DELIVERING ECONOMIC STABILITY: LESSONS FROM MACROECONOMIC POLICY EXPERIENCE

Summary

Britain's past growth performance has been poor compared with other industrialised countries. It has also been highly volatile. The failure to provide a platform of stability has proved costly to investment and long-term growth, and a 'boom and bust' culture has wasted resources and led to significant economic and social costs.

It is the role of macroeconomic policy to deliver economic stability. Faced with an open economy and several major structural changes in the last two decades the policy-makers' task has never been easy. Britain is not unique in having had to face such challenges, yet it has been far less stable than many other countries.

Macroeconomic policy, if set correctly, should be a stabilising force. The powerful influence of government borrowing and interest rates on the economy, however, can be destabilising if not managed effectively. The evidence suggests that fiscal and monetary policies over the last two cycles have failed to provide the requisite stability.

In the past, the failure of policy to be sufficiently forward-looking and transparent often led to interest rates being changed too late and fiscal policy being loosened at the wrong moment - increasing the volatility of policy as attempts were made to 'catch up' and destabilising the economy in the process. Moreover, monetary and fiscal policy failed to work in concert at certain critical periods, notably in the boom of the late 1980s. This exacerbated the task of policy to return the economy to a stable long-term growth path.

The key task for macroeconomic policy - both monetary and fiscal - is to create a platform of stability to allow people and firms to plan ahead with confidence. Last November, the Treasury publication 'Fiscal policy: lessons from the last economic cycle' explained how the Government's design of fiscal policy took account of the experience of the past. This paper reflects on those lessons and explains how lessons from past monetary policy experience have shaped the new monetary policy framework.

The earlier paper identified two important principles for fiscal policy:

- *a prudent approach* by adjusting for the economic cycle and building in a margin for uncertainty.

- openness and transparency by setting stable fiscal rules and explaining clearly fiscal policy decisions.

The themes of stability and transparency - both in the objectives and implementation of policy - are essential in the monetary policy context too. Thus the monetary framework has been designed to take account of three key factors:

- monetary policy decisions benefit from an *open approach* and should be made in the best long-term interests of the economy and *not based on short-term political considerations*;

- monetary policy should be based on a *clear and consistent inflation target*;

- monetary policy should be *forward-looking*.

In addition, a further factor - critically important, even if obvious - is relevant to both monetary and fiscal policy:

- fiscal policy should support - and not oppose - monetary policy in promoting stability over the economic cycle.

In its design of the new macroeconomic framework, the Government has taken account of the lessons of past experience. Both monetary and fiscal policies are now highly transparent, forward-looking, based on clear rules and targets, and underpinned by legislation. This will reduce the risk of short-term political factors interfering with timely and proper action in the long-term interests of the economy.

Compared with the last economic cycle:

- Monetary policy has been tightened much earlier. Base rates were raised as output moved through trend in 1997. In the upswing of the previous cycle, tightening began in mid-1988, some 8 quarters after the economy passed through trend and when output was already a long way above potential.

- The recent cut in rates to 7¼ per cent is timely, coming 3 quarters after the estimated peak in the output gap and with output now close to trend and inflation on target. In late 1990, interest rates began to fall from 15 per cent - more than twice the current level - much later, some 8 quarters after the peak. Although output was by then only a little above trend, RPIX inflation was over 9 per cent.

Fiscal policy has supported monetary policy. A reduction in the structural deficit of almost 3 per cent since 1996-97 occurred as output grew above its trend growth rate and monetary policy was tightened. In the previous cycle, as output moved towards and then through trend, there was a structural loosening of fiscal policy. This complicated the task of monetary policy.

The changes to the framework have strengthened the credibility of policy, and have already brought tangible results:

inflation is at the target level of 2½ per cent;

inflation expectations of independent forecasters are at the target level for the first time - over ½ percentage point lower than before the new monetary framework was introduced - and longer-term expectations implicit in financial markets have fallen by over 1½ percentage points to a similar level;

long-term interest rates are at their lowest levels for 35 years; and 5-year forward spreads against German bunds are about 40 basis points compared with well over 100 basis points eighteen months ago; and

the structural fiscal deficit has been all but eliminated; and the Government is on track to meet its fiscal rules and for fiscal policy to support monetary policy in the next phase of the cycle.

By locking in low inflation and sound public finances, the economy is much better placed to respond to adverse developments. The robust and forward-looking new framework, with its inbuilt capacity to react to new challenges, gives Britain the best possible prospects of steering a stable course through the current economic cycle.

1. Introduction

> "*Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again*". (JM Keynes, 1923)[1]

Over the past, the UK's growth performance has been poor. Moreover, output and inflation have been highly volatile - more so than in most other G7 countries. The consequences have been serious, for economic instability creates uncertainties and difficulties for individuals and businesses alike. It damages investment and long term growth, wastes valuable resources and has significant economic and social costs.

Looking back at past performance is instructive. While some developments over the last two decades - for example financial liberalisation and the shift away from manufacturing industry towards services - have clearly complicated the policy-makers' task to deliver stability, too often policy has contributed to instability rather than acting as a stabilising influence on the economy.

The key task for macroeconomic policy - both monetary and fiscal - is to create a platform of stability to allow people and firms to plan ahead with confidence. The Treasury publication 'Fiscal policy: lessons from the last economic cycle' (November 1997) explained how the Government's design of fiscal policy took account of the experience of the past. This paper reflects on those lessons and explains how lessons from past monetary policy experience has shaped the new monetary policy framework.

The paper concludes that the new monetary and fiscal frameworks have led to better results so far in this cycle than in the previous cycle.

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1 A Tract on Monetary Reform, Macmillan

2. The UK's record of instability

In each of the last two economic cycles, which ran from early in 1978 to mid-1986, and from mid-1986 to the first half of 1997, Britain's macroeconomic performance was poor compared with other G7 countries. During this period, the UK had one of the highest average inflation rates and below average growth; and suffered from the two deepest and longest recessions in its post-war history. Fluctuations in output and inflation were higher than elsewhere, with growth ranging from -2¼ per cent to 5¼ per cent and inflation from 2 per cent to 21 per cent. Interest rates and fiscal deficits were almost twice as volatile as in France, Germany and the US. All this damaged businesses' and consumers' ability to plan ahead effectively.

2.1 Volatility of growth, consumption and inflation

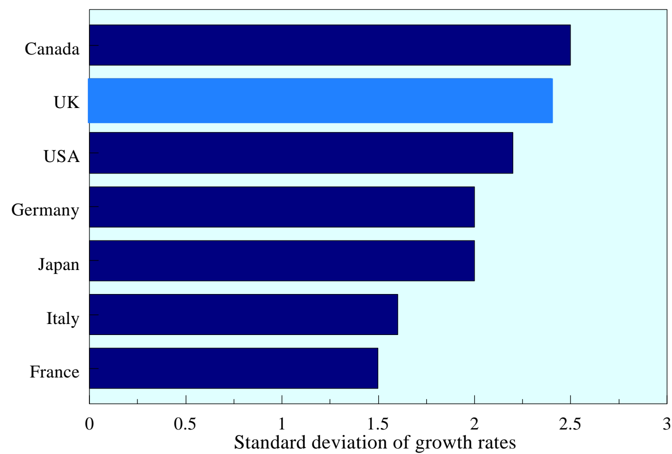
Growth

Low growth is unwelcome. So too is highly volatile output. Unstable growth creates uncertainty, making it more difficult to plan effectively for the long term. This reduces business and consumer confidence and can have adverse effects on long-term investment and productivity. Instability also has substantial personal costs in terms of the lost security and self-confidence that arises from unemployment.

