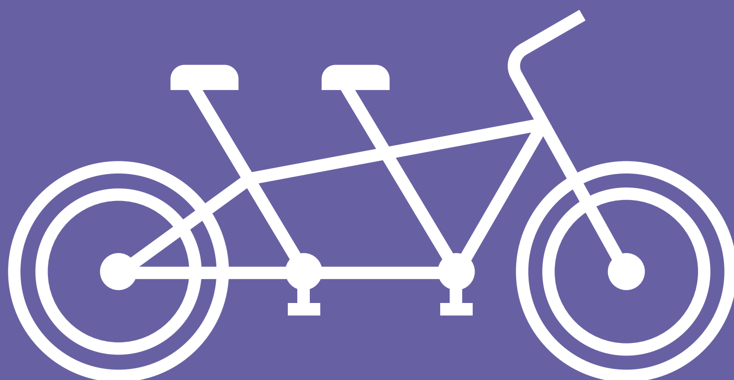
IN TANDEM

THE CASE FOR COORDINATED ECONOMIC POLICYMAKING

MICHAEL JACOBS, ROBERT CALVERT JUMP, JO MICHELL AND FRANK VAN LERVEN



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SUMMARY

The United Kingdom faces a daunting array of economic problems. The 2020s look set to be marked by consistently low growth, underpinned by a continuing shortfall in both business and public investment. Productivity remains more or less stagnant, while average real wages are still below their 2008 level. The UK is one of the most geographically unequal countries in Europe. Meanwhile, the effects of climate change are intensifying, underlining the urgent need to decarbonise.

Although these problems are interconnected, economic policymaking is not. The design of the UK's macroeconomic framework results in the country's major economic policy institutions – the Treasury and the Bank of England – operating in determinedly separate silos, and often pulling in opposite directions. At the same time, the last 25 years have seen a number of new institutions playing a role in macroeconomic policy making and industrial policy, including the devolved governments, the National Infrastructure Bank and advisory bodies such as the Office for Budget Responsibility, Low Pay Commission and the Climate Change Committee. Yet these remain almost entirely uncoordinated.

The aim of this pamphlet is to propose new arrangements which can better coordinate macroeconomic policymaking. We start by examining how disjointed economic objectives and policies since the 2008 financial crisis have resulted in repeatedly suboptimal policymaking. In the austerity years 2010–19, the Bank of England and the Treasury were engaged in a tug of war, with the Bank's policy of 'quantitative easing' (QE) designed to inject demand into the economy just as the government's fiscal policy removed it. In 2020–21 the Bank and Treasury appeared to be quietly working in tandem, but would not admit to doing so, with a huge new round of QE matching almost exactly the extra borrowing required by the government. When Liz Truss and Kwasi Kwarteng's 'mini-budget' in 2022 caused gilt yields to soar, the Bank, having been left in the dark, was unprepared, and had to bail out the pension fund sector to prevent its imminent collapse.

To avoid these repeated failures, we propose a new requirement

to be placed on the Bank of England, and a new fiscal rule for the Treasury. When interest rates are near zero, and monetary policy becomes ineffective, the Bank's governor should be obliged to write to the Chancellor to say this, and to propose that fiscal policy takes up the slack. At the same time, in such conditions, the Treasury's fiscal rules should allow borrowing for current expenditure as well as for investment.

In conditions of inflation, as today, the Treasury and the Bank should acknowledge that raising interest rates is not the only policy instrument available. To mitigate the sharp distributional effects of inflation on lower income households, both spending policies (such as the energy price cap) and tax changes (such as a reduction in VAT) can be used. In a world of higher public investment to drive decarbonisation, coupled with more frequent supply shocks as climate impacts worsen, it will be hard to avoid the greater coordination of fiscal and monetary policy.

Second, and drawing on recent developments in economic theory, we propose a new collaborative arrangement through which the UK's key economic policy institutions can more effectively coordinate their policies and actions. Specifically, we argue for the creation of an Economic Policy Coordination Committee or EPCC, comprising the UK Treasury and Business Department, the devolved governments, the Bank of England, the UK Infrastructure Bank (which we argue should be merged with the British Business Bank to become a National Investment Bank), the Office for Budget Responsibility, the Climate Change Committee and the Low Pay Commission (which we argue should be expanded into an Inequalities Commission). The EPCC should also include representatives from local government, the Confederation of British Industry (or its successor), other business associations, and the Trades Union Congress. Co-chaired by the Chancellor and Secretary of State for Business and Trade, the EPCC would meet twice a year in order to feed into the Treasury's budgets and spring and autumn statements. It would publish the minutes of its meetings to enable improved understanding among the public, markets and media, and would meet on a regular basis at official level. The enhanced policy coordination resulting from these new arrangements – getting our economic institutions to work in tandem – would, we argue, significantly improve the UK's economic outcomes.

INTRODUCTION

THE PROBLEM OF UNCOORDINATED MACROECONOMIC POLICY

In the 15 years since the financial crash of 2008, macroeconomic policy in the UK has been on something of a rollercoaster. In chronological order, we have seen Keynesian stimulus, interest rates reduced to near zero, quantitative easing, sustained public spending cuts, even-nearer-to-zero interest rates, a huge increase in government spending and borrowing alongside further quantitative easing, tax rises, interest rate rises, quantitative tightening, planned tax cuts, emergency Bank of England bond purchases, further interest rate rises, record tax rises, and spending restraint. Some of these shifts have been due to external shocks hitting the UK economy, notably the Covid pandemic in 2020 and the Ukraine war-induced energy price shock of 2022. Others were the result of conscious changes in the government's economic philosophy.

In this same period the UK economy has not performed well. Excluding the extraordinary years of 2020–22, when Covid caused a huge fall in GDP which subsequently bounced back, annual per capita economic growth has averaged 1.3 per cent, a substantially lower rate than that of the previous 15 years, and lower than any other G7 country.[1] Average real wages remain lower than before the financial crisis, and are not expected to return to their 2008 level till 2026.[2] Austerity did not result in a reduction in the UK's debt to GDP ratio, which rose from 63 per cent in January 2010 to 84 per cent in 2017 (and then subsequently to 99 per cent during the pandemic).[3] Both the Office for Budget Responsibility and Bank of England now forecast that the next few years are likely to see annual GDP growth of under 2 per cent.[4]

Meanwhile, other economic problems loom. The UK is one of the most geographically unequal of all major economies.[5] Nearly a million workers are on zero-hours contracts, and another 2.8 million in other forms of insecure work.[6] One in four children live in poverty, while wealth inequalities between the richest households and those in the middle, and between older and younger generations, have risen

starkly since 2008.[7] An ageing society is creating a growing 'fiscal gap' between public spending needs and tax revenues.[8] The global economic effects of climate change are becoming more severe, with impacts felt in the UK in both food and manufacturing supply chains.[9] The UK is significantly behind its own greenhouse gas emissions reduction targets, at the same time as both the US and EU are ramping up industrial subsidies to capture the trade and employment benefits of decarbonisation, with China having done so long ago.[10]

Not all these problems are the consequences of volatility in macroeconomic policy. But at the same time, it is hard to claim that the current framework of policymaking adequately addresses them. In this pamphlet we argue that a new approach is warranted. This is based on two important principles, one familiar in economic theory, the other less so.

The first is that multiple economic objectives require multiple policy instruments. Economists know this as the Tinbergen Rule, after its originator, the Dutch economist and Nobel prize winner Jan Tinbergen. The second is that these policies must be integrated with one another, which in turn, we argue, requires the formal coordination of the economic institutions charged with achieving and advising on them. This may result in some of the objectives being modified or downplayed in some periods as trade-offs are negotiated, but we contend that this is a better outcome than one objective being achieved while the others are not, or all of them failing. It also requires a change in the mandate of some institutions, and the creation of new ones.

Our primary case study is the formal relationship between the two key policymaking institutions in the UK, the Treasury and the Bank of England, and the justification for this relationship in economic theory. We discuss this in the next chapter, followed in chapter 2 by an account of the relationship in practice since 2008 and why it has run into trouble. In chapter 3, we propose new arrangements which would enable the Bank and the Treasury to work better together, and show how this could help not just in times of recession but also in today's inflationary conditions. In chapter 4, we examine the other institutions now involved in macroeconomic policy and industrial strategy (these are described more fully in the appendix) and discuss how their policy activities are interrelated. We then propose a new Economic Policy Coordinating Committee to enable them to more effectively work together. Such a committee could be established quickly by an incoming government.

