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Stability, Growth and UK Fiscal Policy

by

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STABILITY, GROWTH AND UK FISCAL POLICY

Introduction

It is a great pleasure to be here, at the invitation of the York University Economic Department, and in the presence of the Vice Chancellor, to give the inaugural Ken Dixon lecture.

I know that Ken Dixon has been a staunch and loyal supporter of this University. Having presided over the successful merger with Nestle, he left his position as Chairman of Rowntree and became Chairman of this University. And over the past decade he has steered the University though a dramatic expansion from under 5,000 to over 10,000 students and 30 academic departments and research centres – now overtaking Rowntree as the biggest employer in York.

And I know too that Ken Dixon has been a generous source of both advice and support to the Economics Department, supporting seminars and visiting fellows and helping to secure this Department's standing as a leading centre of expertise in macroeconomics and also in the economics of healthcare.

I would like to express my personal gratitude also to Professor Mike Wickens – for his support in organising this lecture, his leadership in this department but also for the advice that he has given the Treasury over recent years:

- on monetary and fiscal issues as a member of the Keynes seminar group;

- and more recently on the work coming out of the Treasury's assessment of the five economic tests on UK membership of the Euro in June, in particular on UK and European fiscal issues.

You will see that Professor Wickens has been taking a close interest in fiscal issues during a period in which, following three decades in which monetary policy has been under greater scrutiny, fiscal policy issues are now to the fore:

- globally as deficits in the United States, fiscal and current account, and the mismatch in growth performance within the G7 have fuelled fears about the sustainability of the global recovery;

- in Europe, as the tensions in the Euro area over the implementation of the Stability and Growth Pact have become heightened and the case for reform hotly debated;

- and, of course, here in Britain as we - like all countries dealing with the fiscal consequences of the recent global downturn – have seen our new fiscal regime tested against the yardsticks of both stability and growth.

Hence the title of my lecture this evening - Stability, Growth and UK Fiscal Policy.

I want to set out the principles that underpin our approach to both monetary and fiscal policy in the UK, the lessons we have learned in operating fiscal policy in our new fiscal regime and assess its performance so far. I will then show how these principles are relevant first to the debate about the role that UK fiscal policy could play in delivering stability and growth were the UK to join the Euro, and second to the current debate about reform of the Stability and Growth Pact.

Principles of Modern Macroeconomic Policy

My starting point is the new challenges that policymakers have had to face up to over recent decades in making monetary and fiscal policy in increasingly open and fast-moving global capital markets and the common lessons we have learned.

It is clear that the combination of instruments, objectives and constraints differs markedly between:

- establishing a new framework for domestic monetary and fiscal policy,
- using fiscal policy as a tool for domestic stabilisation within a monetary union, and
- coordination of monetary and fiscal policy within a trans-national monetary union.

But in each case policymakers are facing the same underlying challenge – how to have a credible, flexible and legitimate policy regime which can promote both stability and growth.

For Britain in 1997, after the boom-bust economic cycles of the past twenty or so years, a change of government provided a unique opportunity to learn the lessons of Britain's post war economic history and establish a modern, pro-stability but post-monetarist macroeconomic framework that responded to the challenges of the global economy.

In establishing this new framework, we knew we had to reject a purely discretionary reliance upon government fine-tuning of the macroeconomy based on an assumed long-term trade-off between unemployment and inflation which had collapsed intellectually and empirically.

And we knew that we needed a credible framework which solved what economists call the problem of "time-inconsistency" – the temptation to make a dash for short-term growth at the expense of long-term stability.

But in the search for credibility we also had to learn from the failure of monetarism as a macroeconomic doctrine - both domestic monetarism and Europe monetarism in the form of the pre-1993 ERM. Its failure was not its rejection of old-style fine-tuning or its desire to achieve long-term credibility in policymaking but its inflexibility in prioritising low money supply growth as the route to low inflation and growth just at the time when the apparently stable relationship between the growth of the money supply and inflation broke down as capital markets were opened up.

Following Britain's exit from the ERM the government of the day did take some tentative steps in the direction of a more credible regime for monetary policy: the shift to inflation targeting and publication of minutes of a monthly discussion between the Chancellor and the Governor. But that did not constitute a credible and sustainable approach.

Decision-making remained highly personalized, the inflation target was ambiguous and deflationary and - as the Treasury concluded in its recent assessment of the old and new systems – "policy-makers operated behind closed doors and decisions were often made with little or no explanation". Most problematic, the suspicion remained that policy was being manipulated for short-term motives.

In fiscal policy, if anything, the flaws were greater still in the 1980s and persisted into the 1990s - as set out in the Treasury 1997 paper *Fiscal Policy: learning the Lessons from the Last Economic Cycle*:

- Fiscal policy objectives were not well specified, and changed frequently. Between the early 1980s and the mid 1990s, at least 8 different fiscal policy objectives can be identified – roughly one every two years.

- Even when objectives persisted for sometime, they were vague, for example 'back towards balance over medium term'. This continual change and vague nature undermined the credibility of fiscal policy.

- reporting requirements on government were much more limited, making it more difficult to judge the performance of fiscal policy. This allowed the government to take an incautious approach to the cyclical position of the economy in late 1980s - at a time when the government's view of the output gap was kept secret - leading to errors in the conduct of fiscal policy. This misjudgment arose, in part, because the underlying trend rate of growth of the economy was overstated.

That is why in 1997 we set out to establish a new British macroeconomic framework which could meet three central objectives:

First, Credibility. We needed a policy framework in which the government's commitment to long-term stability - low inflation and sound public finances - commanded trust from the public, business and markets.

Second, Flexibility. We needed a framework within which policymakers could take early and forward-looking action - in monetary and fiscal policy - in the face of the ups and downs of the economic cycle without jeopardizing the credibility of the Government's long-term goals.

