Are central banks eroding their inflation targets?

Fed has abandoned it, now King suggests Bank of England might move away

I was in Sweden from Monday to Wednesday this week. Since Swedish households are among the most heavily indebted in the world relative to personal disposable income, I thought that I would dedicate this week's comment to a pet theory of mine. This is that it is not only the debt burden that matters, but also the savings rate (not to mention the interest rate burden and so on). I still intend to return to this, perhaps next week. However, a late reading of Wednesday's *Financial Times* made me change my mind. This article referred to a speech by the Governor of the Bank of England (the Stamp Memorial Lecture) hinting that inflation should perhaps no longer be the primary focus of monetary policy. To be fair to Sir Mervyn King, his comments were carefully hedged about with caveats, and he made clear that inflation targeting (IT) can and should remain a central objective of monetary policy. Rather than abandoning IT, he suggested that "It would be sensible to recognise that there may be circumstances in which it is justified to aim off the inflation target for a while in order to moderate the risk of financial crises."

In other words, a plea for a more flexible version of inflation targeting, perhaps similar to that practiced, eg, by the Reserve Bank of Australia. The RBA has a medium-term target of 2-3%, with short- term deviation acceptable as long the rate is expected to return to the target range over the policy-relevant horizon. Since, in my opinion, the RBA is arguably the best central bank in the world today, why would this be an issue? Moreover, the Bank of England inflation target is already flexible in the sense that the target is not to be met each and every month, but over a reasonable time period.

To answer that, I need to digress slightly. I have so far been if the view that inflation is not a possible solution to the still on-going financial crisis. True, inflation wipes out the value of your debt, but it does so at the expense of wiping out somebody else's assets. This somebody else can, of course, be a foreigner, eg, the Chinese government, in which case you may be able to bear this with equanimity. But it is also likely to be domestic pension funds and other holders of fixed-value assets, something which is likely to be far less welcome and even politically hazardous, given large ageing populations with a high propensity to vote. Moreover, in order to work, inflation has to come as a surprise and constantly exceed market expectations. Finally, a conscious policy of aiming at higher inflation would imply that central bankers in inflation-targeting countries are currently conspiring to break the law and to take the consequence of doing so.[1] Broadly speaking, this remains my view.

However, the *FT* article is a cause for concern. The Federal Reserve has already *de facto* abandoned the inflation part of its dual target and is now concentrating almost exclusively on unemployment. Mr Bernanke has made it clear that, in his opinion, monetary policy will not be tightened, even if the rate of inflation accelerates, unless the unemployment rate has come down. In any case, US inflation remains subdued; the Dallas Fed's trimmed mean core PCE deflator has averaged 1.9% over the past year and less than 1.5% over the last three years.

[1] Thanks to Kent Janér at Brummer & Partners for first raising this point with me.

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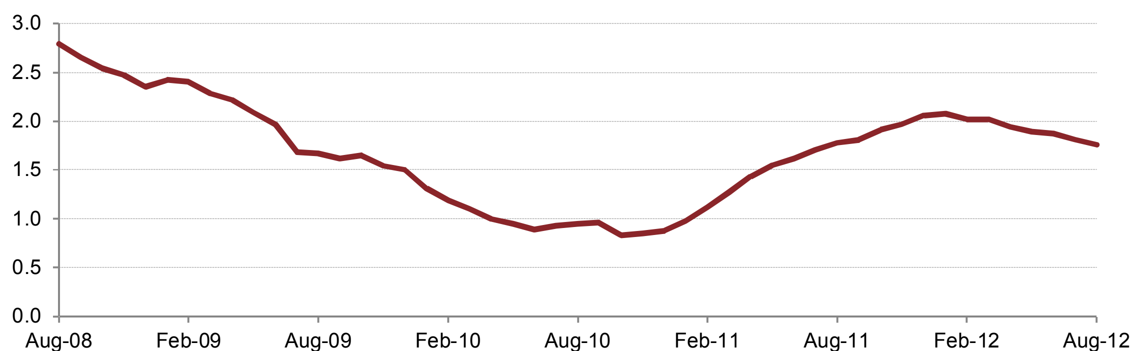

Now Sir Mervyn is also talking about potentially downplaying the role of inflation targeting. Is it possible that we are witnessing a paradigm shift among central banks, part of which will mean at best minimising, at worst abolishing inflation targeting?

I may be making a mountain of a molehill; there are still a large number of staunchly inflation-targeting central banks, such as the RBA, the RBNZ, the Bank of Canada, the Riksbank, Norges Bank and so on, amounting to between 30 and 40 worldwide. The ECB is technically not an inflation-targeting central bank, but operates as one. It is difficult to see any of these abandoning this policy, at least in the near term. Certainly, the Germans would probably have a collective fit at the thought of the ECB abandoning or merely easing its inflation target. (Although euro area inflation has been above the ECB's target for almost two years now, since November 2010.)

Nevertheless, Sir Mervyn's comments could be a straw in the wind. It may well be that, with politicians unwilling and/or unable to tackle root causes of the lack of growth and competitiveness and the prospect of debt mountains (public and private) remaining as far as the eye can see, central bankers will eventually succumb a combination of temptation and pressure to go for the perceived easy solution of "somewhat higher inflation".

The difficulty involved in triggering a bout of inflation at this stage in the cycle, with substantial spare capacity in most economies, means that higher inflation is unlikely to be a short-term prospect. More likely, it is a potential danger over the medium-term, eg, 3-5 years. Even then, it may not happen. However, where I would previously have dismissed "inflation as the solution" out of hand (see, eg, my article in this month's OMFIF Bulletin, *Inflation risks under control*), I am now sufficiently worried to acknowledge that it is becoming more possible.

I think abandoning inflation targeting or even easing the targets would be a major mistake. It would ruin central bank credibility. Once a central bank concedes that higher inflation could be acceptable, it starts

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down a slippery slope. For instance, which rate will you aim for? Is 5% better than 2-3%, and, if it is, why is not 7% better than 5%? How do you keep the new rate stable? The experience of the 1970s and 1980s has shown us that 2-3% inflation may be stable, but that 4-5% certainly is not and higher rates are even less so. Moreover, in order for inflation to work, it constantly has to be higher than expected and constantly remain so. So if markets get used to, say, 5% inflation and real interest rates turn positive, do you up the rate again? Do you eventually intend to return to the original, lower, target rate and, if so, how do you justify that? Not to mention, what do you do with the cohorts of retirees and near-retirees, whose pensions you have now at least partly destroyed, and who, in consequence, will either save more or spend less or need more public sector support in their retirement (or a combination of all three)? To my mind, the downside definitely outweighs the upside.

But, there is a constituency out there in favour of “inflation as the solution” (even where you wouldn’t expect it, eg, the IMF, whose chief economist Oliver Blanchard as early as February 2012 suggested that central banks should move to higher inflation) and so it is important to keep an eye on the debate in to see if more central banks are tempted or induced to ease or abandon their inflation targets - because that certainly will affect asset prices. For one thing, while there might be initial euphoria in bond markets, the ultimate result would be a massive bond bear market.

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