CHAPTER 1

THE RELATIONSHIP BETWEEN THE TREASURY AND THE BANK OF ENGLAND IN THEORY

Since 1997, macroeconomic policy in the UK, as in more or less all rich countries, has been conducted through what is sometimes known as the 'consensus assignment'.[11] This is essentially a division of labour between the two principal institutions of macroeconomic policymaking. An independent central bank, the orthodoxy argues, should use monetary policy to manage aggregate demand to achieve stable inflation over the business cycle, while also maintaining the overall financial stability of the economy. Meanwhile, the government's fiscal policy should focus on a desired level of public spending and taxation, its (re)distributive goals, and the management of sound public finances in terms of the government's annual deficit and its cumulative debt.

This assignment of policy objectives and instruments became the consensus within academic economics, and subsequently among policymakers, after the apparent failure of the Keynesian settlement in the 1970s. For the three decades after the end of the Second World War, when the Treasury controlled the Bank of England (and therefore interest rates), fiscal and monetary policy were effectively integrated, with the goal of achieving economic growth, full employment, and the control of inflation at the same time. But the 'stagflation' of the 1970s, when high inflation coincided with weak growth and rising unemployment, persuaded many economists and policymakers that price stabilisation was a necessary precondition for the government's other objectives, and its achievement should therefore be paramount.[12] This required it to be removed from the direct control of government, which was assumed to have an inevitable bias towards short-term stimulus measures (whether interest rate reductions, public spending increases or tax cuts) aimed at boosting disposable household incomes for electoral gain.[13] The ill-fated 'Barber boom', which did just this in 1971–73, was a famous case in point.[14] The solution, the thinking went, was for central banks to be made independent of government, instructed to achieve price stability whatever the political or economic

conditions. Fiscal and monetary policy were thereby to be separated.

Under the terms of its operational independence in 1997, the Bank of England is mandated to achieve an inflation target set by the Chancellor of the Exchequer. Originally 2.5 per cent using the Retail Prices Index, this was changed to a largely equivalent 2 per cent using the Consumer Prices Index in 2004. Subject to meeting this target, the Bank has a much less precisely defined 'secondary target' of 'supporting the economic policy of His Majesty's Government, including its objectives for growth and employment'. This is generally interpreted as allowing the Bank to ignore short-term movements in the inflation rate where it is forecast to return to 2 per cent within around two years, and therefore where an immediate reaction would unnecessarily damage growth and employment.[15]

The Bank's inflation target is symmetrical: it must return inflation to 2 per cent whether it is above or below. If the target is missed by more than 1 percentage point on either side – ie, if the annual rate of CPI inflation is more than 3 per cent or less than 1 per cent – the Bank's governor must write an open letter to the Chancellor explaining the reasons why inflation has increased or fallen to such an extent, and what the Bank proposes to do to ensure inflation returns to the target.

In 1997 it was assumed that the Bank could achieve its inflation target using a single instrument, Bank Rate. This is the interest rate at which it lends to commercial banks, and which therefore effectively underpins all other interest rates in the economy. The assumption was that this 'short' rate of interest sufficiently influences the other major macroeconomic variables – nominal aggregate demand in particular – to be used on its own to manage the rate of inflation. When inflation is too high, higher interest rates reduce the volume of borrowing in the economy by both firms and households, thereby reducing investment and consumption, and in turn aggregate demand, and in this way exerting downward pressure on prices. Higher interest rates also increase the return on sterling-denominated assets and thus attract financial inflows, raising the value of the pound and thereby lowering the prices of imports.
It was assumed that careful and timely adjustment of these counter-inflationary mechanisms would limit the negative effects on other economic variables, such as employment.

The new post-1997 settlement, meanwhile, envisaged a constrained role for fiscal policy. It was widely accepted that, when averaged over the business cycle, governments should only borrow for capital investment, which would boost medium- and long-term growth; current spending should be covered by tax revenues. This became known as the 'golden rule'. At the same time, anxiety about the risks posed to growth from high levels of public debt led economists to recommend holding the ratio of debt to GDP at a relatively low level. These constraints (with the debt ceiling set at 40 per cent of GDP) became embodied in 1997

in the Treasury's 'fiscal rules', designed to ensure Chancellors of the Exchequer were prevented from pursuing electorally popular but economically damaging unfunded public spending or tax cuts. Initially adopted under Labour Chancellor Gordon Brown, these fiscal rules lasted till 2009. But they were subsequently amended multiple times by his Conservative successors, facing economic conditions and making fiscal choices which made it (they believed) impossible or undesirable to abide by them.[16]

For the 10 years after 1997, the consensus assignment appeared to work well. The Bank of England and the Treasury maintained a formal distance from one another, avoiding any impression of coordination. Inflation averaged 2 per cent, precisely the target the Bank had been set by the Treasury. Through minor adjustments to interest rates – which stayed between 3 and 6.25 per cent – the Bank kept inflation within the range of 1.2 to 2.5 per cent.[17] At the same time, per capita GDP growth averaged a relatively healthy 2.4 per cent, while unemployment fell to its lowest level since 1975 (just over 5 per cent) and public spending increased from 35 per cent to 40 per cent of GDP.[18]

But appearances can be deceptive. At the time, these seemed to be very benign years in macroeconomic terms. US Federal Reserve governor Ben Bernanke famously used the label 'the great moderation' for this period of steady growth, low inflation and rising employment.[19] Former Bank governor Mervyn King coined the acronym 'NICE': non-inflationary, consistently expansionary.[20] Yet as we now know, underneath the apparent stable growth, a huge expansion was occurring in highly risky forms of credit, which eventually proved unsustainable.[21]

Though few realised it at the time, what this period actually demonstrated was the problem of reconciling central banks' monetary and financial stability remits. Profit-seeking behaviour by private firms in competitive financial markets was assumed to lead to self-regulating equilibrium (the 'efficient markets' hypothesis).[22] So financial stability could be left to the markets, while central banks could focus on monetary policy. The shortcomings of this approach became apparent with the onset of the global financial crisis in 2008.

Even during this period, however, some foresaw trouble. Giving evidence to the House of Lords economic affairs committee in 2004, the Financial Times' economics commentator, Samuel Brittan, warned that in more extreme conditions the Treasury and Bank of England would need to work much more closely:[23]

> *I can think of many circumstances when the framework might prove inadequate. Let me take two extremes… If you get a real danger of recession, the Bank of England's freedom of manoeuvre is limited by what is called a zero interest rate barrier; it cannot get interest rates below zero and in practice not even there. This problem has been most extensively explored in the US Federal Reserve; and the consensus*

is, if you need to stimulate purchasing power in a big way, you need the Treasury and finance minister to come closer.

Let me take another extreme: a horrendous oil price explosion that suddenly puts the general price level up by 10 per cent. In these circumstances people are very worried about high double-digit inflation and it is no use saying you are going to have a target of one, two or three percent inflation. What you have to do is to get it down by hook or by crook whenever you can. In these circumstances, too, the kind of rigid framework which appeals to the present Chancellor might not be suitable.

In fact, the last fifteen years have seen both of these conditions, as well as others not anticipated by the architects of the orthodox approach. In all of these cases, the consensus assignment has proved problematic in just the ways that Brittan anticipated.

CHAPTER 2

THE RELATIONSHIP BETWEEN THE TREASURY AND THE BANK OF ENGLAND IN PRACTICE

2008–2019: TUG OF WAR

Like other governments around the world, the Labour government's immediate response to the recession that followed the 2008 financial crash was a Keynesian stimulus package, aimed at restoring output and employment. But the Conservative-led coalition replaced this in 2010 with an austerity programme of severe public spending cuts (along with some tax rises) aimed at reducing the budget deficit and debt. At the same time, the Bank of England attempted to support the UK economy, first by cutting Bank Rate – to 2 per cent and then to 0.5 per cent – and then through an unprecedented programme of 'quantitative easing' (QE), or bond purchasing, aimed at increasing the liquidity of the financial system and forcing wider interest rates down further.[24]

These policies were directly at odds with one another. The government's public spending cuts pulled demand out of the economy: between 2010 and 2019 by a cumulative £540bn relative to the pre-2010 trend of public spending.[25] Meanwhile, the Bank's QE programme was simultaneously attempting to inject demand back into the economy, with bond purchases totalling £445bn between 2009 and 2019.

