Prosperity at Home and Abroad

The Report of the Liberal Democrat Macroeconomics Policy Working Group

Policy Paper 57

LIBERAL DEMOCRATS

"The Liberal Democrats have a long history of sound macroeconomic policies. In the nineteenth century we were united for free trade, which lowered the cost of living at home, and raised living standards abroad.

In the inter-war era it was a Liberal, John Maynard Keynes, who did more than anyone to propose solutions to the problems of the Great Depression.

More recently the Liberal Democrats were the first party to call for independence for the Bank of England, now widely seen as the most successful macroeconomic policy of the last parliament.

And today we alone are united in our belief that joining the Euro is essential to securing the UK's long term prosperity."

Rt Hon Charles Kennedy MP
Leader of the Liberal Democrats

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Summary

Challenges Facing the Economy

Although inflation, unemployment and interest rates are at their lowest for a generation, the UK faces serious macroeconomic challenges. Real interest rates (headline rates minus inflation) are substantially higher here than in the US, the Eurozone or Japan, making it more expensive for firms to invest, reducing the UK's growth potential. The UK continues to suffer exchange rate volatility, including prolonged periods in which the pound is overvalued. This is a problem for many firms, particularly in import and export intensive sectors such as manufacturing.

Principles

Liberal Democrat macroeconomic policy aims to enhance freedom through economic growth which is environmentally and socially sustainable, that is, creating a better standard of living while using resources sustainably. In addition, better access to the UK's domestic market can substantially help to reduce the number of people enslaved by poverty in developing countries.
(See sections 1.3.1-1.4.5)

Making the Poor Less So: a Global Macroeconomic Agenda

In the face of growing concerns about globalisation, Liberal Democrats assert the need for reforms based on international agreement and the rule of law, and restate the case for free trade. Reducing trade barriers allows developing countries, which generally specialise in agricultural products and low value goods such as textiles, to sell more of their goods abroad, raising living standards for people in these countries. Lifting trade barriers will also reduce the price of these products in the UK, helping people here too. (See sections 2.0.1– 2.1.5.)
We propose the following international reforms:

- The World Trade Organisation's Doha round negotiations must deliver. Developed country markets – especially for agricultural goods – should be opened up to less developed nations. In the European Union, the Common Agricultural Policy should be reformed to eliminate export subsidies and implicit and explicit production subsidies, to allow free imports of non-subsidised agricultural goods, with farmers receiving environmental payments rather than production subsidies.
- International Monetary Fund. There should be further work, under international auspices, on both the Chilean reserve and Tobin tax methods to discourage short-term currency speculation.
- We recognise that trade liberalisation can both help and harm the environment, and that measures will be needed to deal with pressures that arise.

The Case for the Euro

Liberal Democrats favour British membership of the euro at a sensible exchange rate, subject to a referendum to allow the British people to make the decision. Entry can make the UK substantially more prosperous by:

- Reducing uncertainty for importers and exporters, so increasing trade.
- Promoting competition in the economy, since trade increases choice for consumers.
- Raising the rate of growth, as innovative firms are able to expand more easily.
- Giving the UK more influence on single European market rules.

(See sections 3.1.1-3.1.10 and 3.2.7-3.3.2)

Monetary and Fiscal Policy

Stable, low inflation is a pre-requisite for economic growth, promoting transparency and reducing uncertainty for consumers and businesses.
(See sections 4.1.1 and Box B)

Outside the Eurozone

Liberal Democrats proposed independence for the Bank of England in our 1997 manifesto, and welcome its success. Both independence and success can be reinforced. Rather than setting a specific target, the government should set a framework, and the Bank itself should decide the most appropriate inflation measure to target, and the appropriate level to aim for. Similarly, Retail Price Index calculations should be independent of government, and there should be greater independence for the independent members of the Bank of England Monetary Policy Committee.
(See sections 4.2.1-4.3.6.)

Rapidly rising house prices have real adverse effects on macroeconomic policy and the economy, but for theoretical and practical reasons we reject calls to include house prices in the Bank's target measure of inflation. The methods to tackle asset price inflation are in policy areas outside macroeconomics.
(See sections 4.4.1-4.4.5.)

We would enhance the government's fiscal rules in two ways. We would define the national debt more accurately by including PFI/PPP contractual obligations and unfunded government pension liabilities. Rather than counting all capital expenditure as investment, we would record as investment only projects expected to yield a return to government.
(See sections 4.5.1-4.5.14.)

Inside the Eurozone

We support the principle of an independent European Central Bank (ECB) and its goal of maintaining price stability. We want it to become more transparent, and its board members to be more independent.
(See sections 4.6.1-4.6.7.)

We support the broad principles of the Stability and Growth Pact (SGP) but want it reformed. There should be greater flexibility, for example, for countries such as the UK which have low public debt levels to borrow for investment.
(See sections 4.7.8-4.7.6.)

Introduction

1.1 What Macroeconomics is, and what it isn't

1.1.1 Macroeconomics covers economy wide events and policies, whereas microeconomics looks at households and firms. Macroeconomics is not the aggregate of microeconomics, but rather about issues that cannot be determined at the microeconomic level. Exchange rates and trade policy are, therefore, macro-economic policies, as is the control of inflation.

1.1.2 Over time, economists have reassessed the boundaries of macro and microeconomics. They are, for example, increasingly convinced that unemployment is a microeconomic issue. The decision to create a job (or destroy one) is made by firms, and the decision to take a job (or to resign one) is made by individuals. Understanding the incentives for firms and individuals is the way to full employment: and understanding such incentives is microeconomic.

1.1.3 Similarly the merits of one tax versus another - say income taxes and environmental taxes - are part of microeconomics. Different taxes affect different markets - in this case the markets for labour and the quantity of pollution, and market-specific effects are microeconomic. Nor do economists believe that the overall level of taxation per se is a macroeconomic issue. There are successful high tax countries - such as Sweden and France, and successful low tax countries, such as the USA. So long as people are prepared to work hard at prevailing tax rates, those rates are not an economic problem. The level of tax is, then, a political question: if people are persuaded that the fruits of higher taxes are worth working for, then higher taxes are no disincentive.

