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OPEN MACROECONOMICS IN AN OPEN ECONOMY

Edward Balls

ABSTRACT

There are three pillars of the new Labour Government's approach to economic policy: delivering macroeconomic stability, tackling the supply-side barriers to growth and delivering employment and economic opportunities to all. This lecture focuses on the reforms the new government has introduced in order to deliver macroeconomic stability and why open and transparent institutions and procedures are central to those reforms.

The lecture sets out four principles for macroeconomic policymaking which flow from changes in the world economy and the world of economic ideas over the past twenty or thirty years. These are:

- the principle of stability through constrained discretion
- the principle of credibility through sound, long-term policies
- the principle of credibility through maximum transparency
- the principle of credibility through pre-commitment

The lecture explains each principle in turn and shows how they are being translated into practice in the macroeconomic policy reforms that the new government is introducing at the Treasury and the Bank of England — reforms which add up to what is now probably one of the most open and accountable system of economic policymaking in the world.

The Centre is pleased to include this lecture among its Occasional Papers as a contribution to the macro-economic debate. The lecture is the Scottish Economic Society/Royal Bank of Scotland Annual Lecture and the author is the Chancellor of the Exchequer's Economic Adviser.

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Edward Balls

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OPEN MACROECONOMICS IN AN OPEN ECONOMY

Edward Balls

1. LABOUR'S ECONOMIC APPROACH — STABILITY, GROWTH, OPPORTUNITY

It is a great pleasure, and an honour, to be here in Edinburgh to give the fourth Scottish Economic Society/Royal Bank of Scotland lecture, the thirty-third in the Society's annual lecture series. I would like to express my thanks to the society for the invitation and to the Royal Bank of Scotland for their kind hospitality.

Founded in 1897, this society has a fine tradition of one hundred years of scholarship and discussion — as you would expect in a country which can boast Adam Smith and David Hume as two of Scotland's great economist ancestors.

It has been a hectic few months since the general election on May 1st, but also a significant period for the new direction in economic policymaking that the incoming Labour Government has taken.

Thankfully, it is still too early to apportion praise or blame. But it is not too early to justify and explain. In just a few short months, the new government has made a number of changes in the institutions and practice of economic policymaking in Britain:

- independence for a reformed Bank of England
- a new structure of financial regulation
- new fiscal rules and a five year deficit reduction plan
- a major corporate tax reform
- a windfall tax on the privatised utilities
- a New Deal for the young people and the long-term unemployed
- reform of the financing of higher education
- a new capital fund to rebuild schools
- a UK Action Plan and for Employment and Flexibility in Europe
- publication of Lord Currie's EMU paper and a new Advisory Taskforce
- and new impetus for debt relief — the Mauritius Mandate

That list is, by no means, exhaustive. And there is more to come:

- the Bank of England Bill
- the first National Assets Register
- a Pre-Budget Report and economic consultation process
- capital gains tax reform
- consultation on the new Individual Savings Account
- tough legislation on competition policy
- the Taylor review of taxes and benefits
- and the Low Pay Commission's report on the minimum wage

I cannot hope to cover in detail tonight the principles which underpin such a wide range of economic policy initiatives — certainly not in one sitting.

Which is why, tonight, I will focus on the reforms the new government has introduced in order to deliver macroeconomic stability and why open and transparent institutions and procedures are central to those reforms.

The institutional changes which have been introduced since May 1st at the Treasury and the Bank of England, in some cases only a few days after election day, add up to what is now probably one of the most open and accountable system of economic policymaking in the world.

Tonight I will try to explain the central importance that the Chancellor places on openness, transparency and the institutional framework in order to deliver the government's wider economic objectives.

I will argue that the changes in both the world economy and our economic understanding of it over the past twenty years mean that policymakers must adjust to new ways of making decisions. Gone are the days of fixed policy rules announced in public and of private deliberations behind closed finance ministry doors, with little or no justification or explanation about policy decisions or mistakes.

Instead I will argue that new principles must guide decision-making and institutional design and show how these principles underpin New Labour's macroeconomic policy reforms — in monetary and fiscal policy. The argument that I will make is that, in a world of global capital markets in which policymaking by fixed rules has been discredited in theory and practice, governments must take a different route to ensuring

macroeconomic credibility. Credibility in modern open economies requires three ingredients:

- a reputation for following sound long-term policies
- maximum openness and transparency
- and new institutional arrangements which guarantee a long-term view

In the UK's case, the particular nature of the new government's inheritance in May of this year, and the difficulties of being a new government after 18 years of opposition, make greater openness and transparency doubly important.

But I believe that these principles, which stress the importance of open macroeconomic policymaking, would apply to any small or medium sized open economy. Indeed, the UK has recently proposed at the recent IMF and World Bank meetings in Hong Kong that the IMF draw up a code of conduct on openness and transparency — a proposal which found favour with other finance ministers, and which the IMF is now developing.[1]

So tonight "Open Macroeconomic Policy in an Open Economy" is my theme. But before I turn to it, I first want to explain how macroeconomic stability fits into Labour's overall economic approach.

Macroeconomic stability — low and stable inflation and sound public finances — is only an instrumental aim — a means to an end. The aim of New Labour economics, as set out in the Chancellor's May 6th letter to the Governor of the Bank of England[2] and reconfirmed in the Treasury's new draft Aim is not simply to ensure low and stable inflation and sound public finances but to deliver high and stable levels of growth and employment by ensuring economic and employment opportunities for all. Growth, jobs and fairness are the tests against which this government will be judged.

Delivering on these objectives depends not simply on one policy pillar, but three — delivering macroeconomic stability, tackling the supply-side barriers to growth and delivering employment and economic opportunities to all.