Such a tug of war was an almost inevitable result of the consensus assignment in such conditions. The assumption that fiscal policy is simply a matter of governments deciding how much they wish to spend, how much tax they need to levy (and on whom), and therefore how much borrowing they need to do, ignores the inescapable impact of fiscal policy on aggregate demand, and the impact of monetary policy on the public finances. When interest rates are at their 'lower bound' (close to zero), this interdependence becomes critical, since there is nowhere left for conventional monetary policy to go. In such conditions, it is counterproductive for the Treasury to operate under fiscal rules aimed simply at controlling the budget deficit

and overall public debt. As Keynes argued, when households and businesses are reining in their spending and borrowing during a recession, governments should supply the missing demand. Had the UK government done so in 2010–13, by sustaining a higher level of borrowing, as the US government did, it would have generated a much stronger recovery. And faster growth would have offset the effects of higher borrowing on the debt to GDP ratio.[26]

Just as Samuel Brittan predicted, macroeconomic policy in this period would have been much more coherent if the Treasury and the Bank of England had coordinated with one another. One simple option, for example, would have been for the Bank of England to write a formal letter to the Chancellor saying that it had run out of monetary policy options to raise aggregate demand and recommending that the Treasury loosen fiscal policy in order to do so.[27] But the strict injunction of the consensus assignment that the central bank and government must remain entirely independent in their decision-making made this impossible.

2020–21: IMPLICIT COORDINATION

When the Covid pandemic hit in 2020, however, the independence of monetary and fiscal policy quickly dissolved. Seeking to protect households and the economy when the country went into lockdown, the UK government, like others in the developed world, operated a 'furlough' scheme under which it paid 80 per cent of the wages and salaries of employees unable to go to work. Alongside other support measures, this required a huge rise in borrowing (from 2.8 per cent of GDP in 2019–20 to 15 per cent in 2020–21)[28] which would have been difficult to fund over such a short time period without generating significant disturbances in financial markets. Simultaneously, the Bank of England enacted a new round of quantitative easing, nearly doubling its holdings of government bonds (gilts). The quantities it purchased in 2020 almost exactly matched the volume issued by the government; yet the two institutions refused to publicly acknowledge that the two figures were related, or that they were, as some believed, effectively coordinating policy.[29] Such coordination, insofar as it happened, was contrary to the principles of the consensus assignment. The 'monetary financing' of government borrowing (the central bank effectively 'printing money' in order to be able to buy the government's bonds)[30] was even more so. Yet the fact remains that, whatever the motivations of policymakers at the time, the Treasury response to the pandemic was almost entirely financed by the Bank of England.[31]

2021–22: RECESSIONARY SYNERGY

The pandemic period gave way to the second of the economic shocks Samuel Brittan had anticipated, when the rapid global recovery in early 2021 created energy and supply chain shortages which began to stoke inflation. Global energy prices started rising steeply in March 2021, hitting an annualised 27 per cent in Europe in January 2022, before the Russian

invasion of Ukraine in February 2022 sent them soaring. UK household gas prices rose 129 per cent in the twelve months from October 2021, and household electricity prices 67 per cent.[32] Inflation rose steadily from its target rate of 2 per cent in July 2021 to a peak of 11.1 per cent in October 2022.[33]

The Bank of England was, at first, slow to raise interest rates as inflation rose, holding Bank Rate at its ultra-low pandemic level of 0.1 per cent throughout 2021. The Bank's Monetary Policy Committee (MPC) indicated that it believed that the energy and supply chain shocks were a temporary phenomenon induced by the rapid global economic recovery, and could therefore be 'looked through' when setting interest rates. But from December 2021 it acknowledged that inflation was not going to be temporary, and there followed a series of interest rate rises, reaching 5.25 per cent by August 2023.[34]

At the same time, the Bank also began 'quantitative tightening' (QT), seeking to set in train the gradual unwinding of its QE programme. In February 2022 it stopped 'rolling over' (replacing) the bonds it had acquired under QE; and then, from November 2022, it began to sell gilts back into the market. (Despite its scale, the effects of QE are poorly understood; the evidence suggests that QE had only a marginal impact on demand and inflation.[35] But it has left policymakers with the problem of how to unwind gilt purchases and avoid large interest payments on the Bank's reserves created as a result of the programme. While QT might be expected to contribute to monetary tightening, the Bank claims that Bank Rate moves can take QT into account so that the net effect becomes neutral.)[36]

As inflation began to cut real household and business incomes during 2022, the UK economy's post-pandemic growth rate began to slow and near-recessionary conditions emerged. But it was not just the Bank's raising of interest rates that threatened to make these conditions worse. Having seen borrowing get close to 100 per cent of GDP during the pandemic, the Treasury was now embarked on a determined drive to reduce public debt, in line with its fiscal rules. In two separate fiscal statements in 2021, the then Chancellor Rishi Sunak signalled a significant rise in taxes, such that total planned tax changes introduced since the start of Boris Johnson's premiership would amount to over 2 per cent of GDP by 2025–26.[37]

From December 2021 to September 2022, the Bank and Treasury were therefore pulling in the same macroeconomic direction. But they were doing so with the unfortunate outcome of reducing aggregate demand as the country moved into recession – with very little impact on supply-side-induced inflation.

SEPTEMBER 2022: DIRECT CONFLICT

The relationship between the Treasury and the Bank changed again after the now notorious 'mini-budget' introduced by new prime minister Liz Truss and her Chancellor, Kwasi Kwarteng, in September 2022. Combining a major (around £100bn) increase in energy bill subsidies with £45bn in tax cuts,

all of it to be funded by borrowing, the Chancellor further unnerved the financial markets by refusing to have his statement accompanied by the usual economic and fiscal analysis conducted by the Office for Budget Responsibility.[38] The mini-budget caused market turmoil, with gilt yields soaring and the pound falling to an all-time low against the dollar as confidence in UK policymaking plummeted. With fiscal and monetary policy once again set against each other, a negative feedback spiral or 'doom loop' threatened, in which further increases in inflation and interest rates would raise public borrowing costs, further weaken investor confidence, and thus push gilt yields yet higher.[39]

But this was not the only problem. The sudden fall in the value of gilts (the inverse of the rise in their yields) caused a crisis in the UK pensions sector, whose risk management strategies required them suddenly to raise cash and sell gilts to cover their positions. As a number of pension funds lurched towards insolvency, a 'fire sale dynamic' emerged: falling gilt prices forced investors to sell more gilts to raise the required cash, putting further downward pressure on prices and risking more selling. The Bank of England was forced to take emergency action, promising to buy up to £65bn of gilts directly from the pension funds to shore up their price and ensure the liquidity of the funds.[40]

But the governor of the Bank, Andrew Bailey, went further. Shortly after pledging the £65bn intervention, he publicly warned the pension funds that they had only three days in which to use it. Market observers were shocked.[41] The Bank's responsibility to ensure financial stability surely required it to do whatever was necessary to shore up gilt prices and protect the pension funds from collapse; such support could not be arbitrarily cut short. As it turned out, the Bank had correctly calculated that the cash on offer was sufficient to tide the pension funds over, but many of them were dragging their feet in accepting it, unwilling to accept the financial penalty built into the Bank's proposal. Bailey's ultimatum successfully forced the hand of the pension funds.[42] But to some observers, it seemed something else was also going on. Determined to maintain the Bank's credibility as an independent monetary policymaker focused on inflation, not one 'fiscally dominated' by the Treasury, Bailey was warning the Chancellor that it would not protect a fiscally reckless government from the bond markets. When the market turmoil led Kwarteng to be sacked by Truss and the prime minister herself was then forced to resign, some commentators argued that the Bank had effectively staged a coup against an elected government.[43]

Two different criticisms of the consensus assignment came together in this extraordinary episode. One was the lack of coordination, or even communication, between the government and Bank. It emerged that the Treasury had not informed the Bank of its tax-cutting intentions before the Budget.[44] Had it done so, either the government or the Bank might have moderated their opposing policies. The other was the potential for conflict between the Bank's price

stability and financial stability mandates. After a decade of ultra-low interest rates, many banks and pension funds in the developed world have become heavily invested in sovereign and corporate bonds. But as central banks (in pursuit of their price stability responsibilities) have raised interest rates over 2022 and 2023, the value of these has inevitably fallen, leaving many in a financially precarious position. While financial meltdown was avoided during the Truss debacle, the collapse of Silicon Valley Bank in March 2023, which necessitated a huge bailout of larger banks in the US and a forced sale of SVB's subsidiary in the UK, highlighted the deepening tension between central banks' monetary policy and financial stability responsibilities.[45]

CHAPTER 3

FISCAL AND MONETARY POLICY COORDINATION

REVISED MANDATES AND FISCAL RULES

What are the lessons, in terms of policy coordination, we should draw from the recent history of Treasury-Bank relations? There are four possible arguments.