Excessive volatility also reduces the economy's trend rate of growth. During boom times, investment accelerates but can become misdirected into highly speculative activities, creating a glut of capital which is never used fully. Recessions have negative effects that may not be reversed quickly or fully when the economy picks up. For example, unemployed people can lose touch with the labour market and find their skills depreciating rapidly. And the accelerated scrapping of physical capital means that productive capacity, which takes a long time to build up in periods of growth, can be lost very quickly.

OECD figures show UK output growth has been more volatile than in other G7 countries apart from Canada (see Chart 2.1) and this may help explain why in terms of GDP per capita the UK ranks equal lowest in the G7 and only ninth in the EU.

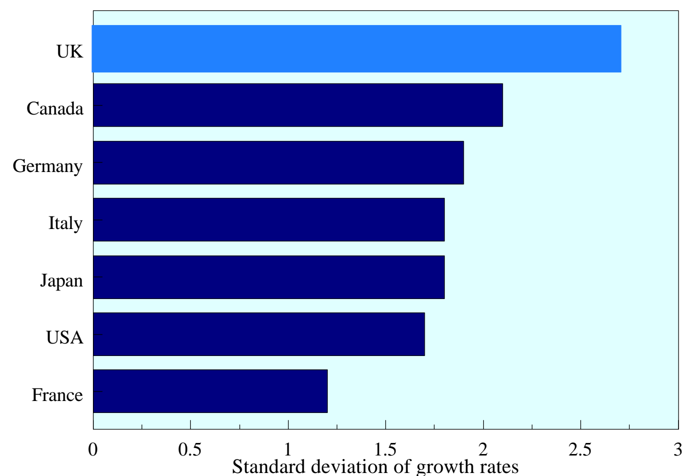
Chart 2.1 - Volatility of GDP growth (1980 Q1 - 1998 Q2)



Consumption

The fluctuation of consumer spending has also been a striking feature of the UK economy. Chart 2.2 shows that the UK's variation of consumption growth, at 2.7 percentage points, has been much higher than any of the other G7 countries.

Chart 2.2 - Consumption growth (1980 Q1 - 1998 Q2)



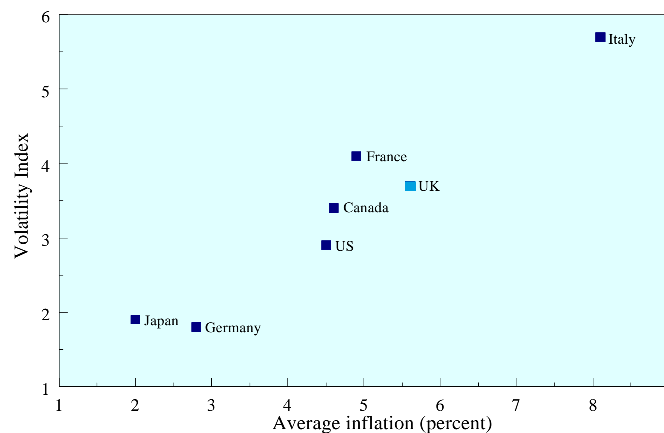
Inflation

High and volatile inflation rates impose costs on the economy. High inflation tends to add to the risk of making investments and reduces savings. It can also distort economic decisions and lead to arbitrary redistributions of income and wealth. High inflation may reduce economic growth even when it is fully anticipated as there are costs involved in avoiding inflation, revising prices and wage contracts and from distortions caused by the tax system. Recent

studies[2] estimate that each additional percentage point of inflation leads to a reduction in productivity growth by up to 0.1 of a percentage point.

Chart 2.3 shows that since 1980 among the G7 countries the UK has had the second highest average inflation rate and that it has been more variable than all but France and Italy. The chart also illustrates a positive relationship between the level of inflation and its variability. Volatile inflation increases uncertainty and thus increases the costs of unanticipated inflation.

Chart 2.3 - G7 average inflation rates and inflation volatility since 1980



2.2 Instability over the last economic cycle

The UK economy was particularly volatile over the last cycle, as demonstrated by the behaviour of the 'output gap' - the estimated difference between the level of output and the economy's potential or capacity level of production. Chart 2.4 shows OECD estimates of the output gap for the UK, France, Germany and the USA. The UK had both the largest boom in the late 1980s and one of the sharpest recessions in the early 1990s.

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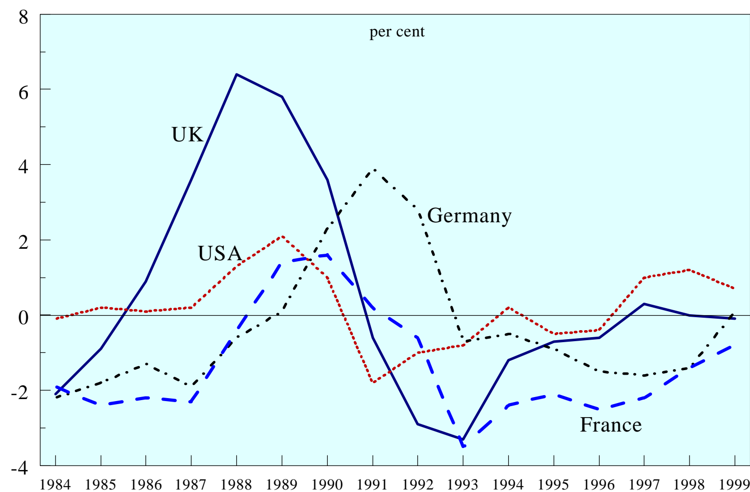
[2] Information on these studies can be found in Edey M., (1994), OECD Economic Studies, Winter edition

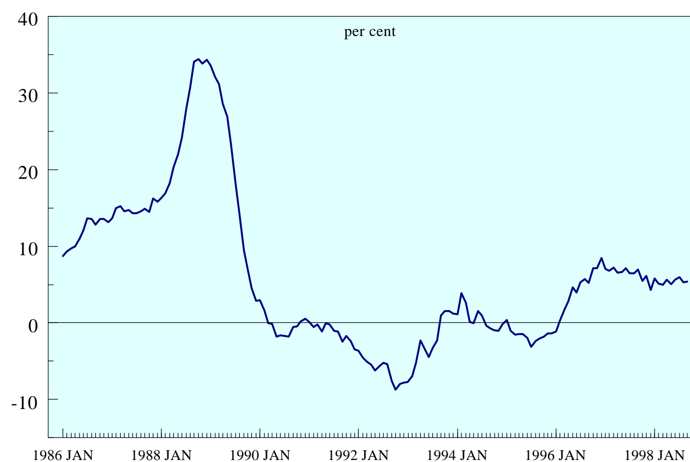
Chart 2.4 - OECD estimates of output gap for UK, France, Germany and the USA (1984-1999)



Behind this cyclical performance lay the exceptional behaviour of consumers' expenditure. Consumption increased at very rapid rates in the late 1980s, hitting an unprecedented peak of 8.1 per cent in 1988 Q1. This reflected an overheating economy, fuelled by loose monetary policy, tax cuts and overoptimism about the strength of the UK economy.

House price inflation, which fed into household wealth and, through equity withdrawal, into consumption was another important feature of the last economic cycle. Chart 2.5 shows how failure to stabilise the economy led to roller-coaster movements in house price inflation in the late 1980s.