And third, Legitimacy. The new framework had to be capable of rebuilding and entrenching public support and establishing a new cross-party political and parliamentary consensus for long-term stability – a new consensus about goals and a new consensus about the institutional arrangements needed to deliver those goals.

The new post-monetarist model of macroeconomic policymaking we have put in place to meet these objectives is based on "constrained discretion". It is an approach which recognises that the *discretion* necessary for effective economic policy - short-term flexibility to meet credible long-term goals - is possible only within an institutional framework that commands market credibility and public trust with the government *constrained* to deliver clearly defined long-term policy objectives and with maximum openness and transparency.

Central banks cannot cut interest rates in the face of weakening global demand if they face accelerating inflation and have to worry about undermining the credibility of their commitment to their inflation target. Governments cannot use fiscal policy to support growth in a downturn – through automatic stabilisers or discretionary changes – if they already have unsustainable levels of debt. Short-term flexibility and discretion is only possible where policy is credibly constrained to deliver long-term stability.

So to make this constrained discretion model of macroeconomic policy operational, we established three principles for sound policymaking:

- Clear and well defined long term policy objectives;

- pre-commitment to sound institutional arrangements which could allow credible and flexible policy responses in the face of shocks;

- and maximum transparency.

Maximal transparency is, in my view, a critical part of the new model. Because combining long-term credibility and short-term constrained discretion to respond to shocks is only possible if policy-makers are seen in practice to be genuinely pre-committed to delivering long-term stability and take the time to build a track record for doing so.

The New UK Monetary Framework

Our first task in 1997 was to apply these “constrained discretion” principles to monetary policy and establish a new model of central bank independence. That new British model has the following features:

First, sound long term objectives:

- a single symmetric inflation target: with no ambiguity about the inflation target, no deflationary bias and no dual targeting of inflation and the short-term exchange rate;

Second pre-commitment to credible institutional arrangements:

- a strategic division of responsibilities: with the elected government setting the wider economic strategy and the objectives for monetary policy, while monthly decisions are passed over to the central bank, thereby pre-committing the government to long-term stability and the Bank to a pre-emptive and forward looking approach to making policy;

- monthly decisions to meet the government's inflation target taken monthly by an independent Monetary Policy Committee made up of the Governor, four Bank executives and four outside experts appointed directly by the Chancellor and with a non-voting Treasury observer present for all meetings;

- and built-in flexibility: with the Open Letter system to allow the necessary flexibility so that policy can respond in the short-term to surprise economic events without jeopardizing long-term goals and proper procedures to ensure co-ordination between monetary and fiscal policy;

Third maximum transparency:

- with, in addition to the Open Letter system, monthly minutes published and individual votes attributed and with a strengthened role for parliament - so that the public and markets can see that decisions were being taken for sound long-term reasons and in order to support the government's wider objectives for living standards and employment.

I want to dwell for a moment on the Open Letter system, which I believe is one of the most important innovations within the 1997 model of Bank independence and which will become relevant later when I turn to UK fiscal policy.

If inflation goes more than one percentage point either side of the inflation target – previously the 2.5 per cent RPIX target, now the 2 per cent CPI target - the Governor is required to write to the Chancellor, on behalf of the MPC, explaining why it has happened, what the MPC has done about it, how long it will take for inflation to come back to target and how the MPC's response is consistent with the government's economic objectives - both for price stability and high and stable levels of growth and employment.

Some have assumed it exists so that the Chancellor can discipline the MPC if inflation goes outside the target range. In fact the opposite is true. From time to time there are inevitably economic events or shocks which throw things off course, and historically, Britain has had deviations beyond this magnitude of 1 percentage point on a number of occasions. 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 2.5 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 - why the shock had occurred, what they were doing to get inflation back to the target over what period - and allows the Chancellor publicly to endorse it. In this way, transparency and accountability have the potential to make it easier for the MPC to be flexible when necessary without risking its long-term credibility.

The New UK Fiscal Framework - principles

Let me turn now to the UK's fiscal regime.

Our first act was Bank of England independence, and monetary policy has since 1997 played the primary stabilisation role. Fiscal policy has been primarily medium-term in its orientation. But, for a government seeking to establish credibility, promote economic stability and embark upon on a sustained period of investment in public services, achieving both credibility and flexibility in fiscal policy was equally important.

I am not going to discuss the reforms to the public spending framework we introduced in 1998 such as three year spending settlements, end year flexibility and output targets for public services. Instead I want to show how in our reforms to the macro-fiscal policy regime, introduced in 1997 and 1998, we have sought to apply the very same "constrained discretion" principles that we have applied in monetary policy.

First, sound long term objectives:

The fiscal counterpart to the symmetric inflation target is the government's two fiscal rules which since 1997 we have operated fiscal policy to meet:

- the golden rule, that we shall borrow only to invest over the economic cycle;

- and the sustainable investment rule, that net debt as a proportion of GDP will be kept at a low and stable level over the economic cycle.

These two fiscal rules:

- focus on fiscal sustainability because the sustainable investment rule ensures that while borrowing for capital investment is permitted over the economic cycle, this borrowing does not affect the long-term sustainability of the public finances. We are committed to maintain net debt below 40 per cent of GDP in each year of the economic cycle. But unlike a balanced budget rule, the sustainable investment rule implies a stable rather than a falling debt-GDP ratio;

- focus on inter-generational equity by permitting borrowing for long-term investment, that benefits future generations, but not for consumption – thereby removing the old bias against capital investment;.

- take account of the cycle in a symmetric way, allowing - subject to meeting the rules over the cycle - the fiscal balances to vary between years in accordance with the cyclical position of the economy. This means that the Government can allow the automatic stabilisers to work in full, and where appropriate use discretionary fiscal policy, so that fiscal policy can support monetary policy in maintaining macroeconomic stability;

- but, unlike monetary policy, the rules are deliberately asymmetric because of deliberately cautious assumptions about, for example, the trend rate of growth. Using cautious assumptions for our key forecast variables, and stress testing our projections against a cautious case of lower trend growth has built a margin against uncertainty.

