Managing the UK economy

Fiscal and monetary policy since 1945

Week 8 – 1997-07: Central Bank independence, New Labour & Great Moderation

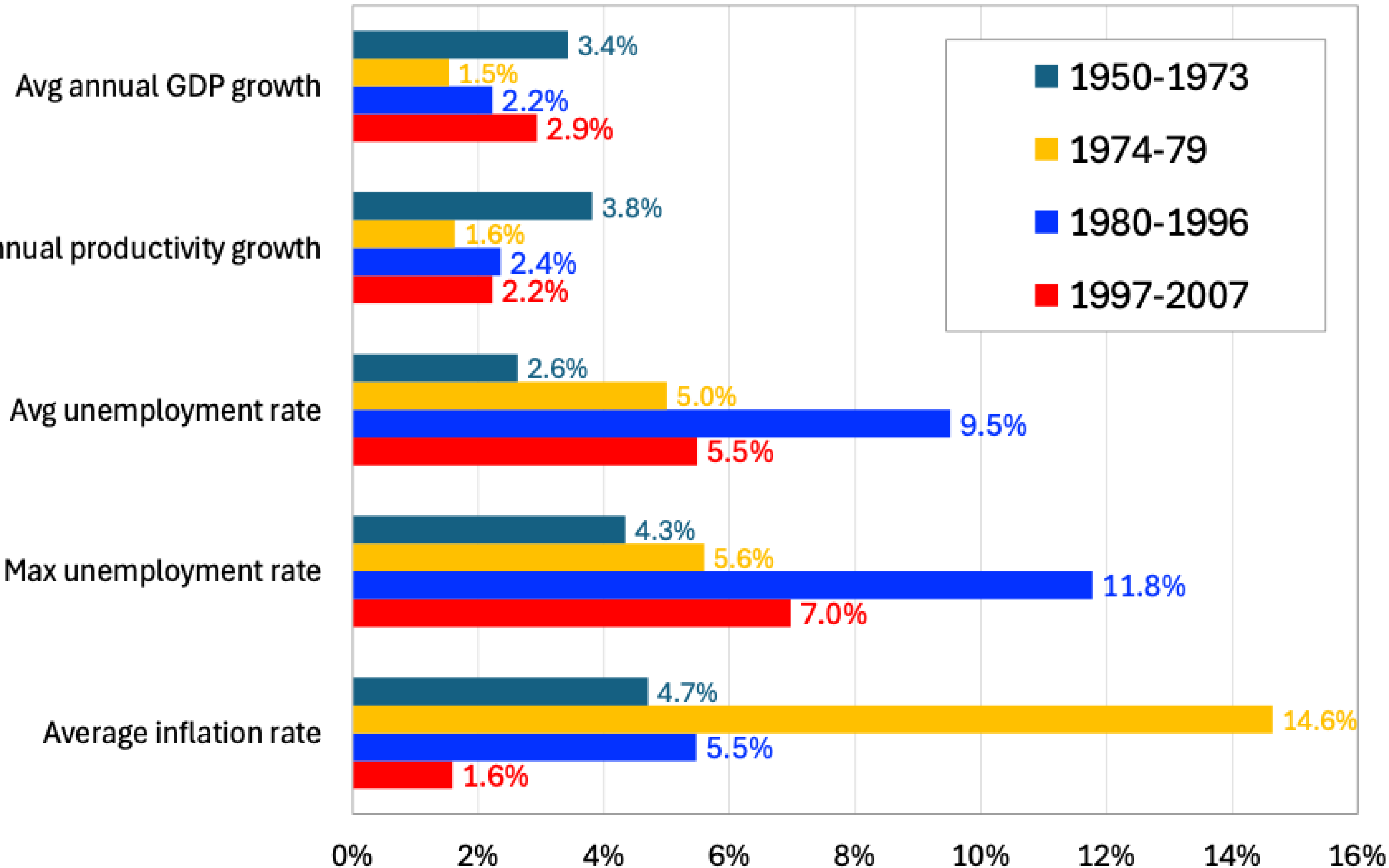
AY 2024-25

Department of Political Economy

Instructor: Daniele Girardi

KING'S College LONDON

1997-2007: Overview

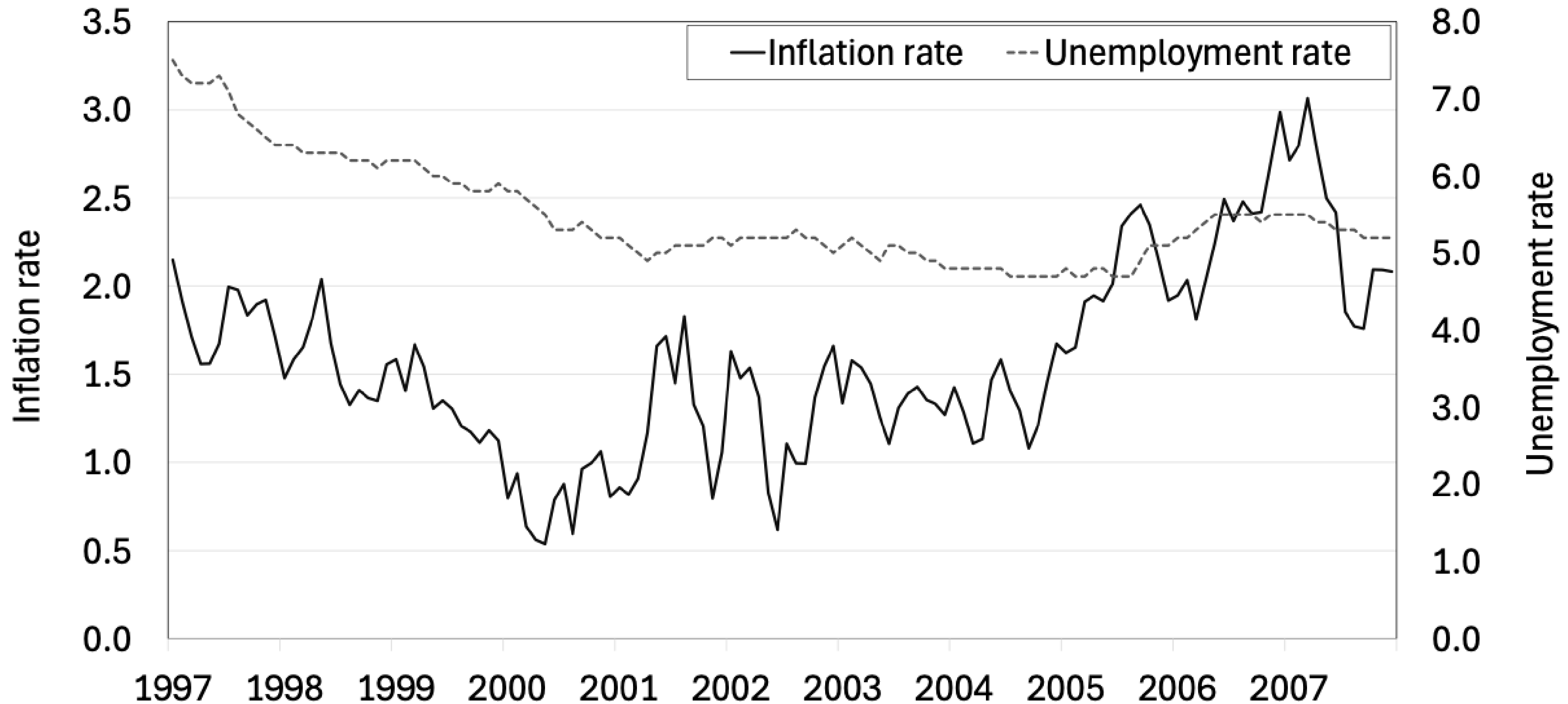


Great moderation:

- Sustained and stable GDP growth.
- Low inflation.
- Decreasing unemployment.
- Limited fluctuations
- Common to other OECD countries.