Chart 2.5 - House price inflation over the last cycle (1986-1997)

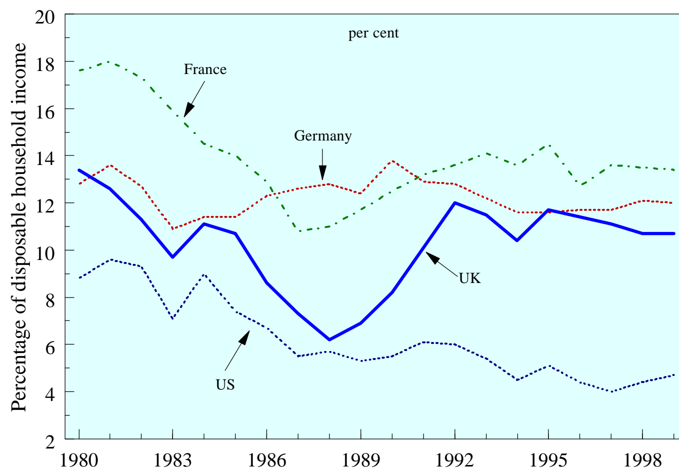


Source: Halifax

House prices increased at an unprecedented rate of nearly 35 per cent in the year to October 1988. In the ensuing recession prices fell sharply - reaching an annual decline of almost 9 per cent in October 1992. Movements of this kind may have been a symptom of economic instability but their impact also exacerbated the economic cycle.

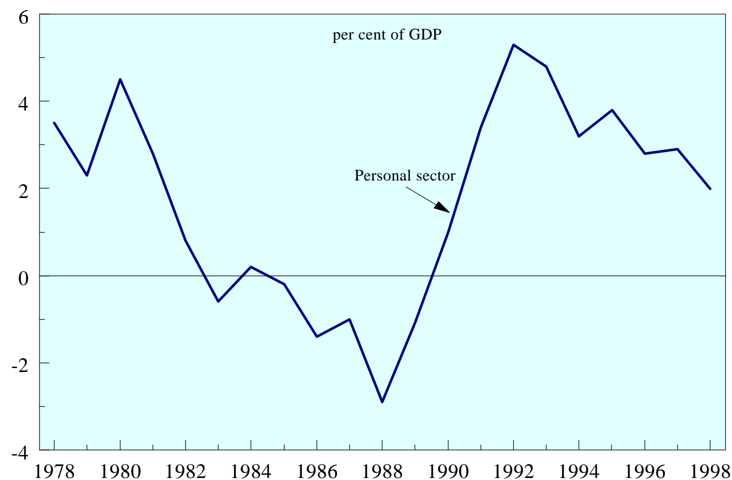
The volatile behaviour of household consumption and wealth was mirrored in a noticeable movement in the savings ratio during this period compared with other major economies (see Chart 2.6).

Chart 2.6 - Household saving ratios: UK, France, Germany and the USA (1980-1998)



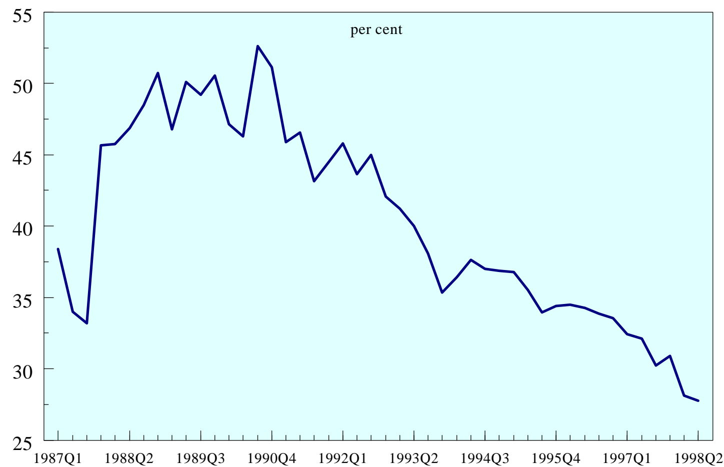
The large fall in the personal sector savings ratio in the mid 1980s was reversed subsequently when economic conditions deteriorated (see Chart 2.7).

Chart 2.7 - Personal sector financial balances (1978-1998)



Industrial and commercial companies borrowed extensively in the boom times, and in the distress circumstances of its immediate aftermath (see Chart 2.8). But this ultimately had to be reversed.

Chart 2.8 - Gearing: private non-financial companies (total loans as % of liabilities) 1987-1998



Both households and companies, having geared up for what was ultimately unsustainable growth, needed subsequently to restructure balance sheets radically to restore their financial health. The consequence, in terms of redundancies, lost businesses and wasted effort, was substantial.

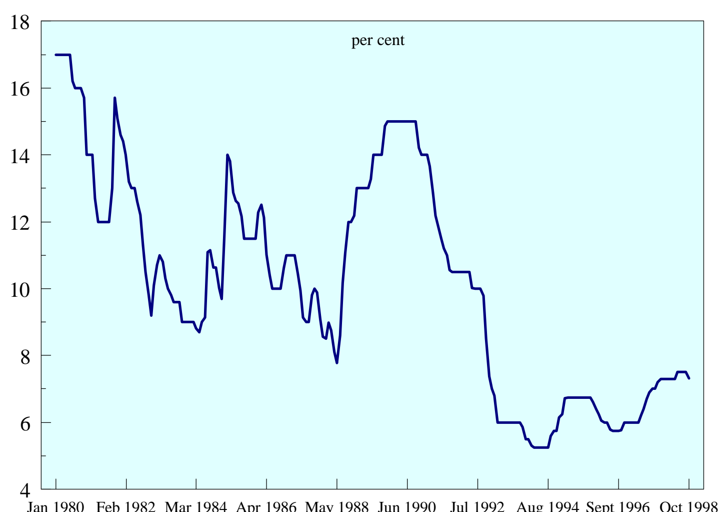
3. Policy instability

Macroeconomic policy can play a vital role in helping to stabilise the economy. But precisely because of its influence it can also be destabilising if not managed effectively. There were a number of changes in the early 1980s, of which financial liberalisation was perhaps the most important, which complicated the task of policy-makers. Nonetheless, the evidence suggests that macroeconomic policy errors must take some of the blame for the instability seen, particularly during the last economic cycle.

3.1 Instability in monetary policy

Interest rates were highly volatile in the last two economic cycles, though less so in the post-ERM period. Chart 3.1 shows that base rates moved up and down much more in the 1980s than the 1990s. This reflects not only political control of interest rate setting but also the fact that interest rates were often used to target variables other than inflation (which themselves varied quite markedly).

Chart 3.1 - Base rates since 1980



During the 1980s there were many changes to the intermediate targets used in the monetary policy framework (see Table 3.1 overleaf). UK monetary policy first targeted broad money, then narrow money. Then more prominence was given to medium-term objectives for nominal income before sterling shadowed the deutschemark, culminating in the UK joining the ERM in 1990. It was only after sterling left the ERM in 1992 that a regime based on targeting inflation directly was introduced.

Table 3.1 Monetary policy targets (1979 - 1997)

	(Annual % change unless stated otherwise)				
Target year[1]	£M3	M4	M0	£ exchange rate (level)	RPIX
1980-81	7-11				
1981-82	6-10				
1982-83[2]	8-12				
1983-84[2]	7-11				
1984-85	6-10		4-8		
1985-86	5-9		3-7		
1986-87	11-15		2-6		
1987-88[3]			2-6		
1988-89			1-5		
1989-90			1-5		
1990-91			1-5	DM2.95[4]	
1991-92[4]			0-4	DM2.95	
1992- 93[5]		4-8[6]	0-4	DM2.95[5]	
1993-94		3-9	0-4		1-4[5]
1994-95		3-9	0-4		1-4
1995-96[7]		3-9	0-4		1-4
1996-97		3-9	0-4		2½ or less
1997-98		3-9	0-4		2½ or less

[1] As set in the Medium-Term Financial Strategy (MTFS)

[2] Targets were also set for PSL2 and M1 in the 1982 and 1983 MTFS.