1.1.4 Again, the level of investment and savings in an economy are issues of microeconomics, because firms decide to invest, and individuals decide to save. Investment and savings are important issues – and the party currently has a commerce working group, and has just announced one to look at pensions savings. It is worth noting that the level of savings does not determine the level of investment: if individuals wish to save more than firms wish to invest here, their excess savings can be invested abroad, equally if firms wish to invest more here than domestic savings allow, money can easily be borrowed from abroad. Both situations are commonplace.

1.1.5 International trade is usually considered part of macroeconomics because it concerns the rules and conditions under which whole economies trade with each other, rather than the decisions of individuals or firms as to whether to export or import specific items. In addition, trade rules affect the price level in the UK. In contrast the IMF and World Bank do not fall under macroeconomics, but rather under development economics. The Liberal Democrats are currently producing policy papers on international trade and development that will look in detail at the effectiveness of these organisations.

1.1.6 This does not mean that macroeconomics has nothing to say, or is a subject in decline. Macroeconomists are more convinced than ever that low inflation is useful to secure a stable and prosperous economy - and we set out that case in this paper. Macroeconomists believe that the best way to achieve that is through an independent central bank. Similarly, macroeconomics tells us how best to run fiscal policy, so that government borrowing does not spiral out of control, and so that governments have room to manoeuvre in recessions.

1.1.7 Nor does it mean that governments are powerless: as all too many countries around the world show, poor macroeconomic policies continue to reduce living standards for millions. In addition, governments have as much power as ever to influence the long term – microeconomic - determinants of living standards: by supporting education, investment, and strong competition policies.

1.2 The state we're in

1.2.1 The UK today has higher employment, lower unemployment, inflation and interest rates than for a generation. Growth is robust, and the stock of government debt low. But for all the self-congratulation sometimes heard, UK unemployment is higher than in the US and in six other European nations. Employment among those aged over 55 is very low. The UK is also becoming a polarised country, increasingly divided between dual-earner and no-earner households.

1.2.2 However, the UK faces serious challenges. Its manufacturing sector is weak, with output falling, profitability low, and investment weak. Although the problems faced by some firms are particular to individual firms or industries, the fact that manufacturing as a whole is performing badly indicates causes at the whole economy level. In the long term, the UK's productivity levels need to increase to those of competitor countries. The way to do this is not macroeconomic, and so lies outside of the scope of this paper. The party does, however, have a strong record of advancing good policies in the necessary areas, such as a stronger education system, especially in under-performing areas, a pro-active competition policy, and so on. But in addition to necessary longer term measures, the high level of the pound in the last five years has made it harder for British firms to export, and easier for foreign firms to import. We believe that the only way to guarantee a sensible level for sterling, at least against European countries, is to join the Euro at a suitable rate. This would reduce uncertainty for all firms, and allow good firms to prosper.

1.2.3 Although headline interest rates are at their lowest since 1955, real interest rates (interest rates minus inflation) are substantially higher than in the US, the Eurozone or Japan, so British firms face higher borrowing costs than firms in almost every other industrialised country. This may lower investment, reducing the UK's long term potential to create wealth. Interest rates can be lowered by reinforcing the independence of the Bank of England, and this paper sets out what we would do to achieve this.

1.2.4 The world faces a major opportunity to ensure that economic growth – now taken for granted in many countries – spreads to parts of the world where it is still the exception. The Doha trade round has been termed a development round, whose aim is to ensure that globalisation – and its benefits – extend to less developed countries. The current government has shown that it is prepared to invest massive amounts of time and political capital in persuading others of what it believes to be a just cause, however unpopular it may be at home and abroad. We believe that there is no cause more just than development in poorer countries, and call on the British government to use its undoubted energy to ensure that the Doha round is successful, and that the UK's domestic markets – especially for agricultural goods – are opened up to less developed nations.

1.3 Liberal Democrat Principles

1.3.1 In line with both the Liberal Democrat party constitution, and "*It's about Freedom*", our recent paper on Liberal Democrat values, macroeconomic policy should *"maintain a framework that encourages the creation of wealth, in other words creating a better standard of living and using resources sustainably".* This is part of the Liberal Democrats' commitment - that no one shall be enslaved by poverty, whilst maintaining a commitment to environmental sustainability.

1.3.2 In addition, freer trade can substantially help to reduce the number of people enslaved by poverty in developing countries. We do not believe that the western ideal of a high material standard of living should be imposed, rather that people in all countries should be able to achieve that goal if they so wish.

1.4 Sustainable Development Matters

1.4.1 There is no necessary conflict between economic growth and the environment. Across the world, countries with high GDP levels generally rank highly on sustainable development (World Economic Forum statistics). GDP and sustainable development indicators can increase together - between 1990 and 2000, for example, British GDP grew 22%, and greenhouse gas emissions fell by 10%. Economic growth can provide societies with the resources to prevent environmental degradation and overcome environmental disasters, both man-made and natural.

1.4.2 Economic growth does not automatically lead to environmental improvements. For example, countries with the highest increases in carbon emissions have typically been those that have grown fastest, and generally richer countries have higher CO2 emission levels per person.

1.4.3 There are circumstances where economic growth and sustainable development are in conflict. Each case will need to be decided on its merits and difficult choices made. Liberal Democrats believe neither that economic growth should be pursued whatever the environmental cost, nor that environmental gains can be pursued whatever the consequences for the economy.

1.4.4 The key consideration is not the level of GDP but the *way* in which GDP is generated. Intelligent environmental taxation policies and astute alignment of incentives with environmental goals provide powerful tools for achieving sustainable economic growth. However, the methods to make economic development sustainable are, without exception, microeconomic, and lie outside the scope of this paper. We recognise that applying the polluter pays principle will, over time, alter the nature of the UK economy and the UK's patterns of consumption. As the price of highly polluting goods and services rises relative to others so people will choose to consume fewer of such goods.

1.4.5 Wise choices can only be made with accurate and consistent information. Liberal Democrats support developing quantitative and qualitative measures of environment and quality of life changes. For example, we support the Office of National Statistics' efforts to develop 'satellite' environmental accounts to supplement UK National Accounts and believe that accurate figures for changes in environmental quality should be incorporated into the National Accounts.