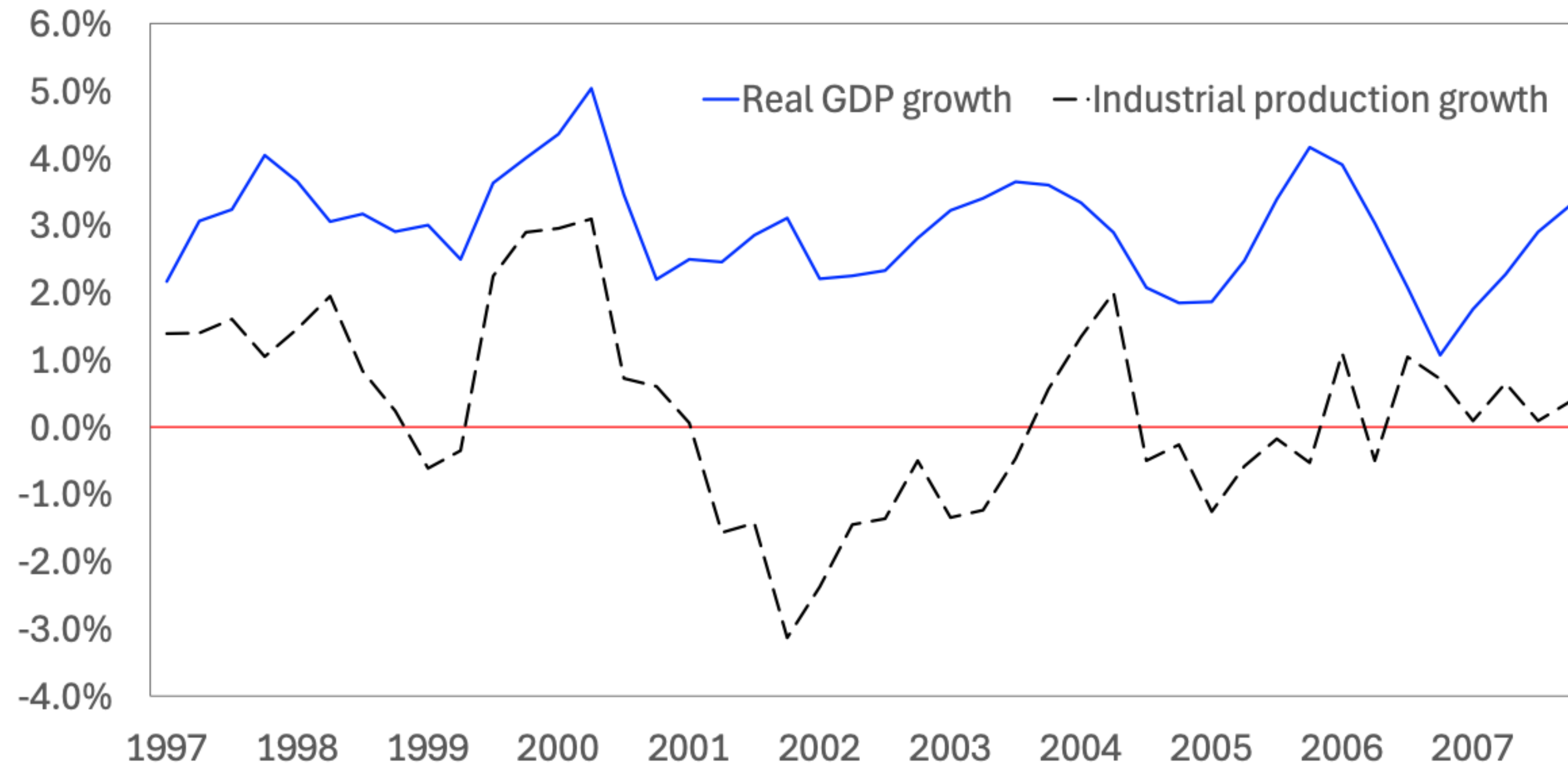
1997-2007: Overview

- Unemployment goes down and stabilizes around 5.5%
- Inflation low & close to 2% target, slightly increases in 2006/7