The Chancellor's Mansion House and Budget speeches made clear that stability — low inflation and sound public finances — is an essential pre-condition for achieving higher levels of growth and employment.[3]

The violent boom-bust economic cycles of the past twenty or so years — more extreme than in any other major developed economy — have had a serious negative impact, not simply on jobs during the recessions, and on long-term interest rates because of higher inflation expectations, but on the employability of the long-term unemployed, the capacity of the economy and the willingness of companies to make long-term investment commitments. As Keynes might say now, there is nothing so damaging for the "animal spirits" of business investors than repeated cycles of boom then bust.

Sustained stability is necessary for investment. But a strong economy is also necessary to make stability sustainable. The UK will only be able to deliver and sustain stable economic growth and employment if we have a strong, productive, wealth-creating economy which can generate both jobs and rising incomes. The inflation of the late post-war period was as much a symptom of a depressed growth potential, and the struggle to get a share of a slower growing cake, as it was of macroeconomic policy errors.

So while stability is the first pillar of New Labour economics, supply-side action to make the economy more dynamic and remove barriers to growth is the second pillar.

That means understanding that the proper role for government in economic policymaking goes well beyond macroeconomic policymaking.

It means a new role for government — not picking winners or responding to market failures by trying to replace the market in its entirety, but using the proper role of government to tackle short-termism and market failures by making markets work more dynamically and encouraging investment in the broadest sense — not just in machines, but in technology and innovation, skills and infrastructure — the fuel for growth in the modern economy.

The need to reorient public spending to promote growth, jobs and fairness infuses the whole Comprehensive Spending Review process which all departments are currently engaged in to re-shape public spending for the next century.

But the new growth agenda goes beyond public spending into all areas where either the wrong kind of government, or the absence of government creates barriers to growth. I hesitate to label this new growth theory — but over the past ten years, following the pioneering work of Paul Romer, the theory of economic policy has been replacing the old idea of exogenous technological change as the main driver of economic growth with a much more sophisticated role for governments: in tax policy, competition policy, corporate governance, support for small business, regional development agencies and education and training.[4]

Without stability, this long-term project of raising the economy's growth potential cannot get off the ground. But it is only by taking action to tackle barriers to growth that we can avoid the mistakes of the past — attempts at maintaining stability which lead to conflict and unemployment. It is the unemployed who have lost most from the instability and slow growth of recent decades.

The third pillar of the new government's economic policy — the key to ensuring stability and growth is translated into high and stable levels of employment as well as rising incomes for those in work — is to actively promote employment opportunity and reform the welfare state so that it promotes work not dependency. The centrepiece of the first Budget was a new approach to employment opportunity for young people, the long-term unemployed, lone parents and the disabled — on a scale and in a manner never attempted before. The New Deal is now at the stage of detailed planning for implementation next Spring. The reform of the tax and benefits system to reward and encourage employment is now, as the Chancellor has said, a live issue for the next Budget. And encouraging higher standards and wider access in education, particularly after 16, is a major aim of the government. Only by providing the skills for work, a tax and benefit system which rewards work, and new opportunities for the long-term unemployed to return to work can government translate stability and growth into high levels of employment.

2. FOUR PRINCIPLES OF OPEN MACROECONOMIC POLICY

Let me now turn to my theme. For while macroeconomic stability may not be sufficient to deliver the government's growth and employment objectives, it is certainly a necessary goal — and one which has eluded British governments for many years.

The institutional changes to macroeconomic policymaking which the government has taken since May of this year represent an important advance towards ensuring long-term stability. The fact that long-term interest rates, measured by the ten year benchmark government bond, have fallen from 7.4 per cent to 6.6 per cent since the day before the election and the spread over German ten year government bonds has narrowed from 191 basis points to 87 points over the same period, is an encouraging sign that I am not the only one to take this view.[5] That the inflation expectation implicit in index-linked ten year gilts remains at 3.2 per cent, albeit down from 3.8 per cent on May 1st, shows we still have some way to go. In modern economic policymaking, outcomes speak louder than reforms.

Tonight I want to set out four principles for macroeconomic policymaking which seem, to me at least, to flow logically from changes in the world economy and the world of economic ideas over the past twenty or thirty years. I am not going to indulge in an orgy of academic history, and a list of references — this is not the right place for that and I would be bound to miss out someone important. I want, instead, to root this political economy analysis in the world of macroeconomic policymaking by showing how these four principles are being translated into practice in the macroeconomic policy reforms that the new government is introducing.

I will not pretend that these four principles are mutually supportive — if only life were so simple. Indeed, the motivation for institutional change is, in part, an attempt to reconcile conflicts between them.

I will call them:

- the principle of stability through constrained discretion
- the principle of credibility through sound, long-term policies
- the principle of credibility through maximum transparency

C the principle of credibility through pre-commitment

And I will try to explain and justify each one in turn.

I. Stability Through Constrained Discretion

The first principle is the simplest way I could think of to embody the pro-stability but post-monetarist intellectual consensus upon which modern macroeconomic policymaking is based.

Before I re-declare the death of monetarism in our time, let me first recognise the debt of gratitude we all share towards Milton Friedman, the father of monetarism, doyen of right-wing libertarian populists, but also one of the great US post-war economists. I first realised that the world was more complicated than the sterile and over-ideological "Keynesians v Monetarists" essays that I wrote as an undergraduate, when — in my first week at the Harvard Economics Department, Professor Greg Mankiw — doyen of the young New Keynesians — eulogised Milton Friedman to the new graduate class. (He had already made clear that there was no doubting his credentials — even Mankiw's dog was called Keynes.)

I quickly realised the intellectual dominance not only of Friedman's work on consumption functions in the 1950s, but of his 1968 American Economic Association Presidential lecture in which, with his vertical expectations-augmented Phillips Curve, he demolished the idea of a long-run trade-off between inflation and unemployment.