Box A:
Our commitment to sustainable economic growth

A1: Provided economic growth is sustainable, it is in line with traditional liberal philosophy, because it directly increases economic freedom.

A2: Economic growth increases social freedom, insofar as economic freedom allows people to exercise lifestyle choices. We note, for example, that political and social rights for both men and women have followed first the growth of the salaried middle class and then the greater role of women in the wage economy. Today, where people do not have a broad range of choices about their lifestyle, it is often because they are economically dependent on others or on the State.

A3: Economic growth is in keeping with our social liberal & social democratic intellectual heritage, because high rates of economic growth raise tax revenues, a prerequisite for world-class public services.

A4: A prosperous UK imports more from other countries, rich and poor, raising their standards of living. It is also more likely to produce knowledge breakthroughs (most obviously in medicine) that have global benefits.

A5: Without sustainable economic growth, the economy will not generate the resources that are the best way to greater prosperity, to reducing poverty at home and abroad, and to providing higher quality public services.

Making the Poor Less So: a Global Macroeconomic Agenda

2.0.1 Given the gap between the richest and poorest in the world, issues of global economic management are of great importance. As a basic principle, we assert the importance of dealing with these issues on the basis of international agreement and the rule of law.

2.0.2 There is a perception, correct in part, that the world today is globalising as never before, but that many receive no benefit from globalisation.

2.0.3 Concerns are expressed about the power of multinational firms, the role of international investment and international finance, and the behaviour of international bodies, such as the IMF, World Bank and WTO. People are concerned both that these organisations are harmful - especially to the poorest - and that they represent a threat to democratically elected governments.[1]

2.0.4 In this paper we set out one area in which we believe significant strides can and should be made, as well as discussing other issues on which we do not believe there is sufficient agreement about the merits of radical change.

2.1 The case for free trade especially in agriculture

2.1.1 If we look around the world today we find that countries that have low levels of international trade are overwhelmingly poor, and have low growth rates. The problem for these countries is not too much globalisation, but the near absence of globalisation. These countries tend to specialise in agricultural products and, insofar as they have a manufacturing sector, in low value goods such as textiles. Yet rich countries - including the UK, the EU, Japan and the US - have higher tariff barriers and more trade restrictions on these goods than on any others.

2.1.2 These barriers prevent poor countries from exporting the products in which they have a comparative advantage, directly reducing their standard of living. These barriers also raise the cost of these products in the United Kingdom. Since the poor in the UK spend a higher share of their income of these products, these barriers inflict relatively greater costs on the poor within this country.

2.1.3 In short, we view such trade barriers, explicit and implicit, as monstrous.

2.1.4 Free trade was part of the nineteenth century Liberal Party's identity. Liberals fought for and won the repeal of the Corn Laws, which had levied a tax on all imported grain. They argued that such laws raised the price of food at home, reduced incomes in (generally poorer) agricultural nations, and set nation against nation. Those arguments remain as true today as then. We therefore unambiguously support the abolition of trade barriers to goods from developing countries.

> *"Farming and rural communities would benefit immensely from comprehensive reform of the CAP*" Andrew George MP, Liberal Democrat Shadow Minister for Food and Rural Affairs.

[1] See, for example, Joseph E. Stiglitz, *Globalisation and its Discontents* (2002).

2.1.5 Since trade liberalisation is least developed in agriculture, the gains to be had from liberalisation, both for developing and developed countries, are greater in agriculture than in any other sector. The IMF estimates the static gain from eliminating all barriers to agricultural trade at £82bn a year, in perpetuity (World Economic Outlook, October 2002, reported in *Financial Times*, 6.11.2002). Of this gain, £18bn a year would go to less developed countries, while the remainder would go to richer nations, mainly as lower food prices.

2.1.6 The WTO has a crucial role to play in this. The WTO, which grew out of the General Agreement on Tariffs and Trade (GATT), represents an unprecedented international pooling of sovereignty among its members which ensures that global trade rules are evenly applied and adhered to by member nations (the principle of non-discrimination). Multilateral, rules-based trade liberalisation under the GATT in the post-war years has banished the spectre of beggar-my-neighbour protectionism that did so much to create the Great Depression of the thirties, and has helped to ensure an unprecedented increase in both world trade and world living standards. World trade has grown seventeenfold since 1951 while world income per head has doubled. Liberal Democrat policy on international trade is set out in full in policy paper 12 *The Balance of Trade* and in policy paper 35 *Global Responses to Global Problems*.

2.1.7 Policy Paper 35 highlighted the value of the WTO in two key areas. Firstly, it is a non-discriminatory system of adjudicating disputes which might otherwise spark trade wars or worse. Secondly, the WTO contributes to the formation of international norms by building up a substantial body of case law. However, the paper also highlighted the need for reforms to the WTO, such as the acceptance of sustainable development as a fundamental objective of the international trading system. It is important to recognise that the pursuit of trade liberalisation has the potential for both environmental damage as well as improvement. Party policy working groups on international trade and development will make recommendations on these areas in due course.

2.1.8 In terms of macroeconomic policy, we place special emphasis on the role that the WTO has played in spreading wealth through global trade. So we believe that agricultural liberalisation should be the primary goal in the Doha round WTO negotiations.

2.1.9 This in turn requires the reform of the Common Agricultural Policy, to eliminate export subsidies and implicit and explicit production subsidies, and to allow free imports of non-subsidised agricultural goods. It does not require the abolition of subsidies to farmers, only the abolition of conventional production subsidies. It is perfectly possible for the current level of subsidies to be given to farmers as environmental payments, supporting environmentally sustainable farming in ways that do not lower production costs.

2.1.10 Ending European production subsidies and allowing the free import of agricultural goods from abroad would lower European food prices substantially, saving European consumers around £35bn a year, that is, £100 per person, per year, in perpetuity. ("Agricultural policies in OECD countries", OECD 2002, reported in Wolf, *Financial Times*, 6.11.2002.) Full details of our proposals are contained in Policy Paper 52 *Rural Futures*.