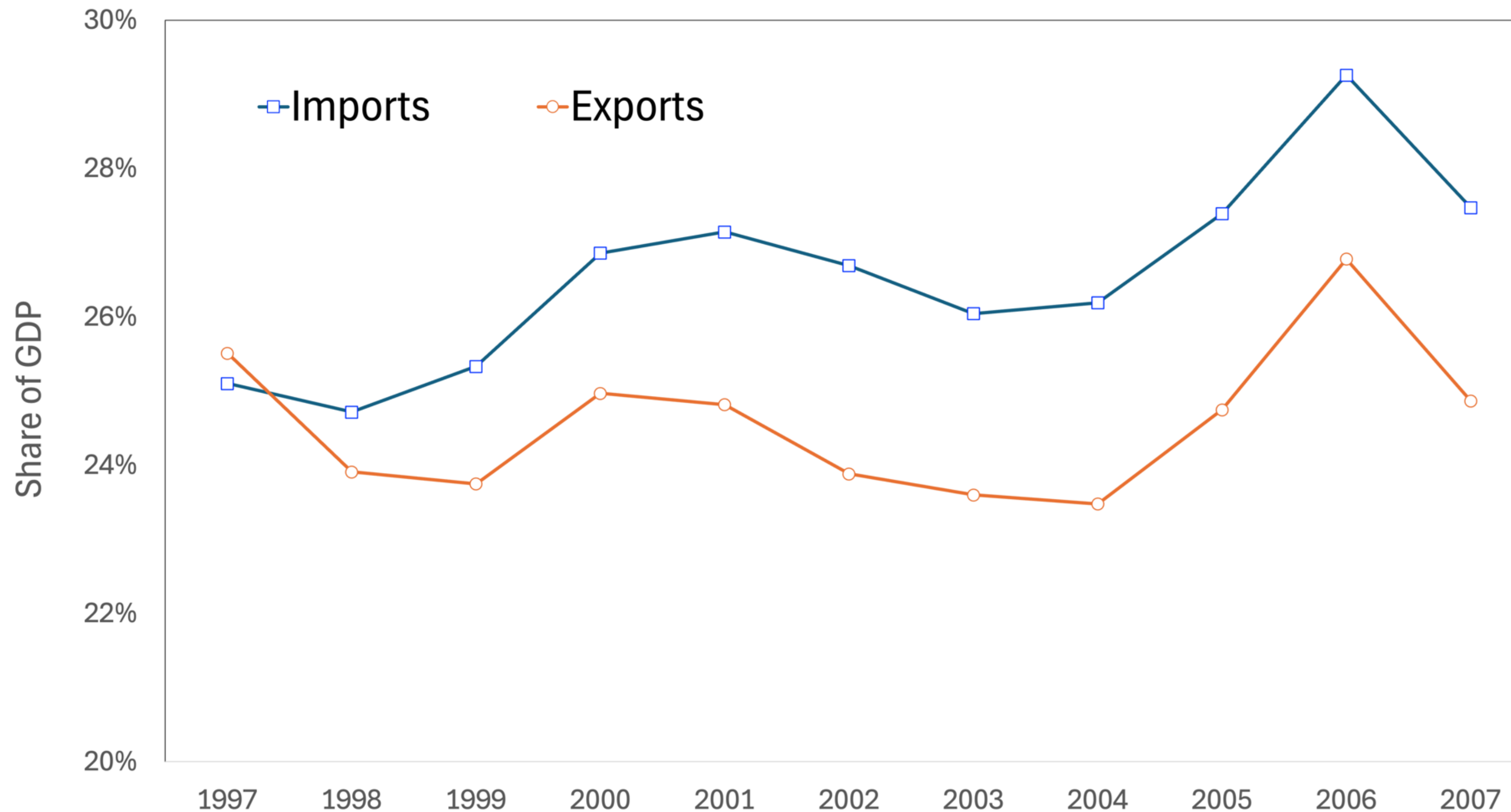
1997-2007: Overview

- Remarkably stable GDP growth rate (*great moderation*).
- Growth now driven by services, not industry



