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Foreword

Gordon Brown

My first words from the Treasury, as I became Chancellor and announced the independence of the Bank of England, were to reaffirm for this government our commitment to the goal first set out in 1944 of high and stable levels of growth and employment, and to state that from 1997 onwards the attainment of this goal would require a wholly new monetary and fiscal framework.

This book, written by those whose expertise shaped the detail of the new policy, traces the intellectual journey to the new economic and financial policy framework.

In 1997, as in 1944, a new paradigm was required. Our analysis indicated that a radical reform of the institutions of policy making was essential if we were to deliver growth and employment and that the key to success was fiscal and monetary stability, not as an end in itself, but as a foundation for growth.

Neither the old 'fine tuning' of the past, which appeared to trade off inflation for growth, nor the rigid monetary targets of the 1980s, made sense in newly liberalised capital markets. We recognised too that the discretion necessary for effective economic policy could only be possible within an institutional framework that commanded market credibility and public trust. That credibility depends upon a long-term approach to policy making, openness, transparency and clear and accountable divisions of responsibility: the fundamental principles of the new macro-economic framework.

So the new monetary and fiscal framework Britain needed had to be based on clear policy rules, well established procedures, and an openness and transparency not seen in the past. Hence the independence of the Bank of England, the new fiscal rules, the Open Letter system, the symmetrical inflation target and our new Code for Fiscal Stability: institutional changes that broke new ground but were firmly rooted in British values and could lay claim to a clear democratic legitimacy.

The reforms are built on three pillars: first, a monetary policy framework with an independent Monetary Policy Committee responsible for setting interest rates to meet the Government's inflation

target; second, a fiscal policy framework which is delivering sound public finances through a Code for Fiscal Stability, firm fiscal rules and better planned public spending which focuses on the quality of public service provision; and third, new institutions such as the Financial Services Authority to ensure financial stability through transparency, responsibility and clear lines of accountability.

It is the conclusion of this book that the new macroeconomic framework is already producing real benefits. At the time of writing unemployment had fallen to levels not seen for over two decades, while inflation is at its lowest level since the 1960s. A sustained track record of stability is the best foundation upon which the Government can deliver its wider goals of high levels of growth and employment, and so deliver rising living standards and better public services. So the true test of the macroeconomic framework will come not just in attaining long-term stability but also in higher living standards and finding the resources to deliver world-class public services to an educated and employed population.

The book makes clear that the prosperity brought about by the new macroeconomic framework is not just for Britain.

Just as in the mid 1940s a new British economic policy was matched by the high ideals that brought the creation of the World Bank and the IMF, so too at the turn of the century the same high ideals are driving change from debt relief to major reforms in the international financial architecture.

We must, at an international level, build a new consensus, with a new and broader emphasis on the conditions for high and stable levels of growth and employment, ensuring countries have in place the macroeconomic, financial, structural and social policies for long-term success in the global economy.

For this reason we have been active in international institutions such as the G8, the IMF and World Bank. Here we have been sharing our experiences and encouraging the development of transparent macroeconomic frameworks to avoid the crises of the past and to reduce poverty and injustice throughout the world. Our proposals include new codes and standards for monetary policy and fiscal policy, corporate behaviour and social policy as the building blocks of the international economic system; far more effective mechanisms for crisis prevention and crisis resolution; a far greater attention to financial stability; and action to meet the 2015 development targets – that all children have primary education, that infant mortality is reduced by two-thirds and that poverty is halved. Here again the attainment of stability is the pre-

condition of economic prosperity but stability has a purpose: the opportunity of prosperity for all.

And while much remains to be done before a new international financial architecture is in place, I believe we are making progress. Britain will continue to contribute to a prosperous world and will actively participate in institutions addressing poverty and injustice. History has taught us that peace, prosperity and justice are indivisible and intertwined. We learned at tremendous cost in the twentieth century how poverty and injustice drove the world to cycles of war and hatred. Our goal, in the twenty-first century, to build prosperity and a more inclusive world, is proof that we are learning from the past and building for the future.

A handwritten signature in black ink that reads "Gordon Brown". The signature is written in a cursive, slightly slanted style.

