Funding the Future

Why the UK's 2% inflation target is wrong

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Earlier this week I suggested *"Why Positive Money is Wrong" (read here). Prof John Weeks wrote this post in response, looking at the issue of the 2% inflation target. It was first published* on *Brave New Europe. John Weeks* is Professor Emeritus at SOAS, University of London, and ***associate of Prime Economics.***

The recent ***article by Richard Murphy clearly and succinctly demonstrated the fallacies of monetary arguments set forward by Positive Money. I write to elaborate one of his five points, the critique of policy seeking to attain and maintain a specific inflation rate, "inflation targeting". Murphy explained the basic flaw, that inflation targeting is dysfunctional and politically reactionary. My focus is more narrow, that the 2% target of both the Bank of England and the European Central Bank is bad policy because technically unsound.***

The European Central Bank aims for a target rate less than 2% of a measure named the Harmonized Index of Consumer Prices, while the Bank of England uses the so-called CPIH measure. Both measures share the flaw of including of internationally traded commodities, over which neither the ECB nor the Bank of England has any substantial influence.

By definition the rate of inflation equals the sum of price changes for internationally traded goods and services, price changes in constrained markets, and changes of domestic ("non-traded") goods and services in unregulated prices. The first category includes all those goods and services whose domestic price is determined in international markets. The most obvious example is petroleum, as well as almost all producer inputs. Airline fares and shipping charges are services whose domestic prices closely follow international petroleum prices.

The second category includes all prices set by contract or public sector regulation. The importance of this category will vary across countries. Examples are public utility pricing (water and gas), public services and some

modes of transport (e.g. railroad and bus fares). In the third category fall all goods and services relatively unaffected by international markets, public regulation or private contracts.

The inflation target rule requires the sum of the price changes for these three categories be close to w 2%. A rise in internationally determined prices above 2%, for example an oil price increase, is beyond the control of the ECB or the Bank of England. Therefore, the prices in one or both of the other categories must rise less than 2% in order to meet the inflation target. However, many goods and services in the second category have prices relatively inflexible in the short run because of public regulation and private contracts.

As a result all the greatest adjustment must occur for domestic goods and services in unregulated markets. The lowest-paid workers tend to find their employment in these markets precisely because they are unregulated — employees not in trade unions and many self-employed such as care workers. The nature of the three types of markets implies that meeting an inflation target tends to reinforce and increase inequalities.

The market structure of every economy also undermines the effectiveness of targeting as an example shows. If half of all goods and services fall into the first two categories and these prices rise by 3%, then prices in unregulated domestic markets can only rise 1% to meet the 'less than 2%' target. It is likely that the first two categories take a considerably larger share than half in Britain and most continental countries, which means no increase or even deflation in unregulated markets. Even if international prices transfer only slowly into domestic prices, the principle remains, that the unregulated markets must bear the weight of adjustment.

More serious is that 'less than 2%' is an unsound target, for an even more fundamental reason. Twenty years ago the Boskin Commission in the US estimated that new products and quality change account for between 0.8 and 1.6 percentage points in the US cost of living index, taking 1.1 as "best estimate". In a world of globalized markets and production, the British and EU estimate is unlikely to be very different. Therefore, an inflation target below 2% de facto aims for an effective rate of less than 1%.

The benefits of a capitalist economy come from its dynamism, the continuous reallocation of resources in response to technical change and shifts in consumer preferences. This allocation occurs through price adjustment. For example, workers move between sectors in response to wage changes. Some wage inflation and therefore price inflation are inherent in the efficient operation of a market economy. The (less than) 2% inflation target is in theory and practice deflationary, achieved by suppressing the price adjustments essential to economic growth.

Inflation targeting is dysfunctional in principle. Assigning this dysfunctional rule a target of 2% is absurd and technically unsound.