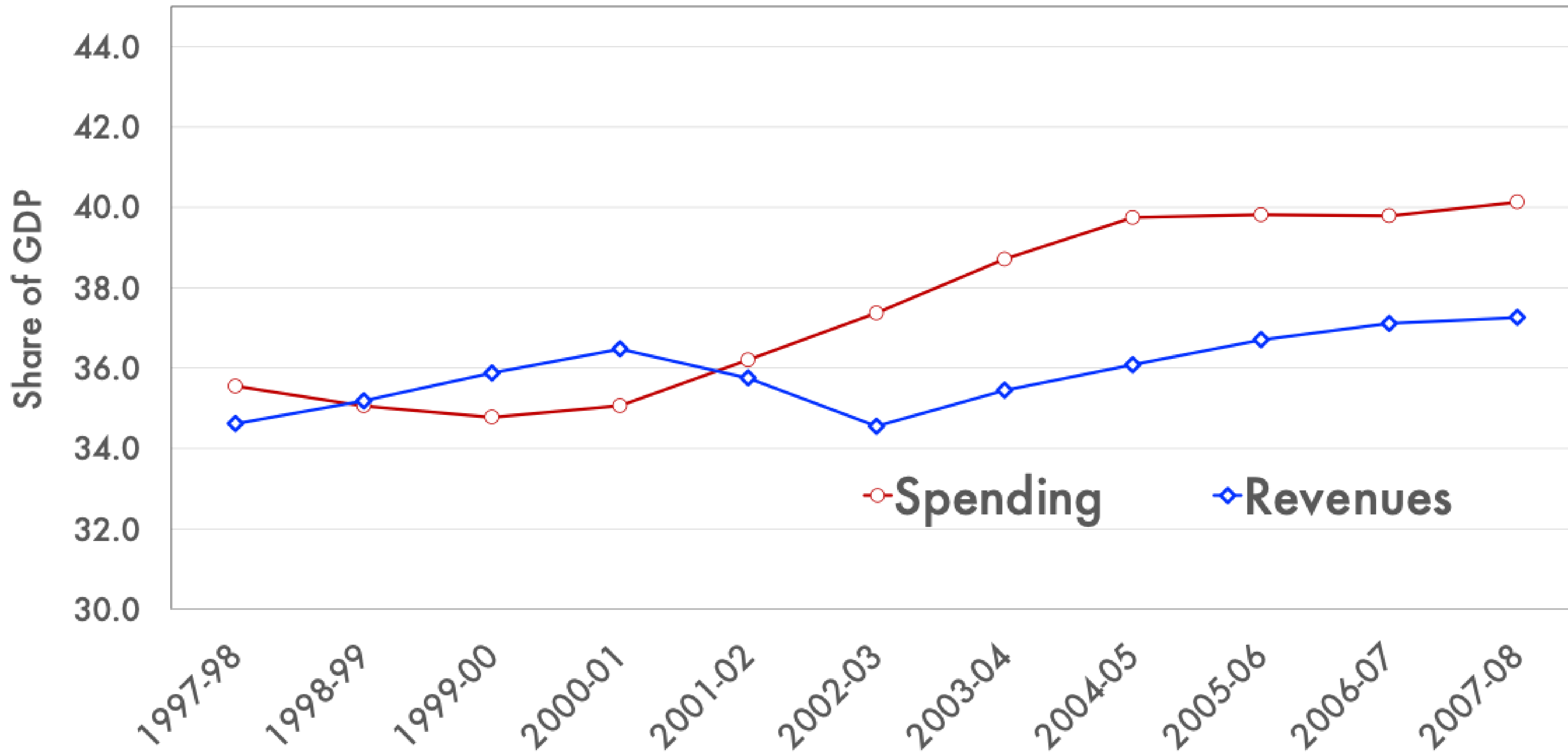
1997-2007: Overview

- A persistent trade deficit opens up.
- Financed by net financial inflows, not loss of reserves.