Which is not, of course, to agree with those who concluded in the 1970s that, because people's expectations are entirely rational and forward-looking, there is not even a short-run trade-off between the unemployment and inflation, or that there is a "natural rate" of unemployment which is not affected by macroeconomic policy. What clearer evidence could there be of the short-run trade-off between reducing inflation and rising unemployment, or the persistent effect this can have in the form of long-term unemployment, than Britain's 1980-81 recession. So severe a long-term cost, indeed, that, when inflation accelerated in the late 1980s Lawson boom, long-term unemployment remained twice as high as at the previous cyclical peak.

In fact, this late 1980s experience — persistent mass unemployment alongside accelerating inflation — serves to make Friedman's 1968 point: an expansionary monetary and fiscal policy mix cannot, in and of itself, deliver, let alone sustain, full employment. Indeed, excessive macroeconomic expansions — which allow inflation to run out of control and then be forcibly restrained — end up involving a long-term price in higher unemployment, a "hysteresis" effect as it was called in the late 1980s.[6]

Enough, though, of Milton Friedman's intellectual triumphs. What I have said earlier about the modern role of government in tackling market failure and countering short-termist or irrational expectations in markets is already enough to indicate little enthusiasm for Friedman's libertarian free-marketism — "broad monetarism" if you like. But it was also Friedman's "narrow monetarist" ideas about the stability of the link between the money supply and inflation which, when taken to such an extreme by the Conservative Government in the early 1980s that even Friedman himself was horrified, were responsible for such macroeconomic errors.

With hindsight, the story of the early 1980s is simple enough. What had seemed to be a stable relationship between money and inflation collapsed with the beginning of financial deregulation in 1979. The growth rate of M3 shot out of its target range and stayed there, even after inflation had begun to fall.[7]

But the then government persisted with a policy of high interest rates and high exchange rate, in a continuing attempt to meet its rigid monetary targets, at the expense of a deep recession. By 1982, it was clear that monetary targets were not a useful guide for monetary policy, although the government persisted in setting targets for a range of indicators until 1985. And Nigel Lawson's flirtation with exchange rate targets in 1987 and 1988 and the debacle of Britain's membership of the Exchange Rate Mechanism both had similar narrow monetarist undertones — attempts to achieve low inflation by clinging doggedly to intermediate indicators which appeared to have been associated with inflation in past times or places, but which now implied perverse policy mixes.

I said I would re-declare the death of monetarism. For, in the actions of central banks across the developed world, this death is declared daily and

monthly. Maintaining low and stable inflation — not too high, not too low — is an increasingly accepted goal of monetary policy around the developed world. Indeed, an increasing number of governments and central banks now adopt inflation targets. But using fixed intermediate monetary targets to achieve this low inflation goal is no longer common practice. No major central bank now uses money supply targets as rigid policy rules, as opposed to using them as one source among a number of sources of economic information. Economic judgement now rules the day, not blind observance of monetary or exchange rate rules.

The reason is twofold.

First, fixed intermediate targets rely on stable money demand functions. But financial deregulation, changing technology and widening consumer choice have delivered such instability in money demand functions that fixed monetary rules have proved unworkable — not just in the UK, but in the US and Germany too. For, while modern open economy macroeconomics says that demand shocks should not be accommodated — the underlying case for fixed intermediate policy rules — these rules break down as a guide to the correct policy response if the money demand function itself breaks down. No-one could accuse the first Conservative Government of accommodating inflationary pressures in 1979 and 1980. In retrospect, domestic monetary policy was too tight during this period. But, according to the government's own monetary targets which were consistently over-shot by the accelerating demand for broad money, policy was too loose. If monetary targets had ever been a reliable guide to policymaking in the UK, they had certainly become redundant by the time they were put to the test.

But second, fixed intermediate targets rely not only on stable money demand but also on the assumption that demand shocks are predominant while shocks to supply are both infrequent and easily recognisable. While standard macroeconomics recommends keeping money supply growth steady in the face of demand shocks, assuming a stable money demand function, to do so in the face of a large supply shock would mean a heavy and unnecessary price in terms of lost output — which is why the standard economic response to a supply-shock is to use monetary and fiscal policy to accommodate its direct effects on the price level, again over-riding any fixed intermediate monetary target. If the aim of policy is to stick to the

policy rule, then stick to the policy rule. But if the aim of policy is to keep inflation low and stable, and growth as high and stable as possible, then the policy rule is again redundant.

So this is the first principle — **stability through constrained discretion**[8]: stability and low inflation is a necessary condition for achieving and sustaining high and stable levels of growth and employment, but achieving stability requires the discretionary ability for macroeconomic policy to respond flexibly to different economic shocks — constrained, of course, by the need to meet the low inflation objective or target over time.

But if the need for discretion was so straightforward, then why the attraction in fixed monetary targets in the first place?

Were monetarist governments in the early 1980s simply putting faith in an empirical relationship which had by then broken down? In which case, if the monetarist belief in fixed policy rules can simply be replaced by our first principle, then macroeconomic policymaking would once more become a straightforward — if technical — task. The Chancellor could sit back, take the advice of his officials and perhaps other experts in private, then simply make decisions which outsiders could observe and, if they so desired, try to rationalise — stability, if you like, through private discretion.

But the answer, of course, is that governments were trying to achieve something more than a simple and automatic rule for monetary policymaking. That extra something was **credibility**. Credibility is the elusive elixir of modern macroeconomics, and also the subject of the first Scottish Economic Society/Royal Bank of Scotland lecture given by Professor Mervyn King, then Chief Economist and now Deputy Governor-Elect of the Bank of England.[9]

In that lecture, King defines credibility as "a question of whether announced intentions are believable". It is not simply a matter of trust — read my lips: no more inflationary booms — but, he says, of whether the monetary authorities face an **incentive** to pursue low inflation. Or to use economics jargon, to make policymaking "time consistent" by ensuring that the government actually has an incentive to achieve the goals in the future what it says now it wants to achieve in the future.

