Comments on “Reforming Britain’s Economic and Financial Policy; Towards Greater Economic Stability”.

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It is a pleasure to be given the opportunity to be part of the launch of this most interesting new book. Rather than attempting the impossible task of summarising or reviewing it, I will concentrate on a few of the issues raised in it that I consider to be of special significance.

Immediately on gaining office in May 1997, the Chancellor of the Exchequer of the New Labour government initiated a major overhaul of monetary, fiscal and regulatory policy. Institutions, rules and policies changed dramatically. I will focus on the new monetary framework, embodied in the 1998 Bank of England Act, but will also touch briefly on the new budgetary rules.

Sticking with the existing monetary and budgetary arrangements was not an attractive option, both from a social and from a partisan political point of view. As regards social welfare, for most of the post World-War II period, macroeconomic management in the UK had been a tale of woe – pro-cyclical and destabilising more often than counter-cyclical and stabilising. It was clearly time to change the rules of the game. What was needed was a commitment mechanism against opportunistic, party political exploitation of the monetary and fiscal policy instruments.

From a partisan political point of view, Labour had spent 18 years in the wilderness; when last spotted in office, (old) Labour had presided over the ‘winter of discontent’. An untried and untested Labour government did not want to spend its first two or three years in office fighting with the international financial markets to build a reputation for monetary rectitude. It did not want to be distracted from its structural reform programme by looming Sterling crises and pointless partisan infighting over the conduct of monetary policy. This raised the question: how could it throw the monetary keys away?

There were two reasonable options open to the UK government in 1997 as regards the monetary and exchange rate regime.

One viable option was to maintain national monetary autonomy and make the Bank of England independent. The second was to rejoin ERMII and shoot for EMU membership at the earliest possible date. Unpleasant memories of ERMI (and especially of the UK’s inelegant exit from that arrangement) argued against the EMU option. So did the fact that EMU was still but a twinkle in Delors’ eye. The earliest possible date for UK EMU

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membership was too far into the future. This finished off the 'rush to EMU' option. It left the 'enhanced national monetary autonomy' option.

When I say that independence for the Bank of England was a natural choice for the Chancellor, I don't mean that I was not surprised at the speed with which independence was granted, or indeed the speed with which the supervisory and regulatory roles of the Bank of England were removed and transferred to the newly created FSA – that certainly surprised the Governor. The timing and speed were breathtaking. Other features of the new arrangement were also surprising, not least the appointment of two foreigners to the MPC. I am afraid that both DeAnne and I have rather spoilt this aspect of the experiment, as we both recently became British citizens.

In principle, national monetary autonomy is compatible with many different monetary and exchange rate rules and institutional arrangements. However, the architects of the new monetary arrangements appear to have been proponents of the strong version of the so-called 'bipolar' view of feasible and desirable exchange rate regimes. In a world with virtually unrestricted international mobility of financial capital, there are only two feasible exchange rate regimes: a floating exchange rate and a credible fixed exchange rate. I share this bi-polar view. In addition, I believe that the only credible fixed exchange rate regime is a 'symmetric', 'non-colonial' common currency, where the members in the currency union share some key supra-national political institutions, and where the monetary policy makers are accountable to the legitimate representatives of all nations in the union. Anything less, including currency boards, unilateral euroisation etc. is easily abandoned and therefore not credible.

Free floating by itself does not translate into a unique set of monetary institutions and a unique monetary policy regime. A variety of monetary policy rules - price level targeting, nominal income targeting, inflation targeting, nominal income growth targeting, targeting the level or growth rate of some monetary aggregate, Taylor rules for the short nominal interest rate and McCallum rules for the growth rate of base money - all are feasible.

The experience since June 1997 has convinced me that, for a country wishing to retain national monetary sovereignty, the UK's new monetary arrangement embodied in the Bank of England Act 1998, represent the best practice monetary arrangement found anywhere in the world. The arrangement is clearly superior to the two major alternatives on offer, one West of here, the other East of here.

The UK monetary and exchange rate regime is one of *inflation targeting* by an *operationally independent central bank* under a *freely floating exchange rate*. These three characteristics do not yet fully characterise the UK regime. The unique strength of the arrangements is found in the details of its design.

The division of labour between the elected political authorities and the technocrats to whom the conduct of monetary policy has been delegated, is clear and appropriate for a society that values openness, transparency and accountability for its public institutions.

There is no target independence. Target independence is unacceptable in a democratic polity. Both the ultimate and the operational targets of monetary policy are determined by the political authorities. There *is* operational independence. There is no interference by the government, or by Parliament, in the conduct of monetary policy. There is openness, transparency and accountability, both substantive and procedural.

There is a free flow of information between the Treasury and the Bank of England, which allows the reconciliation of operational independence and co-ordination of monetary and fiscal policy.

The primary objective of monetary policy is a single nominal target: the growth rate of RPIX. The symmetry of that target means that monetary policy will be appropriately countercyclical in response to shocks to aggregate demand. The open letter procedure – also symmetric – provides the means for handling aggregate supply shocks.

No matter how well the institutions of monetary policy are designed, and regardless of how competent the MPC is, individually and collectively, the effectiveness of monetary policy depends crucially on the fiscal framework. Here to, the UK experience has been largely, successful, certainly when compared to neighbours west and east.

