IFS

The macroeconomic framework: time for a tweak?

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21 February 2007

Outline

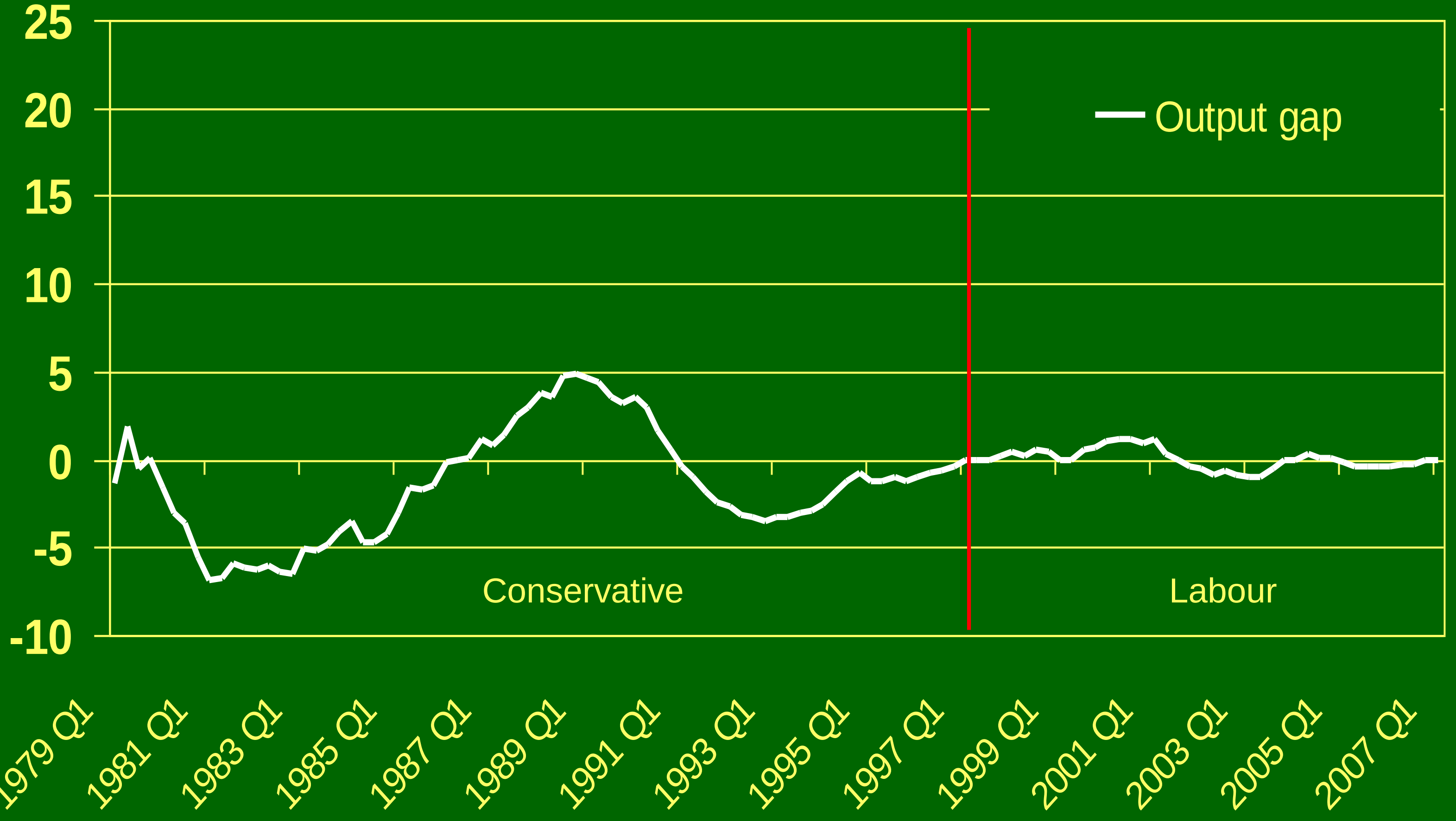
- A tale of two frameworks
- Monetary policy
  - Locking in stability
  - Nice features of UK regime
  - Some room for improvement
- Fiscal policy
  - Framework
  - Serial over-optimism and ‘moving the goalposts’
  - Good time for desirable reform
- Conclusion

A tale of two frameworks

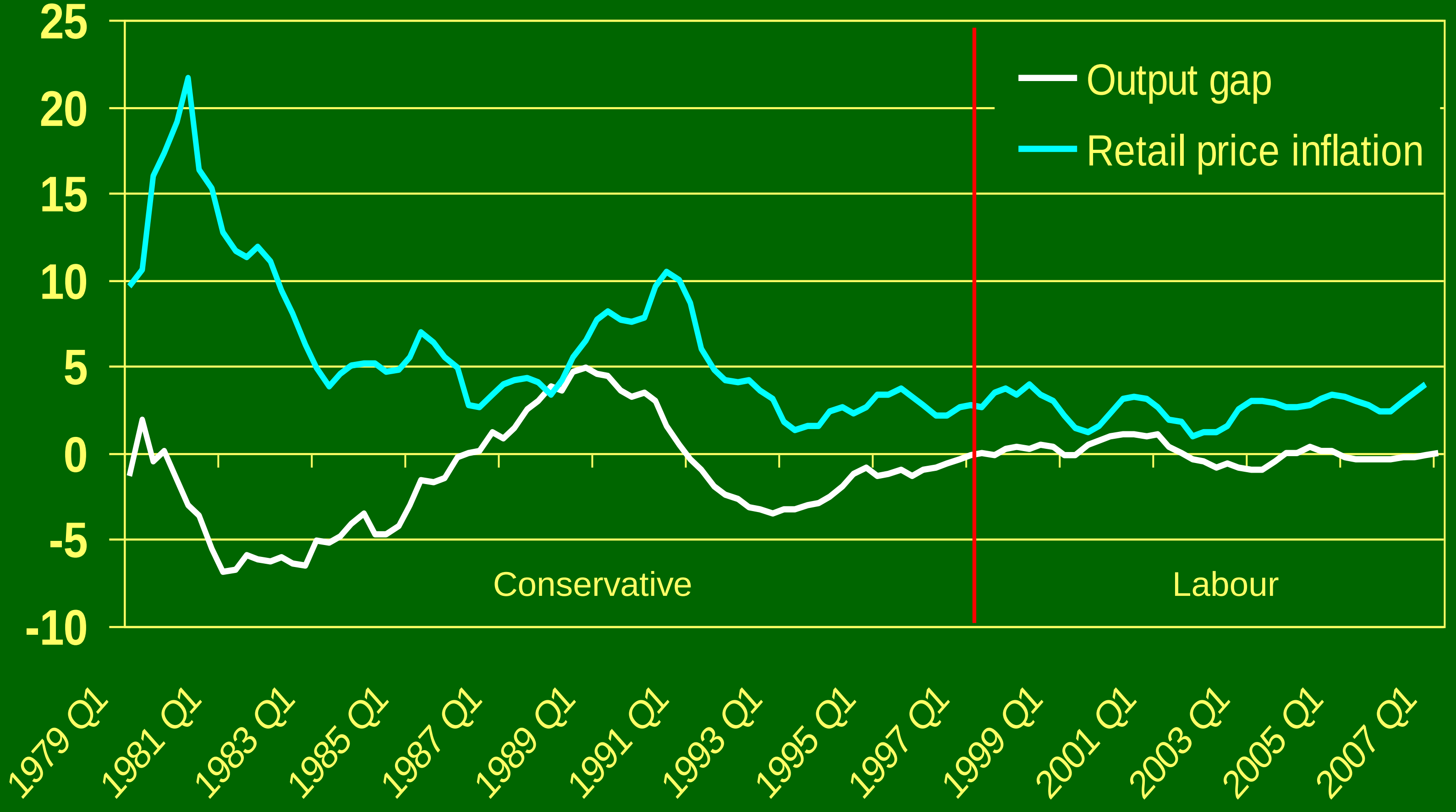
- “It is universally acknowledged that the current framework for monetary policy is sound and appears enduring” (Alan Budd, Wincott, 2004)