Some economists have argued that a better way than the golden rule to measure intergenerational fairness would be through a balance sheet approach, monitoring indicators such as net worth. This would provide a more complete picture of the Government's finances, looking at assets as well as current and future liabilities. But introducing such a framework would be difficult. The current National Accounts measure of net worth is not used in the fiscal framework because of difficulties accurately measuring the Government's assets. And while innovations such as Whole of Government Accounts will offer better quality data, there are many technical and methodological issues that still need to be addressed. Experience with other countries has shown problems with a balance sheet or net worth approach to fiscal policy.

A significant advantage of the golden rule is that it is a clear rule based on widely accepted and internationally agreed accounting principles. We define capital spending based on the internationally agreed definition of general government net fixed capital formation to avoid any accusation that we take a deliberately elastic approach to capital. And, we know from previous experience, that it is a lack of clear rules and objectives that poses one of the greatest threats to credibility.

But we also try to analyse more comprehensive – and complex – indicators of the long-term fiscal position and intergenerational fairness. The Government's Long-Term Public Finance Report sets down a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances. This includes a variety of indicators including measures of intergenerational fairness. These indicators show that, on a basis of reasonable assumptions, that the UK public finances are sustainable in the longer term and are relatively well placed compared to other countries to meet the challenges of an ageing population.

Some commentators have argued that published borrowing and debt figures understate the level of true liabilities as they ignore expenditure under the Private Finance Initiative. But this ignores the fact that the total capital value of all PFI deals amounts to only 3 per cent of GDP, and all PFI deals are subject to independent audit against independent accounting standards and are reflected in public sector accounts accordingly. Today almost 60 per cent of total capital investment under signed PFI contracts is already scored on the public sector balance sheet - including the London Underground PFI contracts - and is reflected in the figures for public sector net investment and public sector net borrowing.

The second principle is pre-commitment to credible institutional arrangements:

One option we considered and rejected would have been to replicate the MPC with an independent fiscal committee. The wider political complexity of fiscal policy making - the different impacts that the different levers have on a range of different objectives of which stabilisation is only one – would have implied a politically unsustainable break with UK parliamentary tradition.

Instead, the fiscal counterpart to Bank of England independence is the Code for Fiscal Stability. This code – given legal backing in the 1998 Finance Bill – is designed to enhance the credibility and transparency of fiscal policy. It requires:

- clearly stated objectives and rules for fiscal policy;
- independent audit of key assumptions; and
- regular and open reporting of fiscal issues.

Third, maximum transparency:

The Government has, through the Code for Fiscal Stability, and further developments made substantial progress in improving the information available on fiscal prospects. This includes:

- publishing full five year ahead forecasts for the public finances – including cyclically-adjusted fiscal aggregates and performance against the fiscal rules;
- twice yearly setting out the economic and other assumptions underpinning the public finance projections;
- publishing the government's estimates of the output gap and cyclically adjusted fiscal aggregates so that progress against the fiscal rules can be assessed across the economic cycle;
- ensuring that key assumptions are subject to independent audit by the NAO; and
- publishing full and complete information on the fiscal outturns in the End of Year Fiscal Report and a thorough analysis of the long-term fiscal projections covering the next 50 years in the Long-Term Public Finance Report.

While it is clear that decisions are still a matter for the Chancellor and the Government, the purpose of the Code is, by combining clear rules, clear procedures and enhanced transparency, to achieve a much greater and more systematic scrutiny of fiscal policy than had been achieved before.

The New UK Macroeconomic Framework – Practice To Date

As in monetary policy, so in fiscal policy it is against the three objectives for modern macroeconomic policymaking - credibility, flexibility, and legitimacy - that the new system must be judged.

First credibility.

With reforms to Bank independence and the fiscal regime, Britain has - I believe - made a decisive step forward to a credible model of macroeconomic policy-making in Britain.

The sound and forward-looking judgments of the MPC over the past seven years have seen the British economy combine stability with growth close to its trend in the face of two global shocks.

But less appreciated is how the new fiscal framework has radically changed the way in which UK fiscal policy operates and helped to reduce domestic macroeconomic volatility.

Pre-1997, the consequence of allowing the fiscal objectives to change from year to year was that tax and spending decisions could be made in isolation from each other with the published fiscal balance the residual in the fiscal policymaking process. The issue of what the rules and the framework should be effectively became a choice variable within the annual Budget decision process.

It is striking how, by committing to keep to the same fiscal rules year on year – now after seven years the longest period of stability in the fiscal regime in the post-war period - the fiscal rules and the Code for Stability have established a new paradigm in which fiscal policy is made, scrutinised and assessed. Whether the government is on track to meet its fiscal rules has become the key test of the credibility and sustainability of fiscal policy-making.

The result is that macro-fiscal policy and the fiscal rules are now central to the Budget making process.

Internally at the Treasury– tax and spending decisions now have to be taken together to ensure that the fiscal rules are met. And the Government's semi-annual fiscal forecast is now as important to the Treasury's fiscal policymaking process as the Bank of England's quarterly inflation forecast is to monetary policy. Both fiscal and monetary policy are now subject to a high degree of public scrutiny, whether it be publishing minutes of the MPC's meetings or the open way in which assumptions underpinning the fiscal projections are independently audited and forecasts debated.

From the outset in 1997 the Government has acted to ensure that its fiscal rules will be met. The two year public spending freeze, tax decisions taken in 1997 and 1998 and, in particular, the decision to use the proceeds from the 3G mobile auction - £22bn – to repay debt – all helped to establish the credibility of the Government's commitment to meeting the fiscal rules – and to strengthening the fiscal position and cutting net debt to a lower level than any other G7 country.