One is to say that the Bank of England should no longer be independent of the Treasury. Central bank independence may have been appropriate to the benign economic conditions of the 2000s, this argument would go, but in a slump or inflationary period the government (which, unlike the Bank, is democratically elected) should take charge again.[46]

But this argument immediately runs up against its cost. The effect of ending central bank independence would be a sharp rise in the cost of government borrowing, since the financial markets would assume that governments will always be tempted to borrow more than is prudent, and they would therefore add a risk premium to the cost of gilts. This would make it more difficult to achieve the government's growth, public spending and redistributive aims, not easier.

A second response to recent events would be to say that the problems have not arisen from lack of coordination, but simply poor policymaking. Many macroeconomists said in 2010–15 that austerity was a bad economic policy, for the obvious reason that when businesses and households are both reining back spending, withdrawing government demand from the economy as well is bound to lead to very low growth at best. And in turn, low growth will inevitably slow the rate at which the debt-to-GDP ratio declines.[47] The same can be said (and was) of the Kwarteng-Truss budget. Had the Chancellor told the Bank of England governor what he was going to announce, it wouldn't have made any difference to the outcome, because borrowing a lot of money to pay for tax cuts was clearly going to raise the cost of government bonds and slash the value of sterling. Neither episode had anything to do with the mandates of the Bank or Treasury; the problem was the policy.

A third approach would accept this, and still claim that some form

of policy coordination would have helped. For example, it might have been harder for the Chancellor to impose austerity if the Bank of England's mandate had included a requirement for the governor to write to the Chancellor when the Bank believed that monetary policy was no longer effective and fiscal policy was required to do any further demand stimulation.[48] This might well have happened in 2010, when Bank Rate was at an unprecedented 0.25 per cent but the early recovery in growth had already started to slow.

A change in the Treasury's fiscal rules could have had the same effect, but even more powerfully. In introducing the idea of fiscal rules to force Chancellors to be prudent, Gordon Brown placed particular emphasis on the 'golden rule' that government borrowing should only be for investment, not for current (day-to-day) spending. But this rule, as a number of economists have pointed out, should have been more sophisticated. It is correct for normal circumstances, when interest rates are around 5 per cent or higher, and the Bank of England can therefore use monetary policy to manage aggregate demand. But it should not apply when interest rates are at their 'lower bound', near zero: at this point, conventional monetary policy has run out of road and fiscal policy should take over the demand-stimulus function.[49] Had this more sophisticated rule been in place in 2010, the Chancellor would have been obliged either to stimulate the economy (instead of imposing austerity) or at least to explicitly say that he was abandoning the rule and to explain why.

So the third approach to the Bank-Treasury relationship would be to say that the two institutions should be encouraged to more effectively coordinate their policies through their individual mandates and rules. Coordination should not mean joint policymaking; it should simply be a more economically sophisticated understanding of each institution's separate role.

One option sometimes mooted for a revision of the rules is a change to the Bank of England's monetary policy goal. It is pointed out that the Bank has a 'single mandate' to maintain stable prices, whereas the Federal Reserve in the US has a 'dual mandate' in which it is also charged with achieving 'maximum employment'. Some argue that such a dual mandate would make the Bank of England less likely to cause recession when it is trying to control inflation. If the consequence of raising interest rates was going to be significantly higher unemployment, the Bank would be required to go more slowly.[50]

But this argument can be overblown. The Bank of England already has a 'secondary' mandate (alongside the maintenance of price stability) 'to support the economic policy of His Majesty's Government, including its objectives for growth and employment.' Indeed, this was explicitly reinforced in guidance given to the Bank by George Osborne in 2013.[51] As a result, the Bank notes on its website that "sometimes, in the short term, we need to balance our target of low inflation with supporting economic

growth and jobs".[52] In other words, it already acts (or should act) like the US Federal Reserve: when growth is slow and unemployment is high, it can effect a slower return to its inflation target than it would otherwise have done. There is a case for making this secondary mandate more formal, as in the US, or for the Chancellor to issue some new guidance emphasising it, but it is not the case that the Bank ignores (or is required to ignore) the employment and growth impacts of its monetary policy.

Revisions to the Treasury's fiscal rules and to the mandate of the Bank of England are sensible reforms. We propose that the governor of the Bank should be required to write to the Chancellor when the Bank believes that monetary policy is no longer able to manage aggregate demand sufficiently, and that fiscal policy should therefore become more active. And the fiscal rules should include a provision to allow governments to borrow for current spending when interest rates are too low to allow monetary policy to remain in the lead. But we do not believe this exhausts the possibilities for greater coordination.

At present the governor of the Bank of England and the Chancellor of the Exchequer have meetings which are not publicised or publicly minuted. In September 2022, after Kwasi Kwarteng had been appointed Chancellor, the Treasury made a point of stating publicly that what had once (apparently) been weekly meetings between Chancellor and governor would now be reinstated, initially bi-weekly.[53] The clear intent was to demonstrate that Kwarteng wanted the Bank to do more to control inflation. But no further meetings have been publicised.

This is as it should be. When the Bank of England was still under Treasury control, there would occasionally be periods when discussions between the Chancellor and the governor emerged into public view: the 'Ken and Eddie Show' (starring Ken Clarke and Eddie George) became something of an institution in the 1990s.[54] But today, with an independent central bank, it is much preferable that these conversations are private. A running commentary on the views of Chancellor and governor would not help smooth policymaking, and the minutes would inevitably be so edited for public consumption as to become uninformative.

But this does not mean that *no* formal coordination between the two institutions is desirable. For medium- and long-term policy making, it would be helpful to have a greater degree of formal coordination. But this should not just be between the Bank and the Treasury. The fourth option for coordination is for a process which extends beyond the Treasury and Bank of England alone. For these are no longer the only two significant institutions in economic policymaking; over recent years others have entered the field. In the following section we will discuss this wider institutional landscape and propose a new institution, an Economic Policy Coordination Committee, to provide a coordinating mechanism. Before that, however, there are other

aspects of fiscal and monetary policy coordination which need exploring. For the economic context has changed significantly in the last few years, and the problems the Treasury and Bank of England must confront have become considerably more complex.

INFLATION AND THE COST OF LIVING CRISIS

In the period since 2008, as we have tried to show, there have been a number of occasions when economic outcomes would have been improved by policy coordination, and monetary and fiscal coordination in particular. In this period, most of the UK economy's problems were caused by inadequate demand, so the need was for coordinated stimulus. But the value of policy coordination applies equally to the current period of inflation and shortages in supply.

The high inflation of the last two years was triggered by acute supply shocks. First, the global recovery of demand in 2021 after the Covid pandemic ran too fast for supply to keep up.[55] Across the world, shortages appeared in everything from semiconductors to HGV drivers, sending prices skyward. Then, after February 2022, the Russian invasion of Ukraine caused a further spike in global energy prices, as Europe cut its consumption of Russian gas and searched desperately for alternative supplies. At the same time, the war led to a dramatic reduction in the export of Russian and Ukrainian grain, raising global food prices and causing a huge increase in global poverty and hunger.[56] Since energy underpins all economic activity, prices started rising in every sector, and generalised inflation set in. In the UK the annualised rate of inflation, as measured by the Consumer Prices Index, rose from 0.2 per cent in August 2020 to a peak of 11.1 per cent in October 2022 before falling to less than 7 per cent during 2023.[57]

How to respond? The consensus assignment was clear. Controlling inflation was the job of central banks, not governments. And the policy instrument to be used – one instrument for one objective, as the Tinbergen Rule prescribes – was raising interest rates. The Bank of England started raising Bank Rate from its near-zero Covid level in October 2021, and raised the rate at 14 consecutive meetings of its Monetary Policy Committee thereafter, reaching 5.25 per cent in August 2023.

The problem, however, was that global supply shocks are not affected by UK interest rates. A higher Bank Rate in the UK has no effect on the supply of Middle Eastern oil and gas, or the cost of imported food. So the initial impact of the orthodox anti-inflation policy on the causes of inflation was more or less nil.

The Bank of England insisted that raising interest rates was still necessary, though, to prevent 'inflationary expectations' setting in, leading to a 'wage-price spiral'. Recalling the UK's experience of the 1970s (but vigorously rejecting the comparison), the Bank's governor, Andrew Bailey, along with other MPC members, warned that if workers expected high inflation they would bargain for higher wages, which would force firms to raise prices further

to cover their costs. Inflation would thereby become 'embedded' in the economy, and hard to shift.[58] Higher interest rates would pre-empt such a spiral by cutting demand in the economy – if necessary, by causing a recession.[59]

How do higher interest rates do this? They make borrowing, and refinancing existing loans, more expensive. So firms reduce investment, and households – particularly those with mortgages – reduce their spending. Lower investment and consumption reduce aggregate demand in the economy. Firms find they can't sell so much, so start to lay off workers, whose spending then falls further. Fearing for their jobs, and finding new jobs more difficult to come by, workers moderate their wage demands. As wage costs fall, firms don't need to increase their prices; and with weak demand they can't do so anyway. So price rises begin to come down, and inflation falls.