- “Almost none use the Chancellor’s fiscal rules anymore as an indication of the health of the public finances.” (Chris Giles, FT, 2007)

Monetary policy locks in stability



Monetary policy locks in stability

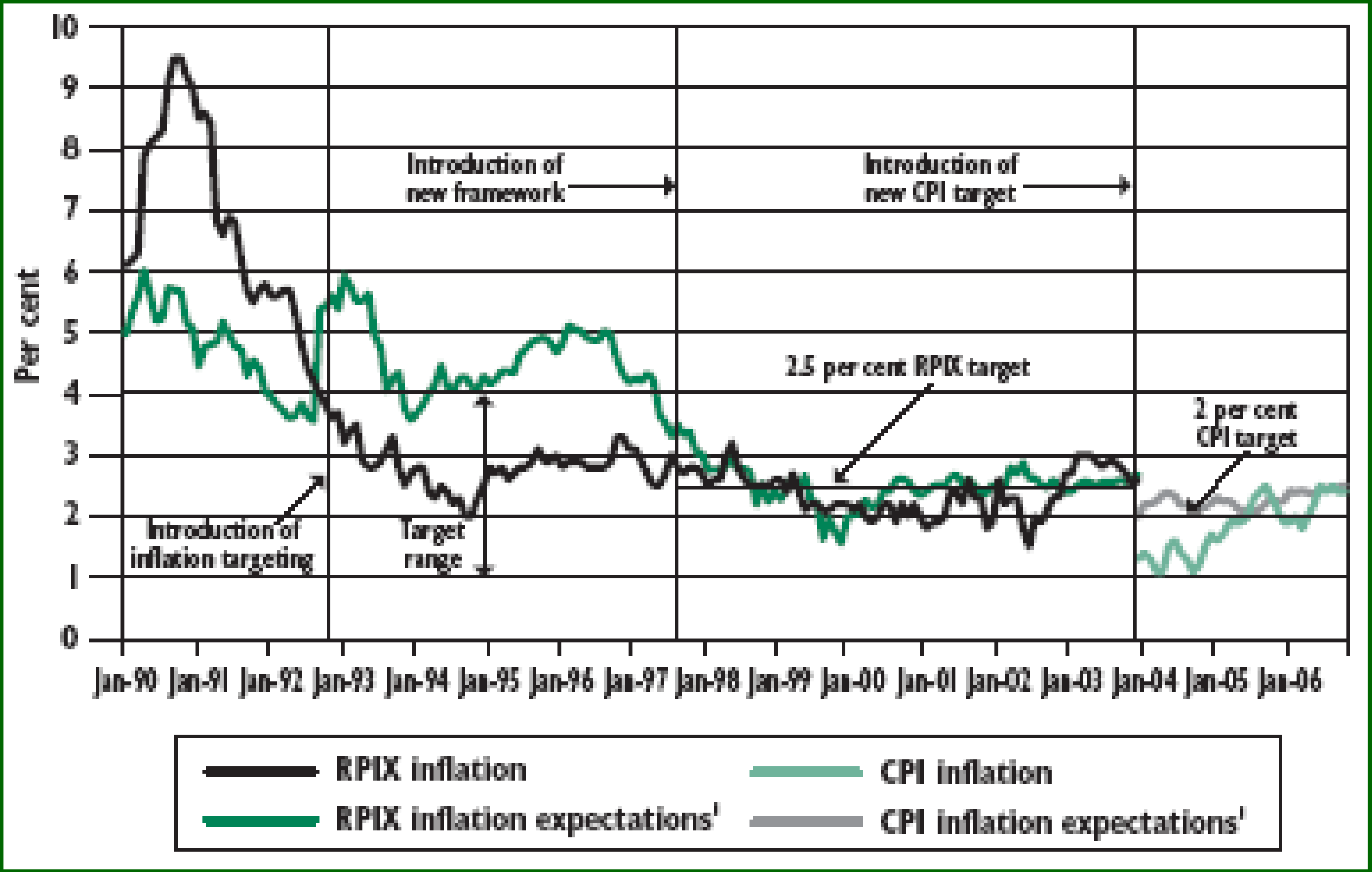


Monetary reform under Labour

- Central bank independence
  - In line with international trend
  - Brown not the first Chancellor to suggest it
  - But Blair the first Prime Minister to agree

- Why might we have worried?
  - Committee decision-making
  - Groupthink
  - Too much too late / too little too late
  - Has the MPC been nimble enough?

Inflation expectations anchored



Has the Bank been tested?

- 1997 the ideal moment for independence
  - Inflation squeezed out in the ERM
  - Devaluation much less inflationary than expected
  - Lots of shocks, but persistent global disinflation
    - China/India imports, bond bubble, immigration
  - MPC has had to anchor inflation, not reduce it
- How would central bank independence have fared if implemented in ’87 or ’92?

Nice features of the UK regime

- Unambiguous and symmetric target
- Transparency and explanation
- Publication of votes
- Individual accountability
- Appointment of experts not interest groups
- Dissent-friendly culture
  - Contrast with FOMC and ECB

Room for improvement?

- Sensible reforms
  - Extend MPC terms to enhance independence
  - Improve appointment process (quality, delays)
  - Encourage individual transparency
- The end of monetary history?
  - Euro
  - Debt burdens and asset price inflation

Gordon’s fiscal framework

- Similar concerns regarding short-termism
- But monetary policy: one instrument aimed at one target; no trade-off between low inflation and other desirable objectives
- Fiscal policy involves more trade-offs
  – Paying for public services
  – Replacing missing markets
  – Paternalism / influencing behaviour
  – Redistribution
- So targets and transparency, not delegation

Gordon’s fiscal rules

- Golden rule
  - Borrow only to invest
  - Current budget in balance or surplus
  - Over economic cycle, not every year

