Is inflation targeting dead?

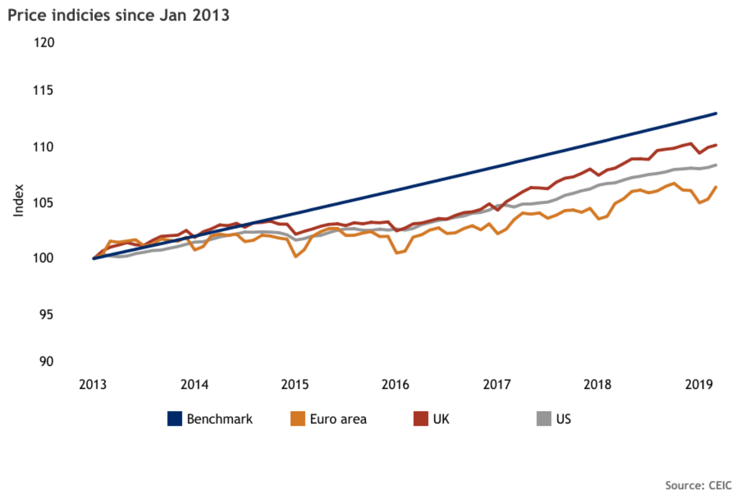
Blog post by Chief Economist Gregor Irwin, 3 May 2019

The consensus underpinning monetary policy in advanced economies over the past 30 years is weakening, with challenges from both the left and the right, and from within the central banking community. The implications are potentially far-reaching, including for institutional arrangements and the independence of central banks. Some central banks are more vulnerable to pressure for change than others, for good and bad. There is a lot at stake for long-term investors.

The generation-long consensus can be crudely described as leaving central banks to get on with the job of keeping inflation – and inflation expectations – low and stable. There is variation in the details. Some central banks, like the Fed, also target other objectives (maximising employment in the Fed's case). Some, like the Bank of England, have a precise numerical target for inflation, while others, such as the ECB, have something vaguer and more flexible. But almost all OECD central banks are at least operationally independent, to help insulate them from short-term political pressures.

Central banks have had to be flexible with their toolkit. After the financial crisis of 2007/8 (earlier in the case of Japan) when short-term policy rates hit the floor, they have had to find ways to influence the short- and longer-term interest rates paid by borrowers more directly, typically by buying financial assets. And they have had to pay even more attention to how they communicate to anchor expectations and influence behaviour. But the idea that central banks should primarily focus on targeting low inflation – and the implicit assumption that that is the best way to support growth and stability – has mostly gone unchallenged, at least until recently.

The problem is that it looks as though the current model isn't delivering. In short, the major central banks have tended to undershoot their inflation objectives for some time, despite exceptionally loose monetary policy, leading Bloomberg Businessweek to ask on its front cover recently *Is inflation dead?*



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The chart compares price levels since 2013 with what we would have seen had inflation hit 2% throughout, which is the target in the US and the UK (in the Euro area the target is for inflation to be below, but close to, 2%). During this period inflation averaged 1.3% in the US and 0.9% in the Euro area. It was somewhat higher in the UK at an average of 1.7%, partly because inflation picked up when sterling depreciated in the aftermath of the 2016 Brexit referendum.

At the same time central banks have also typically over-estimated unemployment and been surprised at how their economies can sustain low unemployment without pushing up inflation. This points to a deeper problem, which is that the relationship between unemployment and inflation appears to be changing. That matters, because that relationship is central to the heuristic rules that central bankers use to determine how interest rates should be set to keep inflation in check.

It is also increasingly obvious that the neutral rate of interest (the rate which keeps the economy steady at full employment) appears to have fallen sharply, from roughly five percent before the financial crisis to around half that rate now. There are many possible reasons linked to technology, productivity and even ageing populations. But whatever the reason, it matters because it means there is a risk of interest rates being stuck at the lower bound (i.e., close to zero) more often, leaving central bankers to rely more heavily on unorthodox (and less effective) policies to fend off downturns.

This is an environment which is fertile for challenges to the existing orthodoxy. And these are now mounting, from all sides.

In February 2019, the right-wing Adam Smith Institute, called on the Bank of England to scrap its inflation target and to replace it with a nominal growth target. The basic idea is that if there is a slowdown then under such a regime the bank would be committed to deliver in future higher-than-usual inflation to get nominal growth back to target, and that will encourage households and firms to spend more now, which should boost the recovery.

Recently there has also been renewed interest from the left in “modern monetary theory” or MMT, which at its core means printing money to finance the government as it spends its way out of recession. That’s a modern take on an old idea, which arguably runs high risks with inflation and financial stability, except perhaps during an extreme slump, when it would need to be done carefully.

We are also seeing introspection from the central banks themselves. In February, the Fed launched a review of its monetary policy strategy. The Fed is particularly interested in the question of whether it should move to targeting average inflation which, a bit like nominal growth targeting, would mean allowing inflation to run hotter following a downturn.

When something appears not to be working as it should, introspection and external challenge are a good thing. But here’s the problem: most central banks operate within frameworks that are intentionally designed to make big changes costly and hard to do; these constraints tend to be idiosyncratic and products of the political system the central banks operate under, meaning they operate very differently; and when the prospect of change is opened up, there is a risk that short-term political concerns dominate long-term interests.

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The Fed review is focusing on issues that it not only has the power to control, but which appear intended to side-step political controversy. The Fed has, for example, ruled out raising the inflation target – arguably one of the easiest ways to address the problem of hitting the lower bound for interest rates more often, in a world where the neutral interest rate has fallen – possibly for fear that this is too politically sensitive and would open up a wider debate about its mandate.

The ECB arguably has even more need for introspection than the Fed, given that inflation has been consistently low in recent years and the policy rate is still firmly rooted at the lower bound. One of the contenders to be the next president of the ECB, Olli Rehn, has called for a review of the ECB's monetary policy strategy. But the current president, Mario Draghi, said recently that the ECB governing council had not discussed the issue, although it would watch what emerges from the Fed's review. That caution probably reflects the more restrictive legal and political framework that the ECB operates under as an institution set up under international treaties that are even harder to change than national legislation.

In the UK, there is political pressure for change, mostly from the opposition Labour Party. The ideas being considered include targeting productivity growth, or house prices, or climate-finance objectives, in addition to inflation. This shows how once the principle of change is accepted (by Labour, if not yet the Conservative government) then the process of change can potentially lead in many directions.

Is inflation targeting dead? Possibly. We may or may not be on the verge of a new era for central banks. But we are likely to see at least some changes to their mandates. Exactly what is unclear and is likely to vary from one to another. Politics will play a part, either in constraining consideration of sensible ideas, or pushing some central banks into adopting broader mandates that they may struggle to satisfy. For long-term investors that rely on low and stable inflation when pricing assets, this means the future is likely to be more uncertain.