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How Good is the Bank's of England's Inflation Targeting Record?

by
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On 6 May 1997, the government granted the Bank of England operational autonomy; the Chancellor would set a target inflation rate and the Bank would implement this with an independently chosen interest rate. The Bank's Monetary Policy Committee (MPC) set interest rates for the first time in June 1997 and its existence was formalised with the Bank of England Act a year later. From June 1997 until December 2003, the inflation target was 2.5 percent, as measured by the Retail Price Index, excluding mortgage interest payments (RPIX). In December 2003, the Chancellor announced a new target of 2.0 percent, as measured by the Consumer Price Index (CPI). Both the old and the new target were meant to be symmetric: should the inflation rate deviate by more than one percentage point in either direction, the Governor of the Bank of England is required to send open letter to the Chancellor explaining the reasons for the deviation and the MPC's intended response.

What has the MPC's inflation record been since June 1997? The Figure shows that over the entire 88-month period from June 1997 to October 2004, RPIX inflation has averaged 2.39 percent and CPI inflation 1.32 percent. This is consistent with the view that the change from an RPIX target of 2.5 percent to a CPI target of 2.0 percent amounted to a half a percentage point easing. To have maintained the same effective inflation target, the CPI inflation target ought to have been 1.5 percent, not 2.0 percent.

Reviewing the MPC's record to date, our first observation is that, on average, actual inflation has remained close to the target. Over the period that the RPIX was targeted, the inflation bias was a tiny -0.11 percent; over the period that the CPI was targeted the average deviation was -0.69 percent. Not only are the mean deviations small (as Milton Friedman once noted, a man can drown in a river that is only 20 inches deep on average), there is little variation. The letter-writing procedure has yet to be invoked, although it was a close thing in June 2002. Our second observation is that, despite the MPC inheriting an RPIX inflation rate that had been above 2.5 percent for the 2-1/2 years prior to June 1997, the inflation bias is *negative* – actual inflation has been below target on average. Our third observation is that the size of the negative inflation bias increased after the end of 2003.

What could account for these observations?

The small magnitude of the negative inflation bias might be due to the MPC being lucky or competent or both. Certainly luck played a part – there have been few large domestic shocks other than the housing boom since the MPC's formation, but luck cannot explain all of the good performance. The international environment was not especially benign. The Asian Crisis of 1997-8 preceded the Russian and Long Term Capital Management crisis of 1998. A global asset boom and tech bubble were

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followed by global recession. This year has seen the fastest global expansion in three decades and rapidly rising commodity prices.

What about the increased magnitude of the negative inflation bias after the end of 2003? We believe that this is probably a consequence of the new inflation target announced in December 2003, which called for an unexpected easing of monetary policy. Given the long, variable and uncertain transmission lags, this has not surprisingly caused a temporary (one to two years) increase in the gap between target and actual inflation. Other things being equal, this increase in the bias should vanish during 2005.

What about the small but persistent negative inflation bias that appears to be present? Three possible explanations are first, a sequence of unexpected disinflationary shocks; second, a systematic forecasting error by the MPC; third, an MPC preference for deviating below rather than above the target. We find the first explanation unconvincing. The only candidate shocks are an increase in the growth rate of potential UK output, a shrinking of profit margins due to more intense competition and weak global commodity prices. Evidence for the first two shocks is weak and the third did not persist. Moreover, for a given path of nominal interest rates set by the MPC, these shocks would only generate a persistent negative inflation bias if they lowered the long-run real interest rate in the UK.

It is difficult to disentangle the effects of a forecast bias from that of a target bias. The Bank's published "inflation fan charts", which invariably have inflation near target at a two-year horizon, are not forecasts in the usual sense of the word, but conditional projections that assume the MPC's interest rate remains constant. While it is not possible to know the personal forecasts of individual members of the MPC, the possibility of a systematic deviation of actual from predicted inflation suggests it might be useful to devote additional resources to research aimed at improving the forecasting process.

Turning to the third explanation, is it likely that the MPC's effective inflation target is *below* the official target? Recent inflation indeed appears more consistent with the explicitly asymmetric inflation target of the European Central Bank -- close to but below 2.0 percent -- than with the symmetric official target of the MPC. What could account for such a bias? Towards the end of the first author's term on the MPC, early in 2000, one of his colleagues made the following observation, 'Say I am the Governor and inflation next month is more than one percent below target. How hard would it be to write the following letter to the Chancellor: "Dear Gordon, the economy is growing at an unprecedented pace and unemployment is at a 40-year low. However, inflation is less than 1.5 percent. Sue me."' If this letter were indeed much easier to write than one that was identical, except for an admission of inflation in excess of 3.5 percent, this amounts to the implicit admission that above-target inflation is viewed as more undesirable than below-target inflation. The MPC's effective inflation target would be below the official one.

The evidence so far is consistent with a small negative inflation bias. Time will tell.