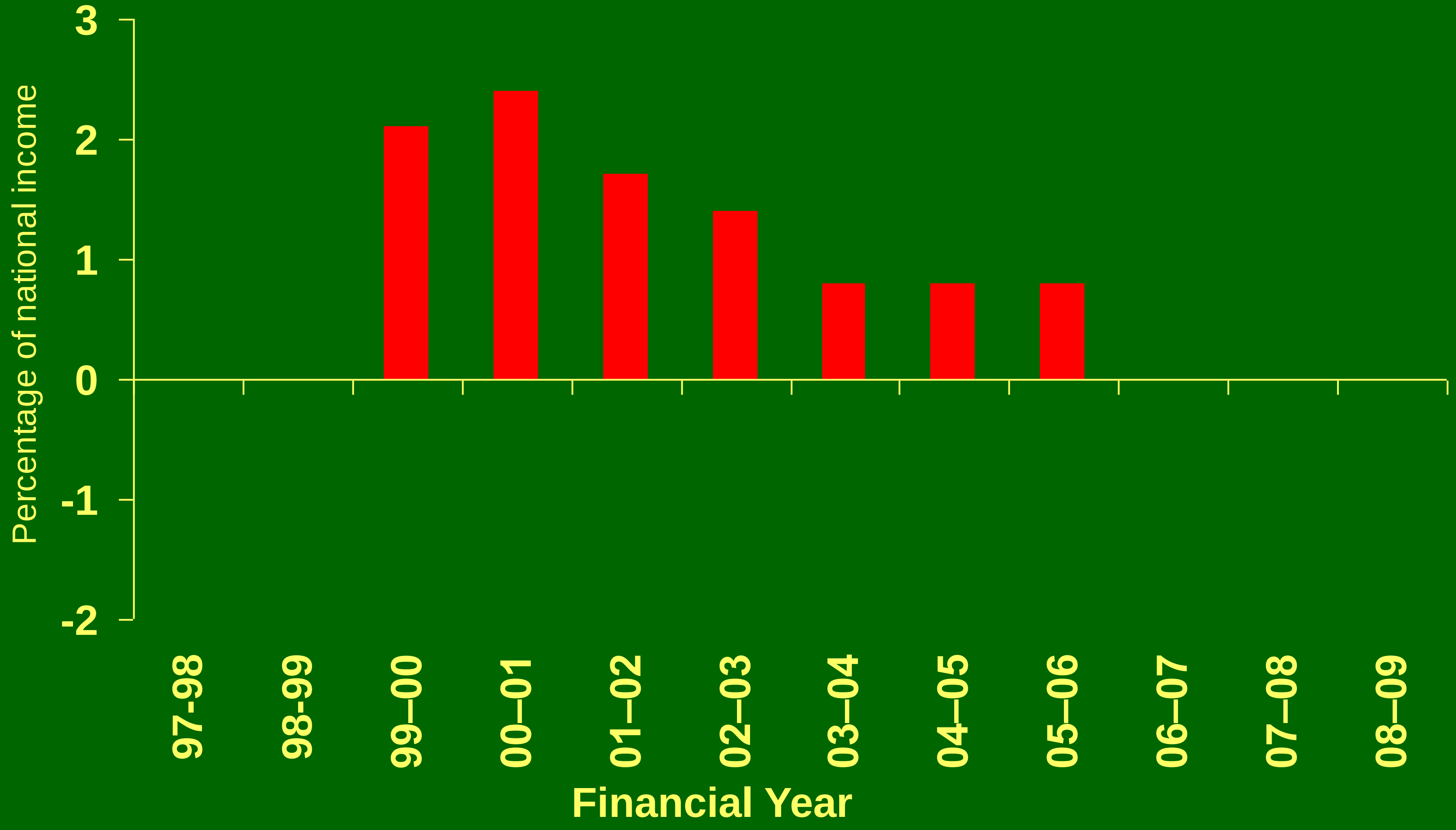
- Sustainable investment rule
  - Keep public sector debt below 40% GDP
  - Every year of the current cycle

The problem

- Early in second term golden rule looked likely to be met by huge margin
- Rhetorical hubris: limitations of rules ignored and ‘conviction forecasting’
- Higher spending and (mostly) unexpectedly weak revenues eroded margin
- Perception that Chancellor moved goalposts to avoid embarrassment of breach

Current budget: Budget 2001

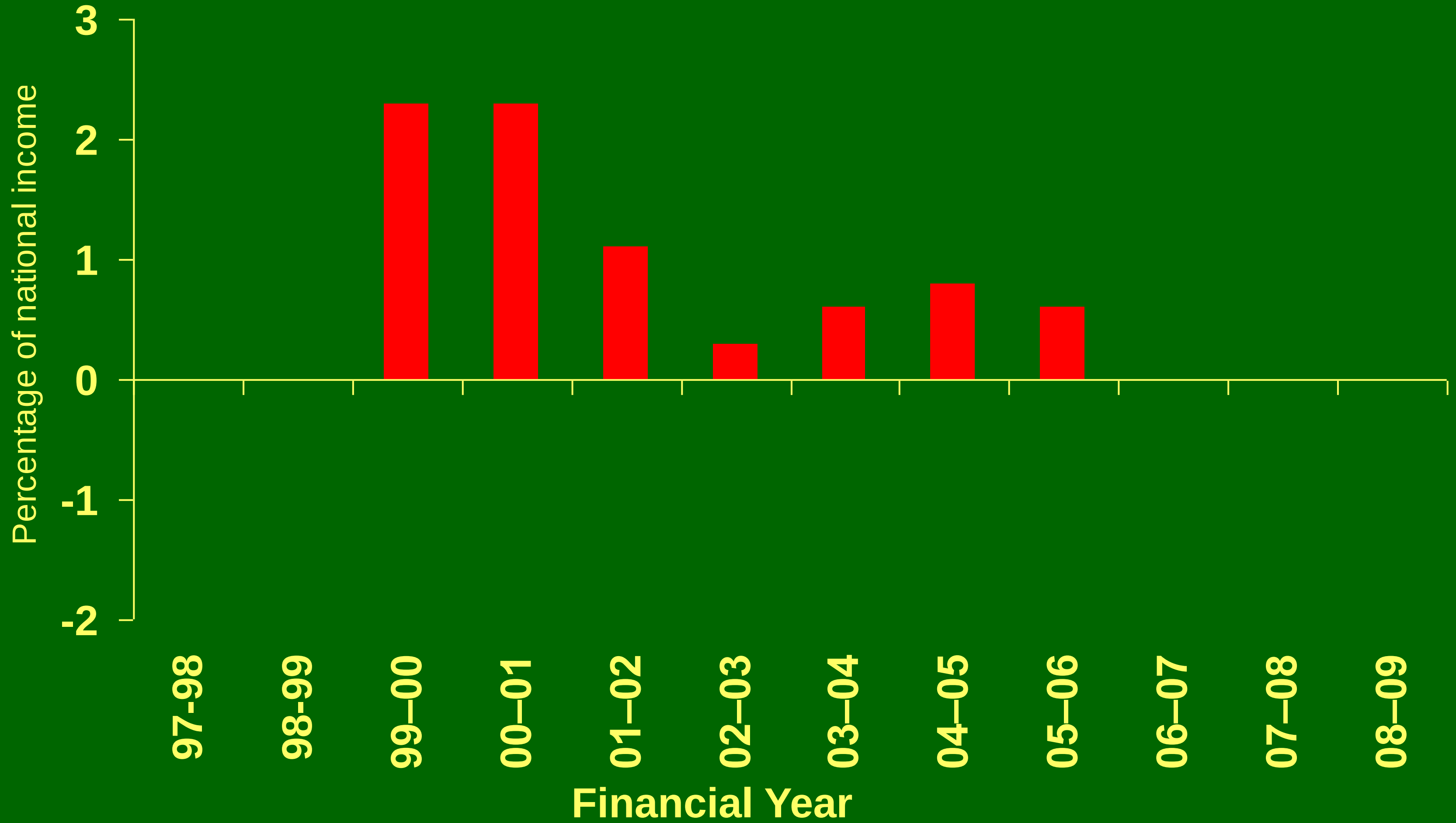
Golden rule met by £130bn over 7 year cycle