[3] 1987-88 MTFS said 'Monetary conditions are assessed in the light of movements in narrow and broad money, and the behaviour of other financial indicators, in particular the exchange rate'. There was no formal target for broad money. Similar references are to be found in the MTFS in 1988-89, 1989-90 and 1990-91.

[4] UK joined the Exchange Rate Mechanism (ERM) of the European Monetary System in October 1990. The 1991-92 MTFS said 'Interest rate decisions must now be set consistently with keeping sterling within its announced bands.'

[5] UK left the ERM in September 1992. The new framework was based on an inflation target for RPIX of 1 to 4 per cent, with inflation in lower part of the range by the end of the Parliament. Medium-term monitoring ranges for M4 and M0 were also announced.

[6] Announced in Autumn Statement in 1992 after UK left the ERM.

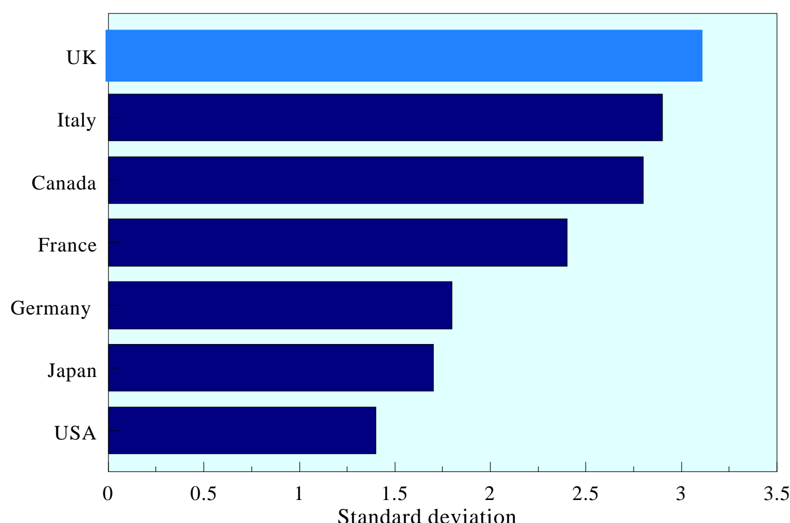
[7] In June 1995 the 1 to 4 range for RPIX was confirmed by the Chancellor and a new target of 2½ per cent or less was announced for beyond the end of this Parliament.

In the aftermath of the ERM a number of significant changes were made, taking policy in a more open direction. As well as targeting RPIX inflation directly for the first time, regular meetings between the Chancellor and the Governor were introduced, along with published explanations of the reasons behind interest rate decisions. The Treasury released information in a monthly monetary report and, from the start of 1993, the Bank began publishing its quarterly Inflation Report. Publication of the minutes of the meetings between the Chancellor and the Governor followed in 1994. However, whilst these changes represented an advance on previous procedures, the system remained flawed.

Following the Election in May 1997, significant moves towards greater transparency were made. The Bank of England was given operational independence to set interest rates and the Monetary Policy Committee (MPC) was established to depersonalise monetary policy decision-making. The Government now sets the MPC a precisely-defined and symmetric inflation target.

Chart 3.2 compares the volatility of nominal interest rates across the G7 since 1985. It shows that the UK has had the most variable nominal interest rates during this period, though in recent years the UK’s performance has improved significantly.

Chart 3.2 - Interest rate volatility (Jan 1985 - Oct 1998)



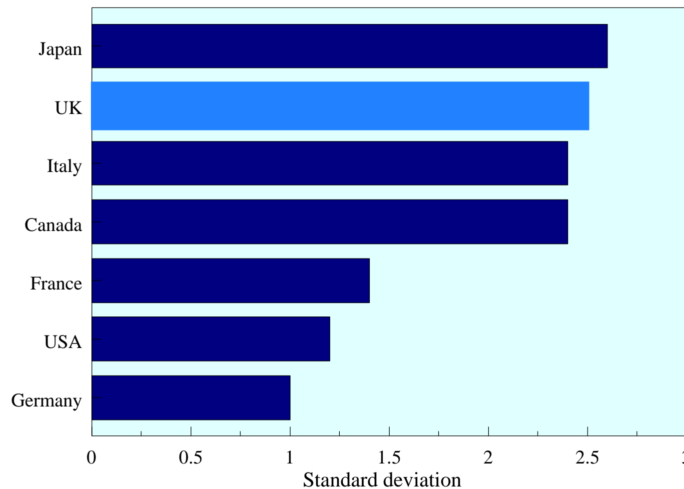
Volatility in interest rates and in the monetary policy regime damaged the ability of businesses and consumers to plan ahead and had a destabilising effect on the economy.

3.2 Volatility in fiscal deficits

The UK’s fiscal deficit has also been highly volatile over the last two decades. In part, this reflects volatile growth and inflation but also destabilising

changes in fiscal policy. Chart 3.3 shows that the UK's general government financial balance as a percentage of GDP since 1980 has fluctuated more than other G7 countries with the exception of Japan.

Chart 3.3 - Volatility of fiscal deficit as a percentage of GDP (1980 - 1997)



The variation in the deficit in part reflects the impact of the cycle and thus the automatic stabilisers. Nonetheless, it is important to note that the structural deficit has also varied considerably. For example, OECD estimates of the cyclically-adjusted deficit show variation from 2 per cent of GDP to over 6 per cent of GDP during this period.

The volatility of the UK's deficit partly reflects a lack of clearly defined and consistently applied fiscal policy objectives. Over the last economic cycle the stated fiscal policy objectives were changed according to circumstances, which meant that policy was never obliged to compensate for slippages. Moreover, a failure to take account of the effects of the economic cycle gave a misleading picture of the health of the public finances, leading to a lack of caution and inappropriate policy decisions.

The lack of consistent objectives allowed debt to rise, increasing the burden of debt interest payments on the government's finances, putting upward pressure on real interest rates and limiting the scope for fiscal policy to cushion the effects of shocks on the economy.

4. The lessons for macroeconomic policy: strengthening the framework

In designing the new macroeconomic framework the Government has taken account of a number of lessons from the past. Common themes are that fiscal and monetary policies need to be transparent, focus on the long-term and underpin stability rather than contribute to the opposite. Central to achieving these objectives has been the use of rules within a coherent long-term framework, in the form of an inflation target, the Golden Rule, and the Sustainable Investment Rule. These enshrine long-term goals and provide businesses and individuals with greater confidence about future economic prospects.

The paper 'Fiscal policy: lessons from the last economic cycle' identified two important principles for fiscal policy:

> *a prudent approach* by adjusting for the economic cycle and building in a margin for uncertainty.
>
> openness and transparency by setting stable fiscal rules and explaining clearly fiscal policy decisions.

The themes of stability and transparency - both in the objectives and implementation of policy - are essential in the monetary policy context too. Thus the monetary framework has been designed to take account of three key factors:

> monetary policy decisions benefit from an *open approach* and should be made in the best long-term interests of the economy and *not based on short-term political considerations*;
>
> monetary policy should be based on a *clear and consistent inflation target*;
>
> monetary policy should be *forward-looking*.