Monetarism, then, was not simply an empirical fact at one extreme, or a free-market dogma at the other. It was also a reaction against post-War

discretionary macroeconomic policymaking which became popular in the academic literature in the late 1970s and early 1980s in the guise of the “new classical” or “rational expectations” movement in macroeconomics which followed Friedman’s seminal presidential lecture.[10]

An incoming government might declare that it wanted to achieve low inflation, but this goal was “time inconsistent” — when it came to pre-election time, the government’s incentive would always be to cheat and dash for growth, knowing that the resulting recession would only come along later. But, as Friedman pointed out, the result of trying to exploit this short-term trade-off between unemployment and inflation was simply to build in higher inflation expectations (and therefore higher long-term interest rates) with no long-term gain in terms of output or employment — indeed possibly higher unemployment and lower investment if the resulting recession had lasting effects.

So policymakers needed to look for ways to deny themselves the temptation of using “discretion” to cheat on electorates by saying they were committed to low inflation, but then privately by trading a little more inflation for a little less unemployment. The monetarist answer to this problem of “time inconsistency” was to buy credibility — and therefore lower inflation expectations and lower long-term interest rates — by “tying the government’s hands” and removing discretion from policymaking — thereby increasing both trust in the government’s long-term goals and in the government’s commitment to operate policy to achieve those goals.

The problem, as I have shown, was that the actual result was quite the opposite. As the UK experience shows, persisting with fixed monetary rules, as monetary aggregates ran out of control was disastrous. Because the government had staked its anti-inflationary credentials on following these rules, it — and the economy — was immediately faced with paying a heavy price for breaking them — not simply in lost output but also lost credibility. As one rule after another proved unsustainable and was replaced by the next, not only were the government’s anti-inflationary credentials weakened, but it took its eye off the ball to such an extent that the information that the double digit growth of M4 did transmit from the mid-1980s onwards was not given the attention it was due.

Nor did the attempt, at the beginning of this decade, to maintain credibility though the ERM fare much better. Linking the anti-inflationary

commitment to a fixed exchange rate target at a time when the unification supply-shock was pulling the anchor currency — the D-Mark — in a direction which most other countries and certainly Britain were not in a position to go, guaranteed that the right economic decisions were not taken and then, when economics proved too much and the nominal anchor broke, the government was left with the credibility of its long-term goals undermined.

This is the lesson of our ERM failure: trying to achieve credibility through sticking to fixed and rigid intermediate policy rules is destabilising, as the principle of **stability through constrained discretion** suggests. But that does not mean that we can reject the need for credibility in the government's commitment to its declared goals or ignore the conflict between credibility and discretion which Friedman and his followers highlighted. So what is the modern route to credibility which preserves discretion? My remaining three principles pick up three different ways in which the world makes private discretion more difficult or costly — and focuses on how long-term, open, transparent and devolved decision-making provides a better alternative route to goal credibility than fixed monetary or exchange rate rules.

II. Credibility Through Sound Long-term Policies

The rapid globalization of the world economy has made achieving credibility more rather than less important, particularly for an incoming left-of-centre government which has been out of power for two decades. This process of globalization has many dimensions — technological change, capital market liberalisation and the growth and global reach of international trade — all of which have profound implications for domestic economic policy. No sensible discussion of New Labour's economic policy could avoid a lengthy discussion of how technological change and the growth of world trade have affected labour market outcomes. While macroeconomic policy errors are one central cause of the rise and persistence of unemployment in the 1980s, the concentration of long-term unemployment among the unskilled demonstrates that changes in the global pattern of demand and supply are another.

For macroeconomic policymaking, there can be no doubt that the most significant change in the world economy is the globalization of international capital markets which began before the collapse of the Bretton Woods system of global fixed exchange rates and, spurred on by liberalisation and technological change, has accelerated apace since.

The power of "the markets" is always and everywhere: dollar slumps on bad trade news, D-Mark rises on good inflation news, or, as the Wall Street Journal once reported in its headline, Dow-Jones falls on no news.

Global capital markets have intensified the "time inconsistency" problem. In a closed economy, the issue is whether governments can fool their electorates into believing higher growth is sustainable for a while before domestic price inflation rises and the value of their real wages falls. But in an open economy, with capital mobility, discretion also gives the government the ability to fool international investors into believing that growth will be sustained before the exchange rate — and therefore the profitability of their investments — falls.

Do governments have this power? Some despair about the power of "the markets", arguing that it renders governments impotent in the face of market judgement, making discretion impossible, full employment unattainable, slow growth inevitable.[11] The time inconsistency problem is solved because governments cannot afford to cheat even for a short while — because markets immediately punish any government which strays from the macroeconomic straight and narrow.

The problem is that this argument is not borne out by either theory or the international evidence: it ignores the theoretical point that, even with free capital markets and perfect information, the existence of nominal wage and price rigidities means that there is still a short-term Philips curve trade-off which governments can try to exploit; but it also enormously overrates the rationality and omnipotence of financial markets. It is precisely because markets can sometimes be misinformed, short-termist, irrational, speculative and herd-like that governments do retain the power of discretion — for good or bad.

What is surprising, in retrospect, about the 1990s financial market turbulence in the UK, Mexico or Thailand is not that exchange rates came under pressure, but that governments were able to get away with unsustainable policies for so long before their soundness came into

question. And far from the markets homogenising economic policies by preventing electorates from choosing different economic policies, what remains striking is the diversity of economic policy across developed economies. As a recent survey of the views of market participants shows, market investors take a strong view of a relatively narrow range of macroeconomic indicators, of which the current and projected inflation rates and fiscal deficits are the most monitored.[12] But these are just a few of the many variables upon which economic policy bites and across which there is wide variation even between European countries: the tax/spending share of GDP, the corporate tax rate, the level of the minimum wage or the toughness of competition law to name but four.