Source: HM Treasury

Current budget: Budget 2002

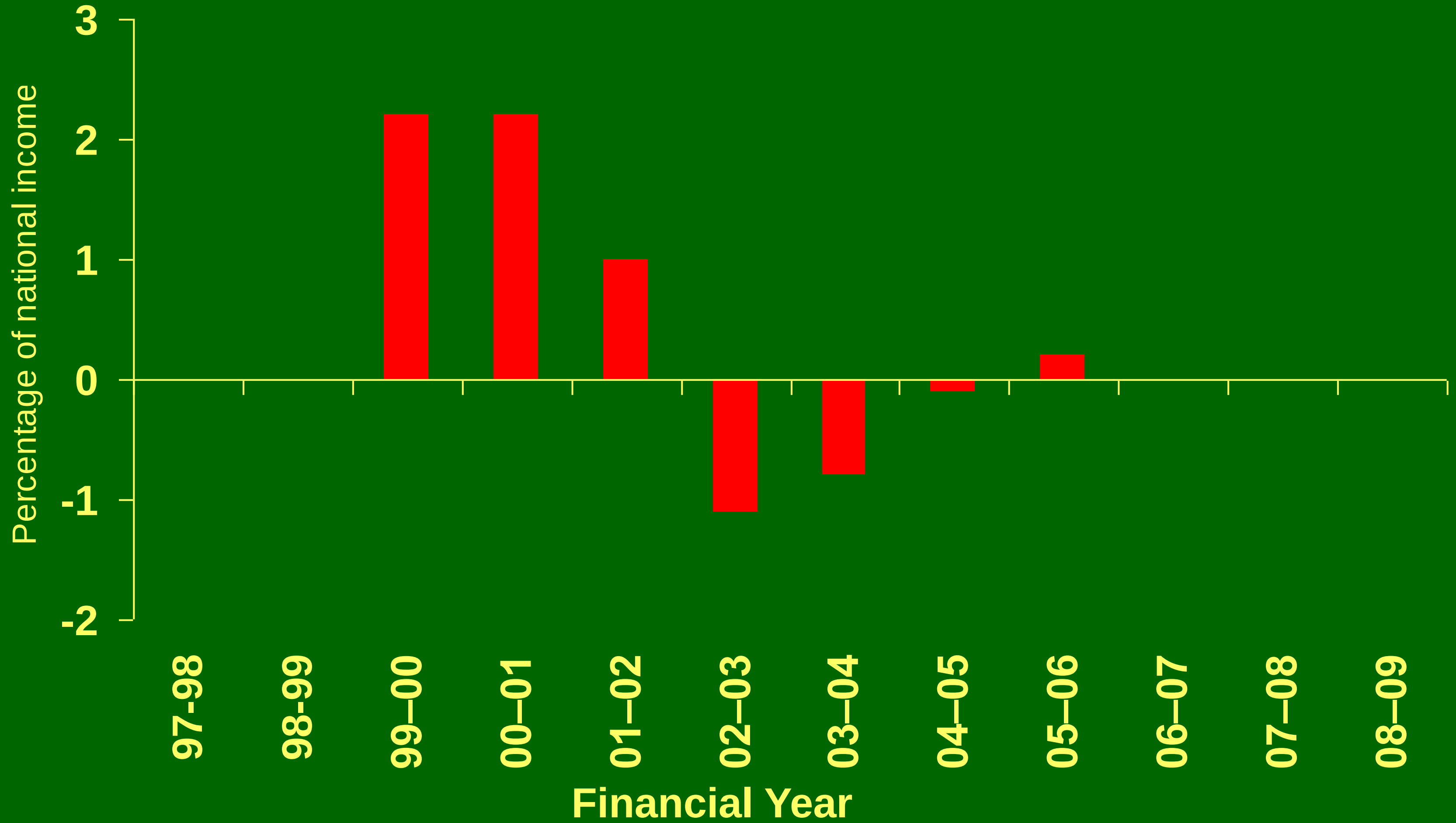
Golden rule met by £103bn over 7 year cycle



Source: HM Treasury

Current budget: Budget 2003

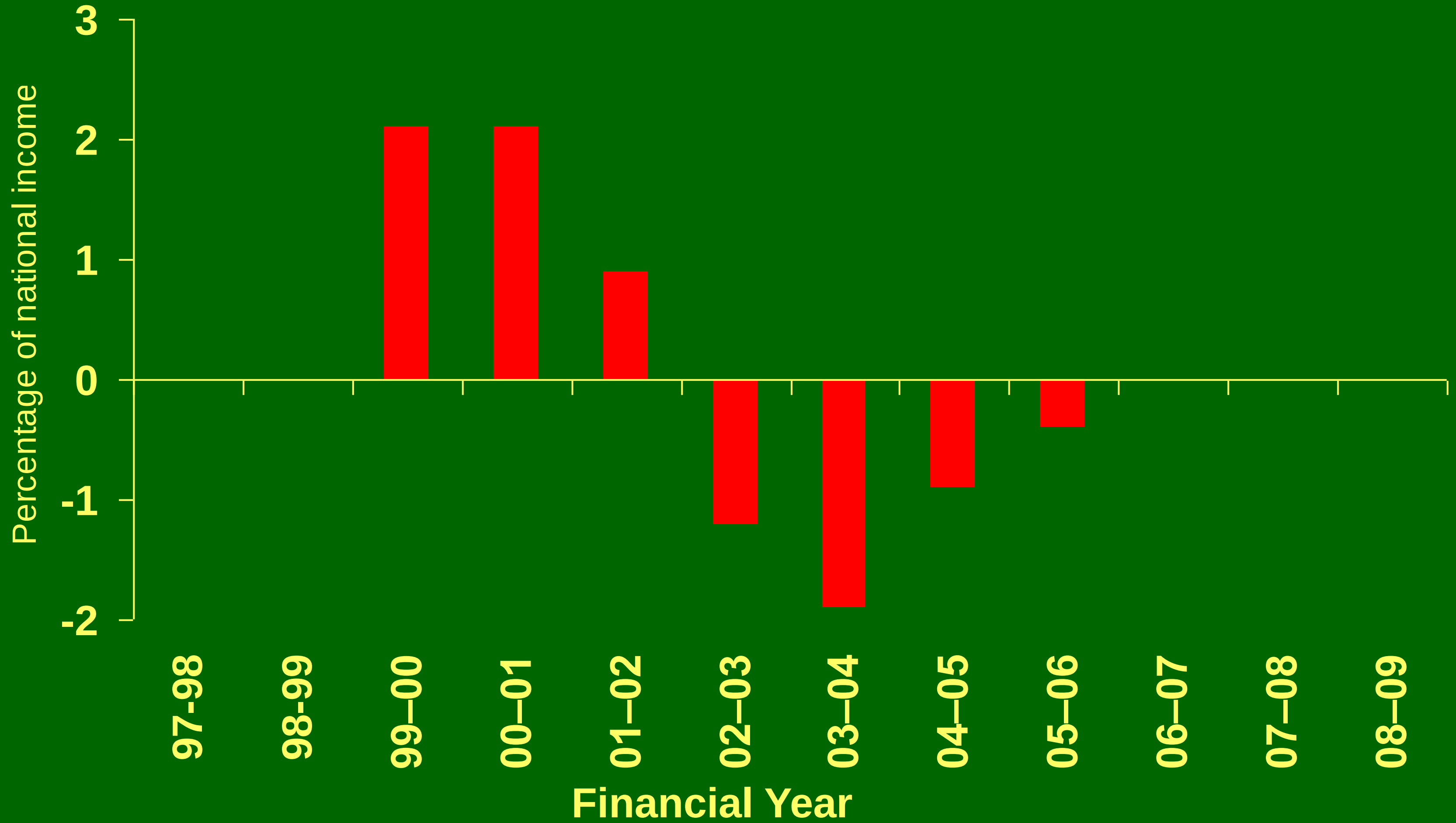
Golden rule met by £47bn over 7 year cycle