In addition, a further factor - critically important, even if obvious - relevant to both monetary and fiscal policy:

> fiscal policy should support - and not oppose - monetary policy in promoting stability.

These issues are addressed below in the context of the last economic cycle.

4.1 Transparency and accountability: macroeconomic policy decisions benefit from an open approach and should be made in best long-term interests of the economy.

Transparency

One of the main flaws in macroeconomic policy-making over the last two cycles was the lack of openness about the goals of policy. Greater transparency and openness are key weapons in avoiding poor policies and bad decision-making. That is why they play a central part in the Government's approach.

In the past, there was a lack of transparency in the stated fiscal objectives. But this was also true of monetary policy objectives. Monetary targets were set but missed; and the targeted measure frequently changed as problems became apparent. At one point UK monetary policy was covertly shadowing the deutschemark but there was no explicit target for policy, so no way of holding the Government to account. More often than not, the link with inflation was not transparent.

The greater transparency and openness of policy-making under the new monetary framework enhances the credibility and effectiveness of policy. Transparency makes it more difficult for policy-makers to spring 'inflation surprises' on the economy. If people understand what actions are being taken and why, they can adjust their inflation expectations accordingly. Openness is particularly important for a new regime or a country with a relatively poor inflation history.

Transparency also makes for a well-informed policy debate, making it easier for people to monitor progress towards policy goals. It helps reduce inflation expectations, and builds up the constituency for stability-orientated policies and low inflation, and makes policy and the effects of policy more predictable. By sending clear signals about the basis of policy decisions, markets can function more effectively.

Greater openness and transparency in the monetary policy process has increased the accountability of monetary policy-making. Accountability has also been increased through scrutiny. A high level of accountability legitimises the central bank's operational freedom to set interest rates and helps to strengthen the democratic process.

The process of monetary policy decision-making in the UK is now one of the most transparent in the world. The OECD recently scored the G7 central banks on seven measures of transparency (see Table 4.1). These included whether the bank reported to Parliament, whether minutes were published and whether monetary policy or inflation reports were published regularly (OECD Economic Survey of the UK, 1998). The UK was the only country to get a "yes" for every measure. By contrast, in the 1980s the UK would probably only have scored yes twice at best.

Table 4.1 - Transparency of G7 central banks (source: OECD, June 1998)

	UK	USA	Japan	Ger	Fran	Italy	Canada
Formal scheduling and publication of calendar of monetary policy decisions making process	**Y**	Y	Y	Y	Y	N	N
Interest rate decisions taken at scheduled meeting under normal circumstances	**Y**	Y	Y	Y	Y	N	N
Publication of explanatory press releases at the time of each official interest rate change	**Y**	Y	Y	N	Y	Y	Y
Minutes of meeting of monetary policy decision making body published	**Y**	Y	Y	N	N	N	N
Regular publication of monetary policy or inflation report	**Y**	Y	Y	Y	Y	Y	Y
Publication of internal forecasts for intermediate or final target variables	**Y**	N	N	N	N	N	N
Reporting to/ monitoring by the Parliament	**Y**	Y	Y	N	Y	Y	Y

In fiscal policy, transparency is one of the key principles of fiscal management set out in the Code for Fiscal Stability. The Code requires, as a matter of law, transparency in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts. Thus the Government is required to publish sufficient information to allow Parliament and the public to scrutinise the conduct of fiscal policy and the state of the public finances. This includes, for example, estimates of the cyclically-adjusted fiscal position and long-term projections of the public finances covering a period of not less than 10 years.

Depoliticising monetary policy

The Government's move to create a more independent central bank was partly in response to the past manipulation of interest rates for short-term political gains. This is in line with the trend towards independence in other

countries - including for instance France and New Zealand - and follows the success of countries like the United States and Germany in maintaining low inflation with no apparent cost in terms of either lower or more volatile output growth.

Most empirical studies have found that inflation and the variability of inflation are lower in countries with more independent central banks. These findings occur because putting interest rate decisions in the hands of an accountable central bank makes policy less open to short-term political manipulation. In particular, such short-termism can mean that interest rates are increased too late, and lead subsequently to a longer and more painful adjustment, as happened in the 1980s and early 1990s. Importantly, the evidence also suggests that the lower and less variable inflation associated with independent central banks does not come at a cost to output and is not associated with greater variation of economic growth rates.[3]

4.2 Monetary and fiscal policy should be based on clear and consistent targets

The new monetary framework is based on a clear and precise objective:

> an inflation target, defined by the annual increase in the Retail Prices Index excluding mortgage interest payments (RPIX), of 2½ per cent.

The target applies at all times; and without prejudice to the objective of price stability, the Bank is required to support the Government's objectives for growth and employment. In addition, outcomes above or below the target are treated equally seriously.

The framework, again established as a matter of law, is intended to be long-lasting and to mark a break with the frequent regime changes of the last two cycles. The fact that policy moved from targeting one indicator to another in the past, frequently failing to meet the targets, reflects the past short-termism of monetary policy.

Inflation targets are clear and easily understood and make the central bank properly accountable. An explicit inflation target provides an effective anchor for monetary policy and inflation expectations, and should succeed in reducing those expectations.

The Government has adopted an explicit inflation targeting framework because it believes this should deliver a better outcome for the specific circumstances of the UK than other approaches. There is no long-term trade-off between inflation and output. Printing money cannot raise sustainable growth, so the only sensible objective of monetary policy is low and stable inflation.

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3 For example, Eijffinger and De Haan looked at 13 studies of this issue and found no relationship either way (*The Political Economy of Central Bank Independence*, Special Papers in International Economics, Princeton University, 1996).

The monetary framework explicitly allows the Monetary Policy Committee (MPC) to respond sensibly to economic shocks. However, the onus is on the MPC to justify its actions. The "open letter" system requires the Governor to write to the Chancellor if inflation is more than 1 per cent above or below target. The letter must explain: why the divergence has occurred; the policy action being taken to deal with it; the period within which inflation is expected to return to the target; and how this will support the Government's objectives for growth and employment.

In the context of fiscal policy, clear rules also apply. Within the framework, the Government's two strict fiscal rules define how sound public finances are to be delivered:

> the *Golden Rule* - on average over the economic cycle the Government will borrow only to invest and not to fund current spending; and
>
> the *Sustainable Investment Rule* - net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

This framework is firmly based on achieving sound public finances and long-term economic stability. Within this framework, which is set over the economic cycle, there is an inbuilt capacity to respond to changing economic circumstances by allowing the automatic stabilisers to operate. In this way, the framework sets a long-term goal for policy without imposing inappropriate restrictions on the flexible operation of policy.

4.3 Monetary policy should be forward-looking

The substantial boom of the late 1980s stemmed not only from a failure to adopt a clear and consistent target but also because monetary policy failed to act early enough to limit emerging inflationary pressures in the economy.

From 1985 interest rates were on a downward trend, partly in response to falling inflation (although it remained moderately high). But interest rates were cut throughout 1986 as the economy went above trend and were reduced by a further 2 percentage points in the first five months of 1987 before the June 1987 election.

By August 1987 output was already a long way above potential - the output gap is estimated to have been nearly 2½ per cent of GDP[4] (see Chart 4.1). The stock market fall of October 1987 caused concern among policy-makers and, although rates had begun to be raised in August, they were then reduced by 1½ percentage points during the rest of 1987. This loosening went too far. Rates continued to be cut as late as May 1988, reaching a low of 7½ per cent, even though by then the estimated output gap was 3½ per cent of GDP. Moreover, the CBI's indicator of capacity utilisation for 1988 Q2, published at the time, stood at 66, far above its long run average of 40.

