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News release

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The Inflation Target 10 Years on – Speech by Mervyn King

In a speech at the London School of Economics today, Mervyn King, Deputy Governor, Bank of England, explains in detail why price stability is desirable and sets out the benefits it has brought to the UK. He also illustrates the difficulties of measuring inflation using historic price data taken from the Harrods catalogue. Mr King then examines the challenges to monetary policy over the next decade, and notes that two questions have been prominent recently - is inflation targeting enough, and is deflation, not inflation, the main threat at present?

Some commentators have suggested that monetary policy should target asset prices in addition to inflation. Mr King says '"But which asset prices, and what would that mean for interest rates? House prices have been rising rapidly, and as a ratio to average earnings have reached the previous peak in the late 1980s. That might suggest that interest rates should have been higher. Sterling has for six years now been around 30% higher against the euro (or its predecessors) than before, the trade deficit has grown and the profitability of manufacturing has fallen by two-thirds. That might suggest that interest rates should have been lower. Equity prices rose by 120% between 1995 and 2000, before falling 40% subsequently. Presumably that would have implied first higher and then lower interest rates. What this means is that asset prices cannot sensibly be viewed in isolation, but only in the context of the economy as a whole. I believe that, although there are justifiable concerns about recent movements in asset prices, the policy dilemma can be analysed within the framework of inflation targeting that we have in the UK."

While targeting asset prices directly is virtually impossible, "changes in asset prices can have a major impact on levels of spending and the MPC devotes considerable time to the question of how such changes should affect policy." Mr King says: "The immediate question is whether changes in asset prices have led to an imbalance within the economy that poses the risk of a large negative demand shock at some point in the future. I believe the answer is yes; but how big is that risk is extremely difficult to judge, and so the appropriate policy response is far from clear. Beneath the surface of overall stability in the UK economy lies a remarkable imbalance between a buoyant consumer and housing sector, on the one hand, and weak external demand, on the other… Even the optimistic Mr Micawber would realise that this cannot continue indefinitely. How then, and over what timescale, will these imbalances unwind?

Three possibilities deserve consideration. First, the rapid growth in household consumption - averaging over 4% for the last five years - may reflect an adjustment to higher real disposable incomes. Consumption growth would then slow naturally as spending and debt reach their new levels. The imbalance between domestic demand and output would unwind as steadily as it built up, with no reason to fear a sudden correction. For this to occur the source of higher disposable incomes must be permanent. In part the increase in recent years has resulted from the improved terms of trade - 7% up on five years ago - which raise real national income for any given level of output. The main threat to the persistence of that improvement is the possibility of a fall in sterling that may be a necessary part of the rebalancing of the UK economy. It is very hard to assess the risk of that over any given time horizon. So far the path of consumer spending is not inconsistent with this benign outcome.

The second possibility is that the level of debt taken out by households - the debt-to-income ratio is now at an all-time high - makes households sensitive to any adverse future shock to their employment or income prospects. In that event the risk is of a sharper adjustment of consumption to the shock than might otherwise have occurred. Monetary policy would respond, but a large negative demand shock might result in an undershoot of the inflation target for some considerable time.

The third possibility I touched on earlier. Households may adjust more quickly to the implications of a low inflation world for the prices of goods and services than for nominal interest rates or the future growth of nominal incomes. A mistaken underestimate of real interest rates or overestimate of nominal income growth may raise borrowing, spending and asset prices temporarily. Eventually households learn and consumption adjusts, again possibly sharply."

The policy dilemma is that by allowing consumption and demand to grow rapidly there is a risk of "a sharp correction of demand later." Mr King says: "In practice it is difficult to know whether an 'imbalance' does contain the seed of a future negative demand shock on a scale that would leave inflation below the target for some considerable time, or whether it will unwind of its own accord."

He adds "The fact that growing imbalances might cause sharp deviations of inflation from target at some point in the future, raises the possibility of a trade off between deviations of inflation from target over the next year or so and deviations of inflation from target further ahead. That, I believe, is the right way to think about the challenge to monetary policy posed by asset price movements. Although there are no simple answers I hope I have shown that inflation targeting is enough, provided that one thinks carefully about the horizon over which policy can hope to affect inflation."

Turning to the second challenge for monetary policy over the next decade, the possibility of deflation, Mr King says . " It is important to recognise that falling prices of manufactured goods is not the same as general deflation. In fact price stability, in the sense of an inflation rate overall of around 2½% a year, is likely to mean that the prices of manufactured goods will, on average, not rise at all. Faster productivity growth in manufacturing than in services, averaging around 2% over the last twenty years, means that the prices of

services will rise faster than those of manufactured goods. And the rise in sterling over the past five years increased the difference between inflation rates in the two sectors."

He concludes that "Deflation - in the sense of a sustained fall in the aggregate price level - can be found among the G7 economies only in Japan, where the consumer price level has been falling almost continuously for four years and by a cumulative total of 4%. Elsewhere, deflation is remote."

Key Resources

The Inflation Target 10 Years on - Full Speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2002/speech181.pdf