2.1.11 Our second aim for the Doha trade round would be to extend the scope of WTO anti-subsidy measures to fossil fuels, and to see faster progress in phasing out rich-country protectionism on textiles. These are areas in which current subsidies both distort trade and cause substantial harm to the environment. We recognise that other actions, including allowing generic medicines under a revised TRIPs (Agreement on Trade-Related Aspects of Intellectual Property Rights) policy, could also improve living standards in many developing countries.

2.1.12 It is also important to note our concern that developing countries are not able to participate fully in the WTO. Although each country has one vote in it, developing countries have problems making any significant impact on proceedings as the better developed countries are able to afford the legal costs involved in disputes. Meanwhile, the WTO could be made more transparent. We believe that all groups, from individual consumers and consumer groups, to NGOs, firms and governments should be able to make submissions to WTO dispute panel procedures.

2.2 The International Monetary Fund & the World Bank

2.2.1 As well as the problem of the endemic and severe poverty that characterise so many nations even today, the current global economy also suffers from periodic and often severe international financial crises. These generally affect middle income countries most severely, especially those countries that are becoming part of the global economy. The IMF represents the primary means by which the world seeks to prevent these problems occurring, and to address them when they do occur. There exist serious and sustained critiques of the IMF. We do not, however, accept the claim made by some that it does more harm than good, and note that developing countries generally do choose involvement.

2.2.2 We note too that the UK has little power to reform these bodies unilaterally. However, for historical reasons, the UK does have significant influence.

2.2.3 That said, we would work with international partners to explore the following areas:

2.2.4 IMF assistance has fallen relative to world trade flows and particularly world capital flows. If it appears that IMF assistance to countries such as Brazil fails because it is too small to be credible, then we believe that the British government should increase its quota in response to any such request.

2.2.5 We believe that the IMF should do more work on the Chilean system, whereby a reserve requirement is levied that bears more heavily on short term than long-term investment. It is possible that such a policy could reduce speculative inflows and outflows of capital, although the cost might be lower liquidity and worse foreign exchange rates for traders.

2.2.6 We continue to believe that more work should be done as to the practicalities and effects of a Tobin tax, a tax on global capital movements. We note that this cannot be imposed unilaterally by the UK, as foreign exchange trade would simply bypass the UK. We therefore think that the British government should work to persuade other nations that the practicality of the idea merits serious study (there has already been extensive work on the theory),[2] and then to push for such a study to be conducted under international auspices.

2.2.7 We believe the convention whereby the EU appoints the head of the

[2] See for example, H Williamson, "Köhler Says IMF Will Look Again at Tobin Tax" FT, September 10, 2001; and M. ul Haq, I. Kaul, and I. Grunberg, eds., *The Tobin Tax: Coping with Financial Volatility* (1996).

IMF and the US the head of the World Bank should end, and that all appointments should be on merit.

2.2.8 It often seems to be the case that aid seems more generous before key votes in many global organisations, such as the UN. Although both sides may be willing participants in these deals, we believe this amounts to little short of buying votes, and that such behaviour treats these organisations with a contempt that is unwarranted, unacceptable and unethical.

2.2.9 Joining a more globalised economic system inevitably curtails the sovereignty of nations, who have to agree to common standards, for example on trade with the WTO, or on government finance with the IMF. We do not believe that such constraints are an unreasonable choice for either developed or developing countries, and note both that governments choose to adopt them, and, crucially, that governments continue to have massive microeconomic and social powers that can be used to affect both economic growth, and the distribution of its results.

2.2.10 More specifically, we note that the British government still has the power to invest in the skilled and productive workforce necessary for any high wage economy in a globalised world. In addition the UK can continue to ensure that it has high levels of research and development, both in universities and in firms, and low levels of corporation tax to give firms and entrepreneurs the incentive to invest.

2.2.11

The case for the Euro

3.1 The Case for the Euro

3.1.1 Liberal Democrats favour UK membership of the euro. We have argued that when the economic conditions are right, based primarily on consideration of the exchange rate, this decision should be made by the British people in a referendum.

3.1.2 The case for the euro is simple. (1) A common currency reduces uncertainty for importers and exporters, increasing trade. (2) More trade means more competition in the economy, since consumers have more choices. (3) More competition raises the rate of growth, as innovative firms are able to expand more easily. (4) In addition, a strong common currency is less liable to be the subject of currency speculation than, for example, sterling was in 1992, reducing risk at a macroeconomic level. (5) Finally, the UK is more likely to be able to influence the rules of the single European market, on which it depends for the majority of its exports, if the UK is part of the common currency used in that market.

3.1.3 In short, joining the euro will make the UK substantially more prosperous; will make the British economy more stable as part of the wider European economy; and will give the UK more influence on European trade rules. That is why the Liberal Democrats believe that it is in the UK's interest to join the euro when the economic conditions are right.

3.1.4 The Euro does increase trade. Since it was created, the trade to GDP ratio has increased from 27 to 32% in Germany and from 28 to 31% in France. At the same time it has fallen in the UK.

3.1.5 Germany and France's experience is in line with previous studies of trade and common currencies. For example, trade is twenty times as high within Canada as across the Canadian-US border,[3] and similar results have been found in broader cross-country studies.[4] We expect the UK's trade to increase were the UK to be inside the Eurozone.

3.1.6 More trade increases competition by definition, since the newly traded products would not be sold unless they were competitive.

3.1.7 Increased competition increases firms' incentives to be innovative, to employ new technologies, increase staff skills, and so on, in order to remain competitive. This raises productivity growth in the economy, the only sustainable basis for long term rises in prosperity. The Bank of England's Professor Steve Nickell finds, for example, that *"competition, measured either by increased numbers of competitors or by lower levels of rents, is associated with higher rates of TFP [Total Factor Productivity] growth"*.[5] A 3 percentage point rise in the ratio of trade to GDP raises GDP itself by 1%.[6] If British trade, therefore, had increased at the rate of German trade since the euro was created, British GDP would already be 2% higher - an increase of £20bn.