Over the period 1996-97 to 2000-01, the fiscal stance was tightened by nearly 4 per cent of GDP. This contrasts with previous periods when the economy moved above trend. Between 1985-86 and 1990-91, the fiscal stance was loosened by nearly 2.5 per cent of GDP; and between 1971-72 and 1974-75 the fiscal stance was loosened by over 7 per cent of GDP.

Having the key assumptions that underpin our fiscal projections independently audited combined with comprehensive and transparent fiscal reporting and thorough parliamentary scrutiny has helped to ensure that the Government's forecasts remained cautious and prudent. Even though during the recent global downturn net borrowing has overshot the Government's fiscal forecasts, as has happened to governments all round the world, the Treasury's forecasting record shows that since 1997, our forecasts for the public finances have been on average cautious – and more cautious than in the past. This year's End-Year Fiscal Report examined the differences between forecasts and for borrowing and outturn for the 15 EU countries over the last five years. It showed that the UK has tended to be one of the most cautious forecasters, overestimating the level of borrowing by 0.7 per cent of GDP on average. In fact the UK has been the third most cautious forecaster in the EU with only Finland and Luxembourg tending to overestimate borrowing by more.

Some commentators have argued during our first Parliament that it was a mistake during the above trend phase of the cycle for the Treasury, using cautious assumptions, to deliberately over achieve its fiscal rules. But the reason for building up a margin for error in the early phase of the economic cycle was precisely to guard against an asymmetric fiscal cycle and the kind of upward revision to borrowing that the UK– like other countries – has seen over the past two years. The fact that we are on track to meet the golden rule with the annual average surplus over this economic cycle projected to be 0.2 per cent of GDP, equivalent to a margin or surplus of £14 billion and to meet the net debt rule with a margin of 4.5 per cent of GDP - or £64 billion - is a direct consequence of the deliberately cautious approach we have taken.

The scrutiny of the Bank of England's Monetary Policy Committee has also helped establish the credibility of the Government's commitment to meeting the fiscal rules. Some in 1997 feared that Bank independence would lead to less co-ordination of fiscal and monetary policy. In fact, monetary and fiscal policy are much more co-ordinated now than they ever were when the sole decision-maker was the Chancellor for both interest rates and fiscal policy.

This is partly because the Treasury representative explains the fiscal strategy to the MPC regularly, and in particular at the meeting before each Budget, on the basis of clearly defined fiscal rules set over the economic cycle. But more importantly the MPC is free - in a transparent way - to respond with interest rates to fiscal policy. And the combination of transparency and the clarity of the symmetric inflation target together mean that, in preparing the Budget, the Treasury knows that it will be judged both in terms of its medium-term fiscal rules and what the MPC does and says in its Minutes about fiscal policy. There is no way, as in the past, that the Chancellor can any reward him or herself with an interest rate cut the day after the Budget as happened on numerous occasion in the past.

As a result of these monetary and fiscal reforms, long-term interest rates - the simplest measure of monetary and fiscal policy credibility – are around their lowest levels since the 1960s. The differential between UK and German 5 year forward rates has fallen by 65 basis points between May 1997 and today, while 10 year forward interest rate differentials with Germany have fallen by around 1.5 percentage points since May 1997. Indeed UK 10 year forward rates are currently almost 0.6 percentage points below those in Germany.

At the same time, inflation expectations in the financial markets 10 years ahead have averaged 2.6 per cent since May 1997 compared to 4.6 per cent in the period between October 1992 and May 1997.

This greater credibility is laying to rest the myth that a left of centre government, with ambitions for full employment, to cut poverty and to deliver sustained investment in public services, cannot run a successful and prudent long-term economic policy.

Second flexibility.

The credibility that the government has built up through these new arrangements in fiscal and monetary policy and its track record for economic management has allowed it to respond flexibly to unexpected global events.

It has been possible to allow the automatic stabilisers to work in full and for fiscal policy to play its full part in supporting monetary policy during a period of below trend growth, while maintaining sound public finances. By contrast, in both the early 1980s and early to mid 1990s, the fiscal stance had to be tightened when the economy was below trend.

Third legitimacy.

Seven years on from Bank independence, is clear that the legitimacy of the UK's new monetary regime has been established with cross party support. It would be premature to reach the same conclusion in fiscal policy. But progress has been made – and the combination of the Code and the transparency of the system mean that it would now be very difficult for any government to drop the current fiscal rules without a credible alternative.

The high level of transparency in the UK's fiscal framework has also attracted growing support. The IMF has "welcomed the high standards of transparency in fiscal policy." These features of the framework have helped to build a consensus that openness and transparency are essential features of a credible fiscal framework.

Some argue that we would have established greater credibility and legitimacy if we had gone further in institutional reform - by getting independent experts, if not to set the fiscal policy stance, at least to give a public view or date the economic cycle.

I am not sure, myself, whether in practice such changes would have made any difference. It is hard to see how public scrutiny or commentary could have been more intense over the past few years. And I have always also been skeptical about the role of government sanctioned public commentators. Some people may believe that the role of the Chancellor's Wise Men between 1993 and 1997 was to hold the Treasury to account. In practice because the Wise Men could never agree, the resulting cacophony if anything reduced the scrutiny of the Treasury's decision-making.

But legitimacy comes, above all, from building a successful track record. It is the credibility of the MPC's commitment to the symmetrical inflation target which allowed it to respond flexibly to global events and avoid recession over the past two years. And it is clear medium-term fiscal rules and the credibility that has come from using the above trend phase of the economic cycle to cut and keep debt well below our 40 per cent ceiling and well below other G7 countries that means that - as we set out in the Pre-Budget Report - we can both allow the automatic stabilizers to work fully and stay firmly on track to meet all our spending commitments and our fiscal rules.

Building a reputation for economic stability requires a continued commitment to vigilance. It is precisely at this stage when past British governments have resorted to short-termism. We will not repeat those mistakes.