Far from rendering governments impotent or rewriting the laws of economics, it seems to me that global capital markets actually render government's **more** powerful in their ability to do bad or good — the main dimensions on which they have influence are scale and speed rather than direction.

Governments which pursue monetary and fiscal policies which are not seen to be sustainable in the long term, and, worse, attempt to conceal the fact through short-term diversion or deceit while delaying the necessary corrective action, are punished hard these days — and much more rapidly then thirty or forty years ago.

When these crises hit, the effects can be hard and painful: high interest rates and fiscal retrenchment to stabilise the macro economy; low investment, fewer jobs and slower growth as a result; a halt to structural reform and the wider economic agenda as the crisis consumes time, energy and confidence; and contagion effects as — perhaps irrationally — confidence slumps in the wider economic area or region. But there is also a longer-term effect to be paid. Once such a mistake occurs, it can take a long time to repair the damage, in terms of lost credibility, and so rebuild the ability to deliver stability through discretion.

Recent examples are illustrative:

C The UK's attempt to maintain its ERM parity in 1992 proved unsustainable, in the face of growing evidence from the traded sector and the domestic economy that the exchange rate and the level of interest rates it demanded could not be maintained; while the

speeches made by government ministers that the policy was central to the government's economic strategy, and the attempt to sell D-Mark denominated bonds to increase the fiscal cost of failure to maintain the parity, only served to demonstrate the degree of desperation and made it much harder to regain credibility once the policy failed.

- Mexico's attempt to have simultaneously a strong exchange rate, large fiscal deficit and low interest rates was unsustainable; selling short-term dollar denominated bonds to boost confidence probably accelerated the crisis, and certainly made it worse when it hit.

- Similarly, the recent crisis in Thailand has at its heart a similar story of a government which despite, and unlike in Mexico, repeated warnings from the IMF, ran into balance of payments difficulties because it tried for credibility purposes to maintain an unsustainable exchange rate, compounded first by excessive credit expansion in a financial sector which was not sufficiently regulated and supervised so that non-performing loans accumulated, and then by an undeclared policy of intervening heavily in the forward market to try to sustain the exchange rate to preserve flagging credibility and confidence in the long-term sustainability of policy. Ironically, when the authorities were finally forced to publish their forward book, the crisis was deepened in the short term because only then did it became clear quite how unsustainable policy had become.

But governments which pursue, and are judged by the markets to be pursuing, sound monetary and fiscal policies, can attract inflows of investment capital at higher speed, in greater volume and at a lower cost than even ten years ago. Witness the huge investment flows into Latin America, China and South-East Asia over the past decade. Or the rapid convergence of long-term interest rates in Europe as more and more southern European economies have increased their perceived probability of joining EMU.

Moreover, if governments are judged to be pursuing sound, long-term macroeconomic policies and institutional procedures, then they can

use discretionary monetary, or indeed fiscal, policy to deal with macroeconomic shocks which need to be accommodated in the short term. It was the fact that German economic policy making institutions were judged to be credible in the long-term that enabled the Bundesbank to accommodate the supply-shock of unification and effectively ignore its favoured money supply targets. It was the fact that Alan Greenspan, as chairman of the US Federal Reserve, had such accumulated credibility that he was able to cut interest rates hard and early at the end of the 1980s without destabilising the financial markets.

So we reach the second principle — **credibility through sound long-term policies**: in a world of rapidly mobile capital, governments can have policy credibility **and** maintain constrained policy discretion if they pursue, and are seen to be pursuing, monetary and fiscal policies which are well understood and sustainable over the long term and where problems are spotted and tackled promptly rather than disguised, while the government clings to intermediate indicators to prop up credibility.

The problem with this second principle is that, while a step in the right direction, it still rather begs the question of how credibility can be achieved and the "time inconsistency" problem solved. Of course it would be much better to be a government which preserves its power of discretion in macroeconomic policy, has low long-term interest rates and has time and space to focus on structural reform. Being truly credible means facing "time inconsistency" down over time. The longer the track-record, the greater the cost of breaking that record and therefore the greater the belief that discretion is being used wisely. But how does a new government establish such a track record? Does it simply have to wait, pay a short-term cost and prove its intentions are genuine? Or are there actions it can take to build credibility, short of fixed policy rules?

Let me pose two questions any government must answer:

The first concerns information: why should I believe you are pursuing sound policies just because you say you are?

The second concerns reputation: just because you have been pursuing sound policies in the past, how do I know you will continue to do so in the future?

III. Credibility Through Maximum Transparency

At the heart of the "time inconsistency" problem is imperfect information — about the true state of the macroeconomy and, more importantly, about the true motivations of policymakers.

Economics requires perfect information — about prices today and in the future and about the quality of the goods you buy — in order to produce first-best outcomes. But, as the great US economist, now Chief Economist at the World Bank, Joseph Stiglitz has argued in numerous articles over the past two decades, if that information is partial, and can be manipulated, then often quite perverse outcomes can result.[13] The consequences of imperfect information underpin much of the new Keynesian research agenda, from failures in insurance or credit markets through job-signalling and efficient wage explanations of unemployment. At its simplest, it is captured in the classic prisoners dilemma, where two isolated prisoners cannot trust each other to co-operate and plead guilty, which would make them both better off, because of the risk that one pleads guilty while the other cheats and pleads not guilty. So they both plead not guilty and remain in jail — the worst outcome.

How does imperfect and asymmetric information affect macroeconomic policymaking?

First, as I have said, at the heart of the time-inconsistency problem is inevitable uncertainty about the true motivations of policymakers — about whether their claims to be pursuing long-term sustainable macroeconomic policies are genuine.