3.1.8 In contrast, keeping the pound means potentially substantial currency fluctuations from year to year against other currencies, and the potential for the pound to be substantially over or undervalued for

[3] McCullum, American Economic Review, June 1995
[4] Rose, Economic Policy, October 2001
[5] S. Nickell, 'Competition and corporate performance', in *Journal of Political Economy*, 104 (1996), pp. 724-746, p. 741.
[6] Frankel and Rose

long periods of time. This is particularly a problem for manufacturing, and makes the UK economy prone to sectoral and regional imbalances.

3.1.9 The increase in trade within Europe reflects European companies' taking advantage of the euro to re-organise production, and create European supply chains. British firms will suffer outside the euro. The longer the UK stays out, the more complete will be these new supply chains by the time of entry, reducing the opportunities for British firms to become part of them. The cost of staying out of the euro will be a low-integration, low-productivity, low-pay UK.

3.1.10 In addition, there is evidence that some overseas companies are less likely to locate and expand in the UK if it does not join the euro. This directly reduces investment in the British economy, and puts at risk the beneficial productivity spill over effects that often come with foreign direct investment into the UK economy.

3.2 Why arguments against the euro are flawed

3.2.1 There is one main economic argument that is put against joining: that a common currency means a common monetary policy, and that there will be times when the interest rate that is right for Europe as a whole is not right for the UK. It is argued that there are two potential cases: a shock may hit the UK and not the rest of Europe, or the British and Eurozone economic cycles may be out of line.

3.2.2 That view is mistaken. The problem of a single monetary policy already exists within the UK: the rate of interest right for the country as a whole will not be right for all regions of the UK. Yet nobody argues that the UK should scrap the pound in favour of separate regional currencies, and separate regional monetary policies. Nobody makes that case because the benefits of independent monetary policies are greatly outweighed by the benefits of easier trade within the UK. Exactly the same arguments apply to the benefits of British membership of the euro.

3.2.3 Making a case based on the problems of a single monetary policy is even harder since the British and Eurozone economies are broadly similar. Both are wealthy largely post-industrial economies, with low inflation and steady rises in the standard of living. Importantly all the economies within Europe - including the UK's - are broadly based. This means that even if one sector in the UK is hit by a shock - as agriculture and tourism were by the outbreak of foot and mouth - the economy is broadly based enough to cope. Even oil and gas account for only 2.1% of British GDP. Because of the small share of any one sector of the British economy, monetary policy is not the appropriate response to shocks whether or not the UK is a member of Eurozone.

3.2.4 In contrast, US states are highly dissimilar, since they tend to be far more specialised: ranging from agricultural states to highly industrialised states. No such similar specialisms exist in Europe, and yet the US single currency, the dollar, works very effectively.

3.2.5 Although the British and Eurozone economies are not in perfect alignment, they are no more unaligned than are the economies of North and South within the UK. Moreover, the UK and Eurozone economies are not far apart: since the Euro was created, for example, the average rate of growth has been 2.2% in the Eurozone and 2.1% in the UK.[7] Furthermore, simply by joining the euro the UK and other European economies will be more closely aligned, because both will then be influenced by the same monetary policy.

3.2.6 We must remember too that the British government will continue to have control over fiscal policy, with which it can influence the economy. Indeed, with public finances currently in generally good shape, and a low debt to GDP ratio, the UK is better placed than many other European

[7] *Financial Times*, 10th Dec. 2002.

countries to use fiscal policy effectively within the context of a common monetary policy. The UK also has flexible labour markets which make adjustments relatively easy, for instance, helping the UK to cope with a loss of half a million manufacturing jobs in the last five years without unemployment rising. This flexibility will be even more valuable inside the Eurozone.

3.2.7 Other arguments are put forward against the euro. Some people claim, for example, that joining the euro would mean the UK inheriting Germany's labour market problems. This is nonsense: joining the euro no more gives us Germany's labour market inflexibilities than it will give us their excellence in training. We believe that many anti euro campaigners have misrepresented the structural problems of the German economy as cyclical problems caused by euro membership. We accept that joining the euro means making a judgement on the gains from increased trade, versus the loss of exchange rate flexibility. We believe that the overwhelming weight of evidence is in favour of entry, and that the proven flexibility of British labour markets will make membership a success.

3.3 Joining the euro

3.3.1 The UK needs to join the euro at a sensible rate. This is why, in contrast to the Chancellor's five economic tests, we have set our own sixth test of the exchange rate. The Expert Commission chaired by Chris Huhne MEP, and including a former member of the Monetary Policy Committee and economists with major business experience, recommended in September 2000 that the target entry range should be 1.25 to 1.45 to the pound (1=69p-80p), although it noted that rises in productivity could raise the level at which the UK could successfully join the euro.

3.3.2 The Government is not powerless to influence the rate at which sterling enters the euro. When it decides to join it should announce a target range that it intends to make the basis for negotiations, sending strong signals to the markets. Existing members, who may oppose a rate they see as giving us an "unfair" competitive advantage, may not accept the UK's proposals. But if the pound is within the range during negotiations, it will be hard for others to deny the market's valuation.

Monetary and Fiscal Policy – inside and outside the euro

4.1 Low and Stable Inflation: a means to an end

4.1.1 The UK has a choice as to whether to join the euro. But inside or out, there is a consensus among economists in favour of low inflation and fiscal rules. This chapter makes specific policy recommendations, and boxes B and C set out the general case for low inflation, and for fiscal rules.

Outside the Eurozone

4.2 The Bank of England: experience so far

4.2.1 The Labour Party did not propose making the Bank of England independent in their 1997 manifesto, but did so immediately on taking office. This was a long-standing Liberal Democrat policy, included in our manifesto. The Conservatives opposed it.

4.2.2 The policy is now widely seen as the best macroeconomic policy implemented in the last Parliament. Immediately the Bank was given independence inflationary expectations fell by 0.5%, and since then they have fallen by a further 1.3%.