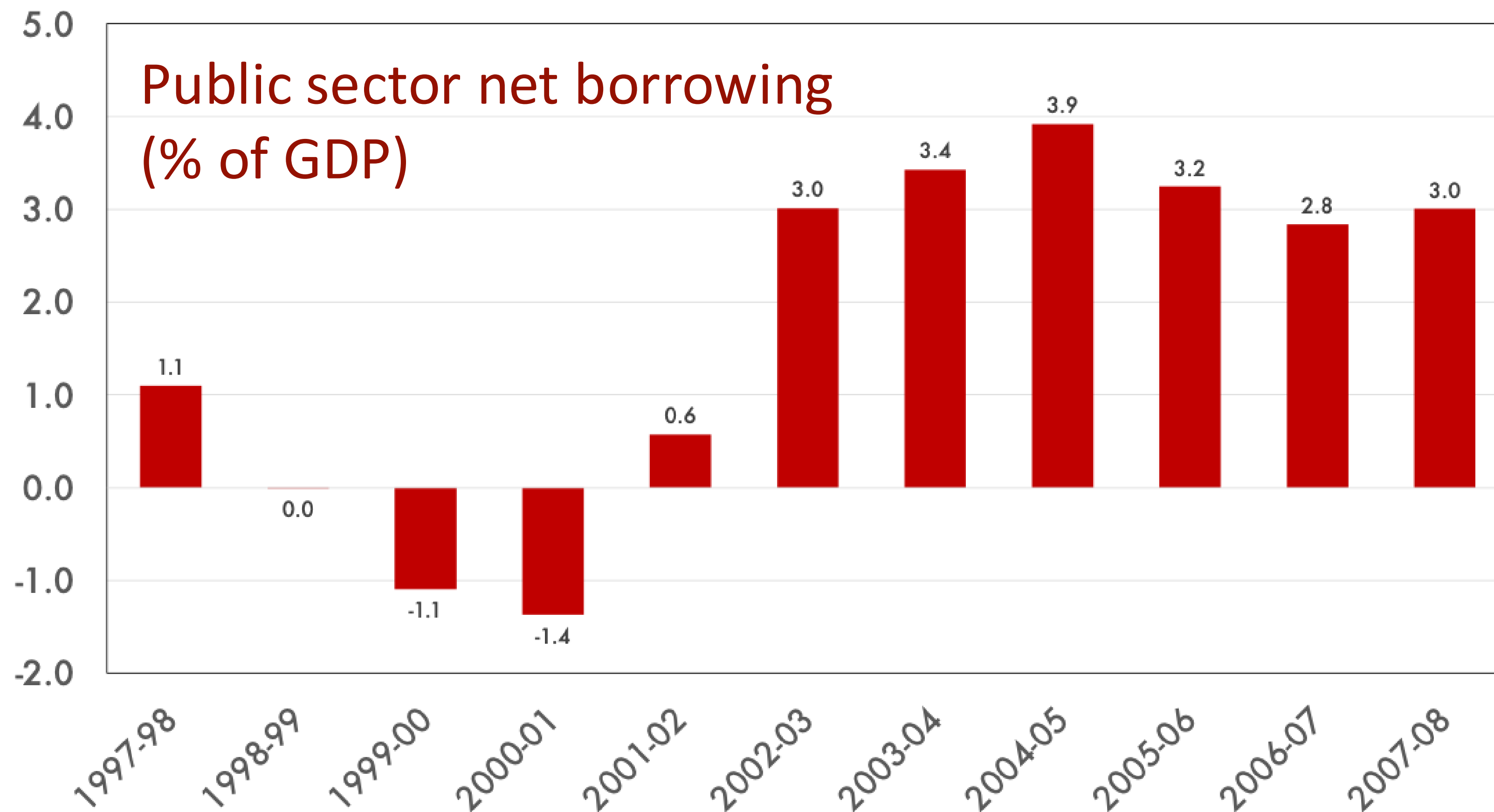
1997-2007: Overview

- Increase in public spending & taxation as a % of GDP after 2001



1997-2007: Overview

- Budget surpluses during Labour's first term in office.
- Turn to deficit (around 3% of GDP) since 2001.



- 1998-2000 surpluses due to both fiscal tightening & higher than expected tax revenues.
- Post-2001 deficits due to both more expansionary policy & lower than expected revenues.

1997-2007: Overview

- New Labour in power since 1997
  - Blair PM, Brown Chancellor until 2007
- Maintains the post-1979 settlement
  - Pro-market stance
  - No nationalizations or interventionist industrial policy (unlike old Labour)
  - Primacy of monetary policy & inflation control
- But with some discontinuity
  - Reverse decline in revenues & spending as % of GDP
  - Social policy & investment in public services
- Reforms both monetary & fiscal policy
  - BoE independence
  - New fiscal policy rules
  - Both in continuity with post-1979 policy trajectory

Bank of England independence

- 1992-1997: inflation-targeting regime
  - Inflation target (2.5% since 1995) and monthly interest rate meeting (Ken & Eddie show)
  - Probably increased BoE influence, but Chancellor still had the last word

- May 1997: Bank of England independence
  - MPC within BoE conducts monetary policy
  - Independent of government but accountable to Parliament
  - Government sets inflation target (unlike USA/Eurozone)

- *Mandate: 'to maintain price stability and, subject to that objective, to support the government's economic policy, including its objectives for growth and employment'*

- Banking supervision & public debt management transferred away from BoE (FSA and DMO)