But this problem is compounded by imperfect information about the state of the economy and policy actions which are being taken. Discretion for macro-policymakers would be straightforward if it were always immediately clear what discretionary action was needed and why and when action was being taken. If it was always clear what the level of the output gap was, or the underlying rate of productivity growth, or whether a particular shock was a supply shock to be accommodated rather than a demand shock to be countered, life would be easier.

The problem is that the suspicion that the government is manipulating information or policy for short-term motives is as damaging to credibility and the economy as evidence that it has done so. Even if macroeconomic

errors begin as mistakes rather than deliberate deception, the more suspicion there is about motivation, and the greater the asymmetry of information between government and the investing public, the higher short-term cost that is paid in lost credibility and the heavier the blow to credibility when things go wrong.

There can be no doubt that the UK paid a price in lost credibility because of the macroeconomic mistakes of the 1980s. But there is no need to suggest that this was the result of deceit. Hubris is as serious a risk. Who can be surprised that a chancellor who, after declaring that an "economic miracle" was occurring for some years, came to believe his own rhetoric and over-estimate the capacity of the economy to sustain higher levels of growth — only to find his miracle to be rather less significant than he hoped and inflation accelerating out of control?

The last few years show that credibility in macroeconomic policymaking is a valuable commodity — once promises on tax, borrowing or interest rates are broken it is hard to rebuild credibility in future promises. And without it, the economy pays a higher price in terms of higher long-term interest rates, slower growth and a constrained ability to use discretion when it is really needed.

But the less the public knows about how decisions are taken, the more suspicious it inevitably will be about motivation and the more the risk of the kinds of market turbulence that can occur when information is incomplete and policies are not well understood. The more economic information that the government withholds from public scrutiny, the greater the suspicion that there is a truth which is being withheld and the books are being cooked. And when discretionary action is needed, the less the public is taken into the confidence of policymakers about the nature of the policy dilemma, and the risks associated, the harder it will be to maintain credibility and support if things do not turn out as anticipated.

This information problem is compounded when the possibility of bail-out by international institutions exists. It is clear that the willingness of the International Monetary Fund, backed by national governments, to provide rapid financial assistance to Mexico in 1995, helped to stabilise that crisis and limit the domestic damage. The need to maintain the capability for rapid financial assistance has been even more apparent in recent months as the crisis in Thailand, clearly the result of policy errors,

has spilled over into a loss of confidence and market turbulence more generally across South-East Asia. The loss of financial market confidence in Indonesia in recent weeks, and the stabilising effects of the swift and substantial assistance from the IMF, shows both the speed with which contagion can spread, the way in which unsustainable policies can be quickly exposed, and the worth of the international institutions.

But the willingness of the IMF to play this "bail-out" role also has a cost — the more the IMF is willing to step in to bail out failure, the less private capital and national governments have to suffer when problems occur, and the less vigilant they need to be in avoiding crises in the first place. Or, to use economists' jargon, this moral hazard problem reduces the risk premium which investors demand from potentially vulnerable countries at the expense of a greater risk borne by those who finance the international institutions. Which is why the international institutions, and their developed countries financiers, have an interest in greater transparency in all countries so that proper surveillance can occur and unsustainable problems are not hidden from view. This is one motivation behind the proposed IMF Code of Conduct I referred to earlier.

So the third principle is — **credibility through maximum transparency**: the greater the degree of transparency about the government's objectives and the reasons why decisions are taken, the more information about outcomes that is published as a matter of routine, and the more checks on the ability of government to manipulate the flow of information, the less likely is it that investors will be suspicious of the government's intentions, the greater the flexibility of policy to react to real crises and the easier it is to build a consensus for difficult decisions.

This principle takes us part, but not all of the way, to credible discretion. It helps guard against the hubris trap. And by making more information available to the public and the markets not only about long-term objectives, but the short-term state of the economy and policy, it makes "cheating" on policy mistakes less likely, and more costly — so helping to ease the time inconsistency problem. But it does not alone solve the problem. Indeed, cynics would argue that the more the government does to persuade the markets and the public that it can be trusted, the more it has to gain **in the short term** from cheating. Which is why we have to turn to

a further strand of economic theory, implicit in the preceding discussion of credibility and discretion, which underpins the final principle.

IV. Credibility Through Pre-commitment

The existence of asymmetric information about the government's motives explains only half of the problem which central bank independence is designed to solve. The second is that we live in a dynamic world in which reputation matters. The tragedy of the prisoner's dilemma is not simply that they choose the second-best outcome, but that they cannot learn from their mistakes. Each time they are offered the opportunity to gamble on mutual co-operation, it is a gamble they dare not take for fear that the other will continue to cheat. If only there was a way in which they could both pre-commit to plead guilty, then the dilemma would be solved.

The same applies to governments. The problem is that the government can get away with cheating once, by claiming that discretion is needed to respond to a shock when all that is intended is a short-term pre-election dash for growth. For it does so at the cost of its reputation in the future. You can only fool people once. But once you have, the public and markets expect it again. And again.

The problems which continued to undermine the credibility of economic policy after the UK left the ERM make this point. The government tried to focus on the long term — by setting an inflation target against which it could be judged. It tried to be more open in the provision of information — the minutes of the new monthly meetings between the Chancellor and Governor were published, and the Bank produced a new, quarterly Inflation report which provided much more information about the state of the economy and the stance of policy. Yet, once the Governor and the Chancellor began to disagree, there was widespread suspicion that this was simply pre-election political manipulation of interest rate policy — certainly enough suspicion to keep long-term interest rates high and make companies more wary about investing.