Chancellor of the Exchequer

Introduction

This book provides a comprehensive guide to the macroeconomic and certain key financial reforms implemented following the change of administration in May 1997. It is intended for all those who wish to understand the economic foundations of these policies and how they have been implemented in practice. It should be useful for those working in private sector financial institutions and public sector bodies, both here and abroad, who wish to understand UK monetary, fiscal and certain aspects of financial policy. At various points, UK policy is contrasted with macroeconomic policies operated elsewhere, especially in the European Union.

We should add that there are of course many aspects of Government economic policy, particularly in terms of structural reform, that are not covered in this book. Interested readers should consult the Treasury web page (www.hm-treasury.gov.uk) for many relevant papers.

The book will also be of interest to economics students, undergraduates or postgraduates. It is most suitable for second- or third-year students and should be read in conjunction with a more traditional macroeconomics textbook such as Romer (2001) or Miles and Scott (2002). This book differs from traditional textbooks in that all the policies described here are actually being implemented. Hence there is much more detail on *how* to achieve certain objectives which those interested only in the theory might choose to skip.

Chapter 1 explains why the new government decided in 1997 to embark on a radical overhaul of monetary and fiscal policy. It explains its diagnosis of the perceived policy mistakes of earlier periods. Chapter 2 describes the underlying principles which guided the choice of solutions. Chapters 3–6 then explain in detail the new monetary policy framework built around an independent Monetary Policy Committee at the Bank of England with responsibility for setting interest rates to hit a symmetrical inflation target.

At the same time, in order to improve the UK's system of financial regulation and help the Bank concentrate on monetary policy, a new single regulator, the Financial Services Authority, was set up. This is described in Chapter 7 which also covers other aspects of Government

2 *Reforming Britain's Economic and Financial Policy*

policy towards financial regulation, including the benchmarking of financial services and stakeholder pensions.

Chapters 8–16 describe various aspects of fiscal policy. It is an unfortunate consequence of the fact that monetary policy decisions are usually made monthly whereas budgets or ‘green’ budgets come only once or twice a year that monetary policy is analysed much more than fiscal policy. It is also the belief of the editors that fiscal policy is much more complicated as there are multiple objectives and multiple instruments. This explains why this part of the book is much longer. It covers not just judgements about how far fiscal policy should stimulate the economy at any point in the cycle but other crucial aspects that are often ignored in the textbooks such as how to plan and control public spending, how to determine whether the public sector is financially viable over the longer term and how best to borrow to finance any gap between revenue and spending.

Chapter 17 explains how the government has applied the same principles, such as openness and transparency, to the reform of international financial ‘architecture’. We should explain that the term ‘architecture’ refers to the relationship between the various international financial institutions, their methods of operation and their guiding principles. It seems that in almost every area of life ‘experts’ develop special terms or give ordinary words special meanings in order to communicate with other experts. It is unfortunately necessary to understand this jargon which is why we have included a lengthy glossary at the end of the book.

Chapter 18 looks at the macroeconomic framework, that is the monetary and fiscal policies and their coordination, that governs the European Union, with particular emphasis on the euro area. It explains how the European Central Bank conducts monetary policy, and how the Stability and Growth Pact affects fiscal policy.

Finally, Chapter 19 gives an assessment of how the new macroeconomic policy framework is operating. No doubt in the years to come as the UK economy experiences various shocks it will be possible to assess in more detail the strengths and weaknesses of the new system. Our hope is that this book will provide the authoritative description of why the Government undertook this set of radical policy changes so others can assess for themselves the degree of success that has been achieved.

It is expected that many readers will use this book as a work of reference. Such readers will want to dip into various chapters without necessarily reading all the preceding ones. For this reason, we have tried to make the chapters as self-contained as possible. This means that there

may be a degree of overlap in the material covered. For example, having read Chapters 1 and 2, it should be possible to skip parts of Chapters 3–6.

The editors would like to thank all Treasury officials past and present, and too numerous to mention by name, who have worked on developing and implementing these policies over the last four years. Many of the same officials have been responsible for various chapters of this book. But we would like to register our particular thanks to Ashok Bhundia, Roland Clarke, Darren Gibbs and Andrew Kilpatrick for their assistance in bringing all this work together. We would also like to express our thanks to officials of the FSA and the Bank of England for comments on earlier drafts of this book. As usual we should add that the opinions expressed in the book are those of HM Treasury, not necessarily of the Bank or the FSA.

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