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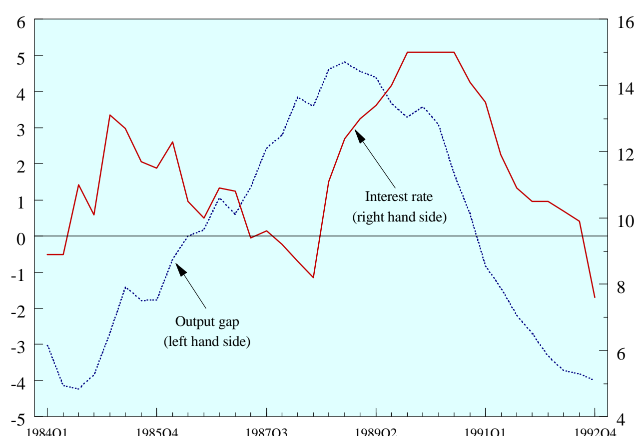
[4] Figures for the output gap in this and the subsequent section are HM Treasury estimates.

Chart 4.1 - The output gap and interest rates 1984 to 1992



In total, over the period from January 1986 to May 1988 interest rates were reduced by 5 percentage points, from 12½ per cent to 7½ per cent, yet the estimated output gap moved from just below trend, -½ per cent, to considerably above trend + 3½ per cent.

By June 1988 there was a belated realisation that the economy was overheating and that interest rates needed to be raised. Base rates were thus increased four times in that month alone - a total of 2 percentage points - and by the end of the year had risen a further 3½ percentage points to 13 per cent. Rates finally peaked at 15 per cent in October 1989 and remained at that level for a year.

Chart 4.1 also illustrates a similar story of policy being changed too late on the downswing, where interest rates clearly lag the output gap profile. Interest rates were still at 14 per cent at the beginning of 1991, even though the output gap had turned negative; and interest rate reductions were delayed throughout 1991 and the first half of 1992 partly as a result of ERM membership.

This experience suggests that monetary policy was insufficiently forward-looking. It is important to act promptly in order to moderate output swings and keep inflation under control. The new monetary framework addresses this.

Lags in the response of inflation to interest rate changes also suggest a forward-looking approach is essential. The Bank's quarterly Inflation Report, which includes an inflation forecast, plays an important role in ensuring a forward-looking approach. In the current context, the MPC of the Bank have indicated policy will continue to be forward-looking as interest rates are reduced. The Bank of England Governor, Eddie George, said on 15 September:

> *"I give you my assurance that we will be just as rigorous in cutting interest rates if the overall evidence begins to point to our undershooting the target as we have been in raising them when the balance of risks was on the upside."*

Mervyn King, Deputy Governor, commented in October that:

> *"The aim of the MPC is to pursue economic stability. It is central to our remit that deviations of inflation from the target are regarded symmetrically. Inflation can be too low as well as too high. For over thirty years, central banks have not, until recently, had many opportunities to show that they understand this. I can assure you that the MPC does. When circumstances change, as they have over the past few months, then so will our policy."*

4.4 Fiscal policy should support monetary policy in promoting stability

Not only was monetary policy behind the game during the late 1980s but fiscal policy was loosened just as the economy was overheating. Fiscal policy was relaxed, for example with tax cuts of £6 billion in the March 1988 Budget and £3½ billion in the March 1989 Budget.

The structural deficit - defined here as cyclically-adjusted public sector net borrowing (PSNB) - moved from an estimated small deficit of 1 per cent of GDP in 1985-86 to a deficit of 2½ per cent of GDP in 1989-90. When monetary policy was finally tightened, interest rates had to be increased by more than would otherwise have been necessary to offset the cumulative loosening of fiscal policy.

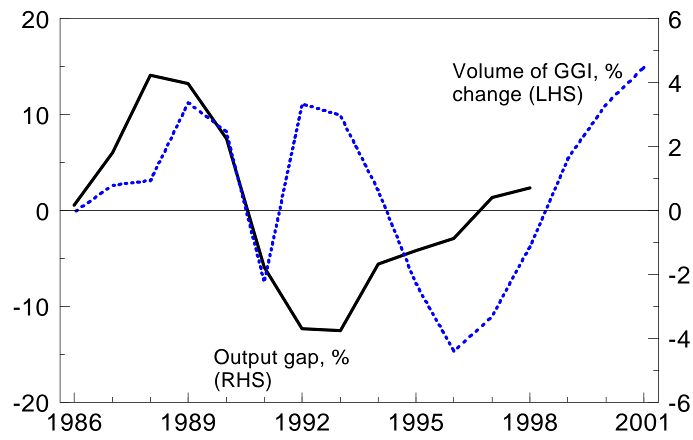
Table 4.1: Change in interest rates, structural deficit and output gap, 1985-86 to 1989-90

Change in:		**1985/86-87/88**	**1987/88-89/90**
Output gap[2]		4	1¼
Interest rates		-2¾	5¼
Structural deficit[3]		1½	¼
	1985-86	**1987-88**	**1989-90**[1]
Memo item:			
Output gap level[2]	-1½	2½	3¾

[1] one year after peak of output gap
[2] as percentage of potential GDP
[3] cyclically-adjusted Public Sector Net Borrowing as percentage of GDP

Within fiscal policy, public investment has at times increased when the economy has been above trend, and fallen when the economy has been slowing down. For example, the volume of investment increased by over 10 per cent in 1989, when the economy was already well above trend, yet it fell by more than 20 per cent between 1994 and 1996, when the economy was less strong. Public investment has thus perversely helped to accentuate the swings in the economic cycle at times.

Chart 4.3 - Change in public investment and the output gap



Note: GGI = gross government investment

5. Towards greater economic stability

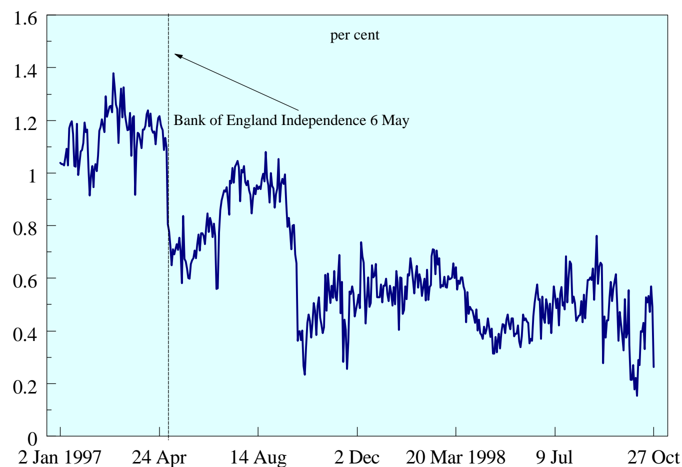
The new frameworks for monetary and fiscal policy make a decisive break from the politicised and short-term policy-making of the past. Although they have only recently been put in place, there is evidence already of greater credibility with the markets, businesses and individuals. It is likely that as the MPC continues to establish a track record and the fiscal framework becomes more familiar this credibility will increase further.

5.1 The new framework has increased credibility

Long-term interest rate differentials

One measure of the credibility of the monetary and fiscal frameworks is the yield on government bonds. Differentials between countries' bond rates reflect market expectations of inflation and other forms of risk. Increased credibility should be reflected in a decline in inflation and other risk premia. To abstract from short-term cyclical differences it is best to look at the forward yield on bonds. The forward rates below compare the inflation and risk expectations 5 years ahead on UK and German bonds.