That it is why we have backed the MPC in the decisions it has taken to lock in stability as the British economy strengthens – as today's fourth quarter GDP figures confirm. And with UK economic growth now clearly strengthening and becoming more balanced and the underlying state of the UK public finances strong and sustainable, the Budget and Spending Review will meet all our commitments and maintain our disciplined approach to the long-term management of the public finances. We will meet our fiscal rules in this economic cycle and in the next economic cycle too.

Internationally, too, I believe there is a growing recognition that, in the face of a series of large and destabilising shocks to the global economy, those countries where monetary and fiscal policy have been flexible, forward-looking and supported growth, with automatic stabilisers allowed to operate fully, have had shallower downturns and are leading the recovery.

By contrast, where monetary policy has been sluggish and inflexible or fiscal policy still based on the old style annual incrementalism, blind to the economic cycle, then economies have tended to fare worse in terms of growth and inflation. Indeed, where there is no credible long-term commitment to fiscal stability over the economic cycle, economies can find themselves in the perverse position of cutting spending or raising taxes at the wrong time of the economic cycle to meet short-term annual deficit targets - putting both growth and stability at risk.

Growth in the Euro zone has continued to be weak and activity in Japan remains fragile. Since the last quarter of 2000 GDP has grown by around 6 per cent in the UK and the US, but by less than 1 per cent in Germany and Japan, around 2 per cent in Italy and France, the Euro area as a whole.

This weaker performance in the Euro area is partly due to structural problems, evidenced by both high unemployment and sluggish labour force growth. But the role of macroeconomic frameworks in allowing monetary and fiscal policy to operate fully is also an issue.

Fiscal Stabilisation in EMU

Which brings me to the Stability and Growth Pact (SGP).

Some have argued that the Stability Pact is not necessary. I disagree.

It is necessary for reasons of fiscal coordination so that monetary and fiscal policy can work sensibly together without putting undue upward pressure on interest rates - a challenge which is inherently more difficult when the counterpart to the monetary authority is not one sovereign state but twelve countries and where coordination between fiscal authorities is a necessary precondition for effective coordination between fiscal and monetary policy.

It is necessary for reasons of fairness and legitimacy – to prevent high debt counties from simply continuing to run high deficits and debts and spreading the risk of default across all the members of the monetary union. The question is whether it is also necessary - as we set out in the UK's Euro assessment – to have a Pact that can legitimise a degree of fiscal flexibility for individual members states.

It is important to recognize that progress has been made in recent years in making the Stability Pact less mechanistic. As is has evolved to meet the new challenges, more recognition has been given in the detailed operation of the Pact to the importance of the cycle and of sustainability.

But the question is whether the SGP has so far proved - at the present time and in its current form – the best possible e vehicle for delivering the fiscal discipline that is necessary in a monetary union.

In the Euro area, general gross debt averaged around 70 per cent of GDP in 2002; and some member states have debt levels above 100 per cent of GDP, compared to 38 per cent in the UK and 60 per cent in the US.

And of course the 3 per cent deficit ceiling makes it difficult to fully operationalise the automatic stabilisers and to deliver fiscal flexibility in the face of global economic shocks.

Our interest in the future evolution of the Stability and Growth Pact is not just because the success of the Euro, in which the UK has a substantial national interest, depends on an effective pro-stability and pro-growth fiscal counterpart to the ECB and because the UK continues to be subject to fiscal surveillance under the Treaty.

It is also because we are committed in principle to membership of the euro – a principled commitment strengthened by our assessment. Upon joining the Euro, the UK would become subject to the full implementation of the Stability and Growth Pact. So how that SGP operates in practice is of critical importance to how the UK could operate fiscal policy in EMU.

This latter issue is a complex one – set out in detail in both the five tests assessment and the supporting paper I have referred to *Fiscal stabilisation and EMU.*

That background study – the eighteenth of the eighteen published alongside the assessment - has attracted a number of comments. It was described as “an imaginative set of proposals” by the FT’s Martin Wolf; “extremely interesting and valuable” by Professor Wickens, “a return to Keynes” by The Business newspaper. It was even described by the economics editor of the Times as “a raunchy report, the economic equivalent of Jilly Cooper” which was quite a tribute to the Treasury economists who authored its contents.

I cannot hope to do justice to the subtlety of all the arguments in that paper in this one lecture. But I will first summarise the proposals we have set out for consultation to amend our current fiscal regime if we were to join the Euro. I will then set out how these proposals are consistent with a well functioning - credible but flexible - Stability Pact.

The five tests assessment sets out in detail the benefits that, based on sustainable and durable convergence, the UK could benefit as a member of the Euro.

It also sets out how, once a British set interest rate is replaced by a European wide interest rate, other adjustment mechanisms in the economy become more important.

Outside the Euro there are four possible ways for the economy to adjust in the fact of a shock to that country in order to sustain stability and growth: monetary policy, exchange rate adjustment, fiscal policy or flexibility in wages and prices.

Once a country joins a monetary union, the range of macroeconomic policy levers available to national authorities narrows.

First, a country necessarily loses monetary policy as a country-specific stabiliser. ECB monetary policy would still play a stabilising role for the UK to the extent that the UK contributes to a rise or a fall in the overall Euro inflation objective, but this is clearly a much less effective tool for UK stabilisation than a UK interest rate.

Second, a country loses the nominal exchange rate as a source of national real exchange rate adjustment.

So the adjustment to an economic shock must come through some combination of

- flexibility in wages, prices, quantities and capital movements;

- or a greater reliance upon fiscal policy as a tool for domestic stabilisation.

That is why the Five Tests assessment emphasises the second flexibility test and why we have embarked on a series of reforms to the labour, product and capital markets to enhance flexibility.

But while flexibility in the economy can and must be enhanced, relying solely on greater flexibility in prices and quantities to accommodate shocks could potentially be disruptive to both stability and growth. So the question naturally arises, if the UK were to join the Euro, is there case for a larger role for UK fiscal policy as a tool for national stabilisation, either through the use of the automatic stabilisers or discretionary action, in the face of UK-specific shocks or a more pronounced UK reaction to a common shock? And how could the current fiscal framework be modified to mitigate the impact of economic shocks and help smooth out the resulting gyrations in output and inflation?