4.2.3 The fall in inflationary expectations led to a fall in interest rates – benefiting government, individuals and firms. Government already saves £1.1bn a year in lower interest bills (2001-2). As more debt is reissued at lower interest rates the savings increase dramatically –by one-third this year alone.[8] In the long run, based on a government debt of £300bn, the savings will amount to £5.4bn a year: real money that can be spent on public services, higher transfer payments, or lower taxes. In addition to savings for government, business has gained from lower long term interest rates, making it cheaper to take on long term loans. Finally, the Bank's credibility has lowered the cost of mortgages and other personal borrowing.

4.2.4 The Bank has been criticised for consistently over-estimating the threat of inflation, and that, as a result, the UK has had higher interest rates than necessary. With the benefit of perfect hindsight this is technically correct: interest rates have been, on average, one quarter of one percent too high since the Bank became independent. Although we regret that error, and urge the Bank to continue to update its model in the light of experience, we believe that, given all the difficulties of making policy in an uncertain and changing world, an average error as small as one quarter of one percent is cause for congratulation, not condemnation.

4.2.5 The Bank’s independence is popular with the public. The Bank of England / NOP *Public Attitudes to Inflation* poll shows that people as well as money markets expect low inflation. Further, the public support the policy and the Bank's conduct.

[8] 2002-3 compared with 2001-2, Ruth Kelly to Matthew Taylor, PQ, 20-06-02 & http://www.bankofengland.co.uk/qb/qb020107.pdf, chart 5

Box B:
Low and stable inflation - a means to an end

B1: Economists and politicians used to believe there was a trade off between unemployment and inflation. Today they believe stable prices are a pre-requisite for economic growth.

B2: Stable prices allow consumers to compare the prices of goods more easily, because it is easier to remember prices over time if they do not change. This means that consumers are more likely to spot – and resist – price rises. Similarly, consumers are more likely to spot genuine bargains, making them more likely to purchase the good. These both give firms a greater incentive to be efficient, so that they can offer low prices that consumers will respond to. These incentives make firms more likely to invest in new equipment, better staff training, and new working practises- the essence of economic growth. In addition, low and stable inflation reduces uncertainty, making it easier for firms and individuals to plan ahead with confidence. It is easier for banks to provide long-term industrial loans, as is common in low inflation Germany. It helps multi-year pay deals, which offer greater certainty and stability to both firms and workers.

B3: Central bankers are well aware that low inflation is not an end in itself. Sir Edward George, in an *Financial Times* interview recently, said *"People think it's just about low inflation; it isn't. Low inflation is really a means to the end of stable growth. If you ask me what's the thing that gives me most pleasure, it is that unemployment is as low as it's been for 25 years. I think that's what it's all really about."* (7.5.02)

B4: The dangers of deflation - steadily falling prices - are different but no less real than the dangers of high inflation.

B5: If consumers expect prices to fall in the future, they will defer purchases until later. This can cause recessions. In addition, deflation makes it hard for the banking system to operate, since even a low nominal rate of interest - necessary to induce savers to put their money on deposit - implies a high real rate of interest (equal to the nominal rate plus the rate of deflation). This in turn places a high floor under real interest rates, reducing investment below its optimal level. Finally, deflation makes it hard for monetary policy to operate effectively. In a world with positive inflation, nominal interest rates can, if necessary, be set at a rate lower than inflation, so that real interest rates are negative. When inflation is 0% or lower this ceases to be possible, monetary policy less effective.

B6: As with high inflation, the best solution to deflation is to avoid it in the first place. If deflation should occur in the UK - which is possible but not particularly likely - then we may need to use more unorthodox policies. For example, the government can commit to a higher future price level by promising to increase excise duties and VAT in future. Similarly, fiscal policy can be used to increase the level of demand in the economy. In extremis, notes and coins can be revalued (downwards) over time, inducing people to spend them more rapidly. Just as the conquest of high inflation is a painful process, so too the policies necessary to overcome deflation are such that it is better to avoid the problem in the first place.

4.2.6 There are two grounds for caution. First, Labour's first term was a relatively benign economic period, and the new institutional arrangements will only be tested in worse economic conditions. Second, long term real interest rates are still significantly higher in the UK than in the Eurozone. We believe that the recommendations that we set out here to enhance the Bank's credibility will reduce real interest rates.

4.3 Enhancing Bank credibility

4.3.1 As the party that first advocated independence for the Bank of England, we continue to seek ways to enhance the Bank's credibility, reducing the gap in real interest rates between the UK and the G7 average.

4.3.2 We propose to follow best practice in target setting. Rather than setting a numerical target the government would set the goal and rationale. We would charge the Bank with "achieving appropriately low inflation as a contribution to a stable and successful economy, characterised by high rates of economic growth and low rates of unemployment". The Bank would then decide the best measure of inflation to target, and the appropriate level to aim for. It would explain the decision to both government and parliament.

4.3.3 We would make the calculation of the RPI independent of government, as advocated by the Statistics Commission.[9] An effect of this would be to make sure that if the Bank of England chose to use RPI as its inflation measure, the government could not undermine Bank independence by strategically altering the RPI.

4.3.4 Rather than being able to appoint independent members of the Bank of England Monetary Policy Committee (MPC) without scrutiny, we would give the Chancellor the right to nominate members. Following a scrutiny process, the Treasury Select Committee would vote on appointments; their decisions could be overturned by a vote in the House of Commons. We would end the exemption from the usual rules on public appointments for MPC members. We would increase the independence of independent members of the MPC by extending their terms from three years to five, and by making the posts non-renewable. They would also be given budgets to commission external research.

4.3.5 Whilst the Bank would retain the right to appoint internal nominees to the MPC, Bank appointees would be required to appear in front of the Treasury Select Committee, to ascertain their views on monetary policy. This will increase transparency and reduce uncertainty.

4.3.6 We support the appointment of non-UK nationals to the MPC, such as Willem Buiter and DeAnne Julius. Such appointments bring rich experience to the MPC. The government should consider the case for appointing people with central bank experience elsewhere, and, in particular, should consider the appointment of individuals who have served with the ECB, to ease transition and co-ordination problems, and to make credible the UK's commitment to joining.