Source: HM Treasury

Current budget: Budget 2004

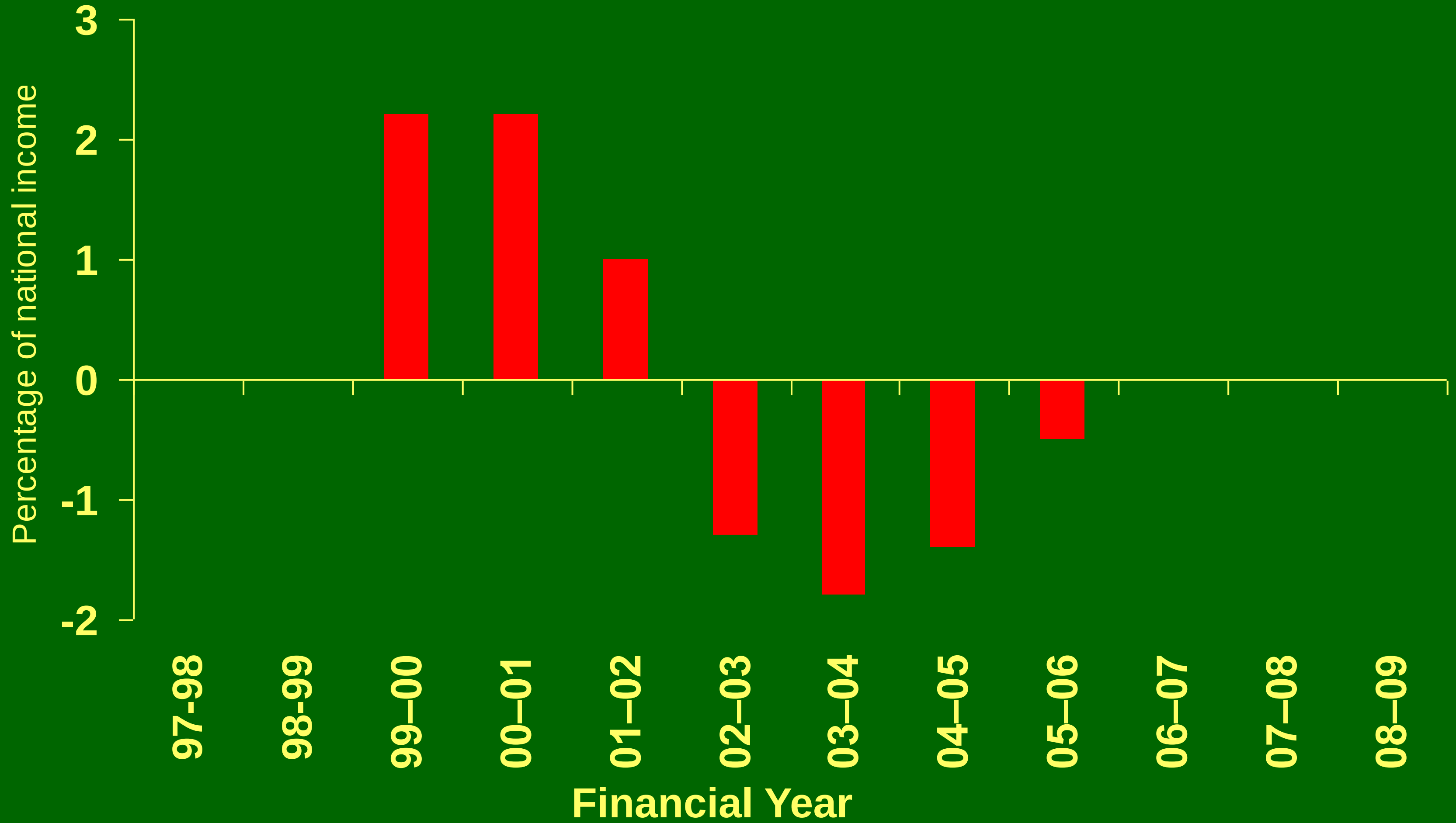
Golden rule met by £8bn over 7 year cycle



Source: HM Treasury

Current budget: Budget 2005

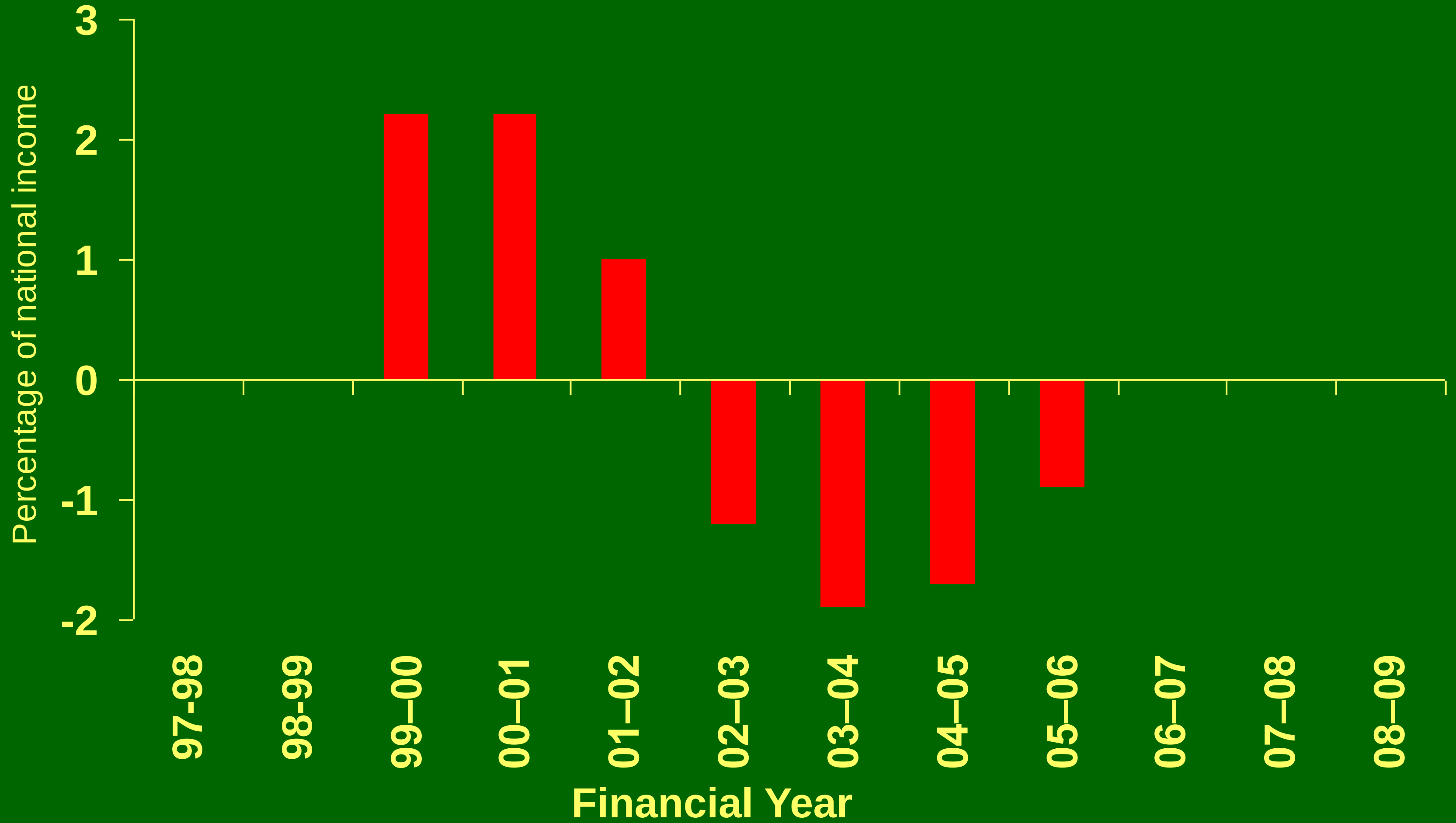
Golden rule met by £5bn over 7 year cycle