This is how conventional anti-inflation policy is meant to work, and in current circumstances it is slowly doing so. (Though it has to be noted that much of the reduction in overall inflation in mid-2023 was the result of a fall in global energy prices, rather than the impact of interest rate rises.)[60] But it comes at a significant social and economic cost. By cutting aggregate demand, increasing unemployment, and slowing growth, the Bank of England risks worsening the recessionary dynamics to which inflation gives rise as higher prices hit real incomes, with particular hardship for households facing huge increases in monthly mortgage payments.[61] Since housing rents are closely tied to mortgage rates, those in the private rented sector have also seen a significant reduction in their disposable incomes.[62]

Accordingly, an unavoidable implication of the current fiscal and monetary set-up is that the Bank of England may have to artificially engineer an economic slowdown – if not a recession – in order to bring down inflation. The distributional effects of such anti-inflation policy are acute. Higher interest rates penalise borrowers, but they benefit savers. So, while mortgage holders and renters are hit hard, owners of financial assets tend to do well (so long as financial stability is maintained).

Is there an alternative policy approach? There is, and it involves better policy coordination between the Bank of England and the Treasury. In line with the principles set out above, it involves recognising that public policy has more than one objective in these conditions, so more than one policy instrument is needed. Inflation should be brought back to the 2 per cent target over an appropriate period of time, and the poorest and most vulnerable households need protecting from the worst effects of the cost of living crisis.

The policy response to the energy price spike which followed the invasion of Ukraine provides an example. In common with almost all European countries, the UK government used a fiscal measure to protect households, and this measure also acted to reduce the official rate of inflation. The energy price guarantee, introduced in October 2022,

saw the government directly subsidising consumer and subsequently business energy costs. The government set a maximum price for gas and electricity which the energy retailers could charge their customers, and then compensated them for the difference between this and the costs the retailers were actually paying in the energy market.[63] The fiscal cost to the government was partially offset by the levying of a windfall tax on the profits of UK-based oil and gas producers.[64] In effect, the combined elements of the fiscal policy took some of the additional profit which the global energy shock had provided to the companies and their shareholders, and redistributed it to the UK households and businesses whose higher energy costs were the source of (some of) those profits. Since the guarantee reduced the energy price paid by customers, it not only mitigated some of the distributional impacts of the crisis, but also reduced the headline measure of inflation targeted by the Bank.

This approach of combining fiscal and monetary policy in response to inflation could be applied more widely.[65] For example, a reduction in VAT would have the dual effect of cushioning the blow of higher prices for households, and reducing CPI inflation directly, curbing workers' and firms' expectations of sustained inflation and thereby reducing wage pressures; this, in turn, would reduce the pressure on the Bank to raise interest rates.[66] Such a policy could be introduced without affecting the overall position of the public finances if taxes were simultaneously raised on those benefiting from inflation. This could include raising the rates of tax on savings, dividends and capital gains, or a windfall tax on the profits earned by banks from higher interest rates. (Margaret Thatcher notably introduced such a tax in similar circumstances in 1980.)[67] Where inflation is found to be driven in part by companies maintaining or raising their profit margins, as is currently the case in the US (and in some sectors in the UK),[68] temporary taxes can be levied on such sectors. Other income support measures, such as raising social security benefits, can also be used to support lower-income households. Again, revenue can be found if needed by taxing those on higher incomes to help counter inflation's distributional effects.

These kinds of targeted increases in taxation can also serve to constrain aggregate demand. If it is judged that inflation is the result of excessive domestic demand, targeted tax increases on higher income households offer a much more precise means of constraining demand than the distributionally blunt instrument of interest rate rises. In this way, fiscal policy can be used to manage the distributional effects of inflation while also limiting the need for Bank Rate hikes to dampen demand. Coordination with fiscal policy would thus provide greater room for manoeuvre for monetary policy.

Policy coordination of this kind can go beyond the fiscal and monetary. The energy price guarantee (and the underlying energy price cap of which it was an extension) was in effect a form of direct price control. It is not impossible to imagine price controls being used

in extremis for other essential items such as food.[69] Indeed, earlier this year, such controls were proposed by the UK government, albeit on a voluntary basis by supermarkets.[70] Other counter-inflationary policies are available in the labour market. Measures to expand the labour force, such as a relaxation of immigration rules, support for childcare and other caring responsibilities, and improvements to health services for the long-term sick would ease wage pressures contributing to inflation.[71]

The wider recognition here is that inflation is inescapably distributional in character: it involves direct conflict between workers seeking to maintain their real incomes and employers seeking to maintain their profits.[72] Whether this kind of distributional 'wage-profit' conflict emerges endogenously (internally) within the economy as a result of a tight labour market and greater worker bargaining power, or in response to exogenous (external) supply shocks, such as an oil price spike, coordinated policy will provide greater scope for its management than the use of interest rates in isolation. As widespread public sector strikes in 2022–23 have shown, the government's critical wage-setting role in the public sector makes it an inevitable participant in this type of conflict. The government's current approach, enforcing wage restraint in order to comply with fiscal rules aimed at controlling deficits, is destined only to worsen the cost of living crisis already created by inflation, particularly for those on low incomes.

The current inflation will subside once the process of repricing in response to supply shocks is complete. But a return to the price stability and apparent macro-tranquillity of the pre-2008 period is unlikely. As the effects of the climate crisis are increasingly felt, commodity shortages will almost certainly become an increasingly frequent occurrence. Such 'climateflation' will require more sophisticated responses than the current institutional framework is capable of providing.[73] Supply-driven inflationary pressure – where the impact on inflation comes from particular supply shortages and price spikes rather than a rise in the general price level – will have acute distributional effects needing more finely calibrated policy tools than interest rate rises alone.[74]

THE CLIMATE CRISIS AND DECARBONISATION

Indeed, the climate crisis poses wider challenges to the current macroeconomic framework. As the Climate Change Committee has shown, achieving the UK's statutory emissions reduction targets (en route to net zero emissions by 2050) will require substantial increases in investment, public investment in particular. This will in turn demand substantial issuance of new debt, both public and private. Ensuring that this debt is financed at affordable rates while avoiding the kind of market turbulence experienced following the Truss-Kwarteng mini-budget will require much closer coordination between the Bank of England, the Treasury, and the UK Infrastructure Bank. The overall design of UK sovereign debt arrangements –

the term lengths of gilts, the proportion that are index-linked, the interest rates paid by the Bank on reserves held by the banking sector[75] – will require careful management.

In turn, the recent increase in interest rates presents additional challenges to achieving the green transition. Not only is an increase in the Bank of England's interest rate designed to curb investments – including green investment – it also disincentivises green energy investments relative to carbon-intensive alternatives.[76] A low carbon transition necessitates a move away from energy infrastructure with low upfront costs but high operating costs (fossil fuels and labour) to renewable infrastructure with significant upfront capital costs but low operating costs (no fuel and very little labour). This makes low carbon energy investments much more sensitive to interest rate rises. As rates rise, green investment will be disincentivised relative to fossil fuel alternatives, exacerbating the UK's 'carbon lock-in' and making it more vulnerable to energy price volatility and supply side shocks. Mitigating the 'green collateral damage' from rate rises will require enhanced macro-economic coordination.[77]

Likewise, taxation and interest rate policy will require greater coordination. The climate transition will require a major and rapid mobilisation of private and public sector resources – probably the largest ever in peacetime. It is likely that this will lead the economy to reach full capacity utilisation (that is, full employment at decent wages), thereby risking inflation. In these circumstances, as discussed above, governments may well need to use taxes to manage aggregate demand and prices, and not simply rely on rising interest rates. The distributional effects of interest rates will be one argument for using tax policy; the revenue generating potential of taxation another.[78]

PUBLIC SECTOR INTEREST PAYMENTS

The recent rise in the Bank of England's interest rate has sharply increased the overall amount the government pays out in interest payments. This will inevitably reduce the level of borrowing a new government will feel it can afford: borrowing is much more expensive than it was just a few years ago. But there is a case to say that it is currently overpaying.

