stabilise inflation and output in the short-term.

3.99 Both banks have managed to gain credibility in the financial markets, by different routes, and both have been able to act to attempt to stabilise output during the recent downturn. They also represent large steps forward in terms of transparency, particularly through regular publication of their views on likely developments in output and inflation.

...though some differences

3.100 There are, however, some key differences between the monetary policy frameworks of the UK and the euro area. The most significant are:

- in the euro area, the ECB defines price stability, while in the UK the Government does;
- unlike the MPC, the ECB does not have an explicitly symmetric inflation target;
- the ECB assigns a special role to monetary aggregates, under its first pillar;
- minutes of MPC meetings and the voting record of MPC members are published, but minutes of ECB Governing Council meetings and a record of the voting patterns of the Governing Council are not;
- there are fewer formal mechanisms to hold the ECB to account; and
- the composition of the decision-making bodies is different, especially in terms of size and composition.

[61] Available at http://www.ecb.int.
[62] Available at http://www.ecb.int.

Box 3.5: Academic ideas for ECB reform

Improving objectives: There is a wide consensus in the economic literature that symmetric inflation targets improve both transparency and clarity, enhancing credibility. For instance, Svensson (2002) argues that *"A symmetric explicit point inflation target … would be better and provide a better anchor for inflation expectations"* (page 2).

Some have also argued that the inflation objective should be somewhat higher than the ECB's current strategy. Artus and Wyplosz (2002) argue that a range from 1 to 4 per cent would be more appropriate, reducing the risk of deflation.

While acknowledging that the ECB does not use monetary data in a dogmatic manner, a number of commentators have also called for a move to a single-pillar strategy, in an attempt to increase the clarity of its objectives. For instance, Begg *et al*. (2002) argue that data from the monetary pillar provide *"unreliable, or downright mistaken, guidance"* and conclude that *"Cracked beyond repair, the monetary pillar should be dismantled"* (page 20).

Aiding credibility: Baldwin *et al.* (2001) recommend that, in the light of enlargement of EMU, monetary policymaking should be delegated to a committee of independent experts, made up of the six members of the ECB's Executive Board and five other members appointed by Heads of Government on recommendation by ECOFIN. They believe that this would reduce the number of individuals responsible for taking monetary policy decisions, enhancing effectiveness, de-nationalise monetary policy and enhance the individual accountability of each committee member.[a] As set out in Box 3.2, the European Commission (2003) have also suggested that some form of 'monetary policy board' might be one way to arrange monetary policy decision making following any enlargement of the euro area.

Improving transparency: Buiter (1999) argues that publication of anonymised minutes of Governing Council meetings could be an important component of a culture of openness and accountability. Favero *et al*. (2000) agree, stating that *"summary minutes not attributing individual views would be possible and helpful"* (pages 37-38).

While applauding the ECB's decision to begin publishing its projections for inflation and other economic variables, Alesina *et al*. (2001) argue that the publication of more forward-looking information would aid predictability. In particular, they argue that *"the forecasts should be made, and eventually published, using the predicted paths of interest rates…"* (page 46) rather than on the basis of a constant interest rate assumption. (The Bank of England publishes its forecasts on the basis of both a constant interest rate assumption and using market interest rate expectations). Along similar lines, Svensson (2000) calls for a greater discussion of future prospects in the ECB's monthly bulletins, describing them as at present *"essentially backward-looking…"* (page 5).

Increasing accountability: Favero *et al*. (2000) argue that accountability and legitimacy could be improved were the ECB's specific target to be set by ECOFIN and/or the European Parliament. They suggest that this would enable the ECB to focus on the technical task of meeting this target. It would also allow democratically elected representatives to change the monetary policy objectives if these differed from those of the public. Favero *et al.* claim that such a move would also *"contribute to fewer national tensions in policy-making and to less contentious appointments. … The goal could be set at regular, say three-year intervals…"* (page 70).

[a] See also Giavazzi (2003), who writes that *"Best practice in central banking strongly argues in favour of delegating interest rate decisions to an independent committee"*.

3.101 It is worth remembering that the ECB is a new institution, which came into being at a time when the euro area was facing great uncertainty from the emerging market crisis. Clearly the operation of monetary policy needs to be seen as an evolving process in which both the ECB and markets are learning.[63] The MPC too has been in existence as an independent decision-making body for less than six years. This is in marked contrast to the much longer history of the US Federal Reserve, which was set up in 1913 and which has developed significantly since, as described in the EMU study by HM Treasury *The United States as a monetary union*.

[63] See also Fitoussi and Creel (2002), who write that "*There is no historical precedent. Nor are there any criteria against which to judge a monetary policy that has been designed for a group of states, which are closely integrated but fall short of a federal structure*" (page 19).