Mervyn King: The New Inflation Target

Speech by Mr Mervyn King, Governor of the Bank of England, at the annual Birmingham Forward/CBI business luncheon, Birmingham, 20 January 2004.

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I have always wanted to perform at Villa Park. Now is my chance. Economists at Villa Park are not as unusual a sight as you might think. It is not well known that John Maynard Keynes also came to Villa Park. In September 1913 Keynes was visiting Birmingham and decided to see the match of the day between the two top teams in the country - Aston Villa and Blackburn Rovers. On the following day, Keynes wrote to Duncan Grant[1]:

"There has been some amusement here, but mixed up with a good deal of boredom. Birmingham has a very definite character. I went yesterday with 40,000 other people to one of the peak football matches. The scene was very much as I imagine the Coliseum. The ground is built on the same model - an immense oval rising all round tier above tier in about 50 rows so far as I could count. The crowd maintained a dull roar nearly all the time, rising into a frenzy of excitement and rage when the slightest thing happened. The match was between the two principal "league" teams of England. The local people were beaten by a team from Lancashire, who had, so I was told, 'the best right wing in England, and the most expensive'".

Sadly, as Keynes recorded, Aston Villa lost 3-1 and finished that season as runners-up to Blackburn. It is unclear whether Keynes ever again visited a football ground, and there must be a real possibility that, for him, Villa Park was the sum total of his football experience.

In later years some of Keynes's disciples forgot not only his connection with Villa Park but also his view that price stability was a necessary condition for a successful economy. Tomorrow is the 80th anniversary of the death of Lenin, and it was to Lenin that Keynes attributed the remark: "The best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens". After doing their best to test this proposition, successive British governments have committed themselves to stable and low inflation. And for the past decade, inflation has ceased to be a dominant consideration in the economic decisions of families and businesses.

That has been achieved by aiming at a symmetrical inflation target. Crucial to the success of such a policy is the ability to anchor inflation expectations on the target. For this to be the case, the target must be clear and well understood. From May 1997 the target was 2½% for RPIX inflation. But in December the Chancellor gave the Monetary Policy Committee a new target for inflation. It is 2% as measured by the Consumer Prices Index or CPI, formerly known as the Harmonised Index of Consumer Prices.

What is this new inflation measure, and how will it affect monetary policy? On the RPIX measure, inflation was at or above target for the whole of last year. In contrast, the CPI measure of inflation was below 2% throughout the same period. Indeed, CPI inflation has been below 2% for all bar three months since May 1997, and it is almost six years since it was last above 2%. How can it be possible for inflation to move from above to below target - just like that? To answer that question, we need to examine how inflation is calculated.

Inflation is measured as the increase in the price of a particular basket of goods and services over the previous twelve months. So there are as many measures of inflation as there are baskets. Since no two people in this room spend their income on exactly the same items, in principle each of you could construct your own measure of inflation. The Office for National Statistics calculates an average inflation measure by weighting together the inflation rates of over 650 different goods and services, using as weights the estimated expenditure on each item for a representative household. But where

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[1] Unpublished writings of J.M.Keynes, copyright of the Provost and Scholars of King's College, Cambridge to whom I am grateful for permission to publish this extract. A reference to the letter appeared in Skidelsky, R. *John Maynard Keynes Volume 1: Hopes Betrayed, 1883-1920*, Macmillan, London, 1983, page 280. The official attendance on 13 September was 38,575; the Villa scorer was the incomparable Clem Stephenson, who may have lacked pace but whose passes were, according to contemporary observers, "as sweet as stolen kisses"; and the 'most expensive' right winger for Blackburn Rovers was John "Jocky" Simpson who cost Blackburn a record fee of £1,850 when he was transferred from Falkirk in 1911.

do those prices come from? Each month - on “Index Day” (either the second or third Tuesday of the month) - around 300 “price collectors” visit a wide range of retail outlets and record the prices charged for 130,000 different items, ranging from small loaves of brown bread to large lawnmowers. Each of these different items will have changed in price by a different amount. A key difference between the CPI and RPIX is how these 130,000 price changes are averaged to give a measure of overall inflation.

RPIX inflation is, for most goods, an arithmetic average of the inflation rates for each item. In contrast, CPI inflation is measured as the increase in the geometric average (the average of the logarithms) of the different prices. That reduces the weight given to those retail outlets where prices are rising the fastest, and allows the overall measure of inflation to take into account the way families are changing their shopping habits away from outlets where prices have been rising relatively rapidly, like traditional high street stores, towards those where they have been rising relatively slowly, like newer more heavily discounted stores. For that reason, the formula used to calculate CPI inflation is superior to the formula used in RPIX. Arcane though it may sound, the “formula” effect reduces estimated inflation in Britain by about half a percentage point a year.