Source: HM Treasury

Current budget: PBR 2005

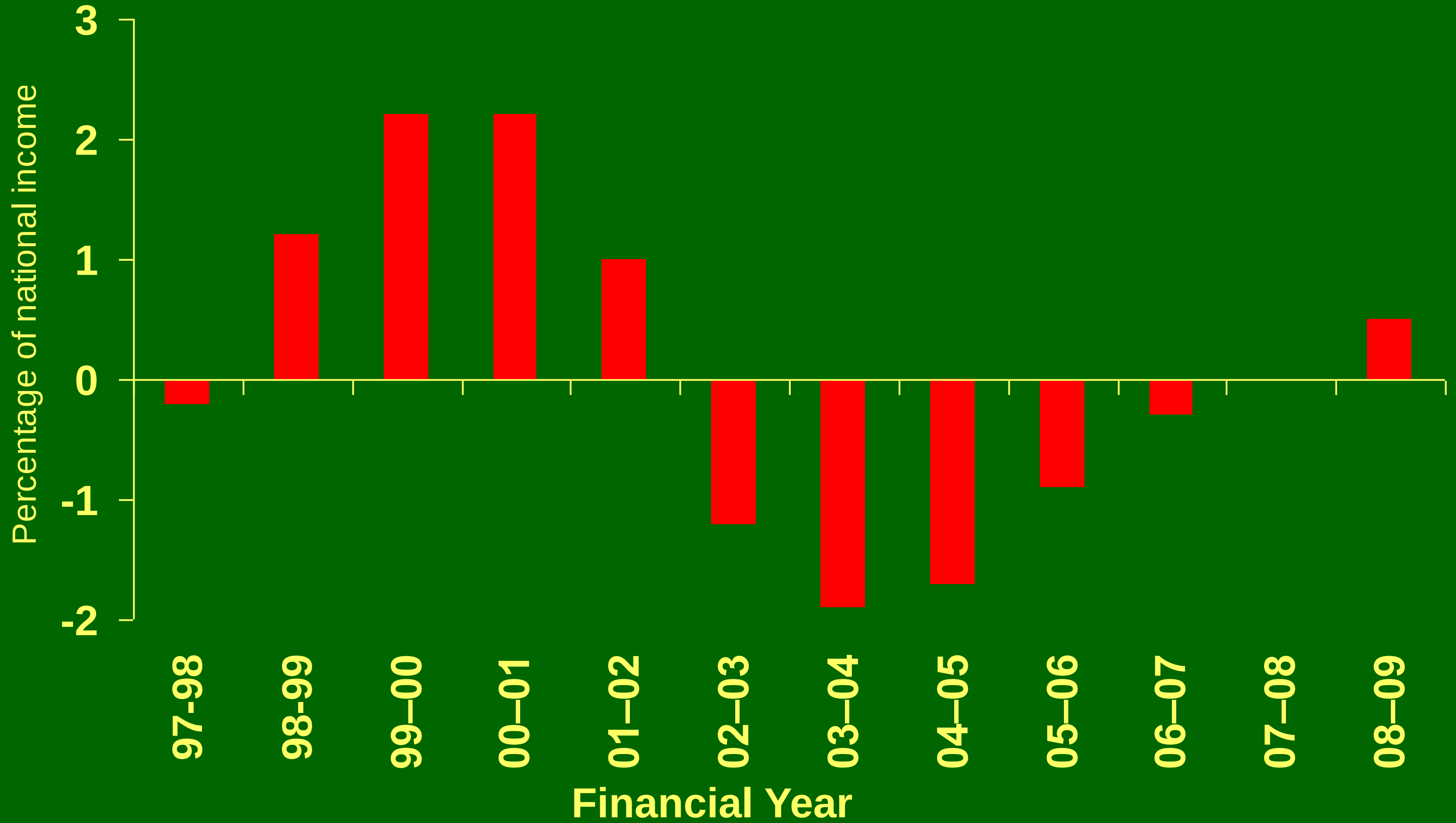
Golden rule would be **missed** by £2bn over 7 year cycle



Source: HM Treasury

Current budget: PBR 2005

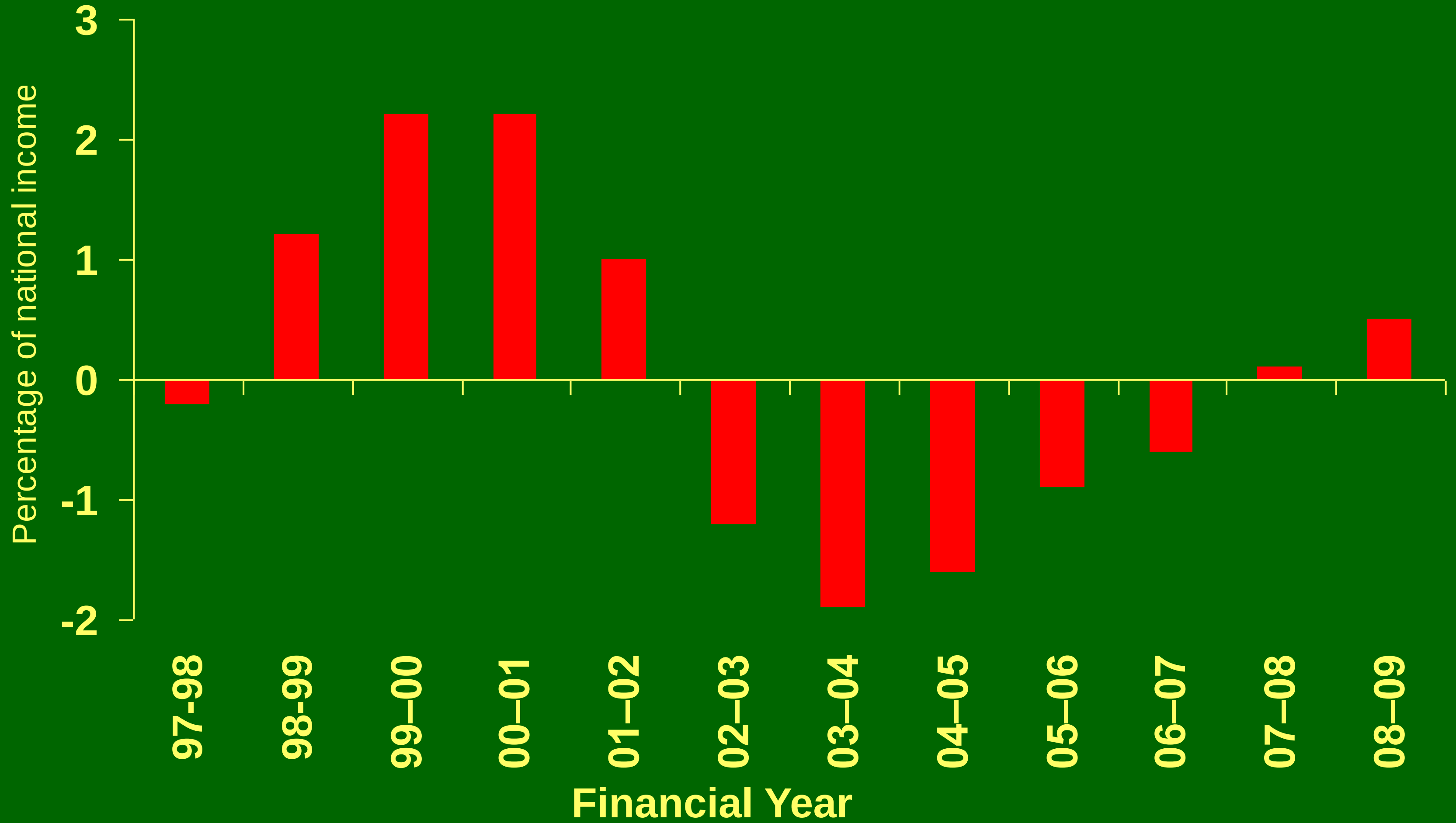
Golden rule met by £14bn over 12 year cycle