The answer is to put in place institutional mechanisms which mean that it is clearly the government's intention to do the right thing — to make, in the jargon of game theory, a strategic pre-commitment. Part of the

solution, as principle III suggests, is to give so much information about the government's objectives and whether it is meeting them, that it makes failure to take a long-term view too costly to contemplate. But it is also possible to go further — to pre-commit not to cheat and dash for growth while retaining the discretion which is lost with fixed policy rules.

Which is, of course, the heart of the case for central bank independence as a solution to the time inconsistency problem, as made by Robert Barro and Robert Gordon in the early 1980s and more recently and most eloquently by Stan Fischer, Managing Director of the IMF.[14] The government, by legislating to make the central bank independent in setting policy to deliver low inflation, can strategically pre-commit policy to meeting that objective while still preserving the discretion for monetary policy to respond flexibly to shocks. Central to the ability of the Bundesbank and the US Federal Reserve to use discretion in the late 1980s, as I outlined earlier, was the fact that they could do so without suspicion that they were manipulating information or policy for short-term political reasons.

And so we reach the final principle — **credibility through pre-commitment**: the more institutional arrangements can demonstrate that policy is truly trying to achieve its declared objectives, and the more difficult it is for the government to cheat by breaking promises or aiming for different objectives, the more the public and investors will believe that decisions are being taken for sound long-term reasons.

There are, of course, a range of types of "independence" depending on how the bank is constituted, whether the government or the central bank sets the targets for policy and the degree of openness in its deliberations. The arguments I have made tonight do not necessarily make the case for one particular model over all others but they certainly give a steer. In particular, credibility through maximum transparency applies, in my view, at least as much when the central bank is independent. Putting aside the more political arguments about the need for democratic legitimacy, and the need to ensure that the government and central bank are seen to be united on objectives, the argument for maximising discretion by explaining to the markets and the public why decisions are being taken and for what purpose strengthens credibility of policy whether in the hands of the government or the central bank.

The same institutional arguments apply also to fiscal policy — but necessarily to a lesser extent. The goal of monetary policy is relatively easy to codify: governments can sensibly set the inflation target but then devolve decision-making over interest rates to an arms length monetary agency which is charged with achieving that goal. But setting targets for public borrowing and then asking a fiscal agency to make the necessary decisions to meet those targets would be much more difficult. The reason, of course, is that public borrowing is the difference between two much larger variables — taxes and public spending. And decisions about how much and who to tax and how much and how to spend affect not simply the level of public borrowing, but a much wider set of economic and social objectives, not least the distribution of income and wealth across society and between generations. It is precisely to make these choices and trade-offs, about ends and means, for which governments are elected — trade-offs which, unlike the supposed long-run trade-off between unemployment and inflation, are not spurious but real. But there are ways in which a government can preserve its ability to make these fiscal choices and yet also buy credibility by making pre-commitments to long-run targets, open procedures and institutional constraints, as the new Labour Government is demonstrating and to which I now turn.

3. PRINCIPLES INTO PRACTICE — THE NEW UK MACROECONOMIC FRAMEWORK

Establishing and retaining credibility is important for any central bank or government — but particularly for a new government from a political party which has been out of power for almost two decades and which has seen substantial changes in its party constitution and policy in a short space of years. So in my final section, I will try to use these four principles:

- stability through constrained discretion
- credibility through sound long-term policies
- credibility through maximum transparency
- credibility trust through pre-commitment

to explain the motivation behind the government's different reforms to macroeconomic policymaking.

The first, and certainly most important, economic reform that the new government has introduced is operational independence for the Bank of England and the accompanying reforms — the new monetary framework — which the Chancellor announced in his letter to the Governor of May 6th. Taken as a whole, this new framework puts all these principles into practice, as I will explain.

The Bank of England will be charged, under the legislation, to set monetary policy to achieve price stability as defined by the government's inflation target — not a fixed intermediate target — of either the monetary or exchange rate target. So through this institutional reform, the government is now pre-committed to a monetary policy which aims to keep inflation low and, without prejudice to that objective, to support the government's objectives for growth and employment. But this secondary objective, combined with the precise formulation of the price stability objective as a target of 2.5 per cent on average, is important because it makes clear that the Bank has discretion to respond intelligently to supply-side shocks — a discretion which is further underpinned by the new "open letter system" which ensures that this discretion is exercised in an open and transparent manner.

There is no doubt about the government and the Bank's sound long-term objectives. The inflation target makes clear that the objective is to achieve, on average, an inflation rate of 2.5 per cent measured by the underlying inflation rate. And it is the Bank's primary role to achieve that objective, without any government over-ride except for very exceptional circumstances. The separate fiscal task of managing the government's debt will be the job of the new debt management agency, while banking supervision will be the task of the new SIB. There is now no risk of mixed motives or reputational contagion between supervision and monetary policymaking while the Bank is responsible for "financial stability". As lender of last resort, responsibility for avoiding problems in the first place is SIB's and the risk of moral hazard is gone.

These new institutional arrangements also maximise openness and transparency. The Bank's new Monetary Policy Committee meets monthly to set interest rates to meet that objective, the minutes of which are

published with a six week delay and which, if there were a vote, would include the votes cast. The Bank publishes a quarterly inflation report which explains its view of the economy and how it is setting policy to meet that objective. The Governor and Deputy Governors will appear regularly before the Treasury Select Committee to explain their actions. The reformed Court of the Bank will be responsible for the Bank's finances and there will be a debate in Parliament each year on the Bank's annual report. The forward book of the government's foreign exchange rate transactions will be published with a lag, and the Bank will follow similar procedures.