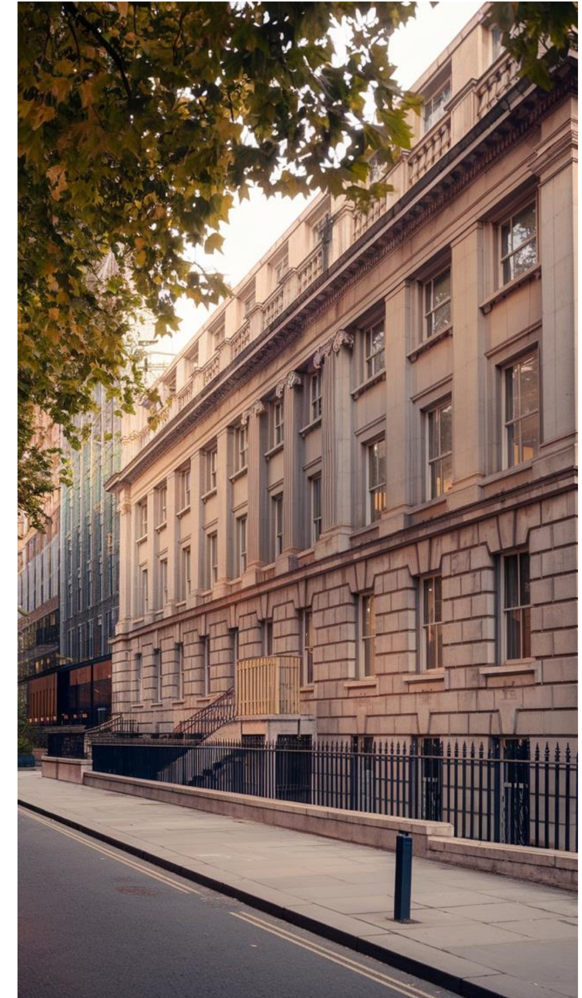
Gordon Brown’s new fiscal rules

1. **Golden rule:**
   over the economic cycle the government will only borrow to invest and not to fund current expenditure.
2. **Sustainable investment rule:**
   public debt as a proportion of national income will be held over the economic cycle at a stable & prudent level.

- Also committed to stick to the spending plans of previous Conservative government over 1997-99.

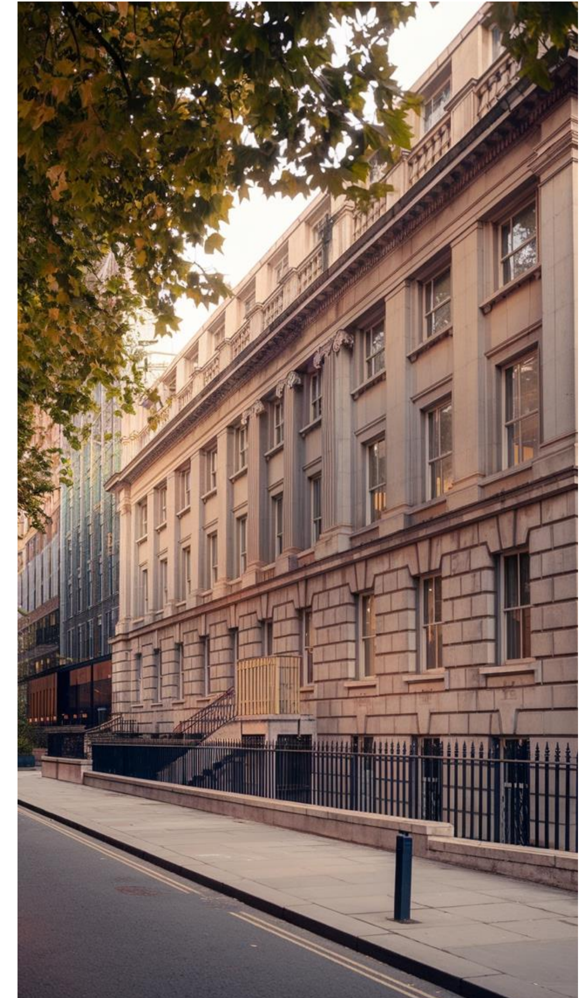
The logic of fiscal rules

- Why fiscal rules, if they are self-imposed?
  - *Couldn’t Brown just do what he thought was optimal, without having to impose a ‘rule’ on himself first?*
- Government ties its hands to avoid a future temptation of opportunistic behaviour
- Gain credibility with citizens, firms, investors
  - Lower inflation expectations
  - Strengthen £
  - Lower medium-long term interest rates on gilts
  - New Labour zealous to gain credibility with markets
- Can make it harder for future governments to use the budget opportunistically