An apparently innocuous change to the Bank's monetary policy framework in 2009 means that the reserves which commercial banks hold at the Bank are now remunerated at the Bank's policy rate. This approach looked practical and fair at the time, when interest rates were near zero and reserve holdings relatively small. But the banking sector now holds nearly £900bn of central bank reserves, and Bank Rate is now over 5 per cent. So this change has become very expensive.[79] One estimate, based on market expectations for interest rates against a stock of reserves consistent with the Bank's current plans for unwinding QE, suggests the Bank of England is set to pay out £34bn in interest payments to the banking sector every year between 2024 and 2028 – equivalent to 2.8 per cent of government spending and averaging over 40 per cent of government

borrowing costs.[80] Given the windfall profits which banks have received as interest rates have risen, this represents an extraordinary transfer of revenue from the public purse to the commercial banking sector.

The wider point is important here. Given the large volume of QE outstanding, the effects of changes to interest rates go well beyond the Bank of England's ostensible demand management role. They have a substantial impact on the government's interest payments, and therefore on the public finances, which are supposed to be the policy target of government fiscal policy.

A number of remedies are available to reduce the scale of these transfers to the banking sector. One would be for the Bank to implement minimum reserve requirements, and only pay interest on balances in excess of these minimum levels.[81] Another possibility would be a windfall tax on the banks. A third would be a change to financial regulations requiring banks to pass on interest income onto their customers.[82] In any of these cases, the unavoidable interactions between monetary and fiscal policy will require much closer coordination between the Treasury and Bank than has been the case in the recent past.

CHAPTER 4

ECONOMIC POLICY COORDINATION

THE NEW ECONOMIC INSTITUTIONS

The Treasury and the Bank of England remain the UK's paramount economic policymakers. But they are not the only ones. Over the past 25 years, a range of new institutions have been created to play a role in macroeconomic and industrial policy. First, the Department of Business and Trade has become more central, as an active industrial strategy has been accepted as a critical part of the policy toolkit. Second, the devolved governments in Scotland, Wales and Northern Ireland, and to a lesser extent the combined authorities and mayoralties created in England, have been given new economic powers and responsibilities. Third, a UK-wide Infrastructure Investment Bank, created to support private sector investment in infrastructure, has joined smaller state development banks in Scotland and Wales. And last, key advisory bodies have also been established: the Office for Budget Responsibility, the Low Pay Commission and the Climate Change Committee.

We describe these institutions in more detail in the appendix, where we also argue that some of them need to be expanded. We recommend a merger of the National Infrastructure Bank with the British Business Bank to create an integrated National Investment Bank. We recommend that the Climate Change Committee's remit is expanded to encompass a wider set of environmental targets and guidance beyond just climate. And we propose that the Low Pay Commission should become an Inequalities Commission, charged with analysing and providing advice not just about pay levels but about wider economic conditions contributing to inequality.

However constituted, the existence of multiple economic institutions makes the question of economic policy coordination considerably more complex. Each institution has its own policy objectives and targets, which they are either required or choose to pursue. Each has specific powers and responsibilities. These objectives and powers sometimes

work together, sometimes in opposition. But they do so almost entirely without formal coordination.

OBJECTIVES AND INSTRUMENTS

Academic economics has acknowledged the problem of multiple objectives. It is widely accepted that, when governments have multiple policy targets, they need multiple policy instruments – at least the same number of instruments as targets. As discussed earlier, this is known as the Tinbergen Rule, after its originator Jan Tinbergen. The terms of Bank of England independence can be viewed as embodying this principle: a single target, price stability, was to be achieved using a single instrument, the short-term rate of interest. Between the Bank of England and the Treasury there were two objectives – price stability and the fiscal rules – and two instruments, interest rates and tax and spending changes.

What the period since 2008 has shown is that this 'consensus assignment' framework is based, first, on an overly simple reading of the Tinbergen Rule; and second, on an overestimation, both of the power of the Bank's single instrument, and the extent to which its target and actions can be cleanly separated from other aspects of economic policymaking.

Recent academic work on the Tinbergen Rule takes a more nuanced approach, considering both the overlap between policy targets and the potential side-effects of policy aimed at a particular target.[83] Instead of the 'one instrument per target' approach, it is now accepted that policy *packages* are required, with instruments analysed not in isolation but in combination. While individual institutions can use particular instruments *primarily* for the purpose of achieving particular targets, policymakers need to acknowledge that each instrument will also affect other targets: they have 'externalities'. This requires a mechanism for coordination between the institutions involved, so that these overlaps and interactions can be managed. The aim should be to generate policy which is as close to optimal (the achievement of all the targets) as possible. In the absence of such a coordination mechanism, the interaction among instruments creates a real risk of 'suboptimal' policy outcomes where the achievement of policy targets is less than could be achieved.[84]

Indeed, the idea that the Tinbergen Rule requires no coordination between instruments is to mistake a special case for a general one. Formally speaking it can be shown that, while there are some circumstances in which an optimal outcome might arise without coordination, this is unusual. Much more likely is that coordination is required.[85]

Governments today have multiple economic objectives. They seek to achieve price stability, stable growth, high employment, rising productivity, rising wages, falling geographical disparities, falling greenhouse gas emissions and improving environmental conditions. They may also seek falling income and/or wealth inequality and falling poverty, and even rising wellbeing.[86] Some of these objectives are (or can be) synergistic in character; others almost certainly involve trade-offs. But there can be little doubt that they are unlikely

to be achieved unless the different policy instruments with which governments seek to achieve them are in some way coordinated. Four different types of circumstance can be envisaged.

First, there are cases where a policy instrument used to achieve one objective can act directly against another. This was the case, for example, when austerity and quantitative easing were operating simultaneously. It is also the case during inflation of the kind we are currently seeing, when high interest rates can have a severe impact on employment and household incomes.

Second, there are cases where a policy instrument is ineffective in achieving its objective. When the Low Pay Commission was established in 1998 to advise on the level of the newly established national minimum wage, insecurely contracted work represented a relatively small element of the labour market. Today, over a million workers are on zero hours contracts and 15 per cent of the labour force is self-employed, often only in nominal terms with a single 'client'.[87] This makes the minimum wage both far more difficult to enforce, and increasingly ineffective as a means of reducing in-work poverty, since large numbers of workers now work less than a 'full-time' week.[88] As the Taylor Review of Modern Working Practices observed, job *quality* – encompassing job security alongside other issues such as unionisation and job satisfaction – is now as important a feature of working experience as the number of jobs or the level of wages.[89] This creates a strong argument for additional policies targeting job security, such as the banning or disincentivisation of zero hours contracts, new employment rights in relation to working time, and the encouragement of trade union membership and collective bargaining.[90]

Third, there are cases where policy instruments have the potential for both synergy or conflict, and coordination would help make the former more likely. This is the case, for example, in relation to devolution, where greater coordination between the UK government, the devolved administrations and combined local authorities, particularly around industrial strategy, planning and skills, would be likely to make each more effective. In climate and environmental policy, a lack of attention to the impacts of economic policies can easily lead to unnecessary costs in the form of greenhouse gas emissions and other forms of environmental damage. Coordinating economic and climate and environmental policies can both reduce such costs and exploit the considerable opportunities for productivity improvement, innovation, and job creation in environmental sectors.[91]

Fourth, there are cases where one policy instrument, or one institution, cannot tackle a policy goal single-handedly. Addressing the UK's 'green investment gap' – the additional investments necessary to achieve the government's climate goals – offers a good example. According to the Climate Change Committee, capital investment in net zero technologies and investments in the UK will need to scale up from around £20bn year in 2023 to nearly £60bn per year in the mid-2030s.[92] Between 2023 and 2030, the private sector alone – despite higher interest

rates – will be required to mobilise an additional £250bn.[93] Addressing the green investment gap will almost certainly therefore require a coordinated programme of public and private investment encompassing aggregate demand management, industrial strategy, patient financing and wider energy, transport and agricultural policies.

AN ECONOMIC POLICY COORDINATION COMMITTEE

There is a good case for the separation of policy objectives between different institutions. Having just one or two well-defined goals per institution ensures a focus on achieving them, and provides clearly defined performance criteria. It is likely to reduce the problem of 'goal displacement', in which the founding objectives of an organisation are progressively replaced by secondary goals which help maintain the organisation's bureaucracy or power structures.[94] This has been widely observed in government ministries with multiple, often ambiguously defined responsibilities, in which means come to be regarded as ends in themselves.[95]

More centralised planning structures might have an intuitive appeal to some. But such an approach to economic management has rarely been successful in the UK, where most of the attempts to introduce corporatist structures have been unhappy.[96] A relatively dispersed policymaking environment is better suited to the UK's liberal political economy.