But, importantly, the new arrangements also preserve discretion — constrained by the inflation target. Policy is aimed at achieving an inflation rate of 2.5 per cent. But if the actual inflation rate were to go more than one percentage point either side of that target, then the Governor would write an open letter to the Chancellor explaining why this has occurred, how long it is expected to persist, the action the Monetary Policy Committee has taken and is taking to get inflation back to the target and how this is consistent with its objectives. This "open letter" is critical for two reasons. First, because it makes clear that the Bank and government is at all times committed to the long-term low inflation policy. But second, it allows the Bank, in full public view with government support and entirely consistent with that long-term aim, to respond when necessary with discretion to the kinds of supply-side shocks I spoke of earlier without paying a high price in terms of lost output.

So the new arrangements are in line with all the four principles. Stability through discretion is preserved. The long-term, soundness of policy is unquestioned. Openness and transparency are maximised. And this is enshrined in new and credible institutional arrangements, set out in legislation.

So too with fiscal policy. The government in its first Budget set out a five year deficit reduction plan to achieve sound public finances. Policy is set to achieve clear and unambiguous fiscal rules: the Golden Rule and to hold the ratio of debt-to-GDP at a stable and prudent level over the economic cycle — rules which, unlike under the previous government, cannot easily be changed as the cycle progresses. Moreover, while the government is pre-committed over the cycle to deliver sound long-term fiscal policies, both the automatic stabilisers and the discretion to use

fiscal policy, if necessary, to respond to an economic shock have been preserved.

In order to reinforce this long-term focus, openness and transparency is being increased in fiscal policy. July's new Red Book also included information that the government has never published before which reveal more information about the government's view of the state of the economy and the public finances. First, the government published cyclically-adjusted estimates for the fiscal deficit — designed to avoid the kinds of errors made in the late 1980s by revealing publicly the government's best view of the underlying state of the public finances. But in order to introduce a bias towards caution, the government published two views of the output gap — a central case and a more cautious case, and cyclically adjusted deficit numbers based on both scenarios. This was only a beginning. In a matter of weeks, the government will publish the first ever National Asset Register which, alongside the Golden Rule and eventually the capital/current distinction which will be offered when resource accounting and budgeting begins, will break greater transparency and rationality to the government's capital budgeting. And a few days later, the government will, for the first time, publish a Pre-Budget Report which will encourage a debate about the state of the economy and public finances and the government's economic policy agenda in advance of the March Budget.

Finally, the government has taken institutional steps to increase fiscal policy credibility. The National Audit Office was asked, before the Budget, to report on changes in the conventions that the government was planning to ensure that decision-making was based on sound assumptions which have not been manipulated. The NAO will have a continuing role in future Budgets. And the government has committed to publish, each year, the IMF's conclusions of its staff visit to examine the government's economic policy, including its Budget judgements.

4. CONCLUSION

So in fiscal policy, as in monetary policy, the government has acted early to boost its policy credibility. Discretion has been preserved. A sound long term basis for policy, with clear targets, has been established. Policymaking

is more transparent than in the past. And institutional changes, at the Bank of England and with the new role for the NAO, guarantee this long-term commitment to stability will be maintained.

Will this make for better policy? Only time will tell. Clear principles, sound institutional reforms, and a genuine commitment to transparency and accountability, create the conditions for better policymaking. But, as I said at the beginning, it is results that count. Outcomes speak louder than reforms.

ENDNOTES

1. Chancellor of the Exchequer's Statement to the IMF Interim Committee meeting, Hong Kong, 21 September 1997.

2. Letter from the Chancellor of the Exchequer to the Governor of the Bank of England, 6 May 1997.

3. Chancellor's speech at the Mansion House, 12 June 1997; Budget Speech, 2 July 1997; Red Book, July 1997.

4. Romer P. (1986), 'Increasing Returns and Long-Run Growth', Journal of Political Economy, 94(5), October; Boltho A. & Holtham G. (1992), 'The Assessment: New Approaches to Economic Growth', Oxford Review of Economic Policy, 8(4) Winter.

5. Financial Market data at close of London markets, 21 October 1997.

6. Blanchard O. J. & Summers L. H. (1990), 'Hysteresis and the European Unemployment Problem', in L.H. Summers, *Understanding Unemployment*, Cambridge, Mass: MIT Press.

7. See, for example, Britton A. (1991), *Macroeconomic Policy in Britain 1974-1987*, Cambridge: Cambridge University Press.

8. I am grateful to Mervyn King who suggested that I add the word "constrained" to the original description of the first principle "stability through discretion", a term he used in his 1997 LSE Financial Markets Group lecture "The Inflation Target — Five Years On" (29 October 1997) and which better captures the fact that the Bank of England exercises discretion only within the constraint of the inflation target.

9. King M. (1995), 'Credibility and Monetary Policy: Theory and Evidence', Scottish Journal of Political Economy, 42(1), February.

10. Kydland F. E. & Prescott E. C. (1976), 'Rules rather than Discretion: The Inconsistency of Optimal Plans', Journal of Political Economy, 85(3), June; Lucas R. E. (1976), 'Econometric Policy

Evaluation: A Critique', Carnegie-Rochester Conference Series on Public Policy, 1(2).

11. For example, Marr A. (1995), *Ruling Britannia: The Failure and Future of British Democracy*, London: Michael Joseph.

12. Mosley L. (1997), 'International Financial Markets and Government Economic Policy: The Importance of Financial Market Operations', unpublished paper prepared for the 1997 Annual Meeting of the American Political Science Association, Duke University August 1997.

13. Stiglitz J. & Weiss A. (1981), 'Credit Rationing in Markets With Imperfect Information', American Economic Review, 71 (3), June; Stiglitz J. E. (1994), *Whither Socialism?*, Cambridge, Mass: MIT Press.

14. Barro R. J. & Gordon D. (1983), 'Rules, Discretion and Reputation in a Model of Monetary Policy', Journal of Monetary Economics, 12(1); Fischer S. (1994), 'Modern Central Banking', in F. Capie, C. Goodhart & N. Schandt (eds), *The Future of Central Banking*, Cambridge: Cambridge University Press.

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