The budgetary guidelines distinguish clearly between cyclical and structural determinants of budget deficits and surpluses. The (current) budget should be balanced 'over the cycle'. The automatic fiscal stabilisers therefore can do their job of damping economic fluctuations, both during periods of above-normal economic activity and during periods of below-normal economic activity. This is far superior to the fiscal criteria of the Maastricht Treaty and the Stability and Growth Pact. Sticking to the letter of the Pact would, today, require many EU members to engage in pro-cyclical, downturn-deepening, restrictive fiscal policy. Grudgingly and belatedly, the enforcers of the Pact are reinterpreting the criteria as applying to cyclically corrected or structural fiscal imbalances.

The budgetary rules recognise the important distinction between current and capital expenditures. Admittedly, the so-called 'golden rule' does not distinguish between capital expenditure that yields a pecuniary return to the government and capital expenditure whose returns are not appropriated by the government. The strict 'golden rule' makes sense only if the present discounted value of future cash returns equals the cost of the public investment project.

One sometimes hears the view that the successful macroeconomic performance of the UK since Bank of England independence has been the result of an unusually benign external economic environment. Life has been easy for the MPC. I think that is hogwash. Identifying the contribution to superior performance of good institutions, good policies and good luck is never easy. Still, between the Asian crisis of 1997/8, the Russian crisis of 1998 and, since the beginning of this year, the worst global recession for at least a generation, the external environment has been anything but benign. I'm afraid that some of the credit for the superior economic performance of the UK since 1997 is due to

superior institutional design and to the more competent execution monetary policy in the UK.

There remains one key monetary policy regime choice to be made by the UK: whether to stick to the existing floating exchange rate cum inflation targeting regime or join the EMU and adopt the Euro. This decision has important constitutional and political aspects – monetary union means a surrender of national monetary sovereignty.

The economic aspects of this decision are complex indeed. Even the basic conceptual toolkit with which the costs and benefits from monetary union are to be evaluated is the subject of disagreement. I hold the view, for instance, that the conventional optimal currency area literature developed by Mundell, McKinnon, Kenen *et. al*., with its emphasis on asymmetric shocks, factor mobility etc is largely irrelevant to the economies of the late 20th and early 21st century.

The conventional OCA approach overestimates what monetary policy can deliver. First, it suffers from a systematic inability to distinguish between nominal and real rigidities – conventional OCA theory is hopelessly 'Old Keynesian'. Second, it suffers from the failure to recognise the importance of monetary policy instrument uncertainty: the existence of pervasive uncertainty about the timing and magnitude of the impact of monetary policy. This gives rise to the 'fine tuning fallacy'. By overestimating what monetary policy can deliver as a mechanism for adjusting efficiently to asymmetric shocks, it overstates the economic cost of giving up national monetary policy autonomy.

The traditional OCA literature also ignores the implications of international capital mobility. With unrestricted financial capital mobility, a floating exchange rate is not just an (overrated) mechanism for responding to asymmetric shocks or asymmetric transmission of common shocks). It is first and foremost a source of excess volatility, unnecessary instability and at times persistent exchange rate misalignment.

While my views on OCA theory are probably not (yet) part of the 'acquis intellectuel' of the majority of the economics profession, it is not too far out on a limb. We therefore must recognise the existence of fundamental disagreement about how we should think about the nature of the gains and losses associated with monetary union.

Even if we were all agreed on the conceptual apparatus, the final judgement on the economic pros and cons of monetary union must be based on an empirical judgement on convergence, flexibility, foreign direct investment, the City and growth and employment. These 'five economic tests' are examples of empirically based criteria that can be motivated from the perspective of the conventional OCA approach. Empirical assessments in economics are never straightforward, and always contestable. Reasonable people sharing the same broad conceptual approach and employing respectable empirical methods, can reach differing conclusions. To argue that the answer is plain as a pike-staff is egregious nonsense.

My co-discussant (or co-defendant) Martin Wolf has written countless fascinating, well-informed and stimulating articles on a truly staggering range of economic issues. He is therefore entitled to lay the occasional egg. And did he lay one on November 26, when he wrote his already notorious column on the self-evident unsuitability of EMU membership for the UK. The column is a veritable ostrich egg served up as an omelette of unsubstantiated assertions on the pros and cons (or rather just the cons) of UK membership in EMU.

Permit me a quote*: "... we may presume that the Treasury will, at Gordon Brown's request, do a thorough evaluation of the economics of euro entry. It will then conclude that entry would be extremely unwise. It is impossible to imagine that any group of competent economists would conclude otherwise".*

This statement is rubbish.

The evaluation of the economic pros and cons of joining EMU is a serious and difficult business. It will require careful, open-minded, honest and hard-headed empirical analysis, performed by professionals. The final judgement will have to balance the risk and return of staying with the current arrangements against the risk and return of joining EMU. Empirical evidence in economics is never of the plain as a pikestaff variety. Those who do not want to be convinced will remain unconvinced and even among the open-minded, unanimity cannot necessarily be expected.

When the Treasury team charged with the task of determining whether the 5 economic tests have been met announce the result of their analysis, I may agree or disagree with it. I know that it will be based on a methodology that can be verified and replicated. It will be based on clear rules of induction and deduction. Unlike Martin's approach to UK membership in EMU, repeated assertion will not be an acceptable third mode of proof. It is good practice for the judge to wait with the verdict until the jury has heard and deliberated on the evidence and has had the chance to pronounce 'guilty' or 'not guilty'.

Being a part of the new, operationally independent Bank of England for its first three years has been the high point of my professional career as an economist. I was part of something special, an arrangement whose achievements will stand the test of time. This book will be a most valuable source of insight into the thoughts, motivations and actions of those who brought about this political institutional transformation.