Chart 5.1 - Five year forward differentials of UK 5 year-bonds over German bunds

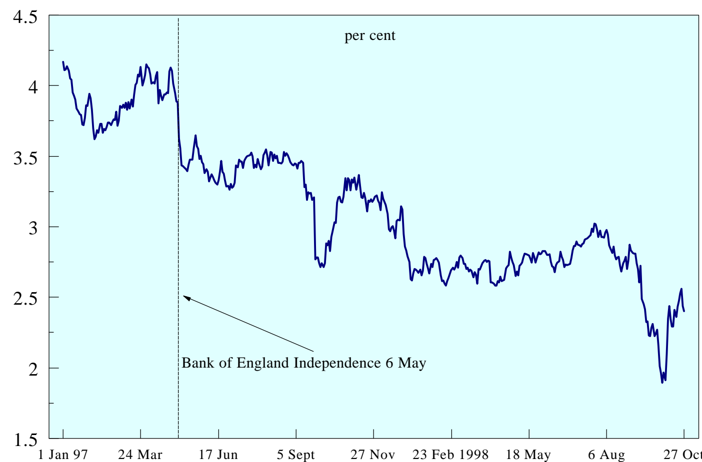


The spread of UK 5-year nominal bond differentials five years ahead against German bunds dropped sharply from 1.2 percentage points in the month before the Bank was made independent to 0.7 percentage points in May 1997. The spread is now around 40 basis points. There has thus been a significant convergence of the yields on UK bonds with those in Germany, reflecting greater market confidence in the ability of UK macroeconomic policy to deliver sustained non-inflationary growth.

Inflation expectations derived from index-linked and conventional gilts

The credibility of the new UK monetary framework can also be gauged by a reduction in inflation expectations. Financial markets expectations can be derived from a comparison of the yield on index-linked gilts with those on conventional gilts.

Chart 5.2 - Inflation expectations 5 years ahead, derived from index-linked and conventional gilts

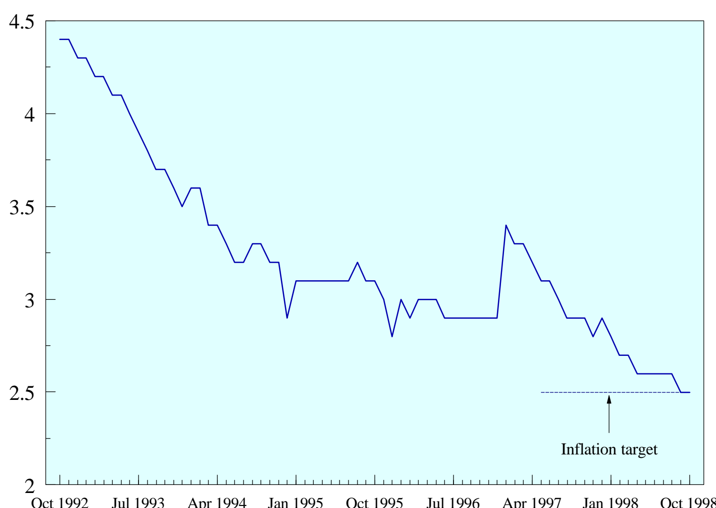


These inflation expectations have been on a downward trend since April 1990, when they stood at 8.1 per cent. Nonetheless, the announcement of Bank independence reduced inflationary expectations from 3.9 per cent in April 1997 to 3.5 per cent in May 1997; and by October 1998 implied inflation expectations had fallen to just 2.3 per cent, below the level of the inflation target.

Independent forecasts of UK inflation

An alternative measure of policy credibility is to look at independent analysts' expectations of inflation. Each month, HM Treasury surveys more than 30 independent organisations' forecasts for the UK economy. Chart 5.3 plots the average of these independent forecasts for UK inflation at the end of the year after the forecast was made (so for example if the forecast was made in 1997 it pertains to the expected inflation rate in Q4 1998).

Chart 5.3 - Average forecast for RPIX inflation one year ahead from HM Treasury survey of independent forecasters



The chart shows that the average independent forecast for inflation for the year ahead has fallen consistently since 1992 to reach 2.5 per cent in October 1998. Inflation expectations for the end of 1998 have fallen by over ½ of a percentage point since April 1997, to the target level.

The independent forecasters' expectations of inflation further ahead have also fallen, demonstrating a belief that inflation will be held to the target level in the medium term. The quarterly survey of independent forecasts shows that expectations of inflation 4 years ahead has come down from 4.2 per cent in August 1993 to just 2.6 per cent in August 1998.

The public perception of inflation

The favourable decline in inflation expected by the markets and among forecasters is not yet fully shared by the public.

Barclays' Basix survey assesses inflation expectations across a range of groups each quarter. The general public's expectation of RPI inflation one year ahead, although it has fallen from a peak of 9.4 per cent in 1990 Q2, was still 4.4 per cent in 1998 Q2. This is some way above the Government's inflation target, even taking into account differences between RPIX and RPI inflation.

So more needs to be done. In particular, those involved in wage bargaining need to recognise that the new environment means permanently low inflation. Failure to understand this will result in unnecessary loss of output and jobs.

5.2 Monetary policy has been tightened earlier this time

Monetary policy was tightened between late 1994 and late 1995, but was loosened by a similar amount in the following six months as the economy showed signs of slowing down. Despite the ¼ percentage point increase in October 1996, economic conditions pointed to the need for a further and sharper increase. The Governor stated in December that in the Bank of England's view an immediate ¼ percentage point increase was needed. There was, however, no further increase until May 1997.

Tightening

By the first half of 1997, the economy was moving above trend with considerable momentum. The new Government raised rates as soon as it took office in May 1997. At this point, the output gap is estimated to have only just turned positive. This stands in sharp contrast to the late 1980s experience (see Chart 5.4 below and Chart 4.1 earlier).

Chart 5.4 - The output gap and interest rates 1993 Q1 - 1998 Q4

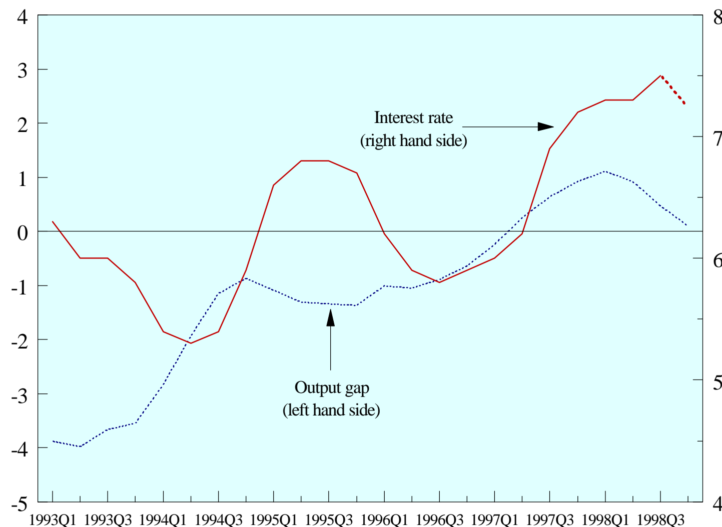


Table 5.1 looks at when monetary policy began to tighten relative to when the output gap closed.