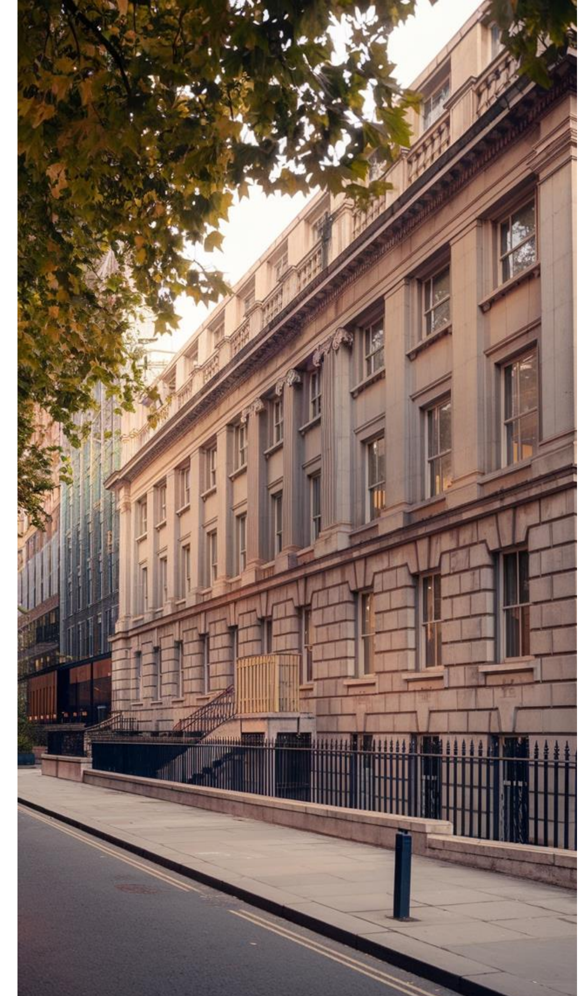
‘Golden rule’ and its logic

- Investment paid upfront but will produce benefits in future years, so makes sense to pay gradually.
- If investment has a (social) return higher than interest rate, it is sound to borrow to finance it.
- Current spending must be renewed every year, so makes sense to cover it with *current* revenues.
- Corrects a possible bias against investment
  - Governments trying to contain the deficit usually find it politically easier to cut investment than current spending
  - Over time, this leads to severe underinvestment
  - Might have happened during the 1980s deficit reduction
- Differed from Euro fiscal rules.



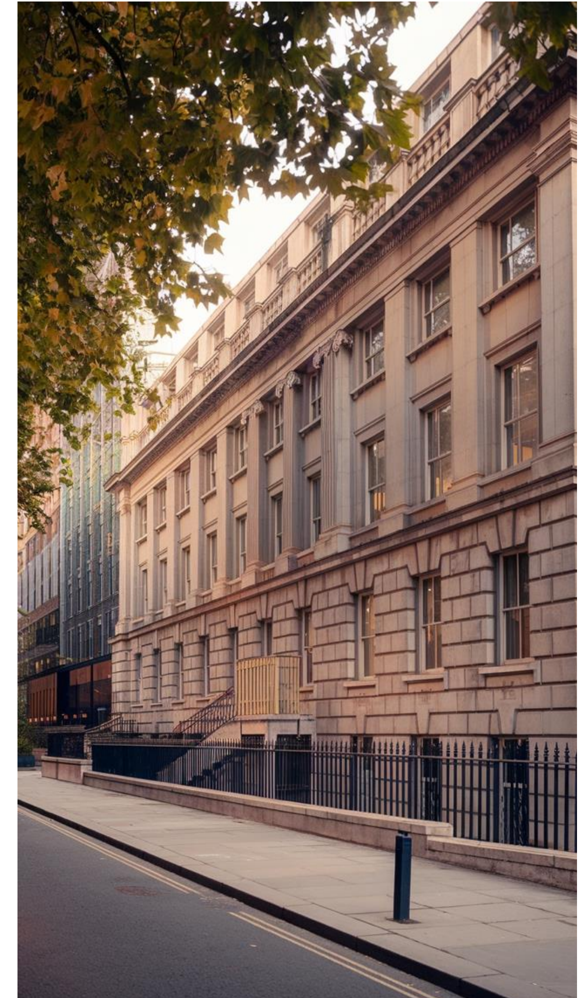
'Sustainable investment' rule and its logic

- Golden rule alone might still allow government to over-invest leading to increasing debt.
- Sustainable investment rule prevents this by committing to stable debt-GDP ratio.
- Note that with $r<g$ deficits are still allowed.
- Both rules apply '<u>over the economic cycle</u>' to allow for higher deficits during downturns, compensated by lower deficits during upturns.
- Brown's rules were maintained & broadly respected over 1997-07 but broke down and were suspended in the 2008-09 crisis.



The Code of Conduct

- Brown also issued a ‘Code of conduct’ for fiscal policy (part of the 1998 budget).
- Pre-Budget Report (PBR) to outline the government plans towards the subsequent budget.
- Publication of a 50-years forecast for public finances, to show how current policy affects long-term fiscal sustainability.
    - National Audit Office (NAO) assesses forecast assumptions to make sure no cheating.
- Publication of cyclically adjusted budget deficit figure.