It is important to strike a note of caution.

Because the history of fiscal activism and fine-tuning in Britain has not always been a happy one. The historical discussion in the Treasury paper demonstrates that in the 1950s and 1960s, when the exchange rate was part of a fixed exchange rate system and in which fiscal policy was the main stabilisation tool, the UK experienced rather unstable output. The paper argues that this was primarily due to three factors:

- rather than taking a symmetric approach to the economic cycle, there was a bias towards loosening - it was always easier to loosen fiscal policy when the economy was weaker, but much harder to tighten fiscal policy when the economy was stronger;

- the existence of long decision and implementation lags meant that, too often, what governments thought were counter-cyclical policy decisions tended to be pro-cyclical and therefore destabilising;

- and there was a lack of coordination between spending and tax decisions with spending decisions often more than offsetting adjustments on the revenue side done for demand management reasons.

It is clear – on reflection - that these problems with fiscal stabilisation in the 1950s and 1960s were exactly the problems which undermined the role of monetary policy and fiscal policy in the 1980s and early 1990s.

Yet while fiscal policy is inherently more complex and less predictable than monetary policy, there are no intrinsic reasons – theoretical or empirical - why fiscal policy cannot work effectively as a tool for stabilisation. The challenge, as we set out in the background study to the Euro assessment paper, is to apply the same principles that we have successfully applied to monetary policy.

That means, in addition to our two fiscal rules, the fiscal stabilisation regime would also need to have:

A clear long term policy goal:

- Symmetric - to deal with that danger of a bias towards loosening and ensure that the regime was operational in both phases of the cycle;

- And explicitly forward looking in order to avoid pro-cyclicality – the danger of the government getting caught behind the curve and tightening or loosening too late.

Clear and transparent operating rules:

- so that fiscal policy can be used in a counter-cyclically in a predictable and orderly way without putting fiscal stability at risk

And be transparent:

- both for reasons of credibility and legitimacy to ensure that stabilisation policy was, as far as possible, separated from other government policy objectives.

One option would be for the UK to stick with its current fiscal framework and simply rely on the automatic stabilisers. The automatic stabilisers are clearly symmetric, operate without policy lags and do not require an active choice to trade off with other objectives.

But while the automatic stabilisers are important – and part of our current work programme is looking at their effectiveness relative to other countries and whether there is a case for enhancing them – they are insufficient by themselves.

First in the face of large shocks, as the simulations accompanying the Euro assessment show, they only partly dampen the shock. And second, while appropriate for a demand shock, in the face of a permanent supply shock, the automatic stabilisers will tend to give a perverse outcome. In the case of a negative supply shock, actual output will tend to be higher than and lag behind the fall in potential output, leading to a positive output gap (so that if anything, a fiscal tightening would be needed). However, as the level of output falls, so falling incomes will tend to lead to a drop in tax revenues through the automatic stabilisers, which would loosen fiscal policy.

But as in domestic monetary policy, it is when governments need to turn to discretionary fiscal policy that risks to credibility start to arise. And in the Euro, this would be further complicated by the risk of tension between domestic stabilisation, the ECB's Europe wide inflation objective and the demands of the Stability and Growth Pact.

So what we have looked for is a system in which discretionary fiscal policy would be the exception rather than the norm – but an exception which, as the Peter Westaway modelling of shocks and adjustment mechanisms in EMU shows, a prudent government would want the flexibility to employ if necessary.

So how could such a flexible and legitimate national regime be designed for national fiscal policy with the Euro zone?

First long-term objectives.

The objective of this fiscal stabilisation rule is clear – subject to the ECB's inflation target, to minimise deviations of output and employment from the economy's trend.

This objective could be specified as a UK inflation target alongside the ECB inflation target. Ideally, these would be the same target to ensure inflation expectations were aligned correctly. But there would be a real presentational risk of confusion because there would be times when the best way to respond to a UK specific shock would be to accommodate the shocks through a temporary period of higher inflation, in order to change relative prices between the UK and the rest of the euro zone.

Alternatively, the stabilisation target could be based on an output gap target, - though the output gap is notoriously harder to measure accurately and subject to revision. This would make it hard to commit to a rigid output-gap based rule.

In any case, either rule applied at all times could well imply much greater fine-tuning and less flexibility in the face of different shocks than the national policy maker would want in fiscal policy.

What is needed is a way of identifying those shocks which were both sufficiently severe and where a fiscal response made sense.

That is how our thinking led us not to a policy rule but to an operational stabilisation rule: that, subject to meet our two existing fiscal rules, if at any point, the deviation of the economy away from a stable path was expected to be over a particular amount then the option - but not the requirement - of a fiscal response would be triggered.

In our stabilisation paper, we proposed for consultation a rule based on an output gap trigger of 1 or 1.5 per cent. If the economy moved away from its sustainable path by more than 1 or 1.5 per cent, then a possible fiscal response would be triggered.

Setting a high value for the trigger point would mean that fiscal policy would be less active and therefore output could be more volatile than necessary (less stabilisation than desirable). A low value means that fiscal stabilisation policy would be used relatively frequently and/or the fiscal impulse itself would be larger.

Looking back over the past two decades, the output gap has exceeded 1.5 per cent for prolonged periods on only three occasions:

- During the deep recession of the early 1980s when the output gap was almost minus 7 per cent at its widest point.

- During the boom of the late 1980s when the output gap peaked at over 4 per cent; and

- During the bust of the early 1990s when the output gap approached minus 4 per cent.

There are clear advantages in defining the rule in this way.

First it is clear that the trigger relates to the underlying objective – avoiding excessive instability in UK output.