In this respect, the difference between RPIX and CPI inflation as a measure of the economic temperature of the economy is rather like the difference between Fahrenheit and Centigrade as a measure of physical temperature. In both cases moving from one measure to another changes the number without there having been any change in the temperature itself. Because the temperature - whether physical or economic - is independent of the particular measure, then the implications for decisions which depend on temperature - whether of farmers deciding on when to harvest their crops and then how to price them or the Monetary Policy Committee deciding on when to change interest rates - are unaffected by the measure used, provided the conversion is calculated correctly. Hence the switch to a new CPI target has in itself no implications for monetary policy. But just as changing from Fahrenheit to Centigrade has not proved easy for those who had become used to the old measure, so it will take time for us all to adjust to the new inflation measure.

Unfortunately, there is an additional complication. Unlike the translation between Fahrenheit and Centigrade, the difference between RPIX and CPI inflation does vary with the economic temperature. That is because the “formula” effect is not the only difference between the two measures. RPIX includes both house prices and Council Tax. Those items are omitted from the basket of goods and services used to construct the CPI. So when house prices are rising faster than prices in general, as has been the case in recent years, RPIX exceeds CPI inflation by more than the half a percentage point represented by the “formula” effect. Over the past 15 years, when data have been collected on both measures, RPIX has exceeded CPI inflation by about three quarters of a percentage point. It is possible to argue, therefore, that moving from a target of 2.5% for RPIX inflation to one of 2% for CPI inflation represents a small increase in the long-run effective target. But no reasonable person could describe a symmetric target of 2% as inconsistent with price stability, defined as a state of affairs in which inflation does not materially affect economic decisions by families and businesses.

Of greater significance than the average difference between the two measures in the long run is the observation that the gap between them varies over time, often quite widely, in line with changes in the temperature of the economy in general and house prices in particular. At present the difference between the two measures is unusually large. It peaked at 1.7 percentage points in June, since when it has narrowed to 1.3 percentage points, but remains well above the 0.5% change in the inflation target. So the change in target gives the impression that inflation has moved from above to below target. Does this mean that monetary policy in the coming months will need to be looser under the new target than it was with the old target? The answer is no. The large difference between the two measures of inflation at present can mostly be explained by house price inflation. It is unlikely that house prices will continue to rise at their recent pace for much longer. We have already seen some slowing since the peak in 2002, and the Monetary Policy Committee judges that a reasonable central view is that house price inflation is likely to subside over the next two years or so. The gap between RPIX and CPI inflation is, therefore, likely to narrow to around half a percentage point over that period. So the change in the target is unlikely to have any material impact on the decisions of the Monetary Policy Committee in the near future. And our decision to leave interest rates unchanged in January reflected that view. Although house prices do not enter the CPI directly, the Committee will continue to monitor the housing market as carefully as before in order to assess the implications for the inflation outlook resulting from changes in the balance between nominal demand and supply and in the exchange rate.

Equally, economic decisions made by businesses and individuals over the next year or so should be unaffected by the change in the target. If the degree of underlying inflationary pressure remains

unchanged, and there is no difference in the stance of monetary policy, then the rates of increase of wages, earnings and prices that are consistent with the new target are no different from those which were compatible with the old target. In other words, wage bargaining should be unaffected by the switch in inflation target - as should price setting by firms. Of course, the new target will make clearer how much of an increase in money earnings represents a real rise in living standards - a pay increase of 2½% that was described as a "cost of living" rise under RPIX will now be shown by the CPI as a ½% increase in real pay, even though no individual price has changed. The MPC will still need to monitor carefully developments in the labour market in case they signal a change in costs that might threaten the target in future.

In Jane Austen's *Emma*, the awful Mrs Elton, wife of the parson, dismisses the newlyarrived family in the village with the words: "They came from Birmingham. … One has not great hopes from Birmingham. I always say there is something direful in the sound" But Birmingham - and the manufacturing industries with which it has always been so closely associated - have changed. Nowhere symbolises this metamorphosis better than Villa Park. Since Keynes' visit, Villa Park has changed from a nineteenth century Coliseum into a magnificent twenty-first century stadium, focussing on quality rather than sheer numbers. Manufacturing industry has also shifted its focus from traditional products valued by weight to high value-added products. But the case for price stability, which Keynes made so forcefully, is unchanged, as is the commitment of the Monetary Policy Committee to meet the inflation target - new or old.