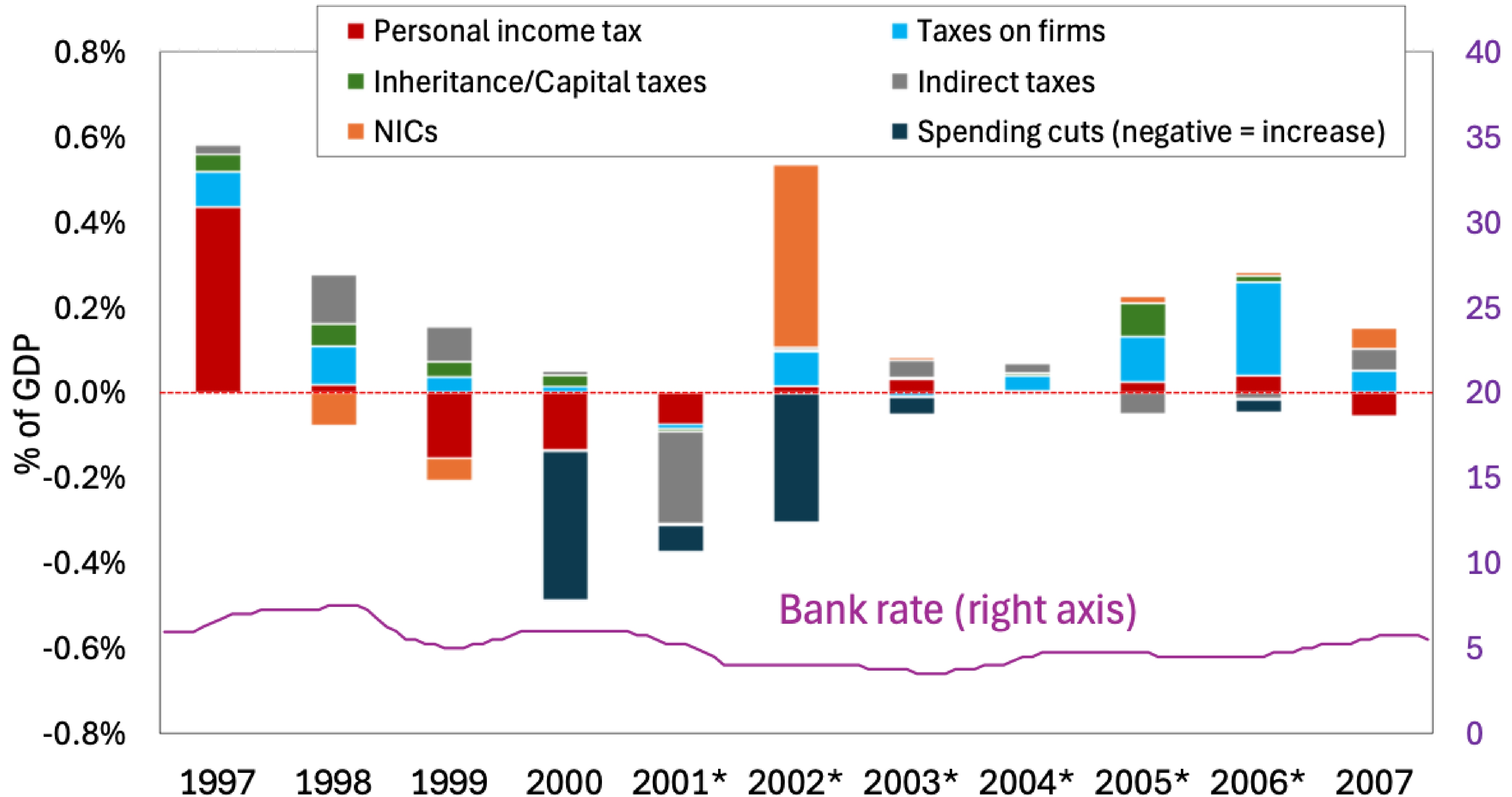
Fiscal policy in 1997-07 [1/2]

- Stability: no huge fiscal or monetary actions
  - Reflected (maybe also contributed to) Great Moderation.
- 1997-1998: Fiscal tightening
  - Tax increases (end of mortgage interest relief)
  - Followed spending plans of previous Conservative government.
  - Combined with higher than expected revenues to generate substantial surplus over 1998-2000
- “Prudence for a purpose”
  - Fiscal discipline not as an end in itself, but as a way to create conditions for sustainable increases in public services and public investment.
  - Establish a reputation for prudent fiscal management
  - Create fiscal space for a subsequent increase in spending.

Fiscal policy in 1997-07 [2/2]

- 1999-2001: Fiscal expansion
  - Increased spending on NHS and education
  - Modest tax cuts
  - Further positive revenue surprises, keeping the deficit small
- 2002-2005: neutral budgets
  - Previous expansion + lower than expected revenues produce increase in deficit (3.9% of GDP in 2004).
  - Government mistakenly assumed that the 1998-2001 increase in revenues given tax rates was structural rather than a temporary random event.
- 2006-08: mild fiscal tightening
  - Reduces deficit to ~3% of GDP.
- Fiscal rules were met over the economic cycle, with previous surpluses compensating subsequent deficits

Fiscal & monetary policy in 1996-07 in one graph



UK & the Euro

- 1992: Major negotiates opt-out from EMU
- 1997: Should UK join Euro 1st wave?
- New Labour takes agnostic position: joining conditional on passing 5 economic tests + winning a referendum.
- Contrasted with the approach of countries like Italy, that saw joining the Euro as a political imperative.
- Oct 1997: Based on Treasury assessment, Brown announces not joining 1st wave.
- June 2003: Second Treasury assessment, again negative conclusions.

Balls & Brown's five economic tests

1. **Convergence test:**
   Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
2. **Flexibility test:**
   If problems emerge, is there sufficient flexibility to deal with them?
3. **Investment test:**
   Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
4. **Financial sector test:**
   What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
5. **Summative test:**
   In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

The Treasury 2003 assessment

- Government was likely not going to join anyway (no political consensus).
- But Treasury produced a massive assessment, of unprecedented quality & breadth of analysis.
- Conclusion: no “clear and unambiguous” case for entry.
- Convergence & flexibility tests not met
  - Economic cycles not fully synchronized
  - Specificities of the UK housing market
  - UK economy not flexible enough to withstand UK-specific shocks without appropriate policy response
- Investment & summative test could not be met if convergence & flexibility were not.
- Only financial sector test fully met

Concluding thoughts on 1997-07

- Macroeconomic context so benign, it makes it hard to assess policy.
- New Labour achieved its goals of acquiring credibility with markets and create fiscal space for investment in public services.
- Debate on whether 2003-07 deficits reduced fiscal space to respond to 2008-09 Great Recession.
- Should the Great Moderation have been used to accumulate larger surpluses?
- But nobody knew 2008 was coming.

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Thank you for your attention