Second the trigger is symmetric so that if the economy is too strong the rule triggers the option of a fiscal tightening; if the economy is weak the option of a fiscal loosening is triggered.

Third while the trigger is predictable, the policy response is not automatic. In each circumstance, the obligation is on the government to justify whether or not it has decided to use fiscal policy to stabilise the economy – just as the MPC, in the current UK system, often has to explain to the markets and Parliament why it has chosen not to act in any particular month.

And fourth, it establishes an explicit link between flexibility and sustainability across the economic cycle and the level of net debt. Because the immediate question becomes: would the use of fiscal policy to support growth put the Government's other fiscal rules at risk? It is only in circumstances where the government is clearly meeting the net debt rule, and the public finances are sustainable, that the Government can, in a credible way, deliver stability by triggering the stabilisation rule.

Having established the rule, the next requirement is to establish a pre-commitment to institutional arrangements which ensure that the discretion to actively use fiscal policy over the cycle is being used in a way which is symmetrical and stabilising.

I explained earlier why, in the current regime, we considered and rejected the option of attempting to mirror the Monetary Policy Committee with an independent fiscal authority. In my view complexity and parliamentary sovereignty would, if anything, be more important issues if the UK were to join the Euro.

Instead, our fiscal paper proposes a different institutional device - a fiscal version of the open letter system in which if the output gap were forecast to be greater than say 1.5 per cent then the government would write a letter to Parliament explaining whether, and how, it intends to use fiscal policy to meet its stabilisation and wider economic objectives.

It is, of course, a different kind of open letter from the monetary policy open letter system – indeed an even more significant and forward-looking one. In the case of the MPC the committee is explaining to the Chancellor how the actions it has already taken are consistent with meeting the inflation target. In the case of the fiscal open letter system, the fiscal open letter is signalling a new decision based on a forecast of the future. The letter would need to explain why the shock is occurring, whether it is right to act, if so, how, how long it will take for output to come back towards trend and also how that action is consistent with the Government's fiscal rules, the Stability and Growth Pact, the ECB inflation target and the Government's wider objectives for growth and stability.

The third requirement is transparency.

Because the communication of fiscal policy becomes critically important both to deliver stability in the economy and to explain to the public why action is or is not justified.

That is why we have proposed a regular Treasury stabilisation report, produced on a quarterly or six-monthly basis, which would effectively take over from the Bank of England Inflation Report as the prime domestic document in which the Government analysed economic developments, published its forecast of the output gap and alongside which a fiscal open letter would be published if necessary.

There are, of course, a large range of secondary issues that I have not been able to address - including ways of further enhancing transparency, parliamentary procedure and the potential role for different fiscal instruments. But I have highlighted that the same principles that have guided our approach to monetary and fiscal policy making up to now would, under these arrangements, guide our approach if the UK were to join the Euro.

The Evolution of the Stability and Growth Pact

It is clear from this discussion that the future evolution of the Stability and Growth Pact is of critical importance.

Within a modernised Stability Pact, decisive action by government to both reduce debt and tighten fiscal policy during the above trend phase of the economic cycle could allow governments the flexibility to respond to asymmetric shocks during the below trend phase of the cycle - better promoting stability and growth.

But the arrangements we have set out for the operation of UK fiscal policy in EMU would only work within the Euro area as a whole if the times when, for individual countries, fiscal activism makes sense are predictable, exceptional and confined to low debt countries.

So the challenge is to have an SGP that is both disciplined and sufficiently accommodating to allow such symmetric stabilising action to take place.

It would require an SGP which can deliver:

- a commitment to fiscal discipline, symmetrical over the cycle for all countries, with a sharper focus on debt so that high debt countries reduce debt at all stages of the economic cycle but particularly when the economy is above trend –thus establishing greater <u>credibility</u> ;

- a recognition of the differences between countries, including in their fiscal rules and attitude towards investment, as well as levels of debt sustainability pressures and the state of their economic cycle and which allows <u>flexibility</u> for low debt countries to use – in certain circumstances – fiscal stabilisation to ensure stability and growth while keeping debt low and public finances sustainable.

- and effectively enforced fiscal co-ordination between national governments, as well as with the ECB, which would enhance its <u>legitimacy</u> .

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What does this mean for the current SGP?

The current SGP has clear policy rules. But in order to build credibility and reduce national fiscal flexibility, the SGP has been based on annual rules without recognition of the importance of the economic cycle.

While the implementation of the Pact has evolved, it was perhaps understandable at the outset that dealing with so many countries, the Pact would resort to mechanistic rules, rather than guiding principles which could afford some constrained discretion. While precise dates by which countries should balance their cyclically adjusted budgets have been dropped, they have been replaced by a target annual reduction of 0.5% of GDP that cannot of themselves take account of debt levels or public investment needs.

So without a clear pre-commitment to flexible operating rules, and as a consequence of the initial failure to make the cycle an issue, the result has been an asymmetric application. In particular we do not have a mechanism to promote tightening of fiscal policy in the above trend phase of the cycle, even for high debt countries.

Perversely countries can end up cutting spending or raising taxes at the wrong stage of the cycle, at the expense of stability and growth, in an attempt to make up the lost ground that should have been made up when the economy was stronger.

There is also a case for saying that without a more precise inflation target and thus a clear and well-specified monetary reaction function there is less incentive for countries to agree on the difficult collective fiscal decisions.

Some have argued that the SGP should be scrapped. I have set out why that would be a mistake. Let me repeat : collective fiscal discipline and coordination is essential for a successful monetary union.

Others have suggested starting again from scratch with new – and often rather complex - fiscal rules and Treaty amendments, such as exempting Member States from the SGP based on an index of national institutional reform, tradeable deficit permits among Member States, and permanent balance rules that ensure that the net present value of future government revenues does not exceed the net present value of future expenditure .

