

# Policy frameworks in the UK and EMU

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EMU study



HM TREASURY

# EXECUTIVE SUMMARY

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**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.