There are, however, obvious costs to this approach. The economic problems that the UK faces are complex and interconnected, and their solutions are not independent of one another. It is evident from recent history, as we have argued, that monetary and fiscal policy cannot be cleanly separated along institutional lines. Treasury and Bank of England policy instruments are interdependent, and a failure to coordinate between them can have substantial costs. Meeting the government's legally binding targets for greenhouse gas emissions while also 'levelling up' employment and living standards across the UK adds further layers of required coordination. Without this, either some policy goals will not be achieved, because others effectively take precedence, or the costs of achieving them will be much higher than they need to be.

To mitigate these costs, while retaining the benefits of separate policy institutions, we propose a mechanism by which policy can be coordinated between them. Specifically, we propose the creation of an Economic Policy Coordination Committee (EPCC). This would comprise representatives from the Treasury, the Department of Business and Trade, the Bank of England, the devolved governments of Scotland, Wales and Northern Ireland, the combined regional mayoral authorities of England and the National Investment Bank, along with the advisory bodies the Office for Budget Responsibility, the Climate Change (and Environment) Committee and the Inequalities Commission. The Confederation of British Industry (or its successor), the British Chamber of Commerce, the Federation of

Small Businesses and the Trades Union Congress should also sit on the EPCC, with other representative economic bodies also invited to attend as appropriate.

The aim of the EPCC would be the better coordination and integration of economic policy between otherwise independent institutions in order to more successfully meet modern governments' multiple policy objectives. Its core member institutions would retain primary responsibility for their own areas of economic policy. But the EPCC would provide each institution with a direct understanding of the analysis and perspective of the others, in order to inform the work of all. By acknowledging and understanding the interactions and feedback between policies, this should make each institution better able to counteract potential negative outcomes arising from these interactions and to maximise synergies between them.

In particular, the purpose of the EPCC would be to provide the Treasury, as rightly the ultimate policymaker within the economic system – both democratically accountable and able to use a variety of policy instruments – with a greater understanding of how the multiple economic objectives of governments across the UK interact with one another and how they might better be integrated.

We envisage the new committee meeting twice a year at ministerial level. These meetings would be co-chaired by the Chancellor of the Exchequer and minister for business and trade, and attended by the premiers and/or finance ministers of the devolved institutions and heads of the other institutions. The EPCC would have a standing structure at official level which would meet and exchange papers more frequently throughout the year.

The principal meetings of the full committee would need to take place in advance of the Treasury's two major fiscal events, the spring statement and autumn budget. At these meetings, the participating institutions would share their objectives, economic analyses, and policy strategies. Areas for potential collaboration would be discussed, policy contradictions identified, and problematic gaps unearthed. It would be wise to place these meetings on a statutory footing, so they could not be bypassed by the government of the day without new legislation. The EPCC would subsequently present a report to the Cabinet and to the devolved governments. As with the Bank of England, the EPCC's minutes would be published to ensure that experts, market actors and civil society organisations are able to understand (and criticise) its deliberations.

Two obvious objections will be raised to the proposal for an Economic Policy Coordination Committee.

The first is that this kind of body has already been tried, and didn't work. In 1962 Harold Macmillan's Conservative government established the National Economic Development Council (NEDC) as a tripartite economic planning forum bringing together representatives of business, trade unions and government. Widely known as 'Neddy', it was supported by a National Economic

Development Office (NEDO), and later expanded into sectoral Economic Development Committees for major industries (known as 'Little Neddies').

As key institutions in the 'corporatist' approach to economic policy making practised by both Conservative and Labour governments in the 1960s and 1970s, the aim of the Neddies was to improve economic performance, particularly industrial productivity and growth, initially using a type of indicative planning.[97] But they were unable to overcome the deep structural problems of the post-colonial British economy, and have generally been regarded as a failure – if not the cause of Britain's inability to modernise its economy in this period, then at least unable to arrest the decline.[98] Margaret Thatcher downgraded them on entering office, before they were finally abolished by John Major in 1992.

But the Economic Policy Coordination Committee we propose would not be a Neddy Mark 2. Its aim would be more modest. Today we have devolved government, with new economic policy responsibilities, a new state investment bank and an array of advisory bodies which did not exist in the 1960s and 70s. The EPCC's aim would simply be to bring a measure of coherence and coordination to their activities.

The second obvious objection is that the EPCC would simply be, or become, a 'talking shop'. This is in one sense true: we are not proposing that it has formal policymaking powers. But this criticism is misplaced. Each government body which would be represented on the EPCC, apart from the three advisory bodies, has constitutional and/or statutory powers over various elements of economic policy. No coordinating committee made up of other bodies would be able to remove or diminish those powers. We are not proposing that this committee should supersede the responsibilities or autonomy of its constituent bodies. Rather, it should provide some wider context for each to work within, and a forum where each can seek to persuade and influence the other institutions which interact with their roles.

The importance of this function should not be underestimated. A better understanding of the wider policy context is bound to improve the quality of policymaking. Coordination between institutions – where each adjusts what it is doing in response to what others are doing, in agreement with them – must do likewise. And, it might be added, publishing the minutes of the ministerial-level meetings can only improve public and media awareness of economic policy and the debates taking place between institutions about such policy. The EPCC would not in this sense be 'simply' a talking shop. It would be a forum in which different perspectives from institutions with significant but different powers could be discussed and better understood. We hope that this would improve the quality of public debate on economic policy, which would in turn increase the accountability of the government and other policy makers to the electorate. It seems hard to argue that mutual conversation among these institutions would not be an improvement on the continuing absence of it.

CONCLUSION

Would an Economic Policy Coordination Committee aimed at encouraging greater institutional coordination improve UK economic policymaking? There can of course be no guarantee. But in each of the periods between 2008 and 2022 when the Treasury and Bank of England came into conflict, there are strong grounds for believing that more open and explicit information-sharing and coordination between them – and with the other institutions in the economic policy field – would have made such conflict and policy failure less likely.[99] The EPCC would enable each institution to be officially informed by the analysis and perspectives of the others. In particular, it would give them a better understanding of the multiple policy goals towards which, collectively, policy is now aimed, and the ways in which policies of different institutions are likely to interact.

Over the coming decades, UK governments will confront increasingly complex and interconnected policy challenges, including an ageing society, household and geographic inequalities, political fragmentation and, above all, a deepening climate and nature crisis.[100] In these circumstances, getting our economic institutions to work in tandem will surely become not just desirable in theory, but increasingly unavoidable in practice.

APPENDIX

THE WIDER INSTITUTIONAL LANDSCAPE

The field of economic policymaking has become a lot more crowded in the period since the Bank of England was made independent in 1997. A number of other economic institutions have been created by UK governments to play a role in macroeconomic policymaking and public investment. They reflect the fact that policymaking today pursues multiple objectives, which require both a wider range of instruments than monetary and fiscal policy alone, and a deeper analytical underpinning. In general, these institutions have also operated within their own silos, with little if any policy coordination, either between themselves or with the two primary policymaking institutions. If greater coordination between the Treasury and Bank might be appropriate, these institutions, too, must be part of the coordination mix. We describe them briefly here.

DEPARTMENT FOR BUSINESS AND TRADE

The oft-renamed business department (since 1997 it has been the Department for Trade and Industry; the Department for Business, Enterprise and Regulatory Reform; the Department for Business, Innovation and Skills and the Department for Business, Energy and Industrial Strategy before its latest renaming in 2022), is the UK ministry responsible for promoting economic growth, business development and private sector job creation. Since 2009 it has had a particular focus on industrial strategy – the direct support by government of priority industrial sectors. This has taken various forms, but in general has included government spending and coordination activities aimed at improving infrastructure, supporting innovation, reducing geographic economic inequalities ('levelling up'), promoting business development, developing domestic supply chains, and improving education and skills.[101]

These activities are intended to complement the overall macroeconomic stance taken by the Treasury and the Bank of England. Along with government policies in the purview

of other departments such as transport and planning, they can be regarded as covering the supply side of economic policymaking, where the Treasury and Bank of England are responsible for the demand side. In practice, given the tendency since 2010 for fiscal policy to be focused on deficit and debt reduction, rather than growth, these fields of policymaking have not been fully complementary. For example, it is often assumed of supply side policies that they can generate productivity improvement, and therefore growth, whatever the wider macroeconomic context. But there are clear limits to this. Business investment is a function of demand and profit expectation: if aggregate demand is consistently constrained, it is hard for skills, innovation, and planning policies to raise the overall rate of private sector investment as a share of GDP. There is therefore a strong *a priori* case for greater coordination between the business department and Treasury (and through the latter with the Bank of England).