Source: HM Treasury

Current budget: Budget 2006

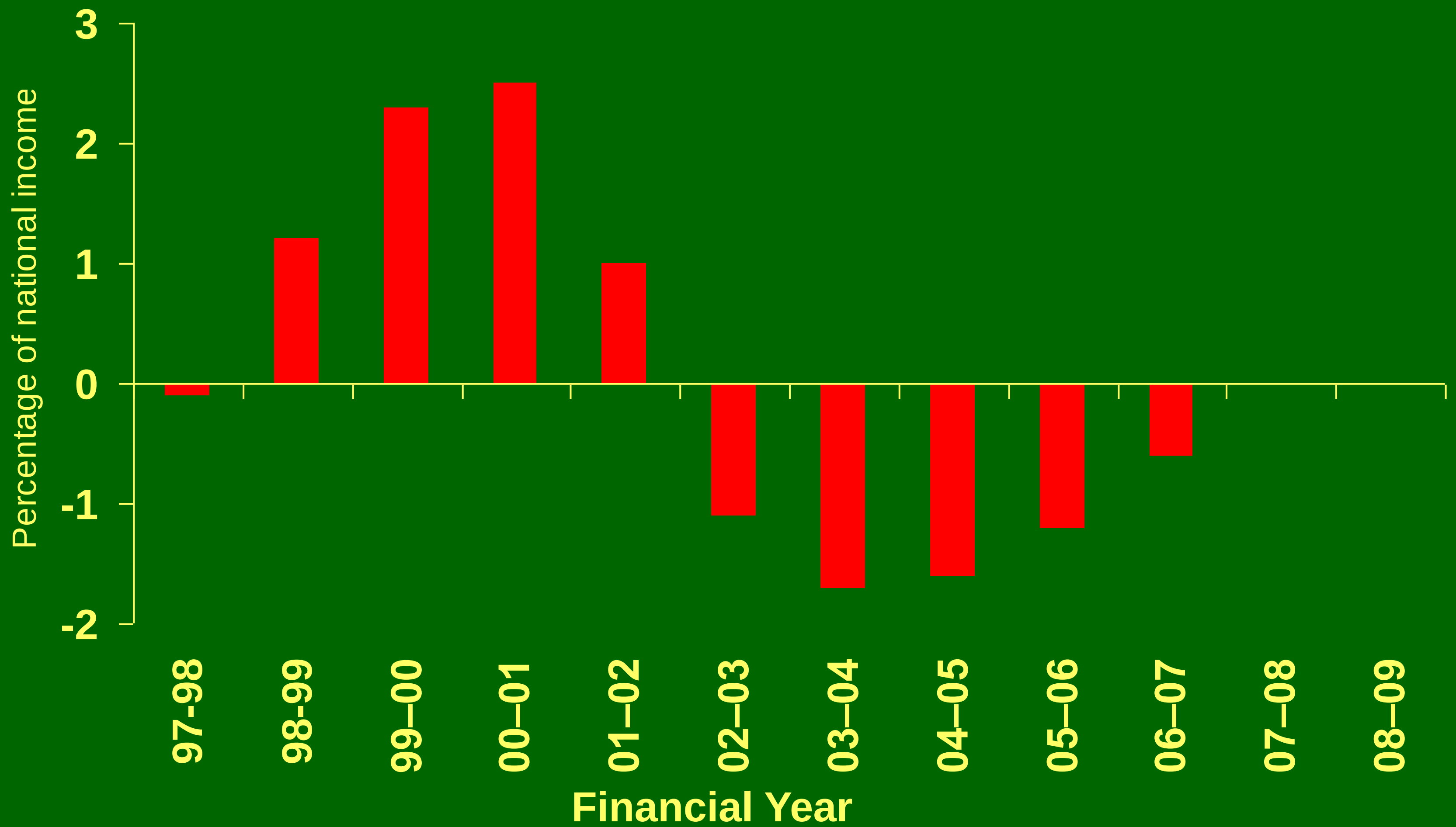
Golden rule met by £10bn over 12 year cycle



