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Replacing the Inflation Target

Pete Comley, author of "Inflation Matters", argues that it is time for a new era of 'Naked Central Bankers'.

This article examines the role of central banks and how monitoring inflation targets came under their remit. It shows that targets have a limited influence over inflation in the short-term. They are also associated with a misleading sense of financial security. It is suggested that we learn from experiments with traffic management that show removal of formal controls results in better outcomes. The MPC should therefore adopt the "Naked Streets" concept and be freed of all formal targets like inflation and instead just focus on the higher-level objective of ensuring financial and economic stability.

Central banks have many functions but a key one is maintaining monetary and financial stability. They have always played such a role right back to the foundation of the very first one: the Amsterdam Wisselbank in 1609. For the Bank of England it became more formalised in the late nineteenth century following their help in bailing out Barings Bank.

Since the Bank was nationalised in 1946 governments have had a greater impact on its work and role. In the 1970s, concerns were expressed over the effectiveness of the Bank and there were calls for greater transparency in its workings. These coincided with a period of high inflation and economic problems. Therefore in 1976 Dennis Healey, under pressure from the IMF, imposed the first target for the Bank of England: one of monetary growth (M3).

Its objective was to bring back financial stability by curtailing the money supply and with it inflation, which at that time had just peaked at 27%. It is debatable how effective such monetary targets were and it was clear from the diaries of Healey that he himself never expected them to work. Part of the problem might have been the Bank's decision to monitor M3 – other central banks were targeting M1. Nevertheless the target was continued for a decade.

In 1987, the government switched to a target of shadowing the Deutschmark and stopped monitoring monetary goals. That regime persisted until such an aim became unsustainable as Britain was ejected from the ERM on 16 September 1992.

In the same era, on the other side of the world in New Zealand, what might have even been almost a joke started a different trend for central banks. The country had sustained inflation rates in excess of 15% for most of the 1980s. On live television on April Fool's Day 1988, without consulting anyone, finance minister Roger Douglas said his central bank was going to completely stabilise prices and set a target of near-zero inflation.

In the aftermath of this TV program, his government, the Reserve Bank of New Zealand and other interested parties, actually agreed to set a target of under 2% inflation to be achieved by the early 1990s. Amazingly, the Reserve Bank delivered and inflation was reduced to below 1% by 1992 and remained on target for three more years.

This experience was inspirational to other governments and set a trend that was quickly followed by many. In 1991, Canada, Chile and Israel all adopted inflation targets and so did the UK in October 1992. Currently they are employed by nearly seventy countries worldwide.

There is fair amount of evidence that setting a target for inflation does indeed have an impact on the broad long-term inflation rate experienced in a country. For example, Switzerland, which sets a target of 0-2%, achieved an average of 0.7% between 2000 and 2013. In contrast, we averaged 2.3% during this period in the UK with our target of 2%, and Russia averaged 10% with its target of 5%. However care must be taken with causality here and governments possibly set targets that they feel they can achieve.

Despite this caveat, inflation rates across the whole world tumbled during the 1990s, as targets were implemented in more and more countries. Central bankers took all the credit for this and their power correspondingly increased – especially at the Fed. However, it might be argued that a lot of this disinflation was due to the impact of China's devaluation in 1994 and the resulting flood of cheap goods around the world. The growing impact of technology and the internet also reduced prices and the Great Moderation was also starting to have an influence. So it is probably fair to say that central bankers had a strong tailwind behind their efforts at achieving inflation targets.

Indeed their track record since, particularly that of the Bank of England, has been far from impressive. For large parts of the time from 2008 until 2013, inflation was significantly above the 2% target and in 2015 it has varied in the opposite direction and been close to zero. This is in spite of Bank of England projections throughout this period stating that it would always return to the 2% target within two years.

It looks like influencing inflation with targets in the short-term is far more difficult than central bankers might have us believe. This brings into question the whole purpose of maintaining such targets in a generally low inflation world. The reason that small differences in the inflation rate are difficult to influence is that much of headline rate observed in the UK is actually outside of the Bank's control. Mervyn King used to frequently bemoan that half of the overshooting of inflation during his latter years was due to government controlled price rises e.g. train fares, tuition fees and utility prices. Also 2015 has again highlighted the significant impact that changing world commodity prices and currency exchange rates have on CPI – again largely outside the Bank's influence.

To make matters worse, the whole point of trying to control the inflation rate was to bring economic and financial stability. The financial crisis of 2007-8 clearly highlighted that a dogged focus on controlling the inflation rate was of no help in averting this crisis. Indeed I would argue that it was a hindrance and it prevented the Bank from acting earlier to defuse the credit time-bomb that was being created during the early Noughties. Had the Bank just a broad remit of economic and financial stability (and the FSA under its control), it would have acted much earlier with regard to the imbalances and problems with financial institutions. Instead, right up to the end of 2007, it was reporting that inflation was spot on target and that it did not need to intervene.

“The financial crisis of 2007-8 clearly highlighted that a dogged focus on controlling the inflation rate was of no help in averting this crisis”

There is a very interesting analogy here in town planning. Following the work of the late Dutch traffic engineer Hans Monderman, many towns have experimented with the concept of shared space roads or “Naked Streets”, as they have come to be known. Monderman showed that accidents could be significantly reduced by removing all the road signs and markers, traffic control measures like lights and removing the clear division between cars and other road users' space.

The psychology behind it was that drivers would be forced to pay more attention to their environment. They would have to switch off their auto-pilots and really look at what was going on around them. Instead of racing through traffic light junctions because the light said green, they would have to slow and actually check what was really going on.

Since then many towns have replicated his findings, though it has been found that they tend to apply most when traffic volumes and speeds are low. Therefore a good example of a successful one is the new Exhibition Road in London.

It strikes me that the current inflation target is very much like a traffic light. The Bank monitors it in a very stop/go fashion. However, for most of the recent time the light has been on amber, i.e. inflation outside the 2% +/-1% range. Like most drivers who see such a light, they just keep their foot down, focus on the road ahead, speed on through the junction and hope no-one hits them.

We need to remove the inflation target traffic light and stop it being a simple crutch which the Bank uses to determine the success, or not, of the economy. Inflation is luckily not a major issue now and has not been in the UK for over a couple of decades. In my latest book, *Inflation Matters*, I suggest that because of world demographic changes, we are probably headed towards a long era of very low inflation.

Inflation targets did have a place in the world economy a few decades ago, as countries needed help to deal with the aftermath of the 1970s. That period has passed and it probably makes sense to move on. Instead we should instruct the MPC to return to their original remit. The MPC needs to open their eyes and become fully aware of everything going on the economy and finance. If they spot a problem, they must be prepared to take action(s), even if there is no evidence of it triggering inflation. Welcome to the new world of Naked Central Bankers. ■

Pete Comley is the founder and director of Join the Dots. He is the author of Inflation Tax (2013) and Inflation Matters (2015).