Table 5.1 When monetary policy tightening started in relation to the output gap

	Date policy started tightening	RPIX inflation	Output Gap	Quarters after output gap was closed
1978-1986 cycle	1979 Q2	12.0	1¾	5
1986-1997 cycle	1988 Q2	4.4	3½	8
This cycle	1997 Q2	2.6	¼	nil

In 1988, monetary policy did not begin to tighten until 8 quarters after the output gap closed, at a point when the economy was already 3½ per cent above trend. In 1997, by contrast, interest rates were raised just as the output gap was closed.

The tightening of monetary policy last year helped to prevent the economy from overheating. In contrast to the 1980s, for example, household and corporate balance sheets have held up well and house price inflation has remained at sustainable levels (see earlier charts). The new framework has clearly played a role in ensuring markets believe that interest rates will move in time to deliver the inflation target, and this has helped prevent speculative bubbles from developing.

By tightening monetary policy at an early stage in the cycle the economy should require less steep increases in interest rates. Table 5.2 shows that UK nominal interest rates have fallen back recently from a much lower level - 7½ per cent - than the 15 per cent interest rate peak of the last economic cycle.

UK nominal interest rates also hit a lower trough (of 5¼ per cent) this time than last (7½ per cent). Further, UK nominal interest rates have been less volatile with a range of just 2¼ percentage points compared with 7½ percentage points in the 1980s cycle.

Table 5.2 - Highs and lows of nominal interest rates in recent cycles

	1981Q1 - 1992Q3	1992Q4 - 1998Q2
Low	7½% (May 88)	5¼% (Feb 94)
High	15% (Oct 89)	7½% (Jun 98)
Change	7½ pp	2¼ pp

Lower nominal rates have also been reflected in UK real rates. These reached a high of 4.9 per cent in August 1998, much lower than the 8.4 per cent seen in the last cycle. UK real rates have also been less volatile with a range of 2.4 percentage points compared with 5.2 percentage points in the 1980s cycle.

Loosening

Table 5.3 shows that in both 1990 and more recently policy was loosened just before the output gap turned negative. But in the last cycle, policy was loosened 8 quarters after the output gap started falling because of the inflationary pressures which had built up in the economy. Policy this time has been loosened fairly quickly, just 3 quarters after the output gap began to narrow. Importantly, inflation is at its target rate, compared with over 9 per cent in 1990 and even higher in the early 1980s cycle.

Table 5.3 - When monetary policy loosening started in relation to the output gap

	Date policy started loosening	RPIX inflation	Output Gap	Quarters after output gap peaked
1978-1986 cycle	1980 Q3	16.5	-4	5
1986-1997 cycle	1990 Q4	9.3	½	8
This cycle	1998 Q4	2.5	¼	3

5.3 Monetary and fiscal policy have been tightened together in this economic cycle

In the current economic cycle monetary and fiscal policy have been used together to slow the economy rather than moving in opposite directions as in the 1980s.

Table 5.4 below shows that fiscal policy, as measured by the change in the cyclically-adjusted deficit, tightened from 1994-95 onwards (following the start of tax increases to address the structural deficit), and when the output gap was still negative. Fiscal policy tightened particularly sharply from 1996-97 with the structural deficit estimated to have fallen by 2¾ per cent to 1998-99, bringing the public finances close to structural balance.

Table 5.4 - Change in interest rates, structural deficit and output gap, 1994-95 to 1998-99

Change in:		**1994/95-96/97**	**1996/97-98/99**
Output gap		½	1
Interest rates		¼	1½
Structural deficit		-1¾	-2¾
	1994-95	**1996-97**	**1998-99**
Memo item:			
Output gap level	-1¼	-¾	¼

Over the 5-year period 1984-85 to 1989-90 as a whole, fiscal policy was loosened, with the structural deficit rising by 1 per cent of GDP, at a point where the economy went well above capacity. In the 5-year period, 1993-94 to 1998-99, when again the output gap closed and turned positive, the structural deficit was *reduced* by 5 per cent of GDP (see Table 5.5).

Table 5.5 Change in output gap and structural deficit, this cycle compared to last

Last cycle	1984-85	1989-90[1]	Change
Output gap[2]	-3¾	3¾	7½
Structural deficit[3]	1½	2½	1
This cycle	**1993-94**	**1998-99[1]**	**Change**
Output gap[2]	-3½	¼	3¾
Structural deficit[3]	5¼	¼	-5

[1] one year after peak of output gap
[2] as percentage of potential GDP
[3] cyclically-adjusted Public Sector Net Borrowing as percentage of GDP

The recent significant tightening of the fiscal stance has undoubtedly helped restrain demand and supported monetary policy. Fiscal policy on this occasion has thus helped monetary policy in the short-term regulation of the economy while remaining demonstrably consistent with the objective of sound public finances and the Government's fiscal rules. This means fiscal policy is better placed to support monetary policy in the next phase of the cycle.

6. Conclusions

The UK economy has historically suffered from higher volatility than comparable economies. These large cycles have been, in part, the consequences of policy mistakes as fiscal and monetary decisions were taken without a clear framework and with changing objectives. Required corrective action was typically not forthcoming until it was too late, resulting in greater than necessary problems and excessive corrective action.

The Government's open and transparent new macroeconomic framework has helped the economy to become more resilient and provides a defence against the risk of a return to 'boom and bust'. The new framework offers not only the means to avoid unnecessarily large fluctuations in activity caused by excessively short-term policy decisions, but also allows responses that limit the adverse effects of external shocks.

In the context of the current economic cycle, a number of developments are relevant:

> *monetary policy was tightened much earlier in this cycle than in the previous cycle*: this has meant that despite rises since May 1997 to offset inflationary pressures, base rates have recently been cut. The present level of short-term interest rates is less than half that at a comparable stage of the previous cycle, 7¼ per cent against 15 per cent;
>
> *fiscal policy was tightened as the economy moved above its trend level in 1997:* this helped to support monetary policy in countering the inflationary pressures that had built up;
>
> *the MPC has acknowledged the new global downside risks to the outlook for output in industrial countries:* it has made it clear that this is a factor they take into account in assessing the prospects of meeting the UK's inflation target; and
>
> *long-standing under-investment in the public sector has been addressed:* by doubling the capital budget over the next three years, this should help promote steady growth by raising the productive capacity of the economy over time.

The strengthening of the macroeconomic framework, and increased credibility of policy-making, have already brought tangible results to inflation, expectations of inflation and long-term interest rates, and the public finances:

> *low inflation:* in recent months inflation has reached the 2½ per cent target level;
>
> *lower inflation expectations:* from September, the average year ahead RPIX inflation forecast of independent forecasters monitored by the Treasury fell to the target level of 2½ per cent for the first time - over ½ percentage point lower than the consensus view before the new

monetary policy framework was introduced. Implied long-term inflation expectations from financial markets have also fallen from 4.2 per cent to the target level over this period;

lower long-term interest rates and forward differentials: yields on 10 year bonds have fallen by 2.4 percentage points to 5.0 per cent since the new monetary framework was put in place - the lowest level for 35 years; and, over the same period, the 5-year forward differential with Germany has narrowed by 0.8 percentage points; and

a £20 billion fall in borrowing last year: this has dealt with the structural problem in the public finances, and means fiscal policy is better placed to support monetary policy in the next phase of the cycle.

The UK is not immune to adverse effects of world developments. However, the achievement of low inflation and sound public finances, within a policy framework designed to lock these results in over the economic cycle, offers important scope to be able to respond successfully. The UK is thus better placed to withstand the pressures of external and other turbulence. While one quarter of the world currently in recession, the prospective slowdown in growth for the UK is expected to be more moderate than otherwise might have been the case.