Source: HM Treasury

Current budget: PBR 2006

Golden rule met by £8bn over 10 year cycle

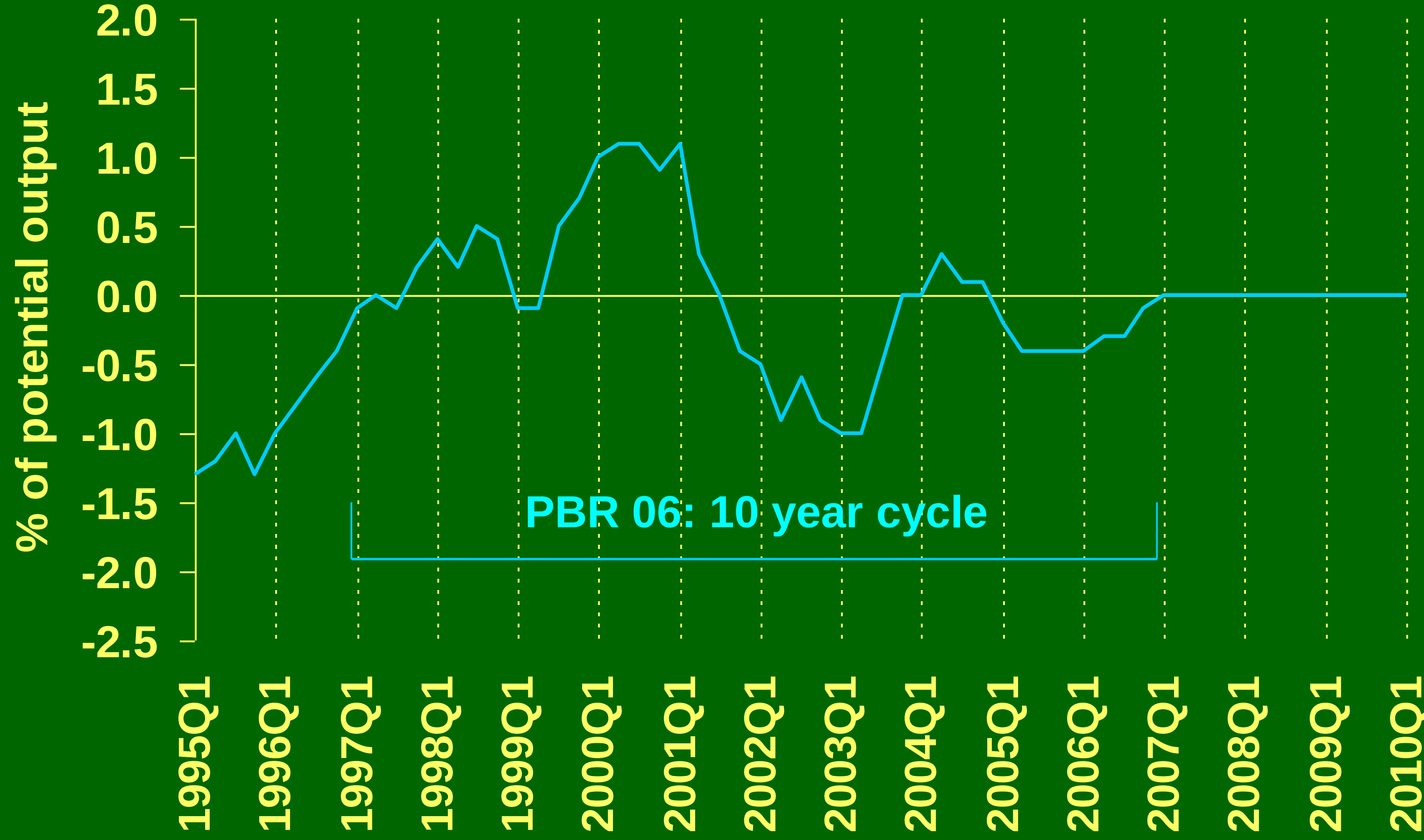


Source: HM Treasury

Rule safe, but credibility dented

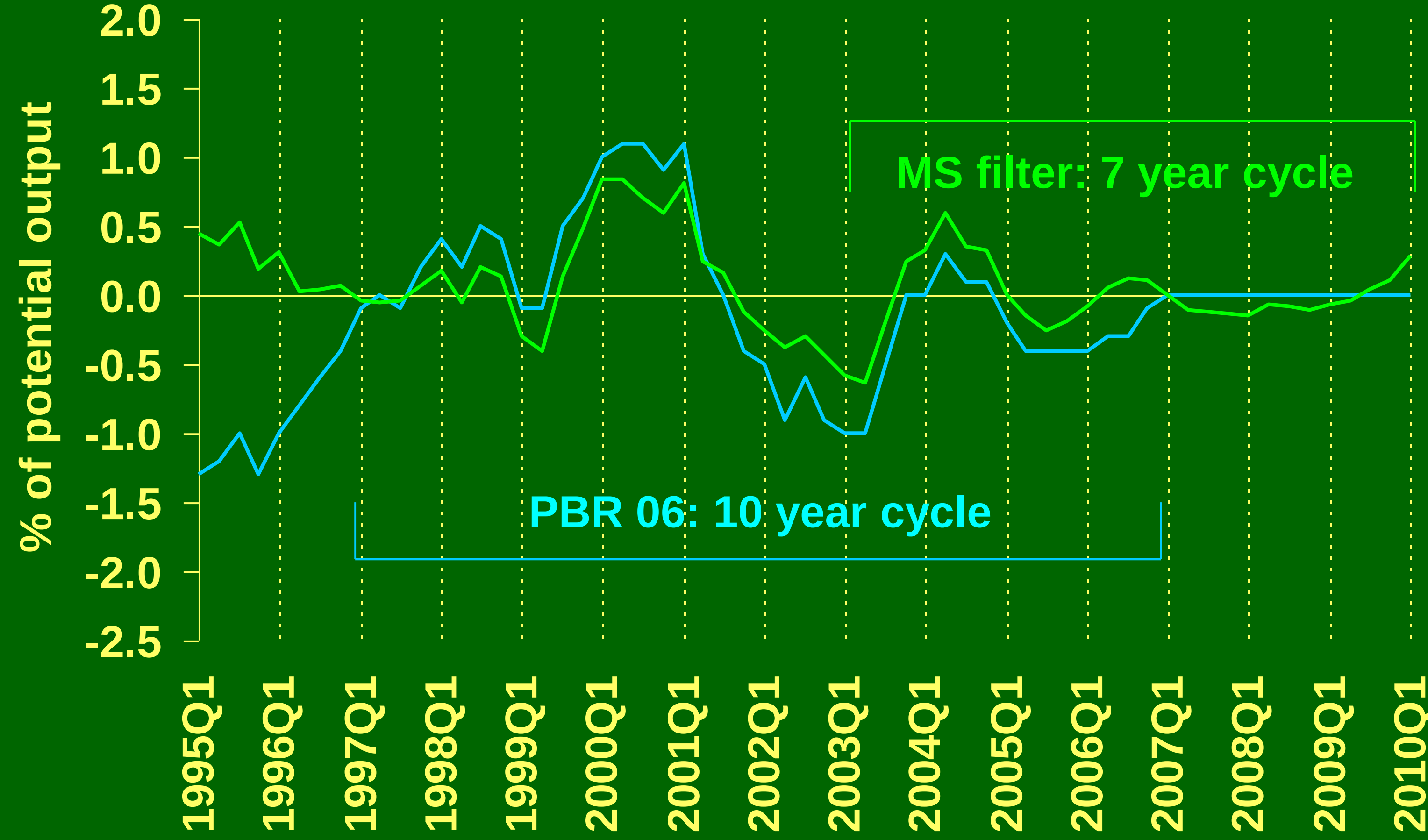
- Golden rule and sustainable investment rule likely to be met in this cycle and the next
- But credibility damaged
- 'Moving the goalposts'
  - Redating the cycle at uniquely convenient time
  - Giving greater weight to early surpluses
  - Reclassification of road spending as capital
  - Failure to state when next cycle will start

Cycle dating crucial



Source: HM Treasury ; Morgan Stanley

Cycle dating crucial



Source: HM Treasury ; Morgan Stanley

Delaying the inevitable?

- Treasury revenue forecasts seen by us and others as too optimistic post-2001 after stock market decline
- We argued through most of second term that tightening of roughly £13bn would be necessary
- “People say that we won’t meet our fiscal rules. Once again, with the public finances strong, we will prove them wrong.” (Gordon Brown, April 2005)
- But once 2005 election safely won: £6bn tax increase implemented and £10bn spending cut pencilled in

The reform challenge

- Good time for reform
  - Declaration of ‘victory’ over current cycle
  - New Chancellor
  - Applying lessons from success of monetary framework
- More realistic approach to rules
  - ‘Rules of thumb’
  - Symmetric and forward-looking golden rule
  - Describe forecasting uncertainties explicitly
- But these may appear to be a ‘softer’ commitment

Independent fiscal authority

- Government sets fiscal target e.g. golden rule
- Independent body tells/advises Treasury how much to raise or give away in each Budget
- Independent body needs same fiscal information set as Treasury now enjoys
  - Within-year spending by departments
  - Revenue forecasts/trends from HMRC
  - How do you cost policy proposals?
- Flexibility + delegation = credibility?

Conclusion

- Monetary framework performing well, but truly tested?
- Modest scope to improve monetary framework
- Public finances stronger than in 1997, but smaller improvement over past decade than in other industrial countries
- Fiscal framework lacks credibility – thanks to goalpost-moving and delaying tax increases / spending cuts until after election
- Good time for reform: combine more realistic approach to rules with delegation of forecasting or budget judgement

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