Central Banks and the Return of Inflation: Do the Emperors have any clothes?

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Introduction

The past decade or more has been a period of very low consumer price inflation. In both the developed and the developing worlds, inflation (and the volatility of inflation) has been at levels not seen for a generation. And the world economy has, by and large, prospered greatly in this environment of low volatility, low absolute inflation.

Central banks have taken a great deal of the credit for this achievement, and stand at the pinnacle of their reputation. Governors are the Emperors[1] of the financial world, greatly respected and all powerful in their chosen field. With a mastery of the economic and monetary process at their fingertips that their predecessors found so elusive, they stand before us truly resplendent in their inflation-fighting robes.

This short essay will not dispute the great success that central banks have had in controlling the measure of inflation that they have been asked to control. But it will pose three questions:

- How much have central banks actually achieved, and could they have achieved more?
- How much has this been due to their skill, and how much due to a benign environment?
- How confident can we be that price stability will survive in a more challenging world?

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It is the third of these questions which is rapidly coming to the fore, because just when we have all become used to the nirvana of price stability, the dragon of inflation is threatening to return. It is time for central banks to prove that their reputation is justified, that the dragon is indeed but a shadow of its former self, and that we really have moved to an era of permanent monetary stability. In short, it is time for the Emperors to show that they really are wearing their new clothes.

How much have central banks achieved?

On the surface, this is an odd question to ask. Central banks have been asked to produce price stability, and, as mentioned above, by the accepted measures they have been very successful. But many consumers, particularly in the developed world, will look at their own finances and not recognise the price stability that the indices proclaim. Housing costs, medical costs, transport costs, administered (government-imposed) costs - all seem to rise a lot faster than official inflation.

This impression is reinforced by the plethora of official inflation indices. For example, in the UK the Bank of England officially targets a measure called the CPI or Consumer Price Index. This index "excludes a number of items that are included in RPI (Retail Price Index), mainly related to housing. These include council tax and a range of owner-occupier housing costs such as mortgage interest payments, house depreciation, buildings insurance, estate agents' and conveyancing fees"[2]. The ONS goes on to observe that "the RPI annual rate generally exceeds the CPI's". In fact in the period from end-1995 to end-2005, the CPI index rose by 16.0% (an annualised rate of 1.5%), whereas the more comprehensive basket represented by the RPI rose by 28.8%, an annualised rate of more than 2.5% or over 1% more per year than the CPI. This is a not insignificant difference, especially when sustained over many years.

Of course the intention in producing "core inflation" indices is not to exclude items with fast-rising costs. Certain items, such as energy costs, housing or food, are often stripped out because they are quite volatile, and to include them risks obscuring the underlying inflation pattern with too much white noise. The problem is that, for the consumer, these items usually appear to be volatile on the upside, ie rising faster than core inflation, and as a result their

1 And, of course, one King.

2 Source: UK National Statistics website. See http://www.statistics.gov.uk/cci/nugget.asp?id=181

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personal spending basket is biased towards rising faster than recorded or official inflation.

This distortion of the measure of price stability is poor public relations for those seeking to control inflation and manage inflationary expectations. As the gap between people's own experiences and the official statistics grows, credibility in the official figures is lessened, and respect for the achievements of the central bank weakens. To take the argument to extremes, if you exclude everything whose price has changed from your chosen index, you would automatically have price stability. It would not be a great achievement for a central bank to have low inflation with such an index as the measure of their success.

This leads to two deeper questions. Firstly, what exactly is price stability; or rather, what should the chosen measure of price stability include? Should it, for example, include house prices and other asset prices as well as retail prices? There is little agreement among central bankers here, except that to include general asset prices in the definition of price stability would make their task many times more difficult. And secondly, if we do keep to the current, narrow definition of price stability, what in fact have we achieved by securing stability according to this measure?

Here we meet two awkward facts. Firstly, we observe from history that price stability (ie inflation around 0-2%, the usual definition in most of the developed world today) is *not necessary for growth*. For most of the 19th century, much of Europe experienced falling prices, with periods of considerable volatility in the year-on-year changes. Yet this did not stop it being an era of solid and growing material prosperity and national wealth in many countries.