4.4 Asset prices

4.4.1 An entirely predictable and direct effect of lower interest rates since 1997 in the context of the British housing market has been higher house prices. Put simply, if mortgage rates go down, everyone can afford a larger mortgage. Since the short run supply of housing is essentially fixed

[9] Statistics Commission, *Price Indices and Deflators Produced at the Office for National Statistics: Report of a Scoping Study* (Sep 2001), para 12. http://www.statscom.org.uk/resources/reports_docs/Prices%20Report.pdf

in the UK, this extra purchasing power does not lead to more or larger houses, but to price increases for existing properties. A more flexible housing market, in which the number of homes built responds better to rises in house prices, would, of course, have dramatically lowered the rise in house prices, making all houses more affordable.

4.4.2 The RPIX inflation index does not include the capital cost of houses, but does include the cost of housing. House inflation alone is currently adding 1% to RPIX, and has added an average of 0.5% to inflation since the start of 2000.[10] House price inflation, therefore, directly raises interest rates, since the Bank uses interest rates to keep inflation at 2.5%. Had house prices not increased as rapidly, the Bank would have lowered interest rates, benefiting both businesses and mortgage holders. Insofar as rent levels relate to mortgage costs, it would also benefit tenants.

4.4.3 It is clear that rising house prices have a real and adverse effect on macroeconomic policy, and although stable asset prices are not part of the Bank's target, it would be possible to include asset price inflation in the target given to the Bank.

4.4.4 There is one theoretical and one empirical objection to including asset prices in the Bank's target. At a theoretical level, the arguments in favour of stable prices set out in 4.1 do not apply to assets. There is, for example, no reason why society would want to aim for a stable stock market. Housing is more complex, since it is both an asset and a consumption good. Empirically, forcing the Bank to keep asset prices at a lower level in the past five years implies higher interest rates over that period. This in turn implies lower levels of growth, higher levels of unemployment and lower levels of RPI inflation, including the possibility of deflation.

[10] Daneshkhu, *Financial Times*, 13-02-2003, p. 3

4.4.5 That is not to argue that house price inflation does not matter, or that the effect of a house price collapse would not have macroeconomic effects. Indeed, as we state above, we believe that the housing market is already having such an effect by keeping interest rates higher than they should be. However, despite their macroeconomic effects, rapidly rising house prices cannot be tackled by macroeconomic policy. They reflect problems primarily in the housing market itself, and, insofar as these problems are concentrated in the south east, with a lack of effective regional policies, rather than with the remit given to the Bank of England. The policy solutions are microeconomic and so beyond the remit of this paper.

4.5 Fiscal and Accounting Rules: Real Progress

4.5.1 The last decade has seen two important advances in fiscal policy: fiscal rules and resource accounting.

Fiscal rules

4.5.2 In the UK, rules-based fiscal policies began with the annual targets for borrowing in the late 1970s. These have evolved into the current fiscal rules of the Chancellor that take a more long term approach to policy setting, focusing on policy over the economic cycle and on the stock of debt.

4.5.3 The "Golden Rule" instituted by Gordon Brown (but originating in Germany and previously proposed by the Liberal Democrats) says that *"over the economic cycle, the Government will borrow only to invest"* while the Chancellor's Sustainable Investment Rule says *"public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level"* which he defines as not more than 40% of GDP. These are similar to rules previously proposed by the Liberal Democrats and we welcomed their introduction after the 1997 election. It is important to remember that the uncertainties in government spending, tax receipts, and the economic cycle mean that these rules are very much rules of thumb. In particular, it is not always possible to tell if a government is conforming to them and for this reason they will always need interpretation.

Refining the rules

4.5.4 The Golden Rule allows government to borrow for capital projects, even when the project has no hope of generating a return to government, while it precludes them from investing in current expenditure, even when that expenditure can generate a return. This means that governments can borrow to invest in white elephant capital projects, but they cannot borrow to invest in smaller class sizes, even if that could be shown to generate an economic rate of return.

4.5.5 Both of these have happened in the past. Governments have invested in capital projects such as nuclear power and Concorde, which had no realistic prospect of return. Similarly, short term budget pressures have prevented governments from improving education, to the long term detriment of the country. For example, Roy Jenkins records in his autobiography his regret that short term post-devaluation financial constraints delayed a rise in the school leaving age.[11]

4.5.6 We would therefore like to see tighter rules with regard to borrowing so that the government cannot borrow to finance a capital project unless it can reasonably show that the project will generate a sound economic return. Like resource accounting, this method of planning borrows from best practise in the private sector. We recognise that, just as for firms, it is not possible for government to assess the future returns to investment perfectly. But, just as for firms, this is no reason for government not to try.

4.5.7 The government's commitment to a stable level of debt has limitations because the government's definition of debt is poor, excluding both PFI/PPP and pension liabilities.

4.5.8 The Prime Minister has said that *"We are absolutely committed to the PFI programme. School buildings and hospitals are being built around the country as a result of it."*[12] However, there are serious problems with PFI/PPP schemes which are 'off balance sheet' budgeting. This is bad practice in itself, since it undermines the discipline that the rules are designed to enforce. It also means that individual project funding decisions are biased by the accounting rule: the government may choose PFI/PPP even when it does not offer the best value for money, because the project will not then count under the fiscal rules. We would include the net present value of PFI/PPP contractual obligations on the balance sheet.

4.5.9 Government liabilities for the unfunded pension rights of teachers, NHS workers, members of the armed forces, and other groups who have pension schemes that are not backed by assets are also excluded from the government's definition of debt. The outstanding liability is large - £350bn in 2001 – more than the existing government debt, and has increased from £195bn in 1995. Rather than stabilising official government debt, it is more important to monitor total government assets *and* total government liabilities, both actual and contingent. Only then can it be judged whether the government's long term finances are sustainable.

[11] Roy Jenkins, *A Life at the Centre* (1991), p. 223.

[12] Prime Minister's Questions, 11th December 2002.

Accounting rules

4.5.10 The use of resource accounting and budgeting was first proposed by the Liberal Democrats, introduced by the Conservatives and implemented by Labour. This is the move to a proper and quasi-commercial system of accounting reporting on total assets and liabilities. It will, for the first time in the public sector remove the bias that previously existed against capital investment, by introducing accruals accounting and capital depreciation.