The dominance of the Treasury over the business department in the UK has been a running feature of postwar economic policymaking. It was famously the reason that Harold Wilson created the Department of Economic Affairs (DEA) in 1964, splitting the Treasury's public finance responsibilities from those of economic and industrial policy. The failure of the DEA (which was abolished after just five years), coupled with the tendency of the Treasury to guard its pre-eminent position in Whitehall – and a general scepticism about industrial policy within the Conservative party – has since limited the policymaking role of the business department.[102] But the increasing importance of industrial policy for a post-Brexit UK economy, now finding itself in a competitive race with the US, EU and China in fields such as green technologies, may suggest the need for a rebalancing of powers.

THE DEVOLVED GOVERNMENTS AND LOCAL GOVERNMENT

Under the terms of the devolution settlements for Scotland, Wales and Northern Ireland, economic development is a devolved matter.[103] The three jurisdictions exercise their economic powers differently, but all three have a strong focus on attracting inward investment, and on planning and infrastructure, business development and education and skills. The Scotland and Wales governments can vary the UK-wide rates of income tax; the Northern Ireland government can vary the rate of corporation tax; all have powers over business rates and some indirect taxes. Scotland and Wales have established national investment banks to support their efforts. The same broad economic development functions are now being undertaken at a much smaller scale by the combined authorities and elected mayors in England's major urban regions, though without comparable budgets, powers, or fiscal independence.[104]

A degree of 'coordination failure' is to be expected in any devolved arrangements: differences in approach between different jurisdictions (which may be run by governments of different political colours) is part of the point. But it is

also true that coordination is likely to improve overall economic performance. Greater coordination between the UK and devolved governments and English city regions would notably enable both greater coherence and more resources and powers to be brought to bear on economic problems in the UK's disadvantaged regions. Recent events suggest that coordination on public sector pay between the different national governments might also help resolve industrial disputes more quickly.[105]

UK INFRASTRUCTURE BANK

The UK Infrastructure Bank was established in June 2021. It was intended to replace the loss of infrastructure finance from the European Investment Bank after Brexit, along with the investment undertaken by the Green Investment Bank before its privatisation in 2017.

The UK Infrastructure Bank's financing capacity (balance sheet) is currently £22bn, with an annual lending capacity of £5.5bn.[106] This represents a rather limited role when compared to the scale of Britain's infrastructure deficit. In comparison, the Labour party's manifesto proposals in 2015 and 2017 for a public investment bank – which, it was intended, would invest not just in infrastructure but in innovation, business development, and potentially housing – included (in 2017) a balance sheet target of around £250bn built up over 10 years. Germany's longstanding national development bank, KfW, lent around €18bn in 2022.[107] So there is clearly potential to scale up the Infrastructure Bank's operations, and it could play a significant role in any overall economic national development plan. This would necessarily require active coordination between the bank and the government's industrial and levelling up policies.

ADVISORY BODIES

Three advisory bodies play a particularly important role in overall economic policy. The best known is the Office for Budget Responsibility (OBR), which has the legal obligation to provide the Chancellor with economic and fiscal analysis prior to every autumn budget and spring statement, and also publishes periodic reports on long-run fiscal risks and sustainability and trends in welfare spending.[108] Although it has no direct policymaking responsibility, the OBR nevertheless has a strong influence on policy (as well as on economic reporting in the media) because it produces the forecasts of macroeconomic variables and public finances which guide the final decisions on fiscal policy. OBR forecasts are also used as the benchmark for testing whether the Chancellor is on track to achieve any self-imposed 'fiscal rules'. The OBR's judgements on such issues – like those of the Bank of England, which produces its own economic forecasts – are not unimpeachable, however; it has been criticised among other things for its assumptions about fiscal multipliers, its estimation of 'output gaps' (between the potential of the economy and actual current output), and its projections of annual productivity improvement.[109]

The Climate Change Committee (CCC) was established under the 2008 Climate Change Act to provide advice

to the government and parliament on the medium-term targets which parliament should adopt to ensure that the UK is on course towards its statutory long-term goal of net zero emissions by 2050 (originally an 80 per cent reduction on 1990 levels), and to report on the government's achievements and shortfalls against those targets. In providing such advice, the CCC must take account of a variety of factors, including the UK's international climate commitments and the economic costs and benefits, social (distributional) implications and wider environmental impacts of climate policies. In practice the CCC's advice is very detailed, analysing not just which technologies need to be used in every major sector to bring emissions down, but the kinds of policies the government could use to incentivise or require their adoption.[110] It is therefore (or should be) an important body for advising on industrial strategy as well as specifically climate-related policy.

The Low Pay Commission (LPC) was also established by the last Labour government, alongside the introduction of the national minimum wage (NMW) in 1998. Its members are drawn from the trade unions, business, and academia, and it consults widely on its analysis and recommendations. Its reports include detailed analysis of UK labour markets. Its specific task is to advise the government every year on the appropriate level of the minimum wage and its age and geographical variants.[111] Since 2020 it has been asked to make its recommendations with an overall goal of having the NMW reach two-thirds of median earnings by 2024. Its recommendations have always been unanimous, and they have almost always been accepted by the government of the day.

REVISED MANDATES

Each of these institutions is involved in economic policymaking; in chapter 4 we suggest how they could work in a more coordinated way. But there are also three mandate changes that would support the better integration of overall policy.

First, we propose a merger of the UK Infrastructure Bank with two other institutions: the National Infrastructure Commission, which analyses the economy's infrastructure priorities, and the British Business Bank, which provides loans and advice to small and medium-sized enterprises. Combining these would create a more appropriately named National Investment Bank, which could then be capitalised at a scale closer to Germany's successful KfW. Indeed, there would be a strong case for a federated UK-wide State Investment Bank combining the balance sheets (and therefore improving the risk profile) of the English, Scottish, Welsh, and Northern Irish equivalents, with autonomous boards in each country and in the English regions.[112]

Second, there is a strong case for the Climate Change Committee's remit to be broadened. Under the 2021 Environment Act, the UK government is empowered to adopt medium- and long-term environmental targets in fields such as air and water pollution and biodiversity.[113] But the Act does not set up a comparable advisory body to

provide guidance on such targets and how they can best be met. The CCC could be given this task. It would provide government with the means both to integrate its environmental objectives into its wider economic (and climate) policies, and to avoid the latter running directly counter to them.

Third, we propose that the Low Pay Commission be expanded into a wider Inequalities Commission. Low pay is not the only source of inequality in the economy; indeed it is arguably no longer the principal source of labour market disparities. Over the past 20 years, the world of work has increasingly been split into two kinds: contractually secure jobs with statutory and negotiated labour rights and working conditions, and the 'gig economy' of insecure jobs, zero hours contracts and sole-contractor self-employment. In most of the latter kind of job, the level of the minimum wage is not the primary source of inequality or poverty; it is the number of hours worked and their lack of predictability and security. So it is no longer appropriate to have an advisory body which analyses low pay but not these wider labour market trends. As the Taylor Review of Modern Working Practices observed in 2017, the Low Pay Commission's remit needs to be broadened to take account of these changes in the labour market.[114] It should be examining issues such as the matching of demand and supply in key sectors and in general, and trends in unionisation rates, job security, job satisfaction and working time.

Beyond this, there are wider sources of inequality in gender and racial pay gaps, in other forms of discrimination on the basis of disability, sexual orientation and so on, and in the distribution of wealth as well as income. An Inequalities Commission mandated to examine all these forms of economic inequality could play the same role on the 'social' side of the economy as the Climate Change Committee already does – and would do more fully if its remit were expanded – on the 'environmental' side. In each case the government could adopt targets, in law and/or policy, on which the commissions would advise, both in terms of what the targets should be, and how they could best be met. In turn, both bodies would report to parliament on government performance. In the 15 years since it was established, the Climate Change Committee has proved an invaluable institution, not merely for its expert (and almost universally accepted) advice, but for holding governments' feet to the fire when it fails to live up to its own commitments. An Inequalities Commission could do the same.

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FABIAN SOCIETY

IN TANDEM

MICHAEL JACOBS, ROBERT CALVERT JUMP,
JO MICHELL AND FRANK VAN LERVEN

The daunting array of economic problems facing Britain – low growth, inadequate investment, stagnant productivity, accelerating climate change and suppressed wages – are closely connected. Yet since 1997, the institutions most responsible for addressing them, the Treasury and the Bank of England, have been kept quite separate, operating in distinct, deliberately constructed siloes.

In this pamphlet, Michael Jacobs, Robert Calvert Jump, Jo Michell and Frank van Lerven scrutinise the so-called 'consensus assignment', which specifies a hard division of labour between the government and the central bank. With informal coordination happening anyway, especially during the pandemic years, the authors argue that new, more transparent arrangements are needed. Analysing the wider array of institutions now involved in economic policymaking, they propose a new Economic Policy Coordinating Committee to help achieve the multiple objectives towards which governments today must aim.

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