The UK by contrast has consistently argued not for a for root and branch reform but instead for an evolutionary approach to a more sensible and credible interpretation of the Maastricht Treaty: a prudent interpretation of the Stability and Growth Pact, grounded in robust economic rationale, which takes account of the economic cycle – and is applied symmetrically throughout the cycle; – which distinguishes between high and low debt countries; and which allows for borrowing for public investment within prudent limits.

The issue is not fundamental overhaul or Treaty change but evolution in its institutional design:

- focusing policy in higher debt countries on the need for fiscal consolidation - particularly when the economy is above trend. And combining that with

- greater flexibility by allowing not only the automatic stabilisers to work fully across the economic cycle - and especially in the below trend phase - but also allowing countries with low debt and sustainable public finances the extra flexibility – when necessary – to use discretionary fiscal policy to support stability and growth.

This is not an impossible task. Indeed there are important and encouraging signs that the SGP is steadily evolving in the right direction. Over the past eighteen months the Council has approved:

- a greater focus on cyclical adjustment

- a recognition publicly that the automatic stabilisers should be allowed to work

- a greater focus on long-run sustainability, including the impact of ageing populations

- a greater emphasis on debt reduction in highly indebted countries

- and a little more emphasis on the importance of the quality of public expenditure - which is a polite way of talking about the current-capital split.

But the question is whether we should now codify these principles within an institutional framework which recognises that it is for governments, collectively and intergovernmentally, to take into account:

- the stage of the economic cycle in each country

- borrowing for capital spending

- the difference between high and low debt countries

The implication of this prudent approach is that there would, occasionally, be circumstances in which a low debt country should be allowed – with the agreement of the Council – to breach for exceptional and temporary reasons the 3per cent reference value – either because of the impact of the automatic stabilisers or discretionary fiscal action and after adjusting for investment spending.

The challenge is to find institutional arrangements which can both enforce discipline in the above trend phase and in high debt countries and at the same time credibly sanction exceptional fiscal action in low debt countries during a downturn.

It is clear that such an approach would imply not a weakening but a strengthening of the degree of fiscal coordination within the Council.

Moreover, as part of a robust institutional framework, where the Council retains responsibility and accountability for enforcing fiscal discipline while exceptionally sanctioning fiscal stabilisation, there would also be a case at the EU level for strengthening the role of independent monitoring, surveillance and transparency.

Some independent surveillance and monitoring already occurs in the European context: for example, under the Excessive Deficit Procedure and through the annual Stability and Convergence programmes.

While retaining the principle of peer review of fiscal policies by Member States, one possibility would be to strengthen the independent surveillance process in the EU as part of wider reforms to the Stability and Growth Pact. For example, the EU could establish an intergovernmental ‘fiscal surveillance committee’, staffed by Member State and European Commission representatives, with delegated authority to conduct analysis and surveillance of national fiscal policies and advise the Council.

It is instructive to ask what would have happened if the existing proposals for a prudent interpretation of the Stability Pact and the UK fiscal open letter had been applied together since 1999. Any Euro member country with an output gap deviating more than 1.5 per cent of GDP from trend, would have been required publicly to write to the Council a fiscal open letter setting out its fiscal strategy and how it was consistent with the reformed SGP. As now, it would have been for the Council to agree or reject that strategy.

Would such a regime have led fiscal policy more effectively to support monetary policy throughout the economic cycle?

Or would it have led to an outbreak of fiscal fine-tuning, over and above the automatic stabilisers, which would have put pressure on both monetary policy and fiscal sustainability?

The only European governments in 2003 or 2004 with a negative output gap in excess of 1.5per cent on the basis of EU 2003 Autumn forecasts and the trend methodology – and which therefore would have been required to produce a fiscal open letter explaining whether or not it was taking discretionary fiscal action to support growth - would have been Germany with an output gap of 1.6per cent in 2003 and the Netherlands and Portugal with output gaps of 1.9 per cent and 2 per cent respectively forecast for 2004. The fact that each country was only above 1.5 per cent in one year, and that both Germany and Portugal have gross debt-GDP ratios around or above 60 per cent, would clearly have influenced the content of their letters and the judgement of the Council.

In 2000, by contrast, the following countries had a positive output gap in excess of 1.5% of GDP – Belgium (2.6%), Spain (1.8%), France (2%), Ireland (6.7%), Luxembourg (7.2%), the Netherlands (3.9%), Austria (2%), Portugal (3.6%) and Finland (4.2%) – all of whom would have published a fiscal open letter explaining whether or not they were tightening fiscal policy. Yet only Ireland, Finland – two of the countries with the lowest debt – Austria and the Netherlands tightened fiscal policy in 2000 relative to 1999.

So far from sanctioning imprudence, such a SGP applied symmetrically over the economic cycle would have led either to fiscal tightening in a number of higher debt countries or fiscal open letters explaining why fiscal tightening was not, in fact, necessary for the Council to consider. The result should have been more fiscal consolidation in the early years of EMU when economies were largely above trend.

And in the below trend phase, while allowing the automatic stabilisers to work, there would not have been a rash of fiscal open letters proposing discretionary fiscal loosening.

Of course these figures are endogenous. The very existence of the regime might have implied different outcomes. But the implication is clear – that fiscal tightening would have occurred in the above trend phase of the economic cycle, a fiscal tightening which would a have made it easier for countries to allow the automatic stabilisers to operate in more recent years. But few or no countries would have been in a situation where discretionary fiscal loosening would have been triggered by the regime.

Conclusion

In conclusion, the lesson I draw from the experience of the SGP so far is a general one applying to both monetary and fiscal policy within and outside EMU: it is possible to design policy frameworks which are both credible in their commitment to sound long term goals and in which countries have the flexibility to deal with the ups and downs of the global economy. While rigidity does not work – in monetary and fiscal policy- constrained discretion can work. With our British model we are trying to show in our own country how to make it work. And with the right evolution of policy including transparency, it can be made to work in monetary unions too. In this way stability and growth can be advanced and sustained together.

Thank you.