4.5.11 Liberal Democrats believe that this new and welcome accounting system should be allowed to settle before major reforms are undertaken.

4.5.12 Given the long time lags in introducing resource accounting, we believe that the government should start preparatory work now on more sophisticated methods of valuing contingent liabilities, an obvious and important weakness in the current system.

4.5.13 We also propose removing powers to set public sector accounting definitions from HM Treasury and giving the responsibility to the Accounting Standards Board. This will enhance the credibility of both the government's fiscal and accountancy rules.

Inside the Eurozone

4.6 The European Central Bank

4.6.1 We strongly support the principle of an independent European central bank.

4.6.2 Unlike the Bank of England, the ECB currently has the right to set its own inflation target. We believe that this will prove a credibility advantage if the economy is attacked by 1970s style supply side shocks.

4.6.3 The ECB's purpose is to maintain price stability and to do this it currently aims to keep inflation under 2% (as measured by the Harmonised Index of Consumer Prices). It has shown its ability to take tough decisions in both directions to secure this aim. It has ignored pleas for lower interest rates at times, whatever the bad publicity (Wim Duisenberg's "I hear but I do not listen") but equally it has lowered interest rates when both monetary policy and inflation were above target, to act as an economic stimulus.

4.6.4 The ECB's mandate already implicitly rejects deflation because it contravenes the goal of price stability; we believe this should be explicit.

4.6.5 The ECB uses the money supply and inflationary outlook to set interest rates. It has cut interest rates when money supply figures were above their target ranges, suggesting that it is prepared to ignore the money supply figures when the two measures give contradictory implications. We believe the ECB should use an explicit model of targeting inflation, and in any case believe that it should be more transparent as to how it uses each measure.

4.6.6 The ECB needs to be more transparent, to allow economic agents (including governments and individuals) to plan ahead, by predicting the Bank's reaction to certain events.

(a) The ECB has made major improvements in this area following a request from the European Parliament. It now publishes its economic model, and six-monthly projections. It also has a good working relationship with the EP economic and monetary affairs committee, with 19 ECB appearances in front of the committee in the last year - considerably more than the number of appearances by MPC members in the Commons.

(b) But more could be done. The ECB should publish a summary of the arguments for and against its decisions on interest rates and publish the voting figures. This would make ECB actions more predictable and should increase the market's confidence in it.

4.6.7 ECB appointment processes can be improved. The ECB Governing Council consists of members of the ECB Executive Board and governors of the national central banks. The ECB structure should place less emphasis on regional representation and give more power to the independent appointees. Otherwise, the need for bargaining and compromise between an ever larger numbers of state representatives could swamp the decision-making process after enlargement.

4.7 The Stability and Growth Pact

4.7.1 The Stability and Growth Pact (SGP) says that member states should aim for a medium term budgetary position close to balance or in surplus and that actual and planned deficits should not exceed 3% of GDP. It is important to note that as the UK is governed by a commitment to apply the EU's fiscal rules, even if the UK remains outside the euro, it must be involved in these rules' development.

4.7.2 There is a debate about the balance between rules that ensure a common discipline, and flexibility for individual members. We are pleased that the current fiscal rules are being interpreted in a sensible rather than mechanistic manner.

4.7.3 We have supported the government's view that the Stability and Growth Pact could usefully be reformed. In our view many of the problems arise from ambiguities in the SGP. Arguably the SGP makes allowance for borrowing for investment by countries such as the UK which have low public debt. Similarly, it does allow deficits of more than 3% of GDP in severe recessions. In practice interpretation has been reasonable, but we believe that the current formulation is open to misrepresentation so we support British government efforts to reform it, with a greater emphasis on structural budget problems.

4.7.4 We believe that in general EU budgetary recommendations are better made when GDP is rising, rather than in recessions, since fiscal reform is easier to undertake during periods of economic success.

4.7.5 We would seek EU-wide support for requiring each Member State's national audit body (in the UK, the National Audit Office), to report annually on the assumptions and conventions underlying the Member State's fiscal projections. Given that national assumptions are very different, the Commission should comment on national assumptions, and re-forecast using alternative assumptions if it thinks them more realistic.

4.7.6 We would allocate the UK's SGP deficit allowance between different tiers of government in line with their share of total taxation revenue. This ensures that borrowing is in keeping with the ability to pay. It also shows that we are able to reconcile our genuine commitment to devolution with our commitment to sound macroeconomic policy, and to our international obligations.

Box C:

Fiscal Rules: the benefits of discipline

C1: There are two sorts of fiscal rules, those concerned with government spending, and those concerned with government accounting. Both are important.

C2: Spending rules prevent one generation bequeathing unsustainably high levels of debt to the next. Such rules also ensure that a government can allow automatic - or discretionary - spending to occur in recessions without debt spiralling out of control. For example, the lack of fiscal restraint during the Lawson boom constrained the UK's room for fiscal manoeuvre in the subsequent Lamont recession of the early 1990s.

C3: Good accounting rules ensure that government macroeconomic spending rules are based on meaningful figures. In addition, they should ensure that government microeconomic spending decisions are taken on fundamental grounds, rather than because of distortions in the accounting system.

This paper has been approved for debate by the Federal Conference by the Federal Policy Committee under the terms of Article 5.4 of the Federal Constitution. Within the policy-making procedure of the Liberal Democrats, the Federal Party determines the policy of the Party in those areas which might reasonably be expected to fall within the remit of the federal institutions in the context of a federal United Kingdom. The Party in England, the Scottish Liberal Democrats and the Welsh Liberal Democrats determine the policy of the Party on all other issues, except that any or all of them may confer this power upon the Federal Party in any specified area or areas. If approved by Conference, this paper will form the policy of the Federal Party, except in appropriate areas where any national party policy would take precedence.

Many of the policy papers published by the Liberal Democrats imply modifications to existing government public expenditure priorities. We recognise that it may not be possible to achieve all these proposals in the lifetime of one Parliament. We intend to publish a costings programme, setting out our priorities across all policy areas, closer to the next general election.

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Note: Membership of the Working Group should not be taken to indicate that every member necessarily agrees with every statement or every proposal in this Paper.

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