And secondly, price stability is *not sufficient to ensure general financial stability*. If one looks at the major crises of the 20th century - whether the 1929 Wall Street crash, or closer to the present day, the FX crises in Europe (1992-93) and Asia (1997-98) or even the global stock market bubble in 2000 - they were all preceded by a period of general price stability. It is one of the ironies of the 1990s that a period of widespread price stability *within* countries was also one of the most unstable and volatile periods for price stability *between* countries, with wrenching exchange rate crises in Europe, Mexico, Asia, Russia, Turkey and Argentina, to list only the major ones.

This has prompted some soul-searching among the central banking community. Indeed, in a recent BIS Working Paper[3], the question is asked directly. While acknowledging the benefits that lower inflation can bring and has brought, the author observes that price stability does not of itself imply either growth or macroeconomic stability, and suggests that too single-minded an attention to price stability alone may not in the long run be optimal for the wider economy.

How much has price stability been due to central bank skill?

To many, and perhaps not just central bankers, the analysis of the previous section may seem a little harsh - after all, they do not unilaterally choose their objectives or the indices against which they are judged, and they can only play by the rules they have been set. But even the success that they have had is open to debate.

The last decade has seen a major structural change in the world economy, as China has become a major exporter and a force for lower prices for traded goods. For many countries, traded goods have in fact fallen in price substantially, which poses a question and an interesting challenge for central banks. The question is, how much of their recent success is actually externally generated by terms of trade effects not their own efforts. And the challenge is, what in fact should they do if a major part of the RPI basket is becoming cheaper? What does overall price stability mean when goods price inflation and service price inflation begin to diverge by more than the odd percentage point?

The response to the second of these has been clear. Whether they have done so openly in public statements (as most notably the Federal Reserve did in 2003-04), or more quietly in their choice of monetary policy and interest rate levels, central banks have declared that "Deflation is to be avoided at all costs". But avoiding *overall* deflation, as measured by the composite indices, has required many prices, for example

3 "Is Price Stability enough?", by William White - BIS Working Paper no 205, April 2006 (www.bis.org)

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prices for services, to rise relatively rapidly to offset the "China-shock" to traded goods prices. And the tool to achieve this - ultra-loose monetary policy - has had the unfortunate side-effect of creating asset price bubbles, first in equities and more recently in many countries in housing[4].

In effect, what we have seen is that the memory of the Great Depression, reinforced by Japan's experience in its recent decade or more of price-level falls, has triumphed over the memory of the long deflation of the 19th century. But this is to confuse deflation due to inadequate demand (1930s, 1990s in Japan), which almost everyone would agree is to be avoided if possible, with deflation due to increased efficiencies and cheaper supply, which was the dominant position in the 19th century and which is by no means as obviously an evil[5].

The relevance of this is that if, in effect, central banks have mis-analysed the deflationary pressures in the last 10 years and have created service price inflation, asset price growth and economic activity that is higher than it should have been, it raises a question about the response to the current more inflationary outlook. It is to this that we now turn.

Will price stability survive?

Once again, many central banks are facing an external threat to their internal price stability. Unlike the challenge of the China-shock, though, the current threat is from higher import prices for commodities, especially energy. But the question is similar: how to respond to a threat to price stability that is the result of external factors, rather than a surplus or deficit of domestic demand?

With just the one tool of monetary policy at their disposal, central banks face an awkward choice. To raise interest rates too aggressively when domestic demand is by no means robust (as is still the case for much of the OECD outside the US) risks causing domestic economic slowdown without a commensurate reduction in the external price pressures the economy faces. But to do nothing risks a follow-through from external prices to internal ones, and the inflationary spiral, so recently declared dead, may revive.

It is not a comfortable position, and not for nothing did Mervyn King look a little enviously at the NICE ("non inflationary constantly expansionary") decade that his predecessor Lord George had enjoyed[6]. For the first time for 30 years, central banks face an environment of externally driven price shocks at a time when many of their economies are already showing signs of imbalance, whether on the current account, or in asset prices, or in continuing sluggish domestic demand.

The questions are, "Are central banks any closer to solving the challenge they faced (and largely failed) in the 1970s?", and "How real are the Emperors' anti-inflation clothes?" The next few years will be testing for central bankers, and will give all of us a much better idea of the true level of their achievements.

4 And, arguably, in bonds, especially risk assets which stand at very tight spreads to the risk-free curve.

5 An additional factor may have been the degree of indebtedness, both private and public, in many economies today. This creates its own incentive to avoid falling prices, as nominal debt can explode in real terms in a severe deflation.

6 In a speech in October 2003, very soon after he had assumed the